

Western Asset Mortgage Capital Corp
Form 10-Q
November 09, 2015
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2015

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to

Commission File Number: 001-35543

Western Asset Mortgage Capital Corporation

(Exact name of Registrant as specified in its charter)

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

Delaware
(State or other jurisdiction of
incorporation or organization)

27-0298092
(IRS Employer
Identification Number)

Western Asset Mortgage Capital Corporation

385 East Colorado Boulevard

Pasadena, California 91101

(Address of Registrant's principal executive offices)

(626) 844-9400

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 under the Securities Exchange Act of 1934).
Yes No

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

As of November 3, 2015, there were 41,919,801 shares, par value \$0.01, of the registrant's common stock issued and outstanding.

Table of Contents

TABLE OF CONTENTS

	Page
Part I FINANCIAL INFORMATION	
<u>ITEM 1.</u>	<u>Financial Statements</u> 2
<u>ITEM 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> 53
<u>ITEM 3.</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u> 117
<u>ITEM 4.</u>	<u>Controls and Procedures</u> 123
Part II OTHER INFORMATION	
<u>ITEM 1.</u>	<u>Legal Proceedings</u> 124
<u>ITEM 1A.</u>	<u>Risk Factors</u> 124
<u>ITEM 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u> 124
<u>ITEM 3.</u>	<u>Defaults Upon Senior Securities</u> 124
<u>ITEM 4.</u>	<u>Mine Safety Disclosures</u> 124
<u>ITEM 5.</u>	<u>Other Information</u> 124
<u>ITEM 6.</u>	<u>Exhibits</u> 125
<u>Signatures</u>	126

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Consolidated Balance Sheets (Unaudited)****(in thousands except share and per share data)**

	September 30, 2015	December 31, 2014
Assets:		
Cash and cash equivalents	\$ 39,703	\$ 47,222
Mortgage-backed securities and other securities, at fair value (\$3,343,683 and \$4,362,532 pledged as collateral, at fair value, respectively)	3,352,509	4,385,723
Residential Whole-Loans, at fair value (amounts related to VIE of \$150,486 and \$7,220, respectively)	150,486	7,220
Linked transactions, net, at fair value		20,627
Receivable under reverse repurchase agreements	758,467	
Investment related receivable	10,734	162,837
Accrued interest receivable (amounts related to VIE of \$1,159 and \$40, respectively)	21,415	27,309
Due from counterparties	236,525	184,757
Derivative assets, at fair value	56,985	73,256
Other assets	773	326
Total Assets	\$ 4,627,597	\$ 4,909,277
Liabilities and Stockholders' Equity:		
Liabilities:		
Borrowings under repurchase agreements	\$ 3,010,268	\$ 3,875,721
Accrued interest payable	21,719	17,573
Investment related payables	10,742	166,608
Due to counterparties	771,784	12,180
Derivative liability, at fair value	227,158	180,280
Accounts payable and accrued expenses (including obligations of VIE of \$5 and \$153, respectively)	2,262	1,794
Payable to related party	2,797	2,705
Dividend payable	25,152	29,204
Total Liabilities	4,071,882	4,286,065
Commitments and contingencies		
Stockholders' Equity:		
Common stock, \$0.01 par value, 500,000,000 shares authorized, 41,919,801 and 41,719,801 shares issued and outstanding, respectively	419	417
Preferred stock, \$0.01 par value, 100,000,000 shares authorized and no shares outstanding		
Additional paid-in capital	762,935	760,925
Retained earnings (accumulated deficit)	(207,639)	(138,130)
Total Stockholders' Equity	555,715	623,212
Total Liabilities and Stockholders' Equity	\$ 4,627,597	\$ 4,909,277

See notes to unaudited consolidated financial statements.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Consolidated Statements of Operations (Unaudited)**

(in thousands except share and per share data)

	For the three months ended September 30, 2015	For the three months ended September 30, 2014	For the nine months ended September 30, 2015	For the nine months ended September 30, 2014
Net Interest Income:				
Interest income	\$ 35,821	\$ 40,718	\$ 117,656	\$ 108,752
Interest expense	6,981	6,468	19,960	15,829
Net Interest Income	28,840	34,250	97,696	92,923
Other Income (Loss):				
Interest income on cash balances and other income (loss), net	(29)	942	1,744	954
Realized gain (loss) on sale of Mortgage-backed securities, other securities and Whole-Loans, net	(2,482)	4,912	9,267	(2,650)
Other loss on Mortgage-backed securities and other securities	(5,917)	(2,857)	(14,884)	(7,565)
Unrealized gain (loss) on Mortgage-backed securities, other securities and Whole-Loans, net	24,723	(4,453)	10,284	140,755
Gain on linked transactions, net		(1,241)		1,666
Loss on derivative instruments, net	(41,363)	(401)	(76,511)	(126,984)
Other Income (Loss), net	(25,068)	(3,098)	(70,100)	6,176
Operating Expenses:				
General and administrative (includes \$509, \$587, \$1,969 and \$1,654 non-cash stock based compensation, respectively)	2,863	2,253	8,862	6,703
Management fee related party	2,761	2,763	8,133	7,127
Total Operating Expenses	5,624	5,016	16,995	13,830
Net income (loss) available to Common Stock and participating securities	\$ (1,852)	\$ 26,136	\$ 10,601	\$ 85,269
Net income (loss) per Common Share Basic	\$ (0.05)	\$ 0.63	\$ 0.24	\$ 2.35
Net income (loss) per Common Share Diluted	\$ (0.05)	\$ 0.63	\$ 0.24	\$ 2.35
Dividends Declared per Share of Common Stock	\$ 0.60	\$ 0.70	\$ 1.91	\$ 2.04

See notes to unaudited consolidated financial statements.

Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

(in thousands except shares and share data)

	Common Stock			Additional Paid-	Retained		Total
	Shares	Par		In Capital	Earnings (Accumulated) Deficit		
Balance at December 31, 2014	41,719,801	\$ 417	\$	760,925	\$(138,130)	\$	623,212
Grants of restricted stock	200,000	2		(2)			
Vesting of restricted stock				1,969			1,969
Net income					10,601		10,601
Dividends on common stock				43	(80,110)		(80,067)
Balance at September 30, 2015	41,919,801	\$ 419	\$	762,935	\$(207,639)	\$	555,715

See notes to unaudited consolidated financial statements.

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

	For the nine months ended September 30, 2015	For the nine months ended September 30, 2014, as Revised (See Note 2)
Cash flows from operating activities:		
Net income	\$ 10,601	\$ 85,269
Adjustments to reconcile net income to net cash provided by operating activities:		
Premium amortization and (discount accretion) on Mortgage-backed securities, other securities and Whole-Loans, net	5,645	8,049
Interest income earned added to principal of Mortgage-backed securities and other securities	(141)	
Amortization of deferred financing costs	295	
Restricted stock amortization expense	1,969	1,654
Premium amortization for MAC interest rate swaps	(1,075)	(928)
Interest payments and basis recovered on MAC interest rate swaps	1,443	(545)
Premium on purchase of Residential Whole-Loans	(2,390)	
Unrealized loss on Mortgage-backed securities, other securities and Whole-Loans, net	(10,284)	(140,755)
Mark-to-market adjustments on linked transactions		1,339
Mark-to-market adjustments on derivative instruments	82,952	126,112
Other loss on Mortgage-backed securities and other securities	14,884	7,565
Realized (gain) loss on sale of Mortgage-backed securities, other securities and Whole-Loans, net	(9,267)	2,650
Realized (gain) loss on sale of Interest-Only Strips accounted for as derivatives, net	(624)	755
Realized loss on termination of MAC interest rate swaps containing an other-than-insignificant financing element	8,658	
Realized (gain) loss on sale of TBAs, net	1,728	(25,169)
Realized loss on sale of swaptions, net	3,873	5,908
Realized loss on forward contracts	980	1,182
Realized loss on futures	627	16,495
Realized gain on option derivatives	(684)	
Realized gain on linked transaction, net		(1,397)
Gain on foreign currency transactions, net	(1,664)	(1,119)
Changes in operating assets and liabilities:		
Decrease (increase) in accrued interest receivable	5,894	(23,365)
Increase in other assets	(279)	(279)
Increase in accrued interest payable	4,146	12,036
Increase in accounts payable and accrued expenses	468	1,008
Increase in payable to related party	92	1,214
Net cash provided by operating activities	117,847	77,679
Cash flows from investing activities:		
Purchase of Mortgage-backed securities and other securities	(570,441)	(3,804,044)
Purchase of securities underlying linked transactions		(38,224)
Proceeds from sale of Mortgage-backed securities and other securities	2,087,678	2,240,338
Proceeds from sale of securities underlying linked transactions		6,214
Principal payments and basis recovered on Mortgage-backed securities and other securities	315,106	233,796

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

Principal payments and basis recovered on securities underlying linked transactions		4,408
Purchase of Residential Whole-Loans	(147,336)	
Principal payments on Residential Whole-Loans	9,077	
Purchase of Commercial Whole-Loans	(8,750)	
Principal payments on Commercial Whole-Loans	8,750	
Payment of premium for option derivatives	(10,864)	(2,813)
Premium received from option derivatives	11,548	
Net settlements of TBAs	466	25,169
Payment on termination of futures	(627)	(16,495)
Proceeds from sale of interest rate swaptions	27,899	
Premium for MAC interest rate swaps, net	(3,595)	11,010
Payments on termination of MAC interest rate swaps	(190)	
Interest payments and basis recovered on MAC interest rate swaps	(1,041)	
Proceeds from (payments made) on reverse repurchase agreements, net	(758,467)	
Premium for interest rate swaptions, net	(34,751)	1,615
Net cash provided by (used in) investing activities	924,462	(1,339,026)

Table of Contents

Cash flows from financing activities:			
Proceeds from issuance of common stock			205,380
Proceeds from private placement of common stock (concurrent with initial public offering)			9,653
Payment of offering costs			(409)
Proceeds from repurchase agreement borrowings	13,645,855		18,161,433
Proceeds from repurchase agreement borrowings underlying linked transactions			142,530
Repayments of repurchase agreement borrowings	(14,541,717)		(16,858,373)
Repayments of repurchase agreement borrowings underlying linked transactions			(178,948)
Proceeds from forward contracts	206,240		14,022
Repayments of forward contracts	(207,220)		(15,205)
Premium for MAC interest rate swaps containing an other-than-insignificant financing element			10,579
Payments on termination of MAC interest rate swaps containing an other-than-insignificant financing element	(18,655)		
Interest payments and basis recovered on MAC interest rate swaps containing an other-than-insignificant financing element	(402)		545
Payments made for deferred financing costs	(463)		
Due from counterparties, net	(51,768)		(94,232)
Due to counterparties, net	2,251		(62,554)
Dividends on common stock	(84,119)		(65,532)
Net cash (used in) provided by financing activities	(1,049,998)		1,268,889
Effect of exchange rate changes on cash and cash equivalents		170	
Net (decrease) increase in cash and cash equivalents	(7,519)		7,542
Cash and cash equivalents beginning of period		47,222	48,525
Cash and cash equivalents end of period		\$ 39,703	\$ 56,067
Supplemental disclosure of operating cash flow information:			
Interest paid	\$	20,363	\$ 14,350
Supplemental disclosure of non-cash financing/investing activities:			
Principal payments on Mortgage-backed securities and other securities, not settled	\$		\$ (317)
Mortgage-backed securities and other securities purchased, not settled	\$		\$ (14,832)
Mortgage-backed securities recorded upon unlinking of linked transactions	\$		\$ (69,838)
Obligation to return collateral used to settle short sales	\$	(757,353)	\$
Net unsettled TBAs	\$	(8)	\$
Deferred offering costs payable	\$		\$ (8)
Dividends and distributions declared, not paid	\$	25,152	\$ 29,203

See notes to unaudited consolidated financial statements.

Table of Contents

Western Asset Mortgage Capital Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Unaudited)

(in thousands- except share and per share data)

The following defines certain of the commonly used terms in these Notes to Consolidated Financial Statements: Agency or Agencies refer to a federally chartered corporation, such as the Federal National Mortgage Association (Fannie Mae or FNMA) or the Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC), or an agency of the U.S. Government, such as the Government National Mortgage Association (Ginnie Mae or GNMA); references to MBS refer to mortgage backed securities, including residential mortgage-backed securities or RMBS , commercial mortgage-backed securities or CMBS , and Interest-Only Strips (as defined herein); Agency MBS refer to RMBS, CMBS and Interest-Only Strips issued or guaranteed by the Agencies while Non-Agency MBS refer to RMBS, CMBS and Interest-Only Strips that are not issued or guaranteed by the Agencies; references to ARMs refers to adjustable rate mortgages; references to Interest-Only Strips refer to interest-only (IO) and inverse interest-only (IIO) securities issued as part of or collateralized with MBS; references to Residential Whole-Loans and Commercial Whole-Loans (collectively Whole Loans) refer to individual mortgage loans secured by single family and commercial properties, respectively.

Note 1 Organization

Western Asset Mortgage Capital Corporation and subsidiaries (are collectively referred to throughout this report as the Company) are a real estate finance company. At the Company s launch in May 2012, its initial investment strategy focused primarily on Agency RMBS (including TBAs as defined herein). Over time, the Company expanded its investment strategy to include Non-Agency RMBS and subsequently, Agency and Non-Agency CMBS, including Non U.S. CMBS and Whole-Loans. In addition, and to a significantly lesser extent, the Company has invested in other securities including certain Agency obligations that are not technically MBS and in asset-backed securities (ABS). These changes in the Company s investment strategy, including future changes, are based on the Manager s perspective of which mix of portfolio assets it believes provide the Company with the best risk-reward opportunities at any given time.

The Company is externally managed by Western Asset Management Company (WAM , or the Manager), an investment advisor registered with the Securities and Exchange Commission (SEC). WAM is a wholly-owned subsidiary of Legg Mason, Inc. The Company operates and has elected to be taxed as a real estate investment trust or REIT commencing with its taxable year ended December 31, 2012.

In light of the aforementioned developments and given the Manager s current market outlook and investment view, while it can be expected that Agency RMBS will continue to be a significant part of the Company s portfolio, Agency RMBS will not necessarily be our primary investment in the future. Going forward, the Manager may vary the allocation among various asset classes subject to maintaining the Company s qualification as a REIT and maintaining its exemption from the Investment Company Act of 1940 (the 1940 Act). These restrictions limit the Company s ability to invest in non-real estate assets and/or assets which are not secured by real estate. Accordingly, the Company s portfolio will continue to be principally invested in MBS and other real estate related assets.

Table of Contents**Note 2 Revision of Previously Issued Financial Statements for Errors Affecting Certain Items Presented in the Statements of Cash Flows and Notes to Financial Statements**

As previously reported in the Company's annual report on Form 10-K for the year ended December 31, 2014, during the process of preparing the Company's 2014 financial statements, the Company discovered that the treatment of premiums received on the market agreed coupon (MAC) interest rate swaps and treatment of proceeds and repayment on rehypothecation of non-cash collateral in its Statements of Cash Flows and a voluntary disclosure surrounding the breakdown between realized and unrealized portion of the change in fair value for derivative instrument were not presented in accordance with GAAP. The Company has evaluated the impact of these errors and has concluded that individually and in the aggregate, these errors were not material to any previously issued financial statements. However, the Company has elected to revise the Statement of Cash Flows for the nine months ended September 30, 2014 and the voluntary disclosure for the three and nine months ended September 30, 2014 in these quarterly financial statements on Form 10-Q to correct the aforementioned errors. The corrections resulted in a reclassification of premiums received and periodic interest payments on interest rate swaps previously reported in cash flows from operating activities and the reclassification of proceeds and repayments on rehypothecation of non-cash collateral previously reported as repurchase agreement proceeds and repayments (as indicated in the tables below). In accordance with the Company's accounting policies, proceeds and repayments on rehypothecation of non-cash collateral is reported on a net basis in Due to counterparties, net. These revisions had no effect on net income, shareholders' equity, net change in cash, or total assets, of the Company reported for these periods.

Statements of Cash Flows (summarized) for the nine months ended September 30, 2014:

Amounts in thousands	For the nine months ended September 30, 2014		
	As Originally Reported	Adjustments	Revised
Statement of Cash Flows (effect on individual line items)			
Net income	\$ 85,269	\$	\$ 85,269
Adjustments to reconcile net income to net cash provided by operating activities:			
Premium amortization for MAC interest rate swaps		(928)	(928)
Interest payments and basis recovered on MAC interest rate swaps		(545)	(545)
Mark-to-market adjustments on derivative instruments	147,968	(21,856)	126,112
All other items	(132,229)		(132,229)
Net cash provided by operating activities	101,008	(23,329)	77,679
Cash flows from investing activities:			
Premium for MAC interest rate swaps, net	(2,235)	13,245	11,010
All other items	(1,350,036)		(1,350,036)
Net cash used in investing activities	(1,352,271)	13,245	(1,339,026)
Cash flows from financing activities:			
Proceeds from repurchase agreement borrowings	18,164,190	(2,757)	18,161,433
Repayments of repurchase agreement borrowings	(16,861,130)	2,757	(16,858,373)
Premium for MAC interest rate swaps containing an other-than-insignificant financing element	1,040	9,539	10,579

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

Interest payments and basis recovered on MAC interest rate swaps containing an other-than-insignificant financing element		545		545
All other items	(45,295)			(45,295)
Net cash provided by financing activities	1,258,805	10,084		1,268,889
Net increase (decrease) in cash and cash equivalents	7,542			7,542
Cash and cash equivalents beginning of period	48,525			48,525
Cash and cash equivalents end of period	\$ 56,067	\$	\$	56,067

Table of Contents

The tables below summarize the effect of interest rate swaps, interest rate swaptions, foreign currency swaps, foreign currency forwards, options, futures contracts, Agency and Non-Agency Interest-Only Strips as derivatives and TBAs reported in a voluntary disclosure surrounding the breakdown between realized and unrealized portion of the change in fair value for derivative instruments for the three and nine months ended September 30, 2014 (dollars in thousands - summarized):

As Originally Reported

Description	Three months ended September 30, 2014				
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to-market adjustments	Total
Interest rate swaps	\$ 23,798	\$ (11,848)	\$	\$ (14,767)	\$ (2,817)
All other items with no changes	1,815	5,863	(4,187)	(1,075)	2,416
Total	\$ 25,613	\$ (5,985)	\$ (4,187)	\$ (15,842)	\$ (401)

Adjustments

Description	Three months ended September 30, 2014				
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to-market adjustments	Total
Interest rate swaps	\$	\$	\$ 820	\$ (820)	\$
All other items with no changes					
Total	\$	\$	\$ 820	\$ (820)	\$

Revised

Description	Three months ended September 30, 2014				
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to-market adjustments	Total
Interest rate swaps	\$ 23,798	\$ (11,848)	\$ 820	\$ (15,587)	\$ (2,817)
All other items with no changes	1,815	5,863	(4,187)	(1,075)	2,416
Total	\$ 25,613	\$ (5,985)	\$ (3,367)	\$ (16,662)	\$ (401)

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

received.

As Originally Reported

Description	Nine months ended September 30, 2014				
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to-market adjustments	Total
Interest rate swaps	\$ 39,796	\$ (25,784)	\$	\$ (144,882)	\$ (130,870)
All other items with no changes	829	20,429	(14,286)	(3,086)	3,886
Total	\$ 40,625	\$ (5,355)	\$ (14,286)	\$ (147,968)	\$ (126,984)

Adjustments

Description	Adjustments				
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to-market adjustments	Total
Interest rate swaps	\$ (22,784)	\$	\$ 928	\$ 21,856	\$
All other items with no changes					
Total	\$ (22,784)	\$	\$ 928	\$ 21,856	\$

Revised

Description	Revised				
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to-market adjustments	Total
Interest rate swaps	\$ 17,012	\$ (25,784)	\$ 928	\$ (123,026)	\$ (130,870)
All other items with no changes	829	20,429	(14,286)	(3,086)	3,886
Total	\$ 17,841	\$ (5,355)	\$ (13,358)	\$ (126,112)	\$ (126,984)

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

Table of Contents

Note 3 Summary of Significant Accounting Policies

Basis of Presentation and Consolidation

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (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 periods. Actual results could differ from those estimates.

The consolidated financial statements include the Company s accounts and those of its consolidated subsidiary. The consolidated financial statements also include the consolidation of certain trusts that each meet the definition of a variable interest entity (VIE) related to the acquisition of Residential Whole-Loans in which the Company has determined itself to be the primary beneficiary of each such trust. Each trust has issued a trust certificate to the Company which is collateralized by pools of Residential Whole-Loans held by such trust. The Company includes the underlying Residential Whole-Loans owned by the trusts in Residential Whole-Loans at fair value on the Consolidated Balance Sheets and has eliminated the intercompany trust certificates in consolidation. The Company records interest income earned on the Residential Whole-Loans in Interest income on the Consolidated Statements of Operations. The Company records the initial underlying assets and liabilities of the consolidated trusts at their fair value upon consolidation into the Company and, as such, a gain or loss would be recorded upon consolidation if appropriate. Upon consolidation of the VIEs, the Company recorded no gain or loss upon consolidation. Refer to Note 6 - Variable Interest Entities for additional information regarding the impact of consolidation of the trusts. All intercompany amounts between the Company and its subsidiary and consolidated trusts have been eliminated in consolidation.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary have been made to present fairly the Company s financial position, results of operations and cash flows. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted in accordance with Article 10 of Regulation S-X and the instructions to Form 10-Q. These consolidated financial statements should be read in conjunction with the Company s annual report on Form 10-K for the year ended December 31, 2014, filed with the Securities and Exchange Commission (SEC) on March 16, 2015. The results of operations for the period ended September 30, 2015 are not necessarily indicative of the results to be expected for the full year or any future period.

The Company currently operates as one business segment.

Cash and Cash Equivalents

The Company considers all highly-liquid short term investments with original maturities of 90 days or less when purchased to be cash equivalents. Cash and cash equivalents are exposed to concentrations of credit risk. The Company places its cash and cash equivalents with what it believes to be high credit quality institutions. At times such investments may be in excess of the Federal Deposit Insurance Corporation insurance limit.

Classification of mortgage-backed securities, other securities and Residential and Commercial Whole-Loans and valuations of financial instruments

Mortgage-backed securities, other securities and Residential and Commercial Whole-Loans - Fair value election

The Company has elected the fair value option for all of its MBS, other securities, and Residential and Commercial Whole-Loans at the date of purchase, which permits the Company to measure these securities and Whole-Loans at fair value with the change in fair value included as a component of earnings. In the Manager's view, this election more appropriately reflects the results of the Company's operations for a particular reporting period, as financial asset fair value changes are presented in a manner consistent with the presentation and timing of the fair value changes of economic hedging instruments.

Table of Contents

Balance Sheet Presentation

The Company's purchases and sales of mortgage-backed securities and other securities are recorded on the trade date, which results in an investment related payable (receivable) for MBS and other securities purchased (sold) for which settlement has not taken place as of the balance sheet date. In addition, the Company's TBAs which have matured but have not settled as of the balance sheet date result in an investment related payable (receivable). The Company's MBS, other securities and Residential Whole-Loans are pledged as collateral against borrowings under repurchase agreements. Other than MBS and other securities which were accounted for as linked transactions through December 31, 2014, described below, the Company's MBS and other securities are included in Mortgage-backed securities and other securities at fair value and Investment related receivables on the Consolidated Balance Sheets, with the fair value of such MBS and other securities pledged disclosed parenthetically. Residential and Commercial Whole-Loan purchases and sales are recorded on the settlement date and are included in Residential Whole-Loans at fair value and Commercial Whole-Loans at fair value on the Consolidated Balance Sheets, respectively, with the fair value of such Residential Whole-Loans pledged disclosed parenthetically.

Valuation of financial instruments

The Company discloses the fair value of its financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). In accordance with GAAP, the Company is required to provide enhanced disclosures regarding instruments in the Level III category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities. GAAP establishes a framework for measuring fair value and expands financial statement disclosure requirements for fair value measurements. GAAP further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level I Quoted prices in active markets for identical assets or liabilities.

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

Level III Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable, for example, when there is little or no market activity for an investment at the end of the period, unobservable inputs may be used.

The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety. Transfers between levels are determined by the Company at the end of the reporting period.

When available, the Company uses quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, the Company consults with independent pricing services or obtains third party broker quotes. If independent pricing service, or third party broker quotes are not available, the Company determines the fair value of the securities using valuation techniques that use, when possible,

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

current market-based or independently-sourced market parameters, such as interest rates and when applicable, estimates of prepayment and credit losses.

Valuation techniques for MBS, Residential and Commercial Whole-Loans and other securities may be based upon models that consider the estimated cash flows of the security or the Whole-Loan. Depending on the asset and the underlying collateral, the primary inputs to the model may include yields for Agency To-Be-Announced securities (also known as TBAs), Agency MBS, the U.S. Treasury market and floating rate indices such as the London interbank offered rate or LIBOR, the Constant Maturity Treasury rate and the prime rate as a benchmark yield. In addition, the model may incorporate the current weighted average maturity and additional pool level information such as prepayment speeds, default frequencies and default severities, if applicable. To the extent such inputs are observable and timely, these assets are categorized as Level II of the fair value hierarchy; otherwise, unless alternative pricing information as described above is available, they are categorized as Level III.

While linked transactions, described below, were treated as derivatives for GAAP through December 31, 2014, the securities underlying the Company's linked transactions were valued using similar techniques to those used for the Company's securities portfolio. The value of the underlying security was then netted against the carrying amount (which approximates fair value) of the repurchase agreement at the valuation date. Additionally, TBA instruments are similar in substance to the Company's Agency RMBS portfolio, and the Company therefore estimates fair value based on similar methods.

Table of Contents

The Company determines the fair value of derivative financial instruments by obtaining quotes from third party pricing services, whose pricing is subject to review by the Manager's pricing committee. In valuing its over-the-counter interest rate derivatives, such as swaps and swaptions, and its currency derivatives, such as swaps and forwards, the Company considers the creditworthiness of both the Company and its counterparties, along with collateral provisions contained in each derivative agreement, from the perspective of both the Company and its counterparties. The majority of the Company's interest rate swaps are cleared through a central clearing house and subject to the clearing house margin requirements. The Company's agreements with its derivative counterparties also contain netting provisions; however the Company has elected to report its interest rate swaps and swaptions and currency swaps and forwards on a gross basis. No credit valuation adjustment was made in determining the fair value of interest rate and/or currency derivatives for the periods ended September 30, 2015 and December 31, 2014.

Fair value under GAAP represents an exit price in the normal course of business, not a forced liquidation price. If the Company is forced to sell assets in a short period to meet liquidity needs, the prices it receives can be substantially less than their recorded fair values. Furthermore, the analysis of whether it is more likely than not that the Company will not be required to sell assets in an unrealized loss position before recovery of its amortized cost basis, the amount of such expected required sales, and the projected identification of which assets will be sold is also subject to significant judgment, particularly in times of market illiquidity.

Any changes to the valuation methodology will be reviewed by the Company and its Manager to ensure the changes are appropriate. As markets and products develop and the pricing for certain products becomes more transparent, the Company will continue to refine its valuation methodologies. The Company utilizes and follows the pricing methodology and fair value hierarchy employed by its Manager, including its review and challenge process. The methods used by the Company may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Company anticipates that its valuation methods will be appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the fair value of certain financial instruments can 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.

All valuations received from independent pricing services are non-binding. The Company primarily utilizes independent third party pricing services as the primary source for valuing the Company's assets.

The Company generally receives one independent pricing service price for each investment in the Company's portfolio. The Manager has established a quarterly process to review and validate the pricing received from the independent pricing services and has a process for challenging prices received from the independent pricing services when necessary. The Company utilizes its Manager's policies in this regard for all securities. The Company utilizes its own policies for the review of the pricing of Whole-Loans received from a third party vendor. The Company's and the Manager's quarterly review of the independent third party pricing data may consist of a review of the daily change in the prices provided by the independent pricing vendor which exceed established tolerances or comparisons to executed transaction prices. The Manager's pricing group, which functions independently from its portfolio management personnel, corroborates the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager's pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that the Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, our Manager generally challenges the independent pricing service price.

In addition, to ensure proper fair value hierarchy, The Company and the Manager review the methodology and data used by the third party pricing service to understand whether observable market data is being utilized in the vendor's pricing methodology. Generally, this review is conducted annually, however ad-hoc reviews of the pricing methodology and the data does occur. The review of the assumptive data received from the vendor includes comparing key inputs. In addition, as part of the Company's regular review of pricing, the Manager's pricing group may

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

have informal discussions with the independent pricing vendor regarding their evaluation methodology or the market data utilized in their determination as well as performing back-testing with regard to the sale of securities. The conclusion that a price should be overridden in accordance with the Manager's pricing methodology may impact the fair value hierarchy of the security for which such price has been adjusted.

Table of Contents

Interest income recognition and Impairment

Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase

Interest income on mortgage-backed and other securities is accrued based on the respective outstanding principal balances and corresponding contractual terms. Premiums and discounts associated with Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase, are amortized into interest income over the estimated life of such securities using the effective yield method. Adjustments to premium and discount amortization are made for actual prepayment activity. The Company estimates prepayments at least quarterly for its securities and, as a result, if prepayments increase (or are expected to increase), the Company will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if prepayments decrease (or are expected to decrease), the Company will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.

The Company's conversion to a new accounting system in the calculation methodology used to determine the amortization of bond premium as of April 1, 2014, resulted in a cumulative retrospective change in estimate of approximately \$1.2 million. The impact of the change in estimate had no impact on Net income and was limited to an increase of approximately \$1.2 million to Interest income and an equal offsetting reduction to Unrealized gain (loss) on Mortgage-backed securities, other securities and Whole-Loans, net on the Consolidated Statement of Operations for the three months ended June 30, 2014. The Company does not believe the aforementioned change in estimate has had a material impact to subsequent periods or will in the future.

The Company assesses its Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase, for other-than-temporary impairment on at least a quarterly basis. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other-than-temporary. In deciding on whether or not a security is other-than-temporarily impaired, the Company considers several factors, including the nature of the investment, communications (if any) from the trustee of securitization regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and the Company's intent not to sell the security and whether it is more likely than not that Company will not be required to sell the security until recovery of its amortized cost basis. An other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in the Company's Consolidated Statement of Operations as Other loss on Mortgage-backed securities and other securities.

The determination as to whether an other-than-temporary impairment exists is subject to management estimates based on consideration of both factual information available at the time of assessment as well as the Company's estimates of the future performance and projected amount and timing of cash flows expected to be collected on the security. As a result, the timing and amount of an other-than-temporary impairment constitutes an accounting estimate that may change materially over time.

Finally, certain of the Company's MBS and other securities that are in an unrealized loss position at September 30, 2015 are also not considered other-than-temporarily impaired because the Company has no intent to sell these investments, it is more likely than not that the Company will not be required to sell the investment before recovery of its amortized cost basis and the Company is not required to sell the security for

regulatory or other reasons.

Table of Contents

Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives

Interest income on Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives are recognized based on the effective yield method. The effective yield on these securities is based on the projected cash flows from each security, which is estimated based on the Company's observation of the then current information and events, where applicable, and will include assumptions related to interest rates, prepayment rates 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. Where appropriate, the Company may include in its cash flow projections the U.S. Department of Justice's settlements with the major residential mortgage originators, regarding certain lending practices. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities are affected by the contractual lives of the underlying collateral, periodic payments of scheduled principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual maturities.

Based on the projected cash flow of such securities purchased at a discount to par value, the Company may designate a portion of such purchase discount as credit protection against future credit losses and, therefore, not accrete such amount into interest income. The amount designated as credit discount 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 discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

In addition, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in the Company's Consolidated Statements of Operations as Other loss on Mortgage-backed securities and other securities.

Securities denominated in a foreign currency contain additional risk in that the amortized cost basis for those securities may not be recovered due to declines in currency exchange rates. The Company considers the length of time that the security's fair value has declined due to the decline in foreign exchange rates, when assessing other-than temporary impairment.

The determination as to whether an other-than-temporary impairment exists is subject to management estimates based on consideration of both factual information available at the time of assessment as well as the Company's estimates of the future performance and projected amount and timing of cash flows expected to be collected on the security. As a result, the timing and amount of an other-than-temporary impairment constitutes an accounting estimate that may change materially over time.

Finally, certain of the Company's MBS and other securities that are in an unrealized loss position at September 30, 2015 are also not considered other-than-temporarily impaired because the Company has no intent to sell these investments, it is more likely than not that the Company will not be required to sell the investment before recovery of its amortized cost basis and the Company is not required to sell the security for regulatory or other reasons.

Residential and Commercial Whole-Loans

The Company records its purchases of Residential and Commercial Whole-Loans as the amount paid to the seller plus any fees paid or less any fees received. All other costs incurred in connection with acquiring Residential and Commercial Whole-Loans or committing to purchase Residential and Commercial Whole-Loans are charged to expense as incurred. The Company amortizes or accretes any premium or discount over the life of the related loan utilizing the effective interest method, based on the contractual payment terms of the loan. On at least a quarterly basis, the Company evaluates the collectability of both interest and principal of each loan, if circumstances warrant, to determine whether such loan is impaired. A loan is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the existing contractual terms. When a loan is impaired, the Company does not record a loss accrual as the Company has elected the fair value option. However, income recognition is suspended for loans at the earlier of the date at which payments become 90-days past due or when, in the opinion of management, a full recovery of income and principal becomes doubtful. When the ultimate collectability of the principal of an impaired loan is in doubt, all payments are applied to principal under the cost recovery method. When the ultimate collectability of the principal of an impaired loan is not in doubt, contractual interest is recorded as interest income when received, under the cash basis method until an accrual is resumed when the loan becomes contractually current and performance is demonstrated to be resumed. A loan is written off when it is no longer realizable and/or legally discharged.

Table of Contents

Sales of securities and Whole-Loans

Sales of securities and Whole-Loans are driven by the Company's portfolio management process. The Company seeks to mitigate risks including those associated with prepayments and will opportunistically rotate the portfolio into securities and/or other assets the Company's Manager believes have more favorable attributes. Strategies may also be employed to manage net capital gains, which need to be distributed for tax purposes. Realized gains or losses on sales of securities and Whole-Loans, including Agency Interest-Only Strips not characterized as derivatives, are included in the net Realized gain (loss) on sale of Mortgage-backed securities, other securities and Whole-Loans, net line item on the Consolidated Statements of Operations, and are recorded at the time of disposition. Realized gains losses on Interest-Only Strips which are characterized as derivatives are included in Gain (loss) on derivative instruments, net line item in the Consolidated Statements of Operations. Prior to January 1, 2015, realized gains or losses on sales of securities which were part of a linked transaction were included in Gain (loss) on linked transactions, net. The cost of positions sold is calculated using the specific identification method.

Investments in an unrealized loss position at the end of each reporting period are evaluated by the Company's Manager to determine whether the Company has the intent to sell such investments. To the extent the Company has no intent as of the end of such reporting period to sell such investments and it is more likely than not that the Company will not be required to sell the investment before recovery of its amortized cost basis, such unrealized loss is included in Unrealized gain (loss) on Mortgage-backed securities, other securities and Whole-Loans, net in the Consolidated Statements of Operations. Otherwise, when the Company has determined its intent to sell such securities, the unrealized loss is characterized as a realized loss and included in Other loss on Mortgage-backed securities and other securities on the Consolidated Statements of Operations. The Company has no intent to sell any of its investments in an unrealized loss position at September 30, 2015.

Foreign currency transactions

The Company has and expects to continue to enter into transactions denominated in foreign currency from time to time. At the date the transaction is recognized, the asset and/or liability will be measured and recorded using the exchange rate in effect at the date of the transaction. At each balance sheet date, such foreign currency assets and liabilities are re-measured using the exchange rate in effect at the date of the balance sheet, resulting in unrealized foreign currency gains or losses. Unrealized foreign currency gains or losses on MBS and other assets are recorded in Unrealized gain (loss) on Mortgage-backed securities, other securities and Whole-Loans, net on the Consolidated Statement of Operations. In addition, the Company evaluates whether an other-than-temporary impairment is deemed to have occurred on MBS and other assets denominated in a foreign currency. Cash flows from MBS and other assets denominated in foreign currencies are received in a foreign currency, and as a result, the Company may incur a loss due to changes in foreign exchange rates even when all contractual cash flows are received. These adjustments are reflected in the Consolidated Statements of Operations as Other loss on Mortgage-backed securities and other securities. Unrealized and realized foreign currency gains or losses on borrowings under repurchase agreements are recorded in Interest income on cash balances and other income (loss), net on the Consolidated Statement of Operations. Interest income from investments denominated in a foreign currency and interest expense on borrowings denominated in a foreign currency are recorded at the average rate of exchange during the period.

Variable Interest Entities (VIEs)

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

VIEs are defined as entities in which equity investors either do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support, are unable to direct the entity's activities or are not exposed to the entity's losses or entitled to its residual returns. VIEs are required to be consolidated by their primary beneficiary. The primary beneficiary of a VIE is determined to be the party that has both the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. This determination of the requirement to consolidate a VIE and the requirement to disclose information about the Company's involvement in a VIE can sometimes involve complex and subjective analyses. Ongoing assessments of whether an enterprise is the primary beneficiary of a VIE is required. The Company has been determined to be the primary beneficiary of two VIEs holding whole-loans.

Table of Contents

Due from counterparties/Due to counterparties

Due from counterparties represents cash posted by the Company with its counterparties as collateral for the Company's interest rate and/or currency derivative financial instruments, repurchase agreements, and TBAs. Due to counterparties represents cash posted with the Company by its counterparties as collateral under the Company's interest rate and/or currency derivative financial instruments, repurchase agreements, and TBAs. Included in the due from counterparties and/or due to counterparties are daily variation margin settlement amounts with counterparties which are based on the price movement of the Company's futures contracts. In addition, as provided below, Due to counterparties may include non-cash collateral, which the Company has the obligation to return, and which the Company has either sold or pledged. To the extent the Company receives collateral other than cash from its counterparties such assets are not included in the Company's Consolidated Balance Sheets. Notwithstanding the foregoing, if the Company either rehypothecates such assets or pledges the assets as collateral pursuant to a repurchase agreement, the cash received and the corresponding liability are reflected on the Consolidated Balance Sheets.

Derivatives and hedging activities

Subject to maintaining its qualification as a REIT for U.S. federal income tax purposes, the Company utilizes derivative financial instruments, including interest rate swaps, interest rate swaptions, mortgage put options, currency forwards, futures contracts, TBAs and Agency and Non-Agency Interest-Only Strips to hedge the interest rate and currency risk associated with its portfolio and related borrowings. Derivatives, subject to REIT requirements, are used for hedging purposes rather than speculation. The Company determines the fair value of its derivative positions and obtains quotations from third parties, including the Chicago Mercantile Exchange or CME, to facilitate the process of determining such fair values. If the Company's hedging activities do not achieve the desired results, reported earnings may be adversely affected.

GAAP requires an entity to recognize all derivatives as either assets or liabilities and to measure those instruments at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives are classified as either hedges of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge) or hedges of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge). If the Company does not elect hedge accounting for a derivative instrument, which the Company has not, fair value adjustments are recorded in earnings immediately.

The Company elected not to apply hedge accounting for its derivative instruments. Accordingly, the Company records, the change in fair value of its derivative instruments, which includes net interest rate swap payments (including accrued amounts) and net currency payments (including accrued amounts) related to interest rate swaps and currency swaps, respectively in Gain (loss) on derivative instruments, net in its Consolidated Statements of Operations. In the Company's Consolidated Statements of Cash Flows, premiums received and paid on termination of its interest rate swaps, excluding interest rate swaps containing an other-than-insignificant financing element and the unamortized premium of market agreed coupon (MAC) interest rate swaps, are included in cash flows from operating activities. Notwithstanding the foregoing, proceeds and payments on settlement of swaptions, mortgage put options, futures contracts and TBAs are included in cash flows from investing activities. Proceeds and payments on settlement of forward contracts are reflected in cash flows from financing activities in the Company's Consolidated Statement of Cash Flows. While payments made at the time of entering MAC interest rate swaps are included in cash flows from investing activities, payments received by

the Company upon entering MAC interest rate swaps are included in either cash flows from investing activities or cash flows financing activities, depending on whether or not the derivative instrument includes an other-than-insignificant financing element. For MAC interest rate swaps containing an other-than-insignificant financing element, all cash flows over the life of the derivative are treated as cash flows from financing activities. Return and recovery of basis activity for MAC interest rate swaps is included in cash flows from investing activities for swaps not containing an other-than-insignificant financing element in the Company's Consolidated Statement of Cash Flows. For Agency and Non-Agency Interest-Only Strips accounted for as derivatives, the purchase, sale and recovery of basis activity is included with MBS and other securities under cash flows from investing activities in the Company's Consolidated Statement of Cash Flows.

Table of Contents

The Company evaluates the terms and conditions of its holdings of Agency and Non-Agency Interest-Only Strips, interest rate swaptions, currency forwards, futures contracts and TBAs to determine if these instruments have the characteristics of an investment or should be considered a derivative under GAAP. In determining the classification of its holdings of Interest-Only Strips, the Company evaluates the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Generally, Interest-Only Strips for which the security represents a strip off of a mortgage pass through security will be considered a hybrid instrument classified as a MBS investment on the Consolidated Balance Sheets utilizing the fair value option. Alternatively, those Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives at fair value. Accordingly, Agency and Non-Agency Interest-Only Strips, interest rate swaptions, currency forwards, futures contracts and TBAs having the characteristics of derivatives are accounted for at fair value with such changes recognized in Gain (loss) on derivative instruments, net in its Consolidated Statements of Operations, along with any interest earned or paid (including accrued amounts). The carrying value of the Agency and Non-Agency Interest-Only Strips, accounted for as derivatives, is included in Mortgage-backed securities on the Consolidated Balance Sheets. The carrying value of interest rate swaptions, currency forwards, futures contracts and TBAs is included in Derivative assets or Derivative liabilities on the Consolidated Balance Sheets.

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. An embedded derivative is separated from the host contract and accounted for separately when all of the guidance criteria are met. Hybrid instruments that are remeasured at fair value through earnings, including the fair value option are not bifurcated. Derivative instruments, including derivative instruments accounted for as liabilities, are recorded at fair value and are re-valued at each reporting date, with changes in the fair value together with interest earned or paid (including accrued amounts) reported in the Gain (loss) on derivatives instruments, net in the Consolidated Statements of Operations. While accounted for as derivative instruments through December 31, 2014, linked transactions, including changes in fair value and interest earned or paid (including accrued amounts) were reported separately in our Consolidated Balance Sheets, Consolidated Statements of Operations and Consolidated Statements of Cash Flows. See Warrants below.

Repurchase agreements and Reverse Repurchase agreements

Mortgage-backed securities and other securities sold under repurchase agreements are treated as collateralized financing transactions, unless they meet sales treatment. Securities financed through a repurchase agreement remain on the Company's Consolidated Balance Sheets as assets and cash received from the lender is recorded in the Company's Consolidated Balance Sheets as a liability, unless such transaction was accounted for as a linked transaction prior to January 1, 2015, as described below. Interest payable in accordance with repurchase agreements is recorded as accrued interest payable on the Consolidated Balance Sheets. Interest paid (including accrued amounts) in accordance with repurchase agreements is recorded as interest expense, unless the repurchase agreement was accounted for as a linked transaction prior to January 1, 2015, as described below. The Company reflects all proceeds from repurchase agreement borrowings and repayment of repurchase agreement borrowings which are not linked transactions, including transactions pertaining to collateral received with respect to certain swap transactions, on a gross basis on the Consolidated Statements of Cash Flows.

The Company may borrow securities under reverse repurchase agreements to deliver a security owned and sold by the Company but pledged to a different counterparty under a separate repurchase agreement when in the Manager's view terminating the outstanding repurchase agreement is not in the Company's interest. Cash paid to the borrower is recorded in the Company's Consolidated Balance Sheets as an asset. Interest receivable in accordance with reverse repurchase agreements is recorded as accrued interest receivable on the Consolidated Balance Sheets. The Company reflects all proceeds from reverse repurchase agreement and repayment of reverse repurchase agreement, on a net basis on the Consolidated Statements of Cash Flows. Upon sale of a pledged security, the Company recognizes an obligation to return the borrowed security

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

on the Consolidated Balance Sheet in Due to Counterparty. The Company establishes haircuts to ensure the market value of the underlying asset remains sufficient to protect the Company in the event of default by the counterparty. Realized gains and losses associated with the sale of the security are recognized in Realized gain (loss) on sale of Mortgage-backed securities, other securities and Whole-Loans, net on the Consolidated Statement of Cash Flows.

Table of Contents

Linked transactions

Prior to January 1, 2015, in instances where the Company acquired a security through a repurchase agreement with the same counterparty from which the security was purchased, the Company evaluated such transaction in accordance with GAAP. This guidance in effect prior to January 1, 2015 required that if the initial transfer of a financial asset and repurchase financing were entered into contemporaneously with, or in contemplation of, one another, such purchase and financing would be considered linked unless all of the criteria found in the guidance were met at the inception of the transaction. If the transaction met all of the conditions, the initial transfer would be accounted for separately from the repurchase financing, and the Company would record the security and the related financing on a gross basis on its Consolidated Balance Sheets with the corresponding interest income and interest expense being reported in the Consolidated Statements of Operations. If the transaction was determined to be linked, the Company would record the initial transfer and repurchase financing on a net basis and record a forward commitment to purchase the security as a derivative instrument. Through December 31, 2014, such forward commitment was recorded at fair value in Linked transactions, net, at fair value on the Consolidated Balance Sheets with subsequent changes through December 31, 2014 in fair value recognized in Gain (loss) on linked transactions, net on its Consolidated Statements of Operations. The Company refers to these transactions as Linked Transactions. Prior to January 1, 2015, when or if a transaction was no longer considered to be linked, the security and related repurchase financing were reported on a gross basis. The unlinking of a transaction caused a realized event in which the fair value of the security as of the date of unlinking, became the cost basis of the security. The difference between the fair value on the unlinking date and the existing cost basis of the security was the realized gain or loss. Recognition of effective yield for such security was calculated prospectively using the new cost basis. For linked transactions, the Company reflected purchases and sales of securities within the investing section of the Consolidated Statements of Cash Flows. Proceeds from repurchase agreements borrowings and repayments of repurchase agreement borrowings were reflected in the financing section of the Consolidated Statements of Cash Flows. Starting in 2015, GAAP no longer requires the segregation and treatment of linked transactions as derivatives. Accordingly, starting in January 2015, the Company reports such securities and the corresponding repurchase agreement on a gross basis on its Consolidated Balance Sheets and with the corresponding interest income and interest expense reported in its Consolidated Statements of Operations. See [Recent accounting pronouncements](#) for details.

Share-based compensation

The Company accounts for share-based compensation to its independent directors, to any employee, to its Manager and to employees of its Manager and its affiliates using the fair value based methodology prescribed by GAAP. Compensation cost related to restricted common stock issued to the Company's independent directors including any such restricted stock which is subject to a deferred compensation program, and any employee of the Company is measured at its fair value at the grant date, and amortized into expense over the service period on a straight-line basis. Compensation cost related to restricted common stock issued to the Manager and to employees of the Manager, including officers of the Company who are employees of the Manager and its affiliates is initially measured at fair value at the grant date, and amortized into expense over the vesting period on a straight-line basis and re-measured on subsequent dates to the extent the awards are unvested.

Warrants

For the Company's warrants, the Company uses a variation of the adjusted Black-Scholes option valuation model to record the financial instruments at their relative fair values at issuance. The warrants issued with the Company's common stock in the private placement to certain accredited institutional investors on May 15, 2012, were evaluated by the Company and were recorded at their relative fair value as a component of equity at the date of issuance. See [Derivatives and hedging activities](#) above.

Income taxes

The Company operates and has elected to be taxed as a REIT commencing with its taxable year ended December 31, 2012. Accordingly, the Company will generally not be subject to corporate U.S. federal or state income tax to the extent that the Company makes qualifying distributions to stockholders, and provided that the Company satisfies, on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If the Company fails to qualify as a REIT, and does not qualify for certain statutory relief provisions, the Company will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which the Company lost its REIT qualification. Accordingly, the failure to qualify as a REIT could have a material adverse impact on the Company's results of operations and amounts available for distribution to stockholders.

Table of Contents

The dividends paid deduction for qualifying dividends paid to stockholders is computed using the Company's taxable income as opposed to net income reported on the consolidated financial statements. Taxable income, generally, will differ from net income reported on the consolidated financial statements because the determination of taxable income is based on tax regulations and not GAAP.

The Company may create and elect to treat certain subsidiaries as Taxable REIT Subsidiaries (TRS). In general, a TRS may hold assets and engage in activities that the Company cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes, and its value may not exceed 25% of the value of the Company. While a TRS may generate net income, a TRS can declare dividends to the Company, which will be included in the Company's taxable income and necessitate a distribution to its stockholders. Conversely, if the Company retains earnings at the TRS level, no distribution is required and it can increase book equity of the consolidated entity. As of September 30, 2015, the Company has a single wholly owned subsidiary, which it has elected to treat as a TRS.

The Company evaluates uncertain tax positions, if any, and classifies interest and penalties, if any, related to unrecognized tax benefits, if any, as a component of the provision for income taxes. In addition, the Company evaluates the performance of the TRS each period to determine the need for a provision for income taxes.

Offering costs

Offering costs borne by the Company in connection with its IPO and concurrent private placement completed on May 15, 2012 as well as its follow-on public stock offering completed on October 3, 2012 and its follow-on public stock offering and concurrent private placement completed on April 9, 2014 (inclusive of the partial exercise of the greenshoe which was completed on May 7, 2014) are reflected as a reduction of additional paid-in-capital.

Earnings per share

GAAP requires use of the two-class method of computing earnings per share for all periods presented for each class of common stock and participating securities as if all earnings for the period had been distributed. Under the two-class method, during periods of net income, the net income is first reduced for dividends declared on all classes of securities to arrive at undistributed earnings. During periods of net losses, the net loss is reduced for dividends declared on participating securities only if the security has the right to participate in the earnings of the entity and an objectively determinable contractual obligation to share in net losses of the entity. The Company's participating securities are not allocated a share of the net loss, as the participating securities do not have a contractual obligation to share in the net losses of the Company.

The remaining earnings are allocated to common stockholders and participating securities, to the extent that each security shares in earnings, as if all of the earnings for the period had been distributed. Each total is then divided by the applicable number of shares to arrive at basic earnings per share. For the diluted earnings, the denominator includes all outstanding common shares and all potential common shares assumed issued if they are dilutive. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of these potential common shares.

Comprehensive Income (Loss)

The Company has none of the components of comprehensive income (loss) and therefore comprehensive income (loss) is not presented.

Accounting standards applicable to emerging growth companies

The JOBS Act contains provisions that relax certain requirements for emerging growth companies, which includes the Company. For as long as the Company is an emerging growth company, which may be up to five full fiscal years, unlike other public companies, the Company will not be required to: (i) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies under Section 102(b)(1) of the JOBS Act; (ii) provide an auditor's attestation report on management's assessment of the effectiveness of the Company's system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act; (iii) comply with any new requirements adopted by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; or (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012, unless the SEC determines otherwise. The Company currently takes advantage of some of these exemptions. The Company's qualification for remaining an emerging growth company under the five full fiscal years expires on December 31, 2017. However, the Company will no longer qualify for such exemption if its gross revenues for any year equals or exceeds \$1.0 billion, the Company issues more than \$1.0 billion in non-convertible debt during the three previous years, or if the Company is deemed to be a large accelerated filer.

Table of Contents

As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. The Company intends to take advantage of such extended transition period. Since the Company will not be required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, its financial statements may not be comparable to the financial statements of companies that comply with public company effective dates. If the Company were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

Recent accounting pronouncements

Accounting Standards Adopted in 2015

In April 2014, the Financial Accounting Standards Board issued updated guidance that changes the requirements for reporting discontinued operations. Under the new guidance, a discontinued operation is defined as a disposal of a component of an entity or group of components of an entity that is disposed of or is classified as held for sale and represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results. The guidance is effective prospectively as of the first quarter of 2015 for a public company and for certain non-for-profit entities, with early adoption permitted for new disposals or new classifications as held-for-sale. The guidance is effective for other entities for annual periods beginning on or after December 15, 2014 and interim periods within annual periods beginning on or after December 15, 2015. The new guidance does not have a material impact on the Company's consolidated financial statements.

In June 2014, the Financial Accounting Standards Board issued guidance that changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements. The new guidance aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. These transactions would all be accounted for as secured borrowings. The guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement, which has resulted in outcomes referred to as off-balance-sheet accounting. In addition, the guidance requires additional disclosures. The guidance for a public company is effective for the first interim or annual period beginning after December 15, 2014. Other entities may elect to apply the requirements for interim periods beginning after December 31, 2014. Certain disclosures under this guidance do not take effect for a public company until the first period beginning after March 15, 2015 and do not take effect for other companies beginning for annual periods commencing after December 31, 2014 and for interim periods beginning after December 15, 2015. Through December 31, 2014, the Company accounted for certain transfers as forward agreements under the previous guidance, which were classified as linked transactions. The new guidance requires the Company to record these transfers as secured borrowings. The implementation of the new guidance resulted in an increase to Mortgage-backed securities and other securities, at fair value of approximately \$52.5 million, an increase in Borrowings under repurchase agreements of approximately \$31.9 million and a decrease in Linked transactions, net, at fair value of approximately \$20.6 million in the Company's Consolidated Balance Sheets as of January 1, 2015. Further, the implementation of the new guidance resulted in a cumulative-effect adjustment of zero to retained earnings as of January 1, 2015.

Accounting Standards to be Adopted in Future Periods

In May 2014, the Financial Accounting Standards Board issued guidance that changes an entity's recognition of revenue from contracts with customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, the new guidance requires improved disclosures to enable users of financial statements to understand the nature, amount, timing, and

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

uncertainty of revenue and cash flows arising from contracts with customers. In applying the new guidance, an entity may use either a retrospective approach to each prior reporting period or a retrospective approach with the cumulative effect recognized at the date of initial application. For a public company, the standard is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted for a public entity. For all other entities, the standard is effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2015. With certain restrictions, a nonpublic entity may elect to apply the guidance earlier. The new guidance is not expected to have a material impact on the Company's consolidated financial statements.

Table of Contents

In August 2014, the Financial Accounting Standards Board issued guidance that will require an entity's management to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. According to the new guidance, substantial doubt exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date the financial statements are issued. The term "probable" is used consistently with its current use in U.S. GAAP for loss contingencies. Disclosures will be required if conditions give rise to substantial doubt about the entity's ability to continue as a going concern, including whether management's plans that are intended to mitigate those conditions will alleviate the substantial doubt when implemented. The guidance is effective for annual periods ending after December 15, 2016. The effective date is the same for both public companies and all other entities. Early application is permitted. The Company's first assessment under the new guidance will be completed for the year ending December 31, 2016.

In January 2015, the FASB issued guidance to simplify income statement presentation by eliminating the concept of extraordinary items. U.S. GAAP currently requires that a company separately classify, disclose and present extraordinary events and transactions. The guidance eliminates the concept of extraordinary items from U.S. GAAP. Under the existing guidance, an entity is required to separately disclose extraordinary items, net of tax, in the income statement after income from continuing operations if an event or transaction is of an unusual nature and occurs infrequently. This separate, net-of-tax presentation (and corresponding earnings per share impact) will no longer be allowed. The existing requirement to separately present items that are of an unusual nature or occur infrequently on a pre-tax basis within income from continuing operations has been retained. The new guidance also requires similar separate presentation of items that are both unusual and infrequent. The standard is effective for periods beginning after December 15, 2015. The effective date is the same for both public companies and all other entities. Early adoption is permitted, but only as of the beginning of the fiscal year of adoption. Upon adoption, a reporting entity may elect prospective or retrospective application. If adopted prospectively, both the nature and amount of any subsequent adjustments to previously reported extraordinary items must be disclosed. The Company has not elected to early adopt this guidance. The new guidance is not expected to have a material impact on the Company's consolidated financial statements.

In February 2015, the FASB issued guidance to simplify and reduce the number of consolidation models through the elimination of an indefinite deferral for certain entities and by placing more emphasis on risk of loss when determining a controlling financial interest. The guidance affects reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidation model. The standard is effective for a public company for fiscal years, and for interim periods within fiscal years beginning after December 15, 2015. The standard is effective for other entities for fiscal years beginning after December 31, 2016, and for interim periods beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The Company has not elected to early adopt this guidance. The new guidance is not expected to have a material impact on the Company's consolidated financial statements.

In April 2015, the FASB issued guidance to amend the presentation of debt issuance cost related to a recognized debt liability. Under the new guidance, the debt issuance costs will be presented in the balance sheet as a direct deduction from the carrying amount of the recognized debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected under the new guidance. The standard is effective for a public company for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The standard is effective for other entities for the fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016. Early adoption is permitted. The guidance should be applied on a retrospective basis. The balance sheet of each individual period presented should be adjusted to reflect the period-specific effects of applying the new guidance. Upon adoption, an entity is required to comply with the applicable disclosures for a change in an accounting principle. These disclosures include the nature of and reason for the change in accounting principle, the transition method, a description of the prior-period information that has been retrospectively adjusted, and the effect of the change on the financial statement line items (i.e., debt issuance cost asset and the debt liability). The Company has not elected to early adopt this guidance. The new guidance is not expected to have a material impact on the Company's consolidated financial statements.

Table of Contents**Note 4 Fair Value of Financial Instruments***Fair Value Accounting Elections*

The Company's MBS and other securities are designated as available-for-sale and the Company has elected the fair value option for all of its MBS and other securities. In addition, the Company has designated its Residential and Commercial Whole-Loans as held-for-investment and has elected the fair value option. As a result, all changes in the fair value of MBS, other securities and Residential and Commercial Whole-Loans are reflected in the results of operations.

Financial Instruments carried at Fair Value

The following tables present the Company's financial instruments carried at fair value as of September 30, 2015 and December 31, 2014, based upon the valuation hierarchy (dollars in thousands):

	September 30, 2015			
	Fair Value			
	Level I	Level II	Level III	Total
Assets				
Agency RMBS:				
20-Year mortgage	\$	\$	817,496	\$ 817,496
30-Year mortgage		1,148,990		1,148,990
Agency RMBS Interest-Only Strips		105,533		105,533
Agency and Non-Agency Interest-Only Strips accounted for as derivatives, included in MBS		64,911	3,819	68,730
Non-Agency RMBS		297,530	244,751	542,281
Agency and Non-Agency CMBS		339,838	152,163	492,001
Other securities		113,949	63,529	177,478
Residential Whole-Loans			150,486	150,486
Subtotal		2,888,247	614,748	3,502,995
Derivative assets		56,985		56,985
Total	\$	\$	2,945,232	\$ 3,559,980
Liabilities				
Derivative liabilities	\$	57	\$	\$ 227,158
Total	\$	57	\$	\$ 227,158
	December 31, 2014			
	Fair Value			
	Level I	Level II	Level III	Total
Assets				
Agency RMBS:				
20-Year mortgage	\$	\$	1,120,031	\$ 1,120,031

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

30-Year mortgage		1,790,219		1,790,219
Agency RMBS Interest-Only Strips		188,506		188,506
Agency and Non-Agency Interest-Only Strips accounted for as derivatives, included in MBS		83,773	4,456	88,229
Non-Agency RMBS		490,093	176,479	666,572
Agency and Non-Agency CMBS		320,171	103,069	423,240
Other securities		101,523	7,403	108,926
Residential Whole-Loans			7,220	7,220
Subtotal		4,094,316	298,627	4,392,943
Derivative assets	451	72,805		73,256
Non-Agency RMBS linked transactions			1,596	1,596
Non-Agency CMBS linked transactions, including Non U.S.			16,152	16,152
Other securities linked transactions			2,879	2,879
Total	\$ 451	\$ 4,167,121	\$ 319,254	\$ 4,486,826
Liabilities				
Derivative liabilities	\$ 1,191	\$ 179,089	\$	\$ 180,280
Total	\$ 1,191	\$ 179,089	\$	\$ 180,280

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

Table of Contents

The following tables present additional information about the Company's financial instruments, which are measured at fair value on a recurring basis for which the Company has utilized Level III inputs to determine fair value:

\$ in thousands	Mortgage-backed securities and other securities			
	Three months ended September 30, 2015	Three months ended September 30, 2014	Nine months ended September 30, 2015	Nine months ended September 30, 2014
Beginning balance	\$ 452,387	\$ 130,584	\$ 291,407	\$ 15,681
Fair value of securities previously accounted for as linked transactions			52,484	
Transfers into Level III from Level II		95,845	37,499	133,136
Transfers from Level III into Level II		(11,207)	(3,996)	(27,910)
Purchases	34,568	52,050	190,893	165,468
Sales and settlements	(14,149)	(3,204)	(86,396)	(26,646)
Principal repayments	(4,259)	(72)	(8,968)	(91)
Total net gains / (losses) included in net income				
Realized gains/(losses), net	(113)	(13)	4,348	2,848
Other loss on Mortgage-backed securities	(2,616)		(5,357)	
Unrealized gains/(losses), net(1)	(138)	4,912	(965)	7,283
Premium and discount amortization, net	(1,418)	(3,911)	(6,687)	(4,785)
Ending balance	\$ 464,262	\$ 264,984	\$ 464,262	\$ 264,984

(1) For Mortgage-backed securities and other securities classified as Level III at September 30, 2015, the Company recorded gross unrealized gains of approximately \$5.2 million and \$9.6 million and gross unrealized losses of approximately \$5.3 million and \$9.7 million, for the three and nine months ended September 30, 2015, respectively. For Mortgage-backed securities and other securities classified as Level III at September 30, 2014, the Company recorded gross unrealized gains of approximately \$5.0 million and \$6.3 million and gross unrealized losses of approximately \$112 thousand and \$489 thousand, for the three and nine months ended September 30, 2014, respectively. These gains and losses are included in Unrealized gain (loss) on Mortgage-backed securities, other securities and Whole-Loans, net on the Consolidated Statements of Operations.

\$ in thousands	Residential Whole-Loans			
	Three months ended September 30, 2015	Three months ended September 30, 2014	Nine months ended September 30, 2015	Nine months ended September 30, 2014
Beginning balance	\$ 22,184	\$	\$ 7,220	\$
Transfers into Level III from Level II				
Transfers from Level III into Level II				
Purchases	129,026		145,562	
Sales and settlements				
Principal repayments	(3,192)		(4,983)	
Total net gains / (losses) included in net income				
Realized gains/(losses), net				
Other loss on Mortgage-backed securities				
Unrealized gains/(losses), net(1)	2,786		3,100	
	(318)		(413)	

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

Premium and discount amortization,
net

Ending balance	\$	150,486	\$	\$	150,486	\$
----------------	----	---------	----	----	---------	----

(1) For Residential Whole-Loans classified as Level III at September 30, 2015, the Company recorded gross unrealized gains of approximately \$2.8 million and \$3.2 million and gross unrealized losses of approximately \$11 thousand and \$7 thousand, for the three and nine months ended September 30, 2015, respectively. These gains and losses are included in Unrealized gain (loss) on Mortgage-backed securities, other securities and Whole-Loans, net on the Consolidated Statements of Operations. The Company did not hold any Residential Whole-Loans for the three and nine months ended September 30, 2014.

Table of Contents

\$ in thousands	Commercial Whole-Loans			
	Three months ended September 30, 2015	Three months ended September 30, 2014	Nine months ended September 30, 2015	Nine months ended September 30, 2014
Beginning balance	\$ 8,743	\$	\$	\$
Transfers into Level III from Level II				
Transfers from Level III into Level II				
Purchases				
Sales and settlements				
Principal repayments	(8,750)			
Total net gains / (losses) included in net income				
Realized gains/(losses), net				
Other loss on Mortgage-backed securities				
Unrealized gains/(losses), net(1)	7			
Premium and discount amortization, net				
Ending balance	\$	\$	\$	\$

(1) The Company did not hold any Commercial Whole-Loans at September 30, 2015 and September 30, 2014.

\$ in thousands	Derivative assets			
	Three months ended September 30, 2015	Three months ended September 30, 2014	Nine months ended September 30, 2015	Nine months ended September 30, 2014
Beginning balance	\$	\$	\$	\$
Transfers into Level III from Level II				126
Transfers out Level III into Level II				
Purchases		2,813		2,813
Sales and settlements				
Principal repayments				
Total net gains/(losses) included in net income				
Realized gains/(losses), net				(1,163)
Other loss on Mortgage-backed securities				
Unrealized gains/(losses), net		(340)		697
Premium and discount amortization, net				
Ending balance	\$	\$ 2,473	\$	\$ 2,473

Table of Contents

\$ in thousands	Linked transactions			
	Three months ended September 30, 2015	Three months ended September 30, 2014	Nine months ended September 30, 2015	Nine months ended September 30, 2014
Beginning balance	\$	\$	\$	\$
Transfers into Level III from Level II		9,348		9,348
Transfers out Level III into Level II				
Purchases		2,840		2,840
Sales and settlements				
Principal repayments				
Total net gains/(losses) included in net income				
Realized gains/(losses), net				
Other loss on Mortgage-backed securities				
Unrealized gains/(losses), net		(1)		(1)
Premium and discount amortization, net		11		11
Ending balance	\$	\$ 12,198	\$	\$ 12,198

\$ in thousands	Derivative liabilities			
	Three months ended September 30, 2015	Three months ended September 30, 2014	Nine months ended September 30, 2015	Nine months ended September 30, 2014
Beginning balance	\$	\$ 863	\$	\$
Transfers into Level III from Level II				
Transfers out Level III into Level II				
Purchases				
Sales and settlements		(863)		(863)
Principal repayments				
Total net gains/(losses) included in net income				
Realized gains/(losses), net				
Other loss on Mortgage-backed securities				
Unrealized gains/(losses), net				863
Premium and discount amortization, net				
Ending balance	\$	\$	\$	\$

Transfers between hierarchy levels during operations for the nine months ended September 30, 2015 and September 30, 2014 were based on the lack of availability of sufficient observable inputs to meet Level II versus Level III criteria. The leveling of these assets was based on information received from a third party pricing service which utilized unobservable inputs, along with the back-testing of historical sales transactions performed by the Manager.

The Company primarily utilizes independent third party pricing services as the main source for valuing the Company's assets. All valuations received from independent pricing services are non-binding. The Company generally receives one independent pricing service price for each investment in its portfolio. The Manager has established a process to review and validate the pricing received from the independent pricing service on a quarterly basis and has a process for challenging prices received from the independent pricing service when necessary. The Company utilizes its Manager's policies in this regard for all securities. The Company utilizes its own policies for the review of the pricing of Whole-Loans received from a third party vendor. The Company's and the Manager's quarterly review of the independent third party pricing data may consist of a review of the daily change in the prices provided by the independent pricing vendor which exceed established tolerances or comparisons to executed transaction prices. The Manager's pricing group, which functions independently from its

portfolio management personnel, corroborates the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager's pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that the Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, the Manager generally challenges the independent pricing service price. In addition, to ensure proper fair value hierarchy, the Company and the Manager review the methodology used by the third party pricing service to understand whether observable market data is being utilized in the vendor's pricing methodology. Such review is conducted no less than annually. In addition, as part of the Company's regular review of pricing, the Manager's pricing group may throughout the year have incremental discussions with the independent pricing vendor regarding their evaluation methodology or the market data utilized in their determination as well as performing back testing with regard to the sale of certain assets.

Table of Contents**Other Fair Value Disclosures**

Due from counterparties and Due to counterparties on the Company's Consolidated Balance Sheets are reflected at cost which approximates fair value.

The fair value of the repurchase agreements is based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best estimate current market interest rates that would be offered for loans with similar characteristics and credit quality. The use of different market assumptions or estimation methodologies could have a material effect on the fair value amounts. At September 30, 2015, the Company's borrowings under repurchase agreements had a fair value of approximately \$3.0 billion and a carrying value of approximately \$3.0 billion. At September 30, 2015, the Company's receivable under reverse repurchase agreements had a fair value of approximately \$758.5 million and a carrying value of approximately \$758.5 million. Inputs used to arrive at the fair value of the repurchase agreement borrowings and receivables under reverse repurchase agreements are generally observable, and therefore, they would be considered a Level II fair value measurement.

Note 5 Mortgage-Backed Securities and other securities

The following tables present certain information about the Company's investment portfolio at September 30, 2015 and December 31, 2014 (dollars in thousands). Real estate securities and other securities that are accounted for as a component of linked transactions as of December 31, 2014 are not reflected in the tables set forth in this note. See Note 10 for further details.

	September 30, 2015						
	Principal Balance	Unamortized Premium (Discount), net	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain (Loss), net	Estimated Fair Value	Net Weighted Average Coupon (1)
Agency RMBS:							
20-Year mortgage	\$ 764,144	\$ 40,949	\$	\$ 805,093	\$ 12,403	\$ 817,496	3.8%
30-Year mortgage	1,056,998	81,814		1,138,812	10,178	1,148,990	4.1%
Agency RMBS							
Interest-Only Strips	N/A	N/A	N/A	98,680	6,853	105,533	3.5%(2)
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives (3)	N/A	N/A	N/A	N/A	N/A	68,730	2.7%(2)
Non-Agency RMBS	604,367	(29,849)	(125,755)	448,763	9,507	458,270	3.7%
Non-Agency RMBS	N/A	N/A	N/A	69,420	14,591	84,011	6.1%(2)

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

Interest- Only Strips								
Agency and Non-Agency CMBS	566,717	(63,362)	(10,706)	492,649	(3,298)	489,351	5.2%	
Agency CMBS Interest-Only Strips	N/A	N/A	N/A	2,332	318	2,650	4.9%(2)	
Other securities (4)	154,496	4,859	(2,830)	179,008	(1,530)	177,478	5.0%	
Total	\$ 3,146,722	\$ 34,411	\$ (139,291)	\$ 3,234,757	\$ 49,022	\$ 3,352,509	4.0%	

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

Table of Contents

	December 31, 2014						
	Principal Balance	Unamortized Premium (Discount), net	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain (Loss), net	Estimated Fair Value	Net Weighted Average Coupon (1)
Agency RMBS:							
20-Year mortgage	\$ 1,054,864	\$ 56,616	\$	\$ 1,111,480	\$ 8,551	\$ 1,120,031	3.6%
30-Year mortgage	1,657,640	127,876		1,785,516	4,703	1,790,219	4.1%
Agency RMBS Interest-Only Strips							
	N/A	N/A	N/A	178,162	10,344	188,506	4.0(2)
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives (3)							
	N/A	N/A	N/A	N/A	N/A	88,229	2.9(2)
Non-Agency RMBS							
	759,068	6,941	(178,883)	587,126	9,791	596,917	3.6%
Non-Agency RMBS Interest-Only Strips							
	N/A	N/A	N/A	61,144	8,511	69,655	6.1(2)
Agency and Non-Agency CMBS							
	449,617	(31,216)	(3,124)	415,277	3,848	419,125	5.3%
Agency CMBS Interest-Only Strips							
	N/A	N/A	N/A	4,017	98	4,115	4.8(2)
Other securities (4)							
	102,323	699		110,425	(1,499)	108,926	4.6%
Total	\$ 4,023,512	\$ 160,916	\$ (182,007)	\$ 4,253,147	\$ 44,347	\$ 4,385,723	4.0%

(1) Net weighted average coupon as of September 30, 2015 and December 31, 2014 is presented, net of servicing and other fees.

(2) Interest-Only Strips and Interest-Only Strips accounted for as derivatives have no principal balances and earn contractual interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities.

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

(4) Other securities include residual interests in asset-backed securities which have no principal balance and an amortized cost of approximately \$22.5 million and \$7.4 million as of September 30, 2015 and December 31, 2014, respectively.

As of September 30, 2015 and December 31, 2014 the weighted average expected remaining term to the expected maturity of the MBS and other securities investment portfolio, excluding linked transactions was 6.0 years and 6.7 years, respectively.

The components of the carrying value of the Company's real estate securities and other securities are as follows (dollars in thousands):

September 30, 2015	December 31, 2014
-----------------------	----------------------

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

Principal balance	\$	3,146,722	\$	4,023,512
Amortized cost of Interest-Only Strips and residual interests		192,915		250,726
Carrying value of Agency and Non-Agency Interest-Only Strips accounted for as derivatives		68,730		88,229
Unamortized premium		146,176		218,561
Unamortized discount		(111,765)		(57,645)
Discount designated as Credit Reserve and OTTI		(139,291)		(182,007)
Gross unrealized gains		76,884		75,444
Gross unrealized losses		(27,862)		(31,097)
Fair value	\$	3,352,509	\$	4,385,723

Table of Contents

The following tables present the changes in the components of the Company's purchase discount and amortizable premium on its Non-Agency RMBS, Non-Agency CMBS and other securities for the three and nine months ended September 30, 2015 and September 30, 2014 (dollars in thousands):

	Three months ended September 30, 2015		
	Discount Designated as Credit Reserve and OTTI	Accretable Discount(1)	Amortizable Premium(1)(2)
Balance at beginning of period	\$ (164,931)	\$ (133,407)	\$ 86,831
Accretion of discount		4,328	
Amortization of premium			(2,217)
Realized credit losses	2,002		
Purchases		(23,903)	
Sales	6,932	6,608	(4,784)
Net impairment losses recognized in earnings	(5,102)		
Transfers/release of credit reserve	21,808	(7,250)	(14,558)
Balance at end of period	\$ (139,291)	\$ (153,624)	\$ 65,272

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

(2) Subsequent reductions in the non-accretable discount results in a corresponding reduction in the amortizable premium.

	Nine months ended September 30, 2015		
	Discount Designated as Credit Reserve and OTTI	Accretable Discount(1)	Amortizable Premium(1)(2)
Balance at beginning of period(3)	\$ (184,327)	\$ (107,197)	\$ 86,815
Accretion of discount		13,594	
Amortization of premium			(7,096)
Realized credit losses	6,997		
Purchases	(34,096)	(87,376)	6,808
Sales	60,747	43,783	(15,802)
Net impairment losses recognized in earnings	(10,493)		
Transfers/release of credit reserve	21,881	(16,428)	(5,453)
Balance at end of period	\$ (139,291)	\$ (153,624)	\$ 65,272

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

(2) Subsequent reductions in the non-accretable discount results in a corresponding reduction in the amortizable premium.

(3) Included in the beginning balance are mortgage-backed securities and other securities with discount designated as credit reserve and OTTI of approximately \$2.3 million, accretable discount of approximately \$1.4 million and amortizable premium of approximately \$4.6 million which were previously accounted for as linked transactions

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

through December 31, 2014.

Three months ended September 30, 2014

	Discount Designated as Credit Reserve and OTTI	Accrutable Discount (1)	Amortizable Premium
Balance at beginning of period	\$ (206,374)	\$ (107,368)	\$ 103,261
Accretion of discount		3,845	
Amortization of premium			(2,461)
Realized credit losses	1,853		
Purchases	(31,080)	(10,173)	32,677
Sales	22,668	20,725	(20,700)
Net impairment losses recognized in earnings	(1,669)		
Unlinking of Linked Transactions			
Transfers/release of credit reserve	29,331	(1,923)	(27,408)
Balance of end of period	\$ (185,271)	\$ (94,894)	\$ 85,369

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

Nine months ended September 30, 2014

	Discount Designated as Credit Reserve and OTTI	Accrutable Discount (1)	Amortizable Premium
Balance at beginning of period	\$ (79,898)	\$ (71,295)	\$ 20,625
Accretion of discount		11,389	
Amortization of premium			(6,129)
Realized credit losses	3,623		
Purchases	(162,805)	(105,261)	92,618
Sales	42,079	72,175	(25,718)
Net impairment losses recognized in earnings	(4,145)		
Unlinking of Linked Transactions	(13,889)	(297)	32,132
Transfers/release of credit reserve	29,764	(1,605)	(28,159)
Balance of end of period	\$ (185,271)	\$ (94,894)	\$ 85,369

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

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

Table of Contents

The following tables present the fair value and contractual maturities of the Company's securities portfolio at September 30, 2015 and December 31, 2014 (dollars in thousands):

	September 30, 2015				
	< or equal to 10 years	> 10 years and < or equal to 20 years	> 20 years and < or equal to 30 years	> 30 years	Total
Agency RMBS:					
20-Year mortgage	\$	\$ 817,496	\$	\$	\$ 817,496
30-Year mortgage			1,148,990		1,148,990
Agency RMBS Interest-Only Strips		45,115	60,418		105,533
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives		11,586	42,152	14,992	68,730
Non-Agency RMBS	15	45,009	104,842	308,404	458,270
Non-Agency RMBS Interest-Only Strips			21,044	62,967	84,011
Agency and Non-Agency CMBS	66,726	40,459	156,793	225,373	489,351
Agency CMBS Interest-Only Strips	2,650				2,650
Other securities	102,698		53,687	21,093	177,478
Total	\$ 172,089	\$ 959,665	\$ 1,587,926	\$ 632,829	\$ 3,352,509

	December 31, 2014				
	< or equal to 10 years	> 10 years and < or equal to 20 years	> 20 years and < or equal to 30 years	> 30 years	Total
Agency RMBS:					
20-Year mortgage	\$	\$ 1,120,031	\$	\$	\$ 1,120,031
30-Year mortgage			1,790,219		1,790,219
Agency RMBS Interest-Only Strips		52,975	135,531		188,506
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives		17,123	53,452	17,654	88,229
Non-Agency RMBS	22	26,632	193,852	376,411	596,917
Non-Agency RMBS Interest-Only Strips			30,217	39,438	69,655
Agency and Non-Agency CMBS	43,286	52,135	82,055	241,649	419,125
Agency CMBS Interest-Only Strips	4,115				4,115
Other securities	65,128		36,395	7,403	108,926
Total	\$ 112,551	\$ 1,268,896	\$ 2,321,721	\$ 682,555	\$ 4,385,723

The following tables present the gross unrealized losses and estimated fair value of the Company's MBS and other securities by length of time that such securities have been in a continuous unrealized loss position at September 30, 2015 and December 31, 2014 (dollars in thousands):

September 30, 2015

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

	Less than 12 Months			12 Months or More			Fair Value	Total	
	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities		Unrealized Losses	Number of Securities
Agency RMBS:									
20-Year mortgage	\$ 157,831	\$ (947)	33	\$ 46,362	\$ (309)	10	\$ 204,193	\$ (1,256)	43
30-Year mortgage	70,671	(593)	17	434,931	(7,961)	88	505,602	(8,554)	105
Agency RMBS Interest-Only Strips	25,113	(363)	10	1,737	(51)	1	26,850	(414)	11
Non-Agency RMBS	115,533	(3,182)	16	15,793	(291)	4	131,326	(3,473)	20
Agency and Non-Agency CMBS	233,835	(8,804)	38	20,525	(703)	5	254,360	(9,507)	43
Other securities	125,475	(2,510)	12	20,352	(2,148)	1	145,827	(4,658)	13
Total	\$ 728,458	\$ (16,399)	126	\$ 539,700	\$ (11,463)	109	\$ 1,268,158	\$ (27,862)	235

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

Table of Contents

	Less than 12 Months			December 31, 2014 12 Months or More			Total		
	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities
Agency RMBS:									
20-Year mortgage	\$ 1,475	\$ (10)	1	\$ 422,287	\$ (5,426)	54	\$ 423,762	\$ (5,436)	55
30-Year mortgage	2,893	(93)	5	882,482	(18,358)	126	885,375	(18,451)	131
Agency RMBS Interest-Only Strips	20,756	(587)	11				20,756	(587)	11
Non-Agency RMBS	112,505	(1,090)	20	11,564	(149)	2	124,069	(1,239)	22
Non-Agency RMBS Interest-Only Strips	5,081	(411)	1				5,081	(411)	1
Agency and Non-Agency CMBS	173,139	(1,716)	34				173,139	(1,716)	34
Other securities	62,345	(3,257)	6				62,345	(3,257)	6
Total	\$ 378,194	\$ (7,164)	78	\$ 1,316,333	\$ (23,933)	182	\$ 1,694,527	\$ (31,097)	260

At September 30, 2015, the Company did not intend to sell any of its MBS and other securities that were in an unrealized loss position, and it is more likely than not that the Company will not be required to sell these MBS and other securities before recovery of their amortized cost basis, which may be at their maturity.

The Company assesses its Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase, for other-than-temporary impairment on at least a quarterly basis. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other-than-temporary. In deciding on whether or not a security is other-than-temporarily impaired, the Company considers several factors, including the nature of the investment, communications (if any) from the securitization trustee regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and the Company's intent not to sell the security and that it is more likely than not that the Company will not be required to sell the security until recovery of its amortized cost. In addition, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in the Company's Consolidated Statement of Operations as Other loss on Mortgage-backed securities and other securities.

For Non-Agency MBS and other securities rated below AA at the time of purchase and Agency and Non-Agency Interest-Only Strips, excluding Interest-Only Strips classified as derivatives, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the beneficial interest is less than its carrying amount. Other than for plain-vanilla variable rate Non-Agency MBS, the Company does not bifurcate the loss between credit loss and loss attributed to change in interest rates, therefore, the entire loss is recorded as other-than-temporary. These adjustments are reflected in the Company's Consolidated Statement of Operations as Other loss on Mortgage-backed securities and other securities. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. If an

other-than-temporary impairment is recognized as a result of this analysis, the yield is maintained at the current accretion rate. The last revised estimated cash flows are then used for future impairment analysis purposes. The Company's prepayment speed estimate was the primary assumption used to determine other-than temporary-impairments for Interest-Only Strips, excluding Agency and Non-Agency Interest-Only Strips accounted for as derivatives, for the three and nine months ended September 30, 2015 and September 30, 2014.

With respect to the Company's securities portfolio, OTTI is generally recorded when the credit quality of the underlying collateral deteriorates and or the schedule payments are faster than previously projected. The credit deterioration could be as a result of, but not limited to, increased projected realized losses, foreclosures, delinquencies and the likelihood of the borrower being able to make payments in the future. Generally, a prepayment occurs when a loan has a higher interest rate relative to current interest rates and lenders are willing to extend credit at the lower current interest rate or the underlying collateral for the loan is sold or transferred. Other-than-temporary-impairments are reported as Other loss on Mortgage-backed securities and other securities in the Company's Consolidated Statement of Operations.

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

Table of Contents

The following table presents the other-than-temporary impairments the Company recorded on its securities portfolio (dollars in thousands):

	For the three months ended September 30, 2015	For the three months ended September 30, 2014	For the nine months ended September 30, 2015	For the nine months ended September 30, 2014
Agency RMBS	\$ 626	1,187	\$ 3,804	\$ 3,420
Non-Agency RMBS	3,716	1,536	6,746	3,862
Non-Agency CMBS	271	104	2,369	215
Other securities	1,304	30	1,965	68
Total	\$ 5,917	\$ 2,857	\$ 14,884	\$ 7,565

The Company has made investments in certain Non-Agency RMBS inverse floaters. These securities' coupon rates have an inverse relationship to a benchmark rate. When the benchmark interest rate increases the coupon payment rate will decrease because the benchmark interest rate is deducted from the coupon payment. The Company has generally purchased these securities at a premium. Accelerated prepayments on these securities could result in an economic loss, as the Company would not recover the upfront premium. The premiums are amortized into income using the effective interest rate method. As of September 30, 2015 and September 30, 2014, the Company held \$84.7 million and \$105.7 million, respectively, in Non-Agency RMBS inverse floaters.

The following tables present components of interest income on the Company's MBS and other securities (dollars in thousands):

	For the three months ended September 30, 2015		
	Coupon Interest	Net (Premium Amortization/ Amortization/ Basis) Discount Amortization	Interest Income
Agency RMBS	\$ 26,511	\$ (11,582)	\$ 14,929
Non-Agency RMBS	11,134	(2,294)	8,840
Agency and Non-Agency CMBS	8,049	11	8,060
Other securities	1,923	770	2,693
Total(1)	\$ 47,617	\$ (13,095)	\$ 34,522

(1) Interest income on the Consolidated Statements of Operations includes coupon interest, net premium/discount amortization and interest income of approximately \$1.5 million, \$(371) thousand and \$1.1 million on Residential Whole-Loans, respectively and coupon interest, net premium amortization and interest income of \$171 thousand, \$0 and \$171 thousand on Commercial Whole-Loans.

	For the nine months ended September 30, 2015		
	Coupon Interest	Net (Premium Amortization/ Amortization Basis) Discount Amortization	Interest Income

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

Agency RMBS	\$	98,000	\$	(39,494)	\$	58,506
Non-Agency RMBS		34,436		(6,602)		27,834
Agency and Non-Agency CMBS		22,403		536		22,939
Other securities		4,729		1,864		6,593
Total(1)	\$	159,568	\$	(43,696)	\$	115,872

(1) Interest income on the Consolidated Statements of Operations includes coupon interest, net premium/discount amortization and interest income of approximately \$1.8 million, \$(483) thousand and \$1.4 million on Residential Whole-Loans, respectively and coupon interest, net premium amortization and interest income of \$424 thousand, \$0 and \$424 thousand on Commercial Whole-Loans.

Table of Contents

For the three months ended September 30, 2014				
		Net (Premium Amortization/ Amortization Basis)		
	Coupon Interest	Discount Amortization	Interest Income	
Agency RMBS	\$ 40,245	\$ (15,373)	\$ 24,872	
Non-Agency RMBS	11,177	(1,376)	9,801	
Agency and Non-Agency CMBS	6,327	(1,407)	4,920	
Other securities	1,033	92	1,125	
Total	\$ 58,782	\$ (18,064)	\$ 40,718	

For the nine months ended September 30, 2014				
		Net (Premium Amortization/ Amortization Basis)		
	Coupon Interest	Discount Amortization	Interest Income	
Agency RMBS	\$ 114,703	\$ (41,373)	\$ 73,330	
Non-Agency RMBS	24,579	(1,282)	23,297	
Agency and Non-Agency CMBS	10,069	(940)	9,129	
Other securities	2,663	333	2,996	
Total	\$ 152,014	\$ (43,262)	\$ 108,752	

The following tables present the sales of the Company's MBS and other securities (dollars in thousands):

For the three months ended September 30, 2015					
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)	
Agency RMBS	\$ 421,351	\$ 3,036	\$ (4,096)	\$ (1,060)	
Non-Agency RMBS	25,663	1,305		1,305	
Agency and Non-Agency CMBS	55,637	772	(71)	701	
Other securities	760,199	59	(2,861)	(2,802)	
Total	\$ 1,262,850	\$ 5,172	\$ (7,028)	\$ (1,856)	

(1) Includes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$5.3 million, gross realized gains of \$628 thousand and gross realized losses of \$2 thousand.

For the nine months ended September 30, 2015					
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)	
Agency RMBS (1)	\$ 931,332	\$ 6,869	\$ (7,673)	\$ (804)	
Non-Agency RMBS	233,257	11,066	(174)	10,892	
Agency and Non-Agency CMBS	146,525	2,123	(80)	2,043	
Other securities	776,564	621	(2,861)	(2,240)	
Total	\$ 2,087,678	\$ 20,679	\$ (10,788)	\$ 9,891	

(1) Includes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$5.3 million, gross realized gains of \$626 thousand and gross realized losses of \$2 thousand.

	Proceeds	For the three months ended September 30, 2014			Net Gain (Loss)
		Gross Gains	Gross Losses		
Agency RMBS (1)	\$ 268,694	\$ 2,557	\$ (4,865)	\$ (2,308)	
Non-Agency RMBS	155,366	6,257	(414)	5,843	
Agency and Non-Agency CMBS	87,844	1,786	(20)	1,766	
Other securities					
Total	\$ 511,904	\$ 10,600	\$ (5,299)	\$ 5,301	

(1) Includes proceeds for Agency CMBS Interest-Only Strips, accounted for as derivatives, of approximately \$3.7 million, gross realized gains of \$389 thousand and gross realized losses of \$0 thousand.

Table of Contents

	For the nine months ended September 30, 2014			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS (1)	\$ 1,605,046	\$ 11,570	\$ (40,934)	\$ (29,364)
Non-Agency RMBS	395,456	19,759	(995)	18,764
Agency and Non-Agency CMBS(2)	160,904	2,153	(22)	2,131
Other securities	78,932	5,064		5,064
Total	\$ 2,240,338	\$ 38,546	\$ (41,951)	\$ (3,405)

(1) Includes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$31.4 million, gross realized gains of \$437 thousand and gross realized losses of approximately \$1.6 million.

(2) Includes proceeds for Agency CMBS Interest-Only Strips, accounted for as derivatives, of approximately \$3.7 million, gross realized gains of \$389 thousand and gross realized losses of approximately \$0.

Note 6 Variable Interest Entities

The Company consolidates a VIE when it is determined that the Company is the primary beneficiary of such VIE. The Company determined that it was the primary beneficiary of a number of trusts because it was involved in certain aspects of the design of each trust, has certain oversight rights on defaulted Residential Whole-Loans and has other significant decision making powers. In addition, the Company has the obligation to absorb losses and the right to receive benefits from the trusts that could potentially be significant to the trusts. The Company assesses modifications to VIEs on an ongoing basis to determine if a significant reconsideration event has occurred that would change the Company's initial consolidation assessment. The consolidated trusts hold 352 performing Residential Whole-Loans, which had no evidence of deteriorated credit quality upon consolidation. The following table presents a summary of the assets and liabilities of the Residential Whole-Loan trusts included in the Consolidated Balance Sheets as of September 30, 2015 and December 31, 2014 (dollars in thousands). Intercompany balances have been eliminated for purposes of this presentation.

	September 30, 2015		December 31, 2014	
Residential Whole-Loans, at fair value	\$	150,486	\$	7,220
Accrued interest receivable		1,159		40
Total assets	\$	151,645	\$	7,260
Accounts payable and accrued expenses	\$	5	\$	153
Total liabilities	\$	5	\$	153

The Company's risk with respect to its investment in each trust is limited to its direct ownership in the trust. The Residential Whole-Loans held by the consolidated trusts are held solely to satisfy the liabilities of the trust, and creditors of the trust have no recourse to the general credit of the Company for the trust certificates issued by the trusts. The assets of a consolidated trust can only be used to satisfy the obligations of that trust. The Company is not contractually required and has not provided any additional financial support to the trusts for the three and nine months ended September 30, 2015. The Company did not deconsolidate any trusts during the three and nine months ended September 30, 2015.

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

The following table presents in the components of the carrying value of Residential Whole-Loans as of September 30, 2015 and December 31, 2014 (dollars in thousands):

	September 30, 2015		December 31, 2014	
Principal balance	\$	145,385	\$	7,034
Unamortized premium		2,030		111
Unamortized discount		(122)		(18)
Gross unrealized gains		3,193		94
Gross unrealized losses				(1)
Fair value	\$	150,486	\$	7,220

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

Table of Contents

The following tables present certain information about the Company's Residential Whole-Loans investment portfolio at September 30, 2015 and December 31, 2014 (dollars in thousands):

Current Coupon Rate	Number of Loans	Principal Balance	September 30, 2015			
			Weighted Average Original Loan to Value	Weighted Average Original FICO Score(1)	Weighted Average Life to Maturity (years)	Weighted Average Coupon Rate
4.01 5.00%	48	\$ 14,509	57.6%	728	1.7	4.8%
5.01 6.00%	292	125,987	55.2%	729	1.6	5.1%
6.01 7.00%	12	4,889	69.1%	722	1.5	6.0%
Total	352	\$ 145,385	55.9%	728	1.6	5.1%

(1) The original FICO score is not available for 101 loans with a principal balance of approximately \$38.9 million at September 30, 2015. The Company has excluded those loans from the weighted average computation.

Current Coupon Rate	Number of Loans	Principal Balance	December 31, 2014			
			Weighted Average Original Loan to Value	Weighted Average Original FICO Score	Weighted Average Life to Maturity (years)	Weighted Average Coupon Rate
4.01 5.00%	5	\$ 3,387	63.8%	744	4.2	4.8%
5.01 6.00%	3	1,001	74.0%	742	3.0	5.8%
6.01 7.00%	7	2,044	70.6%	713	4.1	6.6%
7.01 8.00%	3	381	66.6%	669	4.4	7.3%
8.01 9.00%	1	221	75.0%	665	2.1	8.5%
Total	19	\$ 7,034	67.7%	728	3.9	5.7%

The following tables present the U.S. states in which the collateral securing our Residential Whole-Loans at September 30, 2015 and December 31, 2014 based on principal balance is located (dollars in thousands):

	September 30, 2015	
	State Concentration	Principal Balance
California	84.6%	123,016
Washington	6.4	9,374
Massachusetts	5.6	8,147
Georgia	1.2	1,696
Florida	0.9	1,329
Other	1.3	1,823
Total	100.0%	\$ 145,385

	December 31, 2014	
	State Concentration	Principal Balance
California	58.1%	\$ 4,085
Florida	23.8	1,675
West Virginia	9.2	649

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

New Jersey	4.7		327
Virginia	2.1		149
Pennsylvania	2.1		149
Total	100.0%	\$	7,034

Note 7 Commercial Whole-Loans, at fair value

The Company acquired its first Commercial Whole-Loan, with a loan to value of 67% at acquisition during the first quarter 2015 which was subsequently paid off in full during the third quarter 2015. The Commercial Whole-Loan was a performing first mortgage loan with collateral located in California and with a maturity of January 2016.

Table of Contents**Note 8 Borrowings under Repurchase Agreements**

As of September 30, 2015, the Company had master repurchase agreements with 27 counterparties. As of September 30, 2015, the Company had borrowings under repurchase agreements with 19 counterparties. One of the Company's existing repurchase agreement counterparties and its affiliate has communicated their intention to exit the repurchase market in 2015. The Company had no outstanding borrowings with these two counterparties as of September 30, 2015. The following tables summarize certain characteristics of the Company's repurchase agreements at September 30, 2015 and December 31, 2014 (dollars in thousands):

Securities Pledged	Repurchase Agreement Borrowings	September 30, 2015 Weighted Average Interest Rate on Borrowings Outstanding at end of period	Weighted Average Remaining Maturity (days)
Agency RMBS	\$ 2,012,976	0.54%	38
Non-Agency RMBS	386,779	1.71%	46
Agency and Non-Agency CMBS	367,727	1.67%	37
Other securities and Residential Whole-Loans(1)	242,786	2.04%	50
Total	\$ 3,010,268	0.95%	40

(1) Includes repurchase agreement borrowings of \$118.4 million on Residential Whole-Loans owned through trust certificates. The trust certificates are eliminated upon consolidation.

Securities Pledged	Repurchase Agreement Borrowings	December 31, 2014 Weighted Average Interest Rate on Borrowings Outstanding at end of period	Weighted Average Remaining Maturity (days)
Agency RMBS	\$ 2,994,351	0.40%	32
Non-Agency RMBS	473,942	1.54%	49
Agency and Non-Agency CMBS	325,864	1.55%	29
Other securities and Residential Whole-Loans(1)	81,564	1.55%	34
Total	\$ 3,875,721	0.66%	34

(1) Includes repurchase agreement borrowings of \$4.9 million on Residential Whole-Loans owned through trust certificates. The trust certificates are eliminated upon consolidation.

For the three and nine months ended September 30, 2015, the Company had average borrowings under its repurchase agreements of approximately \$3.1 billion and \$3.5 billion, respectively, had a maximum month-end balance during the periods of approximately \$3.1 billion and \$4.0 billion, respectively. The Company had accrued interest payable at September 30, 2015 of approximately \$2.8 million. For the three and nine months ended September 30, 2014, the

Company had average borrowings under its repurchase agreements of approximately \$4.0 billion and \$3.6 billion, respectively, and had a maximum month-end balance during the three and nine months ended of approximately \$4.2 billion and \$4.2 billion, respectively. In addition, at September 30, 2015, the Company had entered into repurchase agreement borrowings of approximately \$12.4 million, which settled on October 2, 2015, with a weighted average interest rate of 1.63%, a weighted average contractual maturity of 96 days and secured by collateral of approximately \$15.5 million. These borrowings are recorded as a liability in the Company's Consolidated Balance Sheets when settled.

The repurchase agreements bear interest at a contractually agreed-upon rate and typically have terms ranging from one month to three months. The Company's repurchase agreement borrowings are accounted for as secured borrowings when the Company maintains effective control of the financed assets. Under the repurchase agreements, the respective lenders retain the right to determine the fair value of the underlying collateral. A reduction in the value of pledged assets requires the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, and is referred to as a margin call. The inability of the Company to post adequate collateral for a margin call by a counterparty, in a timeframe as short as the close of the same business day, could result in a condition of default under the Company's repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by the Company, which may have a material adverse effect on the Company's financial position, results of operations and cash flows. During 2015 and 2014, the Company rehypothecated pledged U.S. Treasury securities it received from its repurchase agreement and interest rate swap counterparties as incremental collateral in order to increase the Company's cash position. The maximum amount of repurchase borrowings for the rehypothecated U.S. Treasury securities was \$0 and \$530 thousand during the three and nine months ended September 30, 2015 and \$0 during the three and nine months ended September 30, 2014, respectively. At September 30, 2015 and September 30, 2014, the Company did not have any rehypothecated U.S. Treasury securities.

Volatility in the mortgage markets may create additional stress on the overall liquidity of the Company due to the long-term nature of its assets and the short-term nature of its liabilities. In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, the Company could be required to sell assets, possibly even at a loss, to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on the Company's financial position, results of operations and cash flows. All of the Company's repurchase agreement counterparties are either U.S. financial institutions or the U.S. broker-dealer subsidiaries of foreign financial institutions.

Table of Contents

Further, if the Company is unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms it may have a material adverse effect on the Company's financial position, results of operations and cash flow, due to the long term nature of the Company's investments and relatively short-term maturities of the Company's repurchase agreements. Certain of the repurchase agreements provide the counterparty with the right to terminate the agreement if the Company does not maintain certain equity and leverage metrics, the most restrictive of which include a limit on leverage based on the composition of the Company's portfolio. The Company was in compliance with the terms of such financial tests as of September 30, 2015, except for such financial tests with respect to one counterparty as of that date. On November 6, 2015, the Company received a waiver of the condition of default effective as of September 30, 2015, from the counterparty. Accordingly, the Company is now in compliance with such financial tests and the scheduled maturity of the outstanding borrowings under the agreement has not been accelerated.

At September 30, 2015 and December 31, 2014, repurchase agreements collateralized by MBS and other securities had the following remaining maturities:

(dollars in thousands)	September 30, 2015	December 31, 2014
Overnight	\$	\$
1 to 29 days	1,551,368	2,034,282
30 to 59 days	605,537	1,302,439
60 to 89 days	805,552	484,109
90 to 119 days	12,968	40,127
Greater than or equal to 120 days	34,843	14,764
Total	\$ 3,010,268	\$ 3,875,721

As discussed in Note 3, for any transactions determined to be linked through December 31, 2014, the initial transfer and repurchase financing will be recorded as a forward commitment to purchase assets. At December 31, 2014, the Company had repurchase agreements of approximately \$31.9 million that were accounted for as linked transactions. Linked repurchase agreements are not included in the tables above. See Note 10 for details.

At September 30, 2015, the following table reflects amounts of collateral at risk under its repurchase agreements greater than 10% of the Company's equity with any counterparty (dollars in thousands):

Counterparty	Amount of Collateral at Risk, at fair value	September 30, 2015 Weighted Average Remaining Maturity (days)	Percentage of Stockholders Equity
Credit Suisse Securities (USA) LLC	\$ 107,368	45	19.3%
RBC (Barbados) Trading Bank Corporation	106,684	46	19.2
UBS Securities LLC	79,105	47	14.2

Note 9 Collateral Positions

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

The following tables summarize the Company's collateral positions, with respect to its borrowings under repurchase agreements, derivatives and clearing margin account at September 30, 2015 and December 31, 2014 (dollars in thousands):

	September 30, 2015		
	Assets Pledged- Fair Value	Accrued Interest	Fair Value of Assets Pledged and Accrued Interest
Assets pledged for borrowings under repurchase agreements:			
Agency RMBS	\$ 2,118,025	\$ 8,743	\$ 2,126,768
Non-Agency RMBS	546,016	1,100	547,116
Agency and Non-Agency CMBS	504,514	3,112	507,626
Other securities (1)	325,614	1,380	326,994
Cash (2)	21,895		21,895
Cash collateral for derivatives (2):	214,630		214,630
Total	\$ 3,730,694	\$ 14,335	\$ 3,745,029

(1) Other securities include the fair value of Residential Whole-Loans owned through trust certificates pledged of \$150.5 million as of September 30, 2015.

(2) Cash posted as collateral is included in Due from counterparties on the Company's Consolidated Balance Sheets.

Table of Contents

	December 31, 2014		
	Assets Pledged- Fair Value	Accrued Interest	Fair Value of Assets Pledged and Accrued Interest
Assets pledged for borrowings under repurchase agreements:			
Agency RMBS	\$ 3,158,544	\$ 12,685	\$ 3,171,229
Non-Agency RMBS	670,526	1,511	672,037
Agency and Non-Agency CMBS	431,938	2,077	434,015
Other securities (1)	108,743	144	108,887
Cash (2)	25,727		25,727
Cash collateral for derivatives (2):	159,030		159,030
Total	\$ 4,554,508	\$ 16,417	\$ 4,570,925

(1) Other securities include the fair value of Residential Whole-Loans owned through trust certificates pledged of \$7.2 million as of December 31, 2014.

(2) Cash posted as collateral is included in Due from counterparties on the Company's Consolidated Balance Sheets.

A reduction in the value of pledged assets typically results in the repurchase agreement counterparties, derivative counterparties and clearing margin counterparty initiating a daily margin call. At September 30, 2015 and December 31, 2014, MBS and other securities, including Whole-Loans, held by counterparties as security for repurchase agreements totaled approximately \$3.5 billion and approximately \$4.4 billion, respectively. Cash collateral held by counterparties at September 30, 2015 and December 31, 2014 was approximately \$236.5 million and approximately \$184.8 million, respectively. Cash posted by counterparties at September 30, 2015 and December 31, 2014, was approximately \$14.4 million and approximately \$12.2 million, respectively. In addition, at September 30, 2015 and December 31, 2014, the Company held securities of approximately \$5.6 million and approximately \$530 thousand, respectively, received as collateral from its derivative and repurchase agreement counterparties to satisfy margin requirements. The Company has the ability to repledge collateral received from its derivative and repurchase agreement counterparties.

The Company has an obligation to return U.S. Treasuries pledged under reverse repurchase agreements accounted for as securities borrowing transaction which were subsequently sold by the Company with a fair value of \$757.4 million as of September 30, 2015. The borrowed securities were collateral for payments made by the Company of \$758.5 million, which are presented as a receivable under reverse repurchase agreements on the Consolidated Balance Sheets. The reverse repurchase agreements have a weighted average maturity of 1 day and a weighted average interest rate of 0.10%. The Company did not have any obligation to return securities received as collateral at December 31, 2014.

Note 10 Derivative Instruments

The Company's derivatives currently include interest rate swaps, interest rate swaptions, futures contracts, TBAs, currency swaps and forwards, linked transactions (prior to January 1, 2015) and Agency and Non-Agency Interest-Only Strips that are classified as derivatives, and options.

Interest rate swaps and interest rate swaptions

The Company is exposed to certain risks arising from both its business operations and economic conditions. Specifically, the Company's primary source of debt funding is repurchase agreements and the Company enters into derivative financial instruments to manage exposure to variable cash flows on portions of its borrowings under those repurchase agreements. Since the interest rates on repurchase agreements typically change with market interest rates such as LIBOR, the Company is exposed to constantly changing interest rates, which accordingly affects cash flows associated with these rates on its borrowings. To mitigate the effect of changes in these interest rates, the Company enters into interest rate swap agreements, which help to mitigate the volatility in the interest rate exposures and their related cash flows. Interest rate swaps generally involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. Notwithstanding the foregoing, in order to manage its hedge position with regard to its liabilities, the Company on occasion will enter into interest rate swaps which involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. The Company also enters into forward starting swaps and interest rate swaptions to help mitigate the effects of changes in interest rates on a portion of its borrowings under repurchase agreements. Interest rate swaptions provide the Company the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and pay and receive interest rates in the future. On occasion the Company may enter into a MAC interest rate swap in which it may receive or make a payment at the time of entering such interest rate swap to compensate for the out of the market nature of such interest rate swap. Similar to all other interest rate swaps, these interest rate swaps are also subject to margin requirements as previously described.

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

Table of Contents

While the Company has not elected to account for its interest rate swap derivative instruments as hedges under GAAP, it does not use interest rate swaps and swaptions for speculative purposes, but rather uses such instruments to manage interest rate risk and views them as economic hedges. Changes in the fair value of derivatives not designated in hedging relationships are recorded directly in earnings together with periodic net interest settlement amounts.

The Company's interest rate swaps, interest rate swaptions, currency swaps and forwards, futures contracts, TBA derivative instruments, options and linked transactions consisted of the following at September 30, 2015 and December 31, 2014 (dollars in thousands):

Derivative Instrument	Accounting Designation	Consolidated Balance Sheets Location	Notional Amount	September 30, 2015	
				Fair Value, excluding accrued interest	Accrued Interest Payable (receivable)
Interest rate swaps, assets	Non-Hedge	Derivative assets, at fair value	\$ 2,634,300	\$ 32,055	\$ (6,596)
Interest rate swaptions, assets	Non-Hedge	Derivative assets, at fair value	1,105,000	3,084	
Foreign currency swaps, asset	Non-Hedge	Derivative assets, at fair value	25,160	7,802	(189)
Foreign currency forward contracts, asset	Non-Hedge	Derivative assets, at fair value	16,089	224	
TBA securities, assets	Non-Hedge	Derivative assets, at fair value	2,400,000	13,820	
Total derivative instruments, assets				56,985	(6,785)
Interest rate swaps, liability	Non-Hedge	Derivative liability, at fair value	5,897,500	(215,525)	18,801
Futures contract, liability	Non-Hedge	Derivative liability, at fair value	6,500	(57)	
Foreign currency forward contracts, liability	Non-Hedge	Derivative liability, at fair value	5,600	(74)	
TBA securities, liabilities	Non-Hedge	Derivative liability, at fair value	1,800,000	(11,502)	
Total derivative instruments, liabilities				(227,158)	18,801
Total derivative instruments				\$ (170,173)	\$ 12,016

Derivative Instrument	Accounting Designation	Consolidated Balance Sheets Location	Notional Amount	December 31, 2014	
				Fair Value, excluding accrued interest	Accrued Interest Payable (receivable)
Interest rate swaps, assets	Non-Hedge	Derivative assets, at fair value	\$ 3,283,100	\$ 51,170	\$ (6,718)
Interest rate swaptions, assets	Non-Hedge	Derivative assets, at fair value	105,000	178	
Futures contracts, assets	Non-Hedge	Derivative assets, at fair value	592,000	451	
Foreign currency swaps, asset	Non-Hedge	Derivative assets, at fair value	25,160	3,857	
Foreign currency forward contracts, asset	Non-Hedge	Derivative assets, at fair value	23,822	143	
TBA securities, assets	Non-Hedge	Derivative assets, at fair value	2,915,000	17,457	
Total derivative instruments, assets				73,256	(6,718)
Interest rate swaps, liability	Non-Hedge	Derivative liability, at fair value	4,648,870	(166,288)	11,490
Futures contract, liability	Non-Hedge	Derivative liability, at fair value	592,000	(1,191)	
Foreign currency forward contracts, liability	Non-Hedge	Derivative liability, at fair value	33,560	(446)	
TBA securities, liabilities	Non-Hedge	Derivative liability, at fair value	2,590,000	(12,355)	
Total derivative instruments, liabilities				(180,280)	11,490
Linked transactions (1)	Non-Hedge	Linked transactions, net, at fair value	54,117	20,627	(400)

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

Total derivative instruments	\$	(86,397)	\$	4,372
------------------------------	----	----------	----	-------

(1) Notional amount represents the current face of the securities comprising the linked transactions.

Table of Contents

The following tables summarize the average fixed pay rate and average maturity for the Company's interest rate swaps as of September 30, 2015 and December 31, 2014 (excludes interest rate swaptions) (dollars in thousands):

September 30, 2015						
Remaining Interest Rate Swap Term	Notional Amount	Fair Value (Liability), net	Asset	Average Fixed Pay Rate	Average Maturity (Years)	Forward Starting
1 year or less	\$ 1,015,300	\$	(1,006)	0.6%	0.6	%
Greater than 1 year and less than 3 years	1,491,800		(8,193)	1.0	1.6	
Greater than 3 years and less than 5 years	1,204,500		(30,551)	1.9	4.8	
Greater than 5 years	1,881,300		(172,834)	3.0	10.3	51.1
Total	\$ 5,592,900	\$	(212,584)	1.8%	5.0	17.2%

December 31, 2014						
Remaining Interest Rate Swap Term	Notional Amount	Fair Value (Liability), net	Asset	Average Fixed Pay Rate	Average Maturity (Years)	Forward Starting
1 year or less	\$ 89,300	\$	(111)	0.5%	0.9	%
Greater than 1 year and less than 3 years	1,972,300		(733)	0.8	1.8	20.3
Greater than 3 years and less than 5 years	603,000		(4,597)	1.8	4.2	
Greater than 5 years	3,103,770		(156,952)	2.8	9.4	63.1
Total	\$ 5,768,370	\$	(162,393)	2.0%	6.2	40.9%

The Company has entered into swaps to effectively fix the interest rate (for the life of the swap); net of variable-rate payment swaps, of approximately \$2.2 billion of borrowings under its repurchase agreements, excluding forward starting swaps of \$424.7 million.

The following tables summarize the average variable pay-rate and average maturity for the Company's interest rate swaps as of September 30, 2015 and December 31, 2014 (excludes interest rate swaptions) (dollars in thousands):

September 30, 2015						
Remaining Interest Rate interest rate swap Term	Notional Amount	Fair Value (Liability), net	Asset	Average Variable Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 3 years and less than 5 years	\$ 1,735,800	\$	9,249	0.3%	4.8	%
Greater than 5 years	1,203,100		19,865	0.3	11.8	44.6
Total	\$ 2,938,900	\$	29,114	0.3%	7.7	18.3%

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

Table of Contents

December 31, 2014

Remaining Interest Rate interest rate swap Term	Notional Amount	Fair Value (Liability), net	Asset	Average Variable Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 1 years and less than 3 years	\$ 220,000	\$ (164)		0.2%	2.0	%
Greater than 3 years and less than 5 years	634,000		2,210	0.2	4.5	
Greater than 5 years	1,309,600		45,229	0.2	12.1	8.4
Total	\$ 2,163,600	\$ 47,275		0.2%	8.8	5.1%

The Company's agreements with certain of its bilateral interest rate swap counterparties may be terminated at the option of the counterparty and settled at fair value, if the Company does not maintain certain equity and leverage metrics. The most restrictive of which contain provisions which become more restrictive based upon portfolio composition. Through September 30, 2015, the Company was in compliance with the terms of such financial tests.

The following tables present information about the Company's interest rate swaptions as of September 30, 2015 and December 31, 2014 (dollars in thousands):

		Option		September 30, 2015		Underlying Swap	
		Fair Value		Weighted Average Months Until Option Expiration		Notional Amount	Weighted Average Swap Term (Years)
Fixed-Pay Rate for Underlying Swap							
1.76	2.00%	\$	151	0.9	\$	400,000	5.0
2.01	2.25%		22	0.9		100,000	5.0
2.26	2.50%		7	8.8		105,000	1.0
		\$	180	2.3	\$	605,000	4.3

		Option		September 30, 2015		Underlying Swap	
		Fair Value		Weighted Average Months Until Option Expiration		Notional Amount	Weighted Average Swap Term (Years)
Fixed-Receive Rate for Underlying Swap							
1.26	1.50%	\$	2,904	0.9	\$	500,000	5.0
		\$	2,904	0.9	\$	500,000	5.0

		Option		December 31, 2014		Underlying Swap	
		Fair Value		Weighted Average Months Until Option Expiration		Notional Amount	Weighted Average Swap Term (Years)
Fixed-Pay Rate for Underlying Swap							
2.26	2.50%	\$	178	17.8	\$	105,000	1.0
		\$	178	17.8	\$	105,000	1.0

The Company has minimum collateral posting thresholds with certain of its derivative counterparties, including with its clearing broker for cleared swaps, for which it typically pledges cash. The fixed income markets experienced continued market volatility during the three month-ended September 30, 2015, primarily as a result of geopolitical concerns and the timing of when the Federal Reserve will increase short term interest rates. Overall long term interest rates decreased during the three month-ended September 30, 2015. During 2015 and 2014, the Company rehypothecated some of the U.S. Treasury securities it received as incremental collateral on its repurchase borrowings, swaps and swaptions, effectively entering into repurchase agreements with such securities, in order to increase its cash position. The maximum amount of repurchase borrowings for the rehypothecated U.S. Treasury securities was \$530 thousand and \$0 during the nine months ended September 30, 2015 and September 30, 2014, respectively. At September 30, 2015, no U.S. Treasury securities were rehypothecated. As of September 30, 2015 and December 31, 2014, the Company had cash pledged as collateral for derivatives of approximately \$214.6 million and approximately \$159.0 million, respectively, which is reported on the Consolidated Balance Sheets as Due from counterparties. The Company held cash of approximately \$11.3 million and \$10.1 million as collateral against derivatives at September 30, 2015 and December 31, 2014, respectively, which is reported on the Consolidated Balance Sheets as Due to counterparties. As of September 30, 2015, the Company has swaps with two counterparties that are based in England and Switzerland, with fair values in a liability position of approximately \$86 thousand and \$1.5 million and notional balances of \$49.3 million and \$163.9 million, respectively. At December 31, 2014, the Company had swaps with two counterparties that are based in England and Switzerland, with fair values in a liability position of approximately \$86 thousand and fair values in an asset position of \$645 thousand and notional balances of \$49.3 million and \$163.9 million, respectively. Included in the \$214.6 million and \$159.0 million pledged by the Company is cash pledged to the counterparty based in Switzerland of \$2.7 million and \$500 thousand at September 30, 2015 and December 31, 2014, respectively. Included in the \$11.3 million and \$10.1 million received by the Company is cash posted as collateral by the counterparty based in England of approximately \$6.5 million and \$3.4 million at September 30, 2015 and December 31, 2014, respectively.

Table of Contents*Currency Swaps and Forwards*

The Company has invested in and, in the future, may invest in additional securities which are denominated in a currency or currencies other than U.S. dollars. Similarly, it has and may in the future, finance such assets in a currency or currencies other than U.S. dollars. In order to mitigate the impact to the Company, the Company may enter into derivative financial instruments, including foreign currency swaps and foreign currency forwards, to manage fluctuations in the valuation between U.S. dollars and such foreign currencies. Foreign currency swaps involve the payment of a foreign currency at fixed interest rate on a fixed notional amount and the receipt of U.S. dollars at a fixed interest rate on a fixed notional amount. Foreign currency forwards provide for the payment of a fixed amount of a foreign currency in exchange for a fixed amount of U.S. dollars at a date certain in the future. The carrying value of foreign currency swaps and forwards is included in Derivative assets (liabilities), at fair value on the Consolidated Balance Sheets with changes in valuation included in Gain (loss) on derivative instruments, net on the Consolidated Statement of Operations. The following is a summary of the Company's foreign currency forwards at September 30, 2015 and December 31, 2014 (dollars and euros in thousands):

Derivative Type	September 30, 2015			
	Notional Amount	Notional (USD Equivalent)	Maturity	Fair Value
Buy EUR/Sell USD currency forward	11,000	\$ 12,058	October 2015	\$ 223
Buy USD/Sell EUR currency forward	3,610	4,031	October 2015	1
Currency forwards, assets	14,610	\$ 16,089	n/a	\$ 224
Buy USD/Sell EUR currency forward	5,083	\$ 5,600	October 2015	\$ (74)
Currency forwards, liabilities	5,083	\$ 5,600	n/a	\$ (74)
Total currency forwards	19,693	\$ 21,689	n/a	\$ 150

Derivative Type	December 31, 2014			
	Notional Amount	Notional (USD Equivalent)	Maturity	Fair Value
Buy USD/Sell EUR currency forward	3,331	\$ 4,143	January 2015	\$ 112
Buy USD/Sell EUR currency forward	7,766	9,417	January 2015	21
Buy USD/Sell EUR currency forward	3,471	4,211	February 2015	9
Buy EUR/Sell USD currency forward	5,000	6,051	January 2015	1
Currency forwards, assets	19,568	\$ 23,822	n/a	\$ 143
Buy USD/Sell EUR currency forward	5,043	\$ 6,104	February 2015	\$ (1)
Buy EUR/Sell USD currency forward	11,156	13,542	April 2015	(30)
Buy EUR/Sell USD currency forward	11,156	13,914	January 2015	(415)
Currency forwards, liabilities	27,355	\$ 33,560	n/a	\$ (446)
Total currency forwards	46,923	\$ 57,382	n/a	\$ (303)

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

Table of Contents

The following is a summary of the Company's foreign currency swaps with a fair value of \$7.8 million and \$3.9 million at September 30, 2015 and December 31, 2014, respectively (dollars and euros in thousands):

	Date entered	Maturity	Fixed Rate	Denomination	Notional Amount
Payer	June 2014	July 2024	7.25%	EUR	18,500
Receiver	June 2014	July 2024	9.005%	USD	25,160

Interest-Only Strips

The Company also invests in Interest-Only Strips. In determining the classification of its holdings of Interest-Only Strips, the Company evaluates the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Generally, Interest-Only Strips for which the security represents a strip off of a mortgage pass through security will be considered a hybrid instrument classified as a MBS investment on the Consolidated Balance Sheets utilizing the fair value option. Alternatively, those Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives at fair value with changes recognized in Gain (loss) on derivative instruments, net in the Consolidated Statements of Operations, along with any interest received. The carrying value of these Interest-Only Strips is included in Mortgage-backed securities on the Consolidated Balance Sheets.

To-be-announced securities

The Company has also purchased or sold TBAs. As of September 30, 2015 and December 31, 2014, the Company had contracts to purchase (long position) and sell (short position) TBAs on a forward basis. Following is a summary of the Company's long and short TBA positions reported in Derivative assets, at fair value on the Consolidated Balance Sheets as of September 30, 2015 and December 31, 2014 (dollars in thousands):

	September 30, 2015		December 31, 2014	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Purchase contracts, asset	\$ 2,400,000	\$ 13,820	\$ 2,915,000	\$ 17,457
TBA securities, asset	2,400,000	13,820	2,915,000	17,457
Sale contracts, liability	(1,800,000)	(11,502)	(2,590,000)	(12,355)
TBA securities, liability	(1,800,000)	(11,502)	(2,590,000)	(12,355)
TBA securities, net	\$ 600,000	\$ 2,318	\$ 325,000	\$ 5,102

The following table presents additional information about the Company's contracts to purchase and sell TBAs for the nine months ended September 30, 2015 (dollars in thousands):

Notional Amount as of December 31, 2014	Additions	Settlement, Termination, Expiration or Exercise	Notional Amount as of September 30
---	-----------	---	------------------------------------

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

						2015		
Purchase of TBAs	\$	2,915,000	\$	27,526,000	\$	(28,041,000)	\$	2,400,000
Sale of TBAs	\$	2,590,000	\$	27,251,000	\$	(28,041,000)	\$	1,800,000

Futures Contracts

The Company also enters into Eurodollar and U.S. Treasury futures. As of September 30, 2015, the Company had entered into contracts to sell (short position) U.S. Treasuries with a notional amount of \$6.5 million, a fair value in a liability position of \$57 thousand and an expiration date of December 2015. As of December 31, 2014, the Company had purchase contracts (long position) for Eurodollar futures, representing a notional amount of \$592.0 million with a fair value of \$451 thousand and an expiration date of June 2016. In addition, as of December 31, 2014, the Company had sale contracts (short position) for Eurodollar futures, representing a notional amount of \$592.0 million with a fair value in a liability position of \$1.2 million and an expiration date of June 2018. During the nine months ended September 30, 2015, the Company terminated both Eurodollar futures and realized a net loss of \$459 thousand.

Table of Contents*Gain (loss) on derivative instruments*

The below tables summarize the effect of interest rate swaps, interest rate swaptions, foreign currency swaps, foreign currency forwards, options, futures contracts, Agency and Non-Agency Interest-Only Strips characterized as derivatives and TBAs reported in Gain (loss) on derivative instruments, net on our Consolidated Statements of Operations for the three and nine months ended September 30, 2015 and September 30, 2014 (dollars in thousands):

Description	Three months ended September 30, 2015					Total
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to-market adjustments		
Interest rate swaps	\$ 28,291	\$ (5,561)	\$ 337	\$ (64,701)	\$ (41,634)	
Interest rate swaptions	(150)			71	(79)	
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	626	5,437	(4,164)	(1,799)	100	
Options	684				684	
Futures contracts	(168)			(38)	(206)	
Foreign currency forwards	(134)			114	(20)	
Foreign currency swaps		190		652	842	
TBAs	(8,205)			7,155	(1,050)	
Total	\$ 20,944	\$ 66	\$ (3,827)	\$ (58,546)	\$ (41,363)	

Description	Nine months ended September 30, 2015					Total
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to-market adjustments		
Interest rate swaps	\$ 18,729	\$ (11,871)	\$ 1,075	\$ (83,209)	\$ (75,276)	
Interest rate swaptions	(3,873)			(72)	(3,945)	
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	624	16,700	(12,877)	(1,966)	2,481	
Options	684				684	
Futures contracts	(627)			683	56	
Foreign currency forwards	(980)			452	(528)	
Foreign currency swaps		585		3,944	4,529	
TBAs	(1,728)			(2,784)	(4,512)	
Total	\$ 12,829	\$ 5,414	\$ (11,802)	\$ (82,952)	\$ (76,511)	

Description	Three months ended September 30, 2014, as Revised (See Note 2)					Total
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Basis Recovery	Mark-to-market adjustments		
Interest rate swaps	\$ 23,798	\$ (11,848)	\$ 820	\$ (15,587)	\$ (2,817)	
Interest rate swaptions				(624)	(624)	
Agency and Non-Agency Interest-Only Strips	389	5,723	(4,187)	(915)	1,010	

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

accounted for as derivatives					
Options				(340)	(340)
Futures contracts				(200)	(200)
Foreign currency forwards	(1,182)			57	(1,125)
Foreign currency swaps		140		2,057	2,197
TBAs	2,608			(1,110)	1,498
Total	\$ 25,613	\$ (5,985)	\$ (3,367)	\$ (16,662)	\$ (401)

Description	Nine months ended September 30, 2014, as Revised (See Note 2)					Total
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Basis Recovery	Mark-to-market adjustments		
Interest rate swaps	\$ 17,012	\$ (25,784)	\$ 928	\$ (123,026)	\$ (130,870)	
Interest rate swaptions	(5,908)			(5,615)	(11,523)	
Agency and Non-Agency Interest-Only Strips						
accounted for as derivatives	(755)	20,288	(14,286)	(332)	4,915	
Options				(340)	(340)	
Futures contracts	(16,495)			(311)	(16,806)	
Foreign currency forwards	(1,182)			(81)	(1,263)	
Foreign currency swaps		141		2,072	2,213	
TBAs	25,169			1,521	26,690	
Total	\$ 17,841	\$ (5,355)	\$ (13,358)	\$ (126,112)	\$ (126,984)	

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

Table of Contents*Linked Transactions*

Starting in 2015, GAAP no longer requires the segregation and treatment of linked transactions as derivatives. Accordingly, beginning January 1, 2015, the Company reports such assets and the corresponding repurchase agreements on a gross basis on its Consolidated Balance Sheets with the corresponding interest income and interest expense reported in its Consolidated Statements of Operations. See *Recent accounting pronouncements* for details. Prior to January 1, 2015, when the initial transfer of a financial asset and repurchase financing were entered into contemporaneously with, or in contemplation of, one another, the transaction was considered linked unless all of the criteria found in the applicable accounting guidance were met at the inception of the transaction. If the transaction was determined to be linked, the Company recorded the initial transfer and repurchase financing on a net basis and recorded a forward commitment to purchase assets as a derivative instrument with changes in market value being recorded in the Gain (loss) on linked transactions, net on the Consolidated Statements of Operations. While linked transactions were treated as derivatives for GAAP through December 31, 2014, the fair value of linked transactions reflects the value of the underlying security's fair market value netted with the respective linked repurchase agreement borrowings.

The following tables present certain information related to the securities and repurchase agreements accounted for as part of linked transaction which is reported in Gain (loss) on linked transactions, net on the Consolidated Statements of Operations for the three and nine months ended September 30, 2014 (dollars in thousands):

Instrument	Fair Value(2)	For the three months ended September 30, 2014					Weighted Average Coupon / Cost of Funds(2)	Weighted Average Life (years)/ Weighted Average days to Maturity(2)
		Net Interest Income(1) (Expense)	Mark-to-market adjustments on linked transactions	Net Realized Gain (loss)	Gain (loss) on linked transactions, net			
Non-Agency RMBS	\$ 8,507	\$ 249	\$ (171)	\$ 299	\$ 377	27.78%	12.1 years	
Non-Agency CMBS, including Non U.S.	23,370	422	(1,959)		(1,537)	7.25%	8.8 years	
Other securities	5,690	251	(1)	(192)	58	4.50%	10.2 years	
Non-Agency Repurchase Agreement	(6,788)	(45)			(45)	1.55%	17 days	
CMBS Repurchase Agreement, including Non U.S.	(14,022)	(75)			(75)	1.98%	38 days	
Other securities Repurchase Agreement	(2,840)	(19)			(19)	1.93%	38 days	
Linked transactions, net, at fair value	\$ 13,917	\$ 783	\$ (2,131)	\$ 107	\$ (1,241)	n/a	n/a	

(1) Net interest income includes amortization of premium of approximately \$423 thousand for Non-Agency RMBS and \$0 for Non-Agency CMBS and accretion of \$203 thousand for other securities.

(2) Includes information only for linked transactions at September 30, 2014.

Table of Contents

Instrument	Fair Value(2)	For the nine months ended September 30, 2014					Weighted Average Coupon / Cost of Funds(2)	Weighted Average Life (years)/ Weighted Average days to Maturity(2)
		Net Interest Income(1) (Expense)	Mark-to-market adjustments on linked transactions	Net Realized Gain (loss)	Gain (loss) on linked transactions, net			
Non-Agency RMBS	\$ 8,507	\$ 1,423	\$ 353	\$ 1,589	\$ 3,365	27.78%	12.1 years	
Non-Agency CMBS, including Non U.S.	23,370	427	(1,770)	(1,343)		7.25%	8.8 years	
Other securities	5,690	251	(1)	(192)	58	4.50%	10.2 years	
Non-Agency Repurchase Agreement	(6,788)	(319)			(319)	1.55%	17 days	
CMBS Repurchase Agreement, including Non U.S.	(14,022)	(76)			(76)	1.98%	38 days	
Other securities Repurchase Agreement	(2,840)	(19)			(19)	1.93%	38 days	
Linked transactions, net, at fair value	\$ 13,917	\$ 1,687	\$ (1,418)	\$ 1,397	\$ 1,666	n/a	n/a	

(1) Net interest income includes amortization of premium of approximately \$3.1 million for Non-Agency RMBS and \$0 for Non-Agency CMBS and accretion of \$203 thousand for other securities.

(2) Includes information only for linked transactions at September 30, 2014.

At December 31, 2014, the Company pledged MBS and other securities accounted for as linked transactions with a fair value of approximately \$52.5 million as collateral for the related linked repurchase agreements. The Company reduces credit risk on the majority of its derivative instruments by entering into agreements that permit the closeout and netting of transactions with the same counterparty upon occurrence of certain events.

Note 11 Offsetting Assets and Liabilities

The following tables present information about certain assets and liabilities that are subject to master netting agreements (or similar agreements) and can potentially be offset on the Company's Consolidated Balance Sheets at September 30, 2015 and December 31, 2014:

Offsetting of Derivative Assets

As of September 30, 2015

Gross	Gross Amounts	Net Amounts of Assets	Gross Amounts Not Offset in the Consolidated Balance
-------	---------------	-----------------------	--

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

\$s in thousands Description	Amounts of Recognized Assets	Offset in the Consolidated Balance Sheets	presented in the Consolidated Balance Sheets	Financial Instruments (1)	Sheets Cash Collateral Received	Net Amount
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives included in MBS	\$ 68,730	\$	\$ 68,730	\$ (63,716)	\$	\$ 5,014
Derivative asset, at fair value(2)	56,985		56,985	(35,693)	(11,252)	10,040
Receivable under reverse repurchase agreements	758,467		758,467	(757,353)		1,114
Total	\$ 884,182	\$	\$ 884,182	\$ (856,762)	\$ (11,252)	\$ 16,168

Table of Contents**Offsetting of Derivative Liabilities and Repurchase Agreements**

As of September 30, 2015

\$s in thousands Description	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		Net Amount
				Financial Instruments (1)	Cash Collateral Pledged(1)	
Derivative liability, at fair value(2)(3)	\$ 227,158	\$	\$ 227,158	\$ (35,693)	\$ (183,526)	\$ 7,939
Repurchase Agreements(4)	3,010,268		3,010,268	(3,010,268)		
	\$ 3,237,426	\$	\$ 3,237,426	\$ (3,045,961)	\$ (183,526)	\$ 7,939

(1) Amounts disclosed in the Financial Instruments column of the tables above represent securities and Whole-Loans collateral pledged and derivative assets that are available to be offset against liability balances associated with repurchase agreement and derivative liabilities. Amounts disclosed in the Cash Collateral Pledged column of the tables above represents amounts pledged as collateral against derivative transactions.

(2) Derivative asset, at fair value and Derivative liability, at fair value includes interest rate swaps, interest rate swaptions, mortgage put options, currency forwards, futures contracts and TBAs.

(3) Cash collateral pledged against the Company's derivative counterparties was approximately \$214.6 million as of September 30, 2015.

(4) The fair value of securities pledged against the Company's repurchase agreements was approximately \$3.5 billion as of September 30, 2015.

Offsetting of Derivative Assets

As of December 31, 2014

\$s in thousands Description	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets presented in the Consolidated Balance Sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		Net Amount
				Financial Instruments (1)	Cash Collateral Received	
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives included in MBS	\$ 88,229	\$	\$ 88,229	\$ (80,771)	\$	\$ 7,458

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

Derivative asset, at fair value(2)	73,256		73,256	(53,256)	(10,036)	9,964
Linked transactions, net, at fair value	52,484	(31,857)	20,627			20,627
Total	\$ 213,969	\$ (31,857)	\$ 182,112	\$ (134,027)	\$ (10,036)	\$ 38,049

Offsetting of Derivative Liabilities and Repurchase Agreements

As of December 31, 2014

\$s in thousands Description	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		Net Amount
				Financial Instruments (1)	Cash Collateral Pledged(1)	
Derivative liability, at fair value(2)(3)	\$ 180,280	\$	\$ 180,280	\$ (53,256)	\$ (116,791)	\$ 10,233
Repurchase Agreements(4)	3,875,721		3,875,721	(3,875,721)		
	\$ 4,056,001	\$	\$ 4,056,001	\$ (3,928,977)	\$ (116,791)	\$ 10,233

(1) Amounts disclosed in the Financial Instruments column of the tables above represent securities and Whole-Loans collateral pledged and derivative assets that are available to be offset against liability balances associated with repurchase agreement and derivative liabilities. Amounts disclosed in the Cash Collateral Pledged column of the tables above represents amounts pledged as collateral against derivative transactions.

(2) Derivative asset, at fair value and Derivative liability, at fair value includes interest rate swaps, interest rate swaptions, mortgage put options, currency forwards, futures contracts and TBAs.

(3) Cash collateral pledged against the Company's derivative counterparties was approximately \$159.0 million as of December 31, 2014.

(4) The fair value of securities pledged against the Company's repurchase agreements was approximately \$4.4 billion as of December 31, 2014.

Table of Contents

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.

Note 12 Related Party Transactions

Management Agreement

In connection with the Company's IPO in May 2012, the Company entered into a management agreement (the "Management Agreement") with the Manager, which describes the services to be provided by the Manager and compensation for such services. The Manager is responsible for managing the Company's operations, including: (i) performing all of its day-to-day functions; (ii) determining investment criteria in conjunction with the Board of Directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of the Company's Board of Directors. Pursuant to the terms of the Management Agreement, the Manager is paid a management fee equal to 1.50% per annum of the Company's stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, stockholders' equity means the sum of the net proceeds from any issuances of the Company's equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of the Company's shares of common stock, excluding any unrealized gains, losses or other non-cash items, including OTTI charges included in other loss on MBS, other securities and Whole-Loans; unrealized gain (loss) on MBS, other securities and Whole-Loans, net; and the non-cash portion of gain (loss) on derivative instruments, that have impacted stockholder's equity as reported in the Company's consolidated financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between the Manager and the Company's independent directors and after approval by a majority of the Company's independent directors. However, if the Company's stockholders' equity for any given quarter is negative based on the calculation described above, the Manager will not be entitled to receive any management fee for that quarter.

In addition, the Company may be required to reimburse the Manager for certain expenses as described below, and shall reimburse the Manager for the compensation paid to the Company's CFO and controller. Expense reimbursements to the Manager are made in cash on a regular basis. The Company's reimbursement obligation is not subject to any dollar limitation. Because the Manager's personnel perform certain legal, accounting, due diligence tasks and other services that outside professionals or outside consultants otherwise would perform, the Manager may be paid or reimbursed for the documented cost of performing such tasks, provided that such costs and reimbursements are in amounts which are no greater than those which would be payable to outside professionals or consultants engaged to perform such services pursuant to agreements negotiated on an arm's-length basis.

The Management Agreement may be amended, supplemented or modified by agreement between the Company and the Manager. The Management Agreement expires on May 16, 2016. It is automatically renewed for one-year terms on each May 15th unless previously terminated as described below. The Company's independent directors review the Manager's performance and any fees payable to the Manager annually and, the Management Agreement may be terminated annually upon the affirmative vote of at least two thirds (2/3) of the Company's independent directors, based upon: (i) the Manager's unsatisfactory performance that is materially detrimental to the Company; or (ii) the

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

Company's determination that any fees payable to the Manager are not fair, subject to the Manager's right to prevent such termination due to unfair fees by accepting a reduction of management fees agreed to by at least two thirds (2/3) of the Company's independent directors. The Company will provide the Manager 180 days prior notice of any such termination. Unless terminated for cause, the Company will pay the Manager a termination fee equal to three times the average annual management fee earned by the Manager during the prior 24-month period immediately preceding the date of termination, calculated as of the end of the most recently completed fiscal quarter prior to the date of termination.

Table of Contents

The Company may also terminate the Management Agreement at any time, without the payment of any termination fee, with 30 days prior written notice from the Company's Board of Directors for cause, which will be determined by at least two thirds (2/3) of the Company's independent directors, which is defined as: (i) the Manager's continued material breach of any provision of the Management Agreement (including the Manager's failure to comply with the Company's investment guidelines); (ii) the Manager's fraud, misappropriation of funds, or embezzlement against the Company; (iii) the Manager's gross negligence in the performance of its duties under the Management Agreement; (iv) the occurrence of certain events with respect to the bankruptcy or insolvency of the Manager, including an order for relief in an involuntary bankruptcy case or the Manager authorizing or filing a voluntary bankruptcy petition; (v) the Manager is convicted (including a plea of nolo contendere) of a felony; or (vi) the dissolution of the Manager.

For the three and nine months ended September 30, 2015, the Company incurred approximately \$2.8 million and approximately \$8.1 million in management fees, respectively. For the three and nine months ended September 30, 2014, the Company incurred approximately \$2.8 million and \$7.1 million in management fees, respectively. The increase in management fee for the nine months ended September 30, 2015 versus September 30, 2014 is primarily attributable to the follow-on public offering completed in the second quarter of 2014.

In addition to the management fee, the Company is also responsible for reimbursing the Manager for certain expenses paid by the Manager on behalf of the Company, including travel expenses incurred by officers of the Company, and for certain services provided by the Manager to the Company. For the three months and nine months ended September 30, 2015, the Company recorded expenses included in general and administrative expense totaling approximately \$127 thousand and \$921 thousand related to employee costs and benefits associated with the Company's CFO and controller paid by the Manager on behalf of the Company, respectively. For the three and nine months ended September 30, 2014, the Company recorded expenses included in general and administrative expense totaling approximately \$112 thousand and \$521 thousand, respectively related to employee costs and benefits associated with the Company's CFO and controller paid by the Manager on behalf of the Company. Commencing January 1, 2014, the Company reimburses the Manager for the compensation and employee benefits of the Company's CFO and controller. Any such expenses incurred by the Manager and reimbursed by the Company, including the employee compensation expense discussed above, are typically included in the Company's general and administrative expense on its Consolidated Statements of Operations, or may be reflected on the Consolidated Balance Sheets and associated consolidated statement of changes in stockholders' equity, based on the nature of the item. At September 30, 2015 and December 31, 2014, approximately \$2.8 million and \$2.5 million, respectively for management fees incurred but not yet paid was included in Payable to related party on the Consolidated Balance Sheets. In addition, at September 30, 2015 and December 31, 2014, approximately \$37 thousand and \$199 thousand, respectively of costs incurred but not yet paid was included in Payable to related party on the Consolidated Balance Sheets.

Note 13 Share-Based Payments

In conjunction with the Company's IPO and concurrent private placement, the Company's Board of Directors approved the Western Asset Mortgage Capital Corporation Equity Plan (the "Equity Plan") and the Western Asset Manager Equity Plan (the "Manager Equity Plan" and collectively the "Equity Incentive Plans").

On May 15, 2012, the Company granted 51,159 shares of restricted common stock to the Manager under the Manager Equity Plan that is equal to 0.5% of the aggregate number of shares of common stock sold in the IPO and units sold in the concurrent private placement to certain institutional accredited investors. One-third of these restricted shares vested on May 15, 2013, the first anniversary of the grant date, one-third vested on May 15, 2014, the second anniversary of the grant date, and the remaining one-third vested on May 15, 2015 the third anniversary of the grant date.

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

On May 15, 2012, the Company granted a total of 4,500 shares (1,500 each) of restricted common stock under the Equity Plan to the Company's three independent directors. These restricted shares vested in full on May 15, 2013, the first anniversary of the grant date.

On June 25, 2012, the Company granted 10,455 shares of restricted common stock to its chief financial officer under the Equity Plan. One-third of these restricted shares vested on January 1, 2013, one-third vested on January 1, 2014 and the remaining one-third vested on January 1, 2015. As of January 1, 2014, the Company's chief financial officer became an employee of the Manager. As such, the method for recognizing stock based compensation expense for his unvested shares as of such date changed to be accounted for as a non-employee grant subject to subsequent fair value re-measurement.

Table of Contents

On March 1, 2013, the Company granted a total of 150,000 shares of restricted common stock to the Manager under the Manager Equity Plan. One-third of these shares vested on March 1, 2014, one-third of these shares vested on March 1, 2015 and the remaining one-third will vest on March 1, 2016.

On March 1, 2013, the Company granted 10,559 shares of restricted common stock to its chief financial officer under the Equity Plan. One-third of these restricted shares vested on January 1, 2014, one-third vested on January 1, 2015 and the remaining one-third will vest on January 1, 2016. As of January 1, 2014, the Company's chief financial officer became an employee of the Manager. As such, the method for recognizing stock based compensation expense for the remaining unvested shares as of such date changed to be accounted for as a non-employee grant subject to subsequent fair value re-measurement.

On June 10, 2013, the Company granted a total of 4,887 (1,629 each) of restricted common stock under the Equity Plan to the Company's three independent directors. These restricted shares vested in full on June 10, 2014, the first anniversary of the grant date. Each of the independent directors has elected to defer the shares granted to him under the Company's Director Deferred Fee Plan (the Director Deferred Fee Plan). The Director Deferred Fee Plan permits eligible members of the Company's Board of Directors to defer certain stock awards made under its director compensation programs. The Director Deferred Fee Plan allows directors to defer issuance of their stock awards and therefore defer payment of any tax liability until the deferral is terminated, pursuant to the election form executed each year by each eligible director.

On March 12, 2014, the Company granted 200,000 shares of restricted common stock to the Manager under the Manager Equity Plan. One-third of these shares vested on March 1, 2015, one-third will vest on March 1, 2016 and the remaining one-third will vest on March 1, 2017.

On March 12, 2014, the Company granted 15,180 shares of restricted common stock to its chief financial officer under the Equity Plan. One-third of these shares vested on January 1, 2015, one-third will vest on January 1, 2016 and the remaining one-third will vest on January 1, 2017. As of January 1, 2014, the Company's chief financial officer became an employee of the Manager. As such, the stock based compensation expense for the unvested shares as of such date is accounted for as a non-employee grant subject to subsequent fair value re-measurement.

On June 11, 2014, the Company granted a total of 6,264 (2,088 each) of restricted common stock under the Equity Plan to the Company's three independent directors. These restricted shares vested in full on June 11, 2015, the first anniversary of the grant date. Each of the independent directors has elected to defer the shares granted to him under the Company's Director Deferred Fee Plan (the Director Deferred Fee Plan). The Director Deferred Fee Plan permits eligible members of the Company's Board of Directors to defer certain stock awards made under its director compensation programs. The Director Deferred Fee Plan allows directors to defer issuance of their stock awards and therefore defer payment of any tax liability until the deferral is terminated, pursuant to the election form executed each year by each eligible director.

On November 10, 2014, the Company granted 1,334 shares of restricted common stock under the Equity Plan to the Company's new independent director. These restricted shares will vest in full on November 10, 2015, the first anniversary of the grant date.

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

On March 1, 2015, the Company granted 200,000 shares of restricted common stock to the Manager under the Manager Equity Plan. One-third of the shares will vest on March 1, 2016, one-third will vest on March 1, 2017 and the remaining one-third will vest on March 1, 2018.

On June 4, 2015, the Company granted a total of 10,500 (2,625 each) of restricted common stock under the Equity Plan to the Company's four independent directors. These restricted shares will vest in full on June 4, 2016, the first anniversary of the grant date. Each of the independent directors has elected to defer the shares granted to him under the Company's Director Deferred Fee Plan (the "Director Deferred Fee Plan"). The Director Deferred Fee Plan permits eligible members of the Company's board of directors to defer certain stock awards made under its director compensation programs. The Director Deferred Fee Plan allows directors to defer issuance of their stock awards and therefore defer payment of any tax liability until the deferral is terminated, pursuant to the election form executed each year by each eligible director.

Table of Contents

The Equity Incentive Plans include provisions for grants of restricted common stock and other equity-based awards to the Manager, its employees and employees of its affiliates and to the Company's directors, officers and employees. The Company can issue up to 3.0% of the total number of issued and outstanding shares of its common stock (on a fully diluted basis) at the time of each award (other than any shares previously issued or subject to awards made pursuant to one of the Company's Equity Incentive Plans) under these Equity Incentive Plans. At May 15, 2012, there were 308,335 shares of common stock initially reserved for issuance under the Equity Incentive Plans. Upon the completion of the October 3, 2012 follow-on common stock offering, the stock portion of the Company's dividend declared December 19, 2013, and the April 9, 2014 follow-on offering (which includes the partial exercise of the greenshoe on May 7, 2014) and private placement of common stock, the number of shares of common stock available for issuance under the Equity Incentive Plans increased to 1,237,711, inclusive of the 664,838 shares of restricted stock issued as provided above and 22,984 shares of restricted stock issued as a result of the stock portion of the dividend declared on December 19, 2013 and restricted stock attributed to dividends on restricted stock under the Director Deferred Fee Plan. As of September 30, 2015, 549,889 shares remained available for issuance under the Equity Incentive Plans. The Company recognized stock-based compensation expense of approximately \$509 thousand and approximately \$2.0 million for the three and nine months ended September 30, 2015, respectively, and approximately \$587 thousand and approximately \$1.7 million for the three and nine months ended September 30, 2014, respectively. At September 30, 2015 and December 31, 2014, the Company had unamortized compensation expense of \$109 thousand and \$57 thousand for awards fixed on the grant date and not remeasured at fair value, respectively. In addition, the Company had unamortized compensation expense of approximately \$3.6 million and \$3.2 million for awards remeasured at the end of each reporting period, at fair value, until vested at September 30, 2015 and December 31, 2014, respectively.

All restricted common shares granted, other than those whose issuance has been deferred pursuant the Director Deferred Fee Plan, possess all incidents of ownership, including the right to receive dividends and distributions currently, and the right to vote. Dividend equivalent payments otherwise allocable to restricted common shares under the Deferred Compensation Plan are deemed to purchase additional phantom shares of the Company's common stock that are credited to each participant's deferral account. The award agreements include restrictions whereby the restricted shares cannot be sold, assigned, transferred, pledged, hypothecated or otherwise disposed of prior to the lapse of restrictions under the respective award agreement. The restrictions lapse on the unvested restricted shares awarded when vested, subject to the grantee's continuing to provide services to the Company as of the vesting date. Unvested restricted shares and rights to dividends thereon are forfeited upon termination of the grantee.

The following is a summary of restricted common stock vesting dates as of September 30, 2015 and December 31, 2014, including shares whose issuance has been deferred under the Director Deferred Fee Plan:

Vesting Date	September 30, 2015 Shares Vesting	December 31, 2014 Shares Vesting
January 2015		12,745
March 2015		121,518
May 2015		18,708
June 2015		6,873
November 2015	1,334	1,334
January 2016	8,920	8,920
March 2016	188,184	121,518
June 2016	10,956	
January 2017	5,060	5,060
March 2017	133,334	66,667
March 2018	66,667	
	414,455	363,343

Table of Contents

The following table presents information with respect to the Company's restricted stock for the nine months ended September 30, 2015 including shares whose issuance has been deferred under the Director Deferred Fee Plan:

	Shares of Restricted Stock	Weighted Average Grant Date Fair Value (1)
Outstanding at beginning of period	476,200	\$ 18.49
Granted (2)	211,622	14.98
Cancelled/forfeited		
Outstanding at end of period	687,822	\$ 17.41
Unvested at end of period	414,455	\$ 16.31

(1) The grant date fair value of restricted stock awards is based on the closing market price of the Company's common stock at the grant date.

(2) Included in Granted are restricted stock attributed to dividends on restricted stock under the Director Deferred Fee Plan of 1,122 shares.

Note 14 Stockholders' Equity

On July 31, 2014, the Board of Directors of the Company authorized the repurchase of up to 2,050,000 shares of its common stock through December 31, 2015. Purchases made pursuant to the program will be made in the open market, in privately negotiated transactions, or pursuant to any trading plan that may be adopted in accordance with Rules 10b5-1 and 10b-18 of the Securities and Exchange Commission. The authorization does not obligate the Company to acquire any particular amount of common shares and the program may be suspended or discontinued at the Company's discretion without prior notice. The timing, manner, price and amount of any repurchases will be determined by the Company in its discretion and will be subject to economic and market conditions, stock price, applicable legal requirements and other factors. The Company has not yet entered into definitive agreements to utilize the authorization and, accordingly, had not repurchased any shares of common stock pursuant to the authorization as of September 30, 2015.

Note 15 Net Income (Loss) per Common Share

The table below presents basic and diluted net income (loss) per share of common stock using the two-class method for the three and nine months ended September 30, 2015 and September 30, 2014 (dollars, other than shares and per share amounts, in thousands):

For the three months ended September 30,	For the three months ended September 30,	For the nine months ended September 30,	For the nine months ended September 30,
--	--	---	---

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

	2015	2014	2015	2014
Numerator:				
Net income (loss) attributable to common stockholders and participating securities for basic and diluted earnings per share	\$ (1,852)	\$ 26,136	\$ 10,601	\$ 85,269
Less:				
Dividends and undistributed earnings allocated to participating securities	258	258	795	776
Net income (loss) allocable to common stockholders basic and diluted	\$ (2,110)	\$ 25,878	\$ 9,806	\$ 84,493
Denominator:				
Weighted average common shares outstanding for basic earnings per share	41,516,302	41,363,331	41,480,857	35,980,756
Weighted average diluted shares outstanding (stock awards)				
Weighted average diluted shares outstanding (warrants)				
Weighted average common shares outstanding for diluted earnings per share	41,516,302	41,363,331	41,480,857	35,980,756
Basic earnings per common share	\$ (0.05)	\$ 0.63	\$ 0.24	\$ 2.35
Diluted earnings per common share	\$ (0.05)	\$ 0.63	\$ 0.24	\$ 2.35

Table of Contents

Note 16 Income Taxes

Based on the Company's analysis of any potential uncertain income tax positions, the Company concluded that it does not have any uncertain tax positions that meet the recognition or measurement criteria as of September 30, 2015. The Company files U.S. federal and state income tax returns. As of September 30, 2015, tax returns filed by the Company for 2014, 2013 and 2012 are open for examination pursuant to relevant statutes of limitation. In the event that the Company incurs income tax related interest and penalties, the Company's policy is to classify them as a component of its provision for income taxes.

Subject to the limitation under the REIT asset test rules, the Company is permitted to own up to 100% of the stock of one or more TRS. Currently, the Company owns one TRS that is taxable as a corporation and is subject to federal, state and local income tax on its net income at the applicable corporate rates. The TRS, which was formed in Delaware on July 28, 2014, is a limited liability company and a wholly-owned subsidiary of the Company. As of September 30, 2015, the cumulative taxable loss of the TRS was de-minimis. As there can be no certainty that the TRS will have taxable income in the future, no tax benefit was included in these consolidated financial statements.

Note 17 Contingencies

From time to time, the Company may become involved in various claims and legal actions arising in the ordinary course of business. Management is not aware of any material contingencies at September 30, 2015.

Table of Contents

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

FORWARD-LOOKING INFORMATION

The Company makes forward-looking statements herein and will make forward-looking statements in future filings with the Securities and Exchange Commission (the "SEC"), press releases or other written or oral communications within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). For these statements, the Company claims the protections of the safe harbor for forward-looking statements contained in such sections. Forward-looking statements are subject to substantial risks and uncertainties, many of which are difficult to predict and are generally beyond the Company's control. These forward-looking statements include information about possible or assumed future results of the Company's business, financial condition, liquidity, results of operations, plans and objectives. When the Company uses the words "believe," "expect," "anticipate," "estimate," "plan," "continue," "intend," "should," "may" or similar expressions, the Company identifies forward-looking statements. Statements regarding the following subjects, among others, may be forward-looking: market trends in the Company's industry, interest rates, real estate values, the debt securities markets, the U.S. housing and the U.S. and foreign commercial real estate markets or the general economy or the market for residential and/or commercial mortgage loans; the Company's business and investment strategy; the Company's projected operating results; actions and initiatives of the U.S. Government and changes to U.S. Government policies and the execution and impact of these actions, initiatives and policies; the state of the U.S. and to a lesser extent, international economy generally or in specific geographic regions; economic trends and economic recoveries; the Company's ability to obtain and maintain financing arrangements, including securitizations; the current potential return dynamics available in residential mortgage-backed securities ("RMBS"), and commercial mortgage-backed securities ("CMBS" and collectively with RMBS, "MBS"); the level of government involvement in the U.S. mortgage market; the anticipated default rates on Agency and Non-Agency MBS (as defined herein); the loss severity on Non-Agency MBS; the return of the Non-Agency RMBS, CMBS and asset-backed securities ("ABS") securitization markets; the general volatility of the securities markets in which the Company participates; changes in the value of the Company's assets; the Company's expected portfolio of assets; the Company's expected investment and underwriting process; interest rate mismatches between the Company's target assets and any borrowings used to fund such assets; changes in interest rates and the market value of the Company's target assets; changes in prepayment rates on the Company's target assets; effects of hedging instruments on the Company's target assets; rates of default or decreased recovery rates on the Company's target assets; the degree to which the Company's hedging strategies may or may not protect the Company from interest rate and foreign currency volatility; the impact of and changes in governmental regulations, tax law and rates, accounting guidance and similar matters; the Company's ability to maintain the Company's qualification as a real estate investment trust for U.S. federal income tax purposes; the Company's ability to maintain its exemption from registration under the Investment Company Act of 1940, as amended (the "1940 Act"); the availability of opportunities to acquire Agency RMBS, Non-Agency RMBS, CMBS, Residential and Commercial Whole-Loans and other mortgage assets; the availability of opportunities to acquire ABS; the availability of qualified personnel; estimates relating to the Company's ability to make distributions to its stockholders in the future; and the Company's understanding of its competition.

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

The forward-looking statements are based on the Company's beliefs, assumptions and expectations of its future performance, taking into account all information currently available to it. Forward-looking statements are not predictions of future events. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to the Company. Some of these factors, are described in Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's annual report on Form 10-K for the year ended December 31, 2014, filed with the Securities and Exchange Commission (SEC) on March 16, 2015. These and other risks, uncertainties and factors, including those described in the annual, quarterly and current reports that the Company files with the SEC, could cause its actual results to differ materially from those included in any forward-looking statements the Company makes. All forward-looking statements speak only as of the date they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect the Company. Except as required by law, the Company is not obligated to, and does not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Table of Contents

Overview

Western Asset Mortgage Capital Corporation and Subsidiaries (the Company unless otherwise indicated or except where the context otherwise requires we, us or our) upon commencing operations in May 2012, had an initial investment strategy which was primarily focused on investing in, financing and managing Agency RMBS (including TBAs as defined herein). Over time, we have expanded our investment strategy to include both Non-Agency RMBS and subsequently Agency and Non-Agency CMBS and Whole-loans. In addition, and to a significantly lesser extent, we have invested in other securities including certain Agency obligations that are not technically mortgage-backed securities or MBS as well as certain Non U.S. CMBS and ABS investments secured by a portfolio of private student loans. These changes in our investment strategy, including future changes, are based on our Manager's perspective of which mix of portfolio assets it believes provides us with the best risk-reward opportunities at any given time. We have and expect to continue to finance our investment portfolio primarily through the use of repurchase agreements.

We operate and elected to be taxed as a real estate investment trust (REIT), commencing with our taxable year ended December 31, 2012. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute, in accordance with the REIT regulations, all of our net taxable income to stockholders and maintain our intended qualification as a REIT. We also intend to operate our business in a manner that will permit us to maintain our exemption from registration under the 1940 Act.

Our consolidated financial statements include our accounts, those of our wholly owned taxable REIT subsidiary or TRS and certain trusts that meet the definition of a variable interest entity (VIE) related to the acquisition of Residential Whole-Loans in which we are the primary beneficiary. Each trust has issued a trust certificate to us which is collateralized by Residential Whole-Loans held by the trust. We include the underlying Residential Whole-Loans owned by the trusts in Residential Whole-Loans at fair value on our Consolidated Balance Sheets and have eliminated the trust certificates in consolidation.

We are externally managed and advised by Western Asset Management Company (WAM), or the Manager), an SEC-registered investment advisor and a wholly-owned subsidiary of Legg Mason, Inc. Our Manager is responsible for administering our business activities and our day-to-day operations, subject to the supervision of our Board of Directors.

In light of the aforementioned developments and given our Manager's current market outlook and investment view, while we expect that Agency RMBS will continue to be a significant part of our portfolio, Agency RMBS will not necessarily be our primary investment in the future. Going forward, our Manager may vary the allocation among various asset classes subject to maintaining our qualification as a REIT under the federal tax law and maintaining our exemption from the 1940 Act. These restrictions limit our ability to invest in non-real estate assets and/or assets which are not secured by real estate. Accordingly, our portfolio will continue to be principally invested in MBS as well as other assets secured by real estate.

We have invested the proceeds of our initial public offering or IPO and concurrent private placements along with proceeds from our follow-on public offerings and accompanying private placement primarily in Agency RMBS, including Mortgage pass-through certificates, Agency derivatives, Agency Interest-Only Strips, and Agency CMOs;

Non-Agency RMBS; Agency, Non-Agency and Non U.S. CMBS; ABS as well as Residential and Commercial Whole-Loans. We have also used to-be-announced forward contracts, or TBAs, in order to invest in Agency RMBS. Pursuant to these TBAs, we agree to purchase (or deliver), for future settlement, Agency RMBS with certain principal and interest terms and certain underlying collateral. At September 30, 2015, our portfolio was comprised of approximately \$2.1 billion of Agency RMBS (including approximately \$157.9 million of Agency Interest-Only Strips), approximately \$546.1 million of Non-Agency RMBS (including approximately \$87.8 million of Non-Agency Interest-Only Strips), approximately \$40.1 million of Agency CMBS (including approximately \$15.2 million of Agency CMBS Interest-Only Strips), approximately \$464.5 million of Non-Agency CMBS, approximately \$177.5 million of other securities and approximately \$150.5 million of Residential Whole-Loans. To comply with the REIT requirements, some of our investments were held in a taxable REIT subsidiary or TRS. By acquiring investments or engaging in activities through the TRS, it enables us to engage in such activities without jeopardizing our REIT status. These investments or activities are not held or conducted at the REIT level and as a result would not impact our ability to maintain our qualification as a REIT.

We use leverage, currently consisting of borrowings under repurchase agreements, as part of our business strategy in order to increase potential returns to our stockholders. We accomplish this by borrowing against existing MBS and other assets through repurchase agreements. There are no limits on the maximum amount of leverage that we may use, and we are not required to maintain any particular debt-to-equity leverage ratio under our charter. We may also change our financing strategy and leverage without the consent of our stockholders.

Table of Contents

As of September 30, 2015, we had entered into master repurchase agreements with 27 counterparties. As of September 30, 2015, we had approximately \$3.0 billion of borrowings, outstanding under our repurchase agreements collateralized by approximately \$3.3 billion of MBS and other assets. The balance outstanding at September 30, 2015 includes approximately \$118.4 million of borrowings related to Residential Whole-Loans owned through trust certificates of approximately \$150.5 million. The trust certificates are eliminated upon consolidation. We have entered into approximately \$2.2 billion of interest rate swaps to effectively fix the interest rate of our borrowings under our repurchase agreements; net of variable-rate payment interest rate swaps of approximately \$2.4 billion, and excluding forward starting interest rate swaps of \$424.7 million. In addition, as of September 30, 2015, we also owned swaptions on approximately an incremental \$105.0 million notional of interest rate swaps. As of September 30, 2015, our aggregate debt-to-equity ratio was approximately 5.4 to 1.

Recent Market Conditions and Strategy

Our business is affected by general U.S. residential real estate fundamentals, domestic and foreign commercial real estate fundamentals and the overall U.S. and international economic environment. In particular, our strategy is influenced by the specific characteristics of these markets, including but not limited to prepayment rates and interest rate levels. We expect the results of our operations to be affected by various factors, many of which are beyond our control. Our results of operations will primarily depend on, among other things, the level of our net interest income, the market value of our investment portfolio and the supply of and demand for mortgage-related assets. Our net interest income, which includes the amortization of purchase premiums and accretion of discounts, will vary primarily as a result of changes in interest rates, defaults and loss severity rates, borrowing costs, and prepayment speeds on our MBS and other Target Asset (as defined herein) investments. Similarly, the overall value of our investment portfolio will be impacted by these factors as well as changes in the value of residential and commercial real estate and continuing regulatory changes. Commencing in 2014 and continuing into 2015, we have shifted our portfolio to more credit sensitive assets from Agency securities, which we believe, given the current economic and interest rate environment, will provide a better risk adjusted return going forward.

The current economic and market outlook are shaped in a significant manner by the unprecedented level of fiscal and monetary stimulus that the U.S. Government and U.S. Federal Reserve Board has continued to provide in the aftermath of the 2007-2010 financial crisis. The U.S. Federal Reserve Board has maintained a near-zero target for the federal funds rate, and has reiterated its commitment to fulfilling its dual mandate to foster maximum employment and to maintain price stability in the U.S. economy. Since early 2015, U.S. Federal Reserve Board Chairperson Janet Yellen indicated that she expected the first interest rate increase to occur sometime this year, but emphasized that the key is not when the first increase occurs, but the pace and size of subsequent increases. To the surprise of many in the economic community, at its meeting on September 17, 2015, the U.S. Federal Reserve Board left rates unchanged. While noting that the labor market had continued to improve and that household spending and business fixed income have been increasing moderately, the Federal Reserve elected to postpone increasing its target for federal funds rate based on increasing concerns about the overall strength of global demand and overall continuing concern within the Federal Open Market Committee (FOMC) about inflation remaining below the Fed's longer-run target of 2%.

Subsequent to the September 17, 2015, FOMC Meeting, economic data remained weak. While the September job reports showed the unemployment rate remaining steady at 5.1%, only 142,000 jobs were added, despite expectations for an increase of over 200,000 jobs. Further, both the July and August jobs added numbers were revised downward by a total of 59,000. Seasonally adjusted retail sales rose just 0.1% in September and actually fell from August levels once car sales are eliminated. The Labor Department also reported that producer prices fell 0.5% in September and were down 1.1% from a year earlier, the largest 12-month decline during this expansion. Based on these data, two members of the Federal Reserve publicly acknowledged that the Federal Reserve should take a wait-and-see approach with regard to whether the federal funds rate should be increased in 2015.

Table of Contents

Based on these weaker economic data subsequent to the September 17, 2015 FOMC meeting, the fixed income markets were not anticipating that the FOMC would take any action to raise the federal funds rate at its October 27, 2015 meeting. Such was the case, as nine of the ten members voted to maintain FOMC monetary policy in its current form including that the current 0% to 0.25% target range for the federal funds rate remains appropriate. In determining whether it will be appropriate to raise the target range at its next meeting in December, the FOMC will assess progress, both realized and expected, toward its objectives of maximum employment and two percent inflation. This assessment will take into account a wide range of information including measures of labor market conditions, indicators of inflation, inflation expectations and readings on financials and international developments. The FOMC has reported that it will be appropriate to raise the target range for the federal funds rate when it has seen some further improvement in the labor market and is reasonably confident that inflation will move back to its two percent objective over the medium term. Our Manager's view on interest rates remains consistent. Our Manager believes that the long-end of the curve will be range-bound over the near-term and short term rates will remain near zero until the end of 2015, and then gradually increase from there. This view is based on our Manager's belief that economic growth in the U.S. will continue to be modest over the next several quarters, and that the Fed will proceed very slowly in raising short-term rates back to a more normalized level.

On November 4, 2015, Federal Reserve Chair Janet Yellen and New York Fed President William Dudley both said the Fed could boost interest rates as soon as next month. At this point, I see the U.S. economy as performing well, Chair Yellen said in testimony before the House Financial Services Committee in Washington. If economic data continue to point to growth and firmer prices, a December rate hike would be a live possibility, she said. Later, Dudley said he agreed with the chair, but let's see what the data shows. On November 6, 2015, the October 2015 jobs report showed that employers added 271,000 jobs, the most since December 2014. The unemployment rate fell to a seven-year low of 5.0%, supporting our Manager's view that the Fed will likely hike interest rates in December.

As the capital markets have recovered from the 2007-2010 financial crisis commercial banks have re-entered the secured lending market, which has quickened the pace of asset recovery, and the return to more normalized credit spreads. Notwithstanding the foregoing, recent regulatory changes under the Dodd-Frank Act and Basel III have increased regulatory capital requirements for commercial banks to provide such financing, thereby increasing pressure on the availability of financing as well as overall liquidity in the fixed income markets. As a result of the current regulatory environment, we continue to see significant non-bank entities filling the void for residential and commercial real estate credit lending. Financing of Agency and Non-Agency RMBS, Agency and Non-Agency CMBS as well as ABS remains available through, among other vehicles, repurchase agreements. Haircuts, or the discount attributed to the value of securities sold under repurchase agreements, range from a low of 3.0% to a high of 5.0% for Agency RMBS, depending on the specific security used as collateral for such repurchase agreements, while haircuts for Agency IOs and IIOs can range from a low of 20.0% to a high of 25.0% and haircuts for Non-Agency RMBS and Agency and Non-Agency CMBS range from a low of 13.0% to a high of 40.0% and haircuts for other securities and Whole-Loans range from a low of 20.0% to a high of 50.0%. Nevertheless, such regulatory changes may impact the availability and current attractive pricing of such financing in the future.

In response to the impact which the financial crisis had on the housing market, the U.S. government, through the FHA, the Federal Deposit Insurance Corporation, or FDIC, and the U.S. Treasury, commenced or proposed implementation of programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. Such loan modification and refinance programs, as well as potential future U.S. federal, state and/or local legislative or regulatory actions that result in the modification of outstanding mortgage loans, and changes in the requirements necessary to qualify for refinancing mortgage loans with FNMA, FHLMC or GNMA (each as defined herein), may adversely affect the value of, and the returns on, residential mortgage loans, RMBS, real estate-related assets and securities and various other asset classes in which we may invest. In addition to the foregoing, the U.S. Congress and/or various states and local legislators may enact additional legislation or regulatory action, such as the recently enacted qualifying mortgage requirements under the Dodd-Frank Act, to address the current economic issues or for other purposes that could have a material adverse effect on lending in general and our ability to execute our business strategies. In particular, we believe that while the recently enacted qualifying mortgage requirements under the Dodd-Frank Act may present an opportunity to acquire and securitize certain non-qualifying or Non-QM mortgages, it is likely to reduce the overall production of new mortgages, thereby negatively impacting the general supply of RMBS.

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

Finally, ongoing discussions continue with regard to the long term conservatorship or restructuring of the FNMA and FHLMC. While existing shareholders continue to move for a return to privatization, the Federal Government appears to be hesitant to do anything at this time and with the upcoming Presidential elections this issue is unlikely to be addressed prior to 2016.

Our Investment Strategy

Our Manager's investment philosophy, which developed from a singular focus in fixed-income asset management over a variety of credit cycles and conditions, is to provide clients with diversified, tightly controlled, long-term value-oriented portfolios. Through rigorous analysis of all sectors of the fixed-income market, our Manager seeks to identify assets with the greatest risk-adjusted total value potential. In making investment decisions on our behalf, our Manager incorporates its views on the economic environment and the outlook for the mortgage markets, including relative valuation, supply and demand trends, the level of interest rates, the shape of the yield curve, prepayment rates, financing and liquidity, commercial and residential real estate prices, delinquencies, default rates, recovery of various segments of the economy and vintage of collateral, subject to maintaining our REIT qualification and our exemption from registration under the 1940 Act. We benefit from the breadth and depth of our Manager's overall investment philosophy, which focuses on a macroeconomic analysis as well as an in-depth analysis of individual assets and their relative value.

Table of Contents

We rely on our Manager's expertise in asset allocation and identifying attractive assets within our investment strategy. At the time of our IPO, our core investment strategy was focused primarily on Agency RMBS. Our Manager's expertise in related investment disciplines such as Non-Agency RMBS, CMBS, and ABS has provided us with ability to invest in Non-Agency RMBS, Agency and Non-Agency CMBS, Non U.S. CMBS, ABS, Whole-Loans and other securities, as well as, providing valuable investment insights to our Agency RMBS investment selection and strategy.

We currently purchase and sell Agency RMBS (including to-be-announced securities or TBAs) and Non-Agency RMBS, Agency and Non-Agency CMBS, Non U.S. CMBS, ABS as well as other structured securities, Whole-Loans and Whole-Loan securities. Currently, our Manager expects to expand our purchase of Non-Agency RMBS, Agency and Non-Agency CMBS, Non U.S. CMBS and ABS as well as expand our investment in Whole-Loans and Whole-Loan securities subject to applicable regulatory limits. This expansion is the result of our view that, under current market conditions, our credit sensitive investments will continue to perform well in gradually improving U.S. economy, while also exhibiting less interest rate sensitivity than Agency securities. We are also hoping to build on the increase in Whole-loan investments in the last quarter and accordingly, accelerate the shift towards a more diversified credit sensitive portfolio. We do not have specific investment guidelines providing for precise minimum or maximum allocations to any sector other than those necessary for maintaining our qualification as a REIT and our exemption from the 1940 Act. These regulatory limits may limit our ability to shift away from Agency securities and diversify the portfolio. Our Manager has not and does not expect to purchase securities on our behalf with a view to selling them shortly after purchase. However, in order to maximize returns and manage portfolio risk while remaining opportunistic, we may dispose of securities earlier than anticipated or hold securities longer than anticipated depending upon prevailing market conditions, credit performance, availability of leverage or other factors regarding a particular asset and/or our capital position.

Our Target Assets

We have invested the proceeds of our IPO, concurrent private placements and follow-on public offerings and expect to continue to focus on investing in the following types of securities:

Agency RMBS. - Agency RMBS, which are RMBS for which the principal and interest payments are guaranteed by a U.S. Government agency, such as the Government National Mortgage Association (GNMA or Ginnie Mae), or a U.S. Government-sponsored entity, such as the Federal National Mortgage Association (FNMA or Fannie Mae) or the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac). The Agency RMBS we acquire can be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages. Fixed-rate mortgages have interest rates that are fixed for the term of the loan and do not adjust. The interest rates on adjustable-rate mortgages generally adjust annually (although some may adjust more frequently) to an increment over a specified interest rate index. Hybrid adjustable-rate mortgages have interest rates that are fixed for a specified period of time (typically three, five, seven or ten years) and, thereafter, adjust to an increment over a specified interest rate index. Adjustable-rate mortgages and hybrid adjustable-rate mortgages generally have periodic and lifetime constraints on the amount by which the loan interest rate can change on any predetermined interest rate reset date. As of September 30, 2015, all of our Agency RMBS, excluding interest-only strips, are secured by fixed-rate mortgages.

Mortgage pass-through certificates. - Mortgage pass-through certificates are securities representing interests in pools of mortgage loans secured by residential real property where payments of both interest and scheduled principal, plus pre-paid principal, on the underlying loan pools are made monthly to holders of the securities, in effect passing through monthly payments made by the individual borrowers on the mortgage loans that underlie the securities, net of fees paid to the issuer/guarantor of the securities and servicers of the underlying mortgages.

Interest-Only Strips or IOs. - This type of security entitles the holder only to payments of interest based on a notional principal balance. The yield to maturity of Interest-Only Strips is extremely sensitive to the rate of principal payments (particularly prepayments) on the underlying pool of mortgages. We invest in these types of securities primarily to take advantage of particularly attractive prepayment-related or structural opportunities in the MBS markets, as well as to help manage the duration of our overall portfolio.

Table of Contents

Inverse Interest-Only Strips or IIOs. - This type of security has a coupon with an inverse relationship to its index and is subject to caps and floors. Inverse Interest-Only MBS entitles the holder to interest only payments based on a notional principal balance, which is typically equal to a fixed rate of interest on the notional principal balance less a floating rate of interest on the notional principal balance that adjusts according to an index subject to set minimum and maximum rates. The current yield of Inverse Interest-Only MBS will generally decrease when its related index rate increases and increase when its related index rate decreases.

Principal-Only Strips or POs. This type of security generally only entitles the holder to receive cash flows that are derived from principal repayments of an underlying loan pool, but in the case of Non-Agency Principal-Only Strips will also include cash flows from default recoveries and excess interest. The yield to maturity of Principal-Only Strips is extremely sensitive to the rate of principal payments (particularly prepayments) on the underlying pool of mortgages. We invest in these types of securities primarily to take advantage of structural opportunities in the MBS markets.

TBAs. - We may utilize TBAs, in order to invest in Agency RMBS. Pursuant to these TBAs, we agree to purchase (or deliver), for future settlement, Agency RMBS with certain principal and interest terms and certain underlying collateral, but the particular Agency RMBS to be delivered is not identified until shortly before the TBA settlement date. Our ability to invest in Agency RMBS through TBAs may be limited by the 75% real estate income and asset tests applicable to REITs.

Collateralized Mortgage Obligations or CMOs. These are securities that are structured from residential and/or commercial pass-through certificates, which receive monthly payments of principal and interest. CMOs divide the cash flows which come from the underlying mortgage pass-through certificates into different classes of securities that may have different maturities and different weighted average lives than the underlying pass-through certificates.

Non-Agency RMBS. - RMBS that are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations.

The mortgage loan collateral for Non-Agency RMBS consists of residential mortgage loans that do not generally conform to underwriting guidelines issued by a U.S. Government agency or U.S. Government-sponsored entity due to certain factors, including mortgage balances in excess of Agency underwriting guidelines, borrower characteristics, loan characteristics and/or level of documentation, and therefore are not issued or guaranteed by a U.S. Government agency or U.S. Government-sponsored entity. The mortgage loan collateral may be classified as subprime, Alternative-A or prime depending on the borrower's credit rating and the underlying level of documentation. Non-Agency RMBS may be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages.

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

Agency CMBS. - Fixed and floating rate CMBS, for which the principal and interest payments are guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, but for which the underlying mortgage loans are secured by real property other than single family residences. These may include, but are not limited to Fannie Mae DUS (Delegated Underwriting and Servicing) MBS, Freddie Mac Multifamily Mortgage Participation Certificates, Ginnie Mae project loan pools, and/or CMOs structured from such collateral.

Non-Agency CMBS. - Fixed and floating rate CMBS for which the principal and interest payments are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity. To date, our emphasis has been on legacy securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations but we have also invested in subordinated debt for which the property (properties) securing the underlying mortgage collateral is located within the U. S. or the European Union. We do not have an established minimum current rating requirement for such investments.

Non U.S. CMBS. - CMBS which is not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity and which is secured by commercial real estate located outside of the U.S. Although our Manager believes that these investments can provide attractive risk-reward opportunities and offer additional asset diversification, investing in international real estate has a number of additional risks, including but not limited to currency risk, political risk and the legal risk of investing in jurisdiction(s) with varying laws and regulations and potential tax implications. See Item 3: Quantitative and Qualitative Disclosures about Market Risk Foreign Investment Risk and Currency Risk herein.

Table of Contents

Agency and Non-Agency CMBS IO and IIO Securities. Interest-Only and Inverse Interest-Only securities for which the underlying collateral is commercial mortgages the principal and interest on which may or may not be guaranteed by a U.S. Government agency or U.S. Government-sponsored entity. Unlike single family residential mortgages in which the borrower, generally, can prepay at any time, commercial mortgages frequently limit the ability of the borrower to prepay, thereby providing a certain level of prepayment protection. Common restrictions include yield maintenance and prepayment penalties, the proceeds of which are generally at least partially allocable to these securities, as well as, defeasance.

Risk Sharing Securities Issued by Fannie Mae and Freddie Mac. - From time to time we have and may in the future continue to invest in risk sharing securities issued by Fannie Mae and Freddie Mac. Principal and interest payments on these securities are based on the performance of a specified pool of Agency residential mortgages. The payments due on these securities, however, are not secured by the referenced mortgages, but are full faith and credit obligations of Fannie Mae or Freddie Mac respectively. Investments in these securities generally are not qualifying assets for purposes of the 75% real estate asset test applicable to REITs and generally do not generate qualifying income for purposes of the 75% real estate income test applicable to REITs. As a result, we may be limited in our ability to invest in such assets.

ABS. - Debt and/or equity tranches of securitizations backed by various asset classes including, but not limited to, aircrafts, automobiles, credit cards, equipment, franchises, recreational vehicles and student loans. Investments in ABS generally are not qualifying assets for purposes of the 75% real estate asset test applicable to REITs and generally do not generate qualifying income for purposes of the 75% real estate income test applicable to REITs. As a result, we may be limited in our ability to invest in such assets.

Residential Whole-Loans. We made our first investment in Residential Whole-Loan instruments during the fourth quarter 2014 and have continued to increase our investment in this sector since then. In the future, we may continue to expand our investment in these mortgages, secured by single family residential properties. These whole-loan programs involve investing in structured Non-Agency RMBS programs crafted specifically for us, although it is possible that we could hold mortgage loans directly at some point. In addition to holding these instruments for investment, our Manager is also working to provide us with the ability to invest in or acquire Whole-Loans directly or gain exposure to Whole-Loans through investments in structured programs with the intention of securitizing the whole-loans in the future, selling the investment grade portion of the securitized structure and retaining the residual portion. Currently, our Residential Whole-Loans are held in trusts for which we are the sole beneficial owner. Although our expectation is that we will continue to make at least a limited amount of these investments in the near future, increasing these instruments as part of our target assets involves complex investment, structural, regulatory and accounting issues and there can be no assurance that we will in fact expand our investments in Residential Whole-Loans or, if we do, in what form and to what extent we will do so.

Commercial Whole-Loans. - Our Manager is also actively exploring opportunities to invest in small balance, \$2.5 million to \$25.0 million, Commercial Whole-Loans, including commercial mortgages and Small Business Administration or

SBA loans secured primarily by real estate. During the first quarter 2015, we made our first investment in these instruments which has since been paid off. While our Manager has experience in CMBS and we currently invest in Agency and Non-Agency CMBS, as well, as Non U.S. CMBS, investing in Whole-Loans backed or secured by commercial real estate assets involves complex investment, structural, regulatory and accounting issues. Some of these issues are unique to Commercial Whole-Loans as opposed to residential mortgages. Accordingly, there is no assurance of the prevalence such investments will have in our overall portfolio in the future.

Other investments. - In addition to MBS, our principal investment, and ABS, from time to time, we may also make other investments in securities, which our Manager believes will assist us in meeting our investment objective and are consistent with our overall investment policies. These investments will normally be limited by the REIT requirements that 75% our assets be real estate assets and that 75% of our income be generated from real estate, thereby limiting our ability to invest in such assets.

At the time of our IPO, our primary investment strategy focused on Agency RMBS. As discussed above, we have continued to increase the portion of our portfolio allocated to Non-Agency RMBS, Agency and Non-Agency CMBS, Non U.S. CMBS and ABS. In the fourth quarter of 2014, we made our first in investment in Residential Whole-Loan mortgages, and in the first quarter 2015 we made our first investment in Commercial Whole-Loan mortgages. In the future, we are likely to seek to expand our investments in these assets. Notwithstanding the foregoing, the allocation to Non-Agency RMBS, Agency and Non-Agency CMBS, Non U.S. CMBS, Residential and Commercial Whole-Loans and ABS may vary from time to time based on market conditions.

Table of Contents

As of September 30, 2015, the fair value of our investment portfolio was comprised of 60.6% of Agency RMBS, 15.6% of Non-Agency RMBS, 1.1% of Agency CMBS, 13.3% of Non-Agency CMBS, 5.1% of other securities and 4.3% of Residential Whole-Loans.

Our Financing Strategy

The leverage that we employ is specific to each asset class and is determined based on several factors, including potential asset price volatility, margin requirements, the current cycle for interest rates, the shape of the yield curve, the outlook for interest rates and our ability to use and the effectiveness of interest rate hedges. We analyze both historical volatility and market-driven implied volatility for each asset class in order to determine potential asset price volatility. Our leverage targets attempt to risk-adjust asset classes based on each asset class's potential price volatility. The goal of our leverage strategy is to ensure that, at all times, our investment portfolio's overall leverage ratio is appropriate for the level of risk inherent in the investment portfolio.

We may fund the acquisition of our assets through the use of leverage from a number of financing sources, subject to maintaining our qualification as a REIT. We finance purchases of MBS and other securities primarily through the use of repurchase agreements.

Our operating results depend in large part on differences between the income earned on our assets and our cost of borrowing and hedging activities. We use leverage to increase potential returns to our stockholders. We currently accomplish this by borrowing against existing assets through repurchase agreements. Our investment policies place no limits on the maximum amount of leverage that we may use, and we are not required to maintain any particular debt-to-equity leverage ratio under our charter. We may also change our financing strategy and leverage without the consent of our stockholders.

The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate MBS and other fixed rate securities will remain static. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If either of these events happens, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

We expect to maintain a debt to equity ratio of five to ten times the amount of our stockholders' equity, although there is no minimum or maximum leverage that our investment policies explicitly require. To the extent the Agency MBS percentage of our portfolio decreases, our overall leverage is likely to decrease. Depending on the different cost of borrowing funds at different maturities, we will vary the maturities of our borrowed funds to attempt to produce lower borrowing costs and reduce interest rate risk. Generally, we enter into collateralized borrowings only with institutions that are rated investment grade by at least one nationally-recognized statistical rating organization. We rely on financing to acquire, on a leveraged basis, assets in which we invest. If market conditions deteriorate, our lenders may exit the repurchase market, and tighten lending standards, or increase the amount of equity capital required to obtain financing thereby making it more difficult and costly for us to obtain financing.

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

For the three and nine months ended September 30, 2015, we financed our investments with repurchase agreements, on a debt-to-equity basis, ranging from 5.1 to 5.4 and 5.1 to 6.4 times leverage calculated at each month-end, respectively. In the future, we may, however, be limited or restricted in the amount of leverage we may employ by the terms and provisions of any financing or other agreements, and may be subject to margin calls as a result of our financing activity. We had an aggregate debt-to-equity ratio, related to our repurchase agreements of approximately 5.4 to 1 at September 30, 2015. Our debt-to-equity ratio is computed by dividing repurchase borrowings by total stockholders equity.

We finance MBS and other securities with repurchase agreement financing with maturities generally ranging from one to three months, but in some cases longer. At September 30, 2015, we had entered into master repurchase agreements with 27 counterparties. One of our existing repurchase agreement counterparties and one of its affiliates has communicated their intention to exit the repurchase agreement market in 2015. We believe that we have sufficient capacity with our other repurchase agreement counterparties to refinance these positions and had no outstanding borrowings with these two counterparties as of September 30, 2015. We had approximately \$3.0 billion outstanding under our repurchase agreements, including repurchase agreements related to Residential Whole-Loans owned through trust certificates of \$118.4 million at September 30, 2015. The trust certificates are eliminated upon consolidation.

Table of Contents

Our Hedging Strategy

Subject to maintaining our qualification as a REIT for U.S. federal income purposes, we pursue various economic hedging strategies in an effort to reduce our exposure to adverse changes in interest rates and, to a more limited extent, foreign currency. The U.S. federal income tax rules applicable to REITs may require us to implement certain of these techniques through a domestic TRS that is fully subject to federal, state and local corporate income taxation. As of September 30, 2015, we have one wholly owned subsidiary which we have elected to treat as a TRS. Our hedging activity varies in scope based on the level and volatility of interest rates, the type of assets held, including currency denomination and other changing market conditions. As of September 30, 2015, the majority of swaps we entered into are designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swaps generally provide for fixed interest rates indexed off of the London interbank offered rate or LIBOR and effectively fix the floating interest rates. Notwithstanding the foregoing, in order to manage our hedge position with regard to our liabilities, we on occasion will enter into interest rate swaps which involve the receipt of fixed-rate amounts from a counterparty in exchange for us making variable-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. We also enter into compression trades that enable us to terminate substantial amounts of swap contracts before they expire by their terms, when there has been substantial two-way (pay and receive) swap activity. For the three and nine months ended September 30, 2015, we entered into compression trades to terminate approximately \$9.6 billion of fixed-rate payment interest rate swaps and approximately \$9.8 billion of variable-rate payment interest rate swaps realizing a net gain on termination of approximately \$9.1 million. These compression trades reduce the number of interest rate swaps outstanding. In addition to simplifying our balance sheet, by reducing the number of interest rate swaps outstanding, we are frequently able to reduce the amount of margin required to carry such positions. As of September 30, 2015, we effectively fixed the floating interest rates on approximately \$2.2 billion of borrowings under our repurchase agreements, net of variable-rate payment swaps. We also entered into forward starting swaps of approximately \$424.7 million. We utilize forward starting swaps and swaptions for several reasons including replacing expiring swaps, in anticipation of increasing our overall financing and reducing our exposure to future interest rate increases. Interest rate swaptions provide us the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and set pay and receive interest rates in the future. As of September 30, 2015, we owned swaptions on approximately an incremental \$105.0 million of borrowings. As of September 30, 2015, we also entered into foreign currency swaps, agreeing to pay a fixed amount of euros in exchange for a fixed amount of U.S. dollars as well as currency forwards. We entered into the currency swaps and forwards in order to hedge our exposure to foreign currency with respect to Non-U.S. CMBS investments and the corresponding repurchase financings utilized to make such investments. In order to enable us to maintain compliance with the REIT requirements, we have generally elected to treat the aforementioned derivative instruments as hedges for U.S. federal tax purposes. To date, however, we have not elected to apply hedge accounting for financial statement reporting purposes for our derivative instruments. As a result, we record the change in fair value of our derivatives and the associated interest and currency exchange in earnings. Additionally, we may enter into hedging transactions in the form of puts and calls or other financial instruments that we deem appropriate.

Our interest rate hedging techniques are partly based on assumed levels of prepayments of our target assets. If prepayments are slower or faster than assumed, the life of the investment will be longer or shorter, which would reduce the effectiveness of any of the interest rate hedging strategies we may use and may cause losses on such transactions. Hedging strategies, both interest rate and foreign currency, involve the use of derivative securities which are highly complex and may produce volatile returns.

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

We may invest in equity index derivatives such as futures, options on futures and options on indices. These instruments are used normally to hedge interest rate movements as well as credit risks and other risks associated with our portfolio which may be impacted by volatility in the equity markets. Tax and other regulatory rules may limit our overall ability to use these instruments even through a TRS. Investing in these instruments introduces equity market risks into the management of the portfolio although as noted above our Manager uses them for the purpose of hedging our overall interest rate risk. These hedging strategies involving equity index products may not be successful, and may expose us to additional losses, if expected correlations between such risks and the equity markets do not occur. The goal of our hedging strategy is to ensure that, at all times, we are appropriately hedged in accordance with the REIT requirements for the level of interest rate and currency risk inherent in our investment portfolio.

Table of Contents

Critical Accounting Policies

The interim unaudited consolidated financial statements include our accounts, those of our consolidated subsidiary - our wholly owned taxable REIT subsidiary or TRS and certain variable interest entities (VIEs) related to the acquisition of residential Whole-Loans in which we are the primary beneficiary. All intercompany amounts have been eliminated in consolidation. In accordance with GAAP, our consolidated financial statements require the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. In accordance with SEC guidance, the following discussion addresses the accounting policies that we currently apply. Our most critical accounting policies will involve decisions and assessments that could affect our reported assets and liabilities, as well as our reported revenues and expenses. We believe that all of the decisions and assessments upon which our consolidated financial statements have been based were reasonable at the time made and based upon information available to us at that time. We have identified what we believe will be our most critical accounting policies to be the following:

Investments

We elected the fair value option for all of our MBS, other securities and Whole-Loans at the date of purchase, which permits us to measure these securities at fair value with the change in fair value included as a component of earnings. Although we have elected the fair value option for our MBS, other securities and Whole-Loans, we separately compute interest income on our MBS, other securities and Whole-Loans under the prescribed method based on the nature of the investment. As such, premiums and discounts are amortized or accreted into interest income and are included in Interest income in the Consolidated Statements of Operations.

Valuation of financial instruments

We disclose the fair value of our financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). In accordance with GAAP, we are required to provide enhanced disclosures regarding instruments in the Level III category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities. GAAP establishes a framework for measuring fair value in accordance with GAAP and expands financial statement disclosure requirements for fair value measurements. GAAP further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level I Quoted prices in active markets for identical assets or liabilities.

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

Level III Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

When available, we use quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, we consult with independent pricing services or obtain third party broker quotes. If independent pricing service, or third party broker quotes are not available, we determine the fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates.

While linked transactions were treated as derivatives for GAAP through December 31, 2014, the securities underlying the Company's linked transactions were valued using similar techniques to those used for our securities portfolio. The value of the underlying security was then netted against the carrying amount (which approximates fair value) of the repurchase agreement at the valuation date. Additionally, TBA instruments are similar in substance to our Agency RMBS portfolio, and the Company therefore estimates fair value based on similar methods.

Table of Contents

We determine the fair value of derivative financial instruments by obtaining quotes from a third party pricing service, whose pricing is subject to review by our Manager's pricing committee. In valuing our derivatives, such as interest rate swaps and swaptions, we consider the creditworthiness of our counterparties, along with collateral provisions contained in each derivative agreement, from the perspective of both us and our counterparties. All of our interest rate swaps are either cleared through a central clearing house and subject to the clearing house margin requirements or subject to bilateral collateral arrangements. As of September 2013, the vast majority of our newly entered into interest rate swaps are cleared through a central clearing house. We also have netting arrangements in place with all derivative counterparties pursuant to standard documentation developed by the International Swap and Derivatives Association. Consequently, no credit valuation adjustment was made in determining the fair value of interest rate derivatives.

Valuation techniques for MBS, Whole-Loans and other structured securities may be based upon models that consider the estimated cash flows of the security or the Whole-Loan. Depending on the asset and the underlying collateral, the primary inputs to the model include yields for TBAs, Agency RMBS, the U.S. Treasury market and floating rate indices such as LIBOR, the Constant Maturity Treasury rate and the prime rate as a benchmark yield. In addition, the model may incorporate the current weighted average maturity and additional pool level information such as prepayment speeds, default frequencies and default severities, if applicable. To the extent, the inputs are observable and timely, the assets are categorized in Level II of the fair value hierarchy; otherwise, unless alternative pricing information as described is available, they are categorized as Level III.

Fair value under GAAP represents an exit price in the normal course of business, not a forced liquidation price. If we are forced to sell assets in a short period to meet liquidity needs, the prices we receive could be substantially less than the recorded fair values of our assets. Furthermore, the analysis of whether it is more likely than not that we will be required to sell assets in an unrealized loss position prior to an expected recovery in value (if any), the amount of such expected required sales, and the projected identification of which assets will be sold is also subject to significant judgment, particularly in times of market illiquidity.

We will review any changes to the valuation methodology to ensure the changes are appropriate. The methods used may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while we anticipate that our valuation methods will be appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the fair value of certain financial instruments can result in a different estimate of fair value at the reporting date. We use inputs that are current as of the measurement date, which may include periods of market dislocation, during which price transparency may be reduced.

All valuations received from independent pricing services are non-binding. We primarily utilize an independent third party pricing service as the primary source for valuing the Company's assets.

We generally receive one independent pricing service price for each investment in our portfolio. Our Manager has established a quarterly process to review and validate the pricing received from the independent pricing service and has a process for challenging prices received from the independent pricing service when necessary. We utilize our Manager's policies in this regard for all securities. We utilize our own policies for the review of the pricing of Whole-Loans received from a third party vendor. Our and our Manager's quarterly review of the independent third party pricing data may consist of a review of the daily change in the prices provided by the independent pricing vendor which exceed established tolerances or comparisons to executed transaction prices. Our Manager's pricing group, which functions independently from its portfolio management personnel, corroborates the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager's pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that our Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, our Manager generally challenges the independent pricing service price.

In addition, to ensure proper fair value hierarchy, we and our Manager review the methodology used by the third party pricing service to understand whether observable market data is being utilized in the vendor's pricing methodology. Generally, this review is conducted annually, however ad-hoc reviews of the pricing methodology and the data do occur. The review of the assumptive data received from the vendor includes comparing key inputs. In addition, as part of our regular review of pricing, our Manager's pricing group may have informal discussions with the independent pricing vendor regarding their evaluation methodology or the market data utilized in their determination as well as performing back testing with regard to the sale of certain securities. The conclusion that a price should be overridden in accordance with our Manager's pricing methodology may impact the fair value hierarchy of the security for which such price has been adjusted.

Table of Contents

Linked transactions

Prior to January 1, 2015, in instances where we finance the acquisition of securities through repurchase agreements with the same counterparty from which the securities were purchased, we evaluate such transactions in accordance with GAAP. This guidance in effect prior to January 1, 2015 required that if the initial transfer of a financial asset and repurchase financing were entered into contemporaneously with, or in contemplation of, one another, such transaction would be considered linked unless all of the criteria found in the guidance were met at the inception of the transaction. If the transaction met all of the conditions, the initial transfer would be accounted for separately from the repurchase financing, and we would record the securities and the related financing on a gross basis on our Consolidated Balance Sheets with the corresponding interest income and interest expense in our Consolidated Statements of Operations. If the transaction was determined to be linked, we would record the initial transfer and repurchase financing on a net basis and record a forward commitment to purchase securities as a derivative instrument with changes in market value being recorded on our Consolidated Statements of Operations. Such forward commitments were recorded at fair value with subsequent changes through December 31, 2014 in fair value recognized in Gain (loss) on linked transactions, net on our Consolidated Statements of Operations. We refer to these transactions as Linked Transactions. Prior to January 1, 2015, when or if a transaction was no longer considered to be linked, the security and related repurchase financing reported on a gross basis. The unlinking of a transaction caused a realization event in which the fair value of the security as of the date of unlinking became the cost basis of the security. The difference between the fair value on the unlinking date and the existing cost basis of the security was the realized gain or loss. Recognition of effective yield for such security was calculated prospectively using the new cost basis. For linked transactions, we reflected purchases and sales of securities within the investing section of our Consolidated Statements of Cash Flows. Proceeds from repurchase agreement borrowings and repayments of repurchase agreement borrowings were reflected in the financing section of our Consolidated Statements of Cash Flows.

Starting in 2015, GAAP no longer requires us to segregate and treat linked transactions as derivatives. Accordingly, starting January 1, 2015 we report such securities and the corresponding repurchase agreements on a gross basis on our Consolidated Balance Sheets and with the corresponding interest income and interest expense reported on a gross basis in our Consolidated Statements of Operations. See **Recent accounting pronouncements** for details.

Interest income recognition and Impairment

Agency MBS, Non-Agency MBS, and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase

Interest income on mortgage-backed and other securities is accrued based on the respective outstanding principal balances and corresponding contractual terms. Premiums and discounts associated with Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase, are amortized into interest income over the estimated life of such securities using the effective yield method. Adjustments to premium and discount amortization are made for actual prepayment activity. We estimate prepayments at least quarterly for our securities, and as a result, if prepayments increase (or are expected to increase), we will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if prepayments decrease (or are expected to decrease) we will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.

Our conversion to a new accounting system as of April 1, 2014, caused a change in the calculation methodology used to determine the amortization of bond premium. This resulted in a cumulative retrospective change in estimate of approximately \$1.2 million. The impact of this change of estimate was limited to an increase of approximately \$0.03 per share in core earnings (a non-GAAP measure). For financial reporting

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

purposes, the impact of the change in estimate had no impact on Net income and was limited to an increase of approximately \$1.2 million to Interest Income and an equal offsetting reduction to Unrealized gain (loss) on Mortgage-backed securities, other securities and Whole-Loans, net on the Consolidated Statements of Operations for the three months ended June 30, 2014. We do not believe the aforementioned change in estimate will have a material impact to subsequent periods.

Table of Contents

We assess our Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase, for other-than-temporary impairment on at least a quarterly basis. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other-than-temporary. In deciding on whether or not a security is other-than-temporarily impaired, we consider several factors, including the nature of the investment, communications (if any) from the securitization trustee regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and our intent not to sell the security and whether it is more likely than not that we will not be required to sell the security until recovery of its amortized cost basis. An other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in our Consolidated Statement of Operations as Other loss on Mortgage-backed securities and other securities.

The determination as to whether an other-than-temporary impairment exists is subject to management estimates based on consideration of both factual information available at the time of assessment as well as our estimates of the future performance and projected amount and timing of cash flows expected to be collected on the security. As a result, the timing and amount of an other-than-temporary impairment constitutes an accounting estimate that may change materially over time.

Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives

Interest income on Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives, are recognized based on the effective yield method. The effective yield on these securities is based on the projected cash flows from each security, which is estimated based on our observation of the then current information and events, where applicable, and will include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. On at least a quarterly basis, we review and, if appropriate, make adjustments to our cash flow projections based on input and analysis received from external sources, internal models, and our judgment about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Where appropriate, we may include in our cash flow projections the U.S Department of Justice's settlements with major residential mortgage originators, regarding certain lending practices. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities are affected by the contractual lives of the underlying collateral, periodic payments of scheduled principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual maturities.

Based on the projected cash flow of such securities purchased at a discount to par value, we may designate a portion of such purchase discount as credit protection against future credit losses and, therefore, not accrete such amount into interest income. The amount designated as credit discount 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 discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

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

In addition, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in our Consolidated Statements of Operations as Other loss on Mortgage-backed securities and other securities.

Securities denominated in a foreign currency contain additional risk in that the amortized cost basis for those securities may not be recovered due to declines in currency exchange rates. We consider the length of time that the security's fair value has declined due to the decline in foreign exchange rates, when assessing other-than temporary impairment.

Table of Contents

The determination as to whether an other-than-temporary impairment exists is subject to management estimates based on consideration of both factual information available at the time of assessment as well as our estimates of the future performance and projected amount and timing of cash flows expected to be collected on the security. As a result, the timing and amount of an other-than-temporary impairment constitutes an accounting estimate that may change materially over time.

Finally, certain of our MBS and other securities that are in an unrealized loss position at September 30, 2015 are also not considered other-than-temporarily impaired because we have no intent to sell these investments, it is more likely than not that we will not be required to sell the investment before recovery of its amortized cost basis and we are not required to sell the security for regulatory or other reasons.

Residential and Commercial Whole-Loans

We record our purchases of Residential and Commercial Whole-Loans as the amount paid to the seller plus any fees paid or less any fees received. All other costs incurred in connection with acquiring Residential and Commercial Whole-Loans or committing to purchase Residential and Commercial Whole-Loans are expensed as incurred. We amortize or accrete any premium or discount over the life of the related loan utilizing the effective interest method, based on the contractual payments terms of the loan. On at least a quarterly basis, we evaluate the collectability of both interest and principal of each loan, if circumstances warrant, to determine whether such loan is impaired. A loan is impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the existing contractual terms. When a loan is impaired, we do not record a loss accrual as we have elected the fair value option. However, income recognition is suspended for loans at the earlier of the date at which payments become 90-days past due or when, in the opinion of management, a full recovery of income and principal becomes doubtful. When the ultimate collectability of the principal of an impaired loan is in doubt, all payments are applied to principal under the cost recovery method. When the ultimate collectability of the principal of an impaired loan is not in doubt, contractual interest is recorded as interest income when received, under the cash basis method until an accrual is resumed when the loan becomes contractually current and performance is demonstrated to be resumed. A loan is written off when it is no longer realizable and/or legally discharged.

Foreign currency transactions

We have and expect to continue to enter into transactions denominated in foreign currency from time to time. At the date the transaction is recognized, the asset and/or liability will be measured and recorded using the exchange rate in effect at the date of the transaction. At each balance sheet date, such foreign currency assets and liabilities are re-measured using the exchange rate in effect at the date of the balance sheet, resulting in unrealized foreign currency gains or losses. Unrealized foreign currency gains or losses on MBS and other assets are recorded in Unrealized gain (loss) on Mortgage-backed securities, other securities and Whole-Loans, net on the Consolidated Statements of Operations. In addition, we evaluate whether an other-than-temporary impairment is deemed to have occurred on MBS and other assets denominated in a foreign currency. Cash flows from MBS and other assets denominated in foreign currencies are received in a foreign currency, and as a result, we may incur a loss due to changes in foreign exchange rates even when all contractual cash flows are received. These adjustments are reflected in our Consolidated Statements of Operations as Other loss on Mortgage-backed securities and other securities. Unrealized and realized foreign currency gains or losses on borrowings under repurchase agreements are recorded in Interest income on cash balances and other income (loss), net on the Consolidated Statements of Operations. Interest income from investments denominated in a foreign currency and interest expense on borrowings denominated in a foreign currency are recorded at the average rate of exchange during the period.

Variable Interest Entities (VIEs)

VIEs are defined as entities in which equity investors either do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support, are unable to direct the entity's activities or are not exposed to the entity's losses or entitled to its residual returns. VIEs are required to be consolidated by their primary beneficiary. The primary beneficiary of a VIE is determined to be the party that has both the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. This determination of the requirement to consolidate a VIE and the requirement to disclose information about our involvement in a VIE can sometimes involve complex and subjective analyses. Ongoing assessments of whether an enterprise is the primary beneficiary of a VIE is required.

Table of Contents

Due from counterparties/Due to counterparties

Due from counterparties represents cash posted by us with our counterparties as collateral for our interest rate and/or currency derivative financial instruments, repurchase agreements, and TBAs. Due to counterparties represents cash posted with us by our counterparties as collateral under our interest rate and/or currency derivative financial instruments, repurchase agreements, and TBAs. Included in the due from counterparties and/or due to counterparties are daily variation margin settlement amounts with counterparties which are based on the price movement of our futures contracts. In addition, as provided below, Due to counterparties may include non-cash collateral, which we have the obligation to return, and which we have either sold or pledged. To the extent we receive collateral other than cash from our counterparties such assets are not included in our Consolidated Balance Sheets. Notwithstanding the foregoing, if we either rehypothecate such assets or pledge the assets as collateral pursuant to a repurchase agreement, the cash received and the corresponding liability is reflected on our Consolidated Balance Sheets.

Derivatives and hedging activities

Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, we utilize derivative financial instruments, including interest rate swaps, interest rate swaptions, mortgage put options, currency forwards, futures contracts, TBAs and Agency and Non-Agency Interest-Only Strips to hedge the interest rate and currency risk associated with our portfolio and related borrowings. Derivatives, subject to REIT requirements, are used for hedging purposes rather than speculation. We determine their fair value of our derivative positions and obtain quotations from third parties, including the Chicago Mercantile Exchange or CME, to facilitate the process of determining such fair values. If our hedging activities do not achieve the desired results, reported earnings may be adversely affected.

GAAP requires an entity to recognize all derivatives as either assets or liabilities and to measure those instruments at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether we have elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives are classified as either hedges of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge) or hedges of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge). If we do not elect hedge accounting for a derivative instrument, which we have not, fair value adjustments are recorded in earnings immediately.

We elected not to apply hedge accounting for our derivative instruments. Accordingly, we record the change in fair value of our derivative instruments, which includes net interest rate swap payments (including accrued amounts) and net currency payments (including accrued amounts) related to interest rate swaps and currency swaps, respectively, in Gain (loss) on derivative instruments, net in our Consolidated Statements of Operations. In our Consolidated Statements of Cash Flows, premiums received and paid on termination of our interest rate swaps, excluding interest rate swaps containing an other-than-insignificant financing element and the unamortized premium of market agreed coupon (MAC) interest rate swaps, are included in cash flows from operating activities. Alternatively, proceeds and payments on settlement of swaptions, mortgage put options, futures contracts and TBAs are included in cash flows from investing activities. Proceeds and payments on settlement of forward contracts are reflected in cash flows from financing activities in our Consolidated Statement of Cash Flows. While payments made at the time of entering MAC interest rate swaps are included in cash flows from investing activities, payments received by us upon entering MAC interest rate swaps are

included in either cash flows from investing activities or cash flows financing activities, depending on whether or not the derivative instrument includes an other-than-insignificant financing element. For MAC interest rate swaps containing an other-than-insignificant financing element, all cash flows over the life of the derivative are treated as cash flows from financing activities. Return and recovery of basis activity for MAC interest rate swaps is included in cash flows from investing activities for swaps not containing an other-than-insignificant financing element in our Consolidated Statement of Cash Flows. For Agency and Non-Agency Interest-Only Strips accounted for as derivatives, the purchase, sale and recovery of basis activity is included with MBS and other securities under cash flows from investing activities in our Consolidated Statement of Cash Flows.

Table of Contents

We evaluate the terms and conditions of our holdings of Agency and Non-Agency Interest-Only Strips and TBAs to determine if these instruments have the characteristics of an investment or should be considered a derivative under GAAP. In determining the classification of our holdings of Interest-Only Strips, we evaluate the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Generally, Interest-Only Strips for which the security represents a strip off of a mortgage pass through security will be considered a hybrid instrument classified as a MBS investment on our Consolidated Balance Sheets utilizing the fair value option. Alternatively, those Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives at fair value. Accordingly, Agency and Non-Agency Interest-Only Strips and TBAs having the characteristics of derivatives are accounted for at fair value with such changes recognized in Gain (loss) on derivative instruments, net in our Consolidated Statements of Operations, along with any interest earned or paid (including accrued amounts). The carrying value of the Agency and Non-Agency Interest-Only Strips, accounted for as derivatives, is included in Mortgage-backed securities on the Consolidated Balance Sheets. The carrying value of interest rate swaptions, currency forwards, futures contracts and TBAs is included in Derivative assets or Derivative liabilities on the Consolidated Balance Sheets.

We evaluate all of our financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. An embedded derivative is separated from the host contract and accounted for separately when all of the guidance criteria are met. Hybrid instruments that are remeasured at fair value through earnings, including the fair value option, are not bifurcated. Derivative instruments, including derivative instruments accounted for as liabilities, are recorded at fair value and are re-valued at each reporting date, with changes in the fair value together with interest earned or paid (including accrued amounts) reported in the Gain (loss) on derivative instruments, net in our Consolidated Statements of Operations. While accounted for as derivative instruments through December 31, 2014, linked transactions, including changes in fair value and interest earned or paid (including accrued amounts) were reported separately in our Consolidated Balance Sheets, Consolidated Statements of Operations and Consolidated Statements of Cash Flows. See Warrants below.

Repurchase agreements and Reverse Repurchase agreements

Mortgage-backed securities and other securities sold under repurchase agreements are treated as collateralized financing transactions, unless they meet sales treatment. Securities financed through a repurchase agreement remain on our Balance Sheet as an asset and the amount of cash received from the lender is recorded in our Consolidated Balance Sheets as a liability, unless such transaction was accounted for as a linked transaction prior to January 1, 2015, as described below. Interest payable in accordance with repurchase agreements is recorded as accrued interest payable on the Consolidated Balance Sheets. Interest paid (including accrued amounts) in accordance with repurchase agreements is recorded as interest expense, unless the repurchase agreement was accounted for as a linked transaction prior to January 1, 2015, as described below. We reflect all proceeds from repurchase agreement borrowings and repayment of repurchase agreement borrowings which are not linked transactions, including transactions pertaining to collateral received with respect to certain swap transactions, on a gross basis on the Consolidated Statements of Cash Flows.

We may borrow securities under reverse repurchase agreements to deliver a security owned and sold by us but pledged to a different counterparty under a separate repurchase agreement when in the Manager's view terminating the outstanding repurchase agreement is not in our interest. Cash paid to the borrower is recorded in our Consolidated Balance Sheets as an asset. Interest receivable in accordance with reverse repurchase agreements is recorded as accrued interest receivable on our Consolidated Balance Sheets. We reflect all proceeds on reverse

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

repurchase agreement and repayment of reverse repurchase agreement, on a net basis on our Consolidated Statements of Cash Flows. Upon sale of a pledged security, we recognize an obligation to return the borrowed security on our Consolidated Balance Sheet in Due to Counterparty. We establish haircuts to ensure the market value of the underlying asset remains sufficient to protect us in the event of default by the counterparty. Realized gains and losses associated with the sale of the security are recognized in Realized gain (loss) on sale of Mortgage-backed securities, other securities and Whole-Loans, net on our Consolidated Statement of Cash flows.

Share-based compensation

We account for share-based compensation to our independent directors, to any employee, to our Manager and to employees of our Manager and its affiliates using the fair value based methodology prescribed by GAAP. Compensation cost related to restricted common stock issued to our independent directors including any such restricted stock which is subject to a deferred compensation program, and any employee is measured at its fair value at the grant date, and amortized into expense over the service period on a straight-line basis. Compensation cost related to restricted common stock issued to our Manager and to employees of our Manager, including our officers who are employees of the Manager, and its affiliates is initially measured at fair value at the grant date, is revalued on subsequent dates to the extent the awards are unvested and amortized into expense over the vesting period on a straight-line basis using the revised valuations.

Table of Contents

Warrants

For our warrants we use a variation of the adjusted Black-Scholes option valuation model to record the financial instruments at their relative fair values at issuance. The warrants issued with our common stock in the private placement to certain accredited institutional investors on May 15, 2012, were evaluated by us and were recorded at their relative fair value as a component of equity at the date of issuance. See Derivatives and hedging activities above.

Income taxes

We operate and have elected to be taxed as a REIT commencing with our taxable year ended December 31, 2012. Accordingly, we will generally not be subject to corporate U.S. federal or state income tax to the extent that we make qualifying distributions to our stockholders, and provided that we satisfy on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If we fail to qualify as a REIT, and do not qualify for certain statutory relief provisions, we will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which we lost our REIT qualification. Accordingly, our failure to qualify as a REIT could have a material adverse impact on our results of operations and amounts available for distribution to our stockholders.

The dividends paid deduction for qualifying dividends paid to stockholders is computed using our taxable income as opposed to net income reported on the consolidated financial statements. Taxable income, generally, will differ from net income reported on the consolidated financial statements because the determination of taxable income is based on tax provisions and not GAAP.

We may create and elect to treat certain subsidiaries as Taxable REIT Subsidiaries (TRS). In general, a TRS may hold assets and engage in activities that we cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes, and its value may not exceed 25% of the value of the Company. While a TRS may generate net income, a TRS can declare dividends to us, which will be included in our taxable income and necessitate a distribution to our stockholders. Conversely, if we retain earnings at the TRS level, no distribution is required and it can increase book equity of the consolidated entity. As of September 30, 2015, we have a single wholly owned subsidiary which we have elected to treat as a TRS.

We evaluate uncertain tax positions, if any, and classify interest and penalties, if any, related to unrecognized tax benefits, if any, as a component of the provision for income taxes. In addition, we evaluate the performance of the TRS each period to determine the need for a provision for income taxes.

Accounting standards applicable to emerging growth companies

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

The JOBS Act contains provisions that relax certain requirements for emerging growth companies for which we qualify. For as long as we are an emerging growth company, which may be up to five full fiscal years, unlike other public companies, we will not be required to: (i) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies under Section 102(b)(1) of the JOBS Act; (ii) provide an auditor's attestation report on management's assessment of the effectiveness of our system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act; (iii) comply with any new requirements adopted by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; or (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012 unless the SEC determines otherwise. We currently take advantage of some of these exemptions. Our qualification for remaining an emerging growth company under the five full fiscal years expires on December 31, 2017. However, we will no longer qualify for such exemption if our gross revenue for any year equals or exceeds \$1.0 billion or more, we issue more than \$1.0 billion in non-convertible debt during the three previous years, or if we are deemed to be a large accelerated filer.

Table of Contents

As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. We currently take advantage of such extended transition period. Since we are not required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, our financial statements may not be comparable to the consolidated financial statements of companies that comply with public company effective dates. If we were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

Recent accounting pronouncements

Accounting Standards Adopted in 2015

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

In June 2014, the Financial Accounting Standards Board issued guidance that changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements. The new guidance aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. These transactions would all be accounted for as secured borrowings. The guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement, which has resulted in outcomes referred to as off-balance-sheet accounting. In addition, the guidance requires additional disclosures. The guidance is effective for a public company for the first interim or annual period beginning after December 15, 2014. Other entities may elect to apply the requirements for interim periods beginning after December 31, 2014. Certain disclosures under this guidance do not take effect for a public company until the first period beginning after March 15, 2015 and do not take effect for other companies beginning for annual periods beginning after December 31, 2014 and for interim periods beginning after December 15, 2015. Through December 31, 2014, the Company accounted for certain transfers as forward agreements under the previous guidance, which were classified as linked transactions. The new guidance requires us to record these transfers as secured borrowings. The implementation of the new guidance resulted in an increase to Mortgage-backed securities and other securities, at fair value of approximately \$52.5 million, an increase in Borrowings under repurchase agreements of approximately \$31.9 million and a decrease in Linked transactions, net, at fair value of approximately \$20.6 million in our Consolidated Balance Sheets as of January 1, 2015. Further, the implementation of the new guidance resulted in a cumulative-effect adjustment of zero to retained earnings as of January 1, 2015.

Accounting Standards to be Adopted in Future Periods

In May 2014, the Financial Accounting Standards Board issued guidance that changes an entity's recognition of revenue from contracts with customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, the new guidance requires improved disclosures to enable users of financial statements to understand the nature, amount, timing, and

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

uncertainty of revenue and cash flows arising from contracts with customers. In applying the new guidance, an entity may use either a retrospective approach to each prior reporting period or a retrospective approach with the cumulative effect recognized at the date of initial application. For a public company, the standard is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted for a public entity. For all other entities, the standard is effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2015. With certain restrictions, a nonpublic entity may elect to apply the guidance earlier. The new guidance is not expected to have a material impact on our consolidated financial statements.

Table of Contents

In August 2014, the Financial Accounting Standards Board issued guidance that will require an entity's management to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. According to the new guidance, substantial doubt exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date the financial statements are issued. The term "probable" is used consistently with its current use in U.S. GAAP for loss contingencies. Disclosures will be required if conditions give rise to substantial doubt about the entity's ability to continue as a going concern, including whether management's plans that are intended to mitigate those conditions will alleviate the substantial doubt when implemented. The guidance is effective for annual periods ending after December 15, 2016. The effective date is the same for both public companies and all other entities. Early application is permitted. We have not elected to early adopt this guidance. Our first assessment under the new guidance will be completed for the year ending December 31, 2016.

In January 2015, the FASB issued guidance to simplify income statement presentation by eliminating the concept of extraordinary items. U.S. GAAP currently requires that a company separately classify, disclose and present extraordinary events and transactions. The guidance eliminates the concept of extraordinary items from U.S. GAAP. Under the existing guidance, an entity is required to separately disclose extraordinary items, net of tax, in the income statement after income from continuing operations if an event or transaction is of an unusual nature and occurs infrequently. This separate, net-of-tax presentation (and corresponding earnings per share impact) will no longer be allowed. The existing requirement to separately present items that are of an unusual nature or occur infrequently on a pre-tax basis within income from continuing operations has been retained. The new guidance also requires similar separate presentation of items that are both unusual and infrequent. The standard is effective for periods beginning after December 15, 2015. The effective date is the same for both public companies and all other entities. Early adoption is permitted, but only as of the beginning of the fiscal year of adoption. Upon adoption, a reporting entity may elect prospective or retrospective application. If adopted prospectively, both the nature and amount of any subsequent adjustments to previously reported extraordinary items must be disclosed. We have not elected to early adopt this guidance. The new guidance is not expected to have a material impact on our consolidated financial statements.

In February 2015, the FASB issued guidance to simplify and reduce the number of consolidation models through the elimination of an indefinite deferral for certain entities and by placing more emphasis on risk of loss when determining a controlling financial interest. The guidance affects reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidation model. The standard is effective for a public company for fiscal years, and for interim periods within fiscal years beginning after December 15, 2015. The standard is effective for other entities for fiscal years beginning after December 31, 2016, and for interim periods beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. We have not elected to early adopt this guidance. The new guidance is not expected to have a material impact on our consolidated financial statements.

In April 2015, the FASB issued guidance to amend the presentation of debt issuance cost related to a recognized debt liability. Under the new guidance, the debt issuance costs will be presented in the balance sheet as a direct deduction from the carrying amount of the recognized debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected under the new guidance. The standard is effective for a public company for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The standard is effective for other entities for the fiscal years beginning December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016. Early adoption is permitted. The guidance should be applied on a retrospective basis. The balance sheet of each individual period presented should be adjusted to reflect the period-specific effects of applying the new guidance. Upon adoption, an entity is required to comply with the applicable disclosures for a change in an accounting principle. These disclosures include the nature of and reason for the change in accounting principle, the transition method, a description of the prior-period information that has been retrospectively adjusted, and the effect of the change on the financial statement line items (i.e., debt issuance cost asset and the debt liability). We have not elected to early adopt this guidance. The new guidance is not expected to have a material impact on our consolidated financial statements.

Results of Operations

The following discussion of our results of operations highlights our performance for the three and nine months ended September 30, 2015 and September 30, 2014. For the three and nine months ended September 30, 2015, we had a net loss of \$1.9 million and net income of \$10.6 million or \$(0.05) and \$0.24 per basic and diluted weighted average common share, respectively. For the three and nine months ended September 30, 2014, we had a net income of \$26.1 million and \$85.3 million or \$0.63 and \$2.35 per basic and diluted weighted average common share, respectively.

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

Table of Contents

Investments

The following table presents certain information about our investment portfolio at September 30, 2015 (dollars in thousands):

	Principal Balance	Unamortized Premium (Discount)	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain (Loss)	Fair Value	Net Weighted Average Coupon (1)
Agency RMBS							
20-Year mortgage							
Coupon Rate:							
3.00%	\$ 95,394	\$ 4,138	\$	\$ 99,532	\$ (557)	\$ 98,975	3.0%
3.50%	152,775	8,507		161,282	444	161,726	3.5%
4.00%	515,975	28,304		544,279	12,516	556,795	4.0%
	764,144	40,949		805,093	12,403	817,496	3.8%
30-Year mortgage							
Coupon Rate:							
3.50%	203,388	15,104		218,492	(4,674)	213,818	3.5%
4.00%	408,750	33,696		442,446	(69)	442,377	4.0%
4.50%	435,237	31,781		467,018	14,897	481,915	4.5%
5.50%	3,046	470		3,516	(104)	3,412	5.5%
6.00%	6,577	763		7,340	128	7,468	6.0%
	1,056,998	81,814		1,138,812	10,178	1,148,990	4.1%
Agency RMBS IOs and IIOs(2)							
	N/A	N/A		98,680	6,853	105,533	3.5%
Agency and Non-Agency IOs and IIOs accounted for as derivatives (2)(3)							
	N/A	N/A	N/A	N/A	N/A	68,730	2.7%
	N/A	N/A		98,680	6,853	174,263	3.1%
Non-Agency RMBS							
	604,367	(29,849)	(125,755)	448,763	9,507	458,270	3.7%
Non-Agency RMBS IOs and IIOs(2)							
	N/A	N/A	N/A	69,420	14,591	84,011	6.1%
	604,367	(29,849)	(125,755)	518,183	24,098	542,281	4.6%
Agency and Non-Agency CMBS, including Non U.S.							
	566,717	(71,238)	(2,830)	492,649	(3,298)	489,351	5.2%
CMBS Interest-Only Strips(2)							
	N/A	N/A	N/A	2,332	318	2,650	4.9%
	566,717	(71,238)	(2,830)	494,981	(2,980)	492,001	5.1%
Other securities (4)							
	154,496	12,735	(10,706)	179,008	(1,530)	177,478	5.0%
Residential Whole-Loans							
	145,385	1,908		147,293	3,193	150,486	5.1%
Total	\$ 3,292,107	\$ 36,319	\$ (139,291)	\$ 3,382,050	\$ 52,215	\$ 3,502,995	4.0%

(1) Net weighted average coupon as of September 30, 2015 is presented net of servicing and other fees.

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

(2) Agency RMBS IOs and IIOs, Non-Agency RMBS IOs and IIOs, Agency and Non-Agency IOs and IIOs, accounted for as derivatives, and Agency and Non-Agency CMBS IOs and IIOs have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities. At September 30, 2015, the notional balance for Agency RMBS IOs and IIOs, Non-Agency IOs and IIOs, Agency, Non-Agency IOs and IIOs, accounted for as derivatives, and CMBS IOs and IIOs was \$752.7 million, \$331.6 million, \$708.4 million and \$43.3 million, respectively.

(3) Interest on these securities is reported as a component of Gain (loss) on derivative instruments, net.

(4) Other securities includes residual interests in asset-backed securities which have no principal balance and an amortized cost of approximately \$22.5 million.

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

Table of Contents

The following table summarizes our MBS and other securities at fair value according to their estimated weighted average life classifications as of September 30, 2015 (dollars in thousands):

Weighted Average Life	Fair Value	Net Weighted Average Coupon(1)
Less than or equal to three years	\$ 114,192	4.5%
Greater than three years and less than or equal to five years	985,240	4.6%
Greater than five years and less than or equal to 10 years	2,158,767	3.7%
Greater than 10 years	94,310	1.5%
Total	\$ 3,352,509	4.0%

(1) Net weighted average coupon as of September 30, 2015 is presented net of servicing and other fees.

The following table summarizes certain characteristics of our Agency RMBS portfolio by issuer and investment category as of September 30, 2015 (dollars in thousands):

	Principal Balance	Amortized Cost	Fair Value	Net Weighted Average Coupon (1)
Agency RMBS 20-Year and 30-Year				
Fannie Mae	1,272,576	1,361,785	1,378,311	4.0%
Freddie Mac	548,566	582,120	588,175	3.9
Total Agency RMBS 20-Year and 30-Year	1,821,142	1,943,905	1,966,486	4.0
Agency RMBS IOs and IIOs(2)				
Fannie Mae	N/A	38,808	44,291	3.4
Freddie Mac	N/A	23,816	24,012	2.8
Ginnie Mae	N/A	36,056	37,230	4.4
Total Agency RMBS IOs and IIOs(2)	N/A	98,680	105,533	3.5
Agency RMBS IOs and IIOs accounted for as derivatives(2)				
Fannie Mae	N/A	N/A	18,511	3.2
Freddie Mac	N/A	N/A	4,499	3.5
Ginnie Mae	N/A	N/A	29,388	4.2
Total Agency RMBS IOs and IIOs accounted for as derivatives (2)	N/A	N/A	52,398	3.7
Total: Agency RMBS	\$ 1,821,142	\$ 2,042,585	2,124,417	3.8%

(1) Net weighted average coupon as of September 30, 2015 is presented net of servicing and other fees.

(2) Agency RMBS IOs and IIOs, Agency RMBS IOs and IIOs, accounted for as derivatives have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities.

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

The following table details the constant prepayment rates for our Agency portfolio as of September 30, 2015, based on our Manager's estimates which are based on third party models, as adjusted by our Manager, and are updated quarterly on a prospective basis:

Constant Prepayment Rates	Low	High
Agency RMBS		
20-Year mortgage	6.47%	27.54%
30-Year mortgage	5.44%	29.07%
Agency RMBS IOs and IIOs	7.93%	27.11%
Agency RMBS IOs and IIOs accounted for as derivatives	5.22%	29.00%
Agency CMBS and Agency CMBS IOs and IIOs(1)	N/A	N/A
Agency CMBS IOs accounted for as derivatives(1)	N/A	N/A

(1) CMBS generally include prepayment restrictions; therefore, there are no Constant Prepayment Rates available.

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

Table of Contents

The following table presents the fair value and weighted average purchase price for each of our Non-agency RMBS categories, together with certain of their respective underlying loan collateral attributes and current performance metrics as of September 30, 2015 (fair value dollars in thousands):

Category	Fair Value	Weighted Average Purchase Price	Weighted Average Life (Years)	Original LTV	Original FICO	60+ Day Delinquent	6-Month CPR
Prime	\$ 91,756	\$ 73.86	5.6	69.8%	724	6.1%	13.0%
Alt-A	372,436	77.25	5.6	73.9%	707	6.9%	10.7%
Subprime	81,908	66.39	6.8	79.2%	630	10.3%	8.5%
Total	\$ 546,100	\$ 75.05	5.8	74.0%	698	7.3%	10.8%

The following table summarizes the credit ratings of our Non-agency RMBS, Non-agency CMBS and other securities based on fair value as of September 30, 2015:

Non-Agency RMBS Credit Rating (1)	Percentage	Non-Agency CMBS Credit Rating(1)	Percentage	Other Securities Credit Rating(1)	Percentage
BBB	0.2%	BBB	%	BBB	%
BBB-		% BBB-	0.9%	BBB-	%
BB		% BB	5.7%	BB	%
BB-		% BB-	1.8%	BB-	%
B+		% B+	1.9%	B+	%
B	0.9%	B	11.0%	B	%
B-	0.2%	B-	10.6%	B-	%
Below B	80.5%	Below B	46.5%	Below B	6.3%
Not Rated	18.2%	Not Rated	21.6%	Not Rated	93.7%
Total	100.0%	Total	100.0%	Total	100.0%

(1) For securities for which one or two ratings are obtained, the lower rating is used. For securities for which three ratings are obtained, the middle rating is used. Ratings are obtained either from S&P or other rating agencies, stated in terms of the S&P equivalent.

The following table details information for our Non-Agency and other securities portfolio as of September 30, 2015, based on our Manager's estimates which are based on third party models, as adjusted by our Manager, and are updated quarterly on a prospective basis:

	Cumulative Default		Cumulative Severity		Cumulative 5-Year CRR	
	Low	High	Low	High	Low	High
Non-Agency RMBS	0.77%	37.72%	6.04%	69.77%	%	17.88%
Non-Agency RMBS IOs and IIOs	%	32.42%	10.40%	24.94%	8.42%	17.88%
Non-Agency RMBS IOS and IIOs accounted for as derivatives	5.32%	24.93%	6.78%	9.73%	9.21%	12.17%
Non-Agency CMBS	N/A	N/A	N/A	N/A	N/A	N/A
Other securities	%	8.36%	%	75.00%	%	13.47%

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

We made investments in certain Non-Agency RMBS inverse floaters. The coupon rates on these securities have an inverse relationship to a benchmark rate. When the benchmark interest rate increases the coupon payment rate will decrease because the benchmark interest rate is deducted from the coupon payment. We generally purchased these securities at a premium. Accelerated prepayments on these bonds could result in an economic loss, as we would not recover the upfront premium. The premiums are amortized into income using the effective interest rate method. As of September 30, 2015 and September 30, 2014, we held \$84.7 million and \$105.7 million, respectively, in Non-Agency RMBS inverse floaters excluding linked transactions. In addition as of September 30, 2014, we held \$8.5 million in Non-Agency RMBS inverse floaters accounted for as linked transactions.

The following table presents certain information about our Residential Whole-Loans investment portfolio at September 30, 2015 (dollars in thousands):

Current Coupon Rate	Number of Loans	Principal Balance	Weighted Average Original Loan to Value	Weighted Average Original FICO Score(1)	Weighted Average Life to Maturity (years)	Weighted Average Coupon Rate
4.01 5.00%	48	\$ 14,509	57.6%	728	1.7	4.8%
5.01 6.00%	292	125,987	55.2%	729	1.6	5.1%
6.01 7.00%	12	4,889	69.1%	722	1.5	6.0%
Total	352	\$ 145,385	55.9%	728	1.6	5.1%

(1) The original FICO score is not available for 101 loans with a principal balance of approximately \$38.9 million at September 30, 2015. We have excluded those loans from the weighted average computation.

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

Table of Contents

The following table presents the U.S. states in which the collateral securing our Residential Whole-Loans at September 30, 2015, based on principal balance is located (dollars in thousands):

	State Concentration	Principal Balance
California	84.6%	\$ 123,016
Washington	6.4	9,374
Massachusetts	5.6	8,147
Georgia	1.2	1,696
Florida	0.9	1,329
Other	1.3	1,823
Total	100.0%	\$ 145,385

We acquired our first Commercial Whole-Loan, with a loan to value of 67% at acquisition during the first quarter 2015 which was subsequently been paid off in full during the third quarter 2015. The Commercial Whole-Loan was a performing first mortgage loan with collateral located in California and with a maturity of January 2016.

Investment Activity

Agency and Non-Agency RMBS, Agency and Non-Agency CMBS, IO and IIO Securities, Other Securities and Residential and Commercial Whole-Loans.

The following tables present our investment portfolio activity, for the three and nine months ended September 30, 2015 (dollars in thousands):

	For the three months ended September 30, 2015		
	Purchases	Principal Payments and Basis Recovery	Proceeds from Sales
Agency RMBS and Agency RMBS IOs and IIOs	\$	\$ 82,022	\$ 421,351
Non-Agency RMBS		18,835	25,663
Agency CMBS and Agency CMBS IOs and IIOs		1,584	
Non-Agency CMBS	66,758	560	55,637
Other securities	30,000	1,938	760,199
Total MBS and other securities	\$ 96,758	104,939	\$ 1,262,850
Residential Whole-Loans(1)	132,401	6,514	
Commercial Whole-Loans		8,750	
Total MBS and other securities: Including Residential and Commercial Whole-Loans	\$ 229,159	\$ 120,203	\$ 1,262,850

(1) Purchases of Residential Whole-Loans include premiums of \$2.1 million paid at acquisition.

	For the nine months ended September 30, 2015		
	Purchases	Principal Payments and Basis Recovery	Proceeds from Sales
Agency RMBS and Agency RMBS IOs and IIOs	\$ 159,048	\$ 251,018	\$ 931,332
Non-Agency RMBS	128,066	55,765	233,257
Agency CMBS and Agency CMBS IOs and IIOs		3,848	
Non-Agency CMBS	182,339	1,497	146,525
Other securities	95,126	2,933	776,564
Total MBS and other securities	\$ 564,579	315,061	\$ 2,087,678
Residential Whole-Loans(1)	149,726	9,077	
Commercial Whole-Loans	8,750	8,750	
Total MBS and other securities: Including Residential and Commercial Whole-Loans	\$ 723,055	\$ 332,888	\$ 2,087,678

(1) Purchases of Residential Whole-Loans include premiums of \$2.4 million paid at acquisition.

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

Table of Contents

The following tables present our investment portfolio activity, including linked transactions (Non-GAAP) for the three and nine months ended September 30, 2014 (dollars in thousands):

	For the three months ended September 30, 2014		
	Purchases	Principal Payments and Basis Recovery	Proceeds from Sales
Agency RMBS and Agency RMBS IOs and IIOs	\$ 104,228	\$ 73,136	\$ 268,694
Non-Agency RMBS	99,257	20,287	155,366
Agency CMBS and Agency CMBS IOs and IIOs	4,813	830	3,672
Non-Agency CMBS (1)	48,143	883	84,172
Other securities (2)	66,385	672	
Total MBS and other securities: Excluding Linked Transactions (GAAP)	\$ 322,826	\$ 95,808	\$ 511,904
Non-Agency RMBS Linked Transactions		631	6,214
Other securities Linked Transactions	13,083		
Total MBS and other securities: Including Linked Transactions (Non-GAAP)	\$ 335,909	\$ 96,439	\$ 518,118

(1) Principal payments and basis recovery for Non-Agency CMBS was originally reported as \$(883) and has been revised above.

(2) Principal payments and basis recovery for Other securities was originally reported as \$(672) and has been revised above.

	For the nine months ended September 30, 2014		
	Purchases	Principal Payments and Basis Recovery	Proceeds from Sales
Agency RMBS and Agency RMBS IOs and IIOs	\$ 2,448,578	\$ 187,211	\$ 1,605,046
Non-Agency RMBS	703,272	43,049	395,456
Agency CMBS and Agency CMBS IOs and IIOs	24,009	1,664	3,673
Non-Agency CMBS, including Non U.S.	498,458	883	157,231
Other securities	144,559	672	78,932
Total MBS and other securities: Excluding Linked Transactions (GAAP)	\$ 3,818,876	\$ 233,479	\$ 2,240,338
Non-Agency RMBS Linked Transactions		4,408	6,214
Non-Agency CMBS Linked Transactions, including Non U.S.	25,141		
Other securities Linked Transactions	13,083		
Total MBS and other securities: Including Linked Transactions (Non-GAAP)	\$ 3,857,100	\$ 237,887	\$ 2,246,552

(1) Principal payments and basis recovery for Non-Agency CMBS was originally reported as \$(883) and has been revised above.

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

(2) Principal payments and basis recovery for Other securities was originally reported as \$(672) and has been revised above.

For the three and nine months ended September 30, 2014, we realized a net loss of \$192 thousand and a net gain of \$1.1 million, respectively, from the unlinking of securities previously accounted for as derivatives through linked transactions. Through December 31, 2014, we reclassified, from mark-to-market adjustments on linked transactions to realized gain (loss) on linked transactions during the period the respective security became unlinked.

The following table presents the vintage of our investment portfolio at September 30, 2015:

	2001	2003	2004	2005	2006	2007	2010	2011	2012	2013	2014	2015	Total
Agency RMBS													
20-Year Mortgage								0.1%	13.2%	7.7%	12.0%		33.0%
30-Year Mortgage									4.1%	12.1%	7.0%	0.1%	23.3%
Agency Interest Only-Strips					0.2%		0.1%	0.1%	1.6%	0.6%	0.4%		3.0%
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives				0.1%	0.1%		0.2%	0.1%	0.9%	0.5%	0.1%		2.0%
Non-Agency RMBS		0.1%	0.8%	3.9%	3.7%	4.3%					0.8%	1.7%	15.3%
Agency and Non-Agency CMBS					4.6%	3.5%		1.0%	0.2%	0.1%	2.3%	2.3%	14.0%
Other securities	0.3%									0.8%	1.4%	2.6%	5.1%
Residential Whole-Loans								0.2%	0.4%	1.8%	1.7%	0.2%	4.3%
Total	0.3%	0.1%	0.8%	4.0%	8.6%	7.8%	0.3%	1.5%	20.4%	23.6%	25.7%	6.9%	100%

Table of Contents

As of September 30, 2015 the weighted average expected remaining term to the expected maturity of our investment portfolio is 5.8 years.

Financing and Other Liabilities. We have entered into repurchase agreements to finance the vast majority of our MBS and other assets. These agreements are secured by substantially all of our MBS and other securities and bear interest at rates that have historically moved in close relationship to LIBOR. The following table summarizes the fair value of MBS and other collateral pledged as of September 30, 2015 and December 31, 2014 (dollars in thousands):

Collateral	September 30, 2015		December 31, 2014	
	Repurchase Agreement Borrowings Outstanding	Fair Value of Collateral Pledged (1)	Repurchase Agreement Borrowings Outstanding	Fair Value of MBS Collateral Pledged(1)
Agency RMBS	\$ 2,012,976	\$ 2,118,025	\$ 2,994,351	\$ 3,158,544
Non-Agency RMBS	386,779	546,016	473,942	670,526
Agency and Non-Agency CMBS	367,727	504,514	325,864	431,938
Other securities and Whole-Loans(1)	242,786	325,614	81,564	108,743
Total: Excluding Linked Transactions	\$ 3,010,268	\$ 3,494,169	\$ 3,875,721	\$ 4,369,751
Non-Agency RMBS Linked Transactions			6,559	8,156
Non-Agency CMBS Linked Transactions, including Non U.S.			22,458	38,609
Other securities Linked Transactions			2,840	5,719
Total: Including Linked Transactions (Non-GAAP)	\$ 3,010,268	\$ 3,494,169	\$ 3,907,578	\$ 4,422,235

(1) Other securities and Whole-Loans includes repurchase borrowings of \$118.4 million and \$4.9 million and collateral pledged attributed to Residential Whole-Loans owned through trust certificates with a fair value of \$150.5 million and \$7.2 million at September 30, 2015 and December 31, 2014, respectively. The trust certificates are eliminated upon consolidation.

The following tables present our borrowing activity, by type of collateral pledged, for the three and nine months ended September 30, 2015 and September 30, 2014 (dollars in thousands):

Collateral	For the three months ended September 30, 2015		For the nine months ended September 30, 2015	
	Proceeds	Repayments	Proceeds	Repayments
Agency RMBS	\$ 2,918,120	\$ 3,426,576	\$ 9,653,715	\$ 10,635,086
Non-Agency RMBS	544,168	565,300	1,772,226	1,869,682
	514,902	511,486	1,691,077	1,670,225

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

Agency and Non-Agency CMBS					
Other securities and Whole-Loans(1)	256,581	126,534	528,837	366,724	
Total	\$ 4,233,771	\$ 4,629,896	\$ 13,645,855	\$ 14,541,717	

(1) Other securities and Whole-Loans includes repurchase borrowings proceeds of \$110.3 million and \$123.9 million and repayments of \$8.8 million and \$10.4 million for borrowings collateralized by Residential Whole-Loans owned through trust certificates for the three and nine months ended September 30, 2015, respectively. The trust certificates are eliminated upon consolidation.

Collateral	For the three months ended September 30, 2014		For the nine months ended September 30, 2014, as Revised	
	Proceeds	Repayments	Proceeds	Repayments
Agency RMBS	\$ 4,797,884	\$ 5,015,844	\$ 14,617,401	\$ 13,902,320
Non-Agency RMBS	881,572	917,640	2,200,665	1,940,923
Agency and Non-Agency CMBS	512,590	539,778	947,256	676,775
Other securities	171,926	119,831	396,111	338,355
Total: Excluding Linked Transactions	\$ 6,363,972	\$ 6,593,093	\$ 18,161,433	\$ 16,858,373
Non-Agency RMBS Linked Transactions	31,017	36,511	106,826	161,225
Non-Agency CMBS Linked Transactions, including Non U.S.	13,965	14,022	29,163	14,022
Other securities Linked Transactions	6,541	3,701	6,541	3,701
Total	\$ 6,415,495	\$ 6,647,327	\$ 18,303,963	\$ 17,037,321

Revision of borrowing activity, by type of collateral pledged, for the nine months ended September 30, 2014.

Table of Contents

As discussed further in Note 2 – Revision of Previously Issued Financial Statements for Errors Affecting Certain Items Presented in the Statements of Cash Flows and Notes to Financial Statements, we have elected to revise our presentation of borrowing activity, by type of collateral pledged, for the nine months ended September 30, 2014 in this quarterly financial statements on Form 10-Q to correct these errors.

The effect of these errors on the tables presenting our borrowing activity, by type of collateral pledged, for the nine months ended September 30, 2014 (summarized):

As Originally Reported

(dollars in thousands) Collateral	For the nine months ended September 30, 2014	
	Proceeds	Repayments
Non-Agency RMBS	\$ 2,203,422	\$ 1,943,680
All other items with no changes	15,960,768	14,917,450
Total: Excluding Linked Transactions	\$ 18,164,190	\$ 16,861,130
All other Linked Transactions items with no changes	142,530	178,948
Total	\$ 18,306,720	\$ 17,040,078

Adjustments

(dollars in thousands) Collateral	For the nine months ended September 30, 2014	
	Proceeds	Repayments
Non-Agency RMBS	\$ (2,757)	\$ (2,757)
All other items with no changes		
Total: Excluding Linked Transactions	\$ (2,757)	\$ (2,757)
All other Linked Transactions items with no changes		
Total	\$ (2,757)	\$ (2,757)

Revised

(dollars in thousands) Collateral	For the nine months ended September 30, 2014	
	Proceeds	Repayments
Non-Agency RMBS	\$ 2,200,665	\$ 1,940,923
All other items with no changes	15,960,768	14,917,450
Total: Excluding Linked Transactions	\$ 18,161,433	\$ 16,858,373
All other Linked Transactions items with no changes	142,530	178,948
Total	\$ 18,303,963	\$ 17,037,321

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

Table of Contents

At September 30, 2015, we had outstanding repurchase agreement borrowings with the following 19 counterparties totaling approximately \$3.0 billion:

(dollars in thousands) Repurchase Agreement Counterparties	Amount Outstanding	Percent of Total Amount Outstanding	Fair Value of Company Securities & Whole- Loans Held as Collateral	Counterparty Rating(3)
Merrill Lynch Pierce Fenner & Smith Inc. (1)	\$ 456,367	15.2%	\$ 471,517	A
JP Morgan Securities LLC (1)	434,522	14.4%	465,567	A+
RBC (Barbados) Trading Bank Corporation(1)	317,783	10.6%	419,924	P-1
UBS Securities LLC (1)	294,907	9.8%	369,463	A
Deutsche Bank Securities LLC (1)	270,220	9.0%	289,204	BBB+
Credit Suisse Securities (USA) LLC (1)(2)	251,024	8.3%	353,222	A
Barclays Capital Inc. (1)	242,059	8.0%	286,820	A-
BNP Paribas Securities Corporation (1)	166,783	5.5%	176,570	A+
Goldman Sachs Bank USA (1)	151,358	5.0%	157,987	A
Mizuho Securities USA Inc. (1)	108,361	3.6%	124,048	(P)A2
Morgan Stanley & Co. LLC (1)	69,272	2.3%	76,097	A
RBC Capital Markets LLC (1)	67,952	2.3%	71,154	AA-
Nomura Securities International, Inc. (1)	67,839	2.3%	83,510	Unrated(4)
Deutsche Bank AG (1)	64,297	2.1%	93,705	BBB+
Jefferies & Company Inc.	12,192	0.4%	12,903	BBB-
Citigroup Global Markets Inc.	11,434	0.4%	15,326	A
Wells Fargo Securities LLC	10,810	0.4%	11,482	AA-
KGS-Alpha Capital Markets, L.P.	9,782	0.3%	10,131	Unrated
Credit Suisse Securities (Europe) Limited	3,306	0.1%	5,539	A
Total	\$ 3,010,268	100.0%	\$ 3,494,169	

(1) Counterparty holds collateral valued in excess of 5% of our stockholders' equity as security for our obligations under the applicable repurchase agreements as of September 30, 2015.

(2) Fair value of Company assets held as collateral includes Residential Whole-Loans owned through trust certificates with a fair value of \$150.5 million.

(3) The counterparty ratings presented above are the long-term issuer credit ratings as rated at September 30, 2015 by S&P, except for Mizuho Securities USA Inc. which is the long-term issuer credit rating by Moody's at September 30, 2015 and for RBC (Barbados) Trading Bank Corporation which is the short-term issuer credit rating by Moody's at September 30, 2015.

(4) Nomura Holdings, Inc., the parent company of Nomura Securities International, Inc., is rated BBB+ by S&P at September 30, 2015.

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

Table of Contents

At December 31, 2014, we had outstanding repurchase agreement borrowings with the following 21 counterparties totaling approximately \$3.9 billion, which is a Non-GAAP measure due to our Linked Transactions, which is reconciled to GAAP below as follows:

Merrill Lynch Pierce Fenner & Smith Inc. (1)	\$ 598,717	15.3%	\$ 621,152	A
Barclays Capital Inc. (1)	364,609	9.3%	413,245	A
BNP Paribas Securities Corporation (1)	336,531	8.6%	359,216	A+
UBS Securities LLC (1)	256,405	6.6%	307,947	A
Goldman Sachs Bank USA (1)	236,873	6.1%	246,796	A
Morgan Stanley & Co. LLC (1)	157,926	4.0%	162,348	A
RBC Capital Markets LLC (1)	75,003	1.9%	78,413	AA-
The Royal Bank of Scotland plc (1)	51,252	1.3%	70,333	A-
Nomura Securities International, Inc. (1)	41,226	1.1%	42,449	Unrated(4)
Deutsche Bank AG (1)	27,362	0.7%	41,866	A
Wells Fargo Securities LLC	5,974	0.2%	7,968	AA-
Linked Transactions	31,857		52,483	

(1) Counterparty holds collateral valued in excess of 5% of our stockholders' equity as security for our obligations under the applicable repurchase agreements as of December 31, 2014.

(2) Fair value of Company assets held as collateral includes Residential Whole-Loans owned through trust certificates with a fair value of \$7.2 million.

(3) The counterparty ratings presented above are the long-term issuer credit ratings as rated at December 31, 2014 by S&P, except for Mizuho Securities USA Inc. which is the long-term issuer credit rating by Moody's at December 31, 2014 and for RBC (Barbados) Trading Bank Corporation which is the short-term issuer credit rating by Moody's at December 31, 2014.

(4) Nomura Holdings, Inc., the parent company of Nomura Securities International, Inc., is rated BBB+ by S&P at December 31, 2014.

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

Table of Contents

We record the liability for MBS and other securities purchased, for which settlement has not taken place as an investment related payable. As of September 30, 2015, we had investment related payables of \$10.7 million of which no items were outstanding greater than 30 days.

The following tables present our borrowings by type of collateral pledged as of September 30, 2015 and September 30, 2014, and the respective Cost of Funds for the three and nine months then ended (dollars in thousands):

Collateral	Balance (GAAP) September 30, 2015	Weighted Average Cost of Funds for the three months ended September 30, 2015	Weighted Average Cost of Funds for the nine months ended September 30, 2015
Agency RMBS	\$ 2,012,976	0.49%	0.43%
Non-Agency RMBS	386,779	1.64	1.59
Agency and Non-Agency CMBS	367,727	1.62	1.57
Other securities and Whole-Loans (1)	242,786	2.22	2.11
Total	\$ 3,010,268	0.90%	0.75%

(1) Other securities include repurchase borrowings of \$118.4 million collateralized by Residential Whole-Loans owned through trust certificates at September 30, 2015. The trust certificates are eliminated upon consolidation.

Collateral	Balance (GAAP) September 30, 2014	Weighted Average Cost of Funds for the three months ended September 30, 2014	Weighted Average Cost of Funds for the nine months ended September 30, 2014
Agency RMBS	\$ 3,046,358	0.37%	0.38%
Non-Agency RMBS	468,664	1.65	1.63
Agency and Non-Agency CMBS	288,025	1.52	1.48
Other securities	79,080	1.31	1.46
Total	\$ 3,882,127	0.63%	0.58%

The following tables present our borrowings by type of collateral pledged as of September 30, 2015 and September 30, 2014, and the respective Effective Cost of Funds (Non-GAAP financial measure) for the three and nine months then ended (dollars in thousands) See Non-GAAP financial measures :

Collateral	Balance (Non- GAAP) September 30, 2015	Weighted Average Effective Cost of Funds for the three months ended September 30,	Weighted Average Effective Cost of Funds for the nine months ended September 30,
------------	---	---	--

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

		2015 (1)	2015 (1)
Agency RMBS	\$	2,012,976	1.33%
Non-Agency RMBS		386,779	2.03
Agency and Non-Agency CMBS		367,727	2.12
Other securities and Whole-Loans(2)		242,786	2.22
Total	\$	3,010,268	1.58%

(1) The effective cost of funds for the three and nine months ended September 30, 2015 are calculated on an annualized basis and include interest expense for the periods and net periodic interest payments on interest rate swaps, net of premium amortization on MAC swaps, of approximately \$5.2 million and \$10.8 million, respectively. While swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are classified as hedges for purposes of satisfying the REIT requirements. See Non-GAAP Financial Measures.

(2) Other securities and Whole-Loans include repurchase borrowings of \$118.4 million for Residential Whole-Loans owned through trust certificates at September 30, 2015. The trust certificates are eliminated upon consolidation.

Table of Contents

Agency RMBS	\$	3,046,358	1.62%	1.41%
Agency and Non-Agency CMBS		288,025	2.36	2.14
Total: Excluding Linked Transactions	\$	3,882,127	1.72%	1.50%
Non-Agency CMBS Linked Transactions, including Non U.S.		14,022	2.05	1.96
Total	\$	3,905,777	1.72%	1.50%

(1) The effective cost of funds for the three and nine months ended September 30, 2014 are calculated on an annualized basis and include interest expense for the periods and net periodic interest payments on interest rate swaps, net of premium amortization on MAC swaps, of approximately \$11.0 million and \$24.9 million, respectively and interest payments on Non-Agency and other securities linked transactions of approximately \$139 thousand and \$414 thousand, respectively. While swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are classified as hedges for purposes of satisfying the REIT tax requirements. In addition, although certain securities and their respective repurchase borrowings are classified as derivatives, we view the interest expense attributed to these borrowings as additional cost of funds. See Non-GAAP Financial Measures.

Revision of Weighted Average Effective Cost of Funds (Non-GAAP financial measure), by type of collateral pledged, for the three and nine months ended September 30, 2014

As discussed further in Note 2 – Revision of Previously Issued Financial Statements for Errors Affecting Certain Items Presented in the Statements of Cash Flows and Notes to Financial Statements, we have elected to revise our presentation of weighted average effective cost of funds (Non-GAAP financial measure), by type of collateral pledged, for the three and nine months ended September 30, 2014 in this quarterly financial statements on Form 10-Q to correct these errors.

The effect of these errors on the table presenting our weighted average effective cost of funds (Non-GAAP financial measure), by type of collateral pledged, for the three and nine months ended September 30, 2014 (dollars in thousands):

As Originally Reported

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

	Balance (Non- GAAP) September 30, 2014	Weighted Average Effective Cost of Funds for the three months ended September 30, 2014	Weighted Average Effective Cost of Funds for the nine months ended September 30, 2014
Collateral			
Agency RMBS	\$ 3,046,358	1.71%	1.45%
Non-Agency RMBS	468,664	2.00	1.86
Agency and Non-Agency CMBS	288,025	2.42	2.18
Other securities	79,080	1.31	1.46
Total: Excluding Linked Transactions	\$ 3,882,127	1.80%	1.53%
Non-Agency RMBS Linked Transactions	6,788	1.54	1.70
Non-Agency CMBS Linked Transactions, including Non U.S.	14,022	2.05	1.96
Other Securities Linked Transactions	2,840	2.01	1.96
Total	\$ 3,905,777	1.80%	1.53%

Table of Contents

Adjustments

	Balance (Non-GAAP) September 30, 2014	Weighted Average Effective Cost of Funds for the three months ended September 30, 2014	Weighted Average Effective Cost of Funds for the nine months ended September 30, 2014
Collateral			
Agency RMBS	\$	(0.09)%	(0.04)%
Non-Agency RMBS		(0.03)	(0.01)
Agency and Non-Agency CMBS		(0.06)	(0.04)
Other securities			
Total: Excluding Linked Transactions	\$	(0.08)%	(0.03)%
Non-Agency RMBS Linked Transactions			
Non-Agency CMBS Linked Transactions, including Non U.S. Other Securities Linked Transactions			
Total	\$	(0.08)%	(0.03)%

Revised

	Balance (Non-GAAP) September 30, 2014	Weighted Average Effective Cost of Funds for the three months ended September 30, 2014	Weighted Average Effective Cost of Funds for the nine months ended September 30, 2014
Collateral			
Agency RMBS	\$ 3,046,358	1.62%	1.41%
Non-Agency RMBS	468,664	1.97	1.84
Agency and Non-Agency CMBS	288,025	2.36	2.14
Other securities	79,080	1.31	1.46
Total: Excluding Linked Transactions	\$ 3,882,127	1.72%	1.50%
Non-Agency RMBS Linked Transactions	6,788	1.54	1.70
Non-Agency CMBS Linked Transactions, including Non U.S. Other Securities Linked Transactions	14,022	2.05	1.96
Total	\$ 3,905,777	1.72%	1.50%

The following table presents our average borrowings, by type of collateral pledged, on a GAAP and Non-GAAP basis for the three and nine months ended September 30, 2015 and September 30, 2014 (in thousands):

	For the three months ended September 30, 2015		For the three months ended September 30, 2014		For the nine months ended September 30, 2015		For the nine months ended September 30, 2014	
Collateral								
Agency RMBS	\$	2,076,450	\$	3,163,587	\$	2,606,830	\$	3,020,536
Non-Agency RMBS		403,294		479,806		428,576		365,459
Agency and Non-Agency CMBS		362,808		326,917		361,795		190,547
Other securities and Whole-Loans (1)		222,137		71,983		139,180		60,857
	\$	3,064,689	\$	4,042,293	\$	3,536,381	\$	3,637,399

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

Total: Excluding Linked Transactions (GAAP)								
Non-Agency RMBS Linked Transactions (Non-GAAP)			11,604	25,056				
Non-Agency CMBS Linked Transactions (Non-GAAP), including Non U.S.			14,529	5,180				
Other securities Linked Transactions (Non-GAAP)			3,753	1,297				
Total (Non-GAAP)	\$	3,064,689	\$	4,072,179	\$	3,536,381	\$	3,668,932
Maximum borrowings during the period (Non-GAAP)(2)		3,092,726		4,228,887		3,968,357		4,258,778

(1) Other securities and Whole-Loans include average repurchase borrowings of \$105.5 million and \$42.3 million for Residential Whole-Loans owned through trust certificates for the three and nine months ended September 30, 2015, respectively. The trust certificates are eliminated upon consolidation.

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

Table of Contents

Derivative Instruments. As of September 30, 2015, we had entered into interest rate swaps designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements as such repurchase agreements are renewed and/or extended. The interest rate swaps generally provide for fixed interest rates that are indexed off of LIBOR and are viewed by us to effectively fix the floating interest rates, on our repurchase agreements. In managing our interest rate swap position in conjunction with our hedging strategy and potential tax implications, we may enter into variable-rate payment swaps which effectively act as an offset to fixed-rate payment swaps. As of September 30, 2015, we had approximately \$2.4 billion of variable-rate payment swaps in addition to \$537.0 million of forward starting variable-rate payment swaps.

The following tables present information about our fixed pay rate interest rate swaps as of September 30, 2015 and December 31, 2014 (dollars in thousands):

Remaining Interest Rate Swap Term	Notional Amount	September 30, 2015		Average Fixed Pay Rate	Average Maturity (Years)	Forward Starting
		Fair Value (Liability), net	Asset			
1 year or less	\$ 1,015,300	\$ (1,006)		0.6%	0.6	%
Greater than 1 year and less than 3 years	1,491,800	(8,193)		1.0	1.6	
Greater than 3 years and less than 5 years	1,204,500	(30,551)		1.9	4.8	
Greater than 5 years	1,881,300	(172,834)		3.0	10.3	51.1
Total	\$ 5,592,900	\$ (212,584)		1.8%	5.0	17.2%

Remaining Interest Rate Swap Term	Notional Amount	December 31, 2014		Average Fixed Pay Rate	Average Maturity (Years)	Forward Starting
		Fair Value (Liability), net	Asset			
1 year or less	\$ 89,300	\$ (111)		0.5%	0.9	%
Greater than 1 year and less than 3 years	1,972,300	(733)		0.8	1.8	20.3
Greater than 3 years and less than 5 years	603,000	(4,597)		1.8	4.2	
Greater than 5 years	3,103,770	(156,952)		2.8	9.4	63.1
Total	\$ 5,768,370	\$ (162,393)		2.0%	6.2	40.9%

The following tables present information about our variable pay rate interest rate swaps as of September 30, 2015 and December 31, 2014 (dollars in thousands):

Remaining Interest Rate swap Term	Notional Amount	September 30, 2015		Average Variable Pay Rate	Average Maturity (Years)	Forward Starting
		Fair Value (Liability), net	Asset			
Greater than 3 years and less than 5 years	\$ 1,735,800	\$ 9,249		0.3	4.8	
Greater than 5 years	1,203,100	19,865		0.3	11.8	44.6

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

Total	\$	2,938,900	\$	29,114	0.3%	7.7	18.3%
-------	----	-----------	----	--------	------	-----	-------

December 31, 2014

Remaining Interest Rate swap Term	Notional Amount	Fair Value (Liability), net	Asset	Average Variable Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 1 years and less than 3 years	\$ 220,000	\$ (164)		0.2%	2.0	%
Greater than 3 years and less than 5 years	634,000	2,210		0.2	4.5	
Greater than 5 years	1,309,600	45,229		0.2	12.1	8.4
Total	\$ 2,163,600	\$ 47,275		0.2%	8.8	5.1%

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

Table of Contents

The following tables present information about our interest rate swaptions as of September 30, 2015 and December 31, 2014 (dollars in thousands):

		September 30, 2015			
		Option	Weighted Average Months Until Option Expiration	Underlying Swap	Weighted Average Swap Term (Years)
Fixed-Pay Rate for Underlying Swap		Fair Value		Notional Amount	
1.76	2.00%	\$ 151	0.9	\$ 400,000	5.0
2.01	2.25%	22	0.9	100,000	5.0
2.26	2.50%	7	8.8	105,000	1.0
		\$ 180	2.3	\$ 605,000	4.3

		September 30, 2015			
		Option	Weighted Average Months Until Option Expiration	Underlying Swap	Weighted Average Swap Term (Years)
Fixed-Receive Rate for Underlying Swap		Fair Value		Notional Amount	
1.26	1.50%	\$ 2,904	0.9	\$ 500,000	5.0
		\$ 2,904	0.9	\$ 500,000	5.0

		December 31, 2014			
		Option	Weighted Average Months Until Option Expiration	Underlying Swap	Weighted Average Swap Term (Years)
Fixed-Pay Rate for Underlying Swap		Fair Value		Notional Amount	
2.26	2.50%	\$ 178	17.8	\$ 105,000	1.0
		\$ 178	17.8	\$ 105,000	1.0

We also purchased or shorted TBAs. As of September 30, 2015 and December 31, 2014, we had contracts to purchase (long position) and sell (short position) TBAs on a forward basis. Following is a summary of our long and short TBA positions reported in Derivative assets, at fair value, on the Consolidated Balance Sheets as of September 30, 2015 and December 31, 2014 (dollars in thousands):

	September 30, 2015		December 31, 2014	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Purchase contracts, asset	\$ 2,400,000	\$ 13,820	\$ 2,915,000	\$ 17,457
TBA securities, asset	2,400,000	13,820	2,915,000	17,457
Sale contracts, liability	(1,800,000)	(11,502)	(2,590,000)	(12,355)
TBA securities, liability	(1,800,000)	(11,502)	(2,590,000)	(12,355)
TBA securities, net	\$ 600,000	\$ 2,318	\$ 325,000	\$ 5,102

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

The following table presents additional information about our contracts to purchase and sell TBAs for the nine months ended September 30, 2015 (dollars in thousands):

	Notional Amount as of December 31, 2014	Additions	Settlement, Termination, Expiration or Exercise	Notional Amount as of September 30, 2015
Purchase of TBAs	\$ 2,915,000	\$ 27,526,000	\$ (28,041,000)	\$ 2,400,000
Sale of TBAs	\$ 2,590,000	\$ 27,251,000	\$ (28,041,000)	\$ 1,800,000

Table of Contents

We also enter into Eurodollar and U.S. Treasury futures. As of September 30, 2015, we had entered into contracts to sell (short position) U.S. Treasuries with a notional amount of \$6.5 million, a fair value in a liability position of \$57 thousand and an expiration date of December 2015. As of December 31, 2014, we had purchase contracts (long position) for Eurodollar futures, representing a notional amount of \$592.0 million with a fair value of \$451 thousand and an expiration date of June 2016. In addition, as of December 31, 2014, we had sale contracts (short position) for Eurodollar futures, representing a notional amount of \$592.0 million with a fair value in a liability position of \$1.2 million and an expiration date of June 2018. During the nine months ended September 30, 2015, we terminated both Eurodollar futures and realized a net loss of \$459 thousand.

We have invested in and, in the future, may invest in additional assets which are denominated in a currency or currencies other than U.S. dollars. Similarly, we have and may in the future, finance such assets in a currency or currencies other than U.S. dollars. In order to mitigate the impact to us, we may enter into derivative financial instruments, including foreign currency swaps and foreign currency forwards, to manage fluctuations in the valuation between U.S. dollars and such foreign currencies. Foreign currency swaps involve the payment of a foreign currency at fixed interest rate on a fixed notional amount and the receipt of U.S. dollars at a fixed interest rate on a fixed notional amount. Foreign currency forwards provide for the payment of a fixed amount of a foreign currency in exchange for a fixed amount of U.S. dollars at a date certain in the future. The carrying value of foreign currency swaps and forwards is included in Derivative assets (liabilities), at fair value on the Consolidated Balance Sheets with changes in valuation included in Gain (loss) on derivative instruments, net on the Consolidated Statement of Operations. The following is a summary of our foreign currency forwards at September 30, 2015 and December 31, 2014 (dollars and euros in thousands):

Derivative Type	September 30, 2015			
	Notional Amount	Notional (USD Equivalent)	Maturity	Fair Value
Buy EUR/Sell USD currency forward	11,000	\$ 12,058	October 2015	\$ 223
Buy USD/Sell EUR currency forward	3,610	4,031	October 2015	1
Currency forwards, assets	14,610	16,089	n/a	\$ 224
Buy USD/Sell EUR currency forward	5,083	\$ 5,600	October 2015	\$ (74)
Currency forwards, liabilities	5,083	\$ 5,600	n/a	\$ (74)
Total currency forwards	19,693	\$ 21,689	n/a	\$ 150

Derivative Type	December 31, 2014			
	Notional Amount	Notional (USD Equivalent)	Maturity	Fair Value
Buy USD/Sell EUR currency forward	3,331	\$ 4,143	January 2015	\$ 112
Buy USD/Sell EUR currency forward	7,766	9,417	January 2015	21
Buy USD/Sell EUR currency forward	3,471	4,211	February 2015	9
Buy EUR/Sell USD currency forward	5,000	6,051	January 2015	1
Currency forwards, assets	19,568	\$ 23,822	n/a	\$ 143
Buy USD/Sell EUR currency forward	5,043	\$ 6,104	February 2015	\$ (1)

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

Buy EUR/Sell USD currency forward	11,156		13,542	April 2015	(30)
Buy EUR/Sell USD currency forward	11,156		13,914	January 2015	(415)
Currency forwards, liabilities	27,355	\$	33,560	n/a	\$ (446)
Total currency forwards	46,923	\$	57,382	n/a	\$ (303)

The following is a summary of our foreign currency swaps with a fair value of \$7.8 million and \$3.9 million at September 30, 2015 and December 31, 2014, respectively (dollars and euros in thousands):

	Date entered	Maturity	Fixed Rate	Denomination	Notional Amount
Payer	June 2014	July 2024	7.25%	EUR	18,500
Receiver	June 2014	July 2024	9.005%	USD	25,160

Table of Contents***Net Interest Income***

We earned interest income, net of premium amortization and amortization/recovery of basis, and inclusive of discount accretion of approximately \$35.8 million and \$117.7 million for the three and nine months ended September 30, 2015, respectively and approximately \$40.7 million and \$108.8 million for the three and nine months ended September 30, 2014, respectively which represents interest earned on our assets. We incurred interest expense of approximately \$7.0 million and \$20.0 million for the three and nine months ended September 30, 2015, respectively and approximately \$6.5 million and \$15.8 million for the three and nine months ended September 30, 2014, respectively, which was related to borrowings from repurchase agreements. The decrease in interest income and the increase in interest expense for the three months ended September 30, 2015 as compared to the three months ended September 30, 2014, is primarily the result of a smaller average securities portfolio and the deleveraging of our portfolio in 2015. The increase in interest income and interest expense for the nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014 is primarily attributable to the overall increase in the weighted average yield of our portfolio, due to the shift to a more credit sensitive portfolio. The slight increase in interest expense for the nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014 is primarily attributable to a higher cost of funds, which is partially offset by lower average repurchase agreement borrowings. With respect to our borrowings from repurchase agreements, for the nine months ended September 30, 2015, as compared to the nine months ended September 30, 2014, our average borrowings decreased slightly from \$3.6 billion to \$3.5 billion, while the weighted average interest rate for the same periods, increased from 0.58% to 0.75%. Notwithstanding the foregoing, the increase in our average yield and average cost funds for the three and nine months ended September 30, 2015, as compared to the three and nine month periods ended September 30, 2014, is primarily the result of the change in the composition of our portfolio. When we went public in 2012, our focus was on Agency RMBS and at December 31, 2013, our portfolio consisted almost entirely of Agency RMBS. In 2013, the percentage of Agency RMBS in our portfolio decreased from 99.9% to 94.9% with the difference being invested almost entirely in Non-Agency RMBS. This trend continued in 2014, with the percentage of Agency RMBS decreasing to 77.8% and the percentage of Non-Agency RMBS and CMBS increasing to 13.5% and 6.7% respectively. As we shifted to a more credit-oriented portfolio, our average yield increased to 3.95% and 3.80% for the three and nine months ended September 30, 2015, respectively, from 3.64% and 3.58%, for the three and nine months ended September 30, 2014, respectively. While our average cost of funds also increased to 0.90% and 0.75% for the three and nine months ended September 30, 2015, respectively, from 0.63% and 0.58% for the three and nine months ended September 30, 2014. The increase in cost of funds was offset by the increase in average yield, resulting in a slight increase in net interest spread to 3.05% from 3.01% for the three months ended September 30, 2015 and 2014, respectively, and an increase in net interest spread to 3.05% from 3.00% for the nine months ended September 30, 2015 and 2014, respectively. Other factors impacting interest income include assumptions pertaining prepayments, defaults and loss severity on our credit sensitive portfolio. The cost of repurchase financing for Agency RMBS remained relatively constant over the past three years as the Federal Reserve continued to maintain its accommodative monetary policy. Our overall cost of repurchase financing has increased due to our gradual shift to credit sensitive investments. We have supplemented our discussion of GAAP net interest income discussed above, with a discussion below of our net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and net interest income (expenses), net incurred on swaps and linked-transactions, which only apply to the three and nine months ended September 30, 2014, a Non-GAAP measure, defined below, which gives a more concise view of our hedged portfolio as a whole.

Our effective gross yield, a non-GAAP measure, for the three and nine months ended September 30, 2015 was 4.03% and 3.86%, respectively and for the three and nine months ended September 30, 2014 was 3.75% and 3.72%, respectively. Our effective gross yield, a non-GAAP measure, increased for the three and nine months ended September 30, 2015 as compared to September 30, 2014 due to the change in composition of our portfolio to more credit-oriented assets. Our effective cost of funds, a non-GAAP measure, for the three and nine months ended September 30, 2015 was 1.58% and 1.16%, respectively and for the three and nine months ended September 30, 2014 was 1.80% and 1.53%, respectively. The decrease in our effective cost of funds for the three and nine months ended September 30, 2015 and 2014, respectively, primarily resulted from a decrease in the average effective notional of net pay-fixed interest rate swaps and a decrease in the weighted average net interest rate. For the three and nine months ended September 30, 2015, our hedging costs on interest rate swaps was 0.68% and 0.41%, respectively and for the three and nine months ended September 30, 2014 was 1.09% and 0.92%, respectively.

Table of Contents

The following tables set forth certain information regarding our net investment income for the three and nine months ended September 30, 2015 and September 30, 2014:

(dollars in thousands)	For the three months ended September 30, 2015					Total
	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities and Whole-Loans		
Average amortized cost of securities	\$ 2,282,135	\$ 538,623	\$ 467,835	\$ 311,825	\$ 3,600,418	
Total interest income (1)	\$ 14,929	\$ 8,839	\$ 8,061	\$ 3,992	\$ 35,821	
Yield on average securities	2.60%	6.51%	6.84%	5.08%	3.95%	
Average balance of repurchase agreements	\$ 2,076,450	\$ 403,294	\$ 362,808	\$ 222,137	\$ 3,064,689	
Total interest expense	\$ 2,590	\$ 1,668	\$ 1,479	\$ 1,244	\$ 6,981	
Average cost of funds (2)	0.49%	1.64%	1.62%	2.22%	0.90%	
Net interest income	\$ 12,339	\$ 7,171	\$ 6,582	\$ 2,748	\$ 28,840	
Net interest rate spread	2.11%	4.87%	5.22%	2.86%	3.05%	

(1) Amount includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(11.6) million for Agency RMBS, approximately \$(2.3) million for Non-Agency RMBS, approximately \$11 thousand for Agency and Non-Agency CMBS and approximately \$770 thousand for other securities and Whole-Loans for the three months ended September 30, 2015.

(2) For the three months ended September 30, 2015, cost of funds does not include accrual and settlement of interest, net of premium amortization on MAC swaps, of approximately \$5.2 million associated with derivative instruments. In accordance with GAAP, such costs are included in gain (loss) on derivative instruments, in the Consolidated Statement of Operations.

(dollars in thousands)	For the nine months ended September 30, 2015					Total
	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities and Whole-Loans		
Average amortized cost of securities	\$ 2,884,986	\$ 580,881	\$ 471,571	\$ 202,581	\$ 4,140,019	

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

Total interest income (1)	\$	58,508	\$	27,833	\$	22,939	\$	8,376	\$	117,656
Yield on average securities		2.71%		6.41%		6.50%		5.53%		3.80%
Average balance of repurchase agreements	\$	2,606,830	\$	428,576	\$	361,795	\$	139,180	\$	3,536,381
Total interest expense	\$	8,432	\$	5,089	\$	4,238	\$	2,201	\$	19,960
Average cost of funds (2)		0.43%		1.59%		1.57%		2.11%		0.75%
Net interest income	\$	50,076	\$	22,744	\$	18,701	\$	6,175	\$	97,696
Net interest rate spread		2.28%		4.82%		4.93%		3.42%		3.05%

(1) Amount includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(39.5) million for Agency RMBS, approximately \$(6.6) million for Non-Agency RMBS, approximately \$536 thousand for Agency and Non-Agency CMBS and approximately \$1.4 million for other securities and Whole-Loans for the nine months ended September 30, 2015.

(2) For the nine months ended September 30, 2015, cost of funds does not include accrual and settlement of interest, net of premium amortization on MAC swaps, of approximately \$10.8 million associated with derivative instruments. In accordance with GAAP, such costs are included in gain (loss) on derivative instruments, in the Consolidated Statement of Operations.

Table of Contents

(dollars in thousands)	For the three months ended September 30, 2014					Total
	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities		
Average amortized cost of securities	\$ 3,279,209	\$ 667,503	\$ 408,642	\$ 86,333	\$ 4,441,687	
Total interest income (1)	\$ 24,871	\$ 9,802	\$ 4,921	\$ 1,124	\$ 40,718	
Yield on average securities	3.01%	5.83%	4.78%	5.17%	3.64%	
Average balance of repurchase agreements	\$ 3,163,587	\$ 479,806	\$ 326,917	\$ 71,983	\$ 4,042,293	
Total interest expense	\$ 2,985	\$ 1,990	\$ 1,255	\$ 238	\$ 6,468	
Average cost of funds (2)	0.37%	1.65%	1.52%	1.31%	0.63%	
Net interest income	\$ 21,886	\$ 7,812	\$ 3,666	\$ 886	\$ 34,250	
Net interest rate spread	2.64%	4.18%	3.26%	3.86%	3.01%	

(1) Amount includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(15.4) million for Agency RMBS, approximately \$(1.4) million for Non-Agency RMBS, approximately \$(1.4) million for Agency and Non-Agency CMBS, and approximately \$92 thousand for other securities for three months ended September 30, 2014. In accordance with GAAP, interest income does not include \$922 thousand for linked transactions for the three months ended September 30, 2014; instead such amounts are included in gain (loss) on linked transactions.

(2) For the three months ended September 30, 2014, cost of funds does not include accrual and settlement of interest associated with derivative instruments and linked transactions of approximately \$1.8 million and \$139 thousand, respectively. In accordance with GAAP, such costs are included in gain (loss) on derivative instruments and gain (loss) on linked transactions, respectively, in the Consolidated Statement of Operations.

(dollars in thousands)	For the nine months ended September 30, 2014					Total
	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities		
Average amortized cost of securities	\$ 3,223,078	\$ 520,320	\$ 241,659	\$ 73,806	\$ 4,058,863	
Total interest income (1)	\$ 73,331	\$ 23,297	\$ 9,129	\$ 2,995	\$ 108,752	
Yield on average securities	3.04%	5.99%	5.05%	5.43%	3.58%	

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

Average balance of repurchase agreements	\$	3,020,536	\$	365,459	\$	190,547	\$	60,857	\$	3,637,399
Total interest expense	\$	8,607	\$	4,450	\$	2,109	\$	663	\$	15,829
Average cost of funds (2)		0.38%		1.63%		1.48%		1.46%		0.58%
Net interest income	\$	64,724	\$	18,847	\$	7,020	\$	2,332	\$	92,923
Net interest rate spread		2.66%		4.36%		3.57%		3.97%		3.00%

(1) Amount includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(41.4) million for Agency RMBS, approximately \$(1.3) million for Non-Agency RMBS, approximately \$(940) thousand for Agency and Non-Agency CMBS and approximately \$333 thousand for other securities for the nine months ended September 30, 2014. In accordance with GAAP, interest income does not include approximately \$2.1 million for linked transactions for the nine months ended September 30, 2014; instead such amounts are included in gain (loss) on linked transactions.

(2) For the nine months ended September 30, 2014, cost of funds does not include accrual and settlement of interest of approximately \$25.8 million and \$414 thousand associated with derivative instruments and linked transactions, respectively. In accordance with GAAP, such costs are included in gain (loss) on derivative instruments and gain (loss) on linked transactions, respectively, in the Consolidated Statement of Operations.

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

Table of Contents

The following tables set forth certain information regarding our net investment income for the three and nine months ended September 30, 2015 and September 30, 2014, see Non-GAAP Financial Measures :

For the three months ended September 30, 2015:

Non- GAAP Financial Measures:

(dollars in thousands)	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities and Whole-Loans	Total
Average amortized cost of securities held including Agency and Non-Agency Interest-Only Strips accounted for as derivatives	\$ 2,337,842	\$ 541,801	\$ 481,497	\$ 311,825	\$ 3,672,965
Total interest income including interest income on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (1)	\$ 15,907	\$ 8,957	\$ 8,429	\$ 3,991	\$ 37,284
Yield on average amortized cost of securities including adjustments related to cost of Agency and Non-Agency Interest-Only Strips accounted for as derivatives	2.70%	6.56%	6.63%	5.18%	4.03%
Average balance of repurchase agreements	\$ 2,076,450	\$ 403,294	\$ 362,808	\$ 222,137	\$ 3,064,689
Total interest expense including interest income (expense), net incurred on interest rate swaps(2)	\$ 6,964	\$ 2,058	\$ 1,939	\$ 1,244	\$ 12,205
Average cost of funds including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps	1.33%	2.03%	2.12%	2.22%	1.58%
Net interest income including interest income (expense) on Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and interest income (expense), net incurred on interest rate swaps	\$ 8,943	\$ 6,899	\$ 6,490	\$ 2,747	\$ 25,079

Net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on interest rate swaps	1.37%	4.53%	4.51%	2.96%	2.45%
--	-------	-------	-------	-------	-------

(1) Amounts for the three months ended September 30, 2015 includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(17.2) million. This amount is composed of approximately \$(11.6) million for Agency RMBS included in interest income, approximately \$(2.3) million for Non-Agency RMBS included in interest income, approximately \$11 thousand for Agency and Non-Agency CMBS included in interest income, approximately \$770 thousand for Other securities and Whole-Loans included in interest income and approximately \$(4.1) million of amortization/recovery of basis on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments).

(2) Represents the net amount paid, including accrued amounts and premium amortization for MAC interest rate swaps during the period included in loss on derivative instruments for GAAP.

Table of Contents

For the nine months ended September 30, 2015:

Non- GAAP Financial Measures:

(dollars in thousands)	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities and Whole-Loans	Total
Average amortized cost of securities held including Agency and Non-Agency Interest-Only Strips accounted for as derivatives	\$ 2,950,686	\$ 584,559	\$ 486,237	\$ 202,581	\$ 4,224,063
Total interest income including interest income on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (1)	\$ 61,507	\$ 28,188	\$ 23,994	\$ 8,375	\$ 122,064
Yield on average amortized cost of securities including adjustments related to cost of Agency and Non-Agency Interest-Only Strips accounted for as derivatives	2.79%	6.45%	6.28%	5.70%	3.86%
Average balance of repurchase agreements	\$ 2,606,830	\$ 428,576	\$ 361,795	\$ 139,180	\$ 3,536,381
Total interest expense including interest income (expense), net incurred on interest rate swaps(2)	\$ 17,629	\$ 5,845	\$ 5,081	\$ 2,201	\$ 30,756
Average cost of funds including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps	0.90%	1.82%	1.88%	2.11%	1.16%
Net interest income including interest income (expense) on Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and interest income (expense), net incurred on interest rate swaps	\$ 43,878	\$ 22,343	\$ 18,913	\$ 6,174	\$ 91,308
Net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and interest income	1.89%	4.63%	4.40%	3.59%	2.70%

(expense), net incurred on interest
rate swaps

(1) Amounts for the nine months ended September 30, 2015 includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(57.0) million. This amount is composed of approximately \$(39.5) million for Agency RMBS included in interest income, approximately \$(6.6) million for Non-Agency RMBS included in interest income, approximately \$536 thousand for Agency and Non-Agency CMBS included in interest income, approximately \$1.4 million for Other securities and Whole-Loans included in interest income and approximately \$(12.8) million of amortization/recovery of basis on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments).

(2) Represents the net amount paid, including accrued amounts and premium amortization for MAC interest rate swaps during the period included in loss on derivative instruments for GAAP.

Table of Contents

For the three months ended September 30, 2014, as Revised:

Non-GAAP Financial Measures:

(dollars in thousands)	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities	Total
Average amortized cost of securities held including Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$ 3,350,785	\$ 685,106	\$ 449,271	\$ 86,333	\$ 4,571,495
Total interest income including interest income on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions(1)	\$ 26,116	\$ 10,150	\$ 5,675	\$ 1,375	\$ 43,316
Yield on average amortized cost of securities including adjustments related to cost of Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	3.09%	5.88%	4.02%	5.81%	3.75%
Average balance of repurchase agreements, including repurchase agreements on linked transactions	\$ 3,163,587	\$ 491,410	\$ 341,446	\$ 75,736	\$ 4,072,179
Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions, as Revised(2)	\$ 12,926	\$ 2,430	\$ 2,022	\$ 257	\$ 17,635
Average cost of funds including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions, as Revised	1.62%	1.96%	2.35%	1.35%	1.72%
Net interest income including interest income (expense) on Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and interest income (expense), net incurred on interest	\$ 13,190	\$ 7,720	\$ 3,653	\$ 1,118	\$ 25,681

rate swaps and linked transactions,
as Revised

Net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions, as Revised	1.47%	3.92%	1.67%	4.46%	2.03%
--	-------	-------	-------	-------	-------

(1) For the three months ended September 30, 2014 includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(22.5) million. This amount is composed of approximately \$(15.4) million for Agency RMBS included in interest income, approximately \$(1.4) million for Non-Agency RMBS included in interest income, approximately \$(1.4) million for Agency and Non-Agency CMBS included in interest income, approximately \$92 thousand for Other securities included in interest income, approximately \$(423) thousand for Non-Agency linked transactions (Non-GAAP measure), approximately \$203 thousand for other securities linked transactions (Non-GAAP measure), and approximately \$(4.2) million of amortization/recovery of basis on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments).

(2) Represents the net amount paid, including accrued amounts and premium amortization for MAC interest rate swaps during the period included in loss on derivative instruments for GAAP.

Table of Contents

For the nine months ended September 30, 2014, as Revised:

Non-GAAP Financial Measures:

(dollars in thousands)	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities	Total
Average amortized cost of securities held including Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$ 3,301,493	\$ 555,958	\$ 266,694	\$ 73,806	\$ 4,197,951
Total interest income including interest income on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions(1)	\$ 78,411	\$ 24,919	\$ 10,420	\$ 3,246	\$ 116,996
Yield on average amortized cost of securities including adjustments related to cost of Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	3.18%	5.99%	4.65%	5.68%	3.72%
Average balance of repurchase agreements, including repurchase agreements on linked transactions	\$ 3,020,536	\$ 390,515	\$ 195,727	\$ 62,154	\$ 3,668,932
Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions, as Revised(2)	\$ 31,935	\$ 5,354	\$ 3,128	\$ 682	\$ 41,099
Average cost of funds including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions, as Revised	1.41%	1.83%	2.14%	1.47%	1.50%
Net interest income including interest income (expense) on Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and interest income (expense), net incurred on interest	\$ 46,476	\$ 19,565	\$ 7,292	\$ 2,564	\$ 75,897

rate swaps and linked transactions,
as Revised

Net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions, as Revised	1.77%	4.16%	2.51%	4.21%	2.22%
--	-------	-------	-------	-------	-------

(1) For the nine months ended September 30, 2014 includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(60.4) million. This amount is composed of approximately \$(41.4) million for Agency RMBS included in interest income, approximately \$(1.3) million for Non-Agency RMBS included in interest income, approximately \$(940) thousand for Agency and Non-Agency CMBS included in interest income, approximately \$333 thousand for Other securities included in interest income, approximately \$(3.1) million for Non-Agency linked transactions (Non-GAAP measure), approximately \$203 thousand for other securities linked transactions (Non-GAAP measure), and approximately \$(14.3) million of amortization/recovery of basis on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments).

(2) Represents the net amount paid, including accrued amounts and premium amortization for MAC interest rate swaps during the period included in loss on derivative instruments for GAAP.

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

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

Table of Contents

Revision of net investment income (Non-GAAP financial measure) for the three and nine months ended September 30, 2014

As discussed further in Note 2 – Revision of Previously Issued Financial Statements for Errors Affecting Certain Items Presented in the Statements of Cash Flows and Notes to Financial Statements, we have elected to revise our presentation of net investment income (Non-GAAP financial measure) for the three and nine months ended September 30, 2014 in this quarterly financial statements on Form 10-Q to correct these errors.

The effect of these errors on the tables presenting our net investment income (Non-GAAP financial measure) for the three and nine months ended September 30, 2014 (dollars in thousands):

For the three months ended September 30, 2014:

As Originally Reported	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities	Total
Non-GAAP Financial Measures:					
Average amortized cost of securities held including Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$ 3,350,785	\$ 685,106	\$ 449,271	\$ 86,333	\$ 4,571,495
Total interest income including interest income on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$ 26,116	\$ 10,150	\$ 5,675	\$ 1,375	\$ 43,316
Yield on average amortized cost of securities including adjustments related to cost of Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	3.09%	5.88%	4.02%	5.81%	3.75%
Average balance of repurchase agreements, including repurchase agreements on linked transactions	\$ 3,163,587	\$ 491,410	\$ 341,446	\$ 75,736	\$ 4,072,179
Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions	\$ 13,662	\$ 2,464	\$ 2,072	\$ 257	\$ 18,455
Average cost of funds including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate	1.71%	1.99%	2.41%	1.35%	1.80%

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

swaps and linked transactions

Net interest income including interest income (expense) on Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	\$	12,454	\$	7,686	\$	3,603	\$	1,118	\$	24,861
--	----	--------	----	-------	----	-------	----	-------	----	--------

Net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions		1.38%		3.89%		1.61%		4.46%		1.95%
--	--	-------	--	-------	--	-------	--	-------	--	-------

Table of Contents

Adjustments	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities	Total
Non-GAAP Financial Measures:					
Average amortized cost of securities held including Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$	\$	\$	\$	\$
Total interest income including interest income on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$	\$	\$	\$	\$
Yield on average amortized cost of securities including adjustments related to cost of Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions		%	%	%	%
Average balance of repurchase agreements, including repurchase agreements on linked transactions	\$	\$	\$	\$	\$
Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions	\$	(736)	\$	(34)	\$
Average cost of funds including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions		(0.09)%	(0.03)%	(0.06)%	%
Net interest income including interest income (expense) on Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	\$	736	\$	34	\$
Net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions		0.09%	0.03%	0.06%	%

Table of Contents

Revised	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities	Total
Non-GAAP Financial Measures:					
Average amortized cost of securities held including Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$ 3,350,785	\$ 685,106	\$ 449,271	\$ 86,333	\$ 4,571,495
Total interest income including interest income on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$ 26,116	\$ 10,150	\$ 5,675	\$ 1,375	\$ 43,316
Yield on average amortized cost of securities including adjustments related to cost of Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	3.09%	5.88%	4.02%	5.81%	3.75%
Average balance of repurchase agreements, including repurchase agreements on linked transactions	\$ 3,163,587	\$ 491,410	\$ 341,446	\$ 75,736	\$ 4,072,179
Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions	\$ 12,926	\$ 2,430	\$ 2,022	\$ 257	\$ 17,635
Average cost of funds including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	1.62%	1.96%	2.35%	1.35%	1.72%
Net interest income including interest income (expense) on Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	\$ 13,190	\$ 7,720	\$ 3,653	\$ 1,118	\$ 25,681
Net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	1.47%	3.92%	1.67%	4.46%	2.03%

Table of Contents

For the nine months ended September 30, 2014:

As Originally Reported	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities	Total
Non-GAAP Financial Measures:					
Average amortized cost of securities held including Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$ 3,301,493	\$ 555,958	\$ 266,694	\$ 73,806	\$ 4,197,951
Total interest income including interest income on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$ 78,411	\$ 24,919	\$ 10,420	\$ 3,246	\$ 116,996
Yield on average amortized cost of securities including adjustments related to cost of Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	3.18%	5.99%	4.65%	5.68%	3.72%
Average balance of repurchase agreements, including repurchase agreements on linked transactions	\$ 3,020,536	\$ 390,515	\$ 195,727	\$ 62,154	\$ 3,668,932
Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions	\$ 32,768	\$ 5,392	\$ 3,185	\$ 682	\$ 42,027
Average cost of funds including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	1.45%	1.85%	2.18%	1.47%	1.53%
Net interest income including interest income (expense) on Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	\$ 45,643	\$ 19,527	\$ 7,235	\$ 2,564	\$ 74,969
Net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	1.73%	4.14%	2.47%	4.21%	2.19%

Table of Contents

Adjustments	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities	Total
Non-GAAP Financial Measures:					
Average amortized cost of securities held including Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$	\$	\$	\$	\$
Total interest income including interest income on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$	\$	\$	\$	\$
Yield on average amortized cost of securities including adjustments related to cost of Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions		%	%	%	%
Average balance of repurchase agreements, including repurchase agreements on linked transactions	\$	\$	\$	\$	\$
Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions	\$	(833)	\$	(38)	\$
Average cost of funds including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions		(0.04)%	(0.02)%	(0.04)%	%
Net interest income including interest income (expense) on Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	\$	833	\$	38	\$
Net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions		0.04%	0.02%	0.04%	%

Table of Contents

Revised	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Other securities	Total
Non-GAAP Financial Measures:					
Average amortized cost of securities held including Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$ 3,301,493	\$ 555,958	\$ 266,694	\$ 73,806	\$ 4,197,951
Total interest income including interest income on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	\$ 78,411	\$ 24,919	\$ 10,420	\$ 3,246	\$ 116,996
Yield on average amortized cost of securities including adjustments related to cost of Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	3.18%	5.99%	4.65%	5.68%	3.72%
Average balance of repurchase agreements, including repurchase agreements on linked transactions	\$ 3,020,536	\$ 390,515	\$ 195,727	\$ 62,154	\$ 3,668,932
Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions	\$ 31,935	\$ 5,354	\$ 3,128	\$ 682	\$ 41,099
Average cost of funds including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	1.41%	1.83%	2.14%	1.47%	1.50%
Net interest income including interest income (expense) on Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	\$ 46,476	\$ 19,565	\$ 7,292	\$ 2,564	\$ 75,897
Net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	1.77%	4.16%	2.51%	4.21%	2.22%

Table of Contents**Other Income (Loss)**

The following tables present the sales of our MBS, other securities and Whole-Loans (dollars in thousands):

	For the three months ended September 30, 2015			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS	\$ 421,351	\$ 3,036	\$ (4,096)	\$ (1,060)
Non-Agency RMBS	25,663	1,305		1,305
Agency and Non-Agency CMBS	55,637	772	(71)	701
Other securities and Whole-Loans	760,199	59	(2,861)	(2,802)
Total	\$ 1,262,850	\$ 5,172	\$ (7,028)	\$ (1,856)

(1) Includes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$5.3 million, gross realized gains of \$628 thousand and gross realized losses of \$2 thousand.

	For the nine months ended September 30, 2015			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS (1)	\$ 931,332	\$ 6,869	\$ (7,673)	\$ (804)
Non-Agency RMBS	233,257	11,066	(174)	10,892
Agency and Non-Agency CMBS	146,525	2,123	(80)	2,043
Other securities and Whole-Loans	776,564	621	(2,861)	(2,240)
Total	\$ 2,087,678	\$ 20,679	\$ (10,788)	\$ 9,891

(1) Includes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$5.3 million, gross realized gains of \$626 thousand and gross realized losses of \$2 thousand.

	For the three months ended September 30, 2014			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS (1)	\$ 268,694	\$ 2,557	\$ (4,865)	\$ (2,308)
Non-Agency RMBS	155,366	6,257	(414)	5,843
Agency and Non-Agency CMBS	87,844	1,786	(20)	1,766
Other securities				
Total	\$ 511,904	\$ 10,600	\$ (5,299)	\$ 5,301

(1) Includes proceeds for Agency CMBS Interest-Only Strips, accounted for as derivatives, of approximately \$3.7 million, gross realized gains of \$389 thousand and gross realized losses of \$0.

	For the nine months ended September 30, 2014			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS (1)	\$ 1,605,046	\$ 11,570	\$ (40,934)	\$ (29,364)
Non-Agency RMBS	395,456	19,759	(995)	18,764
Agency and Non-Agency CMBS(2)	160,904	2,153	(22)	2,131
Other securities	78,932	5,064		5,064
Total	\$ 2,240,338	\$ 38,546	\$ (41,951)	\$ (3,405)

-
- (1) Includes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$31.4 million, gross realized gains of \$437 thousand and gross realized losses of approximately \$1.6 million.
- (2) Includes proceeds for Agency CMBS Interest-Only Strips, accounted for as derivatives, of approximately \$3.7 million, gross realized gains of \$389 thousand and gross realized losses of approximately \$0.

The mortgage and structured securities markets remain dynamic and, at times, volatile markets. Our Manager regularly reviews the characteristics of our portfolio and may make changes to our portfolio in order to adjust such portfolio characteristics in response to and/or anticipation of changing market conditions in an effort to achieve the appropriate risk reward ratio. Accordingly, due to changes in market conditions or expected changes in market conditions, we sold these MBS and other assets in order to adjust the overall characteristics of our portfolio including, but not limited to, prepayment expectations and duration.

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

Table of Contents

With respect to our MBS, other securities and Residential and Commercial Whole-Loans, we elected the fair value option and, as a result, we record the change in fair value related to MBS, other securities and Residential and Commercial Whole-Loans in earnings. The following tables present amounts related to realized gains and losses as well as changes in fair value of our investment portfolio and derivative instruments that are included in our Consolidated Statement of Operations for the three and nine months ended September 30, 2015 and September 30, 2014 (dollars in thousands):

For the three months ended September 30, 2015:

Description	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Other loss on Mortgage-backed securities	Unrealized Gain (Loss), net	Return (Recovery) of Basis	Mark-to-market adjustments	Total
MBS, Other Securities and Residential and Commercial Whole-Loans	\$ (2,482)	\$	\$ (5,917)	\$ 24,723	\$	\$	\$ 16,324
Cash and cash equivalents (2)	(275)	45		201			(29)
Derivative Instruments:							
Interest rate swaps	28,291	(5,561)			337	(64,701)	(41,634)
Interest rate swaptions	(150)					71	(79)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	626	5,437			(4,164)	(1,799)	100
Options	684						684
Futures contracts	(168)					(38)	(206)
Foreign currency forwards	(134)					114	(20)
Foreign currency swaps		190				652	842
TBAAs	(8,205)					7,155	(1,050)
Total	\$ 18,187	\$ 111	\$ (5,917)	\$ 24,924	\$ (3,827)	\$ (58,546)	\$ (25,068)

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

(2) Cash and cash equivalents realized gain (loss) net includes gain (loss) on foreign currency transactions.

For the nine months ended September 30, 2015:

Description	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Other loss on Mortgage-backed securities	Unrealized Gain (Loss), net	Return (Recovery) of Basis	Mark-to-market adjustments	Total
	\$ 9,267	\$	\$ (14,884)	\$ 10,284	\$	\$	\$ 4,667

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

MBS, Other Securities and Residential and Commercial Whole-Loans					
Cash and cash equivalents (2)	2,523	80	(859)		1,744
Derivative Instruments:					
Interest rate swaps	18,729	(11,871)		1,075	(83,209)
Interest rate swaptions	(3,873)				(72)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives					
Options	624	16,700		(12,877)	(1,966)
Futures contracts	684				683
Foreign currency forwards	(627)				452
Foreign currency swaps	(980)	585			3,944
TBAs					(2,784)
Total	\$ 24,619	\$ 5,494	\$ (14,884)	\$ 9,425	\$ (11,802)
					\$ (82,952)
					\$ (70,100)

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

(2) Cash and cash equivalents realized gain (loss) net includes gain (loss) on foreign currency transactions.

Table of Contents

For the three months ended September 30, 2014, as Revised (See Note 2):

Description	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Other loss on Mortgage -backed securities	Unrealized Gain (Loss), net	Basis Recovery	Mark-to-market adjustments	Total
MBS and Other Securities	\$ 4,912	\$	\$ (2,857)	\$ (4,453)	\$	\$	\$ (2,398)
Cash and cash equivalents(2)	1,070	(128)					942
Derivative Instruments:							
Interest rate swaps	23,798	(11,848)			820	(15,587)	(2,817)
Interest rate swaptions						(624)	(624)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	389	5,723			(4,187)	(915)	1,010
Options						(340)	(340)
Futures contracts						(200)	(200)
Foreign currency forwards	(1,182)					57	(1,125)
Foreign currency swaps		140				2,057	2,197
TBA's	2,608					(1,110)	1,498
Linked Transactions	107	1,206			(423)	(2,131)	(1,241)
Total	\$ 31,702	\$ (4,907)	\$ (2,857)	\$ (4,453)	\$ (3,790)	\$ (18,793)	\$ (3,098)

(1) Contractual interest income (expense), net on derivative instruments includes interest settlement paid or received. In addition, contractual interest income (expense), net on linked transactions includes accretion of approximately \$203 thousand for other securities.

(2) Cash and cash equivalents realized gain (loss) net includes gain (loss) on foreign currency transactions.

For the nine months ended September 30, 2014, as Revised (See Note 2):

Description	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Other loss on Mortgage -backed securities	Unrealized Gain (Loss), net	Basis Recovery	Mark-to-market adjustments	Total
MBS and Other Securities	\$ (2,650)	\$	\$ (7,565)	\$ 140,755	\$	\$	\$ 130,540
Cash and cash equivalents(2)	1,070	(116)					954
Derivative Instruments:							
Interest rate swaps	17,012	(25,784)			928	(123,026)	(130,870)
Interest rate swaptions	(5,908)					(5,615)	(11,523)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	(755)	20,288			(14,286)	(332)	4,915

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

Options						(340)	(340)
Futures contracts	(16,495)					(311)	(16,806)
Foreign currency forwards	(1,182)					(81)	(1,263)
Foreign currency swaps		141				2,072	2,213
TBAs	25,169					1,521	26,690
Linked Transactions	1,397	4,669			(2,982)	(1,418)	1,666
Total	\$ 17,658	\$ (802)	\$ (7,565)	\$ 140,755	\$ (16,340)	\$ (127,530)	\$ 6,176

(1) Contractual interest income (expense), net on derivative instruments includes interest settlement paid or received. In addition, contractual interest income (expense), net on linked transactions includes amortization of approximately \$(122) thousand for Non-Agency RMBS and accretion of approximately \$203 thousand for other securities.

(2) Cash and cash equivalents realized gain (loss) net includes gain (loss) on foreign currency transactions.

With respect to our portfolio, OTTI is generally recorded when the credit quality of the underlying collateral deteriorates and or the schedule payments on our IO securities, which are not characterized as derivatives, are faster than previously projected. The credit deterioration could be as a result of, but not limited to increased projected realized losses, foreclosures, delinquencies and the likelihood of the borrower being able to make payments in the future. Generally, a prepayment occurs when the collateral securing a loan is sold or transferred and/or the loan has a higher interest rate relative to current interest rates and lenders are willing to extend credit at the lower current interest rate.

Table of Contents

In order to mitigate interest rate risk resulting from our future repurchase agreement borrowings, we entered into interest rate swaps with an aggregate notional amount of approximately \$8.5 billion, of which \$1.5 billion are forward starting. As of September 30, 2015, our effective swaps are comprised of approximately \$4.6 billion fixed pay rate swaps and \$2.4 billion are variable pay swaps, which effectively fix (for the life of the swap) the floating interest rate of approximately \$2.2 billion of borrowings. We also invested in interest rate swaptions with an aggregate notional amount of approximately \$105.0 million at September 30, 2015. Similarly, we have entered into currency swaps and currency forwards with an aggregate notional amount of approximately \$46.8 million (38.2 million) in order to mitigate our foreign currency risk on our euro denominated assets and liabilities. The fair value of our interest rate swaps declined by more than the increase in the value of our investments during the quarter due to both mortgage spreads widening and swap spreads tightening. While not designated as a hedge for accounting purposes, our current and future interest rate swaps, interest rate swaptions, foreign currency swaps and foreign currency forwards are, collectively viewed as an economic hedge on a portion of our floating-rate borrowings and foreign currency rate exposure, respectively. Since we do not apply hedge accounting for these instruments, we record the change in fair value related to such agreements in earnings in gain (loss) on derivative instruments, net. Included in Gain (loss) on derivative instruments, net in our Consolidated Statement of Operations are the net interest rate swap payments and currency payments (including accrued amounts) associated with these instruments.

Expenses

General and Administrative Expenses

We incurred general and administrative expenses of approximately \$2.9 million and \$8.9 million for the three and nine months ended September 30, 2015, respectively and approximately \$2.3 million and \$6.7 million for the three and nine months ended September 30, 2014, respectively, which represents professional fees, insurance, non-cash stock based compensation and overhead costs of the Company. The increase in general and administrative expenses from 2015 over 2014 is primarily due to an increase in equity based compensation, professional fees, custodian fees resulting from the successful completion of our follow-on offering in April 2014, compensation expense for our chief financial officer and controller, and transaction costs related to the implementation of our Residential Whole-Loan program.

Management Fee Expense

We incurred management fee expense of approximately \$2.8 million and \$8.1 million for the three and nine months ended September 30, 2015, respectively and approximately \$2.8 million and \$7.1 million for the three and nine months ended September 30, 2014, respectively, of which approximately \$2.8 million was payable at September 30, 2015 to our Manager under the Management Agreement. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.5% per annum of our stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. Management fees primarily increased from 2015 over 2014 due to an increase in our stockholders' equity resulting from the successful completion of our follow-on offering in April 2014.

The management fees, expense reimbursements and the relationship between our Manager and us are discussed further in Note 12, Related Party Transactions, to the financial statements contained in this Quarterly Report on Form 10-Q.

Dividends

The following table presents cash dividends declared and paid by us on our common stock:

Declaration Date	Record Date	Payment Date	Amount per Share	Tax Characterization
2015				
September 24, 2015	October 5, 2015	October 27, 2015	\$ 0.60	Not yet determined
June 18, 2015	June 29, 2015	July 28, 2015	\$ 0.64	Not yet determined
March 26, 2015	April 6, 2015	April 28, 2015	\$ 0.67	Not yet determined
2014				
December 18, 2014	December 29, 2014	January 27, 2015	\$ 0.70	Ordinary income
September 23, 2014	October 3, 2014	October 28, 2014	\$ 0.70	Ordinary income
June 19, 2014	June 30, 2014	July 29, 2014	\$ 0.67	Ordinary income
March 20, 2014	March 31, 2014	April 29, 2014	\$ 0.67	Ordinary income
2013				
April 1, 2013	April 12, 2013	April 30, 2013	\$ 0.95	Ordinary income
June 20, 2013	July 1, 2013	July 29, 2013	\$ 0.90	Ordinary income
September 19, 2013	September 30, 2013	October 29, 2013	\$ 0.90	Ordinary income
December 19, 2013	December 30, 2013	January 28, 2014	\$ 2.35(1)	Ordinary income
2012				
July 26, 2012	August 6, 2012	August 14, 2012	\$ 0.38	Ordinary income
September 20, 2012	October 1, 2012	October 25, 2012	\$ 0.85	Ordinary income
December 19, 2012	December 31, 2012	January 29, 2013	\$ 1.12	Ordinary income

(1) Consisting of cash and stock. For stockholders who elected to receive the entire \$2.35 per share dividend in stock, each stockholder received 0.1590 shares in newly issued common stock for each common share that they held as of the dividend record date. For stockholders who elected to receive the dividend in cash, or did not make an election, each stockholder received \$0.9159 per share in cash and 0.0970 shares in newly issued common stock for each common share that they held as of the dividend record date.

Table of Contents

Liquidity and Capital Resources

General

Our liquidity and capital resources are managed on a daily basis to ensure that we have sufficient liquidity to absorb market events that could negatively impact collateral valuations and result in margin calls as well as to ensure that we have the flexibility to manage our investment portfolio to take advantage of market opportunities.

Liquidity is a measure of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund and maintain our assets and operations, make distributions to our stockholders and other general business needs. We use cash to purchase our Target Assets, repay principal and interest on our borrowings, make distributions to our stockholders and fund our operations.

Under our repurchase agreements and derivative contracts, lenders and counterparties retain the right to determine the fair value of the collateral pledged, or in the case of cleared swaps the required collateral may be determined by clearinghouse rules. A reduction in the value of the collateral pledged will require us to provide additional collateral or fund cash margin calls. Alternatively, since margins calls for our interest rate swaps and swaptions generally are inversely correlated to those of our repurchase agreements, our interest rate swap and swaptions counterparties would likely be required to post collateral with us during a period in which we were required to post collateral with our repurchase agreement counterparties. Similarly, we would likely be required to post collateral with swap and swaption counterparties during periods in which our repo counterparties are required to post collateral with us. During 2014 and continuing into 2015, the market has experienced a sustained period of volatility. For the majority of 2015, such higher rate volatility has resulted in wider mortgage spreads and a higher cost of hedging. We were able to satisfy our additional collateral requirements with cash on hand, unlevered or underleveraged securities, cash from rehypothecation of securities received as incremental collateral and proceeds from our repurchase agreement borrowings and/or our swaps and swaptions, respectively. We were not forced to involuntarily sell any of our assets, nor did any of counterparties sell any of our assets held by them as collateral. During 2015 and 2014, we rehypothecated some of the U.S. Treasury securities we received as incremental collateral on our repurchase borrowings, swaps and swaptions, effectively entering into repurchase agreements with such securities, in order to increase our cash position. The maximum amount of repurchase borrowings for the rehypothecated U.S. Treasury securities was \$0 and \$530 thousand for the three and nine months ended September 30, 2015, respectively, and \$0 during the three and nine months ended September 30, 2014. At September 30, 2015, no U.S. Treasury securities were rehypothecated. In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, we could be required to sell securities, possibly even at a loss to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on our financial position, results of operations and cash flows.

Table of Contents

As part of our risk management process, our Manager closely monitors our liquidity position. This includes the development and evaluation of various alternative processes and procedures, which continue to be updated with regard to scenario testing for purposes of assessing our liquidity in the face of different economic and market developments. We believe we have sufficient current liquidity and access to additional liquidity to meet financial obligations for at least the next 12 months.

Our primary sources of liquidity are as follows:

Cash Generated from Follow-On Public Offerings and Private Placements

During the nine months ended September 30, 2015, we did not generate any proceeds from follow-on public offerings or private placements. However, at the beginning of the second quarter of 2014, we completed a follow-on public offering, including the exercise by the underwriters of a portion of an option to acquire additional shares resulting in net proceeds to us of approximately \$205.4 million. In addition, we sold shares to our Manager in a private placement for an aggregate offering price of approximately \$9.7 million.

Borrowing under Various Financing Arrangements

As of September 30, 2015, we had master repurchase agreements with 27 counterparties. We had borrowings under repurchase agreements with 19 counterparties of approximately \$3.0 billion at September 30, 2015. The following tables present our borrowings by type of collateral pledged as of September 30, 2015 and September 30, 2014, and the respective effective cost of funds (Non-GAAP financial measure) for the three and nine months ended September 30, 2015 and September 30, 2014, respectively. See Non-GAAP Financial Measures (dollars in thousands):

Collateral	Repurchase Agreement Borrowings Outstanding September 30, 2015	Fair Value of Collateral Pledged(1)	Weighted Average Interest Rate end of period	Weighted Average Cost of Funds for the three months ended September 30, 2015	Weighted Average Effective Cost of Funds (Non-GAAP) for the three months ended September 30, 2015 (2)	Weighted Average Cost of Funds for the nine months ended September 30, 2015	Weighted Average Effective Cost of Funds (Non-GAAP) for the nine months ended September 30, 2015 (2)
Agency RMBS	\$ 2,012,976	\$ 2,118,025	0.54%	0.49%	1.33%	0.43%	0.90%
Non-Agency RMBS	386,779	546,016	1.71	1.64	2.03	1.59	1.82
Agency and Non-Agency CMBS(3)	367,727	504,514	1.67	1.62	2.12	1.57	1.88
Other securities and Whole-Loans(4)	242,786	325,614	2.04	2.22	2.22	2.11	2.11
Total	\$ 3,010,268	\$ 3,494,169	0.95%	0.90%	1.58%	0.75%	1.16%

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

- (1) Excludes approximately \$21.9 million of cash collateral posted.
- (2) The effective cost of funds for the period presented is calculated on an annualized basis and includes interest expense for the period and net periodic interest payments on interest rate swaps, net of premium amortization on MAC swaps, of approximately \$5.2 million and \$10.8 million for the three and nine months ended September 30, 2015, respectively. While interest rate swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are treated as hedges for purposes of satisfying the REIT requirements. See Non-GAAP Financial Measures .
- (3) Including Non U.S. CMBS pledged as collateral and Non U.S. repurchase agreement borrowings.
- (4) Other securities and Whole-Loans includes repurchase borrowings of \$118.4 million and collateral pledged attributed to Residential Whole-Loans owned through trust certificates with a fair value of \$150.5 million at September 30, 2015. The trust certificates are eliminated upon consolidation.

Collateral	Repurchase Agreement Borrowings Outstanding September 30, 2014	Fair Value of Collateral Pledged (1)	Weighted Average Interest Rate end of period	Weighted Average Cost of Funds for the three months ended September 30, 2014	Weighted Average Effective Cost of Funds (Non-GAAP) for the three months ended September 30, 2014, as Revised (2)	Weighted Average Cost of Funds for the nine months ended September 30, 2014	Weighted Average Effective Cost of Funds (Non-GAAP) for the nine months ended September 30, 2014, as Revised (2)
Agency RMBS	\$ 3,046,358	\$ 3,197,721	0.38%	0.37%	1.62%	0.38%	1.41%
Non-Agency RMBS	468,664	672,583	1.61	1.65	1.97	1.63	1.84
Agency and Non-Agency CMBS	288,025	378,717	1.52	1.52	2.36	1.48	2.14
Other securities	79,080	96,834	1.54	1.31	1.31	1.46	1.46
Total: Excluding Linked Transactions	\$ 3,882,127	\$ 4,345,855	0.63%	0.63%	1.72%	0.58%	1.50%
Non-Agency RMBS Linked Transactions	6,788	8,507	1.55	n/a	1.54	n/a	1.70
Non-Agency CMBS Linked Transactions (3)	14,022	23,370	1.98	n/a	2.05	n/a	1.96
Other securities Linked Transactions	2,840	5,690	1.93	n/a	2.01	n/a	1.96
Total (Non-GAAP)	\$ 3,905,777	\$ 4,383,422	0.64%	0.63%	1.72%	0.58%	1.50%

- (1) Excludes approximately \$27.9 million of cash collateral posted.
- (2) The effective cost of funds for the periods presented is calculated on an annualized basis and includes interest expense for the periods and net periodic interest payments on interest rate swaps, net of premium amortization on MAC swaps, of approximately \$11.0 million and \$24.9 million and interest expense on linked transactions of approximately \$139 thousand and \$414 thousand for the three and nine months ended September 30, 2014, respectively. While interest rate swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are treated as hedges for purposes of satisfying the REIT tax requirements. See Non-GAAP Financial Measures .
- (3) Including Non U.S. CMBS pledged as collateral and Non U.S. repurchase agreement borrowings.

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

Table of Contents

Revision of Weighted Average Effective Cost of Funds (Non-GAAP financial measure), by type of collateral pledged, for the three and nine months ended September 30, 2014

As discussed further in Note 2 – Revision of Previously Issued Financial Statements for Errors Affecting Certain Items Presented in the Statements of Cash Flows and Notes to Financial Statements, we have elected to revise our presentation of weighted average effective cost of funds (Non-GAAP financial measure), by type of collateral pledged, for the three and nine months ended September 30, 2014 in this quarterly financial statements on Form 10-Q to correct these errors.

The effect of these errors on the table presenting our weighted average effective cost of funds (Non-GAAP financial measure), by type of collateral pledged, for the three and nine months ended September 30, 2014 (dollars in thousands):

As Originally Reported

Collateral	Repurchase Agreement Borrowings Outstanding September 30, 2014	Fair Value of Collateral Pledged	Weighted Average Interest Rate end of period	Weighted Average Cost of Funds for the three months ended September 30, 2014	Weighted Average Effective Cost of Funds (Non-GAAP) for the three months ended September 30, 2014	Weighted Average Cost of Funds for the nine months ended September 30, 2014	Weighted Average Effective Cost of Funds (Non-GAAP) for the nine months ended September 30, 2014
Agency RMBS	\$ 3,046,358	\$ 3,197,721	0.38%	0.37%	1.71%	0.38%	1.45%
Non-Agency RMBS	468,664	672,583	1.61	1.65	2.00	1.63	1.86
Agency and Non-Agency CMBS	288,025	378,717	1.52	1.52	2.42	1.48	2.18
Other securities	79,080	96,834	1.54	1.31	1.31	1.46	1.46
Total: Excluding							
Linked Transactions	\$ 3,882,127	\$ 4,345,855	0.63%	0.63%	1.80%	0.58%	1.53%
Non-Agency RMBS							
Linked Transactions	6,788	8,507	1.55	n/a	1.54	n/a	1.70
Non-Agency CMBS							
Linked Transactions	14,022	23,370	1.98	n/a	2.05	n/a	1.96
Other securities							
Linked Transactions	2,840	5,690	1.93	n/a	2.01	n/a	1.96
Total (Non-GAAP)	\$ 3,905,777	\$ 4,383,422	0.64%	0.63%	1.80%	0.58%	1.53%

Adjustments

Collateral	Repurchase Agreement Borrowings Outstanding September 30, 2014	Fair Value of Collateral Pledged	Weighted Average Interest Rate end of period	Weighted Average Cost of Funds for the three months ended September 30,	Weighted Average Effective Cost of Funds (Non-GAAP) for the three	Weighted Average Cost of Funds for the nine months ended September 30,	Weighted Average Effective Cost of Funds (Non-GAAP) for the nine months
------------	--	----------------------------------	--	---	---	--	---

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

	2014		months ended September 30, 2014		2014		ended September 30, 2014	
Agency RMBS	\$	\$	%	%	(0.09)%	%	(0.04)%	
Non-Agency RMBS					(0.03)		(0.01)	
Agency and Non-Agency CMBS					(0.06)		(0.04)	
Other securities								
Total: Excluding Linked Transactions	\$	\$	%	%	(0.08)%	%	(0.03)%	
Non-Agency RMBS Linked Transactions				n/a		n/a		
Non-Agency CMBS Linked Transactions				n/a		n/a		
Other securities Linked Transactions				n/a		n/a		
Total (Non-GAAP)	\$	\$	%	%	(0.08)%	%	(0.03)%	

Revised

	Repurchase Agreement Borrowings Outstanding September 30, 2014		Fair Value of Collateral Pledged	Weighted Average Interest Rate end of period	Weighted Average Cost of Funds for the three months ended September 30, 2014	Weighted Average Effective Cost of Funds (Non- GAAP) for the three months ended September 30, 2014	Weighted Average Cost of Funds for the nine months ended September 30, 2014	Weighted Average Effective Cost of Funds (Non- GAAP) for the nine months ended September 30, 2014
Agency RMBS	\$	3,046,358	\$ 3,197,721	0.38%	0.37%	1.62%	0.38%	1.41%
Non-Agency RMBS		468,664	672,583	1.61	1.65	1.97	1.63	1.84
Agency and Non-Agency CMBS		288,025	378,717	1.52	1.52	2.36	1.48	2.14
Other securities		79,080	96,834	1.54	1.31	1.31	1.46	1.46
Total: Excluding Linked Transactions	\$	3,882,127	\$ 4,345,855	0.63%	0.63%	1.72%	0.58%	1.50%
Non-Agency RMBS Linked Transactions		6,788	8,507	1.55	n/a	1.54	n/a	1.70
Non-Agency CMBS Linked Transactions		14,022	23,370	1.98	n/a	2.05	n/a	1.96
Other securities Linked Transactions		2,840	5,690	1.93	n/a	2.01	n/a	1.96
Total (Non-GAAP)	\$	3,905,777	\$ 4,383,422	0.64%	0.63%	1.72%	0.58%	1.50%

Table of Contents

As of September 30, 2015, our repurchase agreements with 27 counterparties, require collateral in excess of the loan amount, or haircuts, ranging from a low of 3.0% to a high of 5.0% for Agency RMBS, exclusive of IOs and IIOs for which the haircuts are as high as 25.0%. For Non-Agency RMBS and Agency and Non-Agency CMBS, haircuts range from a low of 13.0% to a high of 40.0%. Haircuts for other securities and Whole-Loans range from a low of 20.0% to a high of 50.0%. Declines in the value of our portfolio can trigger margin calls by our lenders under our repurchase agreements. Margin calls could adversely affect our liquidity. Our inability to post adequate collateral for a margin call by the counterparty could result in a condition of default under our repurchase agreements. An event of default or termination event would give some of our counterparties the option to terminate all existing repurchase transactions with us and require any amount due to the counterparties by us to be payable immediately. If this were to occur, we may be forced to sell assets under adverse market conditions or through foreclosure which may have a material adverse consequence on our business, financial position, our results of operations and cash flows. During the nine months ended September 30, 2015, we were able to satisfy margin calls using cash on hand, unlevered or underleveraged securities, cash from rehypothecation of securities received as incremental collateral and cash from our repurchase agreement borrowings.

Under the repurchase agreements, the respective lenders and counterparties, subject to the terms of the individual agreements, retain the right to determine the fair value of the underlying collateral. A reduction in the value of pledged assets requires us to provide additional collateral or fund margin calls. In addition, certain of the repurchase agreements may be terminated by our counterparties if we do not maintain certain equity and leverage metrics, the most restrictive of which include a limit on leverage based on the composition of our portfolio. We were in compliance with the terms of such financial tests as of September 30, 2015, except for such financial tests with respect to one counterparty as of that date. On November 6, 2015, we received a waiver of the condition of default effective as of September 30, 2015, from the counterparty. Accordingly, we are now in compliance with such financial tests and the scheduled maturity of the outstanding borrowings under the agreement has not been accelerated. At September 30, 2015, MBS and other assets held by counterparties as security for repurchase agreements totaled approximately \$3.5 billion, inclusive of \$150.5 million for repurchase agreements for Residential Whole-Loans owned through trust certificates. At December 31, 2014, MBS and other securities held by counterparties as security for repurchase agreements totaled approximately \$4.4 billion, inclusive of MBS and other securities posted of \$52.5 million for repurchase agreements accounted for as linked transactions and \$7.2 million for repurchase agreements for Residential Whole-Loans owned through trust certificates.

We are also required to pledge cash or securities as collateral as part of a margin arrangement for our derivative contracts, calculated daily, subject either to the terms of individual agreements for bilateral agreements and the clearinghouse rules in the case of cleared swaps. The amount of margin that we are required to post will vary and generally reflects collateral posted with respect to swaps that are in an unrealized loss position to us and a percentage of the aggregate notional amount of swaps per counterparty as well as margin posted with our clearing broker, pursuant to clearinghouse rules and practices, for cleared swaps. Conversely, if our bilateral swaps and swaptions are in an unrealized gain position, our counterparties are required to post collateral with us, under the same terms that we post collateral with them. On occasion we may enter into a MAC interest rate swap in which we may receive or make a payment at the time of entering such interest rate swap to compensate for the out of the market nature of such interest rate swap. Similar to all other interest rate swaps, these interest rate swaps are also subject to margin requirements previously described.

Table of Contents

Cash collateral held by counterparties at September 30, 2015 was approximately \$236.5 million, which is included in Due from counterparties on our Consolidated Balance Sheets, comprised of approximately \$21.9 million held in connection with repurchase agreement borrowings, approximately \$150 thousand held in connection with our futures contracts, \$0 held in connection with TBAs and approximately \$214.5 million held by our interest rate swap and swaption counterparties. Cash collateral held by counterparties at December 31, 2014 was approximately \$184.8 million, which is included in Due from counterparties on our Consolidated Balance Sheets, comprised of approximately \$25.7 million held in connection with repurchase agreement borrowings, approximately \$959 thousand held in connection with our futures contracts, approximately \$0 held in connection with TBAs and approximately \$158.1 million held by our interest rate swap counterparties. At September 30, 2015, Due to counterparties on our Consolidated Balance Sheets was comprised of approximately \$3.1 million posted with us by our repurchase agreement counterparties, approximately \$2.1 million posted in connection with our TBAs and approximately \$9.2 million posted by our interest rate swap and swaption counterparties, approximately \$757.4 million due as a result of the sale of U.S. Treasuries received as collateral under reverse repurchase agreements and \$0 due as a result of the rehypothecation of securities received as collateral under reverse repurchase agreements. At December 31, 2014, Due to counterparties on our Consolidated Balance Sheets was comprised of approximately \$2.1 million posted with us by our repurchase agreement counterparties, approximately \$6.6 million posted in connection with our TBAs and approximately \$3.5 million posted by our interest rate swap and swaption counterparties. In addition, at September 30, 2015 and December 31, 2014, we held securities of \$0 and approximately \$530 thousand, respectively, received as collateral from our repurchase agreement counterparties to satisfy margin requirements.

We had approximately \$10.7 million and \$166.6 million, respectively of unsettled purchased securities as of September 30, 2015 and December 31, 2014, included in Investment related payables on our Consolidated Balance Sheets. In addition, we had approximately \$10.7 million and \$162.8 million of unsettled sold securities as of September 30, 2015 and December 31, 2014, included in Investment related receivables on our Consolidated Balance Sheets.

Cash Generated from Operations

For the nine months ended September 30, 2015, operating activities increased our cash balance by approximately \$117.8 million. This was primarily attributable to the net interest income we earned on our investments for the nine months ended net of adjustments pertaining to the amortization/accretion of premiums and discounts, which are non-cash items. For the nine months ended September 30, 2014, operating activities increased our cash balance by approximately \$77.7 million, as revised see Note 2 for details. This was primarily attributable to the net interest income we earned on our investments for the nine months net of adjustments pertaining to the amortization/accretion of premiums and discounts, which are non-cash items.

Cash Provided by and Used in Investing Activities

For the nine months ended September 30, 2015, our investing activities increased our cash balance by approximately \$924.5 million. This was primarily attributable to our proceeds from sales of MBS and other securities and by our receipt of principal payments on MBS and other securities, partially offset by cash expenditures to acquire MBS and other securities and payments made on reverse repurchase agreements. For the nine months ended September 30, 2014, our investing activities decreased our cash balance by approximately \$1.3 billion, as revised see Note 2 for details. This was primarily attributable to our cash expenditures to acquire MBS, partially offset by proceeds from sales of MBS.

Cash Provided by and Used in Financing Activities

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

For the nine months ended September 30, 2015, our financing activities decreased our cash balance by approximately \$1.0 billion. This was primarily attributable to a decrease in our net borrowings under repurchase agreements. For the nine months ended September 30, 2014, our financing activities increased our cash balance by approximately \$1.3 billion, as revised see Note 2 for details. This was primarily attributable to an increase in our net borrowings under repurchase agreements.

Table of Contents***Other Potential Sources of Financing***

We held cash of approximately \$39.7 million and \$56.1 million at September 30, 2015 and September 30, 2014, respectively. Our primary sources of cash currently consist of repurchase facility borrowings, investment income, principal repayments and the proceeds of any future securities offering, to the extent available in the capital markets. In the future, we expect our primary sources of liquidity to consist of payments of principal and interest we receive on our portfolio of assets, unused borrowing capacity under our financing sources and future issuances of equity and debt securities.

To maintain our qualification as a REIT, we must distribute annually at least 90% of our taxable income, exclusive of undistributed taxable income retained by our TRS. This distribution requirement limits our ability to retain earnings and thereby replenish or increase capital for operations. We believe that our significant capital resources and access to financing will provide us with financial flexibility at levels sufficient to meet current and anticipated capital requirements, including funding new investment opportunities, paying distributions to our stockholders and servicing our debt obligations.

Contractual Obligations and Commitments

Our contractual obligations as of September 30, 2015 are as follows (dollars in thousands):

	Less than 1 year	1 to 3 years	3 to 5 years	More than 5 years	Total
Borrowings under repurchase agreements	\$ 3,010,268				\$ 3,010,268
Investment related payables	10,742				10,742
TBA long positions	2,525,041				2,525,041
Total: Non-GAAP Basis	5,546,051				5,546,051
TBA-long positions	2,525,041				2,525,041
Total: GAAP Basis Excluding TBA-long positions	\$ 3,021,010				\$ 3,021,010

As of September 30, 2015, we have an obligation for approximately \$6.2 million in contractual interest payments related to our repurchase agreements through the respective maturity date of each repurchase agreement. In addition, at September 30, 2015, we had entered into repurchase agreement borrowings of approximately \$12.4 million, which settled on October 2, 2015, with a weighted average interest rate of 1.63%, a weighted average contractual maturity of 96 days and secured by collateral of approximately \$15.5 million. These borrowings are recorded as a liability in our Consolidated Balance Sheets when settled.

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

The table above does not include amounts due under the Management Agreement (as defined herein) with our Manager, as those obligations do not have fixed and determinable payments. For a description of the Management Agreement, see Our Manager and the Management Agreement the Management Agreement.

On May 9, 2012, we entered into a management agreement (the Management Agreement) with our Manager which describes the services to be provided by our Manager and compensation for such services. Our Manager is responsible for managing our operations, including: (i) performing all of our day-to-day functions; (ii) determining investment criteria in conjunction with our Board of Directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of our Board of Directors. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.50% per annum of our stockholders' equity, (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, stockholders' equity means the sum of the net proceeds from any issuances of our equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of our shares of common stock, excluding any unrealized gains, losses or other non-cash items, including OTTI charges included in other loss on MBS and other securities, unrealized gain (loss) on MBS, other securities and Whole-Loans, net and the non-cash portion of gain (loss) on derivative instruments, that have impacted stockholders' equity as reported in our consolidated financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between our Manager and our independent directors and after approval by at least two thirds (2/3) of our independent directors. However, if our stockholders' equity for any given quarter is negative based on the calculation described above, our Manager will not be entitled to receive any management fee for that quarter.

Table of Contents

In addition, under the Management Agreement, we are required to reimburse our Manager for the expenses described below. Expense reimbursements to the Manager are made in cash on a regular basis. Our reimbursement obligation is not subject to any dollar limitation. Because our Manager's personnel perform certain legal, accounting, due diligence tasks and other services that outside professionals or outside consultants otherwise would perform, our Manager may be paid or reimbursed for the documented cost of performing such tasks, provided that such costs and reimbursements are in amounts which are no greater than those which would be payable to outside professionals or consultants engaged to perform such services pursuant to agreements negotiated on an arm's-length basis. We also reimburse our Manager for certain direct costs, such as the travel expenses of our officers, incurred by our Manager on our behalf. As of January 1, 2014, our chief financial officer became an employee of the Manager. Accordingly, we reimburse Manager for his compensation and benefits as well as the compensation and benefits provided to our controller. For the three and nine months ended September 30, 2015, we recorded expenses, paid by the Manager on our behalf, totaling approximately \$127 thousand and \$921 thousand, respectively related to employee costs and benefits associated with our chief financial officer and controller, and approximately \$112 thousand and \$521 thousand for the three and nine months ended September 30, 2014, respectively.

The Management Agreement may be amended, supplemented or modified by agreement between our Manager and us. The Management Agreement currently expires on May 16, 2016. It is automatically renewed for one-year terms on May 15th thereafter unless previously terminated as described below. Our independent directors will review the Manager's performance and any fees payable to the Manager annually and, following the initial term, the Management Agreement may be terminated annually upon the affirmative vote of at least two thirds (2/3) of our independent directors, based upon: (i) our Manager's unsatisfactory performance that is materially detrimental to us; or (ii) our determination that any fees payable to our Manager are not fair, subject to our Manager's right to prevent such termination due to unfair fees by accepting a reduction of management fees agreed to by at least two thirds (2/3) of our independent directors. If applicable, we are required to provide our Manager 180 days prior notice of any such termination. Unless terminated for cause, we will be required to pay our Manager a termination fee equal to three times the average annual management fee earned by our Manager during the prior 24-month period immediately preceding the date of termination, calculated as of the end of the most recently completed fiscal quarter prior to the date of termination.

We may also terminate the Management Agreement at any time, including during the initial term, without the payment of any termination fee, with 30 days prior written notice from our Board of Directors for cause, which will be determined by at least two thirds (2/3) of our independent directors, which is defined as: (i) our Manager's continued material breach of any provision of the Management Agreement (including our Manager's failure to comply with our investment guidelines); (ii) our Manager's fraud, misappropriation of funds, or embezzlement against us; (iii) our Manager's gross negligence in the performance of its duties under the Management Agreement; (iv) the occurrence of certain events with respect to the bankruptcy or insolvency of our Manager, including an order for relief in an involuntary bankruptcy case or our Manager authorizing or filing a voluntary bankruptcy petition; (v) our Manager is convicted (including a plea of nolo contendere) of a felony; or (vi) the dissolution of our Manager.

Off-Balance Sheet Arrangements

As of September 30, 2015, we held contracts to purchase (long position) and sell (short position) TBAs on a forward basis. If a counterparty to one of the TBAs that we enter into defaults on its obligations, we may not receive payments or securities due under the TBA agreement, and thus, we may lose any unrealized gain associated with that TBA transaction.

We do not have any relationships with any entities or financial partnerships, such as entities often referred to as structured investment vehicles, or special purpose or variable interest entities, established to facilitate off-balance sheet arrangements or other contractually narrow or limited purposes.

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

Further, other than guaranteeing certain obligations of our wholly-owned taxable REIT subsidiary or TRS, we have not guaranteed any obligations of any entities or entered into any commitment to provide additional funding to any such entities.

Table of Contents

See Warrants above for a description of our outstanding warrants.

Dividends

We intend to make regular quarterly dividend distributions to holders of our common stock. U.S. federal income tax law generally requires that a REIT distribute annually, in accordance with the REIT regulations, at least 90% of its REIT taxable income for the taxable year, without regard to the deduction for dividends paid and excluding net capital gains as well as undistributed taxable income retained by a TRS. To the extent that we distribute less than 100% of our net taxable income, in accordance with the REIT regulations, for any given year, we will pay tax on such amount at regular corporate rates. We intend to pay regular quarterly dividends to our stockholders based on our net taxable income, if and to the extent authorized by our Board of Directors. Before we pay any dividend, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service on our repurchase agreements and other debts payable. If our cash available for distribution is less than our net taxable income, we could be required to sell assets or borrow funds to make cash distributions or we may make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities.

On September 24, 2015, we declared a regular quarterly dividend of \$0.60 per common share for the quarter ended September 30, 2015. The dividend was paid on October 27, 2015 to shareholders of record as of October 5, 2015.

Non-GAAP Financial Measures

Total Interest Income and Net Interest Income, including Interest Income on Agency and Non-Agency Interest-Only strips accounted for as derivatives and Effective Cost of Funds

Total interest income including interest income on Agency and Non-Agency Interest-Only Strips classified as derivatives and Effective Cost of Funds (as defined below) for the three and nine months ended September 30, 2015 and September 30, 2014, constitute a Non-GAAP financial measures within the meaning of Regulation G promulgated by the SEC. We believe that the measures presented in this Quarterly Report on Form 10-Q, when considered together with U.S. GAAP financial measures, provide information that is useful to investors in understanding our borrowing costs and net interest income, as viewed by us. An analysis of any Non-GAAP financial measure should be made in conjunction with results presented in accordance with GAAP.

For purposes of evaluating operating results, we believe it useful to present investors with additional information pertaining to the net interest margin generated by our portfolio. Net interest margin is gross interest, adjusted for amortization/accretion of bond premium/discount, less interest expense or financing cost. GAAP requires that certain of our Agency and Non-Agency Interest Only Strips be treated as derivatives and, accordingly, the interest income associated with these securities be included with Gain (loss) on derivative instruments, net in our Consolidated Statement of Operations. Similarly, prior to January 1, 2015, GAAP required that interest income on linked transactions be included in Gain (loss) on linked transactions, net in our Consolidated Statement of Operations. Accordingly, in order to determine the gross interest income generated by our IO and IIO securities which are classified as derivatives and our MBS and other securities which are classified as linked transactions prior to January 1, 2015, we calculate the interest income on these securities as if they were not derivatives or linked transactions.

Starting in January 2015, we report our securities and the corresponding repurchase agreements which had previously been classified as linked transactions on a gross basis on our Consolidated Balance Sheets and with the corresponding interest income and interest expense reported in our Consolidated Statements of Operations. See Recent accounting pronouncements for details.

Table of Contents

The following table reconciles total interest income to interest income including interest income on Agency and Non-Agency Interest-Only Strips classified as derivatives and interest income on linked transactions prior to January 1, 2015(Non-GAAP financial measure) for the three and nine months ended September 30, 2015 and September 30, 2014:

(in thousands)	For the three months ended September 30, 2015	For the three months ended September 30, 2014	For the nine months ended September 30, 2015	For the nine months ended September 30, 2014
Coupon interest income	\$ 49,287	\$ 58,782	\$ 161,835	\$ 152,014
Premium accretion, discount amortization and amortization of basis, net	(13,466)	(18,064)	(44,179)	(43,262)
Interest income	\$ 35,821	\$ 40,718	\$ 117,656	\$ 108,752
Contractual interest income, net of amortization of basis on Agency and Non-Agency Interest-Only Strips, classified as derivatives(1):				
Coupon interest income	\$ 5,436	\$ 5,723	\$ 16,700	\$ 20,288
Amortization of basis (Non-GAAP Financial Measure)	(4,163)	(4,187)	(12,877)	(14,286)
Contractual interest income, net on Foreign currency swaps(1)	190	140	585	141
Contractual interest income, net of premium amortization, discount accretion and amortization of basis on Linked transactions (2):				
Coupon interest		1,142		5,002
Premium amortization, discount accretion and amortization of basis, net		(220)		(2,901)
Subtotal	1,463	2,598	4,408	8,244
Total interest income, including interest income on Agency and Non-Agency Interest-Only Strips, classified as derivatives and Linked transactions - Non-GAAP Financial Measure	\$ 37,284	\$ 43,316	\$ 122,064	\$ 116,996

-
- (1) Reported in gain (loss) on derivative instruments in the Consolidated Statement of Operations.
 - (2) Reported in gain (loss) on linked transactions in the Consolidated Statement of Operations.

Effective Cost of Funds includes the net interest component related to our interest rate swaps and borrowings under linked transactions prior to January 1, 2015, as well as the impact of our foreign currency swaps and forwards. While we have not elected hedge accounting for these instruments, such derivative instruments are viewed by us as an economic hedge against increases in future market interest rates on our liabilities and changes in foreign currency exchange rates on our assets and liabilities and are characterized as hedges for purposes of satisfying the REIT requirements and therefore the Effective Cost of Funds reflects interest expense adjusted to include the realized loss (i.e., the interest expense component) for all of our interest rate swaps and the impact of our foreign currency swaps and forwards. In addition, prior to January 1, 2015, our linked transactions were comprised of real estate securities and other structured securities, associated with repurchase agreements. We view the cost of the associated repurchase agreements (interest expense) prior to January 1, 2015 as a component of our Effective Cost of Funds.

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

The following tables reconcile the Effective Cost of Funds (Non-GAAP financial measure) with interest expense for the three and nine months ended September 30, 2015 and September 30, 2014:

(dollars in thousands)	For the three months ended September 30, 2015		For the nine months ended September 30, 2015	
	Reconciliation	Cost of Funds/Effective Borrowing Costs	Reconciliation	Cost of Funds/Effective Borrowing Costs
Interest expense	\$ 6,981	0.90%	\$ 19,960	0.75%
Net interest paid - interest rate swaps	5,224	0.68%	10,796	0.41%
Effective Borrowing Costs	\$ 12,205	1.58%	\$ 30,756	1.16%
Weighted average repurchase borrowings	3,064,689		3,536,381	

(dollars in thousands)	For the three months ended September 30, 2014, as Revised		For the nine months ended September 30, 2014, as Revised	
	Reconciliation	Cost of Funds/Effective Borrowing Costs	Reconciliation	Cost of Funds/Effective Borrowing Costs
Interest expense	\$ 6,468	0.63%	\$ 15,829	0.58%
Interest expense on linked transactions	139	1.84%	414	1.75%
Net interest paid - interest rate swaps	11,028	1.09%	24,856	0.92%
Effective Borrowing Costs	\$ 17,635	1.72%	\$ 41,099	1.50%
Weighted average repurchase borrowings (1)	4,072,179		3,668,932	

(1) Includes average repurchase borrowings under linked transactions.

Table of Contents

Revision of Effective Cost of Funds (Non-GAAP financial measure) reconciliation for the three and nine months ended September 30, 2014

As discussed further in Note 2 – Revision of Previously Issued Financial Statements for Errors Affecting Certain Items Presented in the Statements of Cash Flows and Notes to Financial Statements, we have elected to revise our presentation of the effective cost of funds (Non-GAAP financial measure) reconciliation for the three and nine months ended September 30, 2014 in this quarterly financial statements on Form 10-Q to correct these errors.

The effect of these errors on the table reconciling our effective cost of funds (Non-GAAP financial measure) for the three and nine months ended September 30, 2014 (dollars in thousands):

As Originally Reported

	Reconciliation		Cost of Funds/Effective Borrowing Costs	Reconciliation		Cost of Funds/Effective Borrowing Costs
Interest expense	\$	6,468	0.63%	\$	15,829	0.58%
Interest expense on linked transactions		139	1.84%		414	1.75%
Net interest paid - interest rate swaps		11,848	1.17%		25,784	0.95%
Effective Borrowing Costs	\$	18,455	1.80%	\$	42,027	1.53%
Weighted average repurchase borrowings		4,072,179			3,668,932	

	Reconciliation		Cost of Funds/Effective Borrowing Costs	Reconciliation		Cost of Funds/Effective Borrowing Costs
Interest expense	\$		%\$			%
Interest expense on linked transactions			%			%
Net interest paid - interest rate swaps		(820)	(0.08)%		(928)	(0.03)%
Effective Borrowing Costs	\$	(820)	(0.08)%	\$	(928)	(0.03)%
Weighted average repurchase borrowings						

Interest expense	\$	6,468	0.63%	\$	15,829	0.58%
Interest expense on linked transactions		139	1.84%		414	1.75%
Net interest paid - interest rate swaps		11,028	1.09%		24,856	0.92%
Effective Borrowing Costs	\$	17,635	1.72%	\$	41,099	1.50%
Weighted average repurchase borrowings		4,072,179			3,668,932	

Core Earnings

Our Core Earnings were approximately \$20.0 million and \$76.4 million for the three and nine months ended September 30, 2015, respectively, and approximately \$21.1 million, as revised and \$63.6 million, as revised for the three and nine months ended September 30, 2014, respectively. Core Earnings is a Non-GAAP financial measure that is used by us to approximate cash yield or income associated with our portfolio and is defined as GAAP net income (loss) as adjusted, excluding: (i) net realized gain (loss) on investments and termination of derivative contracts; (ii) net unrealized gain (loss) on investments; (iii) net gain (loss) resulting from mark-to-market adjustments on derivative contracts; (iv) other loss on MBS and other securities; (v) non-cash stock-based compensation expense; and (vi) one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between us, our Manager and our independent directors and after approval by a majority of the our independent directors.

In order to evaluate the effective yield of the portfolio, we use Core Earnings to reflect the net investment income of our portfolio as adjusted to reflect the net interest rate swap interest expense. Core Earnings allows us to isolate the interest expense associated with our interest rate swaps in order to monitor and project our borrowing costs and interest rate spread.

In addition, we utilize Core Earnings as a key metric in conjunction with other portfolio and market factors to determine the appropriate leverage and hedge ratios, as well as the overall structure of the portfolio. We also believe that our investors use Core Earnings or a comparable supplemental performance measure to evaluate and compare our performance and our peers, and as such, we believe that the disclosure of Core Earnings is useful to our investors.

Our presentation of Core Earnings may not be comparable to similarly-titled measures of other companies, who may use different calculations. As a result, Core Earnings should not be considered as a substitute for our GAAP net income as a measure of our financial performance or any measure of our liquidity under GAAP.

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

Table of Contents

The table below reconciles Net Income (Loss) to Core Earnings for the three and nine months ended September 30, 2015 and September 30, 2014:

(dollars in thousands)		For the three months ended September 30, 2015	For the three months ended September 30, 2014, as Revised	For the nine months ended September 30, 2015	For the nine months ended September 30, 2014, as Revised
Net Income (loss) GAAP	\$	(1,852)	\$ 26,136	\$ 10,601	\$ 85,269
Adjustments:					
<i>MBS, other securities and Whole-Loans:</i>					
Unrealized (gain) loss on MBS, other securities and Whole-Loans		(24,723)	4,453	(10,284)	(140,755)
Other loss on mortgage-backed and other securities		5,917	2,857	14,884	7,565
Realized (gain) loss on sale of MBS and other securities		2,482	(4,912)	(9,267)	2,650
<i>Derivative Instruments:</i>					
Realized gain on termination of interest rate swaps		(28,291)	(23,798)	(18,729)	(17,012)
Realized (gain) loss on settlement of TBAs		8,205	(2,608)	1,728	(25,169)
Realized loss on currency forwards		134	1,182	980	1,182
Realized gain on option derivatives		(684)		(684)	
Realized loss on termination of futures		168		627	16,495
Realized loss on sale of swaptions		150		3,873	5,908
Realized gain on sale/unlinking of securities underlying linked transactions			(107)		(1,397)
Realized (gain) loss on Agency Interest-Only Strips accounted for as derivatives		(626)	(389)	(624)	755
Realized (gain) loss on foreign currency transactions		275	(1,070)	(2,523)	(1,070)
Unrealized (gain) loss on foreign currency transactions		(201)		859	
Mark-to-market adjustments on interest rate swaps		64,701	15,587	83,209	123,026
Mark-to-market adjustments on interest rate swaptions		(71)	624	72	5,615
Mark-to-market adjustments on options			340		340
Mark-to-market adjustments on futures contracts		38	200	(683)	311
		(7,155)	1,110	2,784	(1,521)

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

Mark-to- market adjustments on TBAs				
Mark-to-market adjustments on linked transactions		2,131		1,418
Mark-to-market adjustments on derivative instruments	1,799	915	1,966	332
Mark-to-market adjustments on foreign currency swaps	(652)	(2,057)	(3,944)	(2,072)
Mark-to-market adjustments on foreign currency forwards	(114)	(57)	(452)	81
Non-cash stock-based compensation expense				
	509	587	1,969	1,654
Total adjustments	21,861	(5,012)	65,761	(21,664)
Core Earnings Non-GAAP Financial Measure				
	\$ 20,009	\$ 21,124	\$ 76,362	\$ 63,605
Basic Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure				
	\$ 0.48	\$ 0.51	\$ 1.82	\$ 1.75
Diluted Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure				
	\$ 0.48	\$ 0.51	\$ 1.82	\$ 1.75
Basic weighted average common shares and participating securities				
	41,946,885	41,731,928	41,896,839	36,311,055
Diluted weighted average common shares and participating securities				
	41,946,885	41,731,928	41,896,839	36,311,055

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

Table of Contents

Alternatively, our Core Earnings can also be derived as presented in the table below by starting with Net interest income including interest income on Interest-Only Strips accounted for as derivatives and interest expense, net incurred on interest rate swaps and foreign currency swaps and forwards (a Non-GAAP financial measure) subtracting Operating Expenses, net of Non-cash stock based compensation, and adding Interest income on cash balances and other income (loss), net:

(dollars in thousands)	For the three months ended September 30, 2015	For the three months ended September 30, 2014, as Revised	For the nine months ended September 30, 2015	For the nine months ended September 30, 2014, as Revised
Net interest income including interest income on Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and foreign currency swaps (a Non-GAAP financial measure)	\$ 25,079	\$ 25,681	\$ 91,308	\$ 75,897
Total Operating Expenses	(5,624)	(5,016)	(16,995)	(13,830)
Non-cash stock based compensation	509	587	1,969	1,654
Interest income on cash balances and other income (loss), net	45	(128)	80	(116)
Core Earnings (a Non-GAAP) financial measure	\$ 20,009	\$ 21,124	\$ 76,362	\$ 63,605

Revision of Core Earnings for the three and nine months ended September 30, 2014

As discussed further in Note 2 – Revision of Previously Issued Financial Statements for Errors Affecting Certain Items Presented in the Statements of Cash Flows and Notes to Financial Statements, we have elected to revise our presentation of Core Earnings for the three and nine months ended September 30, 2014 in this quarterly financial statements on Form 10-Q to correct these errors.

The effect of these errors on the reconciliation of Net Income (Loss) to Core Earnings for the three and nine months ended September 30, 2014 (summarized):

Net Income (loss) – GAAP	\$	26,136	\$	26,136
Adjustments:				
Mark-to- market adjustments on interest rate swaps		14,767	820	15,587
All other items with no changes		(20,599)		(20,599)
Total adjustments		(5,832)	820	(5,012)
Core Earnings – Non-GAAP Financial Measure	\$	20,304	\$ 820	\$ 21,124
	\$	0.49	\$ 0.02	\$ 0.51

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

Basic Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure				
Diluted Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure	\$	0.49	\$	0.02
			\$	0.51
Basic weighted average common shares and participating securities		41,731,928		41,731,928
Diluted weighted average common shares and participating securities		41,731,928		41,731,928

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

Table of Contents

Net Income (loss) GAAP	\$	85,269	\$	\$	85,269
Adjustments:					
Realized (gain) loss on termination of interest rate swaps		(39,796)		22,784	(17,012)
Mark-to-market adjustments on interest rate swaps		144,882		(21,856)	123,026
All other items with no changes		(127,678)			(127,678)
Total adjustments		(22,592)		928	(21,664)
Core Earnings Non-GAAP Financial Measure	\$	62,677	\$	928	\$ 63,605
Basic Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure					
	\$	1.73	\$	0.02	\$ 1.75
Diluted Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure					
	\$	1.73	\$	0.02	\$ 1.75
Basic weighted average common shares and participating securities					
		36,311,055		36,311,055	36,311,055
Diluted weighted average common shares and participating securities					
		36,311,055		36,311,055	36,311,055

The effect of these errors on the alternative presentation of Core Earnings for the three and nine months ended September 30, 2014:

	As Originally Reported For the three months ended September 30, 2014	Adjustments For the three months ended September 30, 2014	Revised For the three months ended September 30, 2014
(dollars in thousands)			
Net interest income including interest income on Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and foreign currency swaps (a Non-GAAP financial measure)	\$ 24,861	\$ 820	\$ 25,681
Total Operating Expenses	(5,016)		(5,016)
Non-cash stock based compensation	587		587
Interest income on cash balances and other income (loss), net	(128)		(128)
Core Earnings (a Non-GAAP) financial measure	\$ 20,304	\$ 820	\$ 21,124

	As Originally Reported For the nine months ended September 30, 2014	Adjustments For the nine months ended September 30, 2014	Revised For the nine months ended September 30, 2014
(dollars in thousands)			

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

Net interest income including interest income on Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and foreign currency swaps (a Non-GAAP financial measure)	\$	74,969	\$	928	\$	75,897
Total Operating Expenses		(13,830)				(13,830)
Non-cash stock based compensation		1,654				1,654
Interest income on cash balances and other income (loss), net		(116)				(116)
Core Earnings (a Non-GAAP) financial measure	\$	62,677	\$	928	\$	63,605

Table of Contents

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk.

We seek to manage the risks related to the credit quality of our assets, interest rates, liquidity, prepayment speeds and market values while, at the same time, seeking to provide an opportunity to stockholders to realize attractive risk-adjusted returns from our assets through ownership of our common stock. While we do not seek to avoid risk completely, our Manager seeks to actively manage risk for us, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

Credit Risk

We are subject to varying degrees of credit risk in connection with our assets. Although we do not expect to encounter credit risk in our Agency MBS and U.S. Treasury securities, we do expect to encounter credit risk related to Non-Agency MBS and Non-Agency CMBS, Whole-Loans and other portfolio investments. Investment decisions are made following a bottom-up credit analysis and specific risk assumptions. As part of the risk management process, our Manager uses detailed proprietary models, applicable to evaluate, depending on the asset class, house price appreciation and depreciation by region, prepayment speeds and foreclosure/default frequency, cost and timing. If our Manager determines that the proposed investment can meet the appropriate risk and return criteria as well as complement our existing asset portfolio, the investment will undergo a more thorough analysis.

As of September 30, 2015, 14 of the counterparties that we had outstanding repurchase agreement borrowings held collateral which we posted as security for such borrowings in excess of 5% of our Stockholders' equity. Prior to entering into a repurchase agreement with any particular institution, our Manager does a thorough review of such potential counterparty. Such review, however, does not assure the creditworthiness of such counterparty nor that the financial wherewithal of the counterparty will not deteriorate in the future.

Interest Rate Risk

Interest rates are highly sensitive to many factors, including fiscal and monetary policies and domestic and international economic and political considerations, as well as other factors beyond our control. We are subject to interest rate risk in connection with our assets and our related financing obligations. In general, we expect to finance the acquisition of our assets through financings in the form of repurchase agreements, warehouse facilities, securitizations, resecuritizations, bank credit facilities (including term loans and revolving facilities) and public and private equity and debt issuances in addition to transaction or asset specific funding arrangements. Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, we utilize derivative financial instruments to hedge the interest rate risk associated with our borrowings. We also may engage in a variety of interest rate management techniques that seek to mitigate changes in interest rates or other potential influences on the values of our assets.

Interest Rate Effect on Net Interest Income

Our operating results will depend in large part on differences between the income earned on our assets and our borrowing costs. The cost of our borrowings is generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will

increase and the yields earned on our leveraged fixed-rate mortgage assets will remain static. Further, the cost of such financing could increase at a faster pace than the yields earned on our leveraged ARM and hybrid ARM assets. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

Interest Rate Cap Risk

To the extent we invest in adjustable-rate RMBS, such securities are generally subject to interest rate caps, which potentially could cause such RMBS to acquire many of the characteristics of fixed-rate securities if interest rates were to rise above the cap levels. This issue is magnified to the extent we acquire ARM and hybrid ARM assets that are not based on mortgages which are fully indexed. In addition, ARM and hybrid ARM assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding or a portion of the incremental interest rate increase being deferred. To the extent we invest in such ARM and/or hybrid ARM assets, we could potentially receive less cash income on such assets than we would need to pay the interest cost on our related borrowings. To mitigate interest rate mismatches, we may utilize the hedging strategies discussed above under Interest Rate Risk.

Table of Contents***Interest Rate Effects on Fair value***

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

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

Market Risk

Market value risk. Our MBS and other assets are reflected at their fair value with unrealized gains and losses included in earnings. The fair value of our investments fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, the fair value of these assets would be expected to decrease; conversely, in a decreasing interest rate environment, the fair value of these securities would be expected to increase.

The sensitivity analysis table presented below shows the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments, including interest rate swaps, Interest-Only Strips, and net interest income at September 30, 2015, assuming a static portfolio of assets. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager's expectations. The analysis presented utilizes our Manager's assumptions, models and estimates, which are based on our Manager's judgment and experience.

Change in Interest Rates	Percentage Change in Projected Net Interest Income	Percentage Change in Projected Portfolio Value
+1.00%	35.80%	(2.76)%
+0.50%	17.90%	(1.35)%
-0.50%	(17.90)%	1.19%
-1.00%	NA(1)	NA(1)

(1) Not applicable, borrowing rate is below zero.

While the table above reflects the estimated immediate impact of interest rate increases and decreases on a static portfolio, we may rebalance our portfolio from time to time either to seek to take advantage of or reduce the impact of changes in interest rates. It is important to note that the impact of changing interest rates on market value and net interest income can change significantly when interest rates change beyond 100 basis points from current levels. Therefore, the volatility in the market value of our assets could increase significantly when interest rates change

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

beyond amounts shown in the table above. In addition, other factors impact the market value of and net interest income from our interest rate-sensitive investments and derivative instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, interest income would likely differ from that shown above and such difference might be material and adverse to our stockholders.

Certain assumptions have been made in connection with the calculation of the information set forth in the table above and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at September 30, 2015. The analysis presented utilizes assumptions and estimates based on our Manager's judgment and experience. Furthermore, while we generally expect to retain such assets and the associated interest rate risk, future purchases and sales of assets could materially change our interest rate risk profile.

Table of Contents

Prepayment Risk

The value of our Agency and Non-Agency RMBS and our Residential Whole-Loans may be affected by prepayment rates on the underlying residential mortgage. We acquire RMBS and Residential Whole-Loans and anticipate that the underlying residential mortgages will prepay at a projected rate generating an expected yield. If we purchase assets at a premium to par value, when borrowers prepay their residential mortgage loans faster than expected, the corresponding prepayments may reduce the expected yield on our residential mortgage assets because we will have to amortize the related premium on an accelerated basis and, in the case of Agency RMBS, other than interest-only strips, and certain other investment grade rated securities, we are required to make a retrospective adjustment to historical amortization. Conversely, if we purchase assets at a discount to par value, when borrowers prepay their residential mortgage loans slower than expected, such decrease may reduce the expected yield on such assets because we will not be able to accrete the related discount as quickly as originally anticipated and, in the case of Agency RMBS, other than interest-only strips, and certain other investment grade rated securities, we will be required to make a retrospective adjustment to historical amortization.

The value of our Agency and Non-Agency CMBS, as well as, Commercial Whole-Loans will also be affected by prepayment rates, however, commercial mortgages frequently limit the ability of the borrower to prepay, thereby providing a certain level of prepayment protection. Common restrictions include yield maintenance and prepayment penalties, the proceeds of which are generally at least partially allocable to these securities, as well as defeasance.

Likewise, the value of our ABS and other structured securities will also be affected prepayment rates. The collateral underlying such securities may, similar to most residential mortgages, allow the borrower to prepay at any time or, similar to commercial mortgages, limit the ability of the borrower to prepay by imposing lock-out provisions, prepayment penalties and/or make whole provisions.

Extension Risk

Most residential mortgage loans do not prohibit the partial or full prepayment of principal outstanding. Accordingly, while the stated maturity of a residential mortgage loan may be 30 years, or in some cases even longer, historically the vast majority of residential mortgage loans are satisfied prior to their maturity date. In periods of rising interest rates, borrowers have less incentive to refinance their existing mortgages and mortgage financing may not be as readily available. This generally results in a slower rate of prepayments and a corresponding longer weighted average life for RMBS. The increase, or extension, in weighted average life is commonly referred to as *Extension Risk* which can negatively impact our portfolio. To the extent we receive smaller pre-payments of principal; we will have less capital to invest in new assets. This is extremely detrimental in periods of rising interest rates as we will be unable to invest in new higher coupon investments and a larger portion of our portfolio will remain invested in lower coupon investments. Further, our borrowing costs are generally short-term and, even if hedged, are likely to increase in a rising interest rate environment, thereby reducing our net interest margin. Finally, to the extent we acquired investments at a discount to par, a portion of the overall return on such investments is based on the recovery of this discount. Slower principal prepayments will result in a longer recovery period and a lower overall return on our investment.

Prepayment rates on Agency and Non-Agency CMBS, as well as, Commercial Whole-Loans are generally less volatile than residential mortgage assets as commercial mortgages usually limit the ability of the borrower to prepay the mortgage prior to maturity or a period shortly before maturity. Accordingly, extension risk for Agency and Non-Agency CMBS and Commercial Whole-Loans is generally less than RMBS and Residential Whole-Loans as it is presumed that other than defaults (i.e. involuntary prepayments), most commercial mortgages will remain outstanding for the contractual term of the mortgage.

Prepayment rates on ABS and our other structured securities will be determined by the underlying collateral. The extension risk of such securities will generally be less than residential mortgages, but greater than commercial mortgages.

Counterparty Risk

The following discussion on counterparty risk reflects how these transactions are structured, rather than how they are presented for financial reporting purposes.

Table of Contents

When we engage in repurchase transactions, we generally sell securities to lenders (i.e., repurchase agreement counterparties) and receive cash from the lenders. The lenders are obligated to resell the same securities back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the securities to the lender is less than the value of those securities (this difference is the haircut), if the lender defaults on its obligation to resell the same securities back to us, we could incur a loss on the transaction up to the amount of the haircut (assuming there was no change in the value of the securities).

If a counterparty to a bi-lateral interest rate swap cannot perform under the terms of the interest rate swap, we may not receive payments due under that agreement, and thus, we may lose any unrealized gain associated with the interest rate swap. We may also risk the loss of any collateral we have pledged to secure our obligations under interest rate swap if the counterparty becomes insolvent or files for bankruptcy. In the case of a cleared swap, if our clearing broker were to default, become insolvent or file for bankruptcy, we may also risk the loss of any collateral we have posted to the clearing broker unless we were able to transfer or port our positions and held collateral to another clearing broker. In addition, the interest rate swap would no longer mitigate the impact of changes in interest rates as intended. As of September 2013, most of our interest swaps are cleared through a central clearing house which reduces but does not eliminate the aforementioned risks. Also see Liquidity Risk below.

As of September 30, 2015, we have entered into five master securities forward trading agreements, or MSFTAs, which may govern the trading of some or all TBA transactions. Pursuant to the terms of these MSFTAs, we and our counterparties would be required to post margin to the other when the mark to market exposure of the TBA transactions executed under the agreement exceed certain thresholds. We expect to continue to negotiate and enter into MSFTAs with additional TBA counterparties. The margin provisions of the MSFTA help to mitigate, but do not eliminate, counterparty risk associated with TBA transactions. If a counterparty to a TBA transaction cannot perform under the terms of the trade, we may not receive securities we have agreed to purchase or payment for securities we have agreed to sell, and thus, we may lose any unrealized gain associated with such transaction.

Prior to entering into a trading agreement or transaction with any particular institution where we take on counterparty risk, our Manager does a thorough review of such potential counterparty. Such review, however, does not assure the creditworthiness of such counterparty nor that the financial wherewithal of the counterparty will not deteriorate in the future.

Funding Risk

We have financed a substantial majority of our assets with repurchase agreement financing. Over time, as market conditions change, in addition to these financings, we may use other forms of leverage. Changes in the regulatory environment, as well as, weakness in the financial markets, the residential mortgage markets, the commercial mortgage markets, the asset-backed securitization markets and the economy generally could adversely affect one or more of our potential lenders and could cause one or more of our potential lenders to be unwilling or unable to provide us with financing or to increase the costs of that financing.

Liquidity Risk

Our liquidity risk is principally associated with the financing of long-maturity assets with short-term borrowings in the form of repurchase agreements. Although the interest rate adjustments of these assets and liabilities fall within the guidelines established by our operating policies,

maturities are not required to be, nor are they, matched.

Should the value of our assets pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. Our inability to post adequate collateral for a margin call by the counterparty could result in a condition of default under our repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by us, which may have a material adverse consequence on our business and results of operations.

In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, we could be required to sell securities, possibly even at a loss to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on our financial position, results of operations and cash flows.

Table of Contents

Additionally, if one or more of our repurchase agreement counterparties chose not to provide on-going funding, our ability to finance would decline or exist at possibly less advantageous terms. Further, if we are unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms, it may have a material adverse effect on our business, financial position, results of operations and cash flows, due to the long term nature of our investments and relatively short-term maturities of our repurchase agreements. As such, there is no assurance that we will always be able to roll over our repurchase agreements.

The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate MBS and other fixed rate assets will remain static. Further, certain of our floating rate assets may contain annual or lifetime interest rate caps as well as limit the frequency or timing of changes to the underlying interest rate index. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could have a material adverse effect on our liquidity and results of operations.

In addition, the assets that comprise our investment portfolio are not traded on a public exchange. A portion of these assets may be subject to legal and other restrictions on resale or will otherwise be less liquid than publicly-traded securities. The illiquidity of our assets may make it difficult for us to sell such assets if the need or desire arises, including in response to changes in economic and other conditions. Recent regulatory changes have imposed new capital requirements and other restrictions on banks and other market intermediaries' ability and desire to hold assets on their balance sheets and otherwise make markets in fixed income securities and other assets resulting in reduced liquidity in many sectors of the market. This regulatory trend is expected to continue. As a result of these developments it may become increasingly difficult for us to sell assets in the market, especially in credit oriented sectors such as Non-Agency RMBS and CMBS, ABS and Whole-Loans.

We enter into interest rate swaps to manage our interest rate risk. We are required to pledge cash or securities as collateral as part of a margin arrangement, calculated daily, in connection with the interest rate swaps. The amount of margin that we are required to post will vary and generally reflects collateral required to be posted with respect to interest rate swaps that are in an unrealized loss position to us and is generally based on a percentage of the aggregate notional amount of interest rate swaps per counterparty. Margin calls could adversely affect our liquidity. Our inability to post adequate collateral for a margin call could result in a condition of default under our interest rate swap agreement, thereby resulting in liquidation of the collateral pledged by us, which may have a material adverse consequence on our business, financial position, results of operations and cash flows. Conversely, if our interest rate swaps are in an unrealized gain position, our counterparties to bilateral swaps are required to post collateral with us, under the same terms that we post collateral with them. On occasion we may enter into a MAC interest rate swap in which we may receive or make a payment at the time of entering such interest rate swap to compensate for the out of the market nature of such interest rate swap. Similar to all other interest rate swaps, MAC interest rate swaps are also subject to the margin requirements previously described.

Inflation

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more so than does inflation. Changes in interest rates do not necessarily directly correlate with inflation rates or changes in inflation rates. Our consolidated financial statements are prepared in accordance with GAAP and our distributions will be determined by our Board of Directors consistent with our obligation to distribute to our stockholders at least 90% of our net taxable income on an annual basis, in accordance with the REIT regulations, in order to maintain our REIT qualification. In each case, our activities and consolidated balance sheets are measured with reference to historical cost and/or fair market value without considering inflation.

Foreign Investment risk

We have invested in Non U.S. CMBS transactions and, in the future, we may make other investments in non U.S. issuers and transactions. These investments present certain unique risks, including those resulting from future political, legal, and economic developments, which could include favorable or unfavorable changes in currency exchange rates, exchange control regulations (including currency blockage), expropriation, nationalization, or confiscatory taxation of assets, adverse changes in investment capital or exchange control regulations (which may include suspension of the ability to transfer currency from a country), political changes, diplomatic developments, difficulty in obtaining and enforcing judgments against non U.S. entities, the possible imposition of the applicable country's governmental laws or restrictions, and the reduced availability of public information concerning issuers. In the event of a nationalization, expropriation, or other confiscation of assets, the Company could lose its entire investment in a security. Legal remedies available to investors in certain jurisdictions may be more limited than those available to investors in the United States. Issuers of non U.S. securities may not be subject to the same degree of regulation as U.S. issuers.

Table of Contents

Furthermore, non U.S. issuers are not generally subject to uniform accounting, auditing, and financial reporting standards or other regulatory practices and requirements comparable to those applicable to U.S. issuers. There is generally less government supervision and regulation of non U.S. exchanges, brokers, and issuers than there is in the United States, and there is greater difficulty in taking appropriate legal action in Non U.S. courts. There are also special tax considerations that apply to securities of non U.S. issuers and securities principally traded overseas.

To the extent that our investments are denominated in U.S. dollars, the investment is not affected directly by changes in currency exchange rates relative to the dollar and exchange control regulations. We are, however, subject to currency risk with respect to such investments to the extent that a decline in a non U.S. issuer's or borrower's own currency relative to the dollar may impair such issuer's or borrower's ability to make timely payments of principal and/or interest on a loan or other debt security. To the extent that our investments are in non-dollar denominated securities, the value of the investment and the net investment income available for distribution may be affected favorably or unfavorably by changes in currency exchange rates relative to the dollar and exchange control regulations.

Currency exchange rates can be volatile and affected by, among other factors, the general economics of a country, the actions of governments or central banks and the imposition of currency controls and speculation. In addition, a security may be denominated in a currency that is different from the currency where the issuer is domiciled.

Currency Risk

We have and may continue in the future to invest in assets which are denominated in a currency other than U.S. dollars and may finance such investments with repurchase financing or other forms of financing which may also be denominated in a currency other than U.S. dollars. To the extent we make such investments and/or enter into such financing arrangements, we may utilize foreign currency swaps, forwards or other derivative instruments to hedge our exposure to foreign currency risk. Despite being economic hedges, we have elected not to treat such derivative instruments as hedges for accounting purposes and therefore the changes in the value of such instruments, including actual and accrued payments, will be included in our Consolidated Statement of Operations. While such transactions are entered into in an effort to minimize our foreign currency risk, there can be no assurance that they will perform as expected. If actual prepayments of the foreign denominated asset are faster, or slower, than expected, the hedge instrument is unlikely to fully protect us from changes in the valuation of such foreign currency. Further, as with interest rate swaps, there is counterparty risk associated with the future creditworthiness of such counterparty.

Table of Contents

ITEM 4. Controls and Procedures

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

We have evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our disclosure controls and procedures as of September 30, 2015. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the applicable rules and forms, and that it is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

No change occurred in our internal control over financial reporting (as defined in Rule 13a-15(f) and Rule 15d-15(f) of the Exchange Act) during the quarter ended September 30, 2015 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

ITEM 1. Legal Proceedings

From time to time, the Company may be involved in various claims and legal actions arising in the ordinary course of business. As of September 30, 2015, the Company was not involved in any legal proceedings.

ITEM 1A. Risk Factors

There were no material changes during the period covered by this report to the risk factors previously disclosed in our annual report on Form 10-K for the year ended December 31, 2014, as filed with the SEC on March 16, 2015. Additional risks not presently known, or that we currently deem immaterial, also may have a material adverse effect on our business, financial condition and results of operation.

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

None.

ITEM 3. Defaults Upon Senior Securities

None.

ITEM 4. Mine Safety Disclosures

Not Applicable.

ITEM 5. Other Information

None.

Table of Contents

ITEM 6. Exhibits

The following exhibits are filed as part of this report.

Exhibit No.	Description
3.1*	Amended and restated certificate of incorporation of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 3.1 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012
3.2*	Amended and restated bylaws of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 3.2 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012
4.1*	Specimen Common Stock Certificate of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 4.1 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012
10.1*	Form of Unit Purchase Agreement between Western Asset Mortgage Capital Corporation and certain institutional accredited investors, incorporated by reference to Exhibit 10.1 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.2*	Form of Warrant, incorporated by reference to Exhibit 10.2 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.3*	Management Agreement, dated May 9, 2012, between Western Asset Mortgage Capital Corporation and Western Asset Management Company, incorporated by reference to Exhibit 10.4 to the Quarterly Report on Form 10-Q, filed August 14, 2012.
10.4*	Registration Rights Agreement, dated May 15, 2012, among Western Asset Mortgage Capital Corporation, Western Asset Management Company and certain individual holders named therein, incorporated by reference to Exhibit 10.5 to the Quarterly Report on Form 10-Q, filed August 14, 2012.
10.5*	Western Asset Mortgage Capital Corporation Equity Plan, incorporated by reference to Exhibit 10.5 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.6*	Western Asset Mortgage Capital Corporation Manager Equity Plan, incorporated by reference to Exhibit 10.6 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.7*	Form of Indemnification Agreement between Western Asset Mortgage Capital Corporation and a director, incorporated by reference to Exhibit 10.7 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.8*	Restricted Stock Award Agreement, dated May 15, 2012, for Western Asset Management Company, incorporated by reference to Exhibit 10.9 to the Quarterly Report on Form 10-Q, filed August 14, 2012.
10.9*	Form of Restricted Stock Award Agreement for independent directors, incorporated by reference to Exhibit 10.2 to the Form S-8 dated May 15, 2012 (File No. 1-35543).
31.1	Rule 13a-14(a) / 15d-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) / 15d-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer
101.INS	XBRL Instance Document

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

101.SCH XBRL Taxonomy Extension Schema Document
101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF XBRL Taxonomy Extension Definition Linkbase Document
101.LAB XBRL Taxonomy Extension Label Linkbase Document
101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

*Fully or partly previously filed.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: */s/ GAVIN L. JAMES*

Gavin L. James
President, Chief Executive Officer and Director (Principal Executive Officer)

November 9, 2015

By: */s/ STEVEN M. SHERWYN*

Steven M. Sherwyn
Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)

November 9, 2015