UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012

OR

o **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: 1-13991

MFA FINANCIAL, INC.

(Exact name of registrant as specified in its charter)

Maryland	**13-3974868**
(State or other jurisdiction of	(I.R.S. Employer
incorporation or organization)	Identification No.)
350 Park Avenue, 20th Floor, New York, New York (Address of principal executive offices)	**10022** (Zip Code)

(212) 207-6400

(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 x No o

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

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.

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o	Smaller reporting company o

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

357,548,609 shares of the registrant s common stock, $0.01 par value, were outstanding as of October 25, 2012.

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MFA FINANCIAL, INC.

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Per Share Amounts)		September 30, 2012 (Unaudited)		December 31, 2011
Assets:				
Mortgage-backed securities (MBS):				
Agency MBS, at fair value ($6,902,954 and $6,666,963 pledged as collateral, respectively)	$	7,476,848	$	7,137,531
Non-Agency MBS, at fair value ($1,489,463 and $692,534 pledged as collateral, respectively)		2,541,846		1,492,376
Non-Agency MBS transferred to consolidated variable interest entities (VIEs) *(1)*		2,655,129		2,283,070
Securities obtained and pledged as collateral, at fair value		509,704		306,401
Cash and cash equivalents		450,442		394,022
Restricted cash		7,013		15,502
MBS linked transactions, net (Linked Transactions), at fair value		12,767		55,801
Interest receivable		44,980		42,837
Derivative hedging instruments, at fair value				26
Goodwill		7,189		7,189
Prepaid and other assets		29,251		15,879
Total Assets	$	13,735,169	$	11,750,634
Liabilities:				
Repurchase agreements	$	8,832,326	$	7,813,159
Securitized debt *(2)*		749,471		875,520
Obligation to return securities obtained as collateral, at fair value		509,704		306,401
8% Senior Notes due 2042 (Senior Notes)		100,000		
Accrued interest payable		14,117		9,112
Derivative hedging instruments, at fair value		78,169		114,220
Dividends and dividend equivalents rights (DERs) payable		76,051		97,525
Payable for unsettled purchases		126,035		27,056
Accrued expenses and other liabilities		10,142		9,881
Total Liabilities	$	10,496,015	$	9,252,874
Commitments and contingencies (Note 10)				
Stockholders Equity:				
Preferred stock, $.01 par value; series A 8.50% cumulative redeemable; 5,000 shares authorized; 3,840 shares issued and outstanding ($96,000 aggregate liquidation preference)	$	38	$	38
Common stock, $.01 par value; 895,000 shares authorized; 357,013 and 356,112 issued and outstanding, respectively		3,570		3,561
Additional paid-in capital, in excess of par		2,804,688		2,795,925
Accumulated deficit		(255,591)		(243,061)
Accumulated other comprehensive income/(loss)		686,449		(58,703)
Total Stockholders Equity	$	3,239,154	$	2,497,760
Total Liabilities and Stockholders Equity	$	13,735,169	$	11,750,634

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(1) Non-Agency MBS transferred to consolidated VIEs represent assets of the consolidated VIEs that can be used only to settle the obligations of each respective VIE.

(2) Securitized Debt represents third-party liabilities of consolidated VIEs and excludes liabilities of the VIEs acquired by the Company that eliminate in consolidation. The third-party beneficial interest holders in the VIEs have no recourse to the general credit of the Company. (See

Notes 10 and 15 for further discussion.)

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

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MFA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

(In Thousands, Except Per Share Amounts)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Interest Income:				
Agency MBS	$ 47,198	$ 59,957	$ 150,048	$ 186,114
Non-Agency MBS	37,087	24,379	95,555	76,098
Non-Agency MBS transferred to consolidated VIEs	40,812	46,405	128,502	110,435
Cash and cash equivalent investments	38	25	84	106
Interest Income	125,135	130,766	374,189	372,753
Interest Expense:				
Repurchase agreements	39,317	34,924	111,639	102,513
Securitized debt	4,477	3,828	13,186	8,087
Senior Notes	2,007		3,791	
Interest Expense	45,801	38,752	128,616	110,600
Net Interest Income	79,334	92,014	245,573	262,153
Other-Than-Temporary Impairments:				
Total other-than-temporary impairment losses		(14,913)	(879)	(15,550)
Portion of loss recognized in/(reclassified from) other comprehensive income		10,922	(321)	9,167
Net Impairment Losses Recognized in Earnings		(3,991)	(1,200)	(6,383)
Other Income, net:				
Unrealized net gains and net interest income from Linked Transactions	3,177	733	11,444	9,970
Gains on sales of MBS	4,279	4,196	7,232	4,196
Revenue from operations of real estate held-for-sale		390		1,146
Other, net	1	(898)	2	(886)
Other Income, net	7,457	4,421	18,678	14,426
Operating and Other Expense:				
Compensation and benefits	5,984	5,477	16,752	15,591
Other general and administrative expense	2,666	3,031	8,679	7,981
Real estate held-for-sale operating expense		237		774
Operating and Other Expense	8,650	8,745	25,431	24,346
Net Income	78,141	83,699	237,620	245,850
Less: Preferred Stock Dividends	2,040	2,040	6,120	6,120
Net Income Available to Common Stock and Participating Securities	$ 76,101	$ 81,659	$ 231,500	$ 239,730
Earnings per Common Share - Basic and Diluted	$ 0.21	$ 0.23	$ 0.65	$ 0.71
Dividends Declared per share of Common Stock	$ 0.21	$ 0.25	$ 0.68	$ 0.74

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

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MFA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME/(LOSS)

(UNAUDITED)

(In Thousands)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Net Income	$ 78,141	$ 83,699	$ 237,620	$ 245,850
Other Comprehensive Income/(Loss):				
Unrealized gain on Agency MBS, net	61,999	12,035	47,169	50,092
Unrealized gain/(loss) on Non-Agency MBS, net	409,742	(109,294)	666,287	(250,845)
Reclassification adjustment for MBS sales included in net income	(3,130)	(4,525)	(5,529)	(4,869)
Reclassification adjustment for other-than-temporary impairments included in net income		3,991	1,200	6,383
Unrealized gain/(loss) on derivative hedging instruments, net	11,654	(10,255)	36,025	4,483
Other Comprehensive Income/(Loss)	480,265	(108,048)	745,152	(194,756)
Comprehensive income/(loss) before preferred stock dividends	$ 558,406	$ (24,349)	$ 982,772	$ 51,094
Dividends declared on preferred stock	(2,040)	(2,040)	(6,120)	(6,120)
Comprehensive Income/(Loss) Available to Common Stock and Participating Securities	$ 556,366	$ (26,389)	$ 976,652	$ 44,974

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

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MFA FINANCIAL, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

(UNAUDITED)

(In Thousands, Except Per Share Amounts)	**Nine Months Ended September 30, 2012**		
		Dollars	**Shares**
Preferred Stock, Series A 8.50% Cumulative Redeemable Liquidation Preference $25.00 per Share:			
Balance at September 30, 2012 and December 31, 2011	$	38	3,840
Common Stock, Par Value $.01:			
Balance at December 31, 2011		3,561	356,112
Issuance of common stock		9	901
Balance at September 30, 2012		3,570	357,013
Additional Paid-in Capital, in excess of Par:			
Balance at December 31, 2011		2,795,925	
Issuance of common stock, net of expenses		4,389	
Equity-based compensation expense		4,374	
Balance at September 30, 2012		2,804,688	
Accumulated Deficit:			
Balance at December 31, 2011		(243,061)	
Net income		237,620	
Dividends declared on common stock		(242,970)	
Dividends declared on preferred stock		(6,120)	
Dividends attributable to DERs		(1,060)	
Balance at September 30, 2012		(255,591)	
Accumulated Other Comprehensive Income:			
Balance at December 31, 2011		(58,703)	
Change in unrealized gains on MBS, net		709,127	
Change in unrealized losses on derivative hedging instruments		36,025	
Balance at September 30, 2012		686,449	
Total Stockholders Equity at September 30, 2012	$	3,239,154	

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

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MFA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(In Thousands)	Nine Months Ended September 30, 2012		2011	
Cash Flows From Operating Activities:				
Net income	$	237,620	$	245,850
Adjustments to reconcile net income to net cash provided by operating activities:				
Gain on sales of MBS		(7,232)		(4,196)
Other-than-temporary impairment charges		1,200		6,383
Accretion of purchase discounts on MBS		(28,173)		(33,159)
Amortization of purchase premiums on MBS		38,175		26,779
Increase in interest receivable		(1,998)		(6,125)
Depreciation and amortization on real estate and other assets		2,471		2,263
Unrealized (gains)/losses and other on Linked Transactions		(8,851)		4,831
Increase in prepaid and other assets		(10,342)		(47)
Increase in accrued expenses and other liabilities		344		37
Increase/(decrease) in accrued interest payable		5,005		(529)
Equity-based compensation expense		4,374		2,983
Net cash provided by operating activities	$	232,593	$	245,070
Cash Flows From Investing Activities:				
Principal payments on MBS	$	1,977,366	$	1,688,520
Proceeds from sale of MBS		137,079		76,495
Purchases of MBS		(2,896,359)		(4,430,941)
Additions to leasehold improvements, furniture, fixtures and real estate investment		(367)		(2,004)
Net cash used in investing activities	$	(782,281)	$	(2,667,930)
Cash Flows From Financing Activities:				
Principal payments on repurchase agreements	$	(48,911,503)	$	(43,843,055)
Proceeds from borrowings under repurchase agreements		49,930,670		45,821,751
Proceeds from issuance of securitized debt		186,691		963,255
Principal payments on securitized debt		(312,740)		(225,782)
Payments made for resecuritization related costs		(1,814)		(6,981)
Proceeds from issuance of Senior Notes		100,000		
Payments made for Senior Notes related costs		(3,415)		
Cash disbursements on financial instruments underlying Linked Transactions		(513,418)		(2,051,908)
Cash received from financial instruments underlying Linked Transactions		390,363		1,464,965
Payments made for margin calls on repurchase agreements and interest rate swap agreements (Swaps)		(2,390)		(8,460)
Proceeds from reverse margin calls on repurchase agreements and Swaps		10,890		25,914
Payment made to purchase interest rate swaption (Swaption)				(915)
Proceeds from issuances of common stock		4,398		605,765
Dividends paid on preferred stock		(6,120)		(6,120)
Dividends paid on common stock and DERs		(265,504)		(239,786)
Net cash provided by financing activities	$	606,108	$	2,498,643
Net increase in cash and cash equivalents	$	56,420	$	75,783
Cash and cash equivalents at beginning of period	$	394,022	$	345,243
Cash and cash equivalents at end of period	$	450,442	$	421,026

Non-cash Investing and Financing Activities:				
MBS recorded upon de-linking of Linked Transactions	$	174,940	$	744,231
Repurchase agreements recorded upon de-linking of Linked Transactions	$		$	46,698
Securities obtained as collateral	$	203,303	$	
Dividends and DERs declared and unpaid	$	76,051	$	90,200

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

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MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2012

1. Organization

MFA Financial, Inc. (the Company) was incorporated in Maryland on July 24, 1997 and began operations on April 10, 1998. The Company has elected to be treated as a real estate investment trust (REIT) for federal income tax purposes. In order to maintain its qualification as a REIT, the Company must comply with a number of requirements under federal tax law, including that it must distribute at least 90% of its annual REIT taxable income to its stockholders. (See Note 11(b))

2. Summary of Significant Accounting Policies

(a) Basis of Presentation and Consolidation

The interim unaudited financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been condensed or omitted according to these SEC rules and regulations. Management believes that the disclosures included in these interim financial statements are adequate to make the information presented not misleading. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2011. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at September 30, 2012 and results of operations for all periods presented have been made. The results of operations for the nine months ended September 30, 2012 should not be construed as indicative of the results to be expected for the full year.

The consolidated financial statements of the Company have been prepared on the accrual basis of accounting in accordance with GAAP. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although the Company s estimates contemplate current conditions and how it expects them to change in the future, it is reasonably possible that actual conditions could be worse than anticipated in those estimates, which could materially impact the Company s results of operations and its financial condition. Management has made significant estimates in several areas, including other-than-temporary impairment (OTTI) on Agency and Non-Agency MBS (Note 3), valuation of Agency and Non-Agency MBS (Notes 3 and 14), derivative hedging instruments (Notes 4 and 14), and income recognition on certain Non-Agency MBS purchased at a discount (Note 3). Actual results could differ from those estimates.

The consolidated financial statements of the Company include the accounts of all subsidiaries; significant intercompany accounts and transactions have been eliminated. Certain prior period amounts have been reclassified to conform to the current period presentation.

(b) Agency and Non-Agency MBS (including Non-Agency MBS transferred to a consolidated VIE)

The Company has investments in residential MBS that are issued or guaranteed as to principal and/or interest by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or any agency of the U.S. Government, such as Ginnie Mae (collectively, Agency MBS), and residential MBS that are not guaranteed by any U.S. Government agency or any federally chartered corporation (Non-Agency MBS), as described in Note 3.

Designation

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

Upon the sale of an investment security, any unrealized gain or loss is reclassified out of accumulated other comprehensive income/(loss) to earnings as a realized gain or loss using the specific identification method.

Revenue Recognition, Premium Amortization and Discount Accretion

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

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MFA FINANCIAL, INC.

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

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

Determination of MBS Fair Value

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

Impairments/OTTI

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

Non-Agency MBS that are purchased at significant discounts to par and/or are otherwise assessed to be of less than high credit quality on which impairments are recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. The Company s estimate of cash flows for its Non-Agency MBS is based on its review of the underlying mortgage loans securing the MBS. The Company considers information available about the past and expected future performance of underlying mortgage loans, including timing of expected future cash flows, prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, Fair Isaac Corporation (FICO) scores at loan origination, year of origination, loan-to-value ratios, geographic concentrations, as well as reports by credit rating agencies, such as Moody s Investors Services, Inc. (Moody s), Standard & Poor s Corporation (S&P), or Fitch, Inc. (collectively, Rating Agencies), general market assessments, and dialogue with market participants. As a result, significant judgment is used in the Company s analysis to determine the expected cash flows for its Non-Agency MBS. In determining the OTTI related to credit losses for securities that were purchased at significant discounts to par and/or are considered to be of less than high credit quality, the Company compares the present value of the remaining cash flows expected to be collected at the purchase date (or last date previously revised) against the present value of the cash flows expected to be collected at

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MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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the current financial reporting date. The discount rate used to calculate the present value of expected future cash flows is the current yield used for income recognition purposes. Impairment assessment for Non-Agency MBS that were purchased at prices close to par and are considered to be of high credit quality involves comparing the present value of the remaining cash flows expected to be collected against the amortized cost of the security at the assessment date. The discount rate used to calculate the present value of the expected future cash flows is based on the instrument s effective interest rate.

Balance Sheet Presentation

The Company s MBS pledged as collateral against repurchase agreements and Swaps are included in MBS on the consolidated balance sheets with the fair value of the MBS pledged disclosed parenthetically. Purchases and sales of securities are recorded on the trade date. However, if on the purchase settlement date, a repurchase agreement is used to finance the purchase of an MBS with the same counterparty and such transactions are determined to be linked, then the MBS and linked repurchase borrowing will be reported on the same settlement date as Linked Transactions. (See Notes 2(n) and 4)

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

The Company has obtained securities as collateral under collateralized financing arrangements in connection with its financing strategy for Non-Agency MBS. Securities obtained as collateral in connection with these transactions are recorded on the Company s consolidated balance sheet as an asset along with a liability representing the obligation to return the collateral obtained, at fair value. While beneficial ownership of securities obtained remains with the counterparty, the Company has the right to sell the collateral obtained or to pledge it as part of a subsequent collateralized financing transaction. (See Note 2(i) for Repurchase Agreements and Reverse Repurchase Agreements)

(d) Cash and Cash Equivalents

Cash and cash equivalents include cash on deposit with financial institutions and investments in money market funds, all of which have original maturities of three months or less. Cash and cash equivalents may also include cash pledged as collateral to the Company by its repurchase agreement and/or Swap counterparties as a result of reverse margin calls (i.e., margin calls made by the Company). The Company did not hold any cash pledged by its counterparties at September 30, 2012 or December 31, 2011. At September 30, 2012 and December 31, 2011, all of the Company s cash investments were comprised of overnight money market funds, which are not bank deposits and are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. (See Notes 8 and 14)

(e) Restricted Cash

Restricted cash represents the Company s cash held by its counterparties as collateral against the Company s Swaps and/or repurchase agreements. Restricted cash, which earns interest, is not available to the Company for general corporate purposes, but may be applied against amounts due to counterparties to the Company s repurchase agreements and/or Swaps, or returned to the Company when the collateral requirements are exceeded or at the maturity of the Swap or repurchase agreement. The Company had aggregate restricted cash held as collateral against its Swaps of $7.0 million and $15.5 million at September 30, 2012 and December 31, 2011, respectively. (See Notes 4, 7, 8 and 14)

(f) Goodwill

At September 30, 2012 and December 31, 2011, the Company had goodwill of $7.2 million, which represents the unamortized portion of the excess of the fair value of its common stock issued over the fair value of net assets acquired in connection with its formation in 1998. Goodwill is tested for impairment at least annually, or more frequently under certain circumstances, at the entity level. Through September 30, 2012, the Company had not recognized any impairment against its goodwill.

(g) Depreciation

Real Estate

During 2011 the Company had 100% of the ownership interest in Lealand Place, a 191-unit apartment property located in Lawrenceville, Georgia, through Lealand Place, LLC (Lealand), an indirect, wholly-owned subsidiary. This property was acquired through a tax-deferred exchange under Section 1031 of the Internal Revenue Code of 1986, as amended (the Code). This investment was sold for cash proceeds of $11.4 million, resulting in a gain on sale in the fourth quarter of 2011 of $430,000. (See Note 6)

MFA FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2012

The property, capital improvements and other assets held in connection with this investment were carried at cost, net of accumulated depreciation and amortization. Maintenance, repairs and minor improvements were expensed in the period incurred, while real estate assets, except land, and capital improvements were depreciated over their useful life using the straight-line method. The estimated life was 27.5 years for buildings and five to seven years for furniture and fixtures.

Leasehold Improvements and Other Depreciable Assets

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

(h) Resecuritization and Senior Notes Related Costs

Resecuritization related costs are costs associated with the issuance of beneficial interests by consolidated VIEs and incurred by the Company in connection with various resecuritization transactions completed by the Company. Senior Notes related costs are costs incurred by the Company in connection with the issuance of its Senior Notes in April, 2012. These costs may include underwriting, rating agency, legal, accounting and other fees. Such costs, which reflect deferred charges, are included on the Company s consolidated balance sheet in prepaid and other assets. These deferred charges are amortized as an adjustment to interest expense using the effective interest method, based upon the actual repayments of the associated beneficial interests issued to third parties and over the stated legal maturity of the Senior Notes.

(i) Repurchase Agreements and Reverse Repurchase Agreements

The Company finances the acquisition of a significant portion of its MBS with repurchase agreements. Under repurchase agreements, the Company sells securities to a lender and agrees to repurchase the same securities in the future for a price that is higher than the original sale price. The difference between the sale price that the Company receives and the repurchase price that the Company pays represents interest paid to the lender. Although legally structured as sale and repurchase transactions, the Company accounts for repurchase agreements as secured borrowings, with the exception of certain repurchase agreements accounted for as components of Linked Transactions. (See Note 2(n) below) Under its repurchase agreements, the Company pledges its securities as collateral to secure the borrowing, which is equal in value to a specified percentage of the fair value of the pledged collateral, while the Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase financing, unless the repurchase financing is renewed with the same counterparty, the Company is required to repay the loan including any accrued interest and concurrently receives back its pledged collateral from the lender. With the consent of the lender, the Company may renew a repurchase financing at the then prevailing financing terms. Margin calls, whereby a lender requires that the Company pledge additional securities or cash as collateral to secure borrowings under its repurchase financing with such lender, are routinely experienced by the Company when the value of the MBS pledged as collateral declines as a result of principal amortization and prepayments or due to changes in market interest rates, spreads or other market conditions. The Company also may make margin calls on counterparties when collateral values increase.

The Company s repurchase financings typically have terms ranging from one month to six months at inception, but may also have longer or shorter terms. Should a counterparty decide not to renew a repurchase financing at maturity, the Company must either refinance elsewhere or be in a position to satisfy the obligation. If, during the term of a repurchase financing, a lender should default on its obligation, the Company might experience difficulty recovering its pledged assets which could result in an unsecured claim against the lender for the difference between the amount loaned to the Company plus interest due to the counterparty and the fair value of the collateral pledged by the Company to such lender, including accrued interest receivable on such collateral. The Company enters into repurchase agreements with multiple counterparties with a maximum loan from any lender of no more than three times the Company s stockholders equity. (See Notes 2(n), 4, 7, 8 and 14)

In addition to the repurchase agreement financing arrangements discussed above, as part of its financing strategy for Non-Agency MBS, the Company has entered into contemporaneous repurchase and reverse repurchase agreements with a single counterparty. Under a typical reverse repurchase agreement, the Company buys securities from a borrower for cash and agrees to sell the same securities in the future for a price that is higher than the original purchase price. The difference between the purchase price the Company originally paid and the sale price represents interest received from the borrower. In contrast, the contemporaneous repurchase and reverse repurchase transactions effectively resulted in the Company pledging Non-Agency MBS as collateral to the counterparty in connection with the repurchase agreement financing and obtaining U.S. Treasury securities as collateral from the same counterparty in connection with the reverse repurchase agreement. No net cash was exchanged between the Company and counterparty at the inception of the transactions. Securities obtained and pledged as collateral are recorded as an asset on the Company s consolidated balance sheet. Interest income is recorded on the reverse

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repurchase agreement and interest expense is recorded on the repurchase agreement on an accrual basis. Both the Company and the counterparty have the right to make daily margin calls based on changes in the value of the collateral obtained and/or pledged. The Company s liability to the counterparty in connection with this financing arrangement is recorded on the Company s consolidated balance sheet and disclosed as Obligation to return securities obtained as collateral. (See Note 2(c))

(j) Equity-Based Compensation

Compensation expense for equity based awards is recognized ratably over the vesting period of such awards, based upon the fair value of such awards at the grant date. With respect to awards granted in 2009 and prior years, the Company has applied a zero forfeiture rate for these awards, as they were granted to a limited number of employees, and historical forfeitures have been minimal. Forfeitures, or an indication that forfeitures are expected to occur, may result in a revised forfeiture rate and would be accounted for prospectively as a change in estimate.

During 2010, the Company granted certain restricted stock units (RSUs) that vest after either two or four years of service and provided that certain criteria are met, which are based on a formula that includes changes in the Company s closing stock price over a two- or four-year period and dividends declared on the Company s common stock during those periods. During 2011 and 2012, the Company granted certain RSUs that vest annually over a three-year period, provided that certain criteria are met, which are based on a formula that includes changes in the Company s closing stock price over the annual vesting period and dividends declared on the Company s common stock during those periods. Such criteria constitute a market condition which impacts the amount of compensation expense recognized for these awards. Specifically, the uncertainty regarding whether the market condition will be achieved is reflected in the grant date fair valuation of the RSUs, which in addition to estimates regarding the amount of RSUs expected to be forfeited during the associated service period, determines the amount of compensation expense that is recognized. Compensation expense is not reversed should the market condition not be achieved, while differences in actual forfeiture experience relative to estimated forfeitures will result in adjustments to the timing and amount of compensation expense recognized.

The Company has awarded DERs that may be attached to or awarded separately from other equity based awards. Compensation expense for separately awarded DERs is based on the grant date fair value of such awards and is recognized over the vesting period. Payments pursuant to these DERs are charged to stockholders equity. Payments pursuant to DERs that are attached to equity based awards are charged to stockholders equity to the extent that the attached equity awards are expected to vest. Compensation expense is recognized for payments made for DERs to the extent that the attached equity awards do not or are not expected to vest and grantees are not required to return payments of dividends or DERs to the Company. (See Notes 2(k) and 13)

(k) Earnings per Common Share (EPS)

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

(l) Comprehensive Income/(Loss)

The Company s comprehensive income/(loss) available to common stock and participating securities includes net income, the change in net unrealized gains/(losses) on its MBS and its derivative hedging instruments, currently comprised of Swaps, (to the extent that such changes are not recorded in earnings), adjusted by realized net gains/(losses) reclassified out of accumulated other comprehensive income/(loss) for MBS and is reduced by dividends declared on the Company s preferred stock.

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(m) U.S. Federal Income Taxes

The Company has elected to be taxed as a REIT under the provisions of the Code and the corresponding provisions of state law. The Company expects to operate in a manner that will enable it to continue to be taxed as a REIT. A REIT is not subject to tax on its earnings to the extent that it distributes at least 90% of its annual REIT taxable income to its stockholders. As such, no provision for current or deferred income taxes has been made in the accompanying consolidated financial statements. To the extent that the Company incurs interest and/or penalties in connection with its tax obligations, such amounts shall be classified as income tax expense on the Company s consolidated statements of operations.

(n) Derivative Financial Instruments

Hedging Activity

As part of the Company s interest rate risk management, it periodically hedges a portion of its interest rate risk using derivative financial instruments, currently comprised of Swaps. Hedge accounting is used to account for these instruments.

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

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

Although permitted under certain circumstances, the Company does not offset cash collateral receivables or payables against its net derivative positions. (See Notes 4, 8 and 14)

Swaps

Swaps are carried on the Company s balance sheet at fair value, as assets, if their fair value is positive, or as liabilities, if their fair value is negative. Changes in the fair value of the Company s Swaps are recorded in other comprehensive income/(loss) provided that the hedge remains effective. Changes in fair value for any ineffective amount of a Swap are recognized in earnings. The Company has not recognized any change in the value of its existing Swaps through earnings as a result of hedge ineffectiveness.

Swaptions

As part of its strategy to hedge its exposure to increases in interest rates, the Company in 2011 purchased a Swaption, which gave it the right, but not the obligation, to enter into a Swap at a future date. This contract expired unexercised in early 2012. Swaptions are carried as assets on the Company s balance sheet at fair value. Changes in the intrinsic value of the Swap underlying the Swaption are recorded in other comprehensive income/(loss), a component of stockholders equity, provided that the hedge remains effective, while changes in the time value of the Swaption are recorded as gains/losses through earnings as a component of other income during the option period. The Company uses the cumulative dollar-offset ratio to assess the hedge effectiveness of its Swaptions.

Non-Hedging Activity/Linked Transactions

It is presumed that the initial transfer of a financial asset (i.e., the purchase of an MBS by the Company) and contemporaneous repurchase financing of such MBS with the same counterparty are considered part of the same arrangement, or a linked transaction, unless certain criteria are met. The two components of a linked transaction (MBS purchase and repurchase financing) are not reported separately but are evaluated on a combined basis and reported as a forward (derivative) contract and are presented as Linked Transactions on the Company s consolidated balance sheet. Changes in the fair value of the assets and liabilities underlying Linked Transactions and associated interest income and expense are reported as unrealized net gains/(losses) and net interest income from Linked Transactions on the Company s consolidated statements of operations and are not included in other comprehensive income/(loss). However, if certain criteria are met, the initial transfer (i.e., the purchase of a security by the Company) and repurchase financing will not be treated as a Linked Transaction and will be evaluated and reported separately, as an MBS purchase and repurchase financing. When or if a transaction is no longer considered to be linked, the MBS and repurchase financing will be reported on a gross basis. In this case, the fair value of the MBS at the time the transactions are no longer considered linked will become the cost basis of the MBS, and the income recognition yield for such MBS will be calculated prospectively using this new cost basis. (See Notes 4 and 14)

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

The Company s presentation of fair value for its financial assets and liabilities is determined within a framework that stipulates that the fair value of a financial asset or liability is an exchange price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. This definition of fair value is based on a consistent definition of fair value which focuses on exit price and prioritizes the use of market-based inputs over entity-specific inputs when determining fair value. In addition, the framework for measuring fair value establishes a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. (See Note 14)

Although permitted under GAAP to measure many financial instruments and certain other items at fair value, the Company has not elected the fair value option for any of its assets or liabilities. If the fair value option is elected, unrealized gains and losses on such items for which fair value is elected would be recognized in earnings at each subsequent reporting date. A decision to elect the fair value option for an eligible financial instrument, which may be made on an instrument by instrument basis, is irrevocable.

(p) Variable Interest Entities

An entity is referred to as a VIE if it meets at least one of the following criteria: (1) the entity has equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support of other parties; or (2) as a group, the holders of the equity investment at risk lack (a) the power to direct the activities of an entity that most significantly impact the entity s economic performance; (b) the obligation to absorb the expected losses; or (c) the right to receive the expected residual returns; or (3) have disproportional voting rights and the entity s activities are conducted on behalf of the investor that has disproportionally few voting rights.

The Company consolidates a VIE when it has both the power to direct the activities that most significantly impact the economic performance of the VIE and a right to receive benefits or absorb losses of the entity that could be potentially significant to the VIE. The Company is required to reconsider its evaluation of whether to consolidate a VIE each reporting period, based upon changes in the facts and circumstances pertaining to the VIE.

The Company has entered into resecuritization transactions which result in the Company consolidating the VIEs that were created to facilitate the transactions and to which the underlying assets in connection with the resecuritizations were transferred. In determining the accounting treatment to be applied to these resecuritization transactions, the Company evaluated whether the entities used to facilitate these transactions were VIEs and, if so, whether they should be consolidated. Based on its evaluation, the Company concluded that the VIEs should be consolidated. If the Company had determined that consolidation was not required, it would have then assessed whether the transfer of the underlying assets would qualify as a sale or should be accounted for as secured financings under GAAP.

Prior to the completion of its initial resecuritization transaction in October 2010, the Company had not transferred assets to VIEs or Qualifying Special Purpose Entities (QSPEs) and other than acquiring MBS issued by such entities, had no other involvement with VIEs or QSPEs. (See Note 15)

(q) New and Proposed Accounting Standards and Interpretations

Accounting Standards Adopted in 2012

Transfers and Servicing

In April 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-03, *Reconsideration of Effective Control for Repurchase Agreements,* (ASU 2011-03), which changes the assessment of whether repurchase agreement transactions should be accounted for as sales or secured financings. In a typical repurchase agreement transaction, an entity transfers financial assets to the counterparty in exchange for cash with an agreement for the counterparty to return the same or equivalent financial assets for a fixed price in the future. Prior to this update, one of the factors in determining whether sale treatment could be used was whether the transferor maintained effective control of the transferred assets and in order to do so, the transferor must have the ability to repurchase such assets. This ASU changes the assessment of effective control by focusing on a transferor s contractual rights and obligations with respect to transferred financial assets, rather than whether the transferor has the practical ability to perform in accordance with those rights or obligations. ASU 2011-03 was effective for the Company for the first interim or annual period beginning on or after December 15, 2011. With the exception of Linked Transactions, the Company records repurchase agreements as secured borrowings and not sales,

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and accordingly, the adoption of this update on January 1, 2012 did not have a material impact on the Company s consolidated financial statements.

Fair Value Measurements and Disclosures

In May 2011, the FASB issued ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, (ASU 2011-04) further converging U.S. GAAP and International Financial Reporting Standards (IFRS) by providing common fair value measurement and disclosure requirements. The amendments in this update change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. These include those that clarify the FASB s intent about the application of existing fair value measurement and disclosure requirements and those that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. ASU 2011-04 was effective for the Company for interim and annual reporting periods beginning after December 15, 2011 and upon adoption on January 1, 2012, did not have a material impact on the Company s consolidated financial statements.

Comprehensive Income

In June 2011, the FASB issued ASU 2011-05, *Presentation of Comprehensive Income*, (ASU 2011-05) which allows an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income (OCI) either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Either presentation requires the presentation on the face of the financial statements any reclassification adjustments for items that are reclassified from OCI to net income in the statement(s) where the components of net income and the components of OCI are presented. There is no change in what must be reported in OCI or when an item of OCI must be reclassified to net income. ASU 2011-05 requires retrospective application and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. In December 2011, the FASB issued ASU 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*, (ASU 2011-12) which defers certain aspects of ASU 2011-05. Specifically, ASU 2011-12 defers the effective date for the requirements of ASU 2011-05 to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and OCI for all periods presented. All other requirements of ASU 2011-05 are not affected by this update. ASU 2011-12 requires retrospective application and was effective for the Company for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company s adoption of ASU 2011-05 and ASU 2011-12 beginning on January 1, 2012 did not have a material impact on the Company s consolidated financial statements.

Intangibles Goodwill and Other

In September 2011, the FASB issued ASU 2011-08, *Testing Goodwill for Impairment*, (ASU 2011-08) which simplifies how entities test goodwill for impairment. Under ASU 2011-08, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads the entity to determine that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. If the entity concludes otherwise, then it is required to test goodwill for impairment under the currently prescribed two-step process. ASU 2011-08 was effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The Company s adoption of ASU 2011-08 beginning on January 1, 2012, did not have a material impact on its consolidated financial statements.

Recent Accounting Standards to be Adopted in Future Periods

Balance Sheet

In December 2011, the FASB issued ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*, (ASU 2011-11) regarding disclosures concerning the offsetting of assets and liabilities. Under ASU 2011-11, an entity is 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 transactions subject to an agreement similar to a master netting arrangement. The scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. This disclosure is intended to support further the convergence of U.S. GAAP and IFRS requirements. ASU 2011-11 is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The adoption of this ASU is not expected to have a material impact on the Company s consolidated financial statements.

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Proposed Accounting Standards

The FASB has recently issued or discussed a number of proposed standards on such topics as investment companies and investment property entities, financial statement presentation, repurchase agreements and similar transactions, revenue recognition, leases, financial instruments, hedging, measurement of credit impairment and disclosures about liquidity risk and interest rate risk. Some of the proposed changes are potentially significant and could have a material impact on the Company s reporting. The Company has not yet fully evaluated the potential impact of these proposals but will make such an evaluation as the standards are finalized.

3. MBS

The Company s MBS are comprised of Agency MBS and Non-Agency MBS. These MBS are secured by: (i) hybrid mortgages (Hybrids), which have interest rates that are fixed for a specified period of time and, thereafter, generally adjust annually to an increment over a specified interest rate index; (ii) adjustable-rate mortgages (ARMs); (iii) mortgages that have interest rates that reset more frequently (collectively, ARM-MBS); and (iv) 15-year and longer-term fixed rate mortgages. MBS do not have a single maturity date, and further, the mortgage loans underlying ARM-MBS do not all reset at the same time.

The Company pledges a significant portion of its MBS as collateral against its borrowings under repurchase agreements and Swaps. Non-Agency MBS that are accounted for as components of Linked Transactions are not reflected in the tables set forth in this note, as they are accounted for as derivatives. (See Notes 4 and 8)

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

Non-Agency MBS (including Non-Agency MBS transferred to consolidated VIEs): The Company s Non-Agency MBS are secured by pools of residential mortgages, which are not guaranteed by an agency of the U.S. Government or any federally chartered corporation. Non-Agency MBS may be rated by one or more Rating Agencies or may be unrated (i.e., not assigned a rating by any Rating Agency). The rating indicates the opinion of the Rating Agency as to the creditworthiness of the investment, indicating the obligor s ability to meet its full financial commitment on the obligation. A rating of D is assigned when a security has defaulted on any of its contractual terms.

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The following tables present certain information about the Company s MBS at September 30, 2012 and December 31, 2011:

	September 30, 2012								
(In Thousands)	**Current Face**	**Purchase Premiums**	**Accretable Purchase Discounts**	**Discount Designated as Credit Reserve and OTTI (1)**	**Amortized Cost (2)**	**Fair Value**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Net Unrealized Gain/(Loss)**
Agency MBS:									
Fannie Mae	$ 6,357,355	$ 204,196	$ (70)	$	$ 6,561,481	$ 6,792,421	$ 231,889	$ (949)	$ 230,940
Freddie Mac	615,976	20,996			642,312	668,748	26,448	(12)	26,436
Ginnie Mae	14,902	257			15,159	15,679	520		520
Total Agency MBS	6,988,233	225,449	(70)		7,218,952	7,476,848	258,857	(961)	257,896
Non-Agency MBS: *(3)*									
Rated AAA	35,908	179	(938)		35,149	36,259	1,110		1,110
Rated AA	46	1			47	39		(8)	(8)
Rated A	22,713	644			23,357	22,214		(1,143)	(1,143)
Rated BBB	32,049	29	(2,123)	(378)	29,577	31,391	1,981	(167)	1,814
Rated BB	120,010	41	(8,802)	(1,724)	109,525	110,928	2,456	(1,053)	1,403
Rated B	307,488	15	(27,539)	(18,879)	261,085	275,878	17,036	(2,243)	14,793
Rated CCC	1,155,928		(86,864)	(203,508)	865,556	969,810	107,609	(3,355)	104,254
Rated CC	647,499		(27,799)	(128,181)	491,519	533,770	42,923	(672)	42,251
Rated C	1,104,962		(44,439)	(225,212)	835,311	916,709	83,075	(1,677)	81,398
Unrated and D-rated *(4)*	3,030,468		(109,572)	(881,769)	2,039,127	2,299,977	263,737	(2,887)	260,850
Total Non-Agency MBS	6,457,071	909	(308,076)	(1,459,651)	4,690,253	5,196,975	519,927	(13,205)	506,722
Total MBS	$ 13,445,304	$ 226,358	$ (308,146)	$ (1,459,651)	$ 11,909,205	$ 12,673,823	$ 778,784	$ (14,166)	$ 764,618

	December 31, 2011								
(In Thousands)	**Current Face**	**Purchase Premiums**	**Accretable Purchase Discounts**	**Discount Designated as Credit Reserve and OTTI (1)**	**Amortized Cost (2)**	**Fair Value**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Net Unrealized Gain/(Loss)**
Agency MBS:									
Fannie Mae	$ 5,981,834	$ 154,809	$ (135)	$	$ 6,136,508	$ 6,329,925	$ 194,997	$ (1,580)	$ 193,417
Freddie Mac	743,517	22,717			768,572	791,085	22,677	(164)	22,513
Ginnie Mae	15,920	275			16,195	16,521	326		326
Total Agency MBS	6,741,271	177,801	(135)		6,921,275	7,137,531	218,000	(1,744)	216,256
Non-Agency MBS: *(3)*									
Rated AAA	12,258	245			12,503	12,258		(245)	(245)
Rated AA	47	1			48	34		(14)	(14)
Rated A	28,950	765	(624)	(5)	29,086	24,911	341	(4,516)	(4,175)
Rated BBB	46,593	42	(3,020)	(582)	43,033	38,352		(4,681)	(4,681)

Rated BB	100,513	33	(10,749)	(3,223)	86,574	81,789	2,232	(7,017)	(4,785)
Rated B	355,930	17	(30,584)	(25,004)	300,359	277,438	2,729	(25,650)	(22,921)
Rated CCC	1,031,407		(68,174)	(203,185)	760,048	741,028	27,767	(46,787)	(19,020)
Rated CC	687,664		(33,478)	(142,777)	511,409	487,619	14,209	(37,999)	(23,790)
Rated C	2,128,919		(64,963)	(487,397)	1,576,559	1,503,737	44,988	(117,810)	(72,822)
Unrated and D-rated *(4)*	1,022,072		(38,887)	(366,593)	616,592	608,280	34,934	(43,246)	(8,312)
Total Non-Agency MBS	5,414,353	1,103	(250,479)	(1,228,766)	3,936,211	3,775,446	127,200	(287,965)	(160,765)
Total MBS	$ 12,155,624	$ 178,904	$ (250,614)	$ (1,228,766)	$ 10,857,486	$ 10,912,977	$ 345,200	$ (289,709)	$ 55,491

(1) Discount designated as Credit Reserve and amounts related to OTTI are generally not expected to be accreted into interest income. Amounts disclosed at September 30, 2012 reflect Credit Reserve of $1.409 billion and OTTI of $50.3 million. Amounts disclosed at December 31, 2011 reflect Credit Reserve of $1.174 billion and OTTI of $54.5 million.

(2) Includes principal payments receivable of $5.3 million and $2.3 million at September 30, 2012 and December 31, 2011, respectively, which are not included in the Current Face.

(3) Non-Agency MBS, including Non-Agency MBS transferred to consolidated VIEs, are reported based on the lowest rating issued by a Rating Agency, if more than one rating is issued on the security, at the date presented.

(4) Includes 214 Non-Agency MBS that were D-rated and had an aggregate amortized cost and fair value of $2.025 billion and $2.281 billion, respectively, at September 30, 2012 and 78 Non-Agency MBS that were D-rated and had an aggregate amortized cost and fair value of $602.0 million and $593.8 million, respectively, at December 31, 2011.

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Unrealized Losses on MBS and Impairments

The following table presents information about the Company s MBS that were in an unrealized loss position at September 30, 2012:

	Unrealized Loss Position For:							
	Less than 12 Months			12 Months or more			Total	
(In Thousands)	**Fair Value**	**Unrealized Losses**	**Number of Securities**	**Fair Value**	**Unrealized Losses**	**Number of Securities**	**Fair Value**	**Unrealized Losses**
Agency MBS:								
Fannie Mae	$ 117,361	$ 214	23	$ 45,376	$ 735	10	$ 162,737	$ 949
Freddie Mac				2,757	12	1	2,757	12
Total Agency MBS	117,361	214	23	48,133	747	11	165,494	961
Non-Agency MBS:								
Rated AA				39	8	1	39	8
Rated A				22,214	1,143	2	22,214	1,143
Rated BBB				1,282	167	2	1,282	167
Rated BB				30,000	1,053	5	30,000	1,053
Rated B				97,342	2,243	8	97,342	2,243
Rated CCC	6,955	18	1	72,474	3,337	8	79,429	3,355
Rated CC				48,847	672	5	48,847	672
Rated C				74,379	1,677	5	74,379	1,677
Unrated and other				136,871	2,887	14	136,871	2,887
Total Non-Agency MBS	6,955	18	1	483,448	13,187	50	490,403	13,205
Total MBS	$ 124,316	$ 232	24	$ 531,581	$ 13,934	61	$ 655,897	$ 14,166

At September 30, 2012, the Company did not intend to sell any of its MBS that were in an unrealized loss position, and it is more likely than not that the Company will not be required to sell these MBS before recovery of their amortized cost basis, which may be at their maturity. With respect to Non-Agency MBS held by consolidated VIEs, the ability of any entity to cause the sale by the VIE prior to the maturity of these Non-Agency MBS is either specifically precluded, or is limited to specified events of default, none of which have occurred to date.

Gross unrealized losses on the Company s Agency MBS were $961,000 at September 30, 2012. Given the credit quality inherent in Agency MBS, the Company does not consider any of the current impairments on its Agency MBS to be credit related. In assessing whether it is more likely than not that it will be required to sell any impaired security before its anticipated recovery, which may be at their maturity, the Company considers the significance of each investment, the amount of impairment, the projected future performance of such impaired securities, as well as the Company s current and anticipated leverage capacity and liquidity position.Based on these analyses, the Company determined that at September 30, 2012 any unrealized losses on its Agency MBS were temporary.

Unrealized losses on the Company s Non-Agency MBS (including Non-Agency MBS transferred to consolidated VIEs) were $13.2 million at September 30, 2012. Based upon the most recent evaluation, the Company does not consider these unrealized losses to be indicative of OTTI and does not believe that these unrealized losses are credit related, but are rather due to non-credit related factors. The Company has reviewed its Non-Agency MBS that are in an unrealized loss position to identify those securities with losses that are other-than-temporary based on an assessment of changes in expected cash flows for such MBS, which considers recent bond performance and expected future performance of the underlying collateral.

The Company did not recognize credit-related OTTI losses through earnings during the three months ended September 30, 2012 and recognized approximately $1.2 million of credit-related OTTI losses on Non-Agency MBS during the nine months ended September 30, 2012. The Company recognized credit-related OTTI losses through earnings of approximately $4.0 million and $6.4 million on Non-Agency MBS during the three and nine months ended September 30, 2011, respectively.

MBS on which OTTI is recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. The Company s estimate of cash flows for its Non-Agency MBS is based on its review of the underlying mortgage loans securing these MBS. The Company considers information available about the structure of the securitization, including structural credit enhancement, if any, and the past and expected future performance of underlying mortgage loans, including timing of expected future cash flows, prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, FICO scores at loan origination, year of

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origination, loan-to-value ratios, geographic concentrations, as well as Rating Agency reports, general market assessments, and dialogue with market participants. Significant judgment is used in both the Company s analysis of the expected cash flows for its Non-Agency MBS and any determination of the credit component of OTTI.

The following table presents the composition of OTTI charges recorded by the Company for the three and nine months ended September 30, 2012 and 2011:

(In Thousands)	**Three Months Ended September 30, 2012**	**Three Months Ended September 30, 2011**	**Nine Months Ended September 30, 2012**	**Nine Months Ended September 30, 2011**
Total OTTI losses	$	$ (14,913)	$ (879)	$ (15,550)
OTTI recognized in/(reclassified from) other comprehensive income		10,922	(321)	9,167
OTTI recognized in earnings	$	$ (3,991)	$ (1,200)	$ (6,383)

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

(In Thousands)	**Three Months Ended September 30, 2012**	**Nine Months Ended September 30, 2012**
Credit loss component of OTTI at beginning of period	$ 36,115	$ 34,915
Additions for credit related OTTI not previously recognized		458
Subsequent additional credit related OTTI recorded		742
Credit loss component of OTTI at end of period	$ 36,115	$ 36,115

The significant inputs considered and assumptions made at time of impairment in determining the measurement of the component of OTTI recognized in earnings for the Company s Non-Agency MBS for the three and nine months ended September 30, 2012 and 2011 are summarized as follows:

	Three Months Ended September 30, 2012	**Three Months Ended September 30, 2011**	**Nine Months Ended September 30, 2012**	**Nine Months Ended September 30, 2011**
Credit enhancement *(1) (2)*				
Weighted average *(3)*		2.70%	3.26%	3.02%
Range *(4)*		0.00-10.40%	0.00-16.50%	0.00-13.30%

Projected CPR *(2) (5)*			
Weighted average *(3)*	11.00%	9.90%	10.90%
Range *(4)*	6.90-12.20%	9.10-13.30%	1.90-12.20%
Projected Loss Severity *(2) (6)*			
Weighted average *(3)*	56.10%	55.50%	53.60%
Range *(4)*	46.10-70.00%	45.90-60.00%	41.90-70.00%
60+ days delinquent *(2) (7)*			
Weighted average *(3)*	21.40%	24.40%	21.30%
Range *(4)*	9.10-36.70%	18.20-32.40%	7.30-36.70%

(1) Represents a level of protection for these securities, expressed as a percentage of total current underlying loan balance.

(2) Information provided is based on loans for all groups that provide credit enhancement for MBS with credit enhancement. If an MBS no longer has credit enhancement, information provided is based on loans for the individual group owned by the Company.

(3) Calculated by weighting the relevant input/assumptions for each individual security by current outstanding face of the security.

(4) Represents the range of inputs/assumptions based on individual securities.

(5) CPR - conditional prepayment rate.

(6) Projected loss severity represents the projected amount of loss realized on liquidated properties as a percentage of the principal balance.

(7) Includes, for each security, underlying loans 60 or more days delinquent, foreclosed loans and other real estate owned.

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Purchase Discounts on Non-Agency MBS

The following tables present the changes in the components of the Company s purchase discount on its Non-Agency MBS between purchase discount designated as Credit Reserve and OTTI and accretable purchase discount for the three and nine months ended September 30, 2012 and 2011:

	Three Months Ended September 30, 2012		Three Months Ended September 30, 2011	
(In Thousands)	**Discount Designated as Credit Reserve and OTTI (1)**	**Accretable Discount (1) (2)**	**Discount Designated as Credit Reserve and OTTI (1)**	**Accretable Discount (1) (2)**
Balance at beginning of period	$ (1,440,752)	$ (265,137)	$ (1,174,890)	$ (222,930)
Accretion of discount		8,816		10,785
Realized credit losses	49,314		10,735	
Purchases	(122,266)	4,554	(29,141)	(16,198)
Net impairment losses recognized in earnings			(3,991)	
Unlinking of Linked Transactions		(2,256)	(10,419)	(61)
Transfers/release of credit reserve	54,053	(54,053)	11,305	(11,305)
Balance at end of period	$ (1,459,651)	$ (308,076)	$ (1,196,401)	$ (239,709)

	Nine Months Ended September 30, 2012		Nine Months Ended September 30, 2011	
(In Thousands)	**Discount Designated as Credit Reserve and OTTI (3)**	**Accretable Discount (2) (3)**	**Discount Designated as Credit Reserve and OTTI (3)**	**Accretable Discount (2) (3)**
Balance at beginning of period	$ (1,228,766)	$ (250,479)	$ (746,678)	$ (228,966)
Accretion of discount		28,107		33,107
Realized credit losses	107,229		20,612	
Purchases	(370,649)	(3,883)	(360,655)	(19,035)
Reclass discount for OTTI	866	(866)	101	(101)
Net impairment losses recognized in earnings	(1,200)		(6,383)	
Unlinking of Linked Transactions	(38,662)	(9,424)	(116,489)	(11,623)
Transfers/release of credit reserve	71,531	(71,531)	13,091	(13,091)
Balance at end of period	$ (1,459,651)	$ (308,076)	$ (1,196,401)	$ (239,709)

(1) In addition, the Company reallocated $54,000 of purchase discount designated as Credit Reserve to accretable purchase discount on Non-Agency MBS underlying Linked Transactions during the three months ended September 30, 2012. The Company reallocated $1.1 million of purchase discount designated as accretable purchase discount to Credit Reserve on Non-Agency MBS underlying Linked Transactions during the three months ended September 30, 2011.

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

(3) In addition, the Company reallocated $575,000 and $309,000 of purchase discount designated as accretable purchase discount to Credit Reserve on Non-Agency MBS underlying Linked Transactions during the nine months ended September 30, 2012 and 2011, respectively.

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Impact of MBS on Accumulated Other Comprehensive Income/(Loss)

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

(In Thousands)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Accumulated other comprehensive income from MBS:				
Unrealized gain on MBS at beginning of period	$ 296,007	$ 292,376	$ 55,491	$ 393,822
Unrealized gain on Agency MBS, net	61,999	12,035	47,169	50,092
Unrealized gain/(loss) on Non-Agency MBS, net	409,742	(109,294)	666,287	(250,845)
Reclassification adjustment for MBS sales included in net income	(3,130)	(4,525)	(5,529)	(4,869)
Reclassification adjustment for OTTI included in net income		3,991	1,200	6,383
Change in accumulated other comprehensive income/(loss) from MBS	$ 468,611	(97,793)	709,127	(199,239)
Balance at end of period	$ 764,618	$ 194,583	$ 764,618	$ 194,583

Sales of MBS

During the three and nine months ended September 30, 2012, the Company sold certain Agency MBS for $66.0 million and $137.1 million, realizing gross gains of $4.3 million and $7.2 million, respectively. During the first nine months of 2011, the Company sold certain Agency MBS for $76.5 million, realizing gross gains of $4.2 million; all of these sales occurred during the third quarter of 2011.

MBS Interest Income

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

Three Months Ended	Nine Months Ended

	September 30,		September 30,	
(In Thousands)	2012	2011	2012	2011
Coupon interest	$ 61,978	$ 70,654	$ 187,963	$ 212,703
Effective yield adjustment *(1)*	(14,780)	(10,697)	(37,915)	(26,589)
Agency MBS interest income	$ 47,198	$ 59,957		