

Invesco Mortgage Capital Inc.  
Form 10-Q  
May 08, 2013  
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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 March 31, 2013

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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<b>Maryland</b> (State or Other Jurisdiction of Incorporation or Organization)	<b>26-2749336</b> (I.R.S. Employer Identification No.)
<b>1555 Peachtree Street, N.E., Suite 1800</b>  <b>Atlanta, Georgia</b> (Address of Principal Executive Offices)	<b>30309</b> (Zip Code)
<b>(404) 892-0896</b> (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 <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-Accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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 May 8, 2013, there were 135,210,824 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 per share amounts

	March 31, 2013 (Unaudited)	As of December 31, 2012
<b>ASSETS</b>		
Mortgage-backed securities, at fair value	21,248,432	18,470,563
Residential loans, held-for-investment	405,541	
Cash and cash equivalents	274,538	286,474
Investment related receivable	34,155	41,429
Investments in unconsolidated ventures, at fair value	35,456	35,301
Accrued interest receivable	72,863	62,977
Derivative assets, at fair value	8,026	6,469
Deferred securitization and financing costs	13,464	
Other investments	10,000	10,000
Other assets	1,482	1,547
Total assets (1)	22,103,957	18,914,760
<b>LIABILITIES AND EQUITY</b>		
<b>Liabilities:</b>		
Repurchase agreements	17,873,256	15,720,460
Asset-backed securities issued	374,196	
Exchangeable senior notes	400,000	
Derivative liability, at fair value	420,439	436,440
Dividends and distributions payable	91,049	79,165
Investment related payable	305	63,715
Accrued interest payable	17,189	15,275
Accounts payable and accrued expenses	1,109	877
Due to affiliate	10,956	9,308
Total liabilities (1)	19,188,499	16,325,240
<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 issued and outstanding at March 31, 2013 and December 31, 2012, respectively	135,356	135,362
Common Stock: par value \$0.01 per share; 450,000,000 shares authorized, 134,477,190 and 116,195,500 shares issued and outstanding, at March 31, 2013 and December 31, 2012, respectively	1,345	1,162
Additional paid in capital	2,697,177	2,316,290
Accumulated other comprehensive income	35,248	86,436
Retained earnings	15,430	18,848
Total shareholders' equity	2,884,556	2,558,098
Non-controlling interest	30,902	31,422

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Total equity	2,915,458	2,589,520
Total liabilities and equity	22,103,957	18,914,760

- (1) Our consolidated balance sheets include assets of a consolidated variable interest entity ( VIE ) that can only be used to settle obligations of this VIE and liabilities of the VIE for which creditors do not have recourse to the primary beneficiary (IAS Asset I LLC, an indirect subsidiary of Invesco Mortgage Capital, Inc.). At March 31, 2013 and December 31, 2012 assets of the consolidated VIE totaled \$408,291 and \$0 respectively, and liabilities of the consolidated VIE totaled \$375,261 and \$0 respectively. See Note 3 for further discussion.

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

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

<b>\$ in thousands, except per share data</b>	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Interest Income</b>		
Mortgage-backed securities	160,344	141,960
Residential loans	137	
Total interest income	160,481	141,960
<b>Interest Expense</b>		
Repurchase agreements	66,328	55,285
Exchangeable senior note	1,160	
Asset-back securities issued	79	
Total interest expense	67,567	55,285
<b>Net interest income</b>	<b>92,914</b>	<b>86,675</b>
<b>Other Income</b>		
Gain on sale of investments	6,712	6,045
Equity in earnings and fair value change in unconsolidated ventures	1,590	1,009
Unrealized loss on interest rate swaps and swaptions	(2,003)	(509)
Realized and unrealized credit default swap income	351	657
<b>Total other income</b>	<b>6,650</b>	<b>7,202</b>
<b>Expenses</b>		
Management fee related party	10,354	8,639
General and administrative	1,543	1,130
<b>Total Expenses</b>	<b>11,987</b>	<b>9,769</b>
<b>Net income</b>	<b>87,667</b>	<b>84,108</b>
Net income attributable to non-controlling interest	962	1,026
Net income attributable to Invesco Mortgage Capital Inc.	86,705	83,082
Dividends to preferred shareholders	2,713	
Net income attributable to common shareholders	83,992	83,082
Earnings per share:		
Net income attributable to common shareholders		

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(basic)	0.65	0.72
(diluted)	0.64	0.72
Dividends declared per common share	0.65	0.65

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 March 31,</b>	
	<b>2013</b>	<b>2012</b>
Net income	87,667	84,108
Other comprehensive income (loss)		
Unrealized gain (loss) on mortgage-back securities		
Change in fair value	(55,124)	205,904
Reclassification adjustments for (gains) loss included in gain on sale of investments	(15,012)	3,169
Unrealized gain (loss) on mortgage-backed securities, net	(70,136)	209,073
Unrealized gain (loss) on derivatives		
Change in fair value	(17,171)	(18,331)
Reclassification adjustments for loss included in unrealized gain (loss) on interest swap and swaptions	35,562	35,420
Unrealized gains on derivatives, net	18,391	17,089
Other comprehensive income (loss)	(51,745)	226,162
Comprehensive income	35,922	310,270
Less: Comprehensive loss attributable to non-controlling interest	(405)	(3,784)
Less: Dividends to preferred shareholders	(2,713)	
Comprehensive income attributable to common shareholders	32,804	306,486

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 three months ended March 31, 2013

(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	Accumulated Other Comprehensive Income (loss)	Retained Earnings			
<b>Balance at January 1, 2013</b>	5,600,000	135,362	116,195,500	1,162	2,316,290	86,436	18,848	2,558,098	31,422	2,589,520
Net income							86,705	86,705	962	87,667
Other comprehensive loss						(51,188)		(51,188)	(557)	(51,745)
Proceeds from issuance of common stock, net of offering costs			18,274,223	183	380,789			380,972		380,972
Proceeds from issuance of preferred stock, net of offering costs		(6)						(6)		(6)
Stock awards			7,467							
Common stock dividends							(87,410)	(87,410)		(87,410)
Common unit dividends									(926)	(926)
Preferred stock dividends							(2,713)	(2,713)		(2,713)
Amortization of equity-based compensation					98			98	1	99
<b>Balance at March 31, 2013</b>	5,600,000	135,356	134,477,190	1,345	2,697,177	35,248	15,430	2,884,556	30,902	2,915,458

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

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

\$ in thousands	Three Months Ended March 31,	
	2013	2012
<b>Cash Flows from Operating Activities</b>		
Net income	87,667	84,108
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of mortgage-backed securities premiums and discounts, net	46,173	25,402
Amortization of residential loan premiums	4	
Unrealized loss on interest swap and swaptions	2,003	509
Unrealized loss on credit default swap	223	168
Gain on sale of mortgage-backed securities	(6,712)	(6,045)
Equity in earnings and fair value change in unconsolidated ventures	(1,590)	(1,009)
Amortization of equity-based compensation	99	77
Amortization of deferred securitization and financing costs	128	
Changes in operating assets and liabilities:		
Increase in accrued interest receivable	(9,886)	(2,009)
Decrease in other assets	14	150
Increase (decrease) in accrued interest payable	1,914	(293)
Increase (decrease) in due to affiliate	1,444	(57)
Increase in accounts payable and accrued expenses	122	281
Net cash provided by operating activities	121,603	101,282
<b>Cash Flows from Investing Activities</b>		
Purchase of mortgage-backed securities	(4,671,035)	(2,005,516)
Distributions from investment in unconsolidated ventures, net	122	17,615
Principal payments from mortgage-backed securities	742,108	540,608
Investment related receivable		(274)
Proceeds from sale of mortgage-backed securities	986,334	570,409
Payment of premiums for interest rate swaptions	(1,395)	
Purchase of residential loans	(405,262)	
Net cash used in investing activities	(3,349,128)	(877,158)
<b>Cash Flows from Financing Activities</b>		
Proceeds from issuance of common stock	381,276	(36)
Proceeds from issuance of preferred stock	(6)	
Restricted cash		57,082
Proceeds from repurchase agreements	48,870,103	33,933,342
Principal repayments of repurchase agreements	(46,717,307)	(33,180,000)
Proceeds from issuance of exchangeable senior notes	400,000	
Proceeds from issuance of asset-backed-securities	374,218	
Payments of deferred costs	(13,530)	
Payments of dividends and distributions	(79,165)	(75,933)
Net cash provided by financing activities	3,215,589	734,455

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Net change in cash	(11,936)	(41,421)
Cash, beginning of period	286,474	197,224
Cash and cash equivalents, end of period	274,538	155,803

### Supplement Disclosure of Cash Flow Information

Interest paid	65,546	55,577
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### Non-cash Investing and Financing Activities Information

Net change in unrealized gain on mortgage-backed securities and derivatives	(51,745)	226,163
Net change in unconsolidated ventures	1,313	
Net change in restricted cash		1,346
Dividends and distributions declared not paid	91,049	75,939
Payable for mortgage-backed securities purchased	(55,149)	(279,399)

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 March 31, 2013, the Company owned 99.0% of the Operating Partnership and Invesco Investments (Bermuda) Ltd., a direct, wholly-owned subsidiary of Invesco, owned the remaining 1.0%.

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 finances its residential loans through the issuance of asset-backed securities. 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, 2012 which was filed with the SEC on March 1, 2013. The results of operations for the period ended March 31, 2013 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, its subsidiaries and a variable interest entity ( VIE ) in which the Company is the primary beneficiary. The underlying loans owned by the VIE are shown under residential loans on our consolidated balance sheet. The asset-backed securities ( ABS ) issued to third parties by the VIE are shown under asset-backed securities issued. In our consolidated statements of income, we record interest income on the residential loans owned by the VIE and interest expense on the ABS issued by the VIE. All intercompany balances and transactions have been eliminated.

### **Variable Interest Entity**

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

### **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 March 31, 2013, 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.

### **Deferred Costs**

Included in deferred costs are costs associated with the issuance of beneficial interest by a consolidated VIE incurred by the Company and costs incurred in connection with the issuance of its exchangeable senior notes. These costs may include underwriting, rating agency, legal, accounting and other fees. These deferred costs are

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

### **Repurchase Agreements**

The Company finances its Agency RMBS, non-Agency RMBS 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.

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 consolidated 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 consolidated balance sheet. See recent accounting pronouncements not yet adopted.

### **Asset-Backed Debt Securities**

Asset-backed debt securities ( ABS ) are recorded at principal balance net of unamortized premiums or discounts.

### **Fair Value Measurements**

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

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.



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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 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.

### **Residential Loans Held-For-Investment**

Loans held-for-investment include securitized residential mortgage loans held by a VIE in which we hold a controlling interest and which is included in our consolidated balance sheets, and are carried at cost, net of unamortized premiums. The Company expects that it will be required to continue to consolidate the VIE in which such loans are held and generally does not have the authority to sell the residential loans held in the VIE. Loans held-for-sale are recorded in the consolidated balance sheet at the lower of their amortized cost adjusted for any allowance for loan losses or fair value. If the fair value of an individual loan or pool of loans held-for-sale is lower than its amortized cost basis, the difference is reported in earnings. An allowance for loan losses will be recognized only if past and current events indicate it is probable that all amounts due will not be collected according to the terms of the loan agreement.



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### **Interest Income Recognition**

#### *Securities*

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

#### *Residential Loans*

Interest income from the Company's residential loans is recognized on an accrual basis with the related premiums being amortized into interest income using the effective interest method over the weighted average life of these loans. 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 estimation, including the interest rate and timing of principal payments (prepayments, repurchases, defaults and liquidations), the timing and amount of expected credit losses, and other factors. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due or has been individually impaired, at which point the loan is placed on nonaccrual status. Interest previously accrued for loans that have become greater than 90 days past due or individually impaired is reserved for in the allowance for loan losses. Residential loans delinquent more than 90 days or in foreclosure are characterized as delinquent. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due or individually impaired is used to reduce the outstanding loan principal balance. When a delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Alternately, nonaccrual loans may be placed back on accrual status if restructured and after the loan is considered re-performing. A restructured loan is considered re-performing when the loan has been current for at least 12 months.

### **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 consolidated balance sheet date which are payable to common shareholders, preferred shareholders and distributions declared at the consolidated 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 attributable to common shareholders for the period by weighted-average shares of the Company's common stock outstanding for that period. Diluted earnings per share takes into account the effect of dilutive instruments, such as units of limited partnership interest in the Operating Partnership ( OP Units ), 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 consolidated 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 shareholders is computed using its taxable income as opposed to net income reported on the consolidated financial statements. Taxable income, generally, will differ from net income because the determination of taxable income is based on tax regulations and not financial accounting principles.

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

If a TRS generates net income, the TRS can declare dividends to the Company which will be included in its taxable income and necessitate a distribution to its shareholders. Conversely, if the Company retains earnings at a

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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.

### **Reclassifications**

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

### **Recent Accounting Pronouncements**

In January 2013, the FASB issued Accounting Standard Update 2013-01, "Clarifying the Scope of Disclosure about Offsetting Assets and Liabilities" (ASU 2013-01). ASU 2013-01 Clarified Accounting Standard Update 2011-11, "Disclosures about Offsetting Assets and Liabilities" which was issued in December 2011. 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 was effective for periods beginning on or after January 1, 2013, and interim periods within those annual periods. Refer to Note 9 "Offsetting Assets and Liabilities".

In February 2013, the FASB issued Accounting Standards Update 2013-02, "Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income" (ASU 2013-02), which adds new disclosure requirements for items reclassified out of accumulated other comprehensive income. ASU 2013-02 does not amend any existing requirements for reporting net income or other comprehensive income in the financial statements and is effective prospectively for reporting periods beginning after December 15, 2012. ASU 2013-02 increased our disclosures related to items reclassified out of accumulated other comprehensive income, but did not have a significant effect on our consolidated financial statements.

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None.

**Note 3 Variable Interest Entity**

During March 2013, we purchased through our indirect subsidiary a controlling interest in a securitization trust which we determined to be a VIE. The VIE holds a pool of 488 residential mortgage loans having an initial aggregate principal balance of \$389.9 million and it issued a series of asset-backed securities ( ABS ) having an aggregate original principal amount of \$389.9 payable from the cash flow generated by the pool of residential mortgage loans. Our interest in the VIE consists of several classes of such ABS having an aggregate original principal balance of \$28.5 million, which are either subordinate in payment priority, pay interest only, or are payable from certain designated cash flows from the loans.

In determining if the securitized trust should be consolidated, the Company evaluated whether it was a VIE and, if so, whether the Company's direct involvement in the VIE reflects a controlling financial interest that would result in the Company being deemed the primary beneficiary. The Company concluded that its interest in the securitized trust purchased in March 2013, was a VIE because it included the power to direct the activities that most significantly impact the economic performance of the VIE and the obligation to absorb losses or right to receive benefits that are potentially significant to the VIE. Accordingly, for financial statement reporting purposes, the Company consolidated the underlying assets and liabilities of the securitization trust at their fair value and, as such, no gain or loss was recorded upon consolidation. The securitization is a non-recourse financing of the residential mortgage loans held-for-investment. The senior securities issued by the securitization trust and not purchased by the Company, which were sold to unaffiliated third parties, are presented in the consolidated balance sheet as Asset-back securities issued .

The Company is not contractually required and has not provided any additional financial support to the VIE for the period ended March 31, 2013. The following table presents a summary of the assets and liabilities of the VIE. Intercompany balances have been eliminated for purposes of this presentation.

<b>\$ in thousand</b>	<b>March 31, 2013</b>	<b>December 31, 2012</b>
Residential loans, held for investment	405,541	
Accrued interest receivable	1,224	
Deferred costs	1,526	
<b>Total assets</b>	<b>408,291</b>	
Accrued interest payable	1,065	
Asset-backed securities issued	374,196	
<b>Total liabilities</b>	<b>375,261</b>	

**Note 4 Mortgage-Backed Securities**

All of the Company's MBS are classified as available-for-sale and, as such, are reported at fair value, which is determined by obtaining valuations from an independent source. If the fair value of a security is not available from a 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 March 31, 2013 and December 31, 2012, 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 March 31, 2013 and December 31, 2012.

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March 31, 2013

\$ 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	1,927,848	102,811	2,030,659	58,848	2,089,507	4.06%	2.29%	2.19%
30 year fixed-rate	11,302,383	752,598	12,054,981	116,840	12,171,821	4.00%	2.83%	2.84%
ARM	70,163	2,139	72,302	1,753	74,055	3.34%	2.02%	2.13%
Hybrid ARM	461,439	10,529	471,968	14,329	486,297	3.16%	2.23%	2.33%
<b>Total Agency pass-through</b>	<b>13,761,833</b>	<b>868,077</b>	<b>14,629,910</b>	<b>191,770</b>	<b>14,821,680</b>	<b>3.98%</b>	<b>2.73%</b>	<b>2.72%</b>
<b>Agency-CMO<sup>(4)</sup></b>	<b>1,395,266</b>	<b>(894,925)</b>	<b>500,341</b>	<b>2,738</b>	<b>503,079</b>	<b>2.86%</b>	<b>2.46%</b>	<b>1.46%</b>
<b>Non-Agency RMBS<sup>(5)</sup></b>	<b>3,812,636</b>	<b>(350,396)</b>	<b>3,462,240</b>	<b>93,063</b>	<b>3,555,303</b>	<b>4.18%</b>	<b>4.30%</b>	<b>4.63%</b>
<b>CMBS</b>	<b>2,679,653</b>	<b>(477,301)</b>	<b>2,202,352</b>	<b>166,018</b>	<b>2,368,370</b>	<b>4.41%</b>	<b>4.77%</b>	<b>4.75%</b>
<b>Total</b>	<b>21,649,388</b>	<b>(854,545)</b>	<b>20,794,843</b>	<b>453,589</b>	<b>21,248,432</b>	<b>4.00%</b>	<b>3.20%</b>	<b>3.21%</b>

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- (1) Net weighted average coupon as of March 31, 2013 ( WAC ) is presented net of servicing and other fees.
- (2) Average yield based on amortized costs as of March 31, 2013 and incorporates future prepayment and loss assumptions.
- (3) Average yield based on average amortized costs for the three months ended March 31, 2013 and incorporates future prepayment and loss assumptions.
- (4) Included in the Agency-CMO are interest-only securities which represent 15.1% of the balance based on fair value.
- (5) The non-Agency RMBS held by the Company is 72.7% variable rate, 22.7% fixed rate, and 4.6% floating rate based on fair value.

**December 31, 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	1,964,999	102,058	2,067,057	63,839	2,130,896	4.09%	2.37%	2.37%
30 year fixed-rate	9,168,196	601,592	9,769,788	238,949	10,008,737	4.21%	2.89%	2.88%
ARM	109,937	3,464	113,401	2,365	115,766	3.15%	2.06%	2.02%
Hybrid ARM	556,790	13,493	570,283	16,885	587,168	3.19%	2.18%	2.22%
<b>Total Agency pass-through</b>	<b>11,799,922</b>	<b>720,607</b>	<b>12,520,529</b>	<b>322,038</b>	<b>12,842,567</b>	<b>4.13%</b>	<b>2.77%</b>	<b>2.75%</b>
<b>Agency-CMO<sup>(4)</sup></b>	<b>1,322,043</b>	<b>(819,530)</b>	<b>502,513</b>	<b>1,926</b>	<b>504,439</b>	<b>2.89%</b>	<b>2.35%</b>	<b>1.51%</b>
<b>Non-Agency RMBS<sup>(5)</sup></b>	<b>3,339,683</b>	<b>(308,885)</b>	<b>3,030,798</b>	<b>48,238</b>	<b>3,079,036</b>	<b>4.20%</b>	<b>4.61%</b>	<b>4.80%</b>
<b>CMBS</b>	<b>1,868,928</b>	<b>24,070</b>	<b>1,892,998</b>	<b>151,523</b>	<b>2,044,521</b>	<b>5.27%</b>	<b>4.96%</b>	<b>4.82%</b>
<b>Total</b>	<b>18,330,576</b>	<b>(383,738)</b>	<b>17,946,838</b>	<b>523,725</b>	<b>18,470,563</b>	<b>4.17%</b>	<b>3.30%</b>	<b>3.27%</b>

- (1) Net weighted average coupon as of December 31, 2012 ( WAC ) is presented net of servicing and other fees.
  - (2) Average yield based on amortized cost as of December 31, 2012 incorporates future prepayment and loss assumptions.
  - (3) Average yield based on average amortized cost for the three months ended December 31, 2012 incorporates future prepayment and loss assumptions.
  - (4) Included in Agency-CMO are interest-only securities which represent 14.1% of the balance based on fair value.
  - (5) The non-Agency RMBS held by the Company is 79.2% variable rate, 15.5% fixed rate, and 5.3% floating rate based on fair value.
- The following table summarizes our non-Agency RMBS portfolio by asset type as of March 31, 2013 and December 31, 2012, respectively:

\$ in thousands	March 31, 2013	% of Non-Agency	December 31, 2012	% of Non-Agency
Re-REMIC Senior	1,765,156	49.6%	1,844,209	59.9%
Prime	1,151,170	32.4%	754,161	24.5%
Alt-A	627,736	17.7%	468,181	15.2%
Subprime	11,241	0.3%	12,485	0.4%
<b>Total Non-Agency</b>	<b>3,555,303</b>	<b>100.0%</b>	<b>3,079,036</b>	<b>100.0%</b>

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The following table summarizes certain characteristics of our senior Re-REMIC Holdings as of March 31, 2013 and December 31, 2012:

Re-REMIC Subordination <sup>(1)</sup>	Percentage of Re-REMIC Holdings at Fair Value	
	March 31, 2013	December 31, 2012
0-10	3.0%	2.1%
10-20	3.2%	3.2%
20-30	15.0%	15.0%
30-40	26.7%	27.0%
40-50	39.7%	40.4%
50-60	7.8%	7.6%
60-70	4.6%	4.7%
Total	100.0%	100.0%

- (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 March 31, 2013 and December 31, 2012 are presented below:

\$ in thousands	March 31, 2013	December 31, 2012
Principal balance	21,649,388	18,330,576
Unamortized premium	949,516	788,716
Unamortized discount	(1,804,061)	(1,172,454)
Gross unrealized gains	545,324	563,093
Gross unrealized losses	(91,735)	(39,368)
Fair value	21,248,432	18,470,563

The following table summarizes certain characteristics of the Company's investment portfolio, at fair value, according to estimated weighted average life classifications as of March 31, 2013 and December 31, 2012:

\$ in thousands	March 31, 2013	December 31, 2012
Less than one year	73,492	70,044
Greater than one year and less than five years	9,717,411	13,146,577
Greater than or equal to five years	11,457,529	5,253,942
Total	21,248,432	18,470,563

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 March 31, 2013 and December 31, 2012, respectively:



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March 31, 2013	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized	Fair Value	Unrealized	Fair Value	Unrealized
		Losses		Losses		Losses
<b>\$ in thousands</b>						
Agency RMBS:						
15 year fixed-rate	140,809	(341)	13,606	(220)	154,415	(561)
30 year fixed-rate	6,199,401	(63,711)	91,756	(413)	6,291,157	(64,124)
Total Agency pass-through	6,340,210	(64,052)	105,362	(633)	6,445,572	(64,685)
Agency-CMO	39,552	(7,948)	9,631	(2,446)	49,183	(10,394)
Non-Agency RMBS	576,687	(5,226)	369,642	(8,021)	946,329	(13,247)
CMBS	355,612	(2,711)	17,300	(698)	372,912	(3,409)
Total	7,312,061	(79,937)	501,935	(11,798)	7,813,996	(91,735)

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December 31, 2012	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>\$ in thousands</b>						
Agency RMBS:						
15 year fixed-rate	31,269	(279)			31,269	(279)
30 year fixed-rate	1,763,113	(6,469)	78,640	(832)	1,841,753	(7,301)
Total Agency pass-through	1,794,382	(6,748)	78,640	(832)	1,873,022	(7,580)
Agency-CMO	31,719	(7,796)	10,770	(2,812)	42,489	(10,608)
Non-Agency RMBS	516,744	(6,005)	490,503	(12,895)	1,007,247	(18,900)
CMBS	187,349	(1,267)	52,813	(1,013)	240,162	(2,280)
Total	2,530,194	(21,816)	632,726	(17,552)	3,162,920	(39,368)

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Gross unrealized losses on the Company's Agency RMBS were \$64.6 million at March 31, 2013. Due to the inherent credit quality of Agency RMBS, the Company determined that at March 31, 2013, any unrealized losses on its Agency RMBS portfolio are temporary.

Gross unrealized losses on the Company's MBS-CMO, non-Agency RMBS, and CMBS were \$27.1 million at March 31, 2013. 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 months ended March 31, 2013 and 2012.

<b>\$ in thousands</b>	<b>Three Months ended March 31, 2013</b>	<b>Three Months ended March 31, 2012</b>
Accumulated other comprehensive income from investment securities:		
Unrealized gain (loss) on MBS at beginning of period	523,725	(1,218)
Unrealized gain (loss) on MBS, net	(70,136)	209,073
Balance at the end of period	453,589	207,855

During the three months ended March 31, 2013 and 2012, the Company reclassified \$15.0 million of net unrealized gains and \$3.2 million of net unrealized gains, respectively from other comprehensive income into gain (loss) on sale of investments as a result of the Company selling certain investments.

The Company assesses its investment securities for other-than-temporary impairment on at least a quarterly basis. 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 whether a security is other-than-temporarily impaired, the Company considers several factors, including the nature of the investment, 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.

The Company did not have other-than-temporary impairments for the three months ended March 31, 2013 and 2012.

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The following table presents components of interest income on the Company's MBS portfolio for the three months ended March 31, 2013 and 2012.

**For the three months ended March 31, 2013**

\$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	143,414	(45,114)	98,300
Non-Agency	36,411	1,141	37,552
CMBS	26,650	(2,200)	24,450
Other	42		42
<b>Total</b>	<b>206,517</b>	<b>(46,173)</b>	<b>160,344</b>

**For the three months ended March 31, 2012**

\$ in thousands	Coupon Interest	Net (Premium Amortization)/Discount Accretion	Interest Income
Agency	122,314	(31,497)	90,817
Non-Agency	28,283	5,928	34,211
CMBS	16,810	168	16,978
Other	(46)		(46)
<b>Total</b>	<b>167,361</b>	<b>(25,401)</b>	<b>141,960</b>

**Note 5 Residential Loans Held-for-Investment**

The following table details the carrying value for residential loans held-for-investment at March 31, 2013. These loans are held by the VIE that the Company consolidates. At March 31, 2013 there was no allowance for loan loss.

\$ in thousands	March 31, 2013	December 31, 2012
Principal balance	389,886	
Unamortized premium, net	15,655	
<b>Recorded investment</b>	<b>405,541</b>	
Carrying value	405,541	

The following table displays residential loans held-for-investment at March 31, 2013 organized by year of origination.

\$ in thousands	2013	2012	2011	2010	2009	Total
<b>Portfolio Characteristics:</b>						
Number of Loans	114	373			1	488
Current Principal Balance	89,336	300,215			335	389,886
Net Weighted Average Coupon Rate	3.7%	3.8%	0.0%	0.0%	4.0%	3.8%
Weighted Average Maturity (years)	30	30			30	30

**Current Performance:**

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Current	89,336	300,215	335	389,886
30 Day Delinquent				
60 Days Delinquent				
90+ Days Delinquent				
Bankruptcy/Foreclosure				
<b>Total</b>	<b>89,336</b>	<b>300,215</b>	<b>335</b>	<b>389,886</b>

The following table presents the five largest geographic concentrations of the Company's residential loans at March 31, 2013 based on principal balance:

State	Percent
California	49.9%
Virginia	7.3%
Massachusetts	7.3%
Maryland	5.7%
New York	5.2%
Other states (none greater than 4%)	24.6%
<b>Total</b>	<b>100.0%</b>

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Future minimum annual principal payments under the residential loans, held for investments at March 31, 2013:

\$ in thousands	March 31, 2013
<b>Scheduled Principal</b>	
Within one year	6,923
One to three years	14,651
Three to five years	15,794
Greater than or equal to five years	352,518
<b>Total</b>	<b>389,886</b>

**Note 6 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 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 March 31, 2013 for the Invesco IMRF Fund and AIV. The Company realized approximately \$345,000 (2012: \$353,000) of equity in earnings for the three months ended March 31, 2013 related to these investments. The Company also realized \$148,000 of unrealized gain (2012: \$151,000 of unrealized gain) from these investments for the three months ended March 31, 2013.

**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), a limited liability company managed by AIV. The Company has fully funded its commitment to IMRF. The Company realized loss of approximately \$105,000 (2012: \$354,000 realized gain) of equity in earnings and \$1.2 million (2012: \$152,000) of unrealized appreciation from these investments for the three months ended March 31, 2013.

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**Note 7 Borrowings**

The Company has entered into repurchase agreements and an exchangeable senior note to finance the majority of its portfolio of investments. The following table summarizes certain characteristics of the Company's borrowings at March 31, 2013 and December 31, 2012:

\$ in thousands	March 31, 2013			December 31, 2012		
	Amount Outstanding	Weighted Average Interest Rate	Weighted Average Remaining Maturity (days)	Amount Outstanding	Weighted Average Interest Rate	Weighted Average Remaining Maturity (days)
Agency RMBS	13,545,701	0.40%	15	11,713,565	0.48%	16
Non-Agency RMBS	2,520,515	1.62%	32	2,450,960	1.75%	23
CMBS	1,807,040	1.47%	20	1,555,935	1.51%	18
Exchangeable Senior Notes	400,000	5.00%	1,810		%	
<b>Total</b>	<b>18,273,256</b>	<b>0.78%</b>	<b>57</b>	<b>15,720,460</b>	<b>0.78%</b>	<b>17</b>

**Repurchase Agreements**

The repurchase agreements bear interest at a contractually agreed rate. The repurchase obligations mature and typically reinvest every thirty days to one year. Repurchase agreements are being accounted for as secured borrowings since the Company maintains effective control of the financed assets. Under the repurchase agreements, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral or fund margin calls. In addition, the repurchase agreements are subject to certain financial covenants. The Company is in compliance with these covenants at March 31, 2013.

The following tables summarize certain characteristics of the Company's repurchase agreements at March 31, 2013 and December 31, 2012:

**March 31, 2013**

\$ in thousands	Amount Outstanding	Percent of	
		Total Amount Outstanding	Company MBS Held as Collateral
<b>Repurchase Agreement Counterparties</b>			
Credit Suisse Securities (USA) LLC	1,831,940	10.3%	2,202,780
Wells Fargo Securities, LLC	1,305,871	7.4%	1,486,179
Morgan Stanley & Co. Incorporated	1,272,375	7.1%	1,402,549
South Street Securities LLC	1,240,081	6.9%	1,310,504
Banc of America Securities LLC	1,133,073	6.3%	1,243,914
CitiGroup Global Markets Inc.	1,075,152	6.0%	1,205,885
JP Morgan Securities Inc.	1,058,856	5.9%	1,229,961
HSBC Securities (USA) Inc	821,462	4.6%	844,932
Mitsubishi UFJ Securities (USA), Inc.	796,459	4.5%	845,807
Goldman, Sachs & Co.	791,102	4.4%	850,149
ING Financial Market LLC	789,174	4.4%	849,337
Pierpont Securities LLC	733,558	4.1%	776,635
Scotia Capital	708,691	4.0%	757,824
Nomura Securities International, Inc.	655,765	3.7%	706,838
Industrial and Commercial Bank of China Financial Services LLC	591,073	3.3%	638,829
Royal Bank of Canada	569,645	3.2%	655,196
Daiwa Capital Markets America Inc	500,169	2.8%	528,777
BNP Paribas Securities Corp.	480,641	2.7%	521,513

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Deutsche Bank Securities Inc.	473,326	2.6%	546,869
RBS Securities Inc.	421,280	2.4%	516,442
Barclays Capital Inc.	270,704	1.5%	297,938
Mizuho Securities USA Inc.	138,798	0.8%	160,327
KGS-Alpha Capital Markets, L.P.	78,521	0.4%	83,873
Cantor Fitzgerald & Co.	77,824	0.4%	84,038
Guggenheim Liquidity Services, LLC	38,166	0.2%	40,083
TD Securities	19,550	0.1%	24,633
<b>Total</b>	<b>17,873,256</b>	<b>100.0%</b>	<b>19,811,812</b>

**December 31, 2012**

\$ in thousands	Amount Outstanding	Percent of	Company MBS Held as Collateral
		Total Amount Outstanding	
<b>Repurchase Agreement Counterparties</b>			
Credit Suisse Securities (USA) LLC	1,600,331	10.2%	1,919,676
Morgan Stanley & Co. Incorporated	1,275,616	8.1%	1,397,846
Nomura Securities International, Inc.	1,240,231	7.9%	1,350,901
Mitsubishi UFJ Securities (USA), Inc.	941,671	6.0%	990,057
Wells Fargo Securities, LLC	941,556	6.0%	1,079,194
HSBC Securities (USA) Inc	883,726	5.6%	918,551
South Street Securities LLC	819,524	5.2%	871,963



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CitiGroup Global Markets Inc.	780,020	5.0%	882,517
Banc of America Securities LLC	728,609	4.6%	838,216
Scotia Capital	708,750	4.5%	744,692
Industrial and Commercial Bank of China Financial Services LLC	634,928	4.0%	690,783
Deutsche Bank Securities Inc.	587,919	3.7%	666,472
ING Financial Market LLC	573,116	3.6%	622,944
JP Morgan Securities Inc.	561,426	3.6%	697,602
Royal Bank of Canada	560,828	3.6%	641,079
BNP Paribas Securities Corp.	488,375	3.1%	516,770
Goldman, Sachs & Co.	468,806	3.0%	509,660
Daiwa Capital Markets America Inc	456,098	2.9%	479,354
Pierpont Securities LLC	437,095	2.8%	463,466
Barclays Capital Inc.	350,688	2.3%	372,708
RBS Securities Inc.	348,741	2.2%	427,183
Mizuho Securities USA Inc.	101,962	0.6%	122,836
Cantor Fitzgerald & Co.	80,466	0.5%	86,961
KGS-Alpha Capital Markets, L.P.	79,052	0.5%	86,241
Guggenheim Liquidity Services, LLC	43,245	0.3%	45,437
TD Securities	27,681	0.2%	33,129
Total	15,720,460	100.0%	17,456,238

Company MBS held by counterparties as security for repurchase agreements was \$19.8 billion and \$17.5 billion at March 31, 2013 and December 31, 2012, respectively. This represents a collateral ratio (Company MBS Held as Collateral/Amount Outstanding) of 111% and 111% for each period.

No cash collateral was held by the counterparties at March 31, 2013 and December 31, 2012. The cash collateral was replaced by Agency RMBS.

**Asset-Backed Securities Issued**

In March 2013, the Company purchased a controlling interest in a securitization trust which it determined to be a VIE. The securitization trust securitized residential mortgage loans with an aggregate principal balance of \$389.9 million, and issued \$389.9 million aggregate principal amount of ABS, of which \$361.4 million were sold to unaffiliated third parties and the balance was purchased by the Company. As a result, the ABS issued by the securitization trust is recorded as a non-recourse liability in the Company's consolidated balance sheet.

The carrying value of the ABS is based on its amortized cost, which is equal to the remaining principal balance net of unamortized premiums or discounts. The following table provides summary information of the carrying value of the ABS issued, along with other relevant information, at March 31, 2013.

\$ in thousands	ABS	Residential
	Outstanding	loans Held as Collateral
Principal balance	361,424	389,886
Interest-only securities	10,797	
Unamortized premium	2,622	15,655
Unamortized discount	(647)	
Carrying value	374,196	405,541
Range of weighted average interest rates	1.0% - 2.5%	
Number of series	2	

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The following table presents the estimated principal repayment schedule of the Company's ABS at March 31, 2013, based on expected cash flows of the residential mortgage loans, as adjusted for projected losses on such loans.

<b>\$ in thousands</b>	<b>March 31, 2013</b>
<b>Contractual maturity</b>	
Within One Year	63,862
One to Three Years	98,259
Three to Five Years	68,623
Greater Than or Equal to Five Years	130,680
<b>Total</b>	<b>361,424</b>

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The maturity of the Company's ABS is dependent upon cash flows received from the underlying residential mortgage loans. The estimate of their repayment is based on estimated principal payments on the underlying loans. This estimate may differ from actual amounts to the extent prepayments and/or loan losses vary. See Note 5 for a more detailed discussion of the residential loans collateralizing asset-backed debt securities

**Exchangeable Senior Notes**

On March 12, 2013, a wholly owned subsidiary of the Company, issued \$350.0 million in aggregate principal amount of Exchangeable Senior Notes (the "Notes") due 2018. Subsequently, on March 15, 2013, upon the exercise in full by the initial purchasers of such notes of their option to purchase additional notes, the wholly owned subsidiary issued \$50.0 million in aggregate principal amount of the Notes, for a total of \$400.0 million in aggregate principal amount of the Notes. The total net proceeds to the Company after deducting financing expenses was \$387.9 million.

The terms of the Notes are governed by an indenture, dated as of March 12, 2013 (the "Indenture"), by and among the wholly-owned subsidiary, as issuer, the Company, as guarantor, and The Bank of New York Mellon Trust Company, N.A., as trustee (the "Trustee"). The Notes bear interest at 5.00% per annum, payable semi-annually in arrears on March 15 and September 15 of each year, beginning September 15, 2013. The Notes may be exchanged for shares of the Company's common stock at the applicable exchange rate at any time prior to the close of business on the second scheduled trading day prior to the maturity date. The initial exchange rate for each \$1,000 aggregate principal amount of the Notes is 42.0893 shares of the Company's common stock, equivalent to an exchange price of approximately \$23.76 per share. The Notes, including the guaranty, and the shares of common stock of the Company issuable upon exchange of the Notes have not been registered under the Securities Act of 1933. Accrued interest payable on the notes is approximately \$1.1 million as of March 31, 2013.

**Note 8 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.

Our only CDS contract was entered into on December 30, 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%. The remaining notional amount of the CDS at March 31, 2013 is \$72.1 million (2012: \$103.3 million), and we estimated the fair market value of the CDS to be approximately \$1.3 million (2012: \$1.2 million) at March 31, 2013. As of March 31, 2013, we have not made any payments related to the CDS contract.

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At March 31, 2013 and December 31, 2012, the open CDS sold by the Company is summarized as follows:

\$ in thousand	March 31, 2013	December 31, 2012
Fair value amount	1,296	1,519
Notional amount	72,123	79,806
Maximum potential amount of future undiscounted payments	72,123	79,806
Recourse provisions with third parties		
Collateral held by counterparty	11,126	12,371

**Cash Flow Hedges of Interest Rate Risk**

The Company has purchased interest rate swaptions to help mitigate the potential impact of increases or decreases in interest rates on the performance of a portion of the Company's investment portfolio (referred to as convexity risk). The interest rate swaptions provide the Company the option to enter into interest rate swap agreements for a predetermined notional amount, stated term and pay and receive interest rates in the future. The premium paid for interest rate swaptions is reported as an asset in the Company's consolidated balance sheets. The premium is valued at an amount equal to the fair value of the swaption that would have the effect of closing the position adjusted for nonperformance risk, if any. The difference between the premium and the fair value of the swaption is reported in 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. For the three months ended March 31, 2013, the Company had \$2.0 million of unrealized losses, which represents the change in fair value of our interest rate swaptions that are recognized directly in earnings.

During the three months ended March 31, 2013, the Company recorded \$1,000 (2012: \$509,000) 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.

\$ in thousands	Option	Underlying Swap							
		Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Fixed Pay Rate	Average Receive rate	Average Term (Years)
Swaptions									
Payer	< 6 Months	2,140			0.37	200,000	1.85%	3M Libor	5.01
Payer	> 6 Months	8,068	4,342		7.85	800,000	2.87%	3M Libor	10.02
		10,208	4,342		6.36	1,000,000	2.66%		9.01

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 \$161.7 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 129 months.

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As of March 31, 2013, the Company had the following interest rate derivatives outstanding, which were designated as cash flow hedges of interest rate risk:

\$ in thousands			Maturity Date	Fixed Interest Rate in Contract
Counterparty		Notional		
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, LLC		300,000	1/24/2016	2.12%
The Bank of New York Mellon		300,000	1/24/2016	2.13%
Morgan Stanley Capital Services, LLC		300,000	4/5/2016	2.48%
Citibank, N.A.		300,000	4/15/2016	1.67%
Credit Suisse International		500,000	4/15/2016	2.27%
The Bank of New York Mellon		500,000	4/15/2016	2.24%
JPMorgan Chase Bank, N.A.		500,000	5/15/2016	2.31%
Goldman Sachs Bank USA		500,000	5/24/2016	2.34%
Goldman Sachs Bank USA		250,000	6/15/2016	2.67%
Wells Fargo Bank, N.A.		250,000	6/15/2016	2.67%
JPMorgan Chase Bank, N.A.		500,000	6/24/2016	2.51%
Citibank, N.A.		500,000	10/15/2016	1.93%
Deutsche Bank AG		150,000	2/5/2018	2.90%
ING Capital Markets LLC	(5)	350,000	2/24/2018	0.95%
Morgan Stanley Capital Services, LLC		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%
The Royal Bank of Scotland Plc	(7)	400,000	3/15/2023	2.39%
UBS AG	(6)	400,000	3/15/2023	2.51%
HSBC Bank USA, National Association		250,000	6/5/2023	1.91%
HSBC Bank USA, National Association	(1)	250,000	7/5/2023	1.97%
The Royal Bank of Scotland Plc	(2)	500,000	8/15/2023	1.98%
UBS AG	(4)	250,000	11/15/2023	2.23%
HSBC Bank USA, National Association	(3)	500,000	12/15/2023	2.20%
<b>Total</b>		<b>10,650,000</b>		<b>2.11%</b>

- (1) Forward start date of July 2013
- (2) Forward start date of August 2013
- (3) Forward start date of December 2013
- (4) Forward start date of November 2013
- (5) Forward start date of February 2013
- (6) Forward start date of March 2015
- (7) Forward start date of March 2015

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At March 31, 2013, the Company's counterparties held no cash margin deposits and approximately \$475.9 million in Agency RMBS as collateral against its swap contracts. In addition, a counterparty posted Agency RMBS of approximately \$1.9 million as collateral with the Company. Cash margin, if any, is classified as restricted cash and the Agency RMBS collateral is included in the total mortgage-backed securities on the Company's consolidated balance sheet.

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

The table below presents the fair value of the Company's derivative financial instruments, as well as their classification on the consolidated balance sheet as of March 31, 2013 and December 31, 2012.

\$ in thousands

		Asset Derivatives		Liability Derivatives			
		As of March 31, 2013		As of December 31, 2012		As of March 31, 2013	
Balance Sheet	Fair Value	Balance Sheet	Fair Value	Balance Sheet	Fair Value	Balance Sheet	Fair Value
Interest rate swap asset	2,388	Interest rate swap asset		Interest rate swap liability	420,439	Interest rate swap liability	436,440
CDS	1,296	CDS	1,519				
Swaption	4,342	Swaption	4,950				

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**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 months ended March 31, 2013 and 2012.

Three months ended March 31, 2013

\$ 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	17,171	Interest Expense	35,562	Unrealized loss on interest rate swaps and swaptions	1

Three months ended March 31, 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	18,331	Interest Expense	35,420	Unrealized gain (loss) on interest rate swaps and swaptions	509

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 March 31, 2013
CDS Contract	Realized and unrealized credit default swap income	(223)
	Unrealized gain (loss) on interest rate swaps and swaptions	(2,003)

**Credit-risk-related Contingent Features**

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

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



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

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

As of March 31, 2013, 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 \$419.5 million. The

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Company has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of \$475.9 million of Agency RMBS as of March 31, 2013. If the Company had breached any of these provisions at March 31, 2013, 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 March 31, 2013.

**Note 9 Offsetting Assets and Liabilities**

The following tables present information about certain assets and liabilities that are subject to master netting agreements (or similar agreements) and can potentially be offset on the Company's consolidated balance sheet at March 31, 2013 and December 31, 2012.

**Offsetting of Derivative Assets**

As of March 31, 2013

\$ in thousands	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Consolidated Balance Sheet	Net Amounts of Assets presented in the Consolidated Balance Sheet	Gross Amounts Not Offset in the Statement of Consolidated Balance Sheet		
				Financial Instruments	Cash Collateral Received	Net Amount
Derivatives	8,026		8,026	(8,026)		
Total	8,026		8,026	(8,026)		

**Offsetting of Derivative Liabilities and Repurchase agreements**

As of March 31, 2013

\$ in thousands	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheet	Net Amounts of Liabilities presented in the Consolidated Balance Sheet	Gross Amounts Not Offset in the Consolidated Balance Sheet		
				Financial Instruments	Cash Collateral Posted	Net Amount
Derivatives	420,439		420,439	(420,439)		
Repurchase Agreements	17,873,256		17,873,256	(17,873,256)		
	18,293,695		18,293,695	(18,293,695)		

**Offsetting of Derivative Assets**

As of December 31, 2012

\$ in thousands	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Consolidated Balance Sheet	Net Amounts of Assets presented in the Consolidated Balance Sheet	Gross Amounts Not Offset in the Consolidated Balance Sheet		
				Financial Instruments	Cash Collateral Received	Net Amount
Derivatives	6,469		6,469	(6,469)		
Total	6,469		6,469	(6,469)		

**Offsetting of Derivative Liabilities and Repurchase agreements**

As of December 31, 2012

\$ in thousands	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheet	Net Amounts of Liabilities presented in the Consolidated Balance Sheet	Gross Amounts Not Offset in the Consolidated Balance Sheet		
				Financial Instruments	Cash Collateral Posted	Net Amount
Derivatives	436,440		436,440	(436,440)		
Repurchase Agreements	15,720,460		15,720,460	(15,720,460)		
	16,156,900		16,156,900	(16,156,900)		

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

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

**Note 10 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:

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

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

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

The fair values on a recurring basis of the Company's MBS and interest rate hedges based on the level of inputs at March 31, 2013 and December 31, 2012 are summarized below:

<b>\$ in thousands</b>	<b>March 31, 2013</b>			<b>Total at Fair Value</b>
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	
<b>Assets</b>				
Mortgage-backed securities(1)		21,248,432		21,248,432
Investments in unconsolidated ventures			35,456	35,456
Derivatives		6,730	1,296	8,026
<b>Total</b>		<b>21,255,162</b>	<b>36,752</b>	<b>21,291,914</b>
<b>Liabilities</b>				
Derivatives		420,439		420,439
<b>Total</b>		<b>420,439</b>		<b>420,439</b>

<b>\$ in thousands</b>	<b>December 31, 2012</b>			<b>Total at Fair Value</b>
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	
<b>Assets</b>				
Mortgage-backed securities(1)		18,470,563		18,470,563
Investments in unconsolidated ventures			35,301	35,301
Derivatives		4,950	1,519	6,469
<b>Total</b>		<b>18,475,513</b>	<b>36,820</b>	<b>18,512,333</b>
<b>Liabilities</b>				
Derivatives		436,440		436,440
<b>Total</b>		<b>436,440</b>		<b>436,440</b>

(1) For more detail about the fair value of our MBS and type of securities, see Note 4 in the consolidated financial statements.

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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	March 31, 2013	December 31, 2012
Beginning balance	35,301	68,793
Purchases		4,218
Sales and settlements	(1,435)	(44,879)
Total net gains / (losses) included in net income		
Realized gains/(losses), net	239	6,813
Unrealized gains/(losses), net	1,351	356
Unrealized gain/(losses), net included in other comprehensive income		
Ending balance	35,456	35,301

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	March 31, 2013	December 31, 2012
Beginning balance	1,519	1,339
Purchases		
Sales and settlements		
Total net gains / (losses) included in net income		
Realized gains/(losses), net		
Unrealized gains/(losses), net	(223)	180
Unrealized gain/(losses), net included in other comprehensive income		
Ending balance	1,296	1,519

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

\$ in thousands	Fair Value at March 31, 2013	Valuation Technique	Unobservable		Weighted Average
			Input	Range	
CDS Contract	1,296	Discounted cash flow	Swap Rate		2.39%
			Discount Rate		0.53%
			Credit Spread		0.81%
			Constant Prepayment Rate	1.0% - 20.0%	4.97%
			Constant Default Rate	0.6% - 100.0%	4.94%
			Loss Severity	15.3% - 82.1%	47.43%

The significant unobservable inputs used in the fair value measurement of the CDS contract are the swap rate, discount rate, credit spread, constant prepayment rate, constant default rate, and loss severity in the event of default. These inputs change according to market conditions and security performance expectations. Significant increases (decreases) in swap rate, discount rate, credit spread, constant prepayment rate, constant default rate or loss severity in isolation would result in a lower (higher) fair value measurement. Generally, a change in the assumption used for the constant default rate would likely be accompanied by a directionally similar change in the assumptions used for swap rate, credit spread and loss severity and a directionally opposite change in the assumption used for discount rate and constant prepayment rate. If the inputs had not changed during the quarter, the fair value of the CDS contract would have been \$52,000 more than the actual fair value at March 31, 2013.



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The following table presents the carrying value and estimated fair value of our financial instruments that are not carried at fair value on the consolidated balance sheet, at March 31, 2013 and December 31, 2012:

\$ in thousands	March 31, 2013		December 31, 2012	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Financial Assets</b>				
Residential loans, held-for-investment	405,541	405,541		
Other investments	10,000	10,000	10,000	10,000
<b>Total</b>	<b>415,541</b>	<b>415,541</b>	<b>10,000</b>	<b>10,000</b>
<b>Financial Liabilities</b>				
Repurchase agreements	17,873,256	17,882,595	15,720,460	15,730,387
Asset-backed-securities	374,196	374,196		
Exchangeable senior notes	400,000	402,492		
<b>Total</b>	<b>18,647,452</b>	<b>18,659,283</b>	<b>15,720,460</b>	<b>15,730,387</b>

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

The fair value of the residential loans, held-for-investment 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 loans with similar characteristics and credit quality.

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

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

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

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

**Note 11 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

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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**

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,



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

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

For the three months ended March 31, 2013, the Company incurred management fees of \$10.4 million (2012: \$8.6 million), of which \$10.4 million (2012: \$8.6 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 \$1.2 million for the three months ended March 31, 2013 (2012:\$592,000). Approximately \$934,000 (2012: \$550,000) was either prepaid or expensed for the three months ended March 31, 2013. Approximately \$234,000 (2012: \$42,000) was charged against equity as a cost of raising capital for the three months ended March 31, 2013.

### **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 12 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.

### **Exchangeable Senior Notes**

On March 12, 2013, a wholly owned subsidiary of the Company issued \$350.0 million in aggregate principal amount of Exchangeable Senior Notes (the Notes ) due 2018. Subsequently, on March 15, 2013, upon the exercise in full by the initial purchasers of such notes of their option to purchase additional notes, the wholly-owned subsidiary issued \$50.0 million in aggregate principal amount of the Notes, for a total of \$400.0 million in aggregate principal amount of the Notes. The total net proceeds to the Company after deducting financing expenses was \$387.9 million. The Notes may be exchanged for shares of the Company's common stock at the applicable exchange rate at any time prior to the close of business on the second scheduled trading day prior to the maturity date. The initial exchange rate for each \$1,000 aggregate principal amount of the Notes is 42.0893 shares of the Company's common stock, equivalent to an exchange price of approximately \$23.76 per share.

### **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

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

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### **Common Stock Public Offerings**

On January 28, 2013, the Company completed a public offering of 15,000,000 shares of our common stock and an issuance of an additional 2,250,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at \$21.00 per share, resulting in net proceeds of approximately \$359.0 million, after deducting underwriting discounts and estimated offering costs.

During the three months ended March 31, 2013, the Company issued 1,024,223 shares of common stock at an average price of \$21.61 under the DRSP with total proceeds to the Company of approximately \$22.0 million, net of issuance costs of \$130,000.

### **Preferred Stock Public Offering**

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 \$38,000 for the three months ended March 31, 2013 (2012: \$38,000). During the three months ended March 31, 2013, the Company issued 1,770 shares (2012: 2,208 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 using the closing stock market price on the date of the grant.

The Company recognized compensation expense of approximately \$62,000 for the three months ended March 31, 2013 (2012: \$40,000) related to awards to officers and employees of the Manager and its affiliates which is reimbursed by the Manager under the management agreement.

During March 2013, the Company issued 5,697 shares of common stock (net of tax withholding) in exchange for 8,783 restricted stock units that vested under the 2009 Equity Incentive Plan.

### **Dividends**

On March 19, 2013, the Company declared a dividend of \$0.65 per share of common stock. The dividend was paid on April 26, 2013 to shareholders of record as of the close of business on April 1, 2013.

On March 19, 2013, the Company declared a dividend of \$0.4844 per share of Series A Preferred Stock. The dividend was paid on April 25, 2013 to shareholders of record as of the close of business on April 1, 2013.

**Table of Contents****Note 13 Earnings per Share**

Earnings per share for the three months ended March 31, 2013 and 2012 is computed as follows:

\$ in thousands	Three Months Ended March 31,	
	2013	2012
<b>Numerator (Income)</b>		
Basic Earnings		
Net income available to common shareholders	83,992	83,082
Effect of dilutive securities:		
Income allocated to exchangeable senior debt	1,160	
Income allocated to non-controlling interest	962	1,026
<b>Dilutive net income available to shareholders</b>	<b>86,114</b>	<b>84,108</b>
<b>Denominator (Weighted Average Shares)</b>		
Basic Earnings:		
Shares available to common shareholders	128,888	115,398
Effect of dilutive securities:		
Restricted Stock Awards	26	23
OP Units	1,425	1,425
Exchangeable senior debt	3,741	
<b>Dilutive Shares</b>	<b>134,080</b>	<b>116,846</b>

**Note 14 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 March 31, 2013, non-controlling interest related to the outstanding 1,425,000 OP Units represented a 1.0% (2012: 1.2%) interest in the Operating Partnership, respectively. Income allocated to the Operating Partnership non-controlling interest for the three months ended March 31, 2013 was approximately \$962,000 (2012: \$1.0 million). For the three months ended March 31, 2013, distributions paid to the non-controlling interest were \$926,300 (2012: \$926,300).

**Note 15 Subsequent Events**

The Company has reviewed subsequent events occurring through the date that these consolidation financial statements were issued, and determined that no subsequent events occurred that would require accrual or additional disclosure.

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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, 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, including the impact of Congressional debate on the U.S. debt ceiling and budget deficit, 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 markets in which we invest;

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

our expected investments;

our expected book value per share of common stock;

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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;

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 maintain our qualification as a REIT for U.S. federal income tax purposes;

our ability to maintain our exception from the definition of investment company under the Investment Company Act of 1940, as amended (the 1940 Act );

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

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

availability of qualified personnel;

estimates relating to our ability to continue to make distributions to our shareholders in the future;

our understanding of our competition;

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.



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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, which is available on the SEC's website at [www.sec.gov](http://www.sec.gov).

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

The following discussion should be read in conjunction with our consolidated financial statements and the accompanying notes to our consolidated financial statements, which are included in this Report.

### **Overview**

We are a Maryland corporation primarily focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans which we collectively refer to as our target assets. We are externally managed and advised by Invesco Advisers, Inc., our Manager, which is an indirect, wholly-owned subsidiary of Invesco Ltd. We are a REIT for U.S. federal income tax purposes. Accordingly, we generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute currently to our shareholders as long as we maintain our qualification as a REIT. We operate our business in a manner that permits 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 the majority of our investments in Agency RMBS, non-Agency RMBS and CMBS through short-term borrowings structured as repurchase agreements. Our manager has secured commitments for us with a number of repurchase agreement counterparties. We have, in the past, financed our investments in certain non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing capital to the Invesco IMRF Fund that received financing under the U.S. government's PIPP, established and managed by our Manager or one of its affiliates, which, in turn, invests in our target assets.

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### **Recent Developments**

On January 28, 2013, we completed a public offering of 15,000,000 shares of our common stock and an issuance of an additional 2,250,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at \$21.00 per share, resulting in net proceeds of approximately \$359.0 million, after deducting underwriting discounts and estimated offering costs.

On March 12, 2013, our subsidiary issued \$350.0 million in aggregate principal amount of our Exchangeable Senior Notes (the "Notes") due 2018. Subsequently, on March 15, 2013, upon the exercise of the purchasers' option, our subsidiary issued \$50.0 million in aggregate principal amount of the Notes for a total of \$400.0 million. The Notes bear interest at 5.0% per annum, payable semi-annually in arrears on March 15 and September 15 of each year beginning September 15, 2013. The Notes are exchangeable into shares of our common stock at an initial exchange rate of 42.0893 shares of common stock per \$1,000 principal amount of the Notes, subject to adjustment under certain circumstances.

On March 19, 2013, we declared a dividend of \$0.65 per share of common stock. The dividend was paid on April 26, 2013 to shareholders of record as of the close of business on April 1, 2013.

On March 19, 2013, we declared a dividend of \$0.4844 per share of Series A Preferred Stock. The dividend was paid on April 25, 2013 to shareholders of record as of the close of business on April 1, 2013.

On March 28, 2013, we purchased a controlling interest in a securitization trust which we determined to be a VIE. The securitization trust securitized a pool of 488 residential mortgage loans with an aggregate principal amount of \$389.9 million and issued \$389.9 million aggregate principal amount of ABS, of which \$361.4 million of senior ABS and certain interest-only strips were sold to unaffiliated third parties, and \$28.5 million of subordinate ABS and certain interest-only and designated cash classes were purchased by the Company. We incurred \$1.9 million in debt issuance and organizational costs related to this purchase.

### **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 PPIP. Some of these programs have expired and the impact of the wind-down of these programs on the financial sector and on the economic recovery is unknown. Continuing 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, 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 in July 2010, contains numerous provisions affecting the financial and mortgage industries, many of which may have an impact on our operating environment and the target assets in which we invest. Consequently, the Dodd-Frank Act may affect our cost of doing business, may limit our investment opportunities and may affect the competitive balance within our industry and market areas.

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Operation Twist, was a program conducted by the U.S. Federal Reserve in 2011 and 2012. Pursuant to the first Operation Twist, instituted between September 2011 and June 2012, the Federal Reserve purchased \$400 billion of U.S. Treasury securities with remaining maturities between 6 and 30 years and sold an equal amount of U.S. Treasury securities with remaining maturities of 3 years or less. From July 2012 through December 2012, the Federal Reserve deployed \$267 billion to purchase Treasury securities with remaining maturities of 6 years to 30 years and sold or redeemed an equal amount of Treasury securities with remaining maturities of approximately 3 years or less. While it is difficult to identify the specific impact Operation Twist had on our business, the program generally reduced asset values and lowered the interest income we received.

In December 2012, the Federal Reserve announced that it would replace Operation Twist with another round of long-term asset purchases, or quantitative easing, pursuant to which the Federal Reserve will continue to purchase \$40 billion of Agency MBS as well as \$45 billion of longer-term Treasury securities per month. We expect that during these large scale purchases of Agency MBS, yields on Agency MBS values will be lower and refinancing volumes will be higher. As a result, returns on our Agency MBS may be adversely affected.

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 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 HARP until December 31, 2015. It does not change the time period in 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.

On January 30, 2013, 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 as long as the unemployment rate remains above 6.5% or until inflation reaches 2.5%. 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 March 31, 2013, 51.2% (2012: 52.0%) of our equity was invested in Agency RMBS, 39.1% (2012: 28.5%) in non-Agency RMBS, 21.1% (2012: 17.1%) in CMBS, 1.1% in residential loans (2012: 0%), held-for-investments and 1.2% (2012: 2.4%) in other investments. We use leverage on our target assets to achieve our return objectives. With respect to our MBS 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.

The change in allocations between our classes of assets reflects our views on the current risk/return opportunities in the market for our target assets.

As of March 31, 2013, we held \$12.2 billion (2012: \$7.4 billion) 30-year fixed rate Agency RMBS securities that offered higher coupons and call protection based on the collateral attributes. In addition, we held \$2.1 billion (2012: \$2.5 billion) in 15-year fixed rate Agency RMBS securities, \$486.3 million (2012: \$1.5 billion) in hybrid adjustable-rate mortgages Agency RMBS ( ARMs ) and approximately \$74.1 million (2012: \$177.8 million) in Agency ARM RMBS we believe to have similar durations based on prepayment speeds. As of March 31, 2013, we held \$3.6 billion (2012: \$2.3 billion) non-Agency RMBS.

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As of March 31, 2013, we owned \$2.4 billion (2012: \$1.2 billion) in CMBS. As of March 31, 2013, we held \$503.1 million (2012: \$456.8 million) in CMOs. In addition, as of March 31, 2013, we held \$405.5 million of Residential loans, held for investments, securitized by \$374.2 million of asset-backed securities issued.

During the three months ended March 31, 2013, we purchased \$4.6 billion (2012: \$2.3 billion) of mortgage-backed securities. The average yield on these purchases as of March 31, 2013 is 2.9% (2012: 3.1%).

During March 2013, we purchased a controlling interest in a \$389.9 million securitization trust which we considered a VIE. The VIE holds 488 residential mortgage loans paying interest at an aggregate weighted average fixed rate of 3.77% and having an original stated maturity of 30 years.

*Portfolio Characteristics*

The table below represents the vintage of our credit assets as of March 31, 2013:

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
Re-REMIC Senior (1)					0.2%		0.7%	5.0%	32.6%	11.2%		49.7%
Prime	0.5%	1.2%	4.6%	5.1%	13.2%	2.9%			0.3%		4.6%	32.4%
Alt-A		0.3%	5.3%	5.8%	6.2%							17.6%
Subprime		0.2%		0.1%								0.3%
Total Non-Agency	0.5%	1.7%	9.9%	11.0%	19.6%	2.9%	0.7%	5.0%	32.9%	11.2%	4.6%	100.0%
CMBS			15.1%	15.1%	0.9%			13.1%	34.5%	13.7%	7.6%	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 10.9% 2005, 37.8% 2006 and 51.3% 2007. Additionally, 6.2% of our Re-REMIC holdings are not senior classes.

The tables below represent the geographic concentration of the underlying collateral for our MBS portfolio as of March 31, 2013:

Non-Agency RMBS		CMBS	
State	Percentage	State	Percentage
California	48.7%	California	15.2%
Florida	7.3%	New York	11.8%
New York	6.2%	Texas	10.1%
Virginia	3.6%	Florida	5.5%
Maryland	3.2%	Illinois	5.3%
New Jersey	3.2%	Pennsylvania	4.0%
Washington	2.9%	Virginia	3.1%
Arizona	2.2%	New Jersey	3.0%
Colorado	2.2%	Ohio	2.9%
Illinois	2.0%	North Carolina	2.5%
Other	18.5%	Other	36.6%
Total	100.0%	Total	100.0%

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The vintage and geographic concentrations have not significantly changed since December 31, 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

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March 31, 2013, we had entered into repurchase agreements totalling \$17.9 billion. (2012: \$13.0 billion). The increase in the amount of the repurchase agreement balance was due to leveraging additional equity received during the year. 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 Fund ), which, in turn, invests in our target assets. As of March 31, 2013, \$82.9 million (2012: \$79.7 million) of our commitment to the Invesco IMRF Fund and AIV Fund has been called and we are committed to fund \$17.1 million (2012: \$20.3) 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 March 31, 2013 and December 31, 2012, the Company had investment related payables of \$ 305,000 and \$63.7 million, respectively, of which no items were outstanding greater than thirty days. The change in balance was primarily due to a decrease in unsettled mortgage-backed security purchases at the quarter ended March 31, 2013.

*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.

As of March 31, 2013, 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 \$10.7 billion (2012: \$6.9 billion) of borrowings under our repurchase agreements. As of March 31, 2013, included in this amount we had forward starting swaps with a total notional amount of \$2.7 billion, with starting dates ranging from February 21, 2013 to March 16, 2015. The increase in the amount of interest rate swaps was due to our view of interest rate risk and the expected duration of our investment portfolio and liabilities. We intend to continue to add interest rate hedge positions according to our hedging strategy.

### **Book Value per Share**

Our book value per common share was \$20.42 and \$20.83 as of March 31, 2013 and December 31, 2012, 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 consolidated balance sheet. Refer to Note 4 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.

**Table of Contents****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 2012 annual report on Form 10-K as filed with the SEC on March 1, 2013, and the only material change has been that we now also consolidate a variable interest entity ( VIE ) in which we are the primary beneficiary. The underlying loans owned by the VIE are shown under residential loans on our consolidated balance sheet. The asset-backed securities ( ABS ) issued to third parties by the VIE are shown under asset-backed securities issued. In our consolidated statements of income, we record interest income on the residential loans owned at the VIE and interest expense on the ABS issued by the VIE.

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

None.

**Results of Operations**

The table below presents certain information from our Consolidated Statement of Operations for the three month periods ending March 31, 2013 and 2012.

<b>\$ in thousands, except per share data</b>	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Interest income</b>		
Mortgage-backed securities	160,344	141,960
Residential loans	137	
Total interest income	160,481	141,960
<b>Interest expense</b>		
Repurchase agreements	66,328	55,285
Exchangeable senior note	1,160	
Asset-backed securities issued	79	
Total interest expense	67,567	55,285
<b>Net interest income</b>	92,914	86,675
<b>Other income</b>	6,650	7,202
<b>Expenses</b>		
Management fee – related party	10,354	8,639
General and administrative	1,543	1,130
<b>Total expenses</b>	11,897	9,769
Net income	87,667	84,108
Net income attributable to non-controlling interest	962	1,026

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Net income attributable to Invesco Mortgage Capital Inc.	86,705	83,082
Dividends to preferred shareholders	2,713	
Net income attributable to common shareholders	83,992	83,082



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<b>Earnings per share:</b>		
Net income attributable to common shareholders (basic)	0.65	0.72
Net income attributable to common shareholders (diluted)	0.64	0.72
Dividends declared per common share	0.65	0.65
<b>Weighted average number of shares of common stock:</b>		
Basic	128,888	115,398
Diluted	134,080	116,846

<b>\$ in thousands</b>	<b>As of and for the Three Months ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Average Balances*:</b>		
Agency RMBS:		
15 year fixed-rate, at amortized cost	2,045,062	2,461,408
30 year fixed-rate, at amortized cost	11,500,385	7,003,685
ARM, at amortized cost	97,460	177,279
Hybrid ARM, at amortized cost	527,379	1,468,048
MBS-CMO, at amortized cost	502,535	396,103
Non-Agency RMBS, at amortized cost	3,241,229	2,379,370
CMBS, at amortized cost	2,057,457	1,214,162
Residential Loans, at amortized cost	13,518	
Average MBS and Residential Loans portfolio	19,985,025	15,100,055
<b>Average Portfolio Yields (1):</b>		
Agency RMBS:		
15 year fixed-rate	2.19%	2.71%
30 year fixed-rate	2.84%	3.52%
ARM	2.13%	2.46%
Hybrid ARM	2.33%	2.59%
MBS - CMO	1.46%	1.85%
Non-Agency RMBS	4.63%	5.75%
CMBS	4.75%	5.59%
Residential Loans	4.05%	n/a
Average MBS and Residential Loans portfolio	3.21%	3.76%
<b>Average Borrowings*:</b>		
Agency RMBS	12,941,937	10,319,296
Non-Agency RMBS	2,524,189	1,787,893
CMBS	1,674,943	870,104
Exchangeable senior notes	84,444	
Asset-backed securities issued	12,473	
Total borrowed funds	17,237,986	12,977,293
Maximum borrowings during the period (2)	18,647,452	13,089,145
<b>Average Cost of Funds (3):</b>		
Agency RMBS	0.42%	0.32%
Non-Agency RMBS	1.73%	1.81%

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CMBS	1.48%	1.58%
Exchangeable senior note	5.49%	n/a
Asset-backed securities, issued	2.53%	n/a
Unhedged cost of funds	0.74%	0.61%
Hedged cost of funds	1.57%	1.70%
<b>Average Equity (4):</b>	<b>2,708,474</b>	<b>2,082,508</b>
Average debt/equity ratio (average during period)	6.36x	6.23x
Debt/equity ratio (as of period end)	6.40x	6.04x

\* Average amounts for each period are based on weighted month end balances, all percentages are annualized. For the three months ended March 31, 2013, the average balances are presented on an amortized cost basis. The three months ended March 31, 2012 has been reclassified 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. All yields are annualized.
- (2) Amount represents the maximum borrowings at month-end during each of the respective periods.
- (3) Average cost of funds is calculated by dividing annualized interest expense, by our average borrowings.
- (4) Average equity is calculated based on a weighted balance basis.

**Table of Contents****Net Income Summary**

For the three months ended March 31, 2013, our net income attributable to common shareholders was \$84.0 million (2012: \$83.1 million) or \$0.65 (2012: \$0.72) basic income per weighted average share available to common shareholders and \$0.64 (2012: \$0.72) diluted income per weighted average share available to common shareholders.

The increase in net income attributable to common shareholders for 2013 versus 2012 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 approximately \$4.9 billion for the three months ended March 31, 2013 compared to the three months ended March 31, 2012. Since March 31, 2012, we have raised approximately \$397.4 million in equity through follow-on common stock and preferred stock offerings and the share purchase feature 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 March 31, 2013, we had average earning assets of approximately \$20.0 billion (2012: \$15.1 billion) and earned interest income of \$160.5 million (2012: \$142.0 million). The yield on our average investment portfolio was 3.21% (2012: 3.76%). The decline in yield was primarily due to the continued low rate environment brought on by the Federal Reserve's quantitative easing.

The change in our average assets and the portfolio yield for three months ended March 31, 2013 versus March 31, 2012 was primarily attributable to the growth in our average investment portfolio resulting from our preferred stock and common stock offerings during 2012. Our average investment portfolio increased \$4.9 billion as of March 31, 2013 versus March 31, 2012.

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 12.5 and 14.6 for the three months ended March 31, 2013 and December 31, 2012, respectively. The table below shows the three month CPR for our RMBS compared to bonds with similar characteristics ( Cohorts ).

	March 31, 2013		December 31, 2012	
	Company	Cohort	Company	Cohort
15 year Agency RMBS	18.5	27.5	17.4	26.5
30 year Agency RMBS	9.5	19.5	11.6	20.9
Agency Hybrid ARM RMBS	25.6	NA	28.5	NA
Non-Agency RMBS	15.5	NA	17.7	NA
Overall	12.5	NA	14.6	NA

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### **Interest Expense and the Cost of Funds**

Our largest expense is the interest expense on borrowed funds. For the three months ended March 31, 2013, we had average borrowed funds of \$17.2 billion (2012: \$13.0 billion) and total interest expense of \$67.6 million (2012: \$55.3 million). The increase in average borrowed funds and interest expense was primarily the result of increasing the size of our investment portfolio, hedging costs from additional interest rate swaps and the issuance of our exchangeable senior debt.

For the three months ended March 31, 2013, our average cost of funds was 1.57% (2012: 1.70%). 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 under repurchase agreements, borrowing costs on our exchangeable senior debt, 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 March 31, 2013, totaled \$92.9 million (2012: \$86.7 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 March 31, 2013, was 1.64% (2012: 2.06%).

The increase in net interest income was primarily the result of increasing our investment portfolio with the proceeds from our follow-on common stock offerings. 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.

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

As part of our investment process, all of our MBS are continuously reviewed to determine if they continue to meet our risk and return targets. This process involves looking at changing market assumptions and the impact those assumptions will have on the individual securities. We sold securities and recognized net gain of approximately \$6.7 million for the three months ended March 31, 2013 (2012: \$6.0 million).

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

For the three months ended March 31, 2013, we recognized equity in earnings and unrealized gain on the change in fair value of our investment in the Invesco IMRF Fund of approximately \$345,000 (2012: \$353,000), and approximately \$148,000 (2012: \$151,000), respectively.

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 March 31, 2013, we recognized equity in loss and unrealized appreciation on the change in fair value of our investment in the IMRF LLC of approximately \$105,000 (2012: \$354,000 equity in earnings), and \$1.2 million (2012: \$152,000), respectively.

### **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 repurchase agreements change on a one to twelve month basis, we are continuously exposed to changing interest rates. Our objectives in using interest rate derivatives are to add stability to interest expense and to manage our exposure to interest rate movements. To accomplish these objectives, we primarily use interest rate 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

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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.

For the three months ended March 31, 2013, our unrealized loss on interest rate swaps and swaptions consists of approximately \$1,000 (2012: \$509,000) which represents the ineffective portion of the change in fair value of our interest rate swaps and \$2.0 million of unrealized losses which represents the change in fair value of our interest rate swaptions that are recognized directly in earnings.

On December 30, 2010, we entered into a credit default swap ( CDS ) contract. For the three months ended March 31, 2013 we recognized income of \$351,000 (2012: \$657,000) on our investment in the CDS of which \$223,000 (2012: \$168,000) is an unrealized loss based on change in the fair market value of the CDS and \$574,000 (2012: \$825,000) represents premium payments we receive for providing protection. The change in income was primarily due to the decline in the notional amount of the CDS.

## **Expenses**

For the three months ended March 31, 2013, we incurred management fees of \$10.4 million (2012: \$8.6 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 in 2012 and 2013. See "Certain Relationships, Related Transactions, and Director Independence" for a discussion of the management fee and our relationship with our Manager.

For the three months ended March 31, 2013, our general and administrative expense of approximately \$1.5 million (2012: \$1.1 million) include 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.

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

For the three months ended March 31, 2013, our net income after preferred dividends was \$85.0 million (2012: \$84.1 million) and our annualized return on average equity was 12.55% (2012: 16.16%). The change in net income after preferred dividends and average return on equity was primarily the result of increasing our investment portfolio from the proceeds of our common and preferred stock offerings and the changes in our portfolio composition 2013 and 2012. The decline in average return on equity was the result of lower asset yields on the portfolio as a result of the interest rate environment.

## **Liquidity and Capital Resources**

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

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required for continued qualification as a REIT. We generally maintain liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of these borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on our consolidated balance sheet is significantly less important than our potential liquidity available under borrowing arrangements.

We held cash and cash equivalents of \$274.5 million at March 31, 2013 (2012: \$155.8 million). 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 approximately \$121.6 million for the three month periods ended March 31, 2013 (2012: \$101.3 million). 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 \$20.0 billion in investments at March 31, 2013 as compared to \$15.1 billion at March 31, 2012.

Our investing activities used net cash of \$3.3 billion for the three month period ended March 31, 2013 (2012: \$877.2 million). During the three month period ended March 31, 2013 we utilized cash to purchase \$4.7 billion (2012: \$2.0 billion) in securities and \$405.3 million in residential loans which were offset by proceeds from asset sales of \$986.3 million (2012: \$570.4 million) and principal payments of \$742.1 million (2012: \$540.6 million). The increase in principal payments resulted from the larger portfolio at March 31, 2013 as compared to March 31, 2012.

Our financing activities for the three months ended March 31, 2013 consisted of net proceeds from our common stock offering in which we raised approximately \$381.3 million (2012: \$36,000) in equity, net proceeds from our repurchase agreements of \$2.2 billion (2012: \$753.3 million), net proceeds from the issuance our exchangeable senior notes of \$400.0 (2012: \$0) million and net proceeds from our issuance of asset-backed securities of \$374.2 million (2012: \$0).

The table below shows the allocation of our equity and debt-to-equity ratio as of March 31, 2013. 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.

<b>\$ in thousands</b>	<b>Agency</b>	<b>Non-Agency</b>	<b>CMBS</b>	<b>Residential Loans</b>	<b>Unconsolidated Ventures</b>	<b>Corporate Liability</b>	<b>Total</b>
Repurchase agreements	13,545,701	2,520,515	1,807,040				17,873,256
Asset-backed securities				374,196			374,196
Exchangeable note						400,000	400,000
Equity allocation	1,492,451	1,139,988	615,041	31,209	36,769	(400,000)	2,915,458
Debt / Equity Ratio	9.1	2.2	2.9	12.0			6.4
% of Total Equity	51.2%	39.1%	21.1%	1.1%	1.2%	(13.7)%	100.0%

As of March 31, 2013, the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount, which we also refer to as the haircut, under our repurchase agreements for Agency RMBS was approximately 4.60% (weighted by borrowing amount), under our repurchase agreements for non-Agency RMBS was approximately 18.12% and under our repurchase agreements for CMBS was approximately 18.69%. 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 50% and for CMBS range from a low of 10% to a high of 30%. Our hedged cost of funds was approximately 1.57% and 1.70% as of March 31, 2013 and December 31, 2012, 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.

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As discussed above under Market Conditions, the residential mortgage market in the United States, though improving, remains weak and is subject to the following conditions:

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

continued volatility 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 RBMS 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. On April 2, 2013, we registered and reserved for issuance 15,000,000 shares of our common stock pursuant to the DRSP. Under the terms of the DRSP, shareholders who participate in the DRSP may purchase shares of our common stock directly from us, in cash investments up to \$10,000, or greater than \$10,000 if we grant a request for waiver. At our sole discretion, we may accept optional cash investments in excess of \$10,000 per month, which may qualify for a discount from the market price of 0% to 3%. The DRSP participants may also automatically reinvest all or a portion of their dividends for additional shares of our stock. During the three months ended March 31, 2013, we issued 1,021,571 shares of common stock (2012: 2,496 shares) under the waiver feature of the DRSP.

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 March 31, 2013, we have not repurchased any shares under this program.

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

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

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





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

*Forward-Looking Statements Regarding Liquidity*

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

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

**Contractual Obligations**

We have entered into an agreement with our Manager pursuant to which our Manager is entitled to receive a management fee and the reimbursement of certain expenses. The management fee is calculated and payable quarterly in arrears in an amount equal to 1.50% of our shareholders' equity, per annum. Our Manager uses the proceeds from its management fee in part to pay compensation to its officers and personnel who, notwithstanding that certain of those individuals are also our officers, receive no cash compensation directly from us. We are required to reimburse our Manager for operating expenses related to us incurred by our Manager, including 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 11 Related Party Transactions for details of our reimbursements to our Manager.

**Contractual Commitments**

As of March 31, 2013, we had the following contractual commitments and commercial obligations:

\$ in thousands	Total	Payments Due by Period			After 5 years
		Less than 1 year	1-3 years	3-5 years	
<b>Obligations of Invesco Mortgage Capital Inc.</b>					
Repurchase agreements	17,873,256	17,873,256			
Invesco IMRF Fund and AIV Fund	17,139	17,139			
Exchangeable Senior Notes	400,000			400,000	
<b>Total contractual obligations</b>	<b>18,290,395</b>	<b>17,890,395</b>		<b>400,000</b>	
<b>Obligations of Entities Consolidated for Financial Reporting Purposes</b>					
Consolidated ABS (1)	361,424	63,862	98,259	68,623	130,680
Anticipated interest payments on ABS (2)	198,723	11,637	33,504	31,197	122,385
<b>Total Obligations of Entities Consolidated for Financial Reporting Purposes</b>	<b>560,147</b>	<b>75,499</b>	<b>131,763</b>	<b>99,820</b>	<b>253,065</b>
<b>Total Consolidated Obligations and Commitments</b>	<b>\$ 18,850,542</b>	<b>\$ 17,965,894</b>	<b>\$ 131,763</b>	<b>\$ 499,820</b>	<b>\$ 253,065</b>

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- (1) All consolidated ABS issued are collateralized by real estate loans and securities. Although the stated maturities are as shown, the ABS obligations will pay down as the principal balances of these real estate loans or securities pay down. The amount shown is the principal balances of the ABS issued and not necessarily the value reported in our consolidated financial statements.
- (2) The anticipated interest payments on consolidated ABS issued is calculated based on the contractual maturity of the ABS and therefore assumes no prepayments of the principal outstanding at March 31, 2013.

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As of March 31, 2013, we have approximately \$17.0 million in contractual interest payments related to our repurchase agreements and \$101.6 million on anticipated interest payments related to our exchangeable senior notes.

### **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 March 31, 2013 and 2012, approximately \$82.9 million and \$79.7 million of the commitment has been called, 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 30, 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%. The remaining notional amount of the CDS at March 31, 2013 is \$72.1 million (2012: \$103.3 million), and we estimated the fair market value of the CDS to be approximately \$1.3 million (2012: \$1.2 million) at March 31, 2013. As of March 31, 2013, we have not made any payments related to the CDS contract.

### **Shareholders' Equity**

On January 28, 2013, we completed a public offering of 15,000,000 shares of our common stock and an issuance of an additional 2,250,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at \$21.00 per share, resulting in net proceeds of approximately \$359.0 million, after deducting underwriting discounts and estimated offering costs.

During the three months ended March 31, 2013, we issued 1,024,223 shares of common stock at an average price of \$21.61 under the DRSP with total proceeds of approximately \$22.0 million.

### **Unrealized Gains and Losses**

Since we account for our investment securities as available-for-sale, unrealized fluctuations in market values of assets do not impact our U.S. GAAP income but rather are reflected on our consolidated balance 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 March 31, 2013, net unrealized loss included in shareholders' equity was \$51.7 million (2012: \$226.2 million gain).

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The increase in net unrealized loss is primarily attributable to changes in the market values of our cash flow hedges that qualify for hedge accounting. Refer to Note 4 Mortgage-Backed Securities and Note 8 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 March 31, 2013, we recognized compensation expense of approximately \$38,000 (2012: \$38,000) and issued 1,770 shares (2012: 2,208 shares) 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.

During March 2013, we issued 5,697 shares of common stock (net of tax withholding) in exchange for 8,783 restricted stock units which vested under the 2009 Equity Incentive Plan. The remaining restricted stock units awarded to the executive officers of the Company were forfeited.

## **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.

## **Inflation**

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

## **Unrelated Business Taxable Income**

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

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**Other Matters**

We believe 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 March 31, 2013. We also believe that our revenue qualifies for the 75% source of income test and for the 95% source of income test rules for the period ended March 31, 2013. Consequently, we believe we met the REIT income and asset test as of March 31, 2013. We also met all REIT requirements regarding the ownership of our common stock and the distribution of dividends of our net income as of March 31, 2013. Therefore, as of March 31, 2013, we believe that we qualified as a REIT under the Code.

At all times, we intend to conduct our business so that neither we nor our Operating Partnership nor the subsidiaries of our Operating Partnership are required to register as an investment company under the 1940 Act. If we were required to register as an investment company, then our use of leverage would be substantially reduced. Because we are a holding company that conducts our business through our Operating Partnership and the Operating Partnership's wholly-owned or majority-owned subsidiaries, the securities issued by these subsidiaries that are excepted from the definition of investment company under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act, together with any other investment securities the Operating Partnership may own, may not have a combined value in excess of 40% of the value of the Operating Partnership's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis, which we refer to as the 40% test. This requirement limits the types of businesses in which we are permitted to engage in through our subsidiaries. In addition, we believe neither we nor the Operating Partnership are considered an investment company under Section 3(a)(1)(A) of the 1940 Act because they do not engage primarily or hold themselves out as being engaged primarily in the business of investing, reinvesting or trading in securities. Rather, through the Operating Partnership's wholly-owned or majority-owned subsidiaries, we and the Operating Partnership are primarily engaged in the non-investment company businesses of these subsidiaries. IAS Asset I LLC and certain of the Operating Partnership's other subsidiaries that we may form in the future rely upon the exclusion from the definition of investment company under the 1940 Act provided by Section 3(c)(5)(C) of the 1940 Act, which is available for entities primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. This exclusion generally requires that at least 55% of each subsidiary's portfolio be comprised of qualifying assets and at least 80% be comprised of qualifying assets and real estate-related assets (and no more than 20% comprised of miscellaneous assets). Qualifying assets for this purpose generally include mortgage loans fully secured by real estate and other assets, such as whole pool Agency and non-Agency RMBS, that the SEC or its staff in various no-action letters has determined are the functional equivalent of mortgage loans fully secured by real estate. 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 March 31, 2013, 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, principal prepayment and market value. While we do not seek to avoid risk completely, we believe the risk can be quantified from historical experience and we seek to actively manage that risk, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

#### **Interest Rate Risk**

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

#### **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**

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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

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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 March 31, 2013, assuming a static portfolio. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager's expectations. The analysis presented utilized assumptions, models and estimates of our Manager based on our Manager's judgment and experience.

Change in Interest Rates	Percentage Change in Projected Net Interest Income	Percentage Change in Projected Portfolio Value
+1.00%	8.84%	(1.81)%
+0.50%	19.24%	(0.82)%
-0.50%	(23.54)%	0.56%
-1.00%	(51.34)%	0.53%

*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; 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. 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.



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### **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.

### **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 March 31, 2013. 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 three months ended March 31, 2013 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 March 31, 2013, we were not involved in any such legal proceedings.

**ITEM 1A. RISK FACTORS.**

Other than the risk factor set forth below, 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, 2012, as filed with the SEC on March 1, 2013. 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.

*Our exchangeable senior notes are recourse obligations to us.*

On March 12, 2013 and March 15, 2013, our Operating Partnership issued \$350,000,000 and \$50,000,000, respectively, in aggregate principal amount of its 5.00% Exchangeable Senior Notes due 2018 (the Notes). The Company is the sole general partner of the Operating Partnership and directly or indirectly conducts all of its business activities through the Operating Partnership and its subsidiaries. As a result, these amounts are full recourse obligations of the Company. If we are not able to extend, refinance or repurchase the Notes, we may not have the ability to repay these amounts when they come due. Our inability to repay the Notes could cause the acceleration of our other borrowings, which would have a material adverse effect on our business.

*The Notes contain cross-default provisions.*

The indenture governing the Notes contains cross-default provisions whereby a default or acceleration of borrowings under other agreements could result in a default under the indenture. If a cross-default occurred, we may not be able to pay our liabilities or access capital from external sources in order to refinance our borrowings. If some or all of our borrowings default and it causes a default under other borrowings, our business, financial condition and results of operations could be materially and adversely affected.

*The holders of the Notes may elect to exchange the Notes prior to maturity and we would be required to use common stock to satisfy our exchange obligations.*

The Notes may be exchanged at any time prior to maturity at the option of the holder in accordance with the terms of the indenture. At the time of the issuance of the Notes, we made an election to satisfy our exchange obligations with common stock in accordance with the indenture. If holders of the Notes determine to exchange their Notes prior to maturity, we would be required to use common stock to satisfy those exchanges, which could result in significant dilution to our existing stockholders. If the price of our common stock rises or our distributions increase, the economic incentive to exchange the Notes may increase.

**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.

May 8, 2013

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

May 8, 2013

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

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**EXHIBIT INDEX**

**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
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.
4.1	Indenture, dated March 12, 2013, by and among IAS Operating Partnership LP, as issuer, Invesco Mortgage Capital Inc., as guarantor, and The Bank of New York Mellon Trust Company, N.A., as trustee, including the form of 5.00% Exchangeable Senior Notes due 2018 and the related guarantee, incorporated by reference to Exhibit 4.1 to our Current Report on Form 8-K, filed with the Securities and Exchange Commission on March 15, 2013.
10.1	Registration Rights Agreement, dated March 12, 2013, among IAS Operating Partnership LP, Invesco Mortgage Capital Inc., Credit Suisse Securities (USA) LLC, Citigroup Global Markets Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K, filed with the Securities and Exchange Commission on March 15, 2013.
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	The following series of unaudited XBRL-formatted documents are collectively included herewith as Exhibit 101. The financial information is extracted from Invesco Mortgage Capital Inc.'s unaudited consolidated interim financial statements and notes that are included in this Form 10-Q Report.  101.INS XBRL Instance Document  101.SCH XBRL Taxonomy Extension Schema Document  101.CAL XBRL Taxonomy Calculation Linkbase Document  101.LAB XBRL Taxonomy Label Linkbase Document  101.PRE XBRL Taxonomy Presentation Linkbase Document  101.DEF XBRL Taxonomy Definition Linkbase Document  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.