

Invesco Mortgage Capital Inc.  
Form 10-Q  
November 02, 2012  
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**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, 2012

OR

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

For the transition period from            to

Commission file number 001-34385

**INVESCO MORTGAGE CAPITAL INC.**

(Exact Name of Registrant as Specified in Its Charter)

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

**26-2749336**  
(I.R.S. Employer  
Identification No.)

**1555 Peachtree Street, N.E., Suite 1800**

**Atlanta, Georgia**  
(Address of Principal Executive Offices)

**30309**  
(Zip Code)

**(404) 892-0896**  
(Registrant's Telephone Number, Including Area Code)

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

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

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

Large Accelerated filer  Accelerated filer

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

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

As of November 2, 2012, there were 116,191,834 outstanding shares of common stock of Invesco Mortgage Capital Inc.

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**INVESCO MORTGAGE CAPITAL INC.**

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**Table of Contents****PART I****ITEM 1. FINANCIAL STATEMENTS****INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

\$ in thousands, except share and per share amounts	As of	
	September 30, 2012 (Unaudited)	December 31, 2011
<b>ASSETS</b>		
Mortgage-backed securities, at fair value	18,324,208	14,214,149
Cash and cash equivalents	190,848	197,224
Restricted cash	13,473	74,496
Investment related receivable	7,608	160,424
Investments in unconsolidated ventures, at fair value	55,654	68,793
Accrued interest receivable	61,759	54,167
Derivative assets, at fair value	1,866	1,339
Other assets	1,810	1,575
<b>Total assets</b>	<b>18,657,226</b>	<b>14,772,167</b>
<b>LIABILITIES AND EQUITY</b>		
<b>Liabilities:</b>		
Repurchase agreements	14,876,501	12,253,038
Derivative liability, at fair value	471,841	396,780
Dividends and distributions payable	78,628	75,933
Investment related payable	622,731	107,032
Accrued interest payable	11,809	12,377
Accounts payable and accrued expenses	657	556
Due to affiliate	9,628	9,038
<b>Total liabilities</b>	<b>16,071,795</b>	<b>12,854,754</b>
<b>Equity:</b>		
Preferred Stock, par value \$0.01 per share; 50,000,000 shares authorized, 7.75% Series A cumulative redeemable, \$25 liquidation preference, 5,600,000 and no shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively	135,359	
Common Stock, par value \$0.01 per share; 450,000,000 shares authorized, 115,414,186 and 115,395,695 shares issued and outstanding, at September 30, 2012 and December 31, 2011, respectively	1,154	1,154
Additional paid in capital	2,299,950	2,299,543
Accumulated other comprehensive income (loss)	112,543	(393,291)
Retained earnings (distributions in excess of earnings)	4,855	(15,068)
<b>Total shareholders equity</b>	<b>2,553,861</b>	<b>1,892,338</b>
Non-controlling interest	31,570	25,075
<b>Total equity</b>	<b>2,585,431</b>	<b>1,917,413</b>
<b>Total liabilities and equity</b>	<b>18,657,226</b>	<b>14,772,167</b>

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



**Table of Contents****INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

\$ in thousands, except per share data	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>Revenues</b>				
Interest income	140,477	138,291	421,442	315,808
Interest expense	60,327	50,452	172,312	100,237
<b>Net interest income</b>	80,150	87,839	249,130	215,571
<b>Other income</b>				
Gain on sale of investments	12,836	3,637	24,978	8,442
Equity in earnings /(losses) and fair value change in unconsolidated ventures	3,262	(993)	6,231	2,738
Unrealized loss on interest rate swaps and swaptions	(808)	(453)	(2,851)	(655)
Realized and unrealized credit default swap income	1,348	858	2,694	4,649
<b>Total other income</b>	16,638	3,049	31,052	15,174
<b>Expenses</b>				
Management fee related party	9,053	7,884	26,372	17,612
General and administrative	959	829	3,132	2,855
<b>Total expenses</b>	10,012	8,713	29,504	20,467
<b>Net income</b>	86,776	82,175	250,678	210,278
Net income attributable to non-controlling interest	1,026	1,091	3,025	3,948
<b>Net income attributable to Invesco Mortgage Capital Inc.</b>	85,750	81,084	247,653	206,330
Dividends to preferred shareholders	2,682		2,682	
<b>Net income attributable to common shareholders</b>	83,068	81,084	244,971	206,330
<b>Earnings per share:</b>				
Net income attributable to common shareholders (basic/diluted)	0.72	0.79	2.12	2.70
Dividends declared per common share	0.65	0.80	1.95	2.77
<b>Weighted average number of shares of common stock:</b>				
Basic	115,412	103,028	115,405	76,311
Diluted	116,868	104,472	116,858	77,750

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



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**INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Unaudited)

<b>\$ in thousands, except per share data</b>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Net income	86,776	82,175	250,678	210,278
Other comprehensive income (loss)				
Unrealized gains (losses) on mortgage-backed securities, net	316,823	(33,921)	586,309	(33,078)
Unrealized losses on derivatives, net	(24,953)	(266,750)	(74,229)	(383,636)
Other comprehensive income (loss)	291,870	(300,671)	512,080	(416,714)
Comprehensive income (loss)	378,646	(218,496)	762,758	(206,436)
Less: Comprehensive income (loss) attributable to non-controlling interest	(4,585)	3,232	(9,271)	2,564
Less: Dividends to preferred shareholders	(2,682)		(2,682)	
Comprehensive income (loss) attributable to common shareholders	371,379	(215,264)	750,805	(203,872)

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



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## INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF EQUITY

For the nine months ended September 30, 2012

(Unaudited)

\$ in thousands, except per share amounts	Preferred Stock		Common Stock		Attributable to Common Shareholders			Total Shareholders Equity	Non- Controlling Interest	Total Equity
	Shares	Amount	Shares	Amount	Additional Paid in Capital	Other Comprehensive Income (loss)	Retained Earnings Accumulated (Distributions in excess of earnings)			
<b>Balance at January 1, 2012</b>			115,395,695	1,154	2,299,543	(393,291)	(15,068)	1,892,338	25,075	1,917,413
Net income							247,653	247,653	3,025	250,678
Other comprehensive income						505,834		505,834	6,246	512,080
Proceeds from issuance of common stock, net of offering costs			8,504		153			153		153
Proceeds from issuance of preferred stock, net of offering costs	5,600,000	135,359						135,359		135,359
Stock awards			9,987							
Common stock dividends							(225,048)	(225,048)		(225,048)
Common unit dividends									(2,779)	(2,779)
Preferred stock dividends							(2,682)	(2,682)		(2,682)
Amortization of equity-based compensation					254			254	3	257
<b>Balance at September 30, 2012</b>	5,600,000	135,359	115,414,186	1,154	2,299,950	112,543	4,855	2,553,861	31,570	2,585,431

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

**Table of Contents****INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

<b>\$ in thousands</b>	<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>Cash Flows from Operating Activities</b>		
Net income	250,678	210,278
Adjustments to reconcile net income to net cash provided by operating activities		
Amortization of mortgage-backed securities premiums and discounts, net	94,722	25,195
Unrealized loss on interest rate swap and swaptions	2,851	655
Unrealized gain on credit default swap	(406)	(1,580)
Gain on sale of mortgage-backed securities	(24,978)	(8,442)
Equity in earnings and fair value change in unconsolidated ventures	(6,231)	(2,738)
Amortization of equity-based compensation	257	138
Changes in operating assets and liabilities		
Increase in accrued interest receivable	(7,592)	(33,210)
Increase in other assets	(165)	(525)
(Decrease) increase in accrued interest payable	(568)	8,201
Increase in due to affiliate	428	4,685
(Decrease) increase in accounts payable and accrued expenses	64	(208)
Net cash provided by operating activities	309,060	202,449
<b>Cash Flows from Investing Activities</b>		
Purchase of mortgage-backed securities	(6,354,428)	(10,720,992)
(Contributions) distributions (to) from investment in unconsolidated ventures, net	19,370	(52,013)
Principal payments from mortgage-backed securities	1,827,398	936,444
Proceeds from sale of mortgage-backed securities	1,605,902	1,180,416
Payment of premiums for interest rate swaption	(2,140)	
Net cash used in investing activities	(2,903,898)	(8,656,145)
<b>Cash Flows from Financing Activities</b>		
Proceeds from issuance of common stock	103	1,297,079
Proceeds from issuance of preferred stock	135,535	
Restricted cash	57,172	(144,615)
Proceeds from repurchase agreements	111,725,441	63,074,773
Principal repayments of repurchase agreements	(109,101,978)	(55,606,134)
Payments of common stock dividends and common unit distributions	(227,811)	(174,045)
Net cash provided by financing activities	2,588,462	8,447,058
Net change in cash	(6,376)	(6,638)
Cash and cash equivalents, beginning of period	197,224	63,552
Cash and cash equivalents, end of period	190,848	56,914
<b>Supplement disclosure of cash flow information</b>		
Interest paid	172,879	92,036

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### Non-cash investing and financing activities information

Net change in unrealized gain on mortgage-backed securities and derivatives	512,080	(416,714)
Net change in unconsolidated ventures		(1,431)
Net change in restricted cash	3,851	(8,828)
Dividends and distributions declared not paid	78,628	43,708
Payable for mortgage-backed securities purchased	(672,589)	(204,317)
Repurchase agreements, not settled		368,547

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

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**INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**Note 1 Organization and Business Operations**

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

The Company conducts its business through IAS Operating Partnership LP (the Operating Partnership) as its sole general partner. As of September 30, 2012, the Company owned 98.8% of the Operating Partnership and Invesco Investments (Bermuda) Ltd., a direct, wholly-owned subsidiary of Invesco, owned the remaining 1.2%.

The Company finances its Agency RMBS, non-Agency RMBS and CMBS investments through short-term borrowings structured as repurchase agreements. The Company has secured commitments with a number of repurchase agreement counterparties. The Company has, in the past, contributed capital to the Invesco Mortgage Recovery Feeder Fund L.P. managed by the Company's Manager (Invesco IMRF Fund) that received financing under the U.S. government's Public Private Investment Program (PPIP). In March 2012, Invesco IMRF Fund returned substantially all of its proceeds and repaid all financing under the PPIP. The Company is awaiting final distribution from the Invesco IMRF Fund. In addition, the Company may use other sources of financing including committed borrowing facilities and other private financing.

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

**Note 2 Summary of Significant Accounting Policies**

**Basis of Quarterly Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X, promulgated by the Securities and Exchange Commission (the SEC). In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial position and the results of operations of the Company for the interim periods presented have been included. Certain disclosures included in the Company's annual report on Form 10-K are not required to be included on an interim basis in the company's quarterly reports on Forms 10-Q. The Company has condensed or omitted these disclosures. The interim consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and related notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2011 which was filed with the SEC on February 29, 2012. The results of operations for the period ended September 30, 2012 are not necessarily indicative of the results to be expected for the full year or any other future period.

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### **Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany balances and transactions have been eliminated.

### **Use of Estimates**

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

### **Cash and Cash Equivalents**

The Company considers all highly liquid investments that have original or remaining maturity dates of three months or less when purchased to be cash equivalents. At September 30, 2012, the Company had cash and cash equivalents, including amounts restricted, in excess of the FDIC deposit insurance limit of \$250,000 per institution. The Company mitigates its risk of loss by actively monitoring the counterparties.

### **Restricted Cash**

Restricted cash represents the Company's cash held by its counterparties as collateral against the Company's swaps and repurchase agreements. Restricted cash is not available for general corporate purposes but may be applied against amounts due to counterparties under the Company's swap and repurchase agreements, or returned to the Company when the collateral requirements are exceeded or at the maturity of the swap or repurchase agreement.

### **Underwriting Commissions and Offering Costs**

Underwriting commissions and direct costs incurred in connection with the Company's initial public offering ( IPO ) and subsequent stock offerings are reflected as a reduction of additional paid-in-capital.

### **Repurchase Agreements**

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

In instances where the Company acquires Agency RMBS, non-Agency RMBS or CMBS through repurchase agreements with the same counterparty from whom such assets were purchased, the Company accounts for the purchase commitment and repurchase agreement on a net basis and records a forward commitment to purchase such assets as a derivative instrument if the transaction does not comply with the criteria for gross presentation. All of the following criteria must be met for gross presentation in the circumstance where the repurchase assets are financed with the same counterparty:

the initial transfer of and repurchase financing cannot be contractually contingent;

the repurchase financing entered into between the parties provides full recourse to the transferee and the repurchase price is fixed;

the financial asset has an active market and the transfer is executed at market rates; and

the repurchase agreement and financial asset do not mature simultaneously.

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If the transaction complies with the criteria for gross presentation, the Company records the assets and the related financing on a gross basis on its balance sheet, and the corresponding interest income and interest expense in its statements of operations. Such forward commitments are recorded at fair value with subsequent changes in fair value recognized in income. Additionally, the Company records the cash portion of its investment in Agency RMBS and non-Agency RMBS as a mortgage related receivable from the counterparty on its balance sheet.

### **Fair Value Measurements**

In May 2011, the FASB issued Accounting Standards Update 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS (ASU 2011-04). The guidance clarifies the Board's intent about the application of existing fair value measurement requirements, and changes to a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The company adopted these provisions for the period ended March 31, 2012.

The adoption of this provision only affected the disclosure requirements for fair value measurements and as a result had no impact on the Company's consolidated statements of operations and consolidated balance sheets.

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

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

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

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

### **Securities**

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

All securities classified as available-for-sale are reported at fair value, based on market prices from third-party sources, with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders' equity. When applicable, included with available-for-sale securities are forward purchase commitments on to-be-announced securities (TBA). The Company records TBA purchases on the trade date and the corresponding payable is recorded as an outstanding liability as a payable for investments purchased until the settlement date of the transaction. This payable is presented in the Investment related payable line item on the consolidated balance sheet.

The Company evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. The determination of whether a

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

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

## **Interest Income Recognition**

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

## **Investments in Unconsolidated Ventures**

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

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

## **Dividends and Distributions Payable**

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

## **Earnings per Share**

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



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### **Comprehensive Income (Loss)**

Comprehensive income (loss) is comprised of net income, as presented in the consolidated statements of operations, adjusted for changes in unrealized gains or losses on available for sale securities and changes in the fair value of derivatives accounted for as cash flow hedges.

### **Accounting for Derivative Financial Instruments**

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

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

### **Income Taxes**

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

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

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

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

### **Share-Based Compensation**

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

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

### **Dividend Reinvestment Plan**

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

### **Recent Accounting Pronouncements Not Yet Adopted**

In December 2011, the FASB issued Accounting Standards Updated 2011-11, "Disclosures about Offsetting Assets and Liabilities" (ASU 2011-11). ASU 2011-11 amends Topic 210 to require additional disclosure information about offsetting and related arrangements. Entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transaction subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on a basis of US GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards (IFRS). The guidance is effective for periods beginning on or after January 1, 2013, and interim periods within those annual periods. The Company does not believe that the adoption of the amended guidance will have a significant effect on its consolidated financial statements.

**Table of Contents****Note 3 Mortgage-Backed Securities**

All of the Company's MBS are classified as available-for-sale and, as such, are reported at fair value, which is determined by obtaining valuations from an independent source. If the fair value of a security is not available from a dealer or third-party pricing service, or such data appears unreliable, the Company may estimate the fair value of the security using a variety of methods including other pricing services, repurchase agreement pricing, discounted cash flow analysis, matrix pricing, option adjusted spread models and other fundamental analysis of observable market factors. At September 30, 2012 and December 31, 2011, all of the Company's MBS values were based on values obtained from third-party pricing services. The following tables present certain information about the Company's investment portfolio at September 30, 2012 and December 31, 2011:

**September 30, 2012**

\$ in thousands	Principal Balance	Unamortized Premium (Discount)	Amortized Cost	Unrealized Gain/(Loss), net	Fair Value	Net Weighted Average Coupon <sup>(1)</sup>	Period-end Weighted Average Yield <sup>(2)</sup>	Quarterly Weighted Average Yield <sup>(3)</sup>
<b>Agency RMBS:</b>								
15 year fixed-rate	2,099,509	110,129	2,209,638	74,540	2,284,178	4.10%	2.65%	2.40%
30 year fixed-rate	9,419,335	620,748	10,040,083	328,440	10,368,523	4.37%	3.12%	2.92%
ARM	119,157	3,768	122,925	3,046	125,971	3.17%	2.68%	2.75%
Hybrid ARM	615,578	14,813	630,391	20,892	651,283	3.20%	2.64%	2.61%
Total Agency pass-through	12,253,579	749,458	13,003,037	426,918	13,429,955	4.25%	3.01%	2.81%
<b>Agency-CMO<sup>(4)</sup></b>								
Agency-CMO <sup>(4)</sup>	1,346,339	(828,433)	517,906	2,681	520,587	2.88%	3.58%	2.22%
<b>Non-Agency RMBS<sup>(5)</sup></b>								
Non-Agency RMBS <sup>(5)</sup>	2,829,094	(235,582)	2,593,512	32,281	2,625,793	4.12%	4.87%	4.91%
CMBS	1,623,395	1,266	1,624,661	123,212	1,747,873	5.44%	5.31%	5.24%
Total	18,052,407	(313,291)	17,739,116	585,092	18,324,208	4.23%	3.51%	3.31%

- (1) Net weighted average coupon as of September 30, 2012 ( WAC ) is presented net of servicing and other fees.
- (2) Average yield based on amortized cost as of September 30, 2012 incorporates future prepayment and loss assumptions.
- (3) For the three months ended September 30, 2012, the presentation of the quarterly weighted average yield has been changed to be based on amortized cost to be more consistent with the period-end weighted average yield. Prior periods will be adjusted accordingly for comparative purposes. Average yield based on average amortized cost for the three months ended September 30, 2012 incorporates future prepayment and loss assumptions.
- (4) Agency-CMO held by the Company are 14.1% interest only securities based on fair value.
- (5) The non-Agency RMBS held by the Company is 85.5% variable rate, 9.8% fixed rate, and 4.7% floating rate based on fair value.

**December 31, 2011**

\$ in thousands	Principal Balance	Unamortized Premium (Discount)	Amortized Cost	Unrealized Gain/(Loss), net	Fair Value	Net Weighted Average Coupon <sup>(1)</sup>	Period-end Weighted Average Yield <sup>(2)</sup>	Quarterly Weighted Average Yield <sup>(3)</sup>
<b>Agency RMBS:</b>								
15 year fixed-rate	2,289,495	123,610	2,413,105	36,454	2,449,559	4.18%	2.85%	2.75%
30 year fixed-rate	6,055,045	410,257	6,465,302	116,309	6,581,611	4.95%	3.66%	3.52%
ARM	113,413	2,398	115,811	2,065	117,876	3.40%	3.07%	2.90%

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Hybrid ARM	1,321,339	30,516	1,351,855	22,630	1,374,485	3.29%	2.59%	2.49%
Total Agency pass-through	9,779,292	566,781	10,346,073	177,458	10,523,531	4.53%	3.33%	3.19%
Agency-CMO <sup>(4)</sup>	765,172	(592,342)	172,830	(4,368)	168,462	2.86%	3.52%	1.32%
Non-Agency RMBS <sup>(5)</sup>	2,719,797	(252,135)	2,467,662	(108,434)	2,359,228	4.57%	5.07%	6.05%
CMBS	1,250,607	(21,805)	1,228,802	(65,874)	1,162,928	5.38%	5.60%	5.69%
Total	14,514,868	(299,501)	14,215,367	(1,218)	14,214,149	4.52%	3.83%	3.93%

- (1) Net weighted average coupon as of December 31, 2011 ( WAC ) is presented net of servicing and other fees.
- (2) Average yield based on amortized cost as of December 31, 2011 incorporates future prepayment and loss assumptions.
- (3) For the three months ended December 31, 2011, the presentation of the quarterly weighted average yield has been changed to be based on amortized cost to be more consistent with the period-end weighted average yield. Average yield based on average amortized cost for the three months ended December 31, 2011 incorporates future prepayment and loss assumptions.
- (4) Agency-CMO held by the Company are 28.3% interest only securities based on fair value.
- (5) The non-Agency RMBS held by the Company is 85.0% variable rate, 9.8% fixed rate, and 5.2% floating rate based on fair value.
- The following table summarizes our non-Agency RMBS portfolio by asset type as of September 30, 2012 and December 31, 2011, respectively:

\$ in thousands	September 30, 2012	% of Non-Agency	December 31, 2011	% of Non-Agency
Re-REMIC Senior	1,811,216	69.0 %	1,634,376	69.3%
Prime	508,164	19.4 %	482,113	20.4%
Alt-A	298,436	11.3 %	231,936	9.8%
Subprime	7,977	0.3 %	10,803	0.5%
Total Non-Agency	2,625,793	100.0 %	2,359,228	100.0%

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The following table summarizes certain characteristics of our senior Re-REMIC Holdings as of September 30, 2012 and December 31, 2011:

Re-REMIC Subordination <sup>(1)</sup>	Percentage of Re-REMIC Holdings at Fair Value	
	September 30, 2012	December 31, 2011
10-20	2.5%	3.0%
20-30	14.9%	15.3%
30-40	28.6%	19.3%
40-50	41.8%	48.1%
50-60	7.1%	8.3%
60-70	5.1%	6.0%
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>

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

The components of the carrying value of the Company's investment portfolio at September 30, 2012 and December 31, 2011 are presented below:

\$ in thousands	September 30, 2012	December 31, 2011
Principal balance	18,052,407	14,514,868
Unamortized premium	794,903	587,430
Unamortized discount	(1,108,194)	(886,931)
Gross unrealized gains	622,784	203,965
Gross unrealized losses	(37,692)	(205,183)
<b>Fair value</b>	<b>18,324,208</b>	<b>14,214,149</b>

The following table summarizes certain characteristics of the Company's investment portfolio, at fair value, according to estimated weighted average life classifications as of September 30, 2012 and December 31, 2011:

\$ in thousands	September 30, 2012	December 31, 2011
Less than one year	16,088	68,217
Greater than one year and less than five years	14,934,970	12,150,472
Greater than or equal to five years	3,373,150	1,995,460
<b>Total</b>	<b>18,324,208</b>	<b>14,214,149</b>

The following tables present the gross unrealized losses and estimated fair value of the Company's MBS by length of time that such securities have been in a continuous unrealized loss position at September 30, 2012 and December 31, 2011, respectively:

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September 30, 2012

\$ in thousands	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Agency RMBS:						
15 year fixed-rate	15,731	(63)			15,731	(63)
30 year fixed-rate	405,508	(1,692)	85,038	(127)	490,546	(1,819)
Total Agency pass-through	421,239	(1,755)	85,038	(127)	506,277	(1,882)
Agency-CMO	97,220	(7,980)	7,283	(1,435)	104,503	(9,415)
Non-Agency RMBS	485,402	(8,968)	494,781	(15,128)	980,183	(24,096)
CMBS	7,315	(21)	85,138	(2,278)	92,453	(2,299)
Total	1,011,176	(18,724)	672,240	(18,968)	1,683,416	(37,692)

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December 31, 2011

\$ in thousands	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>Agency RMBS:</b>						
15 year fixed-rate	149,092	(754)			149,092	(754)
30 year fixed-rate	844,272	(5,563)			844,272	(5,563)
ARM	25,508	(179)	13,062	(52)	38,570	(231)
Hybrid ARM	24,929	(73)			24,929	(73)
<b>Total Agency pass-through</b>	<b>1,043,801</b>	<b>(6,569)</b>	<b>13,062</b>	<b>(52)</b>	<b>1,056,863</b>	<b>(6,621)</b>
<b>Agency-CMO</b>	<b>50,084</b>	<b>(8,362)</b>			<b>50,084</b>	<b>(8,362)</b>
<b>Non-Agency RMBS</b>	<b>1,981,046</b>	<b>(104,813)</b>	<b>46,193</b>	<b>(11,622)</b>	<b>2,027,239</b>	<b>(116,435)</b>
<b>CMBS</b>	<b>796,965</b>	<b>(73,765)</b>			<b>796,965</b>	<b>(73,765)</b>
<b>Total</b>	<b>3,871,896</b>	<b>(193,509)</b>	<b>59,255</b>	<b>(11,674)</b>	<b>3,931,151</b>	<b>(205,183)</b>

Gross unrealized losses on the Company's Agency RMBS were \$1.9 million at September 30, 2012. Due to the inherent credit quality of Agency RMBS, the Company determined that at September 30, 2012, any unrealized losses on its Agency RMBS portfolio are temporary.

Gross unrealized losses on the Company's Agency-CMO, non-Agency RMBS, and CMBS were \$35.8 million at September 30, 2012. The Company does not consider these unrealized losses to be credit related, but rather due to non-credit related factors such as interest rate spreads, prepayment speeds, and market fluctuations. These investment securities are included in the Company's assessment for other-than-temporary impairment on at least a quarterly basis.

The following table presents the impact of the Company's MBS on its accumulated other comprehensive income for the three and nine months ended September 30, 2012 and 2011:

\$ in thousands	Three Months ended	Three Months ended	Nine Months ended	Nine Months ended
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
<b>Accumulated other comprehensive income from investment securities:</b>				
Unrealized gain on MBS at beginning of period	268,269	32,110	(1,218)	31,267
Unrealized gain (loss) on MBS, net	316,823	(33,921)	586,310	(33,078)
<b>Balance at the end of period</b>	<b>585,092</b>	<b>(1,811)</b>	<b>585,092</b>	<b>(1,811)</b>

During the three months ended September 30, 2012, the Company reclassified \$2.6 million of net unrealized loss from other comprehensive income into loss on sale of investments as a result of the Company selling certain investments.

During the nine months ended September 30, 2012, the Company reclassified \$17.4 million of net unrealized gains from other comprehensive income into gain on sale of investments as a result of the Company selling certain investments.

The Company assesses its investment securities for other-than-temporary impairment on at least a quarterly basis. 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

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Company considers several factors, including the nature of the investment, communications from the trustees of securitizations regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and the Company's intent that it is more likely than not that the Company can hold the security until recovery of its cost basis.



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The Company did not have other-than-temporary impairments for the three and nine months ended September 30, 2012 and 2011.

The following table presents a roll-forward of the credit loss component of other-than-temporary impairments for the three and nine months ended September 30, 2012 and 2011:

<b>\$ in thousands</b>	<b>Three Months ended September 30, 2012</b>	<b>Three Months ended September 30, 2011</b>	<b>Nine Months ended September 30, 2012</b>	<b>Nine Months ended September 30, 2011</b>
Cumulative credit loss amount at the beginning of the period		510		510
Additions for credit losses for which other-than-temporary impairment had not been previously recognized				
Reductions for securities sold				
Cumulative credit loss amount at end of period		510		510

The following table presents components of interest income on the Company's MBS portfolio for the three and nine months ended September 30, 2012 and 2011:

**For the three months ended September 30, 2012**

<b>\$ in thousands</b>	<b>Coupon Interest</b>	<b>Net (Premium Amortization)/Discount Accretion</b>	<b>Interest Income</b>
Agency	132,520	(42,479)	90,041
Non-Agency	26,477	4,149	30,626
CMBS	20,330	(477)	19,853
Other	(43)		(43)
Total	179,284	(38,807)	140,477

**For the nine months ended September 30, 2012**

<b>\$ in thousands</b>	<b>Coupon Interest</b>	<b>Net (Premium Amortization)/Discount Accretion</b>	<b>Interest Income</b>
Agency	382,226	(109,717)	272,509
Non-Agency	79,903	15,204	95,107
CMBS	54,146	(209)	53,937
Other	(111)		(111)
Total	516,164	(94,722)	421,442

**For the three months ended September 30, 2011**

**\$ in thousands**

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	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	102,444	(24,229)	78,215
Non-Agency	31,312	10,193	41,505
CMBS	18,634	(8)	18,626
Other	(55)		(55)
<b>Total</b>	<b>152,335</b>	<b>(14,044)</b>	<b>138,291</b>

**For the nine months ended September 30, 2011**

<b>\$ in thousands</b>	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	232,756	(54,358)	178,398
Non-Agency	72,270	29,125	101,395
CMBS	36,012	38	36,050
Other	(35)		(35)
<b>Total</b>	<b>341,003</b>	<b>(25,195)</b>	<b>315,808</b>

**Note 4 Investments in Unconsolidated Ventures**

The Company's non-controlling, unconsolidated ownership interests in these unconsolidated entities are accounted for under the equity method. Capital contributions, distributions, profits and losses of the entities are allocated in accordance with the terms of the entities' operating agreements. Such allocations may differ from the

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stated percentage interests, if any, as a result of preferred returns and allocation formulas as described in such agreements. The Company has made the fair value election for its investments in all unconsolidated ventures. The fair value measurement for the investments in unconsolidated ventures is based on the net asset value per share of the investment, or its equivalent.

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

The Company invested in certain non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing equity capital to the Invesco IMRF Fund that received financing under the PPIP. In March 2012, Invesco IMRF Fund returned substantially all of its proceeds and repaid all financing under the PPIP. The Company is awaiting final distribution from the Invesco IMRF Fund. In addition, the Manager identified a whole loan transaction for the Company, which resulted in the Company's admission into an alternative investment vehicle, the Invesco Mortgage Recovery Loans AIV, L.P. ( "AIV" ). The Company's initial commitment in the Invesco IMRF Fund and AIV was \$25.0 million. During 2009 and 2010, the Invesco IMRF Fund and AIV accepted additional subscriptions and the Company increased its overall commitment to \$100.0 million which effectively increased the Company's initial ownership interest in the Invesco IMRF Fund and AIV. As of March 31, 2010, the Invesco IMRF Fund stopped accepting investment subscriptions and was deemed closed. The Company made its first contributions to the Invesco IMRF Fund in October 2009. The Company is committed to fund \$17.1 million in aggregate of additional capital at September 30, 2012 for the Invesco IMRF Fund and AIV. The Company realized approximately \$1.4 million (2011: \$823,000) and \$2.1 million (2011: \$6.4 million) of equity in earnings for the three and nine months ended September 30, 2012 related to these investments. The Company had an unrealized loss of \$464,000 (2011: \$1.8 million) and an unrealized gain of \$774,000 (2011: \$3.7 million loss) from these investments for the three and nine months ended September 30, 2012.

### **IMRF Loan Portfolio Member LLC**

On September 30, 2011, the Company invested in a portfolio of commercial mortgage loans by contributing \$16.9 million, net of distributions, of equity capital to IMRF Loan Portfolio Member LLC ( "IMRF LLC" ) a limited liability company managed by AIV. The Company has fully funded its commitment to IMRF LLC. The Company realized approximately \$2.5 million and \$3.2 million of equity in earnings and \$191,000 of unrealized depreciation and \$116,000 of unrealized appreciation from these investments for the three and nine months ended September 30, 2012, respectively. The Company recognized no income or loss in respect of its ownership interest in IMRF LLC for the three and nine months ended September 30, 2011.

**Table of Contents****Note 5 Borrowings****Repurchase Agreements**

The Company has entered into repurchase agreements to finance the majority of its portfolio of investments. The repurchase agreements bear interest at a contractually agreed rate. The repurchase obligations mature and typically reinvest every thirty days to one year and have a weighted average aggregate interest rate of 0.68% and 0.68% at September 30, 2012 and December 31, 2011, respectively. Repurchase agreements are being accounted for as secured borrowings since the Company maintains effective control of the financed assets. The following table summarizes certain characteristics of the Company's repurchase agreements at September 30, 2012 and December 31, 2011:

	September 30, 2012			December 31, 2011		
	Amount Outstanding	Weighted Average Interest Rate	Weighted Average Remaining Maturity (Days)	Amount Outstanding	Weighted Average Interest Rate	Weighted Average Remaining Maturity (Days)
<b>\$ in thousands</b>						
Agency RMBS	11,710,680	0.41%	18	9,491,538	0.38%	22
Non-Agency RMBS	1,915,915	1.77%	25	1,916,620	1.79%	22
CMBS	1,249,906	1.56%	19	844,880	1.55%	22
Total	14,876,501	0.68%	19	12,253,038	0.68%	22

Under the repurchase agreements, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral or fund margin calls. In addition, the repurchase agreements are subject to certain financial covenants. The Company is in compliance with these covenants at September 30, 2012.

The following tables summarize certain characteristics of the Company's repurchase agreements at September 30, 2012 and December 31, 2011:

**September 30,****\$ in thousands**

	Amount Outstanding	Percent of Total Amount Outstanding	Company MBS Held as Collateral
<b>Repurchase Agreement Counterparties</b>			
Credit Suisse Securities (USA) LLC	1,422,312	9.6%	1,730,732
Nomura Securities International, Inc.	1,368,017	9.2%	1,479,510
Morgan Stanley & Co. Incorporated	1,257,017	8.4%	1,400,973
JP Morgan Securities Inc.	1,242,696	8.4%	1,402,680
HSBC Securities (USA) Inc	969,041	6.5%	1,014,753
Mitsubishi UFJ Securities (USA), Inc.	902,941	6.1%	967,244
CitiGroup Global Markets Inc.	855,147	5.7%	939,252
Industrial and Commercial Bank of China Financial Services LLC	840,216	5.6%	912,663
ING Financial Market LLC	713,992	4.8%	763,911
Banc of America Securities LLC	692,899	4.7%	777,219
Goldman, Sachs & Co.	660,278	4.4%	722,868
RBS Securities Inc.	605,019	4.1%	696,515
Deutsche Bank Securities Inc.	573,323	3.9%	630,908
Wells Fargo Securities, LLC	548,636	3.7%	654,449
South Street Securities LLC	533,990	3.6%	571,343
Royal Bank of Canada	475,830	3.2%	548,286
BNP Paribas Securities Corp.	326,733	2.2%	352,569
Barclays Capital Inc.	219,706	1.5%	235,415
TD Securities	183,333	1.2%	191,524

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Daiwa Capital Markets America Inc	142,791	1.0%	152,744
Mizuho Securities USA Inc.	108,401	0.7%	130,404
Guggenheim Liquidity Services, LLC	93,806	0.6%	102,228
KGS-Alpha Capital Markets, L.P.	91,636	0.6%	99,463
Cantor Fitzgerald & Co.	35,051	0.2%	39,816
Pierpont Securities LLC	13,690	0.1%	14,486
Total	14,876,501	100.0%	16,531,955

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December 31, 2011

\$ in thousands

	Amount Outstanding	Percent of Total Amount Outstanding	Company MBS Held as Collateral
<b>Repurchase Agreement Counterparties</b>			
Credit Suisse Securities (USA) LLC	2,419,546	19.8%	2,738,101
Nomura Securities International, Inc.	1,069,235	8.7%	1,152,957
Mitsubishi UFJ Securities (USA), Inc.	925,863	7.6%	979,907
Industrial and Commercial Bank of China Financial Services LLC	848,919	6.9%	895,760
South Street Securities LLC	772,637	6.3%	818,513
JP Morgan Securities Inc.	663,879	5.4%	764,972
Morgan Stanley & Co. Incorporated	645,570	5.3%	710,729
Goldman, Sachs & Co.	606,922	5.0%	649,514
RBS Securities Inc.	593,051	4.8%	671,073
ING Financial Market LLC	537,122	4.4%	568,813
Deutsche Bank Securities Inc.	531,302	4.3%	579,659
Banc of America Securities LLC	455,954	3.7%	521,888
CitiGroup Global Markets Inc.	447,280	3.7%	476,511
Royal Bank of Canada	422,700	3.4%	482,988
Wells Fargo Securities, LLC	389,803	3.2%	479,926
BNP Paribas Securities Corp.	348,707	2.8%	372,876
Mizuho Securities USA Inc.	186,997	1.5%	206,594
Guggenheim Liquidity Services, LLC	139,744	1.1%	147,786
Daiwa Capital Markets America Inc	106,121	0.9%	113,695
UBS Securities Inc.	80,083	0.7%	84,561
Cantor Fitzgerald & Co.	61,603	0.5%	63,999
<b>Total</b>	<b>12,253,038</b>	<b>100.0%</b>	<b>13,480,822</b>

Company MBS held by counterparties as security for repurchase agreements was \$16.5 billion and \$13.5 billion at September 30, 2012 and December 31, 2011, respectively. This represents a collateral ratio (Company MBS Held as Collateral/Amount Outstanding) of 111% and 110% respectively.

Cash collateral held by the counterparties at September 30, 2012 and December 31, 2011 was \$0 and \$37.5 million, respectively. The cash collateral was replaced by Agency RMBS.

**Note 6 Derivatives and Hedging Activities****Risk Management Objective of Using Derivatives**

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

The Company also utilizes credit derivatives such as credit default swaps ( CDS ) to provide credit event protection based on a financial index or specific security in exchange for receiving a fixed-rate fee or premium over the term of the contract. These instruments enable the Company to synthetically assume the credit risk of a reference security, portfolio of securities or index of securities. The counterparty pays a premium to the Company and the Company agrees to make a payment to compensate the counterparty for losses upon the occurrence of a specified credit event.

Although contract-specific, credit events generally include bankruptcy, failure to pay, restructuring, obligation acceleration, obligation default, or repudiation/moratorium. Upon the occurrence of a defined credit event, the difference between the value of the reference obligation and the CDS's notional amount is recorded as a realized loss in the statement of operations.

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The Company's only CDS contract was entered into on December 31, 2010. The Company sold protection against losses on a specific pool of non-Agency RMBS in the event they exceed a specified loss limit of 25% of the balance of the non-Agency RMBS on the trade date. The maximum exposure is the remaining unpaid principal balance of the underlying RMBS in excess of the specified loss threshold. In exchange, the Company is paid a stated fixed rate fee of 3%. The Company is required to post cash collateral as security for potential loss payments.

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At September 30, 2012 and December 31, 2011, the open CDS sold by the Company is summarized as follows:

<b>\$ in thousand</b>	<b>September 30, 2012</b>	<b>December 31, 2011</b>
Fair value amount	1,745	1,339
Notional amount	87,122	112,128
Maximum potential amount of future undiscounted payments	87,122	112,128
Recourse provisions with third parties		
Collateral held by counterparty	13,473	17,324

The Company purchased an interest rate swaption to help mitigate the potential impact of increases or decreases in interest rates on the performance of a portion of the Company's investment portfolio (referred to as convexity risk). The interest rate swaption provides 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. The premium paid for interest rate swaptions is reported as an asset in the Company's consolidated balance sheets. The premium is valued at an amount equal to the fair value of the swaption that would have the effect of closing the position adjusted for nonperformance risk, if any. The difference between the premium and the fair value of the swaption is reported in unrealized gain (loss) on interest rate swaps and swaptions, net in the Company's consolidated statement of operations. If a swaption expires unexercised, the loss on the swaption would be equal to the premium paid. If we sell or exercise a swaption, the realized gain or loss on the swaption would be equal to the difference between the cash or the fair value of the underlying interest rate swap received and the premium paid. As of September 30, 2012, we had one swaption with an original cost of \$2.1 million. The option expires in April 2013. The swaption covers \$200 million notional value at a fixed pay rate of 1.85% for a term of five years.

**Cash Flow Hedges of Interest Rate Risk**

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

During the three months ended September 30, 2012, the Company recorded \$319,000 (2011: \$453,000) of unrealized swap losses in earnings as hedge ineffectiveness attributable primarily to differences in the reset dates on the Company's swaps versus the refinancing dates of certain of its repurchase agreements.

During the nine months ended September 30, 2012, the Company recorded \$832,000 (2011: \$655,000) of unrealized swap losses in earnings as hedge ineffectiveness attributable primarily to differences in the reset dates on the Company's swaps versus the refinancing dates of certain of its repurchase agreements.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest is accrued and paid on the Company's repurchase agreements. During the next twelve months, the Company estimates that an additional \$142.0 million will be reclassified as an increase to interest expense.

The Company is hedging its exposure to the variability in future cash flows for forecasted transactions over a maximum period of 104 months.



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As of September 30, 2012, the Company had the following interest rate derivatives outstanding, that were designated as cash flow hedges of interest rate risk:

\$ in thousands

Counterparty	Notional	Maturity Date	Fixed Interest Rate in Contract
The Bank of New York Mellon	100,000	5/24/2013	1.83%
The Bank of New York Mellon	200,000	6/15/2013	1.73%
SunTrust Bank	100,000	7/15/2014	2.79%
Deutsche Bank AG	200,000	1/15/2015	1.08%
Deutsche Bank AG	250,000	2/15/2015	1.14%
Credit Suisse International	100,000	2/24/2015	3.26%
Credit Suisse International	100,000	3/24/2015	2.76%
Wells Fargo Bank, N.A.	100,000	7/15/2015	2.85%
Wells Fargo Bank, N.A.	50,000	7/15/2015	2.44%
Morgan Stanley Capital Services, Inc.	300,000	1/24/2016	2.12%
The Bank of New York Mellon	300,000	1/24/2016	2.13%
Morgan Stanley Capital Services, Inc.	300,000	4/5/2016	2.48%
Citibank, N.A.	300,000	4/15/2016	1.67%
The Bank of New York Mellon	500,000	4/15/2016	2.24%
Credit Suisse International	500,000	4/15/2016	2.27%
JPMorgan Chase Bank, N.A.	500,000	5/16/2016	2.31%
Goldman Sachs Bank USA	500,000	5/24/2016	2.34%
Wells Fargo Bank, N.A.	250,000	6/15/2016	2.67%
Goldman Sachs Bank USA	250,000	6/15/2016	2.67%
JPMorgan Chase Bank, N.A.	500,000	6/24/2016	2.51%
Citibank, N.A.	500,000	10/15/2016	1.93%
Deutsche Bank AG	150,000	2/5/2018	2.90%
Morgan Stanley Capital Services, Inc.	100,000	4/5/2018	3.10%
JPMorgan Chase Bank, N.A.	200,000	5/15/2018	2.93%
UBS AG	500,000	5/24/2018	1.10%
The Royal Bank of Scotland Plc	500,000	9/5/2018	1.04%
Wells Fargo Bank, N.A.	200,000	3/15/2021	3.14%
Citibank, N.A.	200,000	5/25/2021	2.83%
<b>Total</b>	<b>7,750,000</b>		<b>2.14%</b>

At September 30, 2012, the Company's counterparties held no cash margin deposits and \$547.3 million in Agency RMBS as collateral against its swap contracts. As of September 30, 2012, the Company had forward starting swaps with a total notional amount of \$1.0 billion, with starting dates ranging from May 24, 2013 to September 5, 2013. Cash margin, if any, is classified as restricted cash and the Agency RMBS collateral is included in the total mortgage-backed securities on our consolidated balance sheet.

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

The table below presents the fair value of the Company's derivative financial instruments, as well as their classification on the balance sheet as of September 30, 2012 and December 31, 2011:

\$ in thousands

Balance Sheet	Asset Derivatives		Liability Derivatives			
	As of September 30, 2012 Fair Value	As of December 31, 2011 Fair Value	As of September 30, 2012 Balance Sheet	As of September 30, 2012 Fair Value	As of December 31, 2011 Balance Sheet	As of December 31, 2011 Fair Value
Interest rate swap asset		Interest rate swap asset	Interest rate swap liability	471,841	Interest rate swap liability	396,780
CDS	1,745	CDS				
Swaption	121	Swaption				

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

The table below presents the effect of the Company's derivative financial instruments on the statement of operations for the three and nine months ended September 30, 2012 and 2011:

Three months ended September 30, 2012

\$ in thousands

Derivative type for cash flow hedge	Amount of loss recognized in OCI on derivative (effective portion)	Location of loss reclassified from accumulated OCI into income (effective portion)	Amount of loss reclassified from accumulated OCI into income (effective portion)	Location of loss recognized in income on derivative (ineffective portion)	Amount of loss recognized in income on derivative (ineffective portion)
Interest Rate Swap	60,716	Interest Expense	35,763	Other Expense	319

Nine months ended September 30, 2012

\$ in thousands

Derivative type for cash flow hedge	Amount of loss recognized in OCI on derivative (effective portion)	Location of loss reclassified from accumulated OCI into income (effective portion)	Amount of loss reclassified from accumulated OCI into income (effective portion)	Location of loss recognized in income on derivative (ineffective portion)	Amount of loss recognized in income on derivative (ineffective portion)
Interest Rate Swap	181,280	Interest Expense	107,051	Other Expense	832

Three months ended September 30, 2011

\$ in thousands

Derivative type for cash flow hedge	Amount of loss recognized in OCI on derivative (effective portion)	Location of loss reclassified from accumulated OCI into income (effective portion)	Amount of loss reclassified from accumulated OCI into income (effective portion)	Location of loss recognized in income on derivative (ineffective portion)	Amount of loss recognized in income on derivative (ineffective portion)
Interest Rate Swap	301,503	Interest Expense	34,753	Other Expense	453

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Nine months ended September 30, 2011

\$ in thousands

Derivative type for cash flow hedge	Amount of loss recognized in OCI on derivative (effective portion)	Location of loss reclassified from accumulated OCI into income (effective portion)	Amount of loss reclassified from accumulated OCI into income (effective portion)	Location of loss recognized in income on derivative (ineffective portion)	Amount of loss recognized in income on derivative (ineffective portion)
Interest Rate Swap	450,545	Interest Expense	66,909	Other Expense	655

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Derivative not designated as hedging instrument	Location of unrealized gain recognized in income on derivative	Amount of gain (loss) recognized in income on derivative	
		Three months ended September 30, 2012	Three months ended September 30, 2011
CDS Contract	Realized and unrealized credit default swap income	643	(105)
Swaption Contract	Unrealized loss on interest rate swaps and swaptions	(489)	

Derivative not designated as hedging instrument	Location of gain recognized in income on derivative	Amount of gain (loss) recognized in income on derivative	
		Nine months ended September 30, 2012	Nine months ended September 30, 2011
CDS Contract	Realized and unrealized credit default swap income	406	1,580
Swaption Contract	Unrealized loss on interest rate swaps and swaptions	(2,019)	

**Credit-risk-related Contingent Features**

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

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

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

As of September 30, 2012, the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for non-performance risk, related to these agreements was \$476.7 million. The Company has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of \$547.3 million of Agency RMBS. If the Company had breached any of these provisions at September 30, 2012, it could have been required to settle its obligations under the agreements at their termination value.

The Company was in compliance with all of the financial provisions of these agreements through September 30, 2012.

**Note 7 Financial Instruments**

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

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

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

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

*Level 3 Inputs* Instruments with primarily unobservable value drivers.

The fair values on a recurring basis of the Company's MBS and interest rate hedges based on the level of inputs at September 30, 2012 and December 31, 2011 are summarized below:

\$ in thousands	September 30, 2012			Total at Fair Value
	Fair Value Measurements Using:			
	Level 1	Level 2	Level 3	
<b>Assets</b>				
Mortgage-backed securities(1)		18,324,208		18,324,208
Investments in unconsolidated ventures			55,654	55,654
Derivatives		121	1,745	1,866
<b>Total</b>		18,324,329	57,399	18,381,728
<b>Liabilities</b>				
Derivatives		471,841		471,841
<b>Total</b>		471,841		471,841

\$ in thousands	December 31, 2011			Total at Fair Value
	Fair Value Measurements Using:			
	Level 1	Level 2	Level 3	
<b>Assets</b>				
Mortgage-backed securities(1)		14,214,149		14,214,149
Investments in unconsolidated ventures			68,793	68,793
Derivatives			1,339	1,339
<b>Total</b>		14,214,149	70,132	14,284,281
<b>Liabilities</b>				
Derivatives		396,780		396,780
<b>Total</b>		396,780		396,780

(1) For more detail about the fair value of our MBS and type of securities, see Note 3 in the unaudited consolidated financial statements. The following table presents additional information about the Company's investments in unconsolidated ventures which are measured at fair value on a recurring basis for which the Company has utilized Level 3 inputs to determine fair value:

\$ in thousands

September 30, 2012

December 31, 2011

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Beginning balance	68,793	54,725
Purchases	4,533	74,365
Sales and settlements	(23,903)	(63,598)
Total net gains included in net income		
Realized gains, net	5,341	6,760
Unrealized gains/(losses), net	890	(3,459)
Unrealized gain/(losses), net included in other comprehensive income		
Ending balance	55,654	68,793

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

\$ in thousands	September 30, 2012	December 31, 2011
Beginning balance	1,339	
Purchases		
Sales and settlements		
Total net gains / (losses) included in net income		
Realized gains/(losses), net		
Unrealized gains, net	406	1,339
Unrealized gain/(losses), net included in other comprehensive income		
Ending balance	1,745	1,339

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

\$ in thousands	Fair Value at September 30, 2012	Valuation Technique	Unobservable Input	Range	Weighted Average
CDS Contract	1,745	Discounted cash flow	Swap Rate		2.39%
			Discount Rate		0.49%
			Credit Spread		1.09%
			Constant Prepayment Rate	1.0% - 25.0%	4.83%
			Constant Default Rate	0.4% - 100.0%	4.80%
			Loss Severity	10.0% - 80.3%	48.41%

The significant unobservable inputs used in the fair value measurement of the CDS contract are swap rate, discount rate, credit spread, constant prepayment rate, constant default rate, and loss severity in the event of default. These inputs change according to market conditions and security performance expectations. Significant increases (decreases) in swap rate, discount rate, credit spread, constant prepayment rate, constant default rate or loss severity in isolation would result in a lower (higher) fair value measurement. Generally, a change in the assumption used for the constant default rate would likely be accompanied by a directionally similar change in the assumptions used for swap rate, credit spread and loss severity and a directionally opposite change in the assumption used for discount rate and constant prepayment rate. If the inputs had not changed during the quarter, the fair value of the CDS contract would have been \$756,000 less than the actual fair value at September 30, 2012.

The fair value of the repurchase agreements is a Level 3 fair value measurement, based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best reflect current market interest rates that would be offered for securities with similar characteristics and credit quality. At September 30, 2012 the repurchase agreements had a fair value of \$14.9 billion and a carrying value of \$14.9 billion. At December 31, 2011 the Company's repurchase agreements had a fair value of \$12.3 billion and a carrying value of \$12.3 billion.

**Note 8 Related Party Transactions**

The Company is externally managed and advised by the Manager. Pursuant to the terms of the management agreement, the Manager and its affiliates provide the Company with its management team, including its officers, along with appropriate support personnel. Each of the Company's officers is an employee of Invesco or one of Invesco's affiliates. The Company does not have any employees. With the exception of the Company's Chief Financial Officer and Controller, the Manager is not obligated to dedicate any of its employees exclusively to the Company, nor are the Manager or its employees obligated to dedicate any specific portion of its or their time to the Company's business. The Manager is at all times subject to the supervision and oversight of the Company's Board of Directors and has only such functions and authority as the Company delegates to it.

**Management Fee**



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The Company pays the Manager a management fee equal to 1.50% of the Company's shareholders' equity per annum, which is calculated and payable quarterly in arrears. For purposes of calculating the management fee, shareholders' equity is equal to the sum of the net proceeds from all issuances of equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings at the end of the most recently completed calendar quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid to repurchase common stock since inception, and excluding any unrealized gains, losses or other items that do not affect realized net

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income (regardless of whether such items are included in other comprehensive income or loss, or in net income). This amount will be adjusted to exclude one-time events pursuant to changes in U.S. GAAP, and certain non-cash items after discussions between the Manager and the Company's independent directors and approval by a majority of the Company's independent directors.

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

For the three months ended September 30, 2012, the Company incurred management fees of \$9.1 million (2011: \$7.9 million), of which \$9.1 million (2011: \$7.9 million), was accrued but has not been paid.

For the nine months ended September 30, 2012 and 2011, the Company incurred management fees of \$26.4 million (2011: \$17.6 million), of which \$9.1 million (2011: \$7.9 million), was accrued but has not been paid.

## **Expense Reimbursement**

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

The Company incurred costs, originally paid by Invesco, of approximately \$1.7 million (2011: \$1.6 million) and \$3.1 million (2011: \$4.3 million) for the three and nine months ended September 30, 2012, respectively. Approximately \$1.5 million (2011: \$1.3 million) and \$2.9 million (2011: \$3.5 million) was either prepaid or expensed for the three and nine months ended September 30, 2012, respectively. \$176,000 (2011: \$285,000) and \$218,000 (2011: \$810,000) was charged against equity as a cost of raising capital for the three and nine months ended September 30, 2012, respectively. Approximately \$23,000 was capitalized to other assets as of September 30, 2012.

## **Termination Fee**

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

## **Note 9 Shareholders Equity**

### **Securities Convertible into Shares of Common Stock**

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

### **Registration Rights**

The Company entered into a registration rights agreement with regard to the common stock and OP Units owned by the Manager and Invesco Investments (Bermuda) Ltd., respectively, upon completion of the Company's IPO and any shares of common stock that the Manager may elect to receive under the management agreement or otherwise. Pursuant to the registration rights agreement, the Company has granted to the Manager and Invesco

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Investments (Bermuda) Ltd., (i) unlimited demand registration rights to have the shares purchased by the Manager or granted to it in the future and the shares that the Company may issue upon redemption of the OP Units purchased by Invesco Investments (Bermuda) Ltd. registered for resale, and (ii) in certain circumstances, the right to piggy-back these shares in registration statements the Company might file in connection with any future public offering so long as the Company retains the Manager under the management agreement.

### **Common Stock Public Offering**

During the nine months ended September 30, 2012, the Company issued 8,504 shares of common stock at an average price of \$18.05 under the DRSP with total proceeds to the Company of approximately \$153,480, net of issuance costs.

### **Preferred Stock Public Offering**

During the nine months ended September 30, 2012, the Company completed a public offering of 5.6 million shares of 7.75% Series A Cumulative Redeemable Preferred Stock, or the Series A Preferred Stock at the price of \$25.00 per share for total proceeds of \$135.4 million, net of issuance costs. Holders of the Company's Series A Preferred Stock are entitled to receive dividends at an annual rate of 7.75% of the liquidation preference of \$25 per share or \$1.9375 per share per annum. These dividends are cumulative and payable quarterly in arrears. The shares are not convertible into or exchangeable for any other property or any other securities of the Company at the election of the holders. However, the Company, at its option after July 26, 2017, may redeem the shares at a redemption price of \$25.00, plus any accrued unpaid distributions through the date of the redemption.

### **Share-Based Compensation**

The Company established the 2009 Equity Incentive Plan for grants of restricted common stock and other equity based awards to the independent directors and the executive officers of the Company and personnel of the Manager and its affiliates (the Incentive Plan). Under the Incentive Plan, a total of 1,000,000 shares of common stock are currently reserved for issuance. Unless terminated earlier, the Incentive Plan will terminate in 2019, but will continue to govern the unexpired awards. The Company recognized compensation expense of approximately \$53,000 (2011: \$38,000) for the three months ended September 30, 2012. The Company recognized compensation expense of approximately \$128,000 (2011: \$105,000) for the nine months ended September 30, 2012. During the three months ended September 30, 2012, the Company issued 2,568 shares (2011: 1,722 shares) of restricted stock pursuant to the Incentive Plan to the Company's non-executive directors. During the nine months ended September 30, 2012, the Company issued 6,831 shares (2011: 4,617 shares) of restricted stock pursuant to the Incentive Plan to the Company's non-executive directors. The fair market value of the shares granted was determined by the closing stock market price on the date of the grant.

The Company recognized compensation expense of approximately \$49,000 (2011: \$8,000) for the three months ended September 30, 2012 related to awards to non-executive employees of the Manager and its affiliates which is reimbursed by the Manager under the management agreement.

The Company recognized compensation expense of approximately \$129,000 (2011: \$44,000) for the nine months ended September 30, 2012 related to awards to officers and employees of the Manager and its affiliates which is reimbursed by the Manager under the management agreement.

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**Dividends**

On September 13, 2012, the Company declared a dividend of \$0.65 per share of common stock. The dividend was paid on October 29, 2012 to shareholders of record as of the close of business on September 24, 2012.

On September 13, 2012, the Company declared a dividend of \$0.479 per share of Series A Preferred Stock. The dividend was paid on October 25, 2012 to shareholders of record as of the close of business on October 1, 2012. The dividend is cumulative from, and including, the date of initial issuance of July 26, 2012 to, but not including, the dividend payment date.

**Note 10 Earnings per Share**

Earnings per share for the three and nine months ended September 30, 2012 and 2011 is computed as follows:

\$ in thousands	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
<b>Numerator (Income)</b>				
Basic Earnings				
Net income available to common shareholders	83,068	81,084	244,971	206,330
Effect of dilutive securities:				
Income allocated to non-controlling interest	1,026	1,091	3,025	3,948
Dilutive net income available to shareholders	84,094	82,175	247,996	210,278
<b>Denominator (Weighted Average Shares)</b>				
Basic Earnings:				
Shares available to common shareholders	115,412	103,028	115,405	76,311
Effect of dilutive securities:				
Restricted Stock Awards	31	19	28	14
OP Units	1,425	1,425	1,425	1,425
Dilutive Shares	116,868	104,472	116,858	77,750

**Note 11 Non-controlling Interest - Operating Partnership**

Non-controlling interest represents the aggregate OP Units in the Operating Partnership held by limited partners (the Unit Holders). Income allocated to the non-controlling interest is based on the Unit Holders' ownership percentage of the Operating Partnership. The ownership percentage is determined by dividing the number of OP Units held by the Unit Holders by the total number of dilutive shares of common stock. The issuance of common stock (Share or Shares) or OP Units changes the percentage ownership of both the Unit Holders and the holders of common stock. Since an OP unit is generally redeemable for cash or Shares at the option of the Company, it is deemed to be equivalent to a Share. Therefore, such transactions are treated as capital transactions and result in an allocation between shareholders' equity and non-controlling interest in the accompanying consolidated balance sheet to account for the change in the ownership of the underlying equity in the Operating Partnership. As of September 30, 2012, non-controlling interest related to the outstanding 1,425,000 OP Units represented a 1.2% interest (2011: 1.2%) in the Operating Partnership. Income allocated to the Operating Partnership non-controlling interest for the three months ended September 30, 2012 was approximately \$1.0 million (2011: \$1.1 million). Income allocated to the Operating Partnership non-controlling interest for the nine months ended September 30, 2012 was \$3.0 million (2011: \$3.9 million). For the three months ended September 30, 2012, distributions paid to the non-controlling interest were \$926,000 (2011: \$1.4 million). For the nine months ended September 30, 2012, distributions paid to the non-controlling interest were \$2.8 million (2011: \$4.2 million). As of September 30, 2012, distributions payable to the non-controlling interest were approximately \$926,000 (2011: \$1.1 million).

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**Note 12 Subsequent Events**

**None noted.**

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

*In this quarterly report on Form 10-Q, or this Report, we refer to Invesco Mortgage Capital Inc. and its consolidated subsidiaries as we, us, our Company, or our, unless we specifically state otherwise or the context indicates otherwise. We refer to our external manager, Invesco Advisers, Inc., as our Manager, and we refer to the indirect parent company of our Manager, Invesco Ltd. (NYSE:IVZ,) together with its consolidated subsidiaries (other than us), as Invesco.*

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

#### **Forward-Looking Statements**

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

our business and investment strategy;

our investment portfolio;

our projected operating results;

actions and initiatives of the U.S. government and changes to U.S. government policies, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and mortgage loan modification programs and our ability to respond to and comply with such actions, initiatives and changes;

our ability to obtain additional financing arrangements and the terms of such arrangements;

financing and advance rates for our target assets;

changes to our expected leverage;

general volatility of the securities markets in which we invest;

general volatility of foreign financial markets and their governments' responses;

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interest rate mismatches between our target assets and our borrowings used to fund such investments;

the adequacy of our cash flow from operations and borrowings to meet our short-term liquidity needs;

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our ability to maintain sufficient liquidity to meet any margin calls;

changes in the credit rating of the U.S. government;

changes in interest rates and interest rate spreads and the market value of our target assets;

changes in prepayment rates on our target assets;

the impact of any deficiencies in foreclosure practices of third parties and related uncertainty in the timing of collateral disposition;

effects of hedging instruments on our target assets;

rates of default or decreased recovery rates on our target assets;

modifications to whole loans or loans underlying securities;

the degree to which our hedging strategies may or may not protect us from interest rate volatility;

counterparty defaults;

changes in governmental regulations, tax law and rates, and similar matters and our ability to respond to such changes;

our ability to qualify as a REIT for U.S. federal income tax purposes;

our ability to maintain our exemption from registration under the Investment Company Act of 1940, as amended (the "1940 Act");

availability of investment opportunities in mortgage-related, real estate-related and other securities;

availability of U.S. government Agency guarantees with regard to payments of principal and interest on securities;

availability of qualified personnel;

our understanding of our competition;



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changes to accounting principles generally accepted in the United States of America ( US GAAP ); and

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

These forward-looking statements are based upon information presently available to our management and are inherently subjective, uncertain and subject to change. There can be no assurance that actual results will not differ materially from our expectations. We caution investors not to rely unduly on any forward-looking statements and urge you to carefully consider the risks identified under the captions Risk Factors,

Forward-Looking Statements and Management s Discussion and Analysis of Financial Condition and Results of Operations in this Report and our most recent Form 10-K and subsequent Forms 10-Q, which are available on the SEC s website at [www.sec.gov](http://www.sec.gov).

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All written or oral forward-looking statements that we make, or that are attributable to us, are expressly qualified by this cautionary notice. We expressly disclaim any obligation to update the information in any public disclosure if any forward-looking statement later turns out to be inaccurate, except as may otherwise be required by law.

### **Overview**

We are a Maryland corporation primarily focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans. We are externally managed and advised by Invesco Advisers, Inc., our Manager, which is an indirect, wholly-owned subsidiary of Invesco Ltd. We elected to qualify to be taxed as a REIT commencing with our taxable year ended December 31, 2009. Accordingly, we generally will not be subject to U.S. federal income taxes on our taxable income that we distribute currently to our shareholders as long as we maintain our qualification as a REIT. We operate our business in a manner that will permit us to maintain our exclusion from the definition of investment company under the Investment Company Act of 1940, as amended (the 1940 Act).

Our objective is to provide attractive risk-adjusted returns to our shareholders, primarily through dividends and secondarily through capital appreciation. To achieve this objective, we primarily invest in the following:

Agency RMBS, which are residential mortgage-backed securities, for which a U.S. government Agency such as the Government National Mortgage Association ( Ginnie Mae ) or a federally chartered corporation such as the Federal National Mortgage Association ( Fannie Mae ) or the Federal Home Loan Mortgage Corporation ( Freddie Mac ) guarantees payments of principal and interest on the securities;

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

CMBS, which are commercial mortgage-backed securities; and

Residential and commercial mortgage loans.

We finance our investments in Agency RMBS, non-Agency RMBS and CMBS through short-term borrowings structured as repurchase agreements.

### **Recent Developments**

On July 26, 2012, we completed a public offering of 5.4 million shares of its 7.75% Series A Cumulative Redeemable Preferred Stock, or the Series A Preferred Stock, at the price of \$25.00 per share. On August 2, 2012, the underwriters exercised their over-allotment option in part to purchase an additional 200,000 shares of the Series A Preferred Stock, at the price of \$25.00 per share. Total net proceeds were approximately \$135.4 million, net of issuance costs of \$4.6 million. We granted the underwriters a 30-day option to purchase up to an additional 810,000 shares of the Series A Preferred Stock to cover over-allotments, if any.

On September 13, 2012, we declared a dividend of \$0.65 per share of common stock. The dividend was paid on October 29, 2012 to shareholders of record as of the close of business on September 24, 2012.

On September 13, 2012, we declared a dividend of \$0.479 per share of Series A Preferred Stock. The dividend was paid on October 25, 2012 to shareholders of record as of the close of business on October 1, 2012. The dividend is cumulative from, and including, the date of initial issuance of July 26, 2012 to, but not including, the dividend payment date.

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### **Factors Impacting Our Operating Results**

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

### **Market Conditions**

Beginning in the summer of 2007, significant adverse changes in financial market conditions resulted in a deleveraging of the entire global financial system. As part of this process, residential and commercial mortgage markets in the United States experienced a variety of difficulties, including loan defaults, credit losses and reduced liquidity. As a result, many lenders tightened their lending standards, reduced lending capacity, liquidated significant portfolios or exited the market altogether, and therefore, financing with attractive terms was generally unavailable. In response to these unprecedented events, the U.S. government has taken a number of actions to stabilize the financial markets and encourage lending. Significant measures include the enactment of the Emergency Economic Stabilization Act of 2008 to, among other things, establish the Troubled Asset Relief Program ( TARP ), the enactment of the Housing and Economic Recovery Act of 2008 ( HERA ), which established a new regulator for Fannie Mae and Freddie Mac and the establishment of the Term Asset-Backed Securities Loan Facility ( TALF ) and the U.S. government's Public Private Investment Program ( PPIP ). Some of these programs are beginning to expire and the impact of the wind-down of these programs on the financial sector and on the economic recovery is unknown. Increased volatility in the RMBS markets may have an adverse effect on the market value and performance of the RMBS in which we invest. Moreover, we rely on financing to acquire, on a leveraged basis, the target assets in which we invest. If market conditions deteriorate further, our lenders may exit the repurchase market, further tighten lending standards, or increase the amount of equity capital required to obtain financing making it more difficult and costly for us to obtain financing.

The Dodd-Frank Act enacted on July 21, 2010, contains numerous provisions affecting the financial and mortgage industries, many of which may have an impact on our operating environment and the target assets in which we invest. Consequently, the Dodd-Frank Act may affect our cost of doing business, may limit our investment opportunities and may affect the competitive balance within our industry and market areas.

On September 21, 2011, the U.S. Federal Reserve announced Operation Twist, which is a program by which it intends to purchase, by the end of June 2012, \$400 billion of U.S. Treasury securities with remaining maturities between 6 and 30 years and sell an equal amount of U.S. Treasury securities with remaining maturities of 3 years or less. Operation Twist could result in a flattening in the yield curve and lower long-term interest rates. In June 2012, the Federal Open Market Committee released a statement that it intends to continue Operation Twist by purchasing Treasury securities with remaining maturities of 6 years to 30 years and sell or redeem an equal amount of Treasury securities with remaining maturities of approximately 3 years or less. This continuation of the maturity extension program should put downward pressure on longer term interest rates. Lower long-term interest rates could result in increased prepayment rates and a narrowing of our net interest margin. Consequently, Operation Twist and any other future securities purchase programs and actions by the U.S. Federal Reserve could adversely affect our business, financial condition and results of operations and our ability to pay distributions to our shareholders.

The Federal Housing Finance Agency ( FHFA ) and the Department of the Treasury introduced the Home Affordable Refinance Program ( HARP ) in early 2009. HARP provides borrowers, who may not otherwise qualify for refinancing because of declining home values or reduced access to mortgage insurance, the ability to refinance their mortgages into a lower interest rate and/or more stable mortgage product. On October 24, 2011, the FHFA announced a series of changes to the rules regarding the HARP with the intent of increasing the number of borrowers eligible to refinance their mortgage under this program. The FHFA announced changes to the guidelines related to loan-to-value, appraisals, and certain fees, among other things, subject to a variety of qualifications and the extension of the end date for the HARP until December 31, 2013. It does not change the time period which these loans were originated, maintaining the requirement that the loans must have been guaranteed by Fannie Mae or Freddie Mac on or before May 31, 2009. We do not expect the current HARP or future modifications to have a material impact on our results of operations in future periods.

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On August 1, 2012, the U.S. Federal Reserve announced that it would keep the target range for the federal funds rate at zero to  $\frac{1}{4}$  percent and it currently anticipates that economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014. Low levels of federal funds rates may reduce our borrowing costs. However, there can be no assurance that federal funds rates will remain near zero percent, or that such low levels will reduce our cost of funds.

**Investment Activities**

As of September 30, 2012, 51.9% of our equity was invested in Agency RMBS, 26.8% in non-Agency RMBS, 19.1% in CMBS, and 2.2% in other investments in unconsolidated ventures. We use leverage on our target assets to achieve our return objectives. For our total investment portfolio, we focus on securities we believe provide attractive returns when levered approximately 3 to 7 times. The leverage on classes of assets may periodically exceed the stated ranges as we adjust our borrowings to obtain the best available source and minimize total interest expense, while maintaining our overall portfolio leverage guidelines.

As of September 30, 2012, we had \$10.4 billion in 30-year fixed rate Agency RMBS securities that offered higher coupons and call protection based on the collateral attributes. In addition, we held \$2.3 billion in 15-year fixed rate Agency RMBS securities, \$651.3 million in hybrid adjustable-rate mortgage Agency RMBS ( ARMs ) and \$126.0 million in Agency ARM RMBS we believe to have similar durations based on prepayment speeds. As of September 30, 2012, we held \$2.6 billion non-Agency RMBS.

As of September 30, 2012, we owned \$1.7 billion in CMBS and financed \$1.2 billion in repurchase agreements. In addition, as of September 30, 2012, we held \$520.6 million in CMOs.

During the nine months ended September 30, 2012, we purchased \$7.0 billion of mortgage-backed securities. The average yield on these purchases as of September 30, 2012 is 3.2%.

*Portfolio Characteristics*

The table below represents the vintage of our credit assets as of September 30, 2012:

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total
Re-REMIC Senior <sup>(1)</sup>							0.8%	5.7%	49.2%	13.3%	69.0%
Prime	0.7%	1.6%	1.1%	3.0%	12.4%				0.6%		19.4%
Alt-A			1.2%	5.9%	4.2%						11.3%
Subprime		0.3%									0.3%
Total Non-Agency	0.7%	1.9%	2.3%	8.9%	16.6%		0.8%	5.7%	49.8%	13.3%	100.0%
CMBS			20.3%	23.0%	1.2%			13.6%	35.2%	6.7%	100.0%

(1) For Re-REMIC Seniors, the table reflects the year in which the resecuritizations were issued. The vintage distribution of the securities that collateralize the Company's Re-REMIC Senior investments is 10.4% 2005, 40.7% 2006 and 48.9% 2007.

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The tables below represent the geographic concentration of the underlying collateral for our MBS portfolio as of September 30, 2012:

Non-Agency RMBS State	Percentage	CMBS State	Percentage
California	51.4%	California	15.5%
Florida	7.5%	New York	12.3%
New York	5.6%	Texas	10.1%
Virginia	3.2%	Florida	5.3%
Maryland	3.1%	Illinois	4.6%
Washington	2.9%	Pennsylvania	4.2%
New Jersey	2.8%	Virginia	3.3%
Arizona	2.5%	New Jersey	3.2%
Illinois	2.0%	Massachusetts	3.1%
Colorado	1.9%	Ohio	3.0%
Other	17.1%	Other	35.4%

The vintage and geographic concentrations have not significantly changed since June 30, 2012.

*Financing and Other Liabilities.* We enter into repurchase agreements to finance the majority of our Agency RMBS, non-Agency RMBS and CMBS. These agreements are secured by our Agency RMBS, non-Agency RMBS and CMBS and bear interest at rates that have historically moved in close relationship to the London Interbank Offer Rate ( LIBOR ). As of September 30, 2012, we had entered into repurchase agreements totalling \$14.9 billion. We also committed to invest up to \$100.0 million in the Invesco Mortgage Recovery Feeder Fund L.P. managed by the Company's Manager ( Invesco IMRF Fund ) and Invesco Mortgage Recovery Loans AIV, L.P. ( AIV ), which, in turn, invests in our target assets. As of September 30, 2012, \$82.9 million of our commitment to the Invesco IMRF Fund and AIV Fund has been called and we are committed to fund \$17.1 million in additional capital.

The Company records the liability for mortgage-backed securities purchased for which settlement has not taken place as an investment related payable. As of September 30, 2012 and December 31, 2011, the Company had investment related payables of \$622.7 million and \$107.0 million, respectively, of which no items were outstanding greater than thirty days. The change in balance was primarily due to an increase in mortgage-backed security purchases at the quarter ended September 30, 2012.

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

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

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

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

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

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

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

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As of September 30, 2012, we have entered into interest rate swap agreements designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swap agreements provide for fixed interest rates indexed off of one-month LIBOR and effectively fix the floating interest rates on \$7.8 billion of borrowings under our repurchase agreements. As of September 30, 2012, included in this amount we had forward starting swaps with a total notional amount of \$1.0 billion, with starting dates ranging from May 24, 2013 to September 5, 2013. We intend to continue to add interest rate hedge positions according to our hedging strategy.

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### **Book Value per Share**

Our book value per common share was \$20.93, \$18.40 and \$16.41 as of September 30, 2012, June 30, 2012 and December 31, 2011, respectively, on a fully diluted basis, after giving effect to our units of limited partnership interest in our operating partnership, which may be converted to common shares at the sole election of the Company. The change in our book value was primarily due to the change in valuation of our investment portfolio and our interest rate hedges that are recorded in Other Comprehensive Income (Loss) on our balance sheet. Refer to Note 3 - Mortgage-Backed Securities for the impact of changes in accumulated other comprehensive income on our investment portfolio. The value of our assets and liabilities change daily based on market conditions. Refer to Item 3. Quantitative and Qualitative Disclosures About Market Risks for interest rate risk and its impact on fair value.

### **Critical Accounting Policies**

Our consolidated financial statements are prepared in accordance with U.S. GAAP, which requires the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. Our most critical accounting policies 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 are based are reasonable at the time made and based upon information available to us at that time. We rely upon independent pricing of our assets at each quarter's end to arrive at what we believe to be reasonable estimates of fair market value. The complete listing of our Critical Accounting Policies was disclosed in our 2011 annual report on Form 10-K as filed with the SEC on February 29, 2012, and there have been no material changes to our Critical Accounting Policies as disclosed therein.

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

In December 2011, the FASB issued Accounting Standards Updated 2011-11, Disclosures about Offsetting Assets and Liabilities (ASU 2011-11). ASU 2011-11 amends Topic 210 to require additional disclosure information about offsetting and related arrangements. Entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transaction subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on a basis of US GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards (IFRS). The guidance is effective for periods beginning on or after January 1, 2013, and interim periods within those annual periods. We do not believe that the adoption of the amended guidance will have a significant effect on our consolidated financial statements.

**Table of Contents****Results of Operations**

The table below presents certain information from our Consolidated Statement of Operations for the three and nine month periods ending September 30, 2012 and 2011:

\$ in thousands, except per share data	Three Months ended September 30,		Nine Months ended September 30,	
	2012	2011	2012	2011
<b>Revenues</b>				
Interest income	140,477	138,291	421,442	315,808
Interest expense	60,327	50,452	172,312	100,237
<b>Net interest income</b>	80,150	87,839	249,130	215,571
<b>Other income</b>	16,638	3,049	31,052	15,174
<b>Expenses</b>				
Management fee related party	9,053	7,884	26,372	17,612
General and administrative	959	829	3,132	2,855
<b>Total expenses</b>	10,012	8,713	29,504	20,467
Net income	86,776	82,175	250,678	210,278
Net income attributable to non-controlling interest	1,026	1,091	3,025	3,948
Net income attributable to Invesco Mortgage Capital Inc.	85,750	81,084	247,653	206,330
Dividends to preferred shareholders	2,682		2,682	
Net income attributable to common shareholders	83,068	81,084	244,971	206,330
<b>Earnings per share:</b>				
Net income attributable to common shareholders (basic/diluted)	0.72	0.79	2.12	2.70
Dividends declared per common share	0.65	0.80	1.95	2.77
<b>Weighted average number of shares of common stock:</b>				
Basic	115,412	103,028	115,405	76,311
Diluted	116,868	104,472	116,858	77,750

\$ in thousands	As of and for the Three Months ended September 30,		As of and for the Nine Months ended September 30,	
	2012	2011	2012	2011
<b>Average Balances*:</b>				
<b>Agency RMBS:</b>				
15 year fixed-rate, at amortized cost	2,262,090	2,323,010	2,365,084	2,097,350
30 year fixed-rate, at amortized cost	9,244,544	5,514,277	7,969,201	3,985,708



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ARM, at amortized cost	136,990	109,952	161,715	81,295
Hybrid ARM, at amortized cost	796,446	1,297,070	1,175,280	894,151
MBS-CMO, at amortized cost	502,646	126,300	450,419	75,258
Non-Agency RMBS, at amortized cost	2,496,031	2,555,216	2,391,076	1,895,121
CMBS, at amortized cost	1,516,371	1,364,914	1,329,005	902,722

Average MBS portfolio	16,955,118	13,290,739	15,841,780	9,931,605
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**Average Portfolio Yields: <sup>(1)</sup>**

<b>Agency RMBS:</b>				
15 year fixed-rate,	2.40%	2.88%	2.60%	3.04%
30 year fixed-rate	2.92%	3.71%	3.22%	3.63%
ARM	2.75%	3.16%	2.63%	3.02%
Hybrid ARM	2.61%	2.60%	2.67%	2.63%
MBS-CMO	2.22%	3.21%	2.21%	4.69%
Non-Agency RMBS	4.91%	6.50%	5.30%	7.13%
CMBS	5.24%	5.46%	5.41%	5.32%
Average MBS portfolio	3.31%	4.16%	3.55%	4.24%

**Average Borrowings\*:**

Agency RMBS	11,452,398	8,399,111	10,884,302	6,468,159
Non-Agency RMBS	1,842,351	1,998,255	1,767,130	1,383,534
CMBS	1,145,575	1,069,243	980,341	737,356

Total borrowed funds	14,440,324	11,466,609	13,631,773	8,589,049
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Maximum borrowings during the period <sup>(2)</sup>	14,890,062	12,181,845	14,890,062	12,181,845
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**Average Cost of Funds: <sup>(3)</sup>**

Agency RMBS	0.41%	0.25%	0.37%	0.25%
Non-Agency RMBS	1.77%	1.39%	1.78%	1.37%
CMBS	1.59%	1.35%	1.57%	1.28%
Unhedged cost of funds	0.68%	0.55%	0.64%	0.52%
Hedged cost of funds	1.67%	1.76%	1.69%	1.56%

<b>Average Equity: <sup>(4)</sup></b>	2,329,921	1,847,320	2,198,633	1,526,080
Average debt/equity ratio (average during period)	6.20x	6.21x	6.20x	5.63x
Debt/equity ratio (as of period end)	5.75x	6.33x	5.75x	6.33x

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\* Average amounts for each period are based on weighted month end balances, all percentages are annualized. For the three and nine months ended September 30, 2012, the average balances have been changed to be presented by the average of the amortized cost. Prior periods will be adjusted accordingly for comparative purposes.

- (1) Average portfolio yield for the period was calculated by dividing interest income, including amortization of premiums and discounts, by our average of the amortized cost of the investments.
- (2) Amount represents the maximum borrowings at month-end during each of the respective periods.
- (3) Average cost of funds is calculated by dividing interest expense, by our average borrowings.
- (4) Average equity is calculated based on a weighted average basis.

**Net Income Summary**

For the three months ended September 30, 2012, our net income attributable to common shareholders was \$83.1 million (2011: \$81.1 million) or \$0.72 (2011: \$0.79) basic and diluted income per weighted average share available to common shareholders.

For the nine months ended September 30, 2012, our net income attributable to common shareholders was \$245.0 million (2011: \$206.3 million) or \$2.12 (2011: \$2.70) basic and diluted income per weighted average share available to common shareholders.

The increase in net income attributable to common shareholders and decrease in our earnings per share for the three and nine month periods is primarily attributable to the growth in our investment portfolio resulting from our follow-on common stock and preferred stock offerings and change in the composition of our investment portfolio based on market conditions. The average MBS portfolio increased \$3.7 million and \$5.9 million for the three and nine months ended September 30, 2012 compared to the three and nine months ended September 30, 2011. Since September 30, 2011, we have raised \$334,000 in equity through two follow-on common stock and preferred stock offerings and the share purchase feature of the dividend reinvestment and stock purchase plan (the DRSP ).

**Interest Income and Average Earning Asset Yield**

Our primary source of income is interest earned on our investment portfolio. During the three months ended September 30, 2012, we had average earning assets of \$17.0 billion (2011: \$13.3 billion) and earned interest income of \$140.5 million (2011: \$138.3 million). The yield on our average investment portfolio was 3.31% (2011: 4.16%).

The change in our average assets and the portfolio yield for three months ended September 30, 2012 versus September 30, 2011 was primarily the result of the increase in our investment portfolio in connection with adding leverage and utilizing proceeds from our follow-on common stock and preferred stock offerings during 2011 and 2012 and a change in our portfolio composition as we have allocated a higher amount of equity to Agency RMBS at lower yields and higher leverage.

We had average earning assets of \$15.8 billion (2011: \$14.9 billion) and earned interest income of \$421.4 million (2011: \$315.8 million) for the nine months ended September 30, 2012. The yield on our average investment portfolio was 3.55% (2011: 4.24%) for the respective period. The change in our average assets and the portfolio yield was primarily the result of the change in our portfolio composition as we have allocated a higher amount of equity to Agency RMBS at lower yields and higher leverage.

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

The CPR of our portfolio impacts the amount of premium and discount on the purchase of securities that is recognized into income. Our Agency and non-Agency RMBS had a weighted average CPR of 14.3 and 13.3 for the three months ended September 30, 2012 and June 30, 2012, respectively. The table below shows the three month CPR for our RMBS compared to bonds with similar characteristics ( Cohorts ):

	September 30, 2012		June 30, 2012	
	Company	Cohort	Company	Cohort
15 year Agency RMBS	14.6	23.4	11.3	21.6
30 year Agency RMBS	13.1	20.7	12.3	18.9
Agency Hybrid ARM RMBS	20.0	NA	18.1	NA
Non-Agency RMBS	16.2	NA	16.2	NA
<b>Overall</b>	<b>14.3</b>	<b>NA</b>	<b>13.3</b>	<b>NA</b>

**Interest Expense and the Cost of Funds**

Our largest expense is the interest expense on borrowed funds. For the three months ended September 30, 2012, we had average borrowed funds of \$14.4 billion (2011: \$11.5 billion) and total interest expense of \$60.3 million (2011: \$50.5 million). The increase in average borrowed funds and interest expense was primarily the result of increasing the size of our investment portfolio and hedging costs from additional interest rate swaps.

We had average borrowed funds of \$13.6 billion (2011: \$8.6 billion) and total interest expense of \$172.3 million (2011: \$100.2 million) for the nine months ended September 30, 2012. The increase in average borrowed funds and interest expense was primarily the result of increasing the size of our investment portfolio and hedging costs from additional interest rate swaps.

For the three months ended September 30, 2012, our average cost of funds was 1.67% (2011: 1.76%). Since a substantial portion of our repurchase agreements are short term, changes in market rates are directly reflected in our interest expense. Interest expense includes borrowing costs, as well as costs for our interest rate hedges.

Our average cost of funds was 1.69% and (2011: 1.56%) for the nine months ended September 30, 2012. Since a substantial portion of our repurchase agreements are short term, changes in market rates are directly reflected in our interest expense. Interest expense includes borrowing costs, as well as any hedging costs.

**Net Interest Income**

Our net interest income, which equals interest income less interest expense, for the three months ended September 30, 2012, totaled \$80.2 million (2011: \$87.8 million). Our net interest rate margin, which equals the yield on our average assets for the period less the average cost of funds for the three months ended September 30, 2012, was 1.64% (2011: 2.40%). The decrease in net interest margin was primarily due to higher hedged cost of funds related to the increase in average borrowings and interest rate swaps and a decrease in portfolio yield.

Our net interest income totaled \$249.1 million (2011: \$215.6 million) for the nine months ended September 30, 2012. Our net interest rate margin was 1.86% (2011: 2.68%) for the nine months ended September 30, 2012. The increase in net interest income was primarily the result of increasing our investment portfolio while the decrease in our net interest margin was a direct result of our change in asset mix between Agency RMBS, non-Agency RMBS and CMBS. Refer to the average balance table in the Results of Operations section above for changes in average portfolio balance and asset mix.

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### **Gain on Sale of Investments**

As part of our investment process, all of our MBS are reviewed on a monthly basis to determine if they continue to meet our risk and return targets. This process involves looking at changing market assumptions and the impact those assumptions will have on the individual securities. As a result of our change in market assumptions, we sold securities and recognized net gain of \$12.8 million for the three months ended September 30, 2012 (2011: \$3.6 million).

As a result of our change in market assumptions, we sold securities and recognized net gain of \$25.0 million (2011: \$8.4 million) for the nine month periods ended September 30, 2012.

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

For the three months ended September 30, 2012, we recognized equity in earnings and unrealized loss on the change in fair value of our investment in the Invesco IMRF Fund of approximately \$1.4 million (2011: \$823,000), and \$464,000 (2011: \$1.8 million), respectively. The increase in equity in earnings and decrease in unrealized income on the change in fair value was primarily the result of realizing gains on investments sold during 2012.

For the nine months ended September 30, 2012, we recognized equity in earnings of approximately \$2.1 million (2011: \$6.4 million), and unrealized gain on the change in fair value of our investment in the Invesco IMRF Fund of \$774,000 (2011: \$3.7 million loss). The net earnings from the unconsolidated ventures were primarily the result of a gain realized offset by a decrease in the fair value of the IMRF Fund.

On September 30, 2011, we invested in a portfolio of commercial mortgage loans by contributing \$16.9 million, net of distributions, of equity capital to IMRF Loan Portfolio Member LLC ( IMRF LLC ). For the three months ended September 30, 2012, we recognized equity in earnings and unrealized depreciation on the change in fair value of our investment in the IMRF LLC of approximately \$2.5 million and \$191,000, respectively.

For the nine months ended September 30, 2012, we recognized equity in earnings and unrealized appreciation on the change in fair value of our investment in the IMRF LLC of approximately \$3.2 million and \$116,000, respectively.

We recognized no income or loss in respect to our ownership interest in IMRF LLC for the three and nine months ended September 30, 2011.

### **Other Income (Loss)**

We finance our activities primarily through repurchase agreements, which are generally settled on a short-term basis, usually from one to twelve months. At each settlement date, we refinance each repurchase agreement at the market interest rate at that time. Since the interest rate on its repurchase agreements change on a one to twelve month basis, we are exposed to changing interest rates. Our objectives in using interest rate derivatives are to add stability to interest expense and to manage our exposure to interest rate movements. To accomplish these objectives, we primarily use interest rate swaps and swaptions as part of our interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty in exchange for us making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount. The interest rate swaption provides us the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and pay and receive interest rates in the future. The premium paid for interest rate swaptions is reported as an asset in our consolidated balance sheets. The premium is valued at an amount equal to the fair value of the swaption that would have the effect of closing the position adjusted for nonperformance risk, if any.

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Our other income (loss) relates to the unrealized loss on interest rate swaps and swaptions of \$808,000 million (2011: \$453,000 loss) which represents the ineffective portion of the change in fair value of our interest rate swaps and change in fair value of interest rate swaptions contract which is recognized directly in earnings for the three months ended September 30, 2012 and 2011.

Our other income (loss) relates to the unrealized loss on interest rate swaps and swaptions of \$2.9 million (2011: \$655,000 loss) which represents the ineffective portion of the change in fair value of our interest rate swaps and change in fair value of interested rate swaptions contract which is recognized directly in earnings for the nine months ended September 30, 2012 and 2011.

On December 30, 2010, we entered into a credit default swap ( CDS ) contract. For the three months ended September 30, 2012 we recognized income of \$1.3 million (2011: \$858,000 ) on our investment in the CDS of which \$643,000 (2011: \$105,000 loss) is an unrealized gain based on change in the fair market value of the CDS and \$704,000 (2011: \$1.0 million) represents premium payments we receive for providing protection.

For the nine months ended September 30, 2012 we recognized income of \$2.7 million (2011: \$4.6 million) on our investment in a CDS of which \$406,000 (2011: \$1.6 million) is an unrealized gain based on change in the fair market value of the CDS and \$2.3 million (2011: \$3.0 million) represents premium payments we receive for providing protection.

## **Expenses**

For the three months ended September 30, 2012, we incurred management fees of \$9.1 million (2011: \$7.9 million), which are payable to our Manager under our management agreement. The increase in management fees is attributable to an increase in shareholders equity resulting from our follow-on common stock and preferred stock offerings. The management fee and the relationship between the Company and the Manager are discussed further in our discussion of related party relationships.

We incurred management fees of \$26.4 million (2011: \$17.6 million) for the nine months ended September 30, 2012, which are payable to our Manager under our management agreement. The increase in management fees is attributable to an increase in shareholders equity resulting from our follow-on common stock and preferred stock offerings in 2011 and 2012.

For the three months ended September 30, 2012, our general and administrative expenses of \$959,000 (2011: \$829,000) includes operating expenses not covered under our management agreement. These expenses primarily consist of directors and officers insurance, accounting services, auditing and tax services, filing fees, and miscellaneous general and administrative costs.

Our general and administrative expenses were \$3.1 million (2011: \$2.9 million) for the nine months ended September 30, 2012.

## **Net Income after Preferred Dividends and Return on Average Equity**

For the three months ended September 30, 2012, our net income after preferred dividends was \$84.1 million (2011: \$82.2 million) and our annualized return on average equity was 14.44% (2011: 17.79%). The change in net income and average return on equity was primarily the result of increasing our investment portfolio from the proceeds of our common stock offerings and the changes in our portfolio composition during 2012 and 2011.

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Our net income after preferred dividends was \$248.0 million (2011: \$210.3 million) for the nine months ended September 30, 2012. Our annualized return on average equity was 15.04% (2011: 18.37%) for the nine months ended September 30, 2012. The change in net income and return on average equity was primarily the result of an increase in our net interest income following our portfolio growth and the change in our portfolio composition.

### **Liquidity and Capital Resources**

Liquidity is a measurement of our ability to meet potential cash requirements, including ongoing commitments to pay dividends, fund investments, repayment of borrowings and other general business needs. Our primary sources of funds for liquidity consists of the net proceeds from our common equity offerings, net cash provided by operating activities, cash from repurchase agreements and other financing arrangements and future issuances of equity and/or debt securities. We also have sought, and may continue to finance our assets under, and may otherwise participate in, programs established by the U.S. government.

We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings, margin requirements and the payment of cash dividends as required for continued qualification as a REIT. We generally maintain liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of these borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on our balance sheet is significantly less important than our potential liquidity available under borrowing arrangements.

We held cash and cash equivalents of \$190.8 million (2011: \$56.9 million) at September 30, 2012. Our cash and cash equivalents increased due to normal fluctuations in cash balances related to the timing of principal and interest payments, repayments of debt, and asset purchases and sales.

Our operating activities provided net cash of \$309.1 million (2011: \$202.4 million) for the nine month period ended September 30, 2012. The cash provided by operating activities increased due to the increase in net interest income earned by our portfolio, which increase in net income resulted from the increase in average interest earning assets of \$15.8 billion at September 30, 2012 as compared to \$9.9 billion at September 30, 2011.

Our investing activities used net cash of \$2.9 billion (2011: \$8.7 billion) for the nine month period ended September 30, 2012. During the nine month period ended September 30, 2012 we utilized cash to purchase \$6.4 billion in securities which were offset by proceeds from asset sales of \$1.6 billion and principal payments of \$1.8 billion. During the nine month period ended September 30, 2011 we utilized cash to purchase \$10.7 billion of securities, sold \$1.2 billion of securities and received principal payments of \$936.4 million. The increase in principal payments resulted from the larger portfolio at September 30, 2012 as compared to September 30, 2011.

Our financing activities for the nine months ended September 30, 2012 consisted of net proceeds from the preferred stock offering in which we raised \$135.4 million and \$2.6 billion net from our repurchase agreements.

Our financing activities for the nine months ended September 30, 2011 consisted of net proceeds from our follow-on public offerings in which we raised \$1.3 billion and \$7.5 billion net from our repurchase agreements.

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The table below shows the allocation of our equity and debt-to-equity ratio as of September 30, 2012. The leverage on each class of assets may periodically exceed the stated ranges as we adjust our borrowings to obtain the best available source and minimize total interest expense while maintaining our overall portfolio leverage guidelines:

\$ in thousands	Agency	Non-Agency	CMBS	Unconsolidated Ventures	Total
Borrowings	11,710,680	1,915,915	1,249,906		14,876,501
Equity allocation	1,341,502	693,871	494,404	55,654	2,585,431
Debt / Equity Ratio	8.7	2.8	2.5		5.8
% of Total Equity	51.9%	26.8%	19.1%	2.2%	100.0%

As of September 30, 2012, the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount, which we also refer to as the haircut, under our repurchase agreements for Agency RMBS was 4.75% (weighted by borrowing amount), under our repurchase agreements for non-Agency RMBS was 17.51% and under our repurchase agreements for CMBS was 18.81%. Across our repurchase facilities for Agency RMBS, the haircuts range from a low of 3% to a high of 10%, for non-Agency RMBS range from a low of 10% to a high of 35% and for CMBS range from a low of 10% to a high of 25%. Our hedged cost of funds was 1.69% and 1.64% as of September 30, 2012 and December 31, 2011, respectively. Declines in the value of our securities portfolio can trigger margin calls by our lenders under our repurchase agreements. An event of default or termination event would give some of our counterparties the option to terminate all repurchase transactions existing with us and require any amount due by us to the counterparties to be payable immediately.

As discussed above under Market Conditions, the residential mortgage market in the United States has experienced difficult economic conditions including:

increased volatility of many financial assets, including agency securities and other high-quality RMBS assets, due to potential security liquidations;

increased volatility and deterioration in the broader residential mortgage and RMBS markets; and

significant disruption in financing of RMBS.

If these conditions persist, then our lenders may be forced to exit the repurchase market, become insolvent or further tighten lending standards or increase the amount of required equity capital or haircut, any of which could make it more difficult or costly for us to obtain financing. In addition, because Fannie Mae and Freddie Mac are in conservatorship of the U.S. government, if the U.S. credit rating is further downgraded, it may impact the credit risk associated with Agency RMBS and other assets, and, therefore, decrease the value of the Agency RMBS, non-Agency RMBS and CMBS in our portfolio, which could cause our repurchase counterparties to make margin calls on our borrowings and swaps, if our collateral is insufficient to cover the debt secured by our assets.

Effective as of May 27, 2011, we implemented the DRSP, pursuant to which we registered and reserved for issuance 10,000,000 shares of our common stock. Under the terms of the DRSP, shareholders who participate in the DRSP may purchase shares of our common stock directly from us, in cash investments up to \$10,000, or greater than \$10,000 if we grant a request for a waiver. At our sole discretion, we may accept optional cash investments in excess of \$10,000 per month, which may qualify for a discount from the market price of 0% to 3%. The DRSP participants may also automatically reinvest all or a portion of their dividends for additional shares of our stock. During the nine months ended September 30, 2012, we issued 8,504 shares of common stock (2011: 6,201 shares) under the share purchase feature of our DRSP. During the nine months ended September 30, 2012, we issued zero shares (2011: 4.1 million shares) of common stock under the waiver feature of the DRSP with net proceeds of \$0 (2011: \$85.7 million).

On December 13, 2011, we announced a share repurchase program that was approved by our Board of Directors for up to 7 million shares of our common stock. The shares may be repurchased from time to time through privately negotiated transactions or open market transactions, including pursuant to a trading plan in accordance with Rules 10b5-1 and 10b-18 under the Exchange Act or by any combination of such methods. The manner, price, number and timing of share repurchases will be subject to a variety of factors, including market conditions and applicable SEC rules. As of September 30, 2012, we have not repurchased any shares under this program.





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

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

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

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

### *Forward-Looking Statements Regarding Liquidity*

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

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

## **Contractual Obligations**

On July 1, 2009, we entered into an agreement with our Manager pursuant to which our Manager is entitled to receive a management fee and the reimbursement of certain expenses, which was amended on May 24, 2011. The management fee is calculated and payable quarterly in arrears in an amount equal to 1.50% of our shareholders' equity, per annum. Our Manager uses the proceeds from its management fee in part to pay compensation to its officers and personnel who, notwithstanding that certain of those individuals are also our officers, receive no cash compensation directly from us. We are required to reimburse our Manager for operating expenses related to us incurred by our Manager, including certain salary expenses and other expenses relating to legal, accounting, due diligence and other services. Expense reimbursements to our Manager are made in cash on a monthly basis following the end of each month. Our reimbursement obligation is not subject to any dollar limitation. Refer to Note 8 Related Party Transactions for details of our reimbursements to our Manager.

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As of September 30, 2012, we had the following contractual commitments and commercial obligations:

\$ in thousands	Total	Payments Due by Period			
		Less than 1 year	1-3 years	3-5 years	After 5 years
Repurchase agreements	14,876,501	14,876,501			
Invesco IMRF Fund and AIV Fund	17,139	17,139			
<b>Total contractual obligations</b>	<b>14,893,640</b>	<b>14,893,640</b>			

As of September 30, 2012, we have \$12.7 million in contractual interest payments related to our repurchase agreements.

**Off-Balance Sheet Arrangements**

We committed to invest up to \$100.0 million in the Invesco IMRF Fund, which, in turn, invests in our target assets. In March 2012, Invesco IMRF Fund returned substantially all of its proceeds and repaid all financing under the PPIP. The Company is awaiting final distribution from the Invesco IMRF Fund. As of September 30, 2012 and 2011, \$82.9 million and \$95.3 million of the commitment has been called, net of distributions recallable, respectively.

We also utilize credit derivatives, such as credit default swaps, to provide credit event protection based on a financial index or specific security in exchange for receiving a fixed-rate fee or premium over the term of the contract. These instruments enable us to synthetically assume the credit risk of a reference security, portfolio of securities or index of securities. The counterparty pays a premium to us and we agree to make a payment to compensate the counterparty for losses upon the occurrence of a specified credit event.

Although contract-specific, credit events generally include bankruptcy, failure to pay, restructuring, obligation acceleration, obligation default, or repudiation/moratorium. Upon the occurrence of a defined credit event, the difference between the value of the reference obligation and the CDS's notional amount is recorded as realized loss in the statement of operations.

Our only CDS contract was entered into on December 31, 2010. We sold protection against losses on a specific pool of non-Agency RMBS in the event they exceed a specified loss limit of 25% of the balance of the non-Agency RMBS on the trade date. The maximum exposure is the remaining unpaid principal balance of the underlying RMBS in excess of the specified loss threshold. In exchange, we are paid a stated fixed rate fee of 3%. We are required to post cash collateral as security for potential loss payments. We posted cash collateral to secure potential loss payments of \$13.5 million (2011: \$18.5 million) as of September 30, 2012. The remaining notional amount of the CDS is \$87.1 million (2011: \$120.6 million) at September 30, 2012, and we estimated the fair market value of the CDS to be \$1.7 million (2011: \$1.6 million) at September 30, 2012. As of September 30, 2012, we have not made any payments related to the CDS contract.

**Shareholders' Equity**

During the nine months ended September 30, 2012, we issued 8,504 shares of common stock at an average price of \$18.05 under the share repurchase feature of the DRSP with total proceeds of approximately \$153,480.

During the nine months ended September 30, 2012, we completed a public offering of 5.6 million shares of 7.75% Series A Preferred Stock, or the Series A Preferred Stock at the price of \$25.00 per share for total proceeds of \$135.4 million, net of issuance costs. Holders of our Series A Cumulative

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

### **Unrealized Gains and Losses**

Since we account for our investment securities as available-for-sale, unrealized fluctuations in market values of assets do not impact our U.S. GAAP income but rather are reflected on our balance sheet by changing the carrying value of the asset and shareholders' equity under Accumulated Other Comprehensive Income (Loss). In addition, unrealized fluctuations in market values of our cash flow hedges that qualify for hedge accounting are also reflected in Accumulated Other Comprehensive Income (Loss). For the three months ended September 30, 2012, net unrealized gain included in shareholders' equity was \$291.9 million (2011: \$300.7 million loss).

For the nine months ended September 30, 2012, net unrealized gain included in shareholders' equity was \$512.1 million (2011: \$416.7 million loss).

The increase in net unrealized gain is primarily attributable to changes in the market values of our cash flow hedges that qualify for hedge accounting. Refer to Note 3 Mortgage-Backed Securities and Note 6 Derivative and Hedging Activities for more details on the unrealized gains and losses in both our investment securities and our cash flow hedges.

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

### **Share-Based Compensation**

We established the 2009 Equity Incentive Plan for grants of restricted common stock and other equity based awards to our independent, non-executive directors, and to the officers and employees of the Manager (the Incentive Plan). Under the Incentive Plan, a total of 1,000,000 shares are currently reserved for issuance. Unless terminated earlier, the Incentive Plan will terminate in 2019, but will continue to govern the unexpired awards. Effective July 1, 2011, our three independent, non-executive directors are each eligible to receive \$50,000 in restricted common stock annually. For the three months ended September 30, 2012, we recognized compensation expense of approximately \$53,000 (2011: \$38,000) and issued 2,568 shares (2011: 1,722 shares) of restricted stock to our independent, non-executive directors pursuant to the Incentive Plan. For the nine months ended September 30, 2012, we recognized compensation expense of approximately \$128,000 (2011: \$105,000) and issued 6,831 shares (2011: 4,617 shares), respectively, of restricted stock to our independent, non-executive directors pursuant to the Incentive Plan. The number of shares issued was determined based on the closing price of our common stock on the New York Stock Exchange on the actual date of grant.

### **Dividends**

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

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### **Inflation**

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

### **Unrelated Business Taxable Income**

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

### **Other Matters**

We calculate that we satisfied each of the asset tests in Section 856(c)(4) of the Internal Revenue Code of 1986, as amended (the Code) for the period ended September 30, 2012. We also calculate that our revenue qualifies for the 75% source of income test and for the 95% source of income test rules for the period ended September 30, 2012. Consequently, we believe we met the REIT income and asset test as of September 30, 2012. We also met all REIT requirements regarding the ownership of our common stock and the distribution of dividends of our net income as of September 30, 2012. Therefore, as of September 30, 2012, we believe that we qualified as a REIT under the Code.

At all times, we intend to conduct our business so that neither we nor our Operating Partnership nor the subsidiaries of our Operating Partnership are required to register as an investment company under the 1940 Act. If we were required to register as an investment company, then our use of leverage would be substantially reduced. Because we are a holding company that conducts our business through our Operating Partnership and the Operating Partnership's wholly-owned or majority-owned subsidiaries, the securities issued by these subsidiaries that are excepted from the definition of investment company under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act, together with any other investment securities the Operating Partnership may own, may not have a combined value in excess of 40% of the value of the Operating Partnership's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis, which we refer to as the 40% test. This requirement limits the types of businesses in which we are permitted to engage in through our subsidiaries. In addition, we believe neither we nor the Operating Partnership are considered an investment company under Section 3(a)(1)(A) of the 1940 Act because they do not engage primarily or hold themselves out as being engaged primarily in the business of investing, reinvesting or trading in securities. Rather, through the Operating Partnership's wholly-owned or majority-owned subsidiaries, we and the Operating Partnership are primarily engaged in the non-investment company businesses of these subsidiaries. IAS Asset I LLC and certain of the Operating Partnership's other subsidiaries that we may form in the future rely upon the exclusion from the definition of investment company under the 1940 Act provided by Section 3(c)(5)(C) of the 1940 Act, which is available for entities primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. This exclusion generally requires that at least 55% of each subsidiary's portfolio be comprised of qualifying assets and at least 80% be comprised of qualifying assets and real estate-related assets (and no more than 20% comprised of miscellaneous assets). Qualifying assets for this purpose include mortgage loans fully secured by real estate and other assets, such as whole pool Agency and non-Agency RMBS, that the SEC or its staff in various no-action letters has determined are the functional equivalent of mortgage loans fully secured by real estate. We treat as real estate-related assets CMBS, debt and equity securities of companies primarily engaged in real estate businesses, Agency partial pool certificates and securities issued by pass-through entities of which substantially all of the assets consist of qualifying assets and/or real estate-related assets. Additionally, unless certain mortgage securities represent all the certificates issued with respect to an underlying pool of mortgages, the MBS may be treated as securities separate from the underlying mortgage loans and, thus, may not be considered qualifying interests for purposes of the 55% requirement. We calculate that as of September 30, 2012, we conducted our business so as not to be regulated as an investment company under the 1940 Act.

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

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

#### **Interest Rate Risk**

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

#### **Interest Rate Effect on Net Interest Income**

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

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

#### **Interest Rate Effects on Fair Value**

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

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

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

**Table of Contents****Prepayment Risk**

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

**Extension Risk**

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

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

**Market Risk***Market Value Risk*

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

The sensitivity analysis table presented below shows the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments and net interest income, at September 30, 2012, assuming a static portfolio. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager's expectations. The analysis presented utilized assumptions, models and estimates of our Manager based on our Manager's judgment and experience.

<b>Change in Interest Rates</b>	<b>Percentage Change in Projected Net Interest Income</b>	<b>Percentage Change in Projected Portfolio Value</b>
+1.00%	18.45%	(1.36)%
+0.50%	27.21%	(0.45)%
-0.50%	(27.05)%	0.10%
-1.00%	(47.51)%	(0.33)%

*Real Estate Risk*

Residential and commercial property values are subject to volatility and may be affected adversely by a number of factors, including, but not limited to: national, regional and local economic conditions (which may be adversely affected by industry slowdowns and other factors); local real estate conditions (such as the supply of housing stock); changes or continued weakness in specific industry segments; construction quality, age and design;

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demographic factors; and retroactive changes to building or similar codes. In addition, decreases in property values reduce the value of the collateral and the potential proceeds available to a borrower to repay our loans, which could also cause us to suffer losses.

### **Credit Risk**

We believe that our investment strategy will generally keep our credit losses and financing costs low. However, we retain the risk of potential credit losses on all of the residential and commercial mortgage loans, as well as the loans underlying the non-Agency RMBS and CMBS in our portfolio. We seek to manage this risk through our pre-acquisition due diligence process and through the use of non-recourse financing, which limits our exposure to credit losses to the specific pool of mortgages that are subject to the non-recourse financing. In addition, with respect to any particular asset, our Manager's investment team evaluates, among other things, relative valuation, supply and demand trends, shape of yield curves, prepayment rates, delinquency and default rates, recovery of various sectors and vintage of collateral.

### **Risk Management**

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

monitoring and adjusting, if necessary, the reset index and interest rate related to our target assets and our financings;

attempting to structure our financing agreements to have a range of different maturities, terms, amortizations and interest rate adjustment periods;

using hedging instruments, primarily interest rate swap agreements but also financial futures, options, interest rate cap agreements, floors and forward sales to adjust the interest rate sensitivity of our target assets and our borrowings; and

actively managing, on an aggregate basis, the interest rate indices, interest rate adjustment periods, and gross reset margins of our target assets and the interest rate indices and adjustment periods of our financings.

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**ITEM 4. CONTROLS AND PROCEDURES.**

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

We have evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our disclosure controls and procedures as of September 30, 2012. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the applicable rules and forms, and that it is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

No change occurred in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act) during the nine months ended September 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



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**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS.**

From time to time, we may be involved in various claims and legal actions arising in the ordinary course of business. As of September 30, 2012, we were not involved in any such 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, 2011, as filed with the SEC on February 29, 2012. Additional risks not presently known, or that we currently deem immaterial, also may have a material adverse affect 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.

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**SIGNATURES**

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

INVESCO MORTGAGE CAPITAL INC.

November 2, 2012

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

November 2, 2012

By: /s/ Donald R. Ramon  
Donald R. Ramon  
Chief Financial Officer

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Exhibit No.	Description
3.1	Articles of Amendment and Restatement of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 3.1 to our Quarterly Report on Form 10-Q, filed with the Securities and Exchange Commission on August 12, 2009.
3.2	Amended and Restated Bylaws of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 3.2 to Amendment No. 8 to our Registration Statement on Form S-11 (No. 333-151665), filed with the Securities and Exchange Commission on June 18, 2009.
3.3	Articles Supplementary of 7.75% Series A Cumulative Redeemable Preferred Stock, incorporated by reference to Exhibit 3.3 to the Registrant's Registration Statement on Form 8-A, filed with the Securities and Exchange Commission on July 23, 2012.
4.1	Specimen 7.75% Series A Cumulative Redeemable Preferred Stock Certificate, incorporated by reference to Exhibit 4.1 to the Registrant's Registration Statement on Form 8-A, filed with the Securities and Exchange Commission on July 23, 2012.
31.1	Certification of Richard J. King pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Donald R. Ramon pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Richard J. King pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Donald R. Ramon pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	<p>The following series of unaudited XBRL-formatted documents are collectively included herewith as Exhibit 101. The financial information is extracted from Invesco Mortgage Capital Inc.'s unaudited consolidated interim financial statements and notes that are included in this Form 10-Q Report.</p> <p>101.INS XBRL Instance Document</p> <p>101.SCH XBRL Taxonomy Extension Schema Document</p> <p>101.CAL XBRL Taxonomy Calculation Linkbase Document</p> <p>101.DEF XBRL Taxonomy Definition Linkbase Document</p> <p>101.LAB XBRL Taxonomy Label Linkbase Document</p> <p>101.PRE XBRL Taxonomy Presentation Linkbase Document</p> <p>Users of this data are advised pursuant to Rule 406T of Regulation S-T that this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities and Exchange Act of 1934, and otherwise is not subject to liability under these sections.</p>