

Western Asset Mortgage Capital Corp  
Form 10-Q  
August 05, 2016  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2016

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

For the transition period from      to

Commission File Number: 001-35543

**Western Asset Mortgage Capital Corporation**

(Exact name of Registrant as specified in its charter)

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

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**27-0298092**  
(IRS Employer  
Identification Number)

**Western Asset Mortgage Capital Corporation**

**385 East Colorado Boulevard**

**Pasadena, California 91101**

(Address of Registrant's principal executive offices)

**(626) 844-9400**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. **Yes 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). **Yes 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 (check one).

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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

As of August 3, 2016, there were 41,919,801 shares, par value \$0.01, of the registrant's common stock issued and outstanding.



Table of Contents

TABLE OF CONTENTS

	<b>Page</b>
<b>Part I FINANCIAL INFORMATION</b>	
<u>ITEM 1. Financial Statements</u>	2
<u>ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	48
<u>ITEM 3. Quantitative and Qualitative Disclosures about Market Risk</u>	90
<u>ITEM 4. Controls and Procedures</u>	96
<b>Part II OTHER INFORMATION</b>	
<u>ITEM 1. Legal Proceedings</u>	97
<u>ITEM 1A. Risk Factors</u>	97
<u>ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	97
<u>ITEM 3. Defaults Upon Senior Securities</u>	97
<u>ITEM 4. Mine Safety Disclosures</u>	97
<u>ITEM 5. Other Information</u>	97
<u>ITEM 6. Exhibits</u>	98
<u>Signatures</u>	99

---

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

	<b>June 30, 2016</b>	<b>December 31, 2015</b>
	<b>(Unaudited)</b>	
<b>Assets:</b>		
Cash and cash equivalents	\$ 33,869	\$ 24,711
Mortgage-backed securities and other securities, at fair value (\$2,469,503 and \$2,777,717 pledged as collateral, at fair value, respectively)	2,474,933	2,851,127
Residential Whole-Loans, at fair value (\$189,696 and \$218,538 pledged as collateral, at fair value, respectively)	189,696	218,538
Securitized commercial loan, at fair value	23,688	25,000
Investment related receivable	11,598	572
Accrued interest receivable	24,292	22,621
Due from counterparties	306,070	249,563
Derivative assets, at fair value	172,962	21,915
Other assets	878	382
<b>Total Assets (1)</b>	<b>\$ 3,237,986</b>	<b>\$ 3,414,429</b>
<b>Liabilities and Stockholders' Equity:</b>		
<b>Liabilities:</b>		
Borrowings under repurchase agreements, net	\$ 2,310,719	\$ 2,585,667
Securitized debt, at fair value	10,423	11,000
Accrued interest payable	17,211	20,431
Investment related payables	1,581	66,146
Due to counterparties	16,664	9,950
Derivative liability, at fair value	401,674	180,177
Accounts payable and accrued expenses	2,112	2,078
Payable to related party	2,901	3,019
Dividend payable	12,995	24,313
<b>Total Liabilities (2)</b>	<b>2,776,280</b>	<b>2,902,781</b>
<b>Commitments and contingencies</b>		
<b>Stockholders' Equity:</b>		
Common stock, \$0.01 par value, 500,000,000 shares authorized, 41,919,801 shares issued and outstanding, respectively	419	419
Preferred stock, \$0.01 par value, 100,000,000 shares authorized and no shares outstanding		
Additional paid-in capital	764,230	763,283
Retained earnings (accumulated deficit)	(302,943)	(252,054)
<b>Total Stockholders' Equity</b>	<b>461,706</b>	<b>511,648</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 3,237,986</b>	<b>\$ 3,414,429</b>

See notes to unaudited consolidated financial statements.



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

	<b>June 30, 2016</b>		<b>December 31, 2015</b>
	<b>(Unaudited)</b>		
<b>(1) Assets of consolidated VIEs included in the total assets above:</b>			
Residential Whole-Loans, at fair value (\$189,696 and \$218,538 pledged as collateral, at fair value, respectively)	\$ 189,696	\$	218,538
Securitized commercial loan, at fair value	23,688		25,000
Investment related receivable	6,370		
Accrued interest receivable	1,656		1,836
Total assets of consolidated VIEs	\$ 221,410	\$	245,374
<b>(2) Liabilities of consolidated VIEs included in the total liabilities above:</b>			
Securitized debt, at fair value	\$ 10,423	\$	11,000
Accrued interest payable	82		85
Accounts payable and accrued expenses	2		2
Total liabilities of consolidated VIEs	\$ 10,507	\$	11,087

See notes to unaudited consolidated financial statements.

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

(in thousands except share and per share data)

(Unaudited)

	For the three months ended June 30, 2016	For the three months ended June 30, 2015	For the six months ended June 30, 2016	For the six months ended June 30, 2015
<b>Net Interest Income</b>				
Interest income	\$ 29,220	\$ 41,029	\$ 58,838	\$ 81,835
Interest expense	7,727	6,577	15,706	12,979
Net Interest Income	21,493	34,452	43,132	68,856
<b>Other Income (Loss)</b>				
Realized gain (loss) on sale of investments, net	(352)	4,281	(6,407)	11,749
Other than temporary impairment	(6,356)	(4,316)	(17,153)	(8,967)
Unrealized gain (loss), net	21,510	(42,849)	32,278	(14,439)
Gain (loss) on derivative instruments, net	(14,165)	13,154	(59,335)	(35,148)
Other, net	234	(611)	(98)	1,773
Other Income (Loss)	871	(30,341)	(50,715)	(45,032)
<b>Expenses</b>				
Management fee to affiliate	2,588	2,679	5,340	5,372
Other operating expenses	183	260	621	673
General and administrative expenses				
Compensation expense (including non-cash stock based compensation of \$346, \$781, \$918 and \$1,460, respectively)	649	1,176	1,386	2,149
Professional fees	1,222	1,244	3,224	2,379
Other general and administrative expenses	419	445	847	798
Total general and administrative expenses	2,290	2,865	5,457	5,326
Total Expenses	5,061	5,804	11,418	11,371
<b>Net income (loss) available to Common Stock and participating securities</b>				
	\$ 17,303	\$ (1,693)	\$ (19,001)	\$ 12,453
Net income (loss) per Common Share Basic	\$ 0.41	\$ (0.05)	\$ (0.46)	\$ 0.29
Net income (loss) per Common Share Diluted	\$ 0.41	\$ (0.05)	\$ (0.46)	\$ 0.29
Dividends Declared per Share of Common Stock	\$ 0.31	\$ 0.64	\$ 0.76	\$ 1.31

See notes to unaudited consolidated financial statements.



Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Consolidated Statements of Changes in Stockholders' Equity**

(in thousands, except shares and share data)

	Common Stock		Additional Paid-		Retained	
	Shares	Par	In	Capital	Earnings	Total
					(Accumulated)	
					Deficit	
Balance at December 31, 2014	41,719,801	\$ 417	\$	760,925	\$ (138,130)	\$ 623,212
Grants of restricted stock	200,000	2		(2)		
Vesting of restricted stock				2,301		2,301
Net loss					(9,484)	(9,484)
Dividends declared on common stock				59	(104,440)	(104,381)
Balance at December 31, 2015	41,919,801	\$ 419	\$	763,283	\$ (252,054)	\$ 511,648
Vesting of restricted stock				918		918
Net loss					(19,001)	(19,001)
Dividends declared on common stock				29	(31,888)	(31,859)
Balance at June 30, 2016 (unaudited)	41,919,801	\$ 419	\$	764,230	\$ (302,943)	\$ 461,706

See notes to unaudited consolidated financial statements.

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

	<b>For the six months ended June 30, 2016</b>	<b>For the six months ended June 30, 2015</b>
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ (19,001)	\$ 12,453
<b>Adjustments to reconcile net income (loss) to net cash provided by operating activities:</b>		
Premium amortization and (discount accretion) on investments, net	1,861	3,596
Interest income earned added to principal of securities	(195)	
Amortization of deferred financing costs	134	34
Restricted stock amortization expense	918	1,460
Premium amortization for MAC interest rate swaps	(326)	(738)
Interest payments and basis recovered on MAC interest rate swaps	326	919
Premium on purchase of Residential Whole-Loans		(332)
Unrealized (gain) loss, net	(32,278)	14,439
Mark-to-market adjustments on derivative instruments	72,127	24,406
Other than temporary impairment	17,153	8,967
Realized (gain) loss on sale of securities, net	6,407	(11,749)
Realized loss on sale of Interest-Only Strips accounted for as derivatives, net	155	2
Realized loss on termination of MAC interest rate swaps containing an other-than-insignificant financing element		8,514
Realized gain on sale of TBAs, net	(8,587)	(6,477)
Realized loss on sale of swaptions, net	1,035	3,723
Realized (gain) loss on futures	(13,409)	459
Realized loss on forward contracts	193	846
Realized gain on options	(4,756)	
Realized gain on foreign currency swaps	(3,942)	
Realized gain on total return swaps	(15)	
(Gain) loss on foreign currency transactions, net	561	(1,738)
<b>Changes in operating assets and liabilities:</b>		
Increase in accrued interest receivable	(1,671)	(13,544)
Increase in other assets	(496)	(554)
Increase (decrease) in accrued interest payable	(3,220)	17,267
Increase in accounts payable and accrued expenses	34	815
Increase (decrease) in payable to related party	(118)	679
Net cash provided by operating activities	12,890	63,447
<b>Cash flows from investing activities:</b>		
Purchase of securities	(1,065,782)	(473,683)
Proceeds from sale of securities	1,211,679	824,828
Principal payments and basis recovered on securities	163,960	210,145
Purchase of Residential Whole-Loans		(16,993)
Principal payments on Residential Whole-Loans	21,964	2,563
Purchase of Commercial Whole-Loans		(8,750)
Payment of premium for option derivatives	(17,951)	
Premium received from option derivatives	22,707	
Net settlements of TBAs	8,591	8,664
Net payments on termination of futures	13,409	(459)
Proceeds from sale of interest rate swaptions	2,075	25,621

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

Premium for MAC interest rate swaps	465	(3,245)
Interest payments and basis recovered on MAC interest rate swaps	(326)	(705)
Due from counterparties	(9,719)	
Payment on termination of foreign currency swaps	3,942	
Payments on total return swaps	15	
Premium for interest rate swaptions, net		(29,344)
Net cash provided by investing activities	355,029	538,642
Cash flows from financing activities:		
Proceeds from repurchase agreement borrowings	6,992,363	9,412,084
Repayments of repurchase agreement borrowings	(7,267,742)	(9,911,821)
Proceeds from forward contracts	49,441	153,085
Repayments of forward contracts	(49,634)	(153,931)
Payments on termination of MAC interest rate swaps		(18,414)
Interest payments and basis recovered on MAC interest rate swaps containing an other-than-insignificant financing element		(214)
Payments made for deferred financing costs		(202)
Due from counterparties, net	(46,788)	(46,912)
Due to counterparties, net	6,714	(3,670)
Dividends paid on common stock	(43,177)	(57,289)
Net cash used in financing activities	(358,823)	(627,284)
Effect of exchange rate changes on cash and cash equivalents	62	163
Net increase (decrease) in cash and cash equivalents	9,158	(25,032)
Cash and cash equivalents beginning of period	24,711	47,222
Cash and cash equivalents end of period	\$ 33,869	\$ 22,190
Supplemental disclosure of operating cash flow information:		
Interest paid	\$ 15,478	\$ 13,402
Supplemental disclosure of non-cash financing/investing activities:		
Principal payments of securities, not settled	\$	\$ 22
Securities sold, not settled	\$ 3,652	\$
Net unsettled TBAs	\$ (5)	\$ (2)
Dividends and distributions declared, not paid	\$ 12,995	\$ 26,829
Principal payments of Residential Whole-Loans, not settled	\$ 6,370	

See notes to unaudited consolidated financial statements.

Table of Contents

**Western Asset Mortgage Capital Corporation and Subsidiaries**

**Notes to Consolidated Financial Statements (Unaudited)**

**(in thousands- except share and per share data)**

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

**Note 1 Organization**

Western Asset Mortgage Capital Corporation and subsidiaries (the Company ) is a Delaware corporation commencing operations in May 2012 focusing on investing in, financing and managing a diversified portfolio of real estate related securities, whole-loans and other financial assets. The Company s portfolio is comprised of Agency RMBS (including TBAs as defined herein), Non-Agency RMBS, Agency and Non-Agency CMBS and Whole-Loans. In addition, and to a significantly lesser extent, the Company has invested in other securities including certain Agency obligations that are not technically MBS as well as certain Non U.S. CMBS and in asset-backed securities ( ABS ) investments secured by a portfolio of private student loans. The Company s investment strategy is based on Western Asset Management Company s (the Manager ) perspective of which mix of portfolio assets it believes provides the Company with the best risk-reward opportunities at any given time. The Manager will vary the allocation among various asset classes subject to maintaining the Company s qualification as a REIT and maintaining its exemption from the Investment Company Act of 1940 (the 1940 Act ). These restrictions limit the Company s ability to invest in non-qualifying MBS, non-real estate assets and/or assets which are not secured by real estate. Accordingly, the Company s portfolio will continue to be principally invested in qualifying MBS and other real estate related assets.

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

**Note 2 Summary of Significant Accounting Policies**

***Basis of Presentation and Consolidation***

The accompanying unaudited financial statements and related notes have been prepared in conformity with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial reporting in accordance with Article 10 of Regulation S-X and the instructions to Form 10-Q. Certain prior period amounts have been reclassified to conform to the current period's presentation. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary have been made to present fairly the Company's financial position, results of operations and cash flows. The results of operations for the period ended June 30, 2016 are not necessarily indicative of the results to be expected for the full year or any future period. These consolidated financial statements should be read in conjunction with the Company's annual report on Form 10-K for the year ended December 31, 2015, filed with the Securities and Exchange Commission ( SEC ) on March 11, 2016.

The consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries and variable interest entities ( VIEs ) in which we are considered the primary beneficiary. Refer to Note 5 - Variable Interest Entities for additional information regarding the impact of consolidating these VIEs. All intercompany amounts between the Company and its subsidiary and consolidated VIEs have been eliminated in consolidation.

Table of Contents

*Variable Interest Entities*

VIEs are defined as entities that by design either lack sufficient equity for the entity to finance its activities without additional subordinated financial support or are unable to direct the entity's activities or are not exposed to the entity's losses or entitled to its residual returns. The Company evaluates all of its interests in VIEs for consolidation. When the interests are determined to be variable interests, the Company assesses whether it is deemed the primary beneficiary. The primary beneficiary of a VIE is determined to be the party that has both the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

To assess whether the Company has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, it considers all facts and circumstances, including its role in establishing the VIE and its ongoing rights and responsibilities. This assessment includes first, identifying the activities that most significantly impact the VIE's economic performance; and second, identifying which party, if any, has power over those activities. In general, the parties that make the most significant decisions affecting the VIE or have the right to unilaterally remove those decision makers is deemed to have the power to direct the activities of a VIE.

To assess whether the Company has the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE, it considers all of its economic interests. This assessment requires the Company to apply judgment in determining whether these interests, in the aggregate, are considered potentially significant to the VIE. Factors considered in assessing significance include: the design of the VIE, including its capitalization structure; subordination of interests; payment priority; relative share of interests held across various classes within the VIE's capital structure; and the reasons why the interests are held by the Company.

In instances when a VIE is owned by both the Company and related parties, the Company considers whether there is a single party in the related party group that meets both the power and losses or benefits criteria on its own as though no related party relationship existed. If one party within the related party group meets both these criteria, such reporting entity is the primary beneficiary of the VIE and no further analysis is needed. If no party within the related party group on its own meets both the power and losses or benefits criteria, but the related party group does as a whole meets these two criteria, the determination of primary beneficiary within the related party group is based upon an analysis of the facts and circumstances with the objective of determining which party is most closely associated with the VIE. Determining the primary beneficiary within the related party group requires significant judgment.

In instances when the Company is required to consolidate a VIE that is determined to be a qualifying collateralized financing entity, under GAAP, the Company will measure both the financial assets and financial liabilities of the VIE using the fair value of either the VIE's financial assets or financial liabilities, whichever is more observable.

Ongoing assessments of whether an enterprise is the primary beneficiary of a VIE are required.

*Use of Estimates*

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

The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

### *Cash and Cash Equivalents*

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

Table of Contents

***Fair Value Election***

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

***Valuation of financial instruments***

The Company discloses the fair value of its financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below) in accordance with GAAP. GAAP establishes a framework for measuring fair value and expands financial statement disclosure requirements for fair value measurements. GAAP further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

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

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

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

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

When available, the Company uses quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, the Company will use independent pricing services and if the independent pricing service cannot price a particular asset or liability, the Company will obtain third party broker quotes. The Manager's pricing group, which functions independently from its portfolio management personnel, reviews the third party broker quotes for reasonableness using alternate sources when available. If independent pricing service, or third party broker quotes are not available, the Company determines the fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates and when applicable, estimates of prepayment and credit losses.



*Mortgage-Backed Securities and Other Securities*

The Company's purchases and sales of mortgage-backed securities and other securities are recorded on the trade date, which results in an investment related payable (receivable) for MBS and other securities purchased (sold) for which settlement has not taken place as of the balance sheet date. In addition, the Company's TBAs (as defined herein) which have matured but have not settled as of the balance sheet date result in an investment related payable (receivable). The Company's MBS and other securities are pledged as collateral against borrowings under repurchase agreements. The Company's MBS and other securities are included in Mortgage-backed securities and other securities at fair value and Investment related receivables in the Consolidated Balance Sheets, with the fair value of such MBS and other securities pledged disclosed parenthetically.

Table of Contents

***Residential Whole- Loans***

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

***Interest income recognition and Impairment***

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

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

The Company assesses its Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase, for other-than-temporary impairment ( OTTI ) on at least a quarterly basis. The determination of whether a security is other than temporarily impaired involves judgment and assumptions based on subjective and objective factors. When the fair value of an investment is less than its amortized cost at the balance sheet date, during a reporting period, the security is considered impaired and the impairment is designated as either temporary or other-than-temporary. In deciding on whether or not a security is other-than-temporarily impaired, the Company considers several factors, including the nature of the investment, communications (if any) from the trustee of securitization regarding the credit quality of the security, the severity and duration of the impairment and the cause of the impairment. When a security is impaired an OTTI is considered to have occurred if there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount and either the Company intends to sell the security or it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. The OTTI is recorded in the

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

Company's Consolidated Statements of Operations.

The determination as to whether OTTI exists is subjective given that such determination is based on information available at the time of assessment as well as the Company's estimates of the future performance and cash flow projections on the security. As a result, the timing and amount of an OTTI constitutes an accounting estimate that may change materially over time.

Finally, certain of the Company's MBS and other securities that are in an unrealized loss position at the end of the reporting period are not considered other-than-temporarily impaired because the Company has the ability and intent to hold the securities to maturity or for a period of time sufficient for a price recovery up to or above the amortized cost of the investment and the Company is not required to sell the security for regulatory or other reasons.

Table of Contents

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

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

Based on the projected cash flow of such securities purchased at a discount to par value, the Company may designate a portion of such purchase discount as credit protection against future credit losses and, therefore, not accrete such amount into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

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

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

The determination as to whether OTTI exists is subjective given that such determination is based on information available at the time of assessment as well as the Company's estimates of the future performance and cash flow projections on the security. As a result, the timing and amount of an OTTI constitutes an accounting estimate that may change materially over time.

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

Finally, certain of the Company's MBS and other securities that are in an unrealized loss position at the end of the reporting period are not be considered other-than-temporarily impaired because the Company has the ability and intent to hold the securities to maturity or for a period of time sufficient for a price recovery up to or above the amortized cost of the investment and the Company is not required to sell the security for regulatory or other reasons.

### *Sales of Investments*

Sales of investments are driven by the Company's portfolio management process. The Company seeks to mitigate risks including those associated with prepayments, defaults and severities, amongst others and will opportunistically rotate the portfolio into securities and/or other investments the Company's Manager believes have more favorable attributes. Strategies may also be employed to manage net capital gains, which need to be distributed for tax purposes.

Realized gains or losses on sales of investments, including Agency Interest-Only Strips not characterized as derivatives, are included in Realized gain (loss) on sale of investments, net in the Consolidated Statements of Operations, and are recorded at the time of disposition. Realized gains or losses on Interest-Only Strips which are characterized as derivatives are included in Gain (loss) on derivative instruments, net in the Consolidated Statements of Operations. The cost of positions sold is calculated using the specific identification method.

Table of Contents

***Foreign currency transactions***

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

***Due from counterparties/Due to counterparties***

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

***Derivatives and hedging activities***

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

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

GAAP requires an entity to recognize all derivatives as either assets or liabilities on the balance sheet and to measure those instruments at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative. The fair value adjustment will affect either other comprehensive income in stockholders' equity until the hedged item is recognized in earnings or net income depending on whether the derivative instrument is designated and qualifies as a hedge for accounting purposes and if so, the nature of the hedging activity. The Company elected not to apply hedge accounting for its derivative instruments. Accordingly, the Company records the change in fair value of its derivative instruments, which includes net interest rate swap payments/receipts (including accrued amounts) and net currency payments (including accrued amounts) related to interest rate swaps and currency swaps, respectively, in Gain (loss) on derivative instruments, net in its Consolidated Statements of Operations.

Table of Contents

In the Company's Consolidated Statements of Cash Flows, premiums received or paid on termination of its interest rate swaps, excluding interest rate swaps containing an other-than-insignificant financing element and the unamortized premium of market agreed coupon (MAC) interest rate swaps, are included in cash flows from operating activities. Notwithstanding the foregoing, proceeds and payments on settlement of swaptions, mortgage put options, futures contracts and TBAs are included in cash flows from investing activities. Proceeds and payments on settlement of forward contracts are reflected in cash flows from financing activities in the Company's Consolidated Statements of Cash Flows. While payments made at the time of entering MAC interest rate swaps are included in cash flows from investing activities, payments received by the Company upon entering MAC interest rate swaps are included in either cash flows from investing activities or cash flows financing activities, depending on whether or not the derivative instrument includes an other-than-insignificant financing element. For MAC interest rate swaps containing an other-than-insignificant financing element, all cash flows over the life of the derivative are treated as cash flows from financing activities. Return and recovery of basis activity for MAC interest rate swaps is included in cash flows from investing activities for swaps not containing an other-than-insignificant financing element in the Company's Consolidated Statements of Cash Flows. For Agency and Non-Agency Interest-Only Strips accounted for as derivatives, the purchase, sale and recovery of basis activity is included with MBS and other securities under cash flows from investing activities in the Company's Consolidated Statements of Cash Flows.

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

***Repurchase agreements and Reverse Repurchase agreements***

The Company pledges its investments as collateral under repurchase agreements, which are treated as collateralized financing transactions, unless they meet sales treatment. The terms and conditions of the repurchase agreements are negotiated on a transaction by transaction basis. The borrowed amounts are dependent upon the fair value of the investment pledged as collateral, which fluctuates with changes in interest rates, type of investment and liquidity in the real estate markets. Declines in fair value of pledged investments may result in lenders requiring the Company to post additional collateral or pay down borrowings to re-establish borrowing limits. Interest paid and accrued in connection with the Company's repurchase agreements is recorded as interest expense in the Consolidated Statements of Operations.

The Company may borrow securities under reverse repurchase agreements to deliver a security owned and sold by the Company but pledged to a different counterparty under a separate repurchase agreement when in the Manager's view terminating the outstanding repurchase agreement is not in the Company's interest. Cash paid to the borrower is recorded in the Company's Consolidated Balance Sheets as an asset. Interest receivable in accordance with reverse repurchase agreements is recorded as accrued interest receivable in the Consolidated Balance Sheets. The Company reflects all proceeds on reverse repurchase agreement and repayment of reverse repurchase agreement, on a net basis in the Consolidated Statements of Cash Flows. Upon sale of a pledged security, the Company recognizes an obligation to return the borrowed security in the Consolidated Balance Sheets in Due to Counterparties. The Company establishes haircuts to ensure the market value of the underlying asset remains sufficient to protect the Company in the event of default by the counterparty. Realized gains and losses associated with the sale of the security are recognized in Realized gain (loss) on sale of investments, net in the Consolidated Statement of Cash Flows.



*Securitized debt*

Securitized debt was issued at par by a consolidated securitization trust. The Company elected the fair value option for the debt and as a result all changes in fair value are reflected in Unrealized gain (loss), net in the Consolidated Statement of Operations.

*Share-based compensation*

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

Table of Contents

***Warrants***

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

***Income taxes***

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

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

The Company has elected to treat a wholly-owned subsidiary as a domestic Taxable REIT Subsidiary ( TRS ) and in the future may create and elect other subsidiaries as either a domestic or foreign 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 domestic TRS is subject to U.S. federal, state and local corporate income taxes, and its value may not exceed 25% of the value of the Company. While a TRS may generate net income, a TRS can declare dividends to the Company, which will be included in the Company's taxable income and necessitate a distribution to its stockholders. Conversely, if the Company retains earnings at the TRS level, no distribution is required and it can increase book equity of the consolidated entity.

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

***Offering costs***

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

Offering costs borne by the Company in connection with common stock offerings and private placements are reflected as a reduction of additional paid-in-capital.

### *Earnings per share*

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

Table of Contents

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

***Comprehensive Income (Loss)***

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

***Accounting standards applicable to emerging growth companies***

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

***Recent accounting pronouncements***

Accounting Standards Adopted in 2016

In January 2015, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2015-01, Income Statement - Extraordinary and Unusual Items. The guidance simplifies income statement presentation by eliminating the concept of extraordinary items. U.S. GAAP currently requires that a company separately classify, disclose and present extraordinary events and transactions. The guidance eliminates the concept of extraordinary items from U.S. GAAP. Under the existing guidance, an entity is required to separately disclose extraordinary items, net of tax, in the income statement after income from continuing operations if an event or transaction is of an unusual nature and occurs infrequently. This separate, net-of-tax presentation (and corresponding earnings per share impact) will no longer be allowed. The existing requirement to separately present items that are of an unusual nature or occur infrequently on a

pre-tax basis within income from continuing operations has been retained. The new guidance also requires similar separate presentation of items that are both unusual and infrequent. The standard is effective for periods beginning after December 15, 2015. The effective date is the same for both public companies and all other entities. The 2016 adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In February 2015, the FASB issued ASU 2015-02, Consolidation - Amendments to the Consolidation Analysis. The guidance simplifies and reduces the number of consolidation models through the elimination of an indefinite deferral for certain entities and by placing more emphasis on risk of loss when determining a controlling financial interest. The guidance affects reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidation model. The standard is effective for a public company for fiscal years, and for interim periods within fiscal years beginning after December 15, 2015. The 2016 adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

Table of Contents

In April 2015, the FASB issued ASU 2015-03, Interest - Imputation of Interest - Simplifying the Presentation of Debt Issuance Costs. The guidance amends the presentation of debt issuance cost related to a recognized debt liability. Under the new guidance, the debt issuance costs were presented in the balance sheet as a direct deduction from the carrying amount of the recognized debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected under the new guidance. The standard is effective for a public company for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The guidance should be applied on a retrospective basis. The Company's December 31, 2015 balance sheet was adjusted to reflect the effects of applying the new guidance on a retrospective basis and resulted in a \$134 thousand reduction in Borrowings under repurchase agreements and a corresponding reduction in Other assets. Upon adoption, an entity is required to comply with the applicable disclosures for a change in an accounting principle. These disclosures include the nature of and reason for the change in accounting principle, the transition method, a description of the prior-period information that has been retrospectively adjusted, and the effect of the change on the financial statement line items (i.e., debt issuance cost asset and the debt liability). The 2016 adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

Accounting Standards to be Adopted in Future Periods

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). The guidance changes an entity's recognition of revenue from contracts with customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, the new guidance requires improved disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In March 2016, the FASB issued implementation guidance which clarifies principal versus agent considerations in reporting revenue gross versus net (ASU 2016-08). In April 2016, the FASB issued implementation guidance which clarifies the identification of performance obligations (ASU 2016-10). In applying the new guidance, an entity may use either a retrospective approach to each prior reporting period or a retrospective approach with the cumulative effect recognized at the date of initial application. For a public company, the standard is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early adoption is not permitted for a public entity. The new guidance is not expected to have a material impact on the Company's consolidated financial statements.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. The guidance requires an entity's management to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. According to the new guidance, substantial doubt exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date the financial statements are issued. The term probable is used consistently with its current use in U.S. GAAP for loss contingencies. Disclosures will be required if conditions give rise to substantial doubt about the entity's ability to continue as a going concern, including whether management's plans that are intended to mitigate those conditions will alleviate the substantial doubt when implemented. The guidance is effective for annual periods ending after December 15, 2016. The effective date is the same for both public companies and all other entities. Early application is permitted. The Company's first assessment under the new guidance will be completed for the year ending December 31, 2016.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The guidance improves certain aspects of recognition,

measurement, presentation, and disclosure of financial instruments. The standard is effective for a public company for fiscal years beginning after December 15, 2017, and for interim periods within those fiscal years. Early adoption by public companies for fiscal years or interim periods that have not yet been issued or, by all other entities, that have not yet been made available for issuance of this guidance are permitted as of the beginning of the fiscal year of adoption, under certain restrictions. The Company should apply the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The guidance related to equity securities without readily determinable fair values should be applied prospectively to equity investments that exist at the date of adoption. The Company is currently assessing the impact that this guidance will have on its consolidated financial statements when adopted.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. The guidance changes the accounting for certain aspects of share-based payments to employees. The guidance requires the recognition of the income tax effects of awards in the income statement when the awards vest or are settled, thus eliminating additional paid in capital pools. The guidance also allows for the employer to repurchase more of an employee's shares for tax withholding purposes without triggering liability accounting. In addition, the guidance allows for a policy election to account for forfeitures as they occur rather than on an estimated basis. For a public company, the standard is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is permitted in any interim or annual period. The Company is currently assessing the impact that this guidance will have on its consolidated financial statements when adopted.

Table of Contents

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The guidance requires financial assets measured at amortized cost basis to be presented at the net amount expected to be collected by deducting an allowance for credit losses from the amortized cost basis of the financial assets. For available-for-sale debt securities, the new guidance aligns the income statement recognition of credit losses with the reporting period in which changes occur by recording credit losses through an allowance rather than a write-down and allowing subsequent reversals in credit loss estimates to be recognized in current income. The measurement of expected credit losses will be based on historical experience, current conditions and reasonable and supportable forecasts. An entity must use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances. For a public company, the standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption will be permitted for fiscal years beginning after December 15, 2018. The guidance should be applied through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. For certain assets, a prospective transition approach is required. The company is currently assessing the impact that this guidance will have on its consolidated financial statements when adopted.

**Note 3 Fair Value of Financial Instruments**

The following tables present the Company's financial instruments carried at fair value as of June 30, 2016 and December 31, 2015, based upon the valuation hierarchy (dollars in thousands):

	June 30, 2016			Total
	Level I	Level II	Level III	
<b>Assets</b>				
Agency RMBS:				
20-Year mortgage	\$	\$ 567,105	\$	\$ 567,105
30-Year mortgage		985,364		985,364
Agency RMBS Interest-Only Strips		25,238		25,238
Agency RMBS Interest-Only Strips accounted for as derivatives, included in MBS		27,452		27,452
Agency CMBS		12,870		12,870
Agency CMBS Interest-Only Strips		1,182		1,182
Agency CMBS Interest-Only Strips accounted for as derivatives, included in MBS		9,482		9,482
Subtotal Agency MBS		1,628,693		1,628,693
Non-Agency RMBS		247,748	78,863	326,611
Non-Agency RMBS Interest-Only Strips			84,865	84,865
Non-Agency Interest-Only Strips accounted for as derivatives, included in MBS			3,906	3,906
Non-Agency CMBS		353,386	28,207	381,593
Subtotal Non-Agency MBS		601,134	195,841	796,975
Other securities		18,280	30,985	49,265
Total mortgage-backed securities and other securities		2,248,107	226,826	2,474,933
Residential Whole-Loans			189,696	189,696
Securitized commercial loan			23,688	23,688
Derivative assets	8,861	164,101		172,962



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

Total	\$	8,861	\$	2,412,208	\$	440,210	\$	2,861,279
<b>Liabilities</b>								
Derivative liabilities	\$		\$	399,514	\$	2,160	\$	401,674
Securitized debt						10,423		10,423
Total	\$		\$	399,514	\$	12,583	\$	412,097

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

Table of Contents

	December 31, 2015			Total
	Fair Value			
	Level I	Level II	Level III	
<b>Assets</b>				
Agency RMBS:				
20-Year mortgage	\$	\$ 687,272	\$	\$ 687,272
30-Year mortgage		926,459		926,459
Agency RMBS Interest-Only Strips		71,954		71,954
Agency RMBS Interest-Only Strips accounted for as derivatives, included in MBS		45,362		45,362
Agency CMBS			24,690	24,690
Agency CMBS Interest-Only Strips		2,113		2,113
Agency CMBS Interest-Only Strips accounted for as derivatives, included in MBS		11,069		11,069
Subtotal Agency MBS		1,744,229	24,690	1,768,919
Non-Agency RMBS		278,885	166,564	445,449
Non-Agency RMBS Interest-Only Strips			81,189	81,189
Non-Agency RMBS Interest-Only Strips accounted for as derivatives, included in MBS			3,556	3,556
Non-Agency CMBS		332,574	118,341	450,915
Subtotal Non-Agency MBS		611,459	369,650	981,109
Other securities		29,103	71,996	101,099
Total mortgage-backed securities and other securities		2,384,791	466,336	2,851,127
Residential Whole-Loans			218,538	218,538
Securitized commercial loan			25,000	25,000
Derivative assets	63	21,852		21,915
Total	\$ 63	\$ 2,406,643	\$ 709,874	\$ 3,116,580
<b>Liabilities</b>				
Derivative liabilities	\$ 698	\$ 179,479	\$	\$ 180,177
Securitized debt			11,000	11,000
Total	\$ 698	\$ 179,479	\$ 11,000	\$ 191,177

When available, the Company uses quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, the Company will use independent pricing services and if the independent pricing service cannot price a particular asset or liability, the Company will obtain third party broker quotes. The Manager's pricing group, which functions independently from its portfolio management personnel, reviews the third party broker quotes for reasonableness to alternate sources when available. If independent pricing service, or third party broker quotes are not available, the Company determines the fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates and when applicable, estimates of prepayments and credit losses.

*Mortgage-backed securities and other securities*

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

In determining the proper fair value hierarchy or level, all securities are initially classified in Level III. The Company further determined, given the amount of available observable market data, Agency RMBS should be classified in Level II. For Non-Agency RMBS, CMBS and other securities, to determine whether a security should be a Level II, the securities are grouped by security type and the Manager reviews the internal trade history, for the quarter, for each security type. If there is sufficient trade data above a predetermined threshold of a security type, the Manager determines it has sufficient observable market data and the security will be categorized as a Level II.

Values for the Company's securities are based upon prices obtained from independent third party pricing services. The valuation methodology of the third party pricing services incorporates a commonly used market pricing method. Depending on the type of asset and the underlying collateral, the primary inputs to the model include yields for TBAs, Agency RMBS, the U.S. Treasury market and floating rate indices such as LIBOR, the Constant Maturity Treasury rate and the prime rate as a benchmark yield. In addition, the model may incorporate the current weighted average maturity and additional pool level information such as prepayment speeds, default frequencies and default severities, if applicable. When the third party pricing service cannot adequately price a particular security, the Company utilizes a broker's quote which is reviewed for reasonableness by the Manager's pricing group.

Table of Contents

*Residential Whole-Loans*

Values for the Company's residential whole-loans are based upon prices obtained from an independent third party pricing service that specializes in residential loans, utilizing a trade based valuation model. Their valuation methodology incorporates commonly used market pricing methods, including loan to value (LTV), debt to income, maturity, interest rates, collateral location, and unpaid principal balance, prepayment penalties, FICO scores, lien position and times late. Due to the inherent uncertainty of such valuation, the fair values established for residential loans held by the Company may differ from the fair values that would have been established if a ready market existed for these loans. Accordingly, the Company's loans are classified as Level III.

*Securitized commercial loan and securitized debt*

Values for the Company's securitized commercial loan and securitized debt are based on the fair value that is more observable. Since there is an extremely limited market for the securitized commercial loan, the Company determined the fair value of the securitized debt was more observable. The fair value of the securitized debt was based upon a third party broker quote, which is validated by the Manager's pricing group. Due to the inherent uncertainty of such valuation the Company classifies its securitized commercial loan and securitized debt as Level III.

*Derivatives*

Values for the Company derivatives are based upon prices from third party pricing services, whose pricing is subject to review by the Manager's pricing committee. In valuing its over-the-counter interest rate derivatives, such as swaps and swaptions, its currency derivatives, such as swaps and forwards and credit derivatives such as total return swaps, the Company considers the creditworthiness of both the Company and its counterparties, along with collateral provisions contained in each derivative agreement, from the perspective of both the Company and its counterparties. The majority of the Company's interest rate swaps are cleared through a central clearing house and subject to the clearing house margin requirements. The Company's agreements with its derivative counterparties also contain netting provisions; however the Company has elected to report its interest rate swaps and swaptions and currency swaps and forwards on a gross basis. No credit valuation adjustment was made in determining the fair value of interest rate and/or currency derivatives for the periods ended June 30, 2016 and December 31, 2015.

The Company performs quarterly reviews of the independent third party pricing data. These reviews may consist of a review of the daily change in the prices provided by the independent pricing vendor which exceed established tolerances or comparisons to executed transaction prices, utilizing the Manager's pricing group. The Manager's pricing group, which functions independently from its portfolio management personnel, reviews the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager's pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that the Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, the Manager generally challenges the independent pricing service price.

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

Table of Contents

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

\$ in thousands	Three months ended June 30, 2016			Six months ended June 30, 2016		
	Mortgage-backed securities and other securities	Residential Whole-Loans	Securitized commercial loan	Mortgage-backed securities and other securities	Residential Whole-Loans	Securitized commercial loan
Beginning balance	\$ 233,006	\$ 201,267	\$ 23,675	\$ 466,336	\$ 218,538	\$ 25,000
Transfers into Level III from Level II						
Transfers from Level III into Level II				(158,567)		
Purchases				94		
Sales and settlements				(68,910)		
Principal repayments	(7,066)	(11,114)		(11,086)	(28,335)	
Total net gains / (losses) included in net income						
Realized gains/(losses), net	(244)			(6,435)		
Other than temporary impairment	(992)			(5,055)		
Unrealized gains/(losses), net(1)	5,139	37	13	15,858	584	(1,312)
Premium and discount amortization, net	(3,017)	(494)		(5,409)	(1,091)	
Ending balance	\$ 226,826	\$ 189,696	\$ 23,688	\$ 226,826	\$ 189,696	\$ 23,688

(1) For Mortgage-backed securities and other securities, Residential Whole-Loans and Securitized commercial loans classified as Level III at June 30, 2016, the Company recorded gross unrealized gains of approximately \$7.1 million, \$388 thousand and \$13 thousand, respectively, and gross unrealized losses of approximately \$2.0 million, \$29 thousand and \$0, respectively, for the three months ended June 30, 2016. For Mortgage-backed securities and other securities, Residential Whole-Loans and Securitized commercial loans classified as Level III at June 30, 2016, the Company recorded gross unrealized gains of approximately \$21.9 million, \$1.1 million and \$0, respectively, and gross unrealized losses of approximately \$2.3 million, \$240 thousand and \$1.3 million, respectively, for the six months ended June 30, 2016. These gains and losses are included in Unrealized gain (loss), net on the Consolidated Statements of Operations.

\$ in thousands	Three months ended June 30, 2016		Six months ended June 30, 2016	
	Derivative Liability	Securitized debt	Derivative Liability	Securitized debt
Beginning balance	\$ 866	10,417	\$	11,000
Transfers into Level III from Level II				
Transfers from Level III into Level II				
Purchases				
Sales and settlements				
Principal repayments				

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

Total net gains / (losses) included in net income							
Realized gains/(losses), net							
Other than temporary impairment							
Unrealized (gains)/losses, net(1)	1,294		6		2,160		(577)
Premium and discount amortization, net							
Ending balance	\$ 2,160	\$	10,423	\$	2,160	\$	10,423

(1) For Derivative liability and Securitized debt classified as Level III at June 30, 2016, the Company recorded gross unrealized gains of \$0 and approximately \$0, respectively, and gross unrealized losses of approximately \$1.3 million and \$6 thousand, respectively, for the three months ended June 30, 2016. For Derivative liability and Securitized debt classified as Level III at June 30, 2016, the Company recorded gross unrealized gains of \$0 and approximately \$577 thousand, respectively, and gross unrealized losses of approximately \$2.2 million and \$0, respectively, for the six months ended June 30, 2016. These gains and losses are included in Gain (loss) on derivative instruments, net and Unrealized gain (loss), net in the Consolidated Statements of Operations, respectively.

Table of Contents

\$ in thousands	Three months ended June 30, 2015		
	Mortgage-backed securities and other securities	Residential Whole-Loans	Commercial Whole-Loan
Beginning balance	\$ 398,881	\$ 17,860	\$ 8,900
Fair value of securities previously accounted for as linked transactions(1)			
Fair value of financial instruments previously accounted for as linked transactions(1)			
Transfers into Level III from Level II	32,143		
Transfers from Level III into Level II	(18,228)		
Purchases	66,665	6,865	
Sales and settlements	(22,523)		
Principal repayments	(2,364)	(2,542)	
Total net gains / (losses) included in net income			
Realized gains/(losses), net	(9)		
Other than temporary impairment	(1,547)		
Unrealized gains/(losses), net(2)	1,225	67	(157)
Premium and discount amortization, net	(1,856)	(66)	
Ending balance	\$ 452,387	\$ 22,184	\$ 8,743

(1) Resulting from the implementation of guidance issued by the FASB which eliminated the requirement to account for certain financial instruments as linked transactions.

(2) For Mortgage-backed securities and other securities, Residential Whole-Loans and Commercial Whole-Loan classified as Level III at June 30, 2015, the Company recorded gross unrealized gains of approximately \$4.7 million, \$172 thousand and \$0, respectively, and gross unrealized losses of approximately \$5.6 million, \$59 thousand and \$157 thousand, respectively. These gains and losses are included in Unrealized gain (loss), net in the Consolidated Statements of Operations.

Table of Contents

\$ in thousands	Six months ended June 30, 2015			
	Mortgage-backed securities and other securities	Residential Whole-Loans	Commercial Whole-Loan	Linked Transactions
Beginning balance	\$ 291,407	\$ 7,220	\$	\$ 20,627
Fair value of securities previously accounted for as linked transactions(1)	52,484			
Fair value of financial instruments previously accounted for as linked transactions(1)				(20,627)
Transfers into Level III from Level II	37,499			
Transfers from Level III into Level II	(3,996)			
Purchases	156,326	16,747	8,750	
Sales and settlements	(72,247)			
Principal repayments	(4,709)	(1,997)		
Total net gains / (losses) included in net income				
Realized gains/(losses), net	4,461			
Other than temporary impairment	(2,741)			
Unrealized gains/(losses), net(2)	(827)	313	(7)	
Premium and discount amortization, net	(5,270)	(99)		
Ending balance	\$ 452,387	\$ 22,184	\$ 8,743	\$

(1) Resulting from the implementation of guidance issued by the FASB which eliminated the requirement to account for certain financial instruments as linked transactions.

(2) For Mortgage-backed securities and other securities, Residential Whole-Loans and Commercial Whole-Loan classified as Level III at June 30, 2015, the Company recorded for the six months ended gross unrealized gains of approximately \$7.6 million, \$363 thousand and \$0, respectively, and gross unrealized losses of approximately \$7.6 million, \$50 thousand and \$7 thousand, respectively. These gains and losses are included in Unrealized gain (loss), net in the Consolidated Statements of Operations.

Transfers between hierarchy levels for the six months ended June 30, 2016 and June 30, 2015 were based on the availability of sufficient observable inputs to meet Level II versus Level III criteria. The leveling of these assets was based on information received from a third party pricing service which, along with the back-testing of historical sales transactions performed by the Manager provided the sufficient observable data for the movement from Level III to Level II. The Company did not have transfers between Level I and Level II for the six months ended June 30, 2016 and June 30, 2015.

**Other Fair Value Disclosures**



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

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

The fair value of the repurchase agreements is based on a net present value technique. This method discounts future estimated cash flows using rates the Company determined best estimate current market interest rates that would be offered for loans with similar characteristics and credit quality. The use of different market assumptions or estimation methodologies could have a material effect on the fair value amounts. At June 30, 2016, the Company's borrowings under repurchase agreements had a carrying value which approximates its fair value. Inputs used to arrive at the fair value of the repurchase agreement borrowings and receivables under reverse repurchase agreements are generally observable, and therefore, they would be considered a Level II fair value measurement.

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

Table of Contents

**Note 4 Mortgage-Backed Securities and other securities**

The following tables present certain information about the Company's investment portfolio at June 30, 2016 and December 31, 2015 (dollars in thousands).

	June 30, 2016							
	Principal Balance	Unamortized Premium (Discount), net	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Net Weighted Average Coupon (1)
Agency RMBS:								
20-Year mortgage	\$ 525,619	\$ 27,772	\$	\$ 553,391	\$ 13,714	\$	\$ 567,105	3.9%
30-Year mortgage	898,574	65,470		964,044	21,760	(440)	985,364	4.1%
Agency RMBS Interest-Only Strips (2)								
Agency RMBS Interest-Only Strips, accounted for as derivatives (2) (3)	N/A	N/A	N/A	24,430	1,299	(491)	25,238	2.8%(2)
Agency CMBS Interest-Only Strips(2)	N/A	N/A	N/A	1,063	119		1,182	4.6%(2)
Agency CMBS Interest-Only Strips accounted for as derivatives(2) (3)	N/A	N/A	N/A	N/A	N/A	N/A	9,482	0.6%(2)
Subtotal Agency	1,437,371	93,242		1,556,106	36,963	(1,310)	1,628,693	3.5%
Non-Agency RMBS								
Non-Agency RMBS Interest- Only Strips (2)	N/A	N/A	N/A	61,221	23,644		84,865	5.9%(2)
Non-Agency RMBS Interest-Only Strips, accounted for as derivatives (2) (3)	N/A	N/A	N/A	N/A	N/A	N/A	3,906	4.9%(2)
Non-Agency CMBS	498,546	(72,287)	(11,588)	414,671	3,501	(36,579)	381,593	5.0%
Subtotal Non-Agency	952,922	(94,836)	(127,552)	791,755	42,592	(41,278)	796,975	4.7%
Other securities (4)	30,607	(1,437)	(1,610)	49,523	744	(1,002)	49,265	6.4%
Total	\$ 2,420,900	\$ (3,031)	\$ (129,162)	\$ 2,397,384	\$ 80,299	\$ (43,590)	\$ 2,474,933	4.0%

	December 31, 2015							
	Principal Balance	Unamortized Premium (Discount), net	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Net Weighted Average Coupon (1)
Agency RMBS:								
20-Year mortgage	\$ 645,313	\$ 35,216	\$	\$ 680,529	\$ 8,562	\$ (1,819)	\$ 687,272	3.9%
30-Year mortgage	856,014	71,342		927,356	10,827	(11,724)	926,459	4.2%
Agency RMBS Interest-Only Strips (2)								
Agency RMBS Interest-Only Strips, accounted for as derivatives (2) (3)	N/A	N/A	N/A	71,632	2,499	(2,177)	71,954	3.1%(2)
Agency CMBS Interest-Only Strips(2)	N/A	N/A	N/A	N/A	N/A	N/A	45,362	3.6%(2)

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

Agency CMBS	24,450			24,450	240		24,690	5.2%
Agency CMBS Interest-Only Strips(2)	N/A	N/A	N/A	1,915	198		2,113	4.7%(2)
Agency CMBS Interest-Only Strips accounted for as derivatives(2) (3)	N/A	N/A	N/A	N/A	N/A	N/A	11,069	0.7%(2)
Subtotal Agency	1,525,777	106,558		1,705,882	22,326	(15,720)	1,768,919	3.5%
Non-Agency RMBS	601,233	(16,669)	(141,014)	443,550	9,345	(7,446)	445,449	3.7%
Non-Agency RMBS Interest- Only Strips (2)	N/A	N/A	N/A	66,600	14,589		81,189	5.9%(2)
Non-Agency RMBS Interest-Only Strips, accounted for as derivatives (2) (3)	N/A	N/A	N/A	N/A	N/A	N/A	3,556	5.0%(2)
Non-Agency CMBS	550,901	(73,835)	(9,017)	468,049	4,049	(21,183)	450,915	5.0%
Subtotal Non-Agency	1,152,134	(90,504)	(150,031)	978,199	27,983	(28,629)	981,109	4.7%
Other securities (4)	81,518	1,135	(2,719)	102,778	1,233	(2,912)	101,099	4.8%
Total	\$ 2,759,429	\$ 17,189	\$ (152,750)	\$ 2,786,859	\$ 51,542	\$ (47,261)	\$ 2,851,127	3.9%

(1) Net weighted average coupon as of June 30, 2016 and December 31, 2015 is presented, net of servicing and other fees.

(2) Agency RMBS IOs and IIOs, Non-Agency RMBS IOs and IIOs, Agency and Non-Agency RMBS IOs and IIOs, accounted for as derivatives, Agency CMBS IOs and IIOs, and Agency CMBS IOs and IIOs, accounted for as derivatives have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities. At June 30, 2016, the notional balance for Agency RMBS IOs and IIOs, Non-Agency RMBS IOs and IIOs, Agency RMBS IOs and IIOs, accounted for as derivatives, Non-Agency RMBS IOs and IIOs, accounted for as derivatives, Agency CMBS IOs and IIOs, accounted for as derivatives and Agency CMBS IOs and IIOs was \$261.5 million, \$301.1 million, \$308.3 million \$23.2 million, \$233.3 million and \$41.3 million, respectively. At December 31, 2015, the notional balance for Agency RMBS IOs and IIOs, Non-Agency RMBS IOs and IIOs, Agency RMBS IOs and IIOs, accounted for as derivatives, Non-Agency RMBS IOs and IIOs, accounted for as derivatives, Agency CMBS IOs and IIOs, accounted for as derivatives and Agency CMBS IOs and IIOs was \$593.4 million, \$321.0 million, \$384.1 million, \$24.9 million, \$246.6 million and \$43.2 million, respectively.

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

(4) Other securities include residual interests in asset-backed securities which have no principal balance and an amortized cost of approximately \$22.0 million and \$22.8 million, as of June 30, 2016 and December 31, 2015, respectively.

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

### Table of Contents

As of June 30, 2016 and December 31, 2015 the weighted average expected remaining term of the MBS and other securities investment portfolio was 5.6 years and 7.1 years, respectively.

The following tables present the changes in the components of the Company's purchase discount and amortizable premium on its Non-Agency RMBS, Non-Agency CMBS and other securities for the three and six months ended June 30, 2016 and June 30, 2015 (dollars in thousands):

	Three months ended June 30, 2016		
	Discount Designated as Credit Reserve and OTTI	Accretable Discount(1)	Amortizable Premium(1)
Balance at beginning of period	\$ (118,090)	\$ (143,896)	\$ 43,407
Accretion of discount		4,493	
Amortization of premium			(1,408)
Realized credit losses	(524)		
Purchases	(14,266)		2,120
Sales	3,509	6,582	(1,993)
Net impairment losses recognized in earnings	(5,369)		
Transfers/release of credit reserve(2)	5,578	(6,854)	1,276
Balance at end of period	\$ (129,162)	\$ (139,675)	\$ 43,402

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

(2) Subsequent reductions of a security's non-accretable discount results in a corresponding reduction in its amortizable premium.

	Six months ended June 30, 2016		
	Discount Designated as Credit Reserve and OTTI	Accretable Discount(1)	Amortizable Premium(1)
Balance at beginning of period	\$ (152,750)	\$ (145,532)	\$ 56,163
Accretion of discount		9,230	
Amortization of premium			(3,110)
Realized credit losses	3,142		
Purchases	(14,266)	(2,265)	2,120
Sales	31,663	14,413	(10,429)
Net impairment losses recognized in earnings	(13,814)		
Transfers/release of credit reserve(2)	16,863	(15,521)	(1,342)
Balance at end of period	\$ (129,162)	\$ (139,675)	\$ 43,402

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

(2) Subsequent reductions of a security's non-accretable discount results in a corresponding reduction in its amortizable premium.

Table of Contents

	Three months ended June 30, 2015			
	Discount Designated as Credit Reserve and OTTI		Accretable Discount(1)	Amortizable Premium(1)
Balance at beginning of period	\$	(163,892)	\$	(111,802)
Accretion of discount				4,112
Amortization of premium				(2,151)
Realized credit losses		2,327		
Purchases		(3,509)	(15,175)	4,751
Sales			323	(1,072)
Net impairment losses recognized in earnings		(1,862)		
Transfers/release of credit reserve(2)		2,005	(10,865)	8,860
Balance at end of period	\$	(164,931)	\$	(133,407)
			\$	86,831

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

(2) Subsequent reductions of a security's non-accretable discount results in a corresponding reduction in its amortizable premium.

	Six months ended June 30, 2015			
	Discount Designated as Credit Reserve and OTTI		Accretable Discount(1)	Amortizable Premium(1)
Balance at beginning of period	\$	(182,007)	\$	(105,804)
Securities previously accounted for as linked transactions(2)		(2,320)	(1,393)	4,587
Accretion of discount			9,266	
Amortization of premium				(4,879)
Realized credit losses		4,995		
Purchases		(34,096)	(63,473)	6,808
Sales		53,815	37,175	(11,018)
Net impairment losses recognized in earnings		(5,391)		
Transfers/release of credit reserve(3)		73	(9,178)	9,105
Balance at end of period	\$	(164,931)	\$	(133,407)
			\$	86,831

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

(2) Resulting from the implementation of guidance issued by the FASB which eliminated the requirement to account for certain financial instruments as linked transactions.

(3) Subsequent reductions of a security's non-accretable discount results in a corresponding reduction in its amortizable premium.

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

The following tables present the fair value and contractual maturities of the Company's investment securities at June 30, 2016 and December 31, 2015 (dollars in thousands):

	<b>&lt; or equal to 10 years</b>	<b>&gt; 10 years and &lt; or equal to 20 years</b>	<b>June 30, 2016 &gt; 20 years and &lt; or equal to 30 years</b>	<b>&gt; 30 years</b>	<b>Total</b>
<b>Agency RMBS:</b>					
20-Year mortgage	\$	\$ 567,105	\$	\$	\$ 567,105
30-Year mortgage			985,364		985,364
Agency RMBS Interest-Only Strips		16,025	9,213		25,238
Agency RMBS Interest-Only Strips, accounted for as derivatives	2,247	7,512	17,693		27,452
Agency CMBS	12,870				12,870
Agency CMBS Interest-Only Strips	1,182				1,182
Agency CMBS Interest-Only Strips accounted for as derivatives				9,482	9,482
<b>Subtotal Agency</b>	<b>16,299</b>	<b>590,642</b>	<b>1,012,270</b>	<b>9,482</b>	<b>1,628,693</b>
<b>Non-Agency RMBS</b>	<b>14</b>	<b>56,783</b>	<b>70,533</b>	<b>199,281</b>	<b>326,611</b>
Non-Agency RMBS Interest-Only Strips		2,974	18,005	63,886	84,865
Non-Agency RMBS Interest-Only Strips, accounted for as derivatives			1,415	2,491	3,906
Non-Agency CMBS	25,811	38,179	144,141	173,462	381,593
<b>Subtotal Non-Agency</b>	<b>25,825</b>	<b>97,936</b>	<b>234,094</b>	<b>439,120</b>	<b>796,975</b>
<b>Other securities</b>	<b>11,979</b>	<b>9,286</b>	<b>6,302</b>	<b>21,698</b>	<b>49,265</b>
<b>Total</b>	<b>\$ 54,103</b>	<b>\$ 697,864</b>	<b>\$ 1,252,666</b>	<b>\$ 470,300</b>	<b>\$ 2,474,933</b>

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

Table of Contents

	December 31, 2015					Total
	< or equal to 10 years	> 10 years and < or equal to 20 years	> 20 years and < or equal to 30 years	> 30 years		
Agency RMBS:						
20-Year mortgage	\$	\$	687,272	\$	\$	687,272
30-Year mortgage				926,459		926,459
Agency RMBS Interest-Only Strips			40,900	31,054		71,954
Agency RMBS Interest-Only Strips, accounted for as derivatives	1,310	10,081	33,971			45,362
Agency CMBS	24,690					24,690
Agency CMBS Interest-Only Strips(2)	2,113					2,113
Agency CMBS Interest-Only Strips accounted for as derivatives(2) (3)					11,069	11,069
Subtotal Agency	28,113	738,253	991,484	11,069		1,768,919
Non-Agency RMBS	15	86,172	59,502	299,760		445,449
Non-Agency RMBS Interest-Only Strips				20,639	60,550	81,189
Non-Agency RMBS Interest-Only Strips, accounted for as derivatives				1,248	2,308	3,556
Non-Agency CMBS	40,523	27,849	167,355	215,188		450,915
Subtotal Non-Agency	40,538	114,021	248,744	577,806		981,109
Other securities	29,102	11,088	39,256	21,653		101,099
Total	\$ 97,753	\$ 863,362	\$ 1,279,484	\$ 610,528	\$	\$ 2,851,127

The following tables present the gross unrealized losses and estimated fair value of the Company's MBS and other securities by length of time that such securities have been in a continuous unrealized loss position at June 30, 2016 and December 31, 2015 (dollars in thousands):

	June 30, 2016								
	Less than 12 Months			12 Months or More			Total		
	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities
Agency RMBS:									
30-Year mortgage	\$	\$		\$ 114,857	\$ (440)	25	\$ 114,857	\$ (440)	25
Agency RMBS Interest-Only Strips	14,201	(491)	10				14,201	(491)	10
Agency CMBS	4,610	(379)	1				4,610	(379)	1
Non-Agency RMBS	109,643	(4,211)	24	26,121	(487)	6	135,764	(4,698)	30
Non-Agency CMBS	174,909	(21,280)	43	104,618	(15,300)	18	279,527	(36,580)	61
Other securities	23,103	(1,002)	2				23,103	(1,002)	2
Total	\$ 326,466	\$ (27,363)	80	\$ 245,596	\$ (16,227)	49	\$ 572,062	\$ (43,590)	129

	December 31, 2015								
	Less than 12 Months			12 Months or More			Total		
	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities



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

Agency RMBS:															
20-Year mortgage	\$	113,919	\$	(1,229)	35	\$	44,470	\$	(590)	10	\$	158,389	\$	(1,819)	45
30-Year mortgage		68,890		(1,325)	17		329,716		(10,399)	55		398,606		(11,724)	72
Agency RMBS															
Interest-Only Strips		39,091		(2,177)	18							39,091		(2,177)	18
Non-Agency RMBS		234,897		(6,928)	36		19,656		(519)	5		254,553		(7,447)	41
Non-Agency CMBS		298,369		(19,888)	55		27,755		(1,294)	7		326,124		(21,182)	62
Other securities		59,610		(1,746)	5		11,334		(1,166)	1		70,944		(2,912)	6
Total	\$	814,776	\$	(33,293)	166	\$	432,931	\$	(13,968)	78	\$	1,247,707	\$	(47,261)	244

Table of Contents

At June 30, 2016, the Company did not intend to sell any of its MBS and other securities that were in an unrealized loss position, and it is more likely than not that the Company will not be required to sell these MBS and other securities before recovery of their amortized cost basis, which may be at their maturity.

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

For Non-Agency MBS and other securities rated below AA at the time of purchase and Agency and Non-Agency Interest-Only Strips, excluding Interest-Only Strips classified as derivatives, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the beneficial interest is less than its carrying amount. Other than for plain-vanilla variable rate Non-Agency MBS, the Company does not bifurcate the loss between credit loss and loss attributed to change in interest rates, therefore, the entire loss is recorded as other-than-temporary. These adjustments are reflected in the Company's Consolidated Statement of Operations as Other than temporary impairment. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. If an other-than-temporary impairment is recognized as a result of this analysis, the yield is maintained at the current accretion rate. The last revised estimated cash flows are then used for future impairment analysis purposes. The Company's prepayment speed estimate was the primary assumption used to determine other-than temporary-impairments for Interest-Only Strips, excluding Agency and Non-Agency Interest-Only Strips accounted for as derivatives, for the three and six months ended June 30, 2016, and June 30, 2015.

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

The following table presents the OTTI the Company recorded on its securities portfolio (dollars in thousands):

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

	For the three months ended June 30, 2016	For the three months ended June 30, 2015	For the six months ended June 30, 2016	For the six months ended June 30, 2015
Agency RMBS	\$ 297	\$ 2,056	\$ 1,024	\$ 3,178
Non-Agency RMBS	2,312	364	7,229	3,030
Non-Agency CMBS	2,754	1,498	5,539	2,098
Other securities	993	398	3,361	661
Total	\$ 6,356	\$ 4,316	\$ 17,153	\$ 8,967

Table of Contents

The Company has made investments in certain Non-Agency RMBS inverse floaters. The coupon rate on these securities has an inverse relationship to a benchmark rate. When the benchmark interest rate increases the coupon payment rate will decrease because the benchmark interest rate is deducted from the coupon payment. The Company has generally purchased these securities at a premium. Accelerated prepayments on these securities could result in an economic loss, as the Company would not recover the upfront premium. The premiums are amortized into income using the effective interest rate method. As of June 30, 2016 and June 30, 2015, the Company held \$78.2 million and \$94.0 million, respectively, in Non-Agency RMBS inverse floaters.

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

	<b>For the three months ended June 30, 2016</b>		
	<b>Coupon Interest</b>	<b>Net (Premium Amortization/ Amortization Basis) Discount Amortization</b>	<b>Interest Income</b>
Agency RMBS	\$ 16,845	\$ (7,460)	\$ 9,385
Agency CMBS	729	(424)	305
Non-Agency RMBS	8,745	(1,098)	7,647
Non-Agency CMBS	6,465	1,771	8,236
Other securities	498	754	1,252
Total(1)	\$ 33,282	\$ (6,457)	\$ 26,825

(1) Interest income in the Consolidated Statements of Operations includes coupon interest, net premium/discount amortization and interest income of approximately \$2.3 million, \$(494) thousand and \$1.8 million on Residential Whole-Loans, respectively, and coupon interest, net premium amortization and interest income of \$569 thousand, \$0 and \$569 thousand on a securitized commercial loan, respectively.

	<b>For the six months ended June 30, 2016</b>		
	<b>Coupon Interest</b>	<b>Net (Premium Amortization/ Amortization Basis) Discount Amortization</b>	<b>Interest Income</b>
Agency RMBS	\$ 34,168	\$ (15,965)	\$ 18,203
Agency CMBS	1,517	(853)	664
Non-Agency RMBS	18,523	(2,934)	15,589
Non-Agency CMBS	13,249	3,559	16,808
Other securities	1,192	1,552	2,744
Total(1)	\$ 68,649	\$ (14,641)	\$ 54,008

(1) Interest income in the Consolidated Statements of Operations includes coupon interest, net premium/discount amortization and interest income of approximately \$4.8 million, \$(1.1) million and \$3.7 million on Residential Whole-Loans, respectively, and coupon interest, net premium amortization and interest income of \$1.1 million, \$0 and \$1.1 million on a securitized commercial loan, respectively.

For the three months ended June 30, 2015

	Net (Premium Amortization/ Amortization Basis)			
	Coupon Interest	Discount Amortization	Interest Income	
Agency RMBS	\$ 34,038	\$ (12,505)	\$ 21,533	
Agency CMBS	943	(552)	391	
Non-Agency RMBS	11,433	(1,881)	9,552	
Non-Agency CMBS	6,509	502	7,011	
Other securities	1,539	663	2,202	
Total(1)	\$ 54,462	\$ (13,773)	\$ 40,689	

(1) Interest income in the Consolidated Statements of Operations includes coupon interest, net premium amortization and interest income of \$227 thousand, \$(66) thousand and \$161 thousand on Residential Whole-Loans, respectively, and coupon interest, net premium amortization and interest income of \$179 thousand, \$0 and \$179 thousand on Commercial Whole-Loans.

Table of Contents

	<b>For the six months ended June 30, 2015</b>		
	<b>Net (Premium Amortization/ Amortization Basis) Discount Amortization</b>		
	<b>Coupon Interest</b>		<b>Interest Income</b>
Agency RMBS	\$ 71,489	\$ (27,912)	\$ 43,577
Agency CMBS	1,790	(1,093)	697
Non-Agency RMBS	23,302	(4,308)	18,994
Non-Agency CMBS	12,564	1,618	14,182
Other securities	2,806	1,094	3,900
Total(1)	\$ 111,951	\$ (30,601)	\$ 81,350

(1) Interest income in the Consolidated Statements of Operations includes coupon interest, net premium amortization and interest income of \$344 thousand, \$(112) thousand and \$232 thousand on Residential Whole-Loans, respectively and coupon interest, net premium amortization and interest income of \$253 thousand, \$0 and \$253 thousand on Commercial Whole-Loans.

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

	<b>For the three months ended June 30, 2016</b>			
	<b>Proceeds</b>	<b>Gross Gains</b>	<b>Gross Losses</b>	<b>Net Gain (Loss)</b>
Agency RMBS (1)	\$ 5,122	\$	\$ (475)	\$ (475)
Agency CMBS	3,645	9		9
Non-Agency RMBS	22,639	575	(315)	260
Non-Agency CMBS	12,735		(146)	(146)
Total	\$ 44,141	\$ 584	\$ (936)	\$ (352)

(1) Excludes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$4.4 million, gross realized gains of \$0 and gross realized losses of \$(455).

	<b>For the six months ended June 30, 2016</b>			
	<b>Proceeds</b>	<b>Gross Gains</b>	<b>Gross Losses</b>	<b>Net Gain (Loss)</b>
Agency RMBS (1)	\$ 315,602	\$ 5,250	\$ (5,626)	\$ (376)
Agency CMBS	10,421	9	(55)	(46)
Non-Agency RMBS	105,440	1,794	(4,559)	(2,765)
Non-Agency CMBS	24,994		(2,929)	(2,929)
Other securities	750,226	1,818	(2,109)	(291)
Total	\$ 1,206,683	\$ 8,871	\$ (15,278)	\$ (6,407)

(1) Excludes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$8.6 million, gross realized gains of \$300 thousand and gross realized losses of \$(455).

	For the three months ended June 30, 2015			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS	\$ 208,249	\$ 3,545	\$ (680)	\$ 2,865
Non-Agency CMBS	63,345	863	(9)	854
Other securities	16,365	562		562
Total	\$ 287,959	\$ 4,970	\$ (689)	\$ 4,281

	For the six months ended June 30, 2015			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS (1)	\$ 509,981	\$ 3,835	\$ (3,577)	\$ 258
Non-Agency RMBS	207,594	9,761	(174)	9,587
Non-Agency CMBS	90,888	1,351	(9)	1,342
Other securities	16,365	562		562
Total	\$ 824,828	\$ 15,509	\$ (3,760)	\$ 11,749

---

(1) Excludes gross realized gains of \$(2) thousand for Agency Interest-Only Strips, accounted for as derivatives, as a result of the settlement of prior year sales in January 2015.

Table of Contents

**Note 5 Variable Interest Entities**

*Residential Whole-Loan Trusts*

The consolidated financial statements also include the consolidation of certain trusts that each meet the definition of a VIE related to the acquisition of Residential Whole-Loans in which the Company has determined itself to be the primary beneficiary of each such trust. The Company determined that it was the primary beneficiary of the two residential Whole-Loan trusts, which were merged into one trust during the first quarter of 2016, because it was involved in certain aspects of the design of each trust, has certain oversight rights on defaulted assets and has other significant decision making powers. In addition, the Company has the obligation to absorb losses and the right to receive benefits from the trust that could potentially be significant to the trust. The trust has issued a trust certificate to the Company, which represents the beneficial interest in pools of Residential Whole-Loans held by such trust. As of June 30, 2016, the Company financed the trust certificates with \$154.9 million of repurchase borrowings, which is a liability held outside the trusts. The Company classifies the underlying Residential Whole-Loans owned by the trusts in Residential Whole-Loans at fair value in the Consolidated Balance Sheets and has eliminated the intercompany trust certificates in consolidation.

*Commercial Loan Trust*

In November 2015, the Company acquired \$14.0 million interest in the trust certificate issued by CMSC Trust 2015 Longhouse MZ ( CMSC Trust ), with a fair value of \$13.3 million at June 30, 2016, which is financed with \$6.8 million of repurchase borrowings. The Company determined that CMSC Trust was a VIE and itself the primary beneficiary because it was involved in certain aspects of the design of the trust, has certain oversight rights on defaulted assets and has other significant decision making powers. In addition, the Company has the obligation to absorb losses and the right to receive benefits from the trust that could potentially be significant to the trust. The CMSC Trust holds a \$25.0 million mezzanine loan collateralized by interests in commercial real estate. The mezzanine loan serves as collateral for the \$25.0 million of trust certificates issued. As of June 30, 2016, the Company classified the mezzanine loan at fair value in Securitized commercial loan in the Consolidated Balance Sheets. The \$25.0 million of trust certificates, of which \$14.0 million was eliminated in consolidation and the remaining \$11.0 million held by an affiliate is carried at a fair value of \$10.4 million and classified as Securitized debt in the Consolidated Balance Sheets.

The Company assesses modifications to VIEs on an ongoing basis to determine if a significant reconsideration event has occurred that would change the Company's initial consolidation assessment. The consolidated two trusts hold 486 performing Residential Whole-Loans and 1 performing commercial loan. The following table presents a summary of the assets and liabilities of the residential and commercial loan trusts included in the Consolidated Balance Sheets as of June 30, 2016 and December 31, 2015 (dollars in thousands).

June 30, 2016

December 31, 2015



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

Residential Whole-Loans, at fair value	\$	189,696	\$	218,538
Securitized commercial loan, at fair value		23,688		25,000
Investment related receivable		6,370		
Accrued interest receivable		1,656		1,836
Total assets	\$	221,410	\$	245,374
Securitized debt	\$	10,423	\$	11,000
Accrued interest payable		82		85
Accounts payable and accrued expenses		2		2
Total liabilities	\$	10,507	\$	11,087

The Company's risk with respect to its investment in each trust is limited to its direct ownership in the trust. The Residential Whole-Loans and securitized commercial loan held by the consolidated trusts are held solely to satisfy the liabilities of the trust, and creditors of the trust have no recourse to the general credit of the Company for the trust certificates issued by the trusts. The assets of a consolidated trust can only be used to satisfy the obligations of that trust. The Company is not contractually required and has not provided any additional financial support to the trusts for the three and six months ended June 30, 2016 and June 30, 2015. The Company did not deconsolidate any trusts during the three and six months ended June 30, 2016 and June 30, 2015.

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

Table of Contents

The following table presents the components of the carrying value of Residential Whole-Loans and securitized commercial loan as of June 30, 2016 and December 31, 2015 (dollars in thousands):

	Residential Whole-Loans		Securitized Commercial Loan	
	June 30, 2016	December 31, 2015	June 30, 2016	December 31, 2015
Principal balance	\$ 184,312	\$ 212,647	\$ 25,000	\$ 25,000
Unamortized premium	1,436	2,410		
Unamortized discount	(277)	(161)		
Gross unrealized gains	4,274	3,642		
Gross unrealized losses	(49)		(1,312)	
Fair value	\$ 189,696	\$ 218,538	\$ 23,688	\$ 25,000

The Residential Whole-Loans are comprised of non-qualifying, mostly adjustable rate mortgages with low loan to values (or LTV). The following tables present certain information about the Company's Residential Whole-Loans investment portfolio at June 30, 2016 and December 31, 2015 (dollars in thousands):

June 30, 2016										
Current Coupon Rate		Number of Loans	Principal Balance	Original LTV	Weighted Average		Contractual Maturity (years)	Coupon Rate		
					Original FICO Score(1)	Expected Life (years)				
3.01	4.00%	89	\$ 29,339	57.4%	741	1.3	26.8	3.8%		
4.01	5.00%	113	43,213	56.5%	718	1.3	27.1	4.6%		
5.01	6.00%	278	108,644	54.7%	722	1.5	27.3	5.1%		
6.01	7.00%	6	3,116	71.2%	738	1.3	21.6	6.3%		
Total		486	\$ 184,312	55.8%	725	1.4	27.1	4.8%		

(1) The original FICO score is not available for 131 loans with a principal balance of approximately \$53.3 million at June 30, 2016. The Company has excluded those loans from the weighted average computation.

December 31, 2015										
Current Coupon Rate		Number of Loans	Principal Balance	Original LTV	Weighted Average		Contractual Maturity (years)	Coupon Rate		
					Original FICO Score(1)	Expected Life (years)				
3.01	4.00%	2	\$ 698	35.7%	766	1.9	29.4	3.9%		
4.01	5.00%	211	79,696	56.6%	728	1.4	27.5	4.5%		
5.01	6.00%	302	128,204	55.1%	723	1.6	27.9	5.1%		
6.01	7.00%	9	4,049	71.0%	723	1.4	23.4	6.4%		
Total		524	\$ 212,647	55.9%	725	1.5	27.6	4.9%		

(2) The original FICO score is not available for 139 loans with a principal balance of approximately \$58.7 million at December 31, 2015. The Company has excluded those loans from the weighted average computation.

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

The following tables present the U.S. states in which the collateral securing the Company's Residential Whole-Loans at June 30, 2016 and December 31, 2015, based on principal balance, is located (dollars in thousands):

	<b>June 30, 2016</b>	
	<b>State Concentration</b>	<b>Principal Balance</b>
California	83.2%	\$ 153,414
Washington	6.5	12,125
Massachusetts	5.9	10,812
New York	2.7	4,980
Georgia	0.9	1,599
Other	0.8	1,382
Total	100.0%	\$ 184,312

Table of Contents

	December 31, 2015	
	State Concentration	Principal Balance
California	83.1%	\$ 176,611
Washington	6.8	14,442
Massachusetts	5.6	12,000
New York	2.5	5,399
Georgia	0.9	1,813
Other	1.1	2,382
Total	100.0%	\$ 212,647

As of June 30, 2016, the aggregate fair value of the securitized debt issued by the consolidated VIE was \$10.4 million which is classified as Securitized debt, at fair value in the Company's Consolidated Balance sheets. The cost of financing the securitized debt is approximately 8.9%.

*Unconsolidated VIEs*

As of June 30, 2016 and December 31, 2015, the Company had three investments in VIEs in which it was not the primary beneficiary, and accordingly, the VIEs were not consolidated in the Company's consolidated financial statements. As of June 30, 2016 and December 31, 2015, the Company's maximum exposure to loss from these investments did not exceed the sum of the \$58.7 million and \$58.2 million carrying value of the investments, respectively, which are classified in Mortgage-backed securities and other securities, at fair value in the Company's Consolidated Balance sheets.

**Note 6 Borrowings under Repurchase Agreements**

As of June 30, 2016, the Company had master repurchase agreements with 28 counterparties. As of June 30, 2016, the Company had borrowings under repurchase agreements with 20 counterparties. The following tables summarize certain characteristics of the Company's repurchase agreements at June 30, 2016 and December 31, 2015 (dollars in thousands):

Securities Pledged	Repurchase Agreement Borrowings	June 30, 2016 Weighted Average Interest Rate on Borrowings Outstanding at end of period	Weighted Average Remaining Maturity (days)
Agency RMBS	\$ 1,547,407	0.75%	34
Agency CMBS	20,258	1.81%	7
Non-Agency RMBS	279,591	2.17%	32
Non-Agency CMBS	275,021	2.25%	32
Whole-Loans and securitized commercial loan(1)	161,732	2.47%	8
Other securities	26,710	2.71%	10
Borrowings under repurchase agreements, net	\$ 2,310,719	1.25%	31

(1) Repurchase agreement borrowings on Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

Securities Pledged	Repurchase Agreement Borrowings	December 31, 2015 Weighted Average Interest Rate on Borrowings Outstanding at end of period	Weighted Average Remaining Maturity (days)
Agency RMBS	\$ 1,601,713	0.66%	41
Agency CMBS	32,699	1.80%	21
Non-Agency RMBS	380,177	1.91%	44
Non-Agency CMBS	323,670	1.84%	37
Whole-Loans and securitized commercial loan(1)	180,892	2.38%	26
Other securities	66,650	2.33%	60
Borrowings under repurchase agreements	2,585,801	1.17%	38
Less unamortized debt issuance cost	134	N/A	N/A
Borrowings under repurchase agreements, net	\$ 2,585,667	1.17%	38

(1) Repurchase agreement borrowings on Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

Table of Contents

For the six months ended June 30, 2016 and the year ended December 31, 2015, the Company had average borrowings under its repurchase agreements of approximately \$2.4 billion and \$3.4 billion, respectively, and had a maximum month-end balance during the periods of approximately \$2.4 billion and \$4.0 billion, respectively. The Company had accrued interest payable at June 30, 2016 and December 31, 2015 of approximately \$3.1 million and \$3.0 million, respectively. In addition, at June 30, 2016, the Company had entered into repurchase agreement borrowings of approximately \$34.5 million, which settled between July 1, 2016 and July 5, 2016, with a weighted average interest rate of 2.62%, a weighted average contractual maturity of 27 days and secured by collateral of approximately \$63.7 million.

The repurchase agreements bear interest at a contractually agreed-upon rate and typically have terms ranging from one month to three months. The Company's repurchase agreement borrowings are accounted for as secured borrowings when the Company maintains effective control of the financed assets. Under the repurchase agreements, the respective counterparties retain the right to determine the fair value of the underlying collateral. A reduction in the value of pledged assets requires the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, and is referred to as a margin call. The inability of the Company to post adequate collateral for a margin call by a counterparty, in a timeframe as short as the close of the same business day, could result in a condition of default under the Company's repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by the Company, which may have a material adverse effect on the Company's financial position, results of operations and cash flows. During 2015, the Company also rehypothecated pledged U.S. Treasury securities it received from its repurchase agreement and interest rate swap counterparties as incremental collateral in order to increase the Company's cash position. The maximum amount of repurchase borrowings for the rehypothecated U.S. Treasury securities was \$0 during the three and six months ended June 30, 2016, respectively, and \$0 and \$530 thousand during the three and six months ended June 30, 2015, respectively. At June 30, 2016 and June 30, 2015, the Company did not have any rehypothecated U.S. Treasury securities.

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

Further, if the Company is unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms it may have a material adverse effect on the Company's financial position, results of operations and cash flow, due to the long term nature of the Company's investments and relatively short-term maturities of the Company's repurchase agreements. Certain of the repurchase agreements provide the counterparty with the right to terminate the agreement if the Company does not maintain certain equity and leverage metrics, the most restrictive of which include a limit on leverage based on the composition of the Company's portfolio. The Company was in compliance with the terms of such financial tests as of June 30, 2016.

At June 30, 2016 and December 31, 2015, repurchase agreements collateralized by investments had the following remaining maturities:

(dollars in thousands)

June 30, 2016

December 31, 2015(1)

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

Overnight	\$		\$	
1 to 29 days		1,370,098		1,335,119
30 to 59 days		530,144		362,940
60 to 89 days		391,969		847,781
90 to 119 days		11,579		
Greater than or equal to 120 days		6,929		39,961
Total	\$	2,310,719	\$	2,585,801

---

(1) Excludes unamortized debt issuance costs of \$134 thousand.

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

### Table of Contents

At June 30, 2016, the following table reflects amounts of collateral at risk under its repurchase agreements greater than 10% of the Company's equity with any counterparty (dollars in thousands):

Counterparty	Amount of Collateral at Risk, at fair value	June 30, 2016 Weighted Average Remaining Maturity (days)	Percentage of Stockholders Equity
RBC (Barbados) Trading Bank Corporation	\$ 84,751	43	18.4%
Credit Suisse Securities (USA) LLC	64,515	10	14.0

### **Note 7 Collateral Positions**

The following tables summarize the Company's collateral positions, with respect to its borrowings under repurchase agreements, securitized debt, derivatives and clearing margin account at June 30, 2016 and December 31, 2015 (dollars in thousands):

	June 30, 2016		
	Assets Pledged- Fair Value	Accrued Interest	Fair Value of Assets Pledged and Accrued Interest
Assets pledged for borrowings under repurchase agreements:			
Agency RMBS	\$ 1,599,803	\$ 6,083	\$ 1,605,886
Agency CMBS	23,534	291	23,825
Non-Agency RMBS	415,307	749	416,056
Non-Agency CMBS	381,594	2,370	383,964
Whole-Loans and securitized commercial loan(1)	202,961	1,555	204,516
Other securities	49,265	266	49,531
Cash (2)	30,681		30,681
Securitized commercial loan pledged for securitized debt	10,423	83	10,506
Cash collateral for derivatives (2):	275,389		275,389
<b>Total</b>	<b>\$ 2,988,957</b>	<b>\$ 11,397</b>	<b>\$ 3,000,354</b>

(1) Whole-Loans and securitized commercial loan owned through trust certificates are pledged as collateral. The trust certificates are eliminated upon consolidation.

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

	December 31, 2015		
	Assets Pledged- Fair Value	Accrued Interest	Fair Value of Assets Pledged and Accrued



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

	Interest		
Assets pledged for borrowings under repurchase agreements:			
Agency RMBS	\$ 1,658,865	\$ 7,366	\$ 1,666,231
Agency CMBS	37,872	342	38,214
Non-Agency RMBS	530,110	1,053	531,163
Non-Agency CMBS	449,771	2,949	452,720
Whole-Loans and securitized commercial loan(1)	232,538	1,750	234,288
Other securities	101,099	270	101,369
Cash (2)	38,300		38,300
Securitized commercial loan pledged for securitized debt	11,000	85	11,085
Cash collateral for derivatives (2):	211,263		211,263
<b>Total</b>	<b>\$ 3,270,818</b>	<b>\$ 13,815</b>	<b>\$ 3,284,633</b>

---

(1) Whole-Loans and securitized commercial loan owned through trust certificates are pledged as collateral. The trust certificates are eliminated upon consolidation.

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

Table of Contents

A reduction in the value of pledged assets typically results in the repurchase agreement counterparties, derivative counterparties and clearing margin counterparty initiating a daily margin call. At June 30, 2016 and December 31, 2015, investments held by counterparties as security for repurchase agreements totaled approximately \$2.7 billion and approximately \$3.0 billion, respectively. Cash collateral held by counterparties at June 30, 2016 and December 31, 2015 was approximately \$306.1 million and approximately \$249.6 million, respectively. Cash posted by counterparties at June 30, 2016 and December 31, 2015, was approximately \$16.7 million and approximately \$10.0 million, respectively. In addition, at June 30, 2016 and December 31, 2015, the Company did not hold securities as collateral from its repurchase agreement counterparties. The Company has the ability to repledge collateral received from its repurchase counterparties.

**Note 8 Derivative Instruments**

The Company's derivatives currently include interest rate swaps, interest rate swaptions, futures contracts, TBAs, currency swaps and forwards, Agency and Non-Agency Interest-Only Strips that are classified as derivatives, and total return swaps.

***Interest rate swaps and interest rate swaptions***

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

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

*Currency Swaps and Forwards*

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

Table of Contents

***Interest-Only Strips***

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

***To-Be-Announced Securities***

The Company has also purchased or sold TBAs. As of June 30, 2016 and December 31, 2015, the Company had contracts to purchase ( long position ) and sell ( short position ) TBAs on a forward basis. TBAs having the characteristics of a derivative are accounted for at fair value with such changes recognized in Gain (loss) on derivatives, net in the Consolidated Statement of Operations.

***Futures Contracts***

The Company may enter into Eurodollar, Volatility Index, and U.S. Treasury futures. As of June 30, 2016, the Company had entered into contracts to buy ( long position ) U.S. Treasury futures with a notional amount of \$357.9 million, a fair value in an asset position of \$8.9 million and an expiration date of September 2016. As of December 31, 2015, the Company had entered into contracts to buy ( long position ) U.S. Treasuries with a notional amount of \$480.8 million, a fair value in a liability position of \$635 thousand and an expiration date of March 2016.

***Total Return Swap***

In 2016, the Company has entered into a total return swap and in the future may continue to enter into these types of credit derivatives. This swap transfers the total return of the referenced asset, including interim cash flows and capital appreciation or depreciation from a specified price to the Company. The total return swap has a referenced asset which is a security collateralized by residential loans with a notional of 51.0 million. The Company receives interest from the referenced asset equal to EURIBOR plus 2.75% and is required to pay the counterparty EURIBOR plus 0.50% through June 23, 2019, with the spread decreasing to 0.25% through December 2019, with the spread further decreasing to 0% through the maturity date of the referenced asset in December 2020. The Company was required to post \$9.7 million in cash collateral which is recorded in Due from counterparties in the Consolidated Balance Sheets.

The following tables summarize the Company's derivative instruments at June 30, 2016 and December 31, 2015 (dollars in thousands):

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

Derivative Instrument	Accounting Designation	Consolidated Balance Sheets Location	Notional Amount	June 30, 2016	
				Fair Value, excluding accrued interest	Accrued Interest Payable (receivable)
Interest rate swaps, assets	Non-Hedge	Derivative assets, at fair value	\$ 4,018,600	\$ 155,492	\$ (12,472)
Futures, assets	Non-Hedge	Derivative assets, at fair value	357,900	8,861	
Foreign currency swaps, asset	Non-Hedge	Derivative assets, at fair value	11,560	3,137	(177)
Foreign currency forward contracts, asset	Non-Hedge	Derivative assets, at fair value	5,805	155	
TBA securities, assets	Non-Hedge	Derivative assets, at fair value	705,000	5,317	
Total derivative instruments, assets				172,962	(12,649)
Interest rate swaps, liability	Non-Hedge	Derivative liability, at fair value	5,889,000	(395,572)	14,009
Total return swaps - liability	Non-Hedge	Derivative liability, at fair value	53,320	(2,160)	(103)
Foreign currency forward contracts, liability	Non-Hedge	Derivative liability, at fair value	5,059	(65)	
TBA securities, liabilities	Non-Hedge	Derivative liability, at fair value	465,000	(3,877)	
Total derivative instruments, liabilities				(401,674)	13,906
Total derivative instruments, net				\$ (228,712)	\$ 1,257

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

Table of Contents

Derivative Instrument	Accounting Designation	Consolidated Balance Sheets Location	Notional Amount	December 31, 2015	
				Fair Value, excluding accrued interest	Accrued Interest Payable (receivable)
Interest rate swaps, assets	Non-Hedge	Derivative assets, at fair value	\$ 2,808,700	\$ 9,635	\$ 1,287
Interest rate swaptions, assets	Non-Hedge	Derivative assets, at fair value	1,105,000	1,479	
Futures contract, asset	Non-Hedge	Derivative assets, at fair value	201,600	63	
Foreign currency swaps, asset	Non-Hedge	Derivative assets, at fair value	25,160	7,168	(398)
Foreign currency forward contracts, asset	Non-Hedge	Derivative assets, at fair value	5,825	302	
TBA securities, assets	Non-Hedge	Derivative assets, at fair value	1,650,000	3,268	
Total derivative instruments, assets				21,915	889
Interest rate swaps, liability	Non-Hedge	Derivative liability, at fair value	5,631,800	(178,305)	7,875
Futures contract, liability	Non-Hedge	Derivative liability, at fair value	279,200	(698)	
Foreign currency forward contracts, liability	Non-Hedge	Derivative liability, at fair value	7,671	(281)	
TBA securities, liabilities	Non-Hedge	Derivative liability, at fair value	825,000	(893)	
Total derivative instruments, liabilities				(180,177)	7,875
Total derivative instruments, net				\$ (158,262)	\$ 8,764

*Interest Rate Swaps*

The following tables summarize the average fixed pay rate and average maturity for the Company's interest rate swaps as of June 30, 2016 and December 31, 2015 (excludes interest rate swaptions) (dollars in thousands):

Remaining Interest Rate Swap Term	June 30, 2016					
	Notional Amount	Fair Value (Liability), net	Asset	Average Fixed Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 1 year and less than 3 years	\$ 980,900	\$ (3,154)		1.1%	1.7	89.2%
Greater than 3 years and less than 5 years	2,225,000	(74,568)		1.8	4.4	30.6
Greater than 5 years	2,683,100	(317,850)		2.6	9.4	4.1
Total	\$ 5,889,000	\$ (395,572)		2.0%	6.2	28.3%

  

Remaining Interest Rate Swap Term	December 31, 2015					
	Notional Amount	Fair Value (Liability), net	Asset	Average Fixed Pay Rate	Average Maturity (Years)	Forward Starting
1 year or less	\$ 1,286,000	\$ 163		0.6%	0.6	%
Greater than 1 year and less than 3 years	1,131,800	(1,450)		1.1	1.4	
Greater than 3 years and less than 5 years	1,345,200	(22,705)		2.1	4.6	
Greater than 5 years	2,404,600	(131,744)		2.8	10.2	29.5
Total	\$ 6,167,600	\$ (155,736)		1.9%	5.4	11.5%

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

The Company has entered into swaps to effectively fix the interest rate (for the life of the swap); net of variable-rate payment swaps, of approximately \$205.4 million of borrowings under its repurchase agreements, excluding forward starting swaps of approximately \$1.7 billion.

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

Table of Contents

The following tables summarize the average variable pay-rate and average maturity for the Company's interest rate swaps as of June 30, 2016 and December 31, 2015 (excludes interest rate swaptions) (dollars in thousands):

June 30, 2016						
Remaining Interest Rate swap Term	Notional Amount	Fair Value (Liability), net	Asset	Average Variable Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 3 years and less than 5 years	\$ 2,265,400	\$ 43,648		0.6%	4.3	%
Greater than 5 years	1,753,200	111,844		0.6	10.3	
Total	\$ 4,018,600	\$ 155,492		0.6%	6.9	%

December 31, 2015						
Remaining Interest Rate swap Term	Notional Amount	Fair Value (Liability), net	Asset	Average Variable Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 3 years and less than 5 years	\$ 1,170,700	\$ (8,902)		0.4%	4.5	%
Greater than 5 years	1,102,200	(4,032)		0.4	12.3	
Total	\$ 2,272,900	\$ (12,934)		0.4%	8.2	%

The Company's agreements with certain of its bilateral interest rate swap counterparties may be terminated at the option of the counterparty, and settled at fair value, if the Company does not maintain certain equity and leverage metrics. The most restrictive of which contain provisions which become more restrictive based upon portfolio composition. As of June 30, 2016, the Company was in compliance with the terms of such financial tests.

*Interest Rate Swaptions*

At June 30, 2016, the Company did not have any swaptions in its derivative holdings. The following tables present information about the Company's interest rate swaptions as of December 31, 2015 (dollars in thousands):

December 31, 2015						
Fixed-Pay Rate for Underlying Swap	Option	Fair Value	Weighted Average Months Until Option Expiration	Underlying Swap		
				Notional Amount	Weighted Average Swap Term (Years)	
1.76 2.00%		\$ 890	2.1	\$ 400,000	5.0	
2.01 2.25%		129	2.1	100,000	5.0	
2.26 2.50%		1	5.8	105,000	1.0	
		\$ 1,020	2.7	\$ 605,000	4.3	

December 31, 2015						
Variable-Pay Rate for Underlying Swap	Option	Fair Value	Underlying Swap			



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

				<b>Weighted Average Months Until Option Expiration</b>		<b>Notional Amount</b>		<b>Weighted Average Swap Term (Years)</b>
1.26	1.50%	\$	459	2.1	\$	500,000		5.0
		\$	459	2.1	\$	500,000		5.0

Table of Contents*Derivative Collateral*

The Company has minimum collateral posting thresholds with certain of its derivative counterparties, including with its clearing broker for cleared swaps, for which it typically pledges cash. During 2015, the Company rehypothecated some of the U.S. Treasury securities it received as incremental collateral on its repurchase borrowings, swaps and swaptions, effectively entering into repurchase agreements with such securities, in order to increase its cash position. The maximum amount of repurchase borrowings for the rehypothecated U.S. Treasury securities was \$0 and \$530 thousand during the six months ended June 30, 2016 and June 30, 2015, respectively. At June 30, 2016, no U.S. Treasury securities were rehypothecated. As of June 30, 2016 and December 31, 2015, the Company had cash pledged as collateral for derivatives of approximately \$275.4 million and approximately \$211.3 million, respectively, which is reported in the Consolidated Balance Sheets as Due from counterparties. The Company held cash of approximately \$14.5 million and approximately \$9.4 million as collateral against derivatives at June 30, 2016 and December 31, 2015, respectively, which is reported in the Consolidated Balance Sheets as Due to counterparties.

As of June 30, 2016, the Company has swaps with two counterparties that are based in England and Switzerland, with fair values in an asset position of approximately \$3.3 million and with fair values in a liability position of approximately \$3.1 million and notional balances of \$11.6 million and \$123.9 million, respectively. As of December 31, 2015, the Company has swaps with two counterparties that are based in England and Switzerland, with fair values in an asset position of approximately \$7.6 million and with fair values in a liability position of approximately \$183 thousand and notional balances of \$25.2 million and \$123.9 million, respectively. Included in the \$275.4 million and \$211.3 million pledged by the Company is cash pledged to the counterparty based in Switzerland of \$4.4 million and \$1.4 million at June 30, 2016 and December 31, 2015, respectively. Included in the \$14.5 million and \$9.4 million received by the Company is cash posted as collateral by the counterparty based in England of approximately \$3.5 million and \$7.4 million at June 30, 2016 and December 31, 2015, respectively.

*Foreign Currency Forwards and Swaps*

The following is a summary of the Company's foreign currency forwards at June 30, 2016 and December 31, 2015 (dollars and euros in thousands):

Derivative Type	June 30, 2016			
	Notional Amount	Notional (USD Equivalent)	Maturity	Fair Value
Buy USD/Sell EUR currency forward	5,083	\$ 5,805	July 2016	\$ 155
Currency forwards, assets	5,083	\$ 5,805	n/a	\$ 155
Buy EUR/Sell USD currency forward	4,492	\$ 5,059	July 2016	\$ (65)
Currency forwards, liabilities	4,492	\$ 5,059	n/a	\$ (65)
Total currency forwards	9,575	\$ 10,864	n/a	\$ 90

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

Derivative Type	December 31, 2015			
	Notional Amount	Notional (USD Equivalent)	Maturity	Fair Value
Buy USD/Sell EUR currency forward	5,083	5,825	January 2016	\$ 302
Currency forwards, assets	5,083	\$ 5,825	n/a	\$ 302
Buy EUR/Sell USD currency forward	6,800	\$ 7,671	January 2016	\$ (281)
Currency forwards, liabilities	6,800	\$ 7,671	n/a	\$ (281)
Total currency forwards	11,883	\$ 13,496	n/a	\$ 21

The following is a summary of the Company's foreign currency swaps with a fair value of \$3.1 million and \$7.2 million at June 30, 2016 and December 31, 2015, respectively (dollars and euros in thousands):

June 30, 2016					
	Date entered	Maturity	Fixed Rate	Denomination	Notional Amount
Payer	June 2014	July 2024	7.25%	EUR	8,500
Receiver	June 2014	July 2024	9.005%	USD	11,560

December 31, 2015					
	Date entered	Maturity	Fixed Rate	Denomination	Notional Amount
Payer	June 2014	July 2024	7.25%	EUR	18,500
Receiver	June 2014	July 2024	9.005%	USD	25,160

Table of Contents

*To- Be- Announced Securities*

The following table presents additional information about the Company's contracts to purchase and sell TBAs for the six months ended June 30, 2016 (dollars in thousands):

	Notional Amount as of December 31, 2015	Additions	Settlement, Termination, Expiration or Exercise	Notional Amount as of June 30, 2016
Purchase of TBAs	\$ 1,650,000	\$ 5,055,000	\$ (6,000,000)	\$ 705,000
Sale of TBAs	\$ 825,000	\$ 5,640,000	\$ (6,000,000)	\$ 465,000

*Gain (loss) on derivative instruments*

The below tables summarize the effects of the Company's derivative instruments, including Agency and Non-Agency Interest-Only Strips characterized as derivatives and TBAs, reported in Gain (loss) on derivative instruments, net in the Consolidated Statements of Operations for the three and six months ended June 30, 2016 and June 30, 2015 (dollars in thousands):

Description	Three months ended June 30, 2016				
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to- market adjustments	Total
Interest rate swaps	\$	\$ (6,910)	\$ 167	\$ (17,023)	\$ (23,766)
Interest rate swaptions	(323)			322	(1)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	(455)	3,464	(2,720)	(1,247)	(958)
Futures contracts	(907)			10,655	9,748
Foreign currency forwards	(165)			270	105
Foreign currency swaps		94		538	632
Total return swaps	7	307		(1,294)	(980)
TBAs	848			207	1,055
Total	\$ (995)	\$ (3,045)	\$ (2,553)	\$ (7,572)	\$ (14,165)

Description	Six months ended June 30, 2016				
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to- market adjustments	Total
Interest rate swaps	\$ (3,605)	\$ (15,505)	\$ 334	\$ (71,271)	\$ (90,047)
Interest rate swaptions	(1,035)			1,631	596
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	(155)	7,610	(6,103)	(4,926)	(3,574)
Options	4,756				4,756

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

Futures contracts	13,409			9,496		22,905
Foreign currency forwards	(193)			70		(123)
Foreign currency swaps	3,942	207		(4,031)		118
Total return swaps	15	528		(2,160)		(1,617)
TBAs	8,587			(936)		7,651
Total	\$ 25,721	\$ (7,160)	\$ (5,769)	\$ (72,127)	\$ (59,335)	

Table of Contents

Description	Three months ended June 30, 2015					Total
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to-market adjustments		
Interest rate swaps	\$ (8,513)	\$ (4,526)	\$ 367	\$ 34,697	\$ 22,025	
Interest rate swaptions	(4,436)			730	(3,706)	
Agency and Non-Agency Interest-Only Strips accounted for as derivatives		5,609	(4,235)	2,228	3,602	
Futures contracts	(459)			795	336	
Foreign currency forwards	(1,492)			1,533	41	
Foreign currency swaps		179		(1,064)	(885)	
TBAs	(971)			(7,288)	(8,259)	
Total	\$ (15,871)	\$ 1,262	\$ (3,868)	\$ 31,631	\$ 13,154	

Description	Six months ended June 30, 2015					Total
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to-market adjustments		
Interest rate swaps	\$ (9,562)	\$ (6,310)	\$ 738	\$ (18,508)	\$ (33,642)	
Interest rate swaptions	(3,723)			(143)	(3,866)	
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	(2)	11,263	(8,713)	(167)	2,381	
Futures contracts	(459)			721	262	
Foreign currency forwards	(846)			338	(508)	
Foreign currency swaps		395		3,292	3,687	
TBAs	6,477			(9,939)	(3,462)	
Total	\$ (8,115)	\$ 5,348	\$ (7,975)	\$ (24,406)	\$ (35,148)	

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

**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 Sheets at June 30, 2016 and December 31, 2015:

**Offsetting of Derivative Assets and Reverse Repurchase Agreements as of June 30, 2016**

Gross	Gross	Net Amounts	Gross Amounts Not Offset in
Amounts	Amounts	of Assets	the Consolidated Balance
Offset in the	Offset in the	presented in	Sheets

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

<b>\$ in thousands Description</b>	<b>Amounts of Recognized Assets</b>	<b>Consolidated Balance Sheets</b>	<b>the Consolidated Balance Sheets</b>	<b>Financial Instruments (1)</b>	<b>Cash Collateral Received</b>	<b>Net Amount</b>
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives included in MBS	\$ 40,840	\$	\$ 40,840	\$ (36,131)	\$	\$ 4,709
Derivative asset, at fair value(2)	172,962		172,962	(157,058)	(14,058)	1,846
<b>Total</b>	<b>\$ 213,802</b>	<b>\$</b>	<b>\$ 213,802</b>	<b>\$ (193,189)</b>	<b>\$ (14,058)</b>	<b>\$ 6,555</b>

Table of Contents

**Offsetting of Derivative Liabilities and Repurchase Agreements as of June 30, 2016**

\$ in thousands Description	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Liabilities presented in the Consolidated Balance Sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		Net Amount
				Financial Instruments (1)	Cash Collateral Pledged(1)	
Derivative liability, at fair value(2)(3)	\$ 401,674	\$	\$ 401,674	\$ (157,058)	\$ (242,238)	\$ 2,378
Repurchase Agreements(4)	2,310,719		2,310,719	(2,310,719)		
	\$ 2,712,393	\$	\$ 2,712,393	\$ (2,467,777)	\$ (242,238)	\$ 2,378

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

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

(3) Cash collateral pledged against the Company's derivative counterparties was approximately \$275.4 million as of June 30, 2016.

(4) The fair value of investments pledged against the Company's repurchase agreements was approximately \$2.7 billion as of June 30, 2016.

**Offsetting of Derivative Assets as of December 31, 2015**

\$ in thousands Description	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets presented in the Consolidated Balance Sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		Net Amount
				Financial Instruments (1)	Cash Collateral Received	
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives included in MBS	\$ 59,987	\$	\$ 59,987	\$ (55,372)	\$	\$ 4,615
Derivative asset, at fair value(2)	21,915		21,915	(10,177)	(8,647)	3,091
Total	\$ 81,902	\$	\$ 81,902	\$ (65,549)	\$ (8,647)	\$ 7,706

**Offsetting of Derivative Liabilities and Repurchase Agreements as of December 31, 2015**



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

\$ in thousands Description	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Liabilities presented in the Consolidated Balance Sheets	Gross Amounts Not Offset in the Consolidated Balance Sheets		Net Amount
				Financial Instruments (1)	Cash Collateral Pledged(1)	
Derivative liability, at fair value(2)(3)	\$ 180,177	\$	\$ 180,177	\$ (10,177)	\$ (169,887)	\$ 113
Repurchase Agreements(4)	2,585,801		2,585,801	(2,585,801)		
	\$ 2,765,978	\$	\$ 2,765,978	\$ (2,595,978)	\$ (169,887)	\$ 113

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

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

(3) Cash collateral pledged against the Company's derivative counterparties was approximately \$211.3 million as of December 31, 2015.

(4) The fair value of investments pledged against the Company's repurchase agreements was approximately \$3.0 billion as of December 31, 2015.

Table of Contents

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

**Note 10 Related Party Transactions**

*Management Agreement*

In connection with the Company's IPO in May 2012, the Company entered into a management agreement (the "Management Agreement") with the Manager, which describes the services to be provided by the Manager and compensation for such services. The Manager is responsible for managing the Company's operations, including: (i) performing all of its day-to-day functions; (ii) determining investment criteria in conjunction with the Board of Directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of the Company's Board of Directors. Pursuant to the terms of the Management Agreement, the Manager is paid a management fee equal to 1.50% per annum of the Company's stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, stockholders' equity means the sum of the net proceeds from any issuances of the Company's equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of the Company's shares of common stock, excluding any unrealized gains, losses or other non-cash items, including OTTI charges, prior to January 1, 2016; unrealized gain (loss), net; and the non-cash portion of gain (loss) on derivative instruments, that have impacted stockholders' equity as reported in the Company's consolidated financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between the Manager and the Company's independent directors and after approval by a majority of the Company's independent directors. However, if the Company's stockholders' equity for any given quarter is negative based on the calculation described above, the Manager will not be entitled to receive any management fee for that quarter. For the quarterly periods subsequent to January 1, 2016, to the extent OTTI reduces the Company's stockholders' equity, it will reduce the management fee for such period. See Note 16.

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

The Management Agreement may be amended, supplemented or modified by agreement between the Company and the Manager. The Management Agreement expires on May 16, 2017. It is automatically renewed for one-year terms on each May 15th unless previously terminated as described below. The Company's independent directors review the Manager's performance and any fees payable to the Manager annually and, the Management Agreement may be terminated annually upon the affirmative vote of at least two-thirds (2/3) of the Company's independent directors, based upon: (i) the Manager's unsatisfactory performance that is materially detrimental to the Company; or (ii) the Company's determination that any fees payable to the Manager are not fair, subject to the Manager's right to prevent such termination due to unfair fees by accepting a reduction of management fees agreed to by at least two-thirds (2/3) of the Company's independent directors. The Company will provide the Manager 180 days prior notice of any such termination. Unless terminated for cause, the Company will pay the

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

Manager a termination fee equal to three times the average annual management fee earned by the Manager during the prior 24-month period immediately preceding the date of termination, calculated as of the end of the most recently completed fiscal quarter prior to the date of termination.

Table of Contents

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

For the three and six months ended June 30, 2016, the Company incurred approximately \$2.6 million and approximately \$5.3 million in management fees, respectively. For the three and six months ended June 30, 2015, the Company incurred approximately \$2.7 million and approximately \$5.4 million in management fees, respectively.

In addition to the management fee, the Company is also responsible for reimbursing the Manager for certain expenses paid by the Manager on behalf of the Company as defined in the Management Agreement. For the three and six months ended June 30, 2016, the Company recorded expenses included in compensation expense totaling approximately \$292 thousand and approximately \$364 thousand, respectively, related to reimbursable employee costs. For the three and six months ended June 30, 2015, the Company recorded expenses included in compensation expense totaling approximately \$657 thousand and approximately \$794 thousand, respectively, related to reimbursable employee costs. Any such expenses incurred by the Manager and reimbursed by the Company, including the employee compensation expense, are typically included in the Company's operating expenses in its Consolidated Statements of Operations, or may be reflected in the Consolidated Balance Sheets and associated Consolidated Statement of Changes in Stockholders' Equity, based on the nature of the item. At June 30, 2016 and December 31, 2015, approximately \$2.6 million and approximately \$2.7 million, respectively, for management fees incurred but not yet paid was included in Payable to related party in the Consolidated Balance Sheets. In addition, at June 30, 2016 and December 31, 2015, approximately \$313 thousand and approximately \$277 thousand, respectively, of reimbursable costs incurred but not yet paid was included in Payable to related party in the Consolidated Balance Sheets.

*Securitized debt*

At June 30, 2016, the Company had securitized debt related to the consolidated VIEs, with a balance of \$11.0 million (and a fair value of \$10.4 million) which was held by an affiliate. The securitized debt of the VIEs can only be settled with the commercial loans that serve as collateral for the securitized debt of the VIE and is non-recourse to the Company.

**Note 11 Share-Based Payments**

In conjunction with the Company's IPO and concurrent private placement, the Company's Board of Directors approved the Western Asset Mortgage Capital Corporation Equity Plan (the "Equity Plan") and the Western Asset Manager Equity Plan (the "Manager Equity Plan" and collectively the "Equity Incentive Plans"). The Equity Incentive Plans include provisions for grants of restricted common stock and other equity-based awards to the Manager, its employees and employees of its affiliates and to the Company's directors, officers and employees. The Company can issue up to 3.0% of the total number of issued and outstanding shares of its common stock (on a fully diluted basis) at the time of each award (other than any shares previously issued or subject to awards made pursuant to one of the Company's Equity Incentive Plans) under these Equity Incentive Plans. At May 15, 2012, there were 308,335 shares of common stock initially reserved for issuance under the Equity Incentive Plans. Upon the completion of the October 3, 2012 follow-on common stock offering, the stock portion of the Company's dividend

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

declared on December 19, 2013, and the April 9, 2014 follow-on offering (which includes the partial exercise of the overallotment option on May 7, 2014) and private placement of common stock, the number of shares of common stock available for issuance under the Equity Incentive Plans increased to 1,237,711, inclusive of 681,970 shares of restricted stock granted and 24,827 shares of restricted stock issued as a result of the stock portion of the dividend declared on December 19, 2013 and restricted stock attributed to dividends on restricted stock under the Director Deferred Fee Plan. As of June 30, 2016, 530,914 shares remained available for issuance under the Equity Incentive Plans.

Table of Contents

The Company made the following grants under the Equity Plan for the six months ended June 30, 2016 and the year ended December 31, 2015:

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

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

On June 2, 2016, the Company granted a total of 17,132 (4,283 each) of restricted common stock under the Equity Plan to the Company's four independent directors. These restricted shares will vest in full on June 2, 2017, the first anniversary of the grant date. Each of the independent directors has elected to defer the shares granted to him under the Company's Director Deferred Fee Plan (the "Director Deferred Fee Plan"). The Director Deferred Fee Plan permits eligible members of the Company's board of directors to defer certain stock awards made under its director compensation programs. The Director Deferred Fee Plan allows directors to defer issuance of their stock awards and therefore defer payment of any tax liability until the deferral is terminated, pursuant to the election form executed each year by each eligible director.

On December 8, 2015 the Company's chief financial officer passed away and the board of directors approved the accelerated vesting of 13,980 shares of restricted common stock.

During the six months ended June 30, 2016 and June 30, 2015, 200,983 and 160,510 restricted common shares vested, respectively, including shares whose issuance has been deferred under the Director Deferred Fee Plan. The Company recognized stock-based compensation expense of approximately \$346 thousand and approximately \$918 thousand for the three and six months ended June 30, 2016, respectively, and approximately \$781 thousand and approximately \$1.5 million for the three and six months ended June 30, 2015, respectively. In addition, the Company had unamortized compensation expense of \$146 thousand for equity awards and approximately \$1.5 million for liability awards and \$67 thousand for equity awards and approximately \$2.4 million for liability awards at June 30, 2016 and December 31, 2015, respectively.

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

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

The following is a summary of restricted common stock vesting dates as of June 30, 2016 and December 31, 2015, including shares whose issuance has been deferred under the Director Deferred Fee Plan:

<b>Vesting Date</b>	<b>June 30, 2016 Shares Vesting</b>	<b>December 31, 2015 Shares Vesting</b>
March 2016		188,184
June 2016		11,528
March 2017	133,334	133,334
June 2017	17,132	
March 2018	66,667	66,667
	217,133	399,713

Table of Contents

The following table presents information with respect to the Company's restricted stock for the six months ended June 30, 2016 including shares whose issuance has been deferred under the Director Deferred Fee Plan:

	Shares of Restricted Stock	Weighted Average Grant Date Fair Value (1)
Outstanding at beginning of period	688,394	\$ 17.39
Granted (2)	18,403	9.36
Cancelled/forfeited		
Outstanding at end of period	706,797	\$ 17.18
Unvested at end of period	217,133	\$ 15.00

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

(2) Included 1,271 shares of restricted stock attributed to dividends on restricted stock under the Director Deferred Fee Plan.

**Note 12 Stockholders Equity*****Warrants***

On May 9, 2012, the Company entered into agreements with certain institutional investors to sell 2,231,787 warrant units. Each warrant unit consists of one share of the Company's common stock and a warrant to purchase 0.5 of a share of the Company's common stock, subject to adjustment. As of June 30, 2016, the adjusted exercise price of the warrants was \$16.70 and there were a total of 1,232,916 warrant shares purchasable. The warrants expire on May 15, 2019.

***Share Repurchase Program***

On February 25, 2016, the Board of Directors of the Company reauthorized its repurchase program of up to 2,050,000 shares of its common stock through December 31, 2017. The original authorization expired on December 31, 2015. Purchases made pursuant to the program will be made in the open market, in privately negotiated transactions, or pursuant to any trading plan that may be adopted in accordance with Rules 10b5-1 and 10b-18 of the Securities and Exchange Commission. The authorization does not obligate the Company to acquire any particular amount of common shares and the program may be suspended or discontinued at the Company's discretion without prior notice. The timing, manner, price and amount of any repurchases will be determined by the Company in its discretion and will be subject to economic and market conditions, stock price, applicable legal requirements and other factors. The Company has not repurchased any shares of common stock pursuant to the authorization as of June 30, 2016.



*Dividends*

The following table presents cash dividends declared and paid by the Company on its common stock:

<b>Declaration Date</b>	<b>Record Date</b>	<b>Payment Date</b>	<b>Amount per Share</b>	<b>Tax Characterization</b>
<b>2016</b>				
June 23, 2016	July 5, 2016	July 26, 2016	\$ 0.31	Not yet determined
March 24, 2016	April 4, 2016	April 26, 2016	\$ 0.45	Not yet determined
<b>2015</b>				
December 17, 2015	December 28, 2015	January 26, 2016	\$ 0.58	Ordinary income
September 24, 2015	October 5, 2015	October 27, 2015	\$ 0.60	Ordinary income
June 18, 2015	June 29, 2015	July 28, 2015	\$ 0.64	Ordinary income
March 26, 2015	April 6, 2015	April 28, 2015	\$ 0.67	Ordinary income
<b>2014</b>				
December 18, 2014	December 29, 2014	January 27, 2015	\$ 0.70	Ordinary income
September 23, 2014	October 3, 2014	October 28, 2014	\$ 0.70	Ordinary income
June 19, 2014	June 30, 2014	July 29, 2014	\$ 0.67	Ordinary income
March 20, 2014	March 31, 2014	April 29, 2014	\$ 0.67	Ordinary income

Table of Contents**Note 13 Net Income (Loss) per Common Share**

The table below presents basic and diluted net income (loss) per share of common stock using the two-class method for the three and six months ended June 30, 2016 and June 30, 2015 (dollars, other than shares and per share amounts, in thousands):

	For the three months ended June 30, 2016	For the three months ended June 30, 2015	For the six months ended June 30, 2016	For the six months ended June 30, 2015
<b>Numerator:</b>				
Net income (loss) attributable to common stockholders and participating securities for basic and diluted earnings per share	\$ 17,303	\$ (1,693)	\$ (19,001)	\$ 12,453
Less:				
Dividends and undistributed earnings allocated to participating securities	98	276	225	536
Net income (loss) allocable to common stockholders basic and diluted	\$ 17,205	\$ (1,969)	\$ (19,226)	\$ 11,917
<b>Denominator:</b>				
Weighted average common shares outstanding for basic earnings per share	41,719,800	41,507,256	41,657,761	41,462,840
Weighted average diluted shares outstanding (warrants)				
Weighted average common shares outstanding for diluted earnings per share	41,719,800	41,507,256	41,657,761	41,462,840
Basic earnings per common share	\$ 0.41	\$ (0.05)	\$ (0.46)	\$ 0.29
Diluted earnings per common share	\$ 0.41	\$ (0.05)	\$ (0.46)	\$ 0.29

For the three and six months ended June 30, 2016 and June 30, 2015, the Company excluded the effects of the warrants from the computation of diluted earnings per share since the average market value per share of the Company's common stock was below the exercise price of the warrants.

**Note 14 Income Taxes**

As a REIT, the Company is not subject to federal income tax to the extent that it makes qualifying distributions to its stockholders and satisfies on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income and stock ownership tests.

Based on the Company's analysis of any potential uncertain income tax positions, the Company concluded that it does not have any uncertain tax positions that meet the recognition or measurement criteria as of June 30, 2016. The Company files U.S. federal and state income tax returns.

As of June 30, 2016, tax returns filed by the Company for 2014, 2013 and 2012 are open for examination pursuant to relevant statutes of limitation. In the event that the Company incurs income tax related interest and penalties, the Company's policy is to classify them as a component of its provision for income taxes.

Subject to the limitation under the REIT asset test rules, the Company is permitted to own up to 100% of the stock of one or more TRS. Currently, the Company owns one TRS that is taxable as a corporation and is subject to federal, state and local income tax on its net income at the applicable corporate rates. The TRS, which was formed in Delaware on July 28, 2014, is a limited liability company and a wholly-owned subsidiary of the Company. As of June 30, 2016, the Company is expected to have a cumulative loss for tax purposes and any accrual of benefit of net operating losses for GAAP would be fully reserved and not material not the financial. As there can be no certainty that the TRS will have taxable income in the future, no tax benefit was included in these consolidated financial statements.

**Note 15 Contingencies**

From time to time, the Company may become involved in various claims and legal actions arising in the ordinary course of business. Management is not aware of any material contingencies at June 30, 2016.

**Note 16 Subsequent Events**

On August 3, 2016, the Company and the Manager entered into an amendment to the Management Agreement, which amended the definition of Equity in the Management Agreement. Under the previous definition, OTTI was excluded as a non-cash item and had no impact on the calculation of the Company's management fee. Under the new definition, for all periods beginning on and following January 1, 2016, OTTI will reduce the Company's Equity for any completed fiscal quarter in which OTTI was recognized, which in turn will reduce the Company's management fee. The amendment to the Management Agreement described above is attached to this Quarterly Report on Form 10-Q as Exhibit 10.1.

Table of Contents

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

**FORWARD-LOOKING INFORMATION**

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

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

The forward-looking statements are based on the Company's beliefs, assumptions and expectations of its future performance, taking into account all information currently available to it. Forward-looking statements are not predictions of future events. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to the Company. Some of these factors, are described in Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's annual report on Form 10-K for the year ended December 31, 2015, filed with the Securities and Exchange Commission (SEC) on March 11, 2016. These and other risks, uncertainties and factors, including those described in the annual, quarterly and current reports that the Company files with the SEC, could cause its actual results to differ materially from those included in any forward-looking statements the Company makes. All forward-looking statements speak only as of the date they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect the Company. Except as required by law, the Company is not obligated to, and does not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Table of Contents

**Overview**

Western Asset Mortgage Capital Corporation and Subsidiaries (the Company unless otherwise indicated or except where the context otherwise requires we, us or our) is a Delaware corporation commencing operations in May 2012, focused on investing in, financing and managing a diversified portfolio of real estate related securities, whole-loans and other financial assets. Our investment strategy is based on Western Asset Management Company's (our Manager) perspective of which mix of portfolio assets it believes provides us with the best risk-reward opportunities at any given time. Our Manager will vary the allocation among various asset classes subject to maintaining our qualification as a REIT under the federal tax law and maintaining our exemption from the 1940 Act. These restrictions limit our ability to invest in non-real estate assets and/or assets which are not secured by real estate.

We raised approximately \$720.0 million, after subtracting underwriting commissions and offering expenses, and have invested the proceeds of our initial public offering or IPO and concurrent private placements along with proceeds from our follow-on public offerings and accompanying private placement primarily in Agency RMBS, including Mortgage pass-through certificates, Agency derivatives, Agency Interest-Only Strips, and Agency CMOs; Non-Agency RMBS; Agency CMBS, Non-Agency CMBS, Non U.S. CMBS, ABS as well as Residential and Commercial Whole-Loans. We have also used to-be-announced forward contracts, or TBAs, in order to invest in Agency RMBS. Pursuant to these TBAs, we agree to purchase (or deliver), for future settlement, Agency RMBS with certain principal and interest terms and certain underlying collateral.

At June 30, 2016, our investment portfolio was comprised of approximately \$1.6 billion of Agency RMBS (including approximately \$52.7 million of Agency Interest-Only Strips), approximately \$415.4 million of Non-Agency RMBS (including approximately \$88.8 million of Non-Agency Interest-Only Strips), approximately \$23.5 million of Agency CMBS (including approximately \$10.7 million of Agency CMBS Interest-Only Strips), approximately \$381.6 million of Non-Agency CMBS, approximately \$49.3 million of other securities and approximately \$189.7 million of Residential Whole-Loans. In addition, we hold a \$14.0 million controlling financial interest in a CMBS trust, which resulted in the consolidation of the assets and liabilities of the trust. As a result of the consolidation of the CMBS trust, our holdings included a \$13.3 million securitized commercial loan.

We generate income principally from the difference between the yields earned on our investments and our cost of borrowing and any hedging activity. We use leverage as part of our business strategy in order to increase potential returns to our stockholders. We primarily finance our investments through short-term borrowings structured as repurchase agreements. We may also change our financing strategy and leverage without the consent of our stockholders.

As of June 30, 2016, we had entered into master repurchase agreements or MRAs with 28 counterparties. As of June 30, 2016, we had approximately \$2.3 billion of borrowings outstanding under our repurchase agreements collateralized by approximately \$2.7 billion of our investments. We have entered into approximately \$205.4 million of interest rate swaps to effectively fix the interest rate of our borrowings under our repurchase agreements; net of variable-rate payment interest rate swaps of approximately \$4.0 billion, and excluding forward starting interest rate swaps of approximately \$1.7 billion. As of June 30, 2016, our aggregate debt-to-equity ratio was approximately 5.0 to 1. Our debt-to-equity ratio is computed by dividing the sum of our borrowings under repurchase agreements by total stockholders' equity. The debt to equity ratio is not a comprehensive statement of overall investment portfolio leverage which is affected by any leverage embedded in TBAs and derivative instruments.

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

We operate and elected to be taxed as a real estate investment trust ( REIT ), commencing with our taxable year ended December 31, 2012. To comply with the REIT requirements, some of our investments were held in a taxable REIT subsidiary or TRS . By acquiring investments or engaging in activities through the TRS, it enables us to engage in such activities without jeopardizing our REIT status. These investments or activities are not held or conducted at the REIT level and as a result would not impact our ability to maintain our qualification as a REIT. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute, in accordance with the REIT regulations, all of our net taxable income to stockholders and maintain our intended qualification as a REIT.

We also intend to operate our business in a manner that will permit us to maintain our exemption from registration under the 1940 Act.

Table of Contents

**Factors Impacting Our Operating Results**

Our results of operations are affected by a number of factors and primarily depend on our net interest income, changes in the market value of our investments, derivative instruments and to a lesser extent realized gains and losses on the sale of our investments and termination of our derivative instruments. Our overall performance is also impacted by the supply and demand for our target assets in the market, the terms and availability of financing for such assets, general economic conditions, the impact of U.S Government actions that affect the real estate and mortgage sectors, and the unanticipated credit events experienced by borrowers whose loans are included in our MBS, as well as our Whole-Loan borrowers.

Our net interest income varies primarily as a result of changes in market interest rates and constant prepayment rates (or CPR) on our RMBS. The CPR measures the amount of unscheduled principal prepayments on RMBS as a percentage of the principal balance, and includes the conditional repayment rate (or CRR), which measures voluntary prepayments of mortgages collateralizing a particular RMBS and conditional default rates (or CDR), which measures involuntary prepayments resulting from defaults of the underlying mortgage loans. CPRs 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. In addition, our borrowing costs and available credit are further affected by the collateral pledged and general conditions in the credit market. Interest income on our Non-Agency RMBS is recorded using an effective yield, which reflects an estimate of expected cash flows for each security. In forecasting cash flows on our Non-Agency RMBS, we make certain assumptions about the underlying mortgage loans which include, but are not limited to, future interest rates, voluntary prepayment rates, default rates, modifications and loss severities. To the extent that our current assessment of future performance differs from our prior assessment, such changes are either reflected in the current period as other-than-temporary impairment or in the income recognized on such securities prospectively. Credit losses greater than those anticipated, or in excess of purchase discount on a given security, could have a material adverse impact on our operating results.

**Recent Market Conditions**

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

The first quarter was extremely challenging and volatile for the credit markets, resulting in a disappointing first quarter of 2016 for credit sensitive securities. The markets experienced a downturn in January and February as concerns surrounding global economic conditions and commodity prices exerted pressure on mortgage and asset backed securities, resulting in credit spreads widening during the quarter. We believe the spread widening in credit sensitive securities that negatively impacted our performance during the first quarter were more technical in nature and not driven by any fundamental deterioration in the fundamentals of the U.S real estate markets. Consumer mortgage credit continued to show stable to modest improvement in borrower performance. Home prices also continued to modestly rise and consumer appetite for housing continued to remain stable with expanding mortgage credit availability.



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

During the first two months of the second quarter investor sentiment improved, resulting in a rebound in the equity, corporate fixed income markets and the credit sensitive mortgage markets. In June the markets experienced a downturn as Brexit triggered risk-off sentiment due to the uncertainty in the European geopolitical landscape. After the Brexit induced market volatility and rally in the U.S. treasury market waned, both our Agency and Non-Agency securities spreads tightened. We were able to deliver improved performance in the second quarter as a result of spreads tightening and reduced hedge adjusted borrowing costs.

Table of Contents

Although there remains uncertainty in the European geopolitical landscape we expect continued yet gradual growth in the U.S. and a positive outlook for both the residential and consumer markets. Wall Street remains skeptical the Federal Reserve will raise rates at all in 2016 and we believe the U.S. will remain in a lower for longer rate environment.

**Our Investment Strategy**

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

Our target assets are Agency RMBS (including to-be-announced securities or TBAs) and Non-Agency RMBS, Agency CMBS, Non-Agency CMBS, Non U.S. CMBS, ABS, Residential Whole-Loans and Whole-Loan securities. In 2016, under current market conditions, we expect to deploy our capital to Agency RMBS Non-Agency RMBS, Residential Whole-Loans and Whole-Loan securities with the intention of shifting our investments towards a balanced portfolio. We do not have specific investment guidelines providing for precise minimum or maximum allocations to any sector other than those necessary for maintaining our qualification as a REIT and our exemption from the 1940 Act. These regulatory limits restrict our ability to shift away from Agency securities and diversify the portfolio as certain MBS securities that do not qualify as real estate assets. Accordingly, subject to these limits, allocations to various sectors may vary significantly with market constraints and our Manager's investment views. Our Manager has not and does not expect to purchase securities on our behalf with a view to selling them shortly after purchase. However, in order to maximize returns and manage portfolio risk while remaining opportunistic, we may dispose of securities earlier than anticipated or hold securities longer than anticipated depending upon prevailing market conditions, credit performance, availability of leverage or other factors regarding a particular asset and/or our capital position.

As of June 30, 2016, the fair value of our investment portfolio, excluding the securitized commercial loan from a consolidated VIE, was comprised of 60.3% of Agency RMBS, 15.6% of Non-Agency RMBS, 0.9% of Agency CMBS, 14.3% of Non-Agency CMBS, 1.8% of other securities and 7.1% of Residential Whole-Loans.

**Our Target Assets**

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

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

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

Table of Contents

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

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

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

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

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

*Non-Agency RMBS.* - RMBS that are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations. The mortgage loan collateral for Non-Agency RMBS consists of residential mortgage loans that do not generally conform to underwriting guidelines issued by a U.S. Government agency or U.S. Government-sponsored entity due to certain factors, including mortgage balances in excess of Agency underwriting guidelines, borrower characteristics, loan characteristics and/or level of documentation, and therefore are not issued or guaranteed by a U.S. Government agency or U.S.

Government-sponsored entity. The mortgage loan collateral may be classified as subprime, Alternative-A or prime depending on the borrower's credit rating and the underlying level of documentation. Non-Agency RMBS may be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages.

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

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

Table of Contents

*Non U.S. CMBS.* - CMBS which is not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity and which is secured by commercial real estate located outside of the U.S. Although our Manager believes that these investments can provide attractive risk-reward opportunities and offer additional asset diversification, investing in international real estate has a number of additional risks, including but not limited to currency risk, political risk and the legal risk of investing in jurisdiction(s) with varying laws and regulations and potential tax implications. See Item 7A: Quantitative and Qualitative Disclosures about Market Risk Foreign Investment Risk and Currency Risk herein.

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

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

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

*Residential Whole-Loans.* Residential Whole-Loans are mortgages secured by single family residences held directly by us or through structured Non Agency RMBS programs crafted specifically for us and other clients of our Manager. To date our Residential Whole-Loans have been mostly adjustable rate loans that do not qualify for the Consumer Finance Protection Bureau's (or CFPB) safe harbor provision for qualifying mortgages. However, our Manager's review, relating to possible purchases of loans, includes an analysis of the loan originator's procedures and documentation for compliance with Ability to Repay requirements. These loans are held in consolidated trusts with us holding the beneficial interest in the trusts. We may in the future securitize the whole-loan interests, selling more senior interests in the pool of loans and retaining residual portions. The characteristics of our Residential Whole-Loans may vary going forward.

*Commercial Whole-Loans.* - Our Manager is also actively exploring opportunities to invest in small balance, \$2.5 million to \$25.0 million, Commercial Whole-Loans, including commercial mortgages and Small Business Administration or SBA loans secured primarily by real estate. While our Manager has experience in CMBS and we currently invest in Agency and Non-Agency CMBS, as well as, Non U.S. CMBS, investing in Whole-Loans backed or secured by commercial real estate assets involves complex investment, structural, regulatory and accounting issues. Some of these issues are unique to Commercial Whole-Loans as opposed to residential mortgages. Accordingly, there is no assurance of the prevalence such investments will have in our overall portfolio in the future.

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

Table of Contents

**Our Financing Strategy**

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

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

Our operating results depend in large part on differences between the income earned on our assets and our cost of borrowing and hedging activities. We use leverage to increase potential returns to our stockholders. We currently accomplish this by borrowing against existing investments through repurchase agreements.

We primarily finance our investments through repurchase agreements for which we pledge our assets. Our pledged assets are currently comprised of Agency RMBS, Non-Agency RMBS, Agency CMBS, Non-Agency CMBS, other securities and Residential Whole-Loans. Our repurchase agreements have maturities generally ranging from one to three months, but in some cases longer. The amount borrowed under our repurchase agreements is a specified percentage of the asset's fair value, which is dependent on the collateral type. The portion of the pledged collateral held by the counterparty in excess of the amount borrowed under the repurchase agreement is the margin requirement for that borrowing. Repurchase agreements involve the transfer of the pledged collateral to a counterparty at an agreed upon price in exchange for such counterparty's simultaneous agreement to return the same security back to the borrower at a future date (i.e., the maturity of the borrowing). Under our repurchase agreements, we retain beneficial ownership of the pledged collateral, while the counterparty maintains custody of such collateral. At the maturity of a repurchase financing, unless the repurchase financing is renewed with the same counterparty, we are required to repay the loan, including any accrued interest, and concurrently reacquire custody of the pledged collateral or, with the consent of the counterparty, we may renew the repurchase financing at the then prevailing market interest rate and terms. Margin calls from counterparties are routinely experienced by us when the fair value of our existing pledged collateral declines as a result of principal amortization and prepayments or due to changes in market interest rates, spreads or other market conditions. As a result, the counterparty will require that we pledge additional securities and/or cash as collateral to secure our borrowings under repurchase financing. In certain circumstances, we also may make margin calls on our counterparties when collateral values increase. As of June 30, 2016, we had \$30.7 million of cash collateral held by our repurchase agreement counterparties and we have satisfied all of our margin calls.

The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate MBS and other fixed rate securities will remain static. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an



increase in short-term interest rates could also have a negative impact on the market value of our assets. If either of these events happens, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

We expect to maintain a debt to equity ratio of three to ten times the amount of our stockholders' equity, although there is no stated minimum or maximum leverage in our investment policies. To the extent the Agency MBS percentage of our portfolio decreases, our overall leverage is likely to decrease. Depending on the different cost of borrowing funds at different maturities, we will vary the maturities of our borrowed funds to attempt to produce lower borrowing costs and reduce interest rate risk. Generally, we enter into collateralized borrowings only with institutions that are rated investment grade by at least one nationally-recognized statistical rating organization. We rely on financing to acquire, on a leveraged basis, assets in which we invest. If market conditions deteriorate, our counterparties may exit the repurchase market, and tighten lending standards, or increase the amount of equity capital required to obtain financing thereby making it more difficult and costly for us to obtain financing. In the future, we may be limited or restricted in the amount of leverage we may employ by the terms and provisions of any financing or other agreements. We may also change our financing strategy and leverage without the consent of our stockholders.

#### **Our Hedging Strategy**

Subject to maintaining our qualification as a REIT for U.S. federal income purposes, we pursue various economic hedging strategies in an effort to reduce our exposure to adverse changes in interest rates and, to a more limited extent, foreign currency. The U.S. federal income tax rules applicable to REITs may require us to implement certain of these techniques through a domestic TRS that is fully subject to federal, state and local corporate income taxation.

Table of Contents

Our hedging activity varies in scope based on the level and volatility of interest rates, the type of assets held, including currency denomination and other changing market conditions. The majority of swaps we entered into are designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swaps generally provide for fixed interest rates indexed off of the London interbank offered rate or LIBOR and effectively fix the floating interest rates. Notwithstanding the foregoing, in order to manage our hedge position with regard to our liabilities, we on occasion will enter into interest rate swaps which involve the receipt of fixed-rate amounts from counterparty in exchange for us making variable-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. We also enter into compression trades that enable us to terminate substantial amounts of swap contracts before they expire by their terms, when there has been substantial two-way (pay and receive) swap activity. These compression trades reduce the number of interest rate swaps outstanding. In addition to simplifying, our balance sheet, by reducing the number of interest rate swaps outstanding, we are frequently able to reduce the amount of margin required to carry such positions.

We utilize forward starting swaps and swaptions for several reasons including replacing expiring swaps, in anticipation of increasing our overall financing and reducing our exposure to future interest rate increases. Interest rate swaptions provide us the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and set pay and receive interest rates in the future.

We utilize foreign currency swaps, agreeing to pay a fixed amount of non U.S. currency such as the euro in exchange for a fixed amount of U.S. dollars as well as currency forwards. We entered into the currency swaps and forwards in order to hedge our exposure to foreign currency with respect to Non U.S. CMBS investments and the corresponding repurchase financings utilized to make such investments.

In order to enable us to maintain compliance with the REIT requirements, we have generally elected to treat the aforementioned derivative instruments as hedges for U.S. federal tax purposes. To date, however, we have not elected to apply hedge accounting for financial statement reporting purposes for our derivative instruments. As a result, we record the change in fair value of our derivatives and the associated interest and currency exchange in earnings. Additionally, we may enter into hedging transactions in the form of puts and calls or other financial instruments that we deem appropriate.

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

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



Table of Contents

**Critical Accounting Policies**

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

**Fair value option**

We elected the fair value option for all of our investments at the date of purchase and for our securitized debt, which permits us to measure these investments and securitized debt at fair value with the change in fair value included as a component of earnings. Although we have elected the fair value option for our investments and securitized debt, we separately compute interest income on our MBS, other securities and Whole-Loans under the prescribed method based on the nature of the investment.

**Valuation of financial instruments**

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

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

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

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

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

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

When available, we use quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, we will use independent pricing services and if the independent pricing service cannot price a particular asset or liability, we will obtain third party broker quotes. Our Manager's pricing group, which functions independently from its portfolio management personnel, reviews the third party broker quotes for reasonableness using alternate sources when available. If independent pricing service, or third party broker quotes are not available, we determine the fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates and when applicable, estimates of prepayments and credit losses.

Fair value under GAAP represents an exit price in the normal course of business, not a forced liquidation price. If we are forced to sell assets in a short period to meet liquidity needs, the prices we receive could be substantially less than the recorded fair values of our assets.

We perform quarterly reviews of the independent third party pricing data which may consist of a review of the daily change in the prices provided by the independent pricing vendor that exceed established tolerances or comparisons to executed transaction prices, utilizing our Manager's pricing group. Our Manager's pricing group reviews the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager's pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that our Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, our Manager generally challenges the independent pricing service price.

Table of Contents

**Interest income recognition and Impairment**

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

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

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

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

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

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

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

prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities are affected by the contractual lives of the underlying collateral, periodic payments of scheduled principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual maturities.

Based on the projected cash flow of such securities purchased at a discount to par value, we may designate a portion of such purchase discount as credit protection against future credit losses and, therefore, not accrete such amount into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

Table of Contents

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

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

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

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

*Residential and Commercial Loans*

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

**Variable Interest Entities ( VIEs )**

VIEs are defined as entities that by design either lack sufficient equity for the entity to finance its activities without additional subordinated financial support or are unable to direct the entity's activities or are not exposed to the entity's losses or entitled to its residual returns. We



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

evaluate all of our interests in VIEs for consolidation. When the interests are determined to be variable interests, we assess whether we are deemed the primary beneficiary. The primary beneficiary of a VIE is determined to be the party that has both the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

To assess whether we have the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, we consider all facts and circumstances, including its role in establishing the VIE and our ongoing rights and responsibilities. This assessment includes first, identifying the activities that most significantly impact the VIE's economic performance; and second, identifying which party, if any, has power over those activities. In general, the parties that make the most significant decisions affecting the VIE or have the right to unilaterally remove those decision makers is deemed to have the power to direct the activities of a VIE.

Table of Contents

To assess whether we have the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE, we consider all of its economic interests. This assessment requires that we apply judgment in determining whether these interests, in the aggregate, are considered potentially significant to the VIE. Factors considered in assessing significance include: the design of the VIE, including its capitalization structure; subordination of interests; payment priority; relative share of interests held across various classes within the VIE's capital structure; and the reasons why the interests are held by us.

In instances when a VIE is owned by both us and related parties, we consider whether there is a single party in the related party group that meets both the power and losses or benefits criteria on its own as though no related party relationship existed. If one party within the related party group meets both these criteria, such reporting entity is the primary beneficiary of the VIE and no further analysis is needed. If no party within the related party group on its own meets both the power and losses or benefits criteria, but the related party group does as a whole meets these two criteria, the determination of primary beneficiary within the related party group is based upon an analysis of the facts and circumstances with the objective of determining which party is most closely associated with the VIE. Determining the primary beneficiary within the related party group requires significant judgement.

In instances when we are required to consolidate a VIE that is determined to be a qualifying collateralized financing entity, under GAAP, we will measure both the financial assets and financial liabilities of the VIE using the fair value of either the VIE's financial assets or financial liabilities, whichever is more observable.

Ongoing assessments of whether an enterprise is the primary beneficiary of a VIE is required.

**Derivatives and hedging activities**

Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, we utilize derivative financial instruments, including interest rate swaps, interest rate swaptions, mortgage put options, currency forwards, futures contracts, total return swaps, TBAs and Agency and Non-Agency Interest-Only Strips to hedge the interest rate and currency risk associated with our portfolio and related borrowings. We have also entered into credit derivatives such as total return swaps. The total return swap will allow us to receive the total economic return on a referenced asset without actually buying the asset. Derivatives, subject to REIT requirements, are generally used for hedging purposes rather than speculation, but may also be used to establish positions in assets without purchasing them. We determine their fair value of our derivative positions and obtain quotations from third parties, including the Chicago Mercantile Exchange or CME, to facilitate the process of determining such fair values. If our hedging activities do not achieve the desired results, reported earnings may be adversely affected.

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

We elected not to apply hedge accounting for our derivative instruments. Accordingly, we record the change in fair value of our derivative instruments, which includes net interest rate swap payments (including accrued amounts) and net currency payments (including accrued amounts) related to interest rate swaps and currency swaps, respectively, in Gain (loss) on derivative instruments, net in our Consolidated Statements of Operations. In our Consolidated Statements of Cash Flows, premiums received and paid on termination of our interest rate swaps, excluding interest rate swaps containing an other-than-insignificant financing element and the unamortized premium of market agreed coupon ( MAC ) interest rate swaps, are included in cash flows from operating activities. Alternatively, proceeds and payments on settlement of swaptions, mortgage put options, futures contracts and TBAs are included in cash flows from investing activities. Proceeds and payments on settlement of forward contracts are reflected in cash flows from financing activities in our Consolidated Statement of Cash Flows. While payments made at the time of entering MAC interest rate swaps are included in cash flows from investing activities, payments received by us upon entering MAC interest rate swaps are included in either cash flows from investing activities or cash flows financing activities, depending on whether or not the derivative instrument includes an other-than-insignificant financing element. For MAC interest rate swaps containing an other-than-insignificant financing element, all cash flows over the life of the derivative are treated as cash flows from financing activities. Return and recovery of basis activity for MAC interest rate swaps is included in cash flows from investing activities for swaps not containing an other-than-insignificant financing element in our Consolidated Statement of Cash Flows. For Agency and Non-Agency Interest-Only Strips accounted for as derivatives, the purchase, sale and recovery of basis activity is included with MBS and other securities under cash flows from investing activities in our Consolidated Statement of Cash Flows.

Table of Contents

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

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

**Accounting standards applicable to emerging growth companies**

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

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

to Section 107 of the JOBS Act.

Table of Contents

**Recent accounting pronouncements**

Accounting Standards to be Adopted in Future Periods

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). The guidance changes an entity's recognition of revenue from contracts with customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, the new guidance requires improved disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In March 2016, the FASB issued implementation guidance which clarifies principal versus agent considerations in reporting revenue gross versus net (ASU 2016-08). In April 2016, the FASB issued implementation guidance which clarifies the identification of performance obligations (ASU 2016-10). In applying the new guidance, an entity may use either a retrospective approach to each prior reporting period or a retrospective approach with the cumulative effect recognized at the date of initial application. For a public company, the standard is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early adoption is not permitted for a public entity. The new guidance is not expected to have a material impact on our consolidated financial statements.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. The guidance that will require an entity's management to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. According to the new guidance, substantial doubt exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date the financial statements are issued. The term "probable" is used consistently with its current use in U.S. GAAP for loss contingencies. Disclosures will be required if conditions give rise to substantial doubt about the entity's ability to continue as a going concern, including whether management's plans that are intended to mitigate those conditions will alleviate the substantial doubt when implemented. The guidance is effective for annual periods ending after December 15, 2016. The effective date is the same for both public companies and all other entities. Early application is permitted. Our first assessment under the new guidance will be completed for the year ending December 31, 2016.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The guidance improves certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The standard is effective for a public company for fiscal years beginning after December 15, 2017, and for interim periods within those fiscal years. Early adoption by public companies for fiscal years or interim periods that have not yet been issued or, by all other entities, that have not yet been made available for issuance of this guidance are permitted as of the beginning of the fiscal year of adoption, under certain restrictions. The Company should apply the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The guidance related to equity securities without readily determinable fair values should be applied prospectively to equity investments that exist at the date of adoption. We are currently assessing the impact that this guidance will have on our consolidated financial statements when adopted.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. The guidance changes the accounting for certain aspects of share-based payments to employees. The guidance requires the recognition of the income tax effects of awards in the income statement when the awards vest or are settled, thus eliminating additional paid

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

in capital pools. The guidance also allows for the employer to repurchase more of an employee's shares for tax withholding purposes without triggering liability accounting. In addition, the guidance allows for a policy election to account for forfeitures as they occur rather than on an estimated basis. For a public company, the standard is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is permitted in any interim or annual period. We are currently assessing the impact that this guidance will have on our consolidated financial statements when adopted.

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

### Table of Contents

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The guidance requires financial assets measured at amortized cost basis to be presented at the net amount expected to be collected by deducting an allowance for credit losses from the amortized cost basis of the financial assets. For available-for-sale debt securities, the new guidance aligns the income statement recognition of credit losses with the reporting period in which changes occur by recording credit losses through an allowance rather than a write-down and allowing subsequent reversals in credit loss estimates to be recognized in current income. The measurement of expected credit losses will be based on historical experience, current conditions and reasonable and supportable forecasts. An entity must use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances. For a public company, the standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption will be permitted for fiscal years beginning after December 15, 2018. The guidance should be applied through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. For certain assets, a prospective transition approach is required. We are currently assessing the impact that this guidance will have on its consolidated financial statements when adopted.

### *Investments*

#### *Our Current Investment Portfolio*

The following table presents certain information about our investment portfolio at June 30, 2016 (dollars in thousands):

	Principal Balance	Unamortized Premium (Discount)	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain (Loss)	Fair Value	Net Weighted Average Coupon (1)
<b>Agency RMBS</b>							
20-Year mortgage							
Coupon Rate:							
3.50%	135,835	7,047		142,882	2,421	145,303	3.5%
4.00%	389,784	20,725		410,509	11,293	421,802	4.0%
	525,619	27,772		553,391	13,714	567,105	3.9%
30-Year mortgage							
Coupon Rate:							
3.50%	227,007	11,799		238,806	1,471	240,277	3.5%
4.00%	269,046	22,485		291,531	2,603	294,134	4.0%
4.50%	343,479	23,989		367,468	16,169	383,637	4.5%
5.00%	54,192	6,588		60,780	987	61,767	5.0%
5.50%	2,389	338		2,727	(41)	2,686	5.5%
6.00%	2,461	271		2,732	131	2,863	6.0%
	898,574	65,470		964,044	21,320	985,364	4.1%
<b>Agency RMBS IOs and IIOs(2)</b>							
	N/A	N/A		24,430	808	25,238	2.8%
<b>Agency RMBS IOs and IIOs accounted for as derivatives</b>							
(2)(3)	N/A	N/A	N/A	N/A	N/A	27,452	3.4%
	N/A	N/A		24,430	808	52,690	3.1%



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

Agency CMBS	13,178			13,178	(308)	12,870	5.1%
Agency CMBS Interest-Only Strips(2)	N/A	N/A	N/A	1,063	119	1,182	4.6%
Agency CMBS IOs and IIOs accounted for as derivatives (2)(3)	N/A	N/A	N/A	N/A	N/A	9,482	0.6%
	13,178			14,241	(189)	23,534	1.4%
Non-Agency RMBS	454,376	(22,549)	(115,964)	315,863	10,748	326,611	3.8%
Non-Agency RMBS IOs and IIOs(2)	N/A	N/A	N/A	61,221	23,644	84,865	5.9%
Non-Agency RMBS IOs and IIOs accounted for as derivatives (2)(3)	N/A	N/A	N/A	N/A	N/A	3,906	4.9%
	454,376	(22,549)	(115,964)	377,084	34,392	415,382	4.6%
Non-Agency CMBS, including Non U.S. Other securities(4)	498,546	(72,287)	(11,588)	414,671	(33,078)	381,593	5.0%
Residential Whole-Loans	30,607	(1,437)	(1,610)	49,523	(258)	49,265	6.4%
Securitized commercial loan	184,312	1,159		185,471	4,225	189,696	4.8%
Total	25,000			25,000	(1,312)	23,688	9.0%
	\$ 2,630,212	\$ (1,872)	\$ (129,162)	\$ 2,607,855	\$ 39,622	\$ 2,688,317	4.0%

(1) Net weighted average coupon as of June 30, 2016 is presented net of servicing and other fees.

(2) IOs and IIOs have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities. At June 30, 2016, the notional balance for Agency RMBS IOs and IIOs, Agency RMBS IOs and IIOs accounted for as derivatives, Non-Agency RMBS IOs and IIOs, Non-Agency RMBS IOs and IIOs accounted for as derivatives, Agency CMBS IOs and IIOs, and Agency CMBS IOs and IIOs accounted for as derivatives was \$261.5 million, \$308.3 million, \$301.1 million, \$23.2 million, \$41.3 million and \$233.3 million, respectively.

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

(4) Other securities include residual interests in asset-backed securities which have no principal balance and an amortized cost of approximately \$22.0 million.

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

### Table of Contents

The following table summarizes our MBS and other securities at fair value according to their estimated weighted average life classifications as of June 30, 2016 (dollars in thousands):

Weighted Average Life	Fair Value	Net Weighted Average Coupon(1)
Less than or equal to three years	\$ 88,849	4.8%
Greater than three years and less than or equal to five years	1,151,195	3.9%
Greater than five years and less than or equal to 10 years	1,096,037	4.1%
Greater than 10 years	138,852	3.3%
<b>Total</b>	<b>\$ 2,474,933</b>	<b>3.0%</b>

(1) Net weighted average coupon as of June 30, 2016 is presented net of servicing and other fees.

### *Our Agency Portfolio*

The following table summarizes certain characteristics of our Agency portfolio by issuer and investment category as of June 30, 2016 (dollars in thousands):

	Principal Balance	Amortized Cost	Fair Value	Net Weighted Average Coupon (1)
<b>Agency RMBS 20-Year and 30-Year</b>				
Fannie Mae	\$ 1,032,033	\$ 1,103,404	\$ 1,129,283	4.1%
Freddie Mac	392,160	414,031	423,186	3.9
<b>Total Agency RMBS 20-Year and 30-Year</b>	<b>1,424,193</b>	<b>1,517,435</b>	<b>1,552,469</b>	<b>4.0</b>
<b>Agency RMBS IOs and IIOs(2)</b>				
Fannie Mae	N/A	8,820	9,426	3.1
Freddie Mac	N/A	9,592	9,601	2.4
Ginnie Mae	N/A	6,018	6,211	3.2
<b>Total Agency RMBS IOs and IIOs(2)</b>	<b>N/A</b>	<b>24,430</b>	<b>25,238</b>	<b>2.8</b>
<b>Agency RMBS IOs and IIOs accounted for as derivatives(2)</b>				
Fannie Mae	N/A	N/A	13,869	2.9
Freddie Mac	N/A	N/A	3,220	3.5
Ginnie Mae	N/A	N/A	10,363	4.2
<b>Total Agency RMBS IOs and IIOs accounted for as derivatives (2)</b>	<b>N/A</b>	<b>N/A</b>	<b>27,452</b>	<b>3.4</b>
<b>Total: Agency RMBS</b>	<b>1,424,193</b>	<b>1,541,865</b>	<b>1,605,159</b>	<b>3.5</b>
<b>Agency CMBS</b>				
Freddie Mac	13,178	13,178	12,870	5.1
<b>Agency CMBS IOs and IIOs(2)</b>				
Fannie Mae	N/A	1,063	1,182	4.6
<b>Agency CMBS IOs and IIOs accounted for as derivatives(2)</b>				

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

Ginnie Mae		N/A		N/A	9,482	0.6
Total: Agency CMBS		13,178		14,241	23,534	1.4
Total	\$	1,437,371	\$	1,556,106	\$ 1,628,693	3.5%

---

(1) Net weighted average coupon as of June 30, 2016 is presented net of servicing and other fees.

(2) IOs and IIOs have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on the interest-only class of securities.

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

### Table of Contents

The following table details the constant prepayment rates for our Agency portfolio as of June 30, 2016, based on our Manager's estimates which are based on third party models, as adjusted by our Manager, and are updated quarterly on a prospective basis:

Constant Prepayment Rates	Low	High
Agency RMBS		
20-Year mortgage	7.50%	31.59%
30-Year mortgage	7.18%	33.65%
Agency RMBS IOs and IIOs	7.78%	26.00%
Agency RMBS IOs and IIOs accounted for as derivatives	6.60%	29.10%
Agency CMBS and Agency CMBS IOs and IIOs(1)	N/A	N/A
Agency CMBS IOs accounted for as derivatives(1)	N/A	N/A

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

### *Our Non-Agency Portfolio*

The following table presents the fair value and weighted average purchase price for each of our Non-agency RMBS categories, including IOs accounted for as derivatives, together with certain of their respective underlying loan collateral attributes and current performance metrics as of June 30, 2016 (fair value dollars in thousands):

Category	Fair Value	Purchase Price	Life (Years)	Weighted Average			60+ Day Delinquent	6-Month CPR
				Original LTV	Original FICO			
Prime	\$ 65,494	\$ 71.23	8.6	64.2%	721		13.8%	13.0%
Alt-A	304,763	77.50	9.0	68.4%	702		18.9%	12.1%
Subprime	45,125	59.64	7.9	72.5%	632		20.3%	8.0%
Total	\$ 415,382	\$ 74.57	8.8	68.2%	698		18.3%	11.8%

The following table presents certain characteristics of our Non-Agency CMBS portfolio as of June 30, 2016 (dollars in thousands):

Type	Vintage	Principal Balance	Fair Value	Weighted Average	
				Life (Years)	Original LTV
Conduit:					
	2006-2009	\$ 260,510	\$ 228,016	3.5	71.8%
	2010-2015	177,245	102,206	8.7	63.7%
		437,755	330,222	5.1	69.3%
Single Asset:					
	2010-2015	60,791	51,371	6.6	55.1%
Total		\$ 498,546	\$ 381,593	5.3	69.1%

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

The following table summarizes the credit ratings of our Non-agency RMBS, Non-agency CMBS and other securities based on fair value as of June 30, 2016:

Non-Agency RMBS		Non-Agency CMBS		Other Securities	
Credit Rating (1)	Percentage	Credit Rating(1)	Percentage	Credit Rating(1)	Percentage
BBB	0.2%	BBB		% BBB	%
BBB-		% BBB-	1.0%	BBB-	%
BB		% BB	5.9%	BB	%
BB-		% BB-	5.2%	BB-	%
B+		% B+		% B+	%
B		% B	10.4%	B	%
B-	0.6%	B-	5.3%	B-	%
Below B	81.2%	Below B	53.0%	Below B	18.8%
Not Rated	18.0%	Not Rated	19.2%	Not Rated	81.2%
Total	100.0%	Total	100.0%	Total	100.0%

---

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

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

### Table of Contents

The following table details information for our Non-Agency and other securities portfolio as of June 30, 2016, based on our Manager's estimates which are based on third party models, as adjusted by our Manager, and are updated quarterly on a prospective basis:

	Cumulative Default		Cumulative Severity		Cumulative 5-Year CRR (1)	
	Low	High	Low	High	Low	High
Non-Agency RMBS	3.50%	44.06%	20.00%	84.70%	2.97%	14.09%
Non-Agency RMBS IOs and IIOs	1.50%	40.20%	20.00%	75.00%	5.97%	15.00%
Non-Agency RMBS IOS and IIOs accounted for as derivatives	3.50%	9.18%	20.00%	50.70%	6.50%	13.22%
Non-Agency CMBS	N/A	N/A	N/A	N/A	N/A	N/A
Other securities	1.50%	1.98%	100.00%	100.00%	6.00%	16.78%

### (1) Conditional Repayment Rate

The mortgages underlying our Non-Agency RMBS and Non-Agency CMBS are located in various states across the United States and other countries. The following table presents the five largest concentrations by location for the mortgages collateralizing our Non-Agency RMBS and Non-Agency CMBS as of June 30, 2016 based on fair value (dollars in thousands):

	Non-Agency RMBS		Non-Agency CMBS		
	Concentration	Fair Value	Concentration	Fair Value	
California	34.8%	\$ 144,487	California	12.0%	\$ 45,863
Florida	8.5%	35,285	Florida	7.1%	26,965
New York	8.0%	33,346	Texas	6.5%	24,648
Virginia	4.5%	18,523	New York	6.1%	23,092
Maryland	4.0%	16,741	Virginia	5.3%	20,228

We made investments in certain Non-Agency RMBS inverse floaters. The coupon rates on these securities have an inverse relationship to a benchmark rate. When the benchmark interest rate increases the coupon payment rate will decrease because the benchmark interest rate is deducted from the coupon payment. We generally purchased these securities at a premium. Accelerated prepayments on these bonds could result in an economic loss, as we would not recover the upfront premium. The premiums are amortized into income using the effective interest rate method. As of June 30, 2016 and December 31, 2015, we held \$78.2 million and \$79.1 million, respectively, in Non-Agency RMBS inverse floaters.

### *Our Whole-Loan Portfolio*

Our Residential Whole-Loans are comprised of non-qualifying, mostly adjustable rate mortgages with low LTV's. The following table presents certain information about our Residential Whole-Loans investment portfolio at June 30, 2016 (dollars in thousands):

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

Current Coupon Rate		Number of Loans	Principal Balance	Original LTV	Weighted Average		Contractual Maturity (years)	Coupon Rate
					Original FICO Score(1)	Expected Life (years)		
3.01	4.00%	89	\$ 29,339	57.4%	741	1.3	26.8	3.8%
4.01	5.00%	113	43,213	56.5%	718	1.3	27.1	4.6%
5.01	6.00%	278	108,644	54.7%	722	1.5	27.3	5.1%
6.01	7.00%	6	3,116	71.2%	738	1.3	21.6	6.3%
Total		486	\$ 184,312	55.8%	725	1.4	27.1	4.8%

---

(1) The original FICO score is not available for 131 loans with a principal balance of approximately \$53.3 million at June 30, 2016. We have excluded those loans from the weighted average computation.

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

### Table of Contents

The following table presents the U.S. states in which the collateral securing our Residential Whole-Loans at June 30, 2016 based on principal balance is located (dollars in thousands):

	State Concentration	Principal Balance
California	83.2%	\$ 153,414
Washington	6.5%	12,125
Massachusetts	5.9%	10,812
New York	2.7%	4,980
Georgia	0.9%	1,599
Other	0.8%	1,382
<b>Total</b>	<b>100.0%</b>	<b>\$ 184,312</b>

As of June 30, 2016, all of our Residential Whole-Loans were performing.

### *Investment Activity*

The following tables present our investment portfolio activity for the three and six months ended June 30, 2016 and June 30, 2015 (dollars in thousands):

	For the three months ended June 30, 2016		
	Purchases	Principal Payments and Basis Recovery	Proceeds from Sales
Agency RMBS and Agency RMBS IOs and IIOs	\$ 684	\$ 58,303	\$ 9,540
Non-Agency RMBS	5,378	19,146	22,639
Agency CMBS and Agency CMBS IOs and IIOs		1,469	3,645
Non-Agency CMBS		9,242	12,735
Other securities		269	
Total MBS and other securities	\$ 6,062	\$ 88,429	\$ 48,559
Residential Whole-Loans		11,113	
Total MBS and other securities: Including Whole-Loans and securitized commercial loan	\$ 6,062	\$ 99,542	\$ 48,559

	For the six months ended June 30, 2016		
	Purchases	Principal Payments and Basis Recovery	Proceeds from Sales
Agency RMBS and Agency RMBS IOs and IIOs	\$ 288,004	\$ 101,745	\$ 324,250
Non-Agency RMBS	10,796	34,214	105,440
Agency CMBS and Agency CMBS IOs and IIOs		2,515	10,421
Non-Agency CMBS		23,149	24,994
Other securities	700,836	1,765	750,226



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

Total MBS and other securities	\$	999,636	\$	163,388	\$	1,215,331
Residential Whole-Loans				28,334		
Total MBS and other securities: Including Whole-Loans and securitized commercial loan	\$	999,636	\$	191,722	\$	1,215,331

For the three months ended June 30, 2015

	Purchases	Principal Payments and Basis Recovery	Proceeds from Sales	
Agency RMBS and Agency RMBS IOs and IIOs	\$	\$	89,302	
Non-Agency RMBS			17,990	
Agency CMBS and Agency CMBS IOs and IIOs			1,255	
Non-Agency CMBS	84,178	511	63,345	
Other securities	55,076	383	16,365	
Total MBS and other securities	\$	\$	109,441	
Residential Whole-Loans(1)	6,865	2,543		
Total MBS and other securities: Including Residential and Commercial Whole-Loans	\$	\$	111,984	
			\$	287,959

(1) Purchases of Residential Whole-Loans include premiums of \$102 thousand paid at acquisition.

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

Table of Contents

	For the six months ended June 30, 2015		
	Purchases	Principal Payments and Basis Recovery	Proceeds from Sales
Agency RMBS and Agency RMBS IOs and IIOs	\$ 159,048	168,996	509,981
Non-Agency RMBS	128,066	36,930	207,594
Agency CMBS and Agency CMBS IOs and IIOs		2,264	
Non-Agency CMBS	115,581	937	90,888
Other securities	65,126	995	16,365
Total MBS and other securities	\$ 467,821	210,122	\$ 824,828
Residential Whole-Loans(1)	17,325	2,563	
Commercial Whole-Loans	8,750		
Total MBS and other securities: Including Residential and Commercial Whole-Loans	\$ 493,896	\$ 212,685	\$ 824,828

(1) Purchases of Residential Whole-Loans include premiums of \$332 thousand paid at acquisition.

The following table presents the vintage of our investment portfolio at June 30, 2016:

	2001	2003	2004	2005	2006	2007	2010	2011	2012	2013	2014	2015	2016	Total
Agency RMBS														
20-Year Mortgage									2.3%	11.0%	6.2%	1.6%		21.1%
30-Year Mortgage								0.1%	9.2%	7.5%	10.8%	4.5%	4.6%	36.7%
Agency RMBS Interest Only- Strips									0.4%	0.1%	0.3%			0.8%
Agency RMBS Interest-Only Strips, accounted for as derivatives					0.1%		0.1%	0.1%	0.6%	0.1%	0.1%			1.1%
Agency CMBS											0.5%			0.5%
Agency CMBS Interest-Only Strips, accounted for as derivatives									0.1%	0.3%				0.4%
Non-Agency RMBS		0.1%		4.0%	2.8%	2.8%					0.3%	2.1%		12.1%
Non-Agency RMBS Interest Only- Strips				0.3%	0.8%	2.1%								3.2%
Non-Agency RMBS Interest-Only Strips, accounted for as derivatives				0.1%										0.1%
Non-Agency CMBS					4.6%	3.9%		1.2%	0.2%	0.1%	1.3%	2.9%		14.2%
Other securities	0.3%										0.5%	1.0%		1.8%
Residential Whole-Loans								0.3%	0.5%	4.0%	2.1%	0.2%		7.1%
Securitized commercial loan												0.9%		0.9%
Total	0.3%	0.1%	%	4.4%	8.3%	8.8%	0.1%	1.7%	13.3%	23.1%	22.1%	13.2%	4.6%	100%

As of June 30, 2016 the weighted average expected remaining term to the expected maturity of our investment portfolio was 5.3 years.

*Financing and Other Liabilities*

We have entered into repurchase agreements to finance the vast majority of our investments. These agreements are secured by substantially all of our investments and bear interest at rates that have historically moved in close relationship to LIBOR. The following table summarizes our repurchase agreements and the fair value of the collateral pledged as of June 30, 2016 and December 31, 2015 (dollars in thousands):

Collateral	June 30, 2016		December 31, 2015	
	Repurchase Agreement Borrowings Outstanding	Fair Value of Collateral Pledged (1)	Repurchase Agreement Borrowings Outstanding	Fair Value of MBS Collateral Pledged
Agency RMBS	\$ 1,547,407	\$ 1,599,803	\$ 1,601,713	\$ 1,658,865
Agency CMBS	20,258	23,534	32,699	37,872
Non-Agency RMBS	279,591	415,307	380,177	530,110
Non-Agency CMBS	275,021	381,594	323,670	449,771
Whole-Loans and securitized commercial loan(1)	161,732	202,961	180,892	232,538
Other securities	26,710	49,265	66,650	101,099
Borrowings under repurchase agreements	2,310,719	2,672,464	2,585,801	3,010,255
Less unamortized debt issuance cost		N/A	134	N/A
Borrowings under repurchase agreements, net	\$ 2,310,719	\$ 2,672,464	\$ 2,585,667	\$ 3,010,255

(1) Repurchase borrowings and collateral pledged attributed to Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

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

### Table of Contents

The following tables present our repurchase agreement borrowing activity, by type of collateral pledged, for the three and six months ended June 30, 2016 and June 30, 2015 (dollars in thousands):

Collateral	For the three months ended June 30, 2016		For the six months ended June 30, 2016	
	Proceeds	Repayments	Proceeds	Repayments
Agency RMBS	\$ 1,688,132	\$ 1,732,606	\$ 3,911,836	\$ 3,966,142
Agency CMBS	50,832	54,141	109,355	121,796
Non-Agency RMBS	359,522	375,299	816,986	917,572
Non-Agency CMBS	392,099	411,377	780,006	828,952
Whole-Loans and securitized commercial loan(1)	645,496	654,551	1,093,590	1,112,750
Other securities	80,523	80,759	280,590	320,530
<b>Total</b>	<b>\$ 3,216,604</b>	<b>\$ 3,308,733</b>	<b>\$ 6,992,363</b>	<b>\$ 7,267,742</b>

(1) Repurchase borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

Collateral	For the three months ended June 30, 2015		For the six months ended June 30, 2015	
	Proceeds	Repayments	Proceeds	Repayments
Agency RMBS	\$ 3,030,332	\$ 3,302,170	\$ 6,735,595	\$ 7,208,510
Agency CMBS	64,756	65,438	143,699	145,449
Non-Agency RMBS	617,655	626,995	1,228,058	1,304,382
Non-Agency CMBS	482,720	464,352	1,032,476	1,013,290
Whole-Loans and securitized commercial loan(1)	5,410	1,533	13,612	1,548
Other securities	136,269	119,923	258,644	238,642
<b>Total</b>	<b>\$ 4,337,142</b>	<b>\$ 4,580,411</b>	<b>\$ 9,412,084</b>	<b>\$ 9,911,821</b>

(1) Repurchase borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

At June 30, 2016, we had outstanding repurchase agreement borrowings with the following counterparties totaling approximately \$2.3 billion:

(dollars in thousands)	Amount Outstanding	Percent of Total Amount Outstanding	Fair Value of Company Investments Held as Collateral(1)	Counterparty Rating(2)
Repurchase Agreement Counterparties				
Merrill Lynch Pierce Fenner & Smith Inc.	\$ 493,194	21.4%	\$ 501,313	A+
Morgan Stanley & Co. LLC	298,485	12.9%	325,259	A+

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

RBC (Barbados) Trading Bank Corporation	252,260	10.9%	329,285	P-1
Barclays Capital Inc.	182,930	7.9%	221,701	A-
Credit Suisse AG, Cayman Islands Branch	154,942	6.7%	189,696	A
TD Securities (USA) LLC	153,233	6.6%	161,181	AA-
The Bank of Nova Scotia	100,526	4.4%	102,428	A+
Deutsche Bank AG	95,400	4.1%	124,022	BBB+
Deutsche Bank Securities LLC	94,595	4.1%	98,523	BBB+
Credit Suisse Securities (USA) LLC	90,062	3.9%	153,992	A
RBC Capital Markets LLC	88,724	3.8%	92,603	AA-
Goldman Sachs Bank USA	66,975	2.9%	105,921	A+
KGS-Alpha Capital Markets, L.P.	62,378	2.7%	65,426	Unrated
Mizuho Securities USA Inc.	57,863	2.5%	63,229	A
BNP Paribas Securities Corporation	57,350	2.5%	61,746	A
Nomura Securities International, Inc.	42,330	1.8%	52,529	Unrated(3)
All other counterparties (4)	19,472	0.9%	23,610	
Total	\$ 2,310,719	100.0%	\$ 2,672,464	

(1) Fair value of Company assets held as collateral includes Residential Whole-Loans and securitized commercial loan owned through trust certificates with a fair value of \$189.9 million and \$13.3 million, respectively.

(2) The counterparty ratings presented above are the long-term issuer credit ratings as rated at June 30, 2016 by S&P, except for RBC (Barbados) Trading Bank Corporation which is the short-term issuer credit rating by Moody's at June 30, 2016.

(3) Nomura Holdings, Inc., the parent company of Nomura Securities International, Inc., is rated BBB+ by S&P at June 30, 2016.

(4) Represents amount outstanding with four counterparties each holds collateral valued less than 5% of our stockholders' equity as security for our obligations under the applicable repurchase agreements as of June 30, 2016.

Table of Contents

At December 31, 2015, we had outstanding repurchase agreement borrowings with the following counterparties totaling approximately \$2.6 billion:

(dollars in thousands) Repurchase Agreement Counterparties	Amount Outstanding(1)	Percent of Total Amount Outstanding	Fair Value of Company Investments Held as Collateral(2)	Counterparty Rating(3)
Merrill Lynch Pierce Fenner & Smith Inc.	\$ 347,601	13.4%	\$ 347,998	A
RBC (Barbados) Trading Bank Corporation	322,154	12.5%	420,564	P-1
Credit Suisse Securities (USA) LLC	310,897	12.0%	429,833	A
JP Morgan Securities LLC	301,424	11.7%	324,133	A+
Barclays Capital Inc.	222,058	8.6%	262,381	A-
UBS Securities LLC	143,318	5.5%	193,130	A
BNP Paribas Securities Corporation	123,181	4.8%	129,483	A+
Goldman Sachs Bank USA	117,897	4.6%	120,848	A
Deutsche Bank Securities LLC	110,610	4.3%	120,550	BBB+
TD Securities (USA) LLC	88,157	3.4%	92,686	AA-
Mizuho Securities USA Inc.	85,825	3.3%	96,008	(P)A2
KGS-Alpha Capital Markets, L.P.	72,778	2.8%	76,261	Unrated
Morgan Stanley & Co. LLC	67,110	2.6%	72,693	A
Nomura Securities International, Inc.	65,677	2.5%	79,196	Unrated(4)
Deutsche Bank AG	61,442	2.4%	90,260	BBB+
RBC Capital Markets LLC	59,695	2.3%	62,029	AA-
The Bank of Nova Scotia	58,801	2.3%	59,922	A+
All other counterparties (5)	27,176	1.0%	32,280	
<b>Total</b>	<b>\$ 2,585,801</b>	<b>100.0%</b>	<b>\$ 3,010,255</b>	

(1) Excludes unamortized debt issuance costs of \$134 thousand.

(2) Fair value of Company assets held as collateral includes Residential Whole-Loans and securitized commercial loan owned through trust certificates with a fair value of \$218.5 million and \$14.0 million, respectively.

(3) The counterparty ratings presented above are the long-term issuer credit ratings as rated at December 31, 2015 by S&P, except for Mizuho Securities USA Inc. which is the long-term issuer credit rating by Moody's at December 31, 2015 and for RBC (Barbados) Trading Bank Corporation which is the short-term issuer credit rating by Moody's at December 31, 2015.

(4) Nomura Holdings, Inc., the parent company of Nomura Securities International, Inc., is rated BBB+ by S&P at December 31, 2015.

(5) Represents amount outstanding with four counterparties each holds collateral valued less than 5% of our stockholders' equity as security for our obligations under the applicable repurchase agreements as of December 31, 2015.

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

We record the liability for MBS and other securities purchased, for which settlement has not taken place as an investment related payable. As of June 30, 2016, we had investment related payables of \$1.6 million of which no items were outstanding greater than 30 days.

The following tables present our repurchase agreement borrowings by type of collateral pledged as of June 30, 2016 and June 30, 2015, and the respective Cost of Funds for the periods then ended (dollars in thousands):

Collateral	Balance (GAAP) June 30, 2016	Weighted Average Cost of Funds for the three months ended June 30, 2016	Weighted Average Cost of Funds for the six months ended June 30, 2016
Agency RMBS	\$ 1,547,407	0.76%	0.75%
Agency CMBS	20,258	1.87	1.86
Non-Agency RMBS	279,591	2.22	2.15
Non-Agency CMBS	275,021	2.19	2.11
Whole-Loans and securitized commercial loan (1)	161,732	2.50	2.55
Other securities	26,710	2.58	2.63
<b>Total</b>	<b>\$ 2,310,719</b>	<b>1.27%</b>	<b>1.28%</b>

---

(1) Repurchase borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

Table of Contents

<b>Collateral</b>	<b>Balance (GAAP) June 30, 2015</b>	<b>Weighted Average Cost of Funds for the three months ended June 30, 2015</b>	<b>Weighted Average Cost of Funds for the six months ended June 30, 2015</b>
Agency RMBS	\$ 2,521,435	0.42%	0.41%
Agency CMBS	36,280	1.22	1.15
Non-Agency RMBS	407,910	1.61	1.56
Non-Agency CMBS	327,997	1.60	1.59
Whole-Loans and securitized commercial loan (1)	16,995	3.35	2.82
Other securities	95,743	2.06	1.89
<b>Total</b>	<b>\$ 3,406,360</b>	<b>0.71%</b>	<b>0.68%</b>

(1) Repurchase borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

The following tables present our repurchase agreement borrowings by type of collateral pledged as of June 30, 2016 and June 30, 2015, and the respective Effective Cost of Funds (Non-GAAP financial measure) for the periods then ended (dollars in thousands), see Non-GAAP financial measures :

<b>Collateral</b>	<b>Balance (Non- GAAP) June 30, 2016</b>	<b>Weighted Average Effective Cost of Funds for the three months ended June 30, 2016 (1)</b>	<b>Weighted Average Effective Cost of Funds for the six months ended June 30, 2016 (1)</b>
Agency RMBS	\$ 1,547,407	0.76%	0.75%
Agency CMBS	20,258	1.87	1.86
Non-Agency RMBS	279,591	2.22	2.15
Non-Agency CMBS	275,021	2.19	2.11
Whole-Loans and securitized commercial loans(2)	161,732	2.50	2.55
Other securities	26,710	2.58	2.63
Interest rate swaps	n/a	1.14	1.27
<b>Total</b>	<b>\$ 2,310,719</b>	<b>2.44%</b>	<b>2.59%</b>

(1) The effective cost of funds for the three and six months ended June 30, 2016, are calculated on an annualized basis and include interest expense for the periods and net periodic interest payments on interest rate swaps, net of premium amortization on MAC swaps, of approximately \$6.7 million and \$15.2 million, respectively. While swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are classified as tax hedges for purposes of satisfying the REIT requirements. See Non-GAAP Financial Measures.



(2) Repurchase agreement borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

Table of Contents

		Weighted Average Effective Cost of Funds for the three months ended June 30, 2015 (1)	Weighted Average Effective Cost of Funds for the six months ended June 30, 2015 (1)
<b>Collateral</b>	<b>Balance (Non- GAAP) June 30, 2015</b>		
Agency RMBS	\$ 2,521,435	0.42%	0.41%
Agency CMBS	36,280	1.22	1.15
Non-Agency RMBS	407,910	1.61	1.56
Non-Agency CMBS	327,997	1.60	1.59
Whole-Loans and securitized commercial loans(2)	16,995	3.35	2.82
Other securities	95,743	2.06	1.89
Interest rate swaps	n/a	0.48	0.31
Total	\$ 3,406,360	1.19%	0.99%

(1) The effective cost of funds for the three and six months ended June 30, 2015 are calculated on an annualized basis and include interest expense for the periods and net periodic interest payments on interest rate swaps, net of premium amortization on MAC swaps, of approximately \$4.2 million and \$5.6 million, respectively. While swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are classified as hedges for purposes of satisfying the REIT requirements. See Non-GAAP Financial Measures.

(2) Repurchase agreement borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

The following table presents our average repurchase agreement borrowings, excluding unamortized debt issuance costs, by type of collateral pledged for the three and six months ended June 30, 2016 and June 30, 2015 (dollars in thousands):

Collateral	For the three months ended June 30, 2016	For the three months ended June 30, 2015	For the six months ended June 30, 2016	For the six months ended June 30, 2015
Agency RMBS	\$ 1,577,380	\$ 2,736,483	\$ 1,536,494	\$ 2,876,416
Agency CMBS	21,688	37,112	24,731	37,834
Non-Agency RMBS	291,314	422,987	315,512	441,426
Non-Agency CMBS	292,807	329,103	301,512	322,573
Whole-Loans and securitized commercial loan (1)	164,267	13,635	171,378	10,164
Other securities	28,881	94,371	40,447	86,850
Total	\$ 2,376,337	\$ 3,633,691	\$ 2,390,074	\$ 3,775,263
Maximum borrowings during the period(2)	2,403,129	3,628,233	2,390,074	3,968,357

(1) Repurchase agreement borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

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

*Derivative Instruments.* As of June 30, 2016, we had entered into interest rate swaps designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements as such repurchase agreements are renewed and/or extended. The interest rate swaps generally provide for fixed interest rates that are indexed off of LIBOR and are viewed by us to effectively fix the floating interest rates, on our repurchase agreements. In managing our interest rate swap position in conjunction with our hedging strategy and potential tax implications, we may enter into variable-rate payment swaps which effectively act as an offset to fixed-rate payment swaps. As of June 30, 2016, we have entered into approximately \$205.4 million of interest rate swaps to effectively fix the interest rate of our borrowings under our repurchase agreements; net of variable-rate payment interest rate swaps of approximately \$4.0 billion, and excluding forward starting interest rate swaps of \$1.7 billion.

The following tables present information about our fixed pay rate interest rate swaps as of June 30, 2016 and December 31, 2015 (dollars in thousands):

Remaining Interest Rate Swap Term	Notional Amount	June 30, 2016		Average Fixed Pay Rate	Average Maturity (Years)	Forward Starting
		Fair Value (Liability), net	Asset, net			
Greater than 1 year and less than 3 years	\$ 980,900	\$ (3,154)		1.1%	1.7	89.2%
Greater than 3 years and less than 5 years	2,225,000	(74,568)		1.8	4.4	30.6
Greater than 5 years	2,683,100	(317,850)		2.6	9.4	4.1
<b>Total</b>	<b>\$ 5,889,000</b>	<b>\$ (395,572)</b>		<b>2.0%</b>	<b>6.2</b>	<b>28.3%</b>

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

Table of Contents

December 31, 2015						
Remaining Interest Rate Swap Term	Notional Amount	Fair Value (Liability), net	Asset	Average Fixed Pay Rate	Average Maturity (Years)	Forward Starting
1 year or less	\$ 1,286,000	\$	163	0.6%	0.6	%
Greater than 1 year and less than 3 years	1,131,800		(1,450)	1.1	1.4	
Greater than 3 years and less than 5 years	1,345,200		(22,705)	2.1	4.6	
Greater than 5 years	2,404,600		(131,744)	2.8	10.2	29.5
Total	\$ 6,167,600	\$	(155,736)	1.9%	5.4	11.5%

The following tables present information about our variable pay rate interest rate swaps as of June 30, 2016 and December 31, 2015 (dollars in thousands):

June 30, 2016						
Remaining Interest Rate swap Term	Notional Amount	Fair Value (Liability), net	Asset	Average Variable Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 3 years and less than 5 years	\$ 2,265,400	\$	43,648	0.6%	4.3	%
Greater than 5 years	1,753,200		111,844	0.6	10.3	
Total	\$ 4,018,600	\$	155,492	0.6%	6.9	%

December 31, 2015						
Remaining Interest Rate swap Term	Notional Amount	Fair Value (Liability), net	Asset	Average Variable Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 3 years and less than 5 years	\$ 1,170,700	\$	(8,902)	0.4%	4.5	%
Greater than 5 years	1,102,200		(4,032)	0.4	12.3	
Total	\$ 2,272,900	\$	(12,934)	0.4%	8.2	%

At June 30, 2016, we had no swaptions in our derivative holdings. The following tables present information about our interest rate swaptions as of December 31, 2015 (dollars in thousands):

December 31, 2015						
Fixed-Pay Rate for Underlying Swap	Fair Value	Option Expiration	Option Weighted Average Months Until	Underlying Swap		
				Notional Amount	Weighted Average Swap Term (Years)	
1.76 2.00%	\$ 890		2.1	\$ 400,000	5.0	
2.01 2.25%	129		2.1	100,000	5.0	
2.26 2.50%	1		5.8	105,000	1.0	
	\$ 1,020		2.7	\$ 605,000	4.3	

December 31, 2015

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

		Option			Underlying Swap	
Variable-Pay Rate for Underlying Swap		Fair Value	Weighted Average Months Until Option Expiration	Notional Amount	Weighted Average Swap Term (Years)	
1.26	1.50%	\$ 459	2.1	\$ 500,000	5.0	
		\$ 459	2.1	\$ 500,000	5.0	

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

Table of Contents

We also purchased or shorted TBAs. As of June 30, 2016 and December 31, 2015, we had contracts to purchase ( long position ) and sell ( short position ) TBAs on a forward basis. Following is a summary of our long and short TBA positions reported in Derivative assets, at fair value and Derivative liability, at fair value in the Consolidated Balance Sheets as of June 30, 2016 and December 31, 2015 (dollars in thousands):

	June 30, 2016		December 31, 2015	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Purchase contracts, asset	\$ 705,000	\$ 5,317	\$ 1,650,000	\$ 3,268
TBA securities, asset	705,000	5,317	1,650,000	3,268
Sale contracts, liability	(465,000)	(3,877)	(825,000)	(893)
TBA securities, liability	(465,000)	(3,877)	(825,000)	(893)
TBA securities, net	\$ 240,000	\$ 1,440	\$ 825,000	\$ 2,375

The following table presents additional information about our contracts to purchase and sell TBAs for the six months ended June 30, 2016 (dollars in thousands):

	Notional Amount as of December 31, 2015		Additions	Settlement, Termination, Expiration or Exercise	Notional Amount as of June 30, 2016
Purchase of TBAs	\$ 1,650,000	\$ 5,055,000	\$ (6,000,000)	\$ 705,000	
Sale of TBAs	\$ 825,000	\$ 5,640,000	\$ (6,000,000)	\$ 465,000	

We may enter into Eurodollar, Volatility Index, and U.S. Treasury futures. As of June 30, 2016, we had entered into contracts to buy ( long position ) U.S. Treasury futures with a notional amount of \$357.9 million, a fair value in an asset position of \$8.9 million and an expiration date of September 2016. As of December 31, 2015, we had entered into contracts to buy ( long position ) U.S. Treasuries with a notional amount of \$480.8 million, a fair value in a liability position of \$635 thousand and an expiration date of March 2016.

We have invested in and, in the future, may invest in additional assets which are denominated in a currency or currencies other than U.S. dollars. Similarly, we have and may in the future, finance such assets in a currency or currencies other than U.S. dollars. In order to mitigate the impact to us, we may enter into derivative financial instruments, including foreign currency swaps and foreign currency forwards, to manage fluctuations in the valuation between U.S. dollars and such foreign currencies. Foreign currency swaps involve the payment of a foreign currency at fixed interest rate on a fixed notional amount and the receipt of U.S. dollars at a fixed interest rate on a fixed notional amount. Foreign currency forwards provide for the payment of a fixed amount of a foreign currency in exchange for a fixed amount of U.S. dollars at a date certain in the future. The carrying value of foreign currency swaps and forwards is included in Derivative assets (liabilities), at fair value in the Consolidated Balance Sheets with changes in valuation included in Gain (loss) on derivative instruments, net in the Consolidated Statement of Operations. The following is a summary of our foreign currency forwards at June 30, 2016 and December 31, 2015 (dollars and euros in thousands):

Derivative Type	June 30, 2016	
	Maturity	Fair Value

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

	Notional Amount		Notional (USD Equivalent)			
Buy USD/Sell EUR currency forward	5,083	\$	5,805	July 2016	\$	155
Currency forwards, assets	5,083	\$	5,805	n/a	\$	155
Buy EUR/Sell USD currency forward	4,492	\$	5,059	July 2016	\$	(65)
Currency forwards, liabilities	4,492	\$	5,059	n/a	\$	(65)
Total currency forwards	9,575	\$	10,864	n/a	\$	90

Table of Contents

Derivative Type	December 31, 2015			
	Notional Amount	Notional (USD Equivalent)	Maturity	Fair Value
Buy USD/Sell EUR currency forward	5,083	\$ 5,825	January 2016	\$ 302
Currency forwards, assets	5,083	\$ 5,825	n/a	\$ 302
Buy EUR/Sell USD currency forward	6,800	\$ 7,671	January 2016	\$ (281)
Currency forwards, liabilities	6,800	\$ 7,671	n/a	\$ (281)
Total currency forwards	11,883	\$ 13,496	n/a	\$ 21

The following is a summary of our foreign currency swaps with a fair value of \$3.1 million and \$7.2 million at June 30, 2016 and December 31, 2015, respectively (dollars and euros in thousands):

	Date entered	Maturity	June 30, 2016		
			Fixed Rate	Denomination	Notional Amount
Payer	June 2014	July 2024	7.25%	EUR	8,500
Receiver	June 2014	July 2024	9.005%	USD	11,560

	Date entered	Maturity	December 31, 2015		
			Fixed Rate	Denomination	Notional Amount
Payer	June 2014	July 2024	7.25%	EUR	18,500
Receiver	June 2014	July 2024	9.005%	USD	25,160

**Results of Operations**

**General**

For the three and six months ended June 30, 2016, we had net income of \$17.3 million and net loss of \$19.0 million, respectively, or \$0.41 and \$(0.46) per basic and diluted weighted average common share, respectively, compared to net loss of \$1.7 million and net income of \$12.5 million or \$(0.05) and \$0.29 per basic and diluted weighted average common share for the three and six months ended June 30, 2015, respectively. Our results of operations, for the three and six months ended June 30, 2016, were impacted by a smaller investment portfolio coupled with a higher average cost of funds resulting in lower net interest income of our investment portfolio. This was partially offset by increases in fair value of our investment portfolio, as a result of generally tightening spreads on our investments in the second quarter of 2016.

**Net Interest Income**

The following table sets forth certain information regarding our net investment income for the three and six months ended June 30, 2016 and June 30, 2015 (dollars in thousands):



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

Period Ended	Average Amortized Cost of Assets	Total Interest Income(1)	Yield on Average Assets	Average Balance of Borrowings	Total Interest Expense	Average Cost of Funds(2)	Net Interest Income	Net Interest Spread
<b>Three months ended June 30, 2016</b>								
Agency RMBS	\$ 1,574,388	\$ 9,385	2.40%	\$ 1,577,380	\$ 2,975	0.76%	\$ 6,410	1.64%
Agency CMBS	18,760	305	6.54%	21,688	101	1.87%	204	4.67%
Non-Agency RMBS	402,311	7,647	7.65%	291,314	1,606	2.22%	6,041	5.43%
Non-Agency CMBS	426,006	8,236	7.78%	292,807	1,591	2.19%	6,645	5.59%
Residential								
Whole-Loans	194,595	1,826	3.77%	157,477	971	2.48%	855	1.29%
Securitized commercial loan	25,000	569	9.15%	17,790	298	6.74%	271	2.41%
Other Securities	49,976	1,252	10.07%	28,881	185	2.58%	1,067	7.49%
<b>Total</b>	<b>\$ 2,691,036</b>	<b>\$ 29,220</b>	<b>4.37%</b>	<b>\$ 2,387,337</b>	<b>\$ 7,727</b>	<b>1.30%</b>	<b>\$ 21,493</b>	<b>3.07%</b>

Table of Contents

<b>Six months ended June 30, 2016</b>									
Agency RMBS	\$ 1,573,385	\$ 18,203	2.33%	\$ 1,536,494	\$ 5,740	0.75%	\$ 12,463	1.58%	
Agency CMBS	20,656	664	6.46%	24,731	229	1.86%	435	4.60%	
Non-Agency RMBS	435,720	15,589	7.20%	315,512	3,373	2.15%	12,216	5.05%	
Non-Agency CMBS	436,632	16,808	7.84%	301,512	3,169	2.11%	13,639	5.73%	
Residential Whole-Loans	205,689	3,692	3.61%	164,549	2,070	2.53%	1,622	1.08%	
<b>Commercial</b>									
Whole-Loans	25,000	1,138	9.15%	17,829	597	6.73%	541	2.42%	
Other Securities	76,878	2,744	7.18%	40,447	528	2.63%	2,216	4.55%	
<b>Total</b>	<b>\$ 2,773,960</b>	<b>\$ 58,838</b>	<b>4.27%</b>	<b>\$ 2,401,074</b>	<b>\$ 15,706</b>	<b>1.32%</b>	<b>\$ 43,132</b>	<b>2.95%</b>	

<b>Three months ended June 30, 2015</b>									
Agency RMBS	\$ 3,014,793	\$ 21,533	2.86%	\$ 2,736,483	\$ 2,863	0.42%	\$ 18,670	2.44%	
Agency CMBS	28,377	391	5.53%	37,112	113	1.22%	278	4.31%	
Non-Agency RMBS	570,666	9,552	6.71%	422,987	1,694	1.61%	7,858	5.10%	
Non-Agency CMBS	448,985	7,011	6.26%	329,103	1,309	1.60%	5,702	4.66%	
Residential Whole-Loans	16,951	161	3.81%	13,635	114	3.35%	47	0.46%	
<b>Commercial</b>									
Whole-Loans	8,750	179	8.21%			%	179	8.21%	
Other Securities	149,281	2,202	5.91%	94,371	484	2.06%	1,718	3.85%	
<b>Total</b>	<b>\$ 4,237,803</b>	<b>\$ 41,029</b>	<b>3.89%</b>	<b>\$ 3,633,691</b>	<b>\$ 6,577</b>	<b>0.71%</b>	<b>\$ 34,452</b>	<b>3.18%</b>	

<b>Six months ended June 30, 2015</b>									
Agency RMBS	\$ 3,157,933	\$ 43,577	2.78%	\$ 2,876,416	\$ 5,842	0.41%	\$ 37,735	2.37%	
Agency CMBS	28,978	697	4.85%	37,834	216	1.15%	481	3.70%	
Non-Agency RMBS	599,878	18,994	6.38%	441,426	3,421	1.56%	15,573	4.82%	
Non-Agency CMBS	439,766	14,182	6.38%	322,573	2,543	1.59%	11,639	4.91%	
Residential Whole-Loans	12,899	232	3.63%	10,164	142	2.82%	90	0.81%	
<b>Commercial</b>									
Whole-Loans	6,333	253	8.06%			%	253	8.06%	
Other Securities	129,013	3,900	6.09%	86,850	815	1.89%	3,085	4.20%	
<b>Total</b>	<b>\$ 4,374,800</b>	<b>\$ 81,835</b>	<b>3.78%</b>	<b>\$ 3,775,263</b>	<b>\$ 12,979</b>	<b>0.68%</b>	<b>\$ 68,856</b>	<b>3.10%</b>	

(1) Amount includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(7.5) million for Agency RMBS, \$(424) thousand for Agency CMBS, approximately \$(1.1) million for Non-Agency RMBS, approximately \$1.8 million for Non-Agency CMBS, approximately \$(494) thousand for Residential Whole-Loans and \$754 thousand for other securities for the three months ended June 30, 2016. For the six months ended June 30, 2016, amount includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(16.0) million for Agency RMBS, \$(853) thousand for Agency CMBS, approximately \$(2.9) million for Non-Agency RMBS, approximately \$3.6 million for Non-Agency CMBS, approximately \$(1.1) million for Residential Whole-Loans and approximately \$1.6 million for other securities. For the three months ended June 30, 2015, amount includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(12.5) million for Agency RMBS, \$(552) thousand for Agency CMBS, approximately \$(1.9) million for Non-Agency RMBS, approximately \$502 thousand for Non-Agency CMBS, approximately \$(66) thousand for Residential Whole-Loans and approximately \$729 thousand for other securities. For the six months ended June 30, 2015, amount includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(27.9) million for Agency RMBS, approximately \$(1.1) million for Agency CMBS, approximately \$(4.3) million for Non-Agency RMBS, approximately \$1.6 million for Non-Agency CMBS, approximately \$(112) thousand for Residential Whole-Loans and approximately \$1.1 million for other securities.

(2) For the three and six months ended June 30, 2016, cost of funds does not include accrual and settlement of interest, net of premium amortization on MAC swaps, of approximately \$6.7 million and \$15.2 million, respectively, associated with derivative instruments. For the three and six months ended June 30, 2015, cost of funds does not include accrual and settlement of interest, net of premium amortization on MAC swaps, of approximately \$4.2 million and \$5.6 million, respectively, associated with derivative instruments. In accordance with GAAP, such costs are included in gain (loss) on derivative instruments, in the Consolidated Statement of Operations.



Table of Contents

For the three and six months ended June 30, 2016, we earned interest income on our investments of approximately \$29.2 million and \$58.8 million, respectively, and incurred interest expense, which primarily related to our borrowings under repurchase of approximately \$7.7 million and \$15.7 million, respectively. For the three and six months ended June 30, 2015, we earned interest income on our investments of approximately \$41.0 million and \$81.8 million, respectively, and incurred interest expense, which primarily related to our borrowings under repurchase of approximately \$6.6 million and \$13.0 million, respectively. The decrease in interest income for the three and six months ended June 30, 2016 compared to the three and six months ended June 30, 2015 was primarily the result of an overall smaller investment portfolio which was offset by a higher yield on our investment portfolio due to our strategic shift to deploy capital to credit-sensitive investments, generating higher yields and spreads, relative to our Agency RMBS. Our yield on average assets for the three and six months ended June 30, 2016 increased to 4.37% and 4.27%, respectively, from 3.89% and 3.78% for the three and six months ended June 30, 2015. Our higher borrowing costs were a result of: (i) the increase in interest rates and (ii) increased interest costs associated with financing our credit-sensitive investments which generally have higher interest rates than repurchase agreements on Agency RMBS. The increase was partially offset by lower average repurchase agreement borrowings. Our average borrowings decreased from \$3.6 billion and \$3.8 billion for the three and six months ended June 30, 2015, respectively to \$2.4 billion and \$2.4 billion for the three and six months ended June 30, 2016, respectively, while the average cost of funds for the same periods, increased from 0.71% and 0.68% for the three and six months ended June 30, 2015, respectively, to 1.30% and 1.32% for the three and six months ended June 30, 2016, respectively. While the yield on our investments increased our average cost of funds also increased for the three and six months ended June 30, 2016, resulting in a decrease in net interest spread to 3.07% and 2.95% for the three and six months ended June 30, 2016 from 3.18% and 3.10% for the three and six months ended June 30, 2015, respectively. Other factors impacting interest income include assumptions pertaining to prepayments, defaults and loss severity on our credit sensitive portfolio.

***Other income (loss), net******Realized gain (loss) on investments***

The mortgage and structured securities markets remain dynamic and, at times, volatile markets. Our Manager regularly reviews the characteristics of our portfolio and may make changes to our portfolio in order to adjust such portfolio characteristics in response to and/or anticipation of changing market conditions in an effort to achieve the appropriate risk reward ratio. Accordingly, due to changes in market conditions or expected changes in market conditions, we sold these MBS and other assets in order to adjust the overall characteristics of our portfolio.

The following tables present the sales and realized gains (loss) of our investments for each of the three and six months ended June 30, 2016 and June 30, 2015 (dollars in thousands):

	Proceeds	For the three months ended June 30, 2016			Net Gain (Loss)
		Gross Gains	Gross Losses		
Agency RMBS (1)	\$ 5,122	\$	\$ (475)	\$	(475)
Agency CMBS	3,645		9		9
Non-Agency RMBS	22,639		575		260
Non-Agency CMBS	12,735		(146)		(146)
Total	\$ 44,141	\$	\$ 584	\$	(936)
		\$	\$ (936)	\$	(352)

(1) Excludes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$4.4 million, gross realized gains of \$0 thousand and gross realized losses of \$455.

	For the six months ended June 30, 2016			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS (1)	\$ 315,602	\$ 5,250	\$ (5,626)	\$ (376)
Agency CMBS	10,421	9	(55)	(46)
Non-Agency RMBS	105,440	1,794	(4,559)	(2,765)
Non-Agency CMBS	24,994		(2,929)	(2,929)
Other securities	750,226	1,818	(2,109)	(291)
Total	\$ 1,206,683	\$ 8,871	\$ (15,278)	\$ (6,407)

(1) Excludes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately \$8.6 million, gross realized gains of \$300 thousand and gross realized losses of \$455.

	For the three months ended June 30, 2015			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS	\$ 208,249	\$ 3,545	\$ (680)	\$ 2,865
Non-Agency CMBS	63,345	863	(9)	854
Other securities	16,365	562		562
Total	\$ 287,959	\$ 4,970	\$ (689)	\$ 4,281

Table of Contents

	Proceeds	For the six months ended June 30, 2015			Net Gain (Loss)
		Gross Gains	Gross Losses		
Agency RMBS (1)	\$ 509,981	\$ 3,835	\$ (3,577)	\$ 258	
Non-Agency RMBS	207,594	9,761	(174)	9,587	
Non-Agency CMBS	90,888	1,351	(9)	1,342	
Other securities	16,365	562		562	
Total	\$ 824,828	\$ 15,509	\$ (3,760)	\$ 11,749	

(1) Excludes gross realized gains of \$(2) thousand for Agency Interest-Only Strips, accounted for as derivatives, as a result of the settlement of prior year sales in January 2015.

*Unrealized gain (loss), net*

With respect to our investments and securitized debt, we elected the fair value option and, as a result, we record the change in fair value related to these investments and securitized debt in earnings. The change in unrealized gain (loss) is directly attributable to changes in market pricing on the underlying investments and securitized debt during the period. For the three and six months ended June 30, 2016, unrealized gain (loss), net was \$21.5 million and \$32.3 million, respectively, increasing from \$(42.8) million and \$(14.4) million for the three and six months ended June 30, 2015, respectively. While our average investment portfolio was smaller the increase in the fair value was attributable to higher average price as a result of mortgage spreads tightening.

The following table presents the net unrealized gains and losses we recorded on our investments and securitized debt (dollars in thousands):

	For the three months ended June 30, 2016	For the six months ended June 30, 2016	For the three months ended June 30, 2015	For the six months ended June 30, 2015
Agency RMBS	\$ 11,567	\$ 29,673	\$ (39,866)	\$ (16,331)
Agency CMBS	391	(627)	29	74
Non-Agency RMBS	8,312	17,906	(2,034)	821
Non-Agency CMBS	(578)	(15,944)	(2,148)	(1,885)
Whole-Loans	50	(729)	(90)	307
Other securities	1,774	1,421	1,260	2,575
Securitized debt	(6)	578		
Total	\$ 21,510	\$ 32,278	\$ (42,849)	\$ (14,439)

*Other than temporary impairment*

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

a result of an increase in expected payments being faster than previously projected.

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

Table of Contents

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

	For the three months ended June 30, 2016		For the six months ended June 30, 2016		For the three months ended June 30, 2015		For the six months ended June 30, 2015	
Agency RMBS	\$	297	\$	1,024	\$	2,056	\$	3,178
Non-Agency RMBS		2,312		7,229		364		3,030
Non-Agency CMBS		2,754		5,539		1,498		2,098
Other securities		993		3,361		398		661
Total	\$	6,356	\$	17,153	\$	4,316	\$	8,967

*Gain (loss) on derivatives, net*

**For the three months ended June 30, 2016:**

Description	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to- market adjustments	Total
Interest rate swaps	\$	\$ (6,910)	\$ 167	\$ (17,023)	\$ (23,766)
Interest rate swaptions	(323)			322	(1)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	(455)	3,464	(2,720)	(1,247)	(958)
Options					
Futures contracts	(907)			10,655	9,748
Foreign currency forwards	(165)			270	105
Foreign currency swaps		94		538	632
Total return swaps	7	307		(1,294)	(980)
TBAs	848			207	1,055
Total	\$ (995)	\$ (3,045)	\$ (2,553)	\$ (7,572)	\$ (14,165)

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

**For the six months ended June 30, 2016:**

Description	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to- market adjustments	Total
Interest rate swaps	\$ (3,605)	\$ (15,505)	\$ 334	\$ (71,271)	\$ (90,047)



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

Interest rate swaptions	(1,035)			1,631	596
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	(155)	7,610	(6,103)	(4,926)	(3,574)
Options	4,756				4,756
Futures contracts	13,409			9,496	22,905
Foreign currency forwards	(193)			70	(123)
Foreign currency swaps	3,942	207		(4,031)	118
Total return swaps	15	528		(2,160)	(1,617)
TBAs	8,587			(936)	7,651
Total	\$ 25,721	\$ (7,160)	\$ (5,769)	\$ (72,127)	\$ (59,335)

---

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

Table of Contents**For the three months ended June 30, 2015:**

Description	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to- market adjustments	Total
Interest rate swaps	\$ (8,513)	\$ (4,526)	\$ 367	\$ 34,697	\$ 22,025
Interest rate swaptions	(4,436)			730	(3,706)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives		5,609	(4,235)	2,228	3,602
Futures contracts	(459)			795	336
Foreign currency forwards	(1,492)			1,533	41
Foreign currency swaps		179		(1,064)	(885)
TBAs	(971)			(7,288)	(8,259)
Total	\$ (15,871)	\$ 1,262	\$ (3,868)	\$ 31,631	\$ 13,154

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

**For the six months ended June 30, 2015:**

Description	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Return (Recovery) of Basis	Mark-to- market adjustments	Total
Interest rate swaps	\$ (9,562)	\$ (6,310)	\$ 738	\$ (18,508)	\$ (33,642)
Interest rate swaptions	(3,723)			(143)	(3,866)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	(2)	11,263	(8,713)	(167)	2,381
Futures contracts	(459)			721	262
Foreign currency forwards	(846)			338	(508)
Foreign currency swaps		395		3,292	3,687
TBAs	6,477			(9,939)	(3,462)
Total	\$ (8,115)	\$ 5,348	\$ (7,975)	\$ (24,406)	\$ (35,148)

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

In order to mitigate interest rate risk resulting from our future repurchase agreement borrowings, we entered into interest rate swaps with an aggregate notional amount of approximately \$9.9 billion, of which \$1.7 billion are forward starting. As of June 30, 2016, our effective swaps are comprised of approximately \$4.2 billion fixed pay rate swaps and \$4.0 billion are variable pay swaps, which effectively fix (for the life of the swap) the floating interest rate of approximately \$205.4 million of borrowings. Similarly, as of June 30, 2016 we have entered into currency swaps and currency forwards with an aggregate notional amount of approximately \$22.4 million ( 18.1 million) in order to mitigate our

foreign currency risk on our euro denominated assets and liabilities. The fair value of our interest rate swaps declined as a result of the swap spreads tightening. While not designated as a hedge for accounting purposes, our current and future interest rate swaps, interest rate swaptions, foreign currency swaps and foreign currency forwards are, collectively viewed as an economic hedge on a portion of our floating-rate borrowings and foreign currency rate exposure, respectively. Since we do not apply hedge accounting for these instruments, we record the change in fair value related to such agreements in earnings in Gain (loss) on derivative instruments, net. Included in Gain (loss) on derivative instruments, net in our Consolidated Statement of Operations are the net interest rate swap payments and currency payments (including accrued amounts) associated with these instruments.

*Other, net*

For the three and six months ended June 30, 2016 other income (loss) was \$234 thousand and \$(98) thousand, respectively, of which \$13 thousand and \$(561) thousand, respectively was related to net foreign currency loss which was partially offset by miscellaneous net interest income on cash collateral for our derivative and repurchase agreements. For the three and six months ended June 30, 2015, other income (loss) was approximately \$(611) thousand and approximately \$1.8 million of which approximately \$(658) thousand and \$1.7 million, respectively, was related to net foreign currency gain and the balance comprised of miscellaneous interest income/expense on cash collateral for our derivatives and repurchase agreements. Generally, our foreign currency denominated investments are financed with repurchase agreements in the same currency. We recognize a gain or loss in foreign currency exchange, depending on the movement of the exchange rates during the period.

Table of Contents

*Expenses*

*Management Fee Expense*

We incurred management fee expense of approximately \$2.6 million and \$5.3 million for the three and six months ended June 30, 2016, respectively, and approximately \$2.7 million and \$5.4 million for the three and six months ended June 30, 2015, respectively, of which approximately \$2.6 million was payable at June 30, 2016 to our Manager under the Management Agreement. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.5% per annum of our stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears.

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

*Other Operating Expenses*

We incurred other operating expenses of approximately \$183 thousand and \$621 thousand for the three and six months ended June 30, 2016 and approximately \$260 thousand and \$673 thousand for the three and six months ended June, 2015, respectively. The decrease was attributable to lower transaction cost related to our interest rate derivatives from less activity.

*General and Administrative Expenses*

We incurred general and administrative expenses of approximately \$2.3 million and \$5.5 million for the three and six months ended June 30, 2016, respectively, and approximately \$2.9 million and \$5.3 million for the three and six months ended June, 2015, respectively. The following describes the key decreases in general and administrative expenses.

*Compensation Expense*

Compensation expense decreased from approximately \$1.2 million and approximately \$2.1 million for the three and six months ended June 30, 2015, respectively to approximately \$649 thousand and approximately \$1.4 million for the three and six months ended June 30, 2016, respectively. The decrease was primarily related the outsourcing of our interim chief financial officer for the first five months of 2016.

*Professional Fees*

Professional fees remained at approximately \$1.2 million for the three months ended June 30, 2016 and June 30, 2015, respectively. However, professional fees increased from approximately \$2.4 million for the six months ended June 30, 2015 to approximately \$3.2 million for the six months ended June 30, 2016. The increase was primarily related to the following: i) costs attributable to the position of interim chief financial officer being included in professional fees for the first five months of 2016, ii) higher audit fees, and iii) other one-time professional fees.

***Book Value Per Share***

As of June 30, 2016 and December 31, 2015, our book value per common share was \$11.01 and \$12.21, respectively.

**Non-GAAP Financial Measures**

Total interest income including interest income on Agency and Non-Agency Interest-Only Strips classified as derivatives and Effective Cost of Funds (as defined below) for the three and six months ended June 30, 2016 and June 30, 2015, constitute a Non-GAAP financial measures within the meaning of Regulation G promulgated by the SEC. We believe that the measures presented in this Quarterly Report on Form 10-Q, when considered together with U.S. GAAP financial measures, provide information that is useful to investors in understanding our borrowing costs and net interest income, as viewed by us. An analysis of any Non-GAAP financial measure should be made in conjunction with results presented in accordance with GAAP.

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

### Table of Contents

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

The following table sets forth certain information regarding our net investment income for the three and six months ended June 30, 2016 and June 30, 2015 (dollars in thousands):

#### Non- GAAP Financial Measures:

Period Ended	Average Amortized Cost of Assets(1)	Total Interest Income(2)	Yield on Average Assets(1)	Average Balance of Borrowings	Total Interest Expense(3)	Average Effective Cost of Funds	Net Interest Income	Net Interest Spread
<b>Three months ended June 30, 2016</b>								
Agency RMBS	\$ 1,607,471	\$ 9,905	2.48%	\$ 1,577,380	\$ 2,975	0.76%	\$ 6,930	1.72%
Agency CMBS	28,950	393	5.46%	21,688	101	1.87%	292	3.59%
Non-Agency RMBS	404,872	7,785	7.73%	291,314	1,606	2.22%	6,179	5.51%
Non-Agency CMBS	426,006	8,330	7.86%	292,807	1,591	2.19%	6,739	5.67%
Residential Whole-Loans	194,595	1,826	3.77%	157,477	971	2.48%	855	1.29%
Securitized commercial loan	25,000	569	9.15%	17,790	298	6.74%	271	2.41%
Other Securities	49,976	1,251	10.07%	28,881	185	2.58%	1,066	7.49%
Total return swaps	9,719	306	12.66%	n/a	n/a	n/a	306	12.66%
Interest rate swaps	n/a	n/a	n/a	n/a	6,743	1.14%	(6,743)	(1.14)%
<b>Total</b>	<b>\$ 2,746,589</b>	<b>\$ 30,365</b>	<b>4.45%</b>	<b>\$ 2,387,337</b>	<b>\$ 14,470</b>	<b>2.44%</b>	<b>\$ 15,895</b>	<b>2.01%</b>
<b>Six months ended June 30, 2016</b>								
Agency RMBS	\$ 1,613,310	\$ 19,258	2.40%	\$ 1,536,494	\$ 5,740	0.75%	\$ 13,518	1.65%
Agency CMBS	31,542	870	5.55%	24,731	229	1.86%	641	3.69%
Non-Agency RMBS	438,473	15,835	7.26%	315,512	3,373	2.15%	12,462	5.11%
Non-Agency CMBS	436,632	17,015	7.84%	301,512	3,169	2.11%	13,846	5.73%
Residential Whole-Loans	205,689	3,692	3.61%	164,549	2,070	2.53%	1,622	1.08%
Commercial Whole-Loans	25,000	1,138	9.15%	17,829	597	6.73%	541	2.42%
Other Securities	76,878	2,744	7.18%	40,447	528	2.63%	2,216	4.55%
Total return swaps	8,224	528	12.91%	n/a	n/a	n/a	528	12.91%
Interest rate swaps	n/a	n/a	n/a	n/a	15,171	1.27%	(15,171)	(1.27)%
<b>Total</b>	<b>\$ 2,835,748</b>	<b>\$ 61,080</b>	<b>4.33%</b>	<b>\$ 2,401,074</b>	<b>\$ 30,877</b>	<b>2.59%</b>	<b>\$ 30,203</b>	<b>1.74%</b>
<b>Three months ended June 30, 2015</b>								
Agency RMBS	\$ 3,077,444	\$ 22,621	2.95%	\$ 2,736,483	\$ 2,863	0.42%	\$ 19,758	2.53%
Agency CMBS	42,689	559	5.25%	37,112	113	1.22%	446	4.03%

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

Non-Agency RMBS	574,086	9,670	6.76%	422,987	1,694	1.61%	7,976	5.15%
Non-Agency CMBS	448,985	7,191	6.42%	329,103	1,309	1.60%	5,882	4.82%
Residential Whole-Loans	16,951	161	3.81%	13,635	114	3.35%	47	0.46%
Commercial Whole-Loans	8,750	179	8.21%			%	179	8.21%
Other Securities	149,281	2,201	5.91%	94,371	484	2.06%	1,717	3.85%
Interest rate swaps	n/a	n/a	n/a	n/a	4,159	0.48%	(4,159)	(0.48)%
<b>Total</b>	<b>\$ 4,318,186</b>	<b>\$ 42,582</b>	<b>3.98%</b>	<b>\$ 3,633,691</b>	<b>\$ 10,736</b>	<b>1.19%</b>	<b>\$ 31,846</b>	<b>2.79%</b>

### Six months ended June 30, 2015

Agency RMBS	\$ 3,224,992	\$ 45,600	2.85%	\$ 2,876,416	\$ 5,842	0.41%	\$ 39,758	2.44%
Agency CMBS	43,682	987	4.56%	37,834	216	1.15%	771	3.41%
Non-Agency RMBS	603,556	19,231	6.43%	441,426	3,421	1.56%	15,810	4.87%
Non-Agency CMBS	439,766	14,578	6.68%	322,573	2,543	1.59%	12,035	5.09%
Residential Whole-Loans	12,899	232	3.63%	10,164	142	2.82%	90	0.81%
Commercial Whole-Loans	6,333	253	8.06%			%	253	8.06%
Other Securities	129,013	3,899	6.09%	86,850	815	1.89%	3,084	4.20%
Interest rate swaps	n/a	n/a	n/a	n/a	5,572	0.31%	(5,572)	(0.31)%
<b>Total</b>	<b>\$ 4,460,241</b>	<b>\$ 84,780</b>	<b>3.85%</b>	<b>\$ 3,775,263</b>	<b>\$ 18,551</b>	<b>0.99%</b>	<b>\$ 66,229</b>	<b>2.86%</b>

(1) Includes Agency and Non-Agency Interest-Only Strips accounted for as derivatives.

(2) Amounts for the three months ended June 30, 2016 include net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(9.7) million. This amount is composed of approximately \$(7.5) million for Agency RMBS included in interest income, \$(424) thousand for Agency CMBS included in interest income, approximately \$(1.1) million for Non-Agency RMBS included in interest income, approximately \$1.8 million for Non-Agency CMBS included in interest income, approximately \$(494) thousand for Residential Whole-Loans included in interest income, approximately \$754 thousand for Other securities included in interest income and approximately \$(2.8) million of amortization/recovery of basis on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments). For the six months ended June 30, 2016 include net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(21.8) million. This amount is composed of approximately \$(16.0) million for Agency RMBS included in interest income, \$(853) thousand for Agency CMBS included in interest income, approximately \$(2.9) million for Non-Agency RMBS included in interest income, approximately \$3.6 million for Non-Agency CMBS included in interest income, approximately \$(1.1) million for Residential Whole-Loans included in interest income, approximately \$1.6 million for Other securities included in interest income and approximately \$(6.1) million of amortization/recovery of basis on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments). For the three months ended June 30, 2015 include net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(18.0) million. This amount is composed of approximately \$(12.5) million for Agency RMBS included in interest income, \$(552) thousand for Agency CMBS included in interest income, approximately \$(1.9) million for Non-Agency RMBS included in interest income, approximately \$502 thousand for Non-Agency CMBS included in interest income, approximately \$(66) thousand for Residential Whole-Loans included in interest income, approximately \$729 thousand for Other securities included in interest income and approximately \$(4.2) million of amortization/recovery of basis on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments). For the six months ended June 30, 2015 include net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately \$(39.4) million. This amount is composed of approximately \$(27.9) million for Agency RMBS included in interest income, approximately \$(1.1) million for Agency CMBS included in interest income, approximately \$(4.3) million for Non-Agency RMBS included in interest income, approximately \$1.6 million for Non-Agency CMBS included in interest income, approximately \$(112) thousand for Residential Whole-Loans included in interest income, approximately \$1.1 million for Other securities included in interest income and approximately \$(8.7) million of amortization/recovery of basis on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments).

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





Table of Contents

We have supplemented our discussion of GAAP net interest income discussed above, with a discussion below of our net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and net interest income (expenses), net incurred on swaps, a Non-GAAP measure, defined below, which gives a more concise view of our hedged portfolio as a whole.

Our effective gross yield, a non-GAAP measure, for the three months ended June 30, 2016 and June 30, 2015 was 4.45% and 3.98%, respectively. Our effective gross yield, a non-GAAP measure, for the six months ended June 30, 2016 and June 30, 2015 was 4.33% and 3.85%, respectively. Our effective gross yield, a non-GAAP measure, increased for the three and six months ended June 30, 2016 due to the change in composition of our portfolio to more credit-oriented assets. Our effective cost of funds, a non-GAAP measure, for the three months ended June 30, 2016 and June 30, 2015 was 2.44% and 1.19%, respectively. Our effective cost of funds, a non-GAAP measure, for the six months ended June 30, 2016 and June 30, 2015 was 2.59% and 0.99%, respectively. The increase in our effective cost of funds for the three and six months ended June 30, 2016 was a result of: (i) the increase in interest rates, (ii) increased interest costs associated with financing our credit-sensitive investments which generally have higher interest rates than repurchase agreements on Agency RMBS and (iii) the increase in the average effective notional of our net current pay-fixed interest rate swap. The increase was partially offset by lower average repurchase agreement borrowings.

The following table reconciles total interest income to interest income including interest income on Agency and Non-Agency Interest-Only Strips classified as derivatives (Non-GAAP financial measure) for the three and six months ended June 30, 2016 and June 30, 2015:

(dollars in thousands)	For the three months ended June 30, 2016	For the three months ended June 30, 2015	For the six months ended June 30, 2016	For the six months ended June 30, 2015
Coupon interest income	\$ 36,171	\$ 54,868	\$ 74,570	\$ 112,548
Premium accretion, discount amortization and amortization of basis, net	(6,951)	(13,839)	(15,732)	(30,713)
Interest income	\$ 29,220	\$ 41,029	\$ 58,838	\$ 81,835
Contractual interest income, net of amortization of basis on Agency and Non-Agency Interest-Only Strips, classified as derivatives(1):				
Coupon interest income	\$ 3,464	5,610	7,610	11,264
Amortization of basis (Non-GAAP Financial Measure)	(2,720)	(4,236)	(6,103)	(8,714)
Contractual interest income, net on Foreign currency swaps(1)	94	179	207	395
Contractual interest income, net on Total return swaps(1)	307	528	528	528
Subtotal	1,145	1,553	2,242	2,945
Total interest income, including interest income on Agency and Non-Agency Interest-Only Strips, classified as derivatives and other derivative instruments - Non-GAAP Financial Measure	\$ 30,365	\$ 42,582	\$ 61,080	\$ 84,780

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

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

Effective Cost of Funds includes the net interest component related to our interest rate. While we have not elected hedge accounting for these instruments, such derivative instruments are viewed by us as an economic hedge against increases in future market interest rates on our liabilities and are characterized as hedges for purposes of satisfying the REIT requirements and therefore the Effective Cost of Funds reflects interest expense adjusted to include the realized loss (i.e., the interest expense component) for all of our interest rate swaps.

The following table reconciles the Effective Cost of Funds (Non-GAAP financial measure) with interest expense for the three and six months ended June 30, 2016 and June 30, 2015:

(dollars in thousands)	For the three months ended June 30, 2016		For the three months ended June 30, 2015		For the six months ended June 30, 2016		For the six months ended June 30, 2015	
	Reconciliation	Cost of Funds/ Effective Borrowing Costs	Reconciliation	Cost of Funds/ Effective Borrowing Costs	Reconciliation	Cost of Funds/ Effective Borrowing Costs	Reconciliation	Cost of Funds/ Effective Borrowing Costs
Interest expense	\$ 7,727	1.30%	\$ 6,577	0.71%	\$ 15,706	1.32%	\$ 12,979	0.63%
Net interest paid - interest rate swaps	6,743	1.14%	4,159	0.48%	15,171	1.27%	5,572	0.31%
Effective Borrowing Costs	\$ 14,470	2.44%	\$ 10,736	1.19%	\$ 30,877	2.59%	\$ 18,551	0.99%
Weighted average repurchase borrowings	\$ 2,387,337		\$ 3,633,691		\$ 2,401,074		\$ 3,775,263	

### *Core Earnings*

Our Core Earnings were approximately \$11.4 million and \$20.2 million for the three and six months ended June 30, 2016, respectively, and approximately \$26.9 million and \$56.4 million for the three and six months ended June 30, 2015, respectively. Core Earnings is a Non-GAAP financial measure that is used by us to approximate cash yield or income associated with our portfolio and is defined as GAAP net income (loss) as adjusted, excluding: (i) net realized gain (loss) on investments and termination of derivative contracts; (ii) net unrealized gain (loss) on investments; (iii) net unrealized gain (loss) resulting from mark-to-market adjustments on derivative contracts; (iv) other than temporary impairment; (v) non-cash stock-based compensation expense; and (vi) one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between us, our Manager and our independent directors and after approval by a majority of the our independent directors.

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

### Table of Contents

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

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

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

The table below reconciles Net Income (Loss) to Core Earnings for the three and six months ended June 30, 2016 and June 30, 2015:

(dollars in thousands)	For the three months ended June 30, 2016	For the three months ended June 30, 2015	For the six months ended June 30, 2016	For the six months ended June 30, 2015
Net Income (loss) GAAP	\$ 17,303	\$ (1,693)	\$ (19,001)	\$ 12,453
Adjustments:				
<i>Investments:</i>				
Unrealized (gain) loss on investments and securitized debt	(21,510)	42,849	(32,278)	14,439
Other than temporary impairment	6,356	4,316	17,153	8,967
Realized (gain) loss on sale of investments	352	(4,281)	6,407	(11,749)
Realized (gain) loss on foreign currency transactions	638	(1,093)	117	(2,798)
Unrealized (gain) loss on foreign currency transactions	(651)	1,751	444	1,060
<i>Derivative Instruments:</i>				
Net realized (gain) loss on derivatives	995	15,871	(25,721)	8,115
Unrealized (gain) loss on derivatives	7,572	(31,631)	72,127	24,406
Non-cash stock-based compensation expense	346	781	918	1,460
Total adjustments	(5,902)	28,563	39,167	43,900
Core Earnings Non-GAAP Financial Measure	\$ 11,401	\$ 26,870	\$ 20,166	\$ 56,353
Basic Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure	\$ 0.27	\$ 0.64	\$ 0.48	\$ 1.35

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

Diluted Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure	\$	0.27	\$	0.64	\$	0.48	\$	1.35
Basic weighted average common shares and participating securities		41,956,898		41,938,369		41,953,547		41,871,319
Diluted weighted average common shares and participating securities		41,956,898		41,938,369		41,953,547		41,871,319

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

(dollars in thousands)	For the three months ended June 30, 2016	For the three months ended June 30, 2015	For the six months ended June 30, 2016	For the six months ended June 30, 2015
Net interest income including interest income on Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps, total return swaps and foreign currency swaps (a Non-GAAP financial measure)	\$ 15,895	\$ 31,846	\$ 30,203	\$ 66,229
Total Operating Expenses	(5,061)	(5,804)	(11,418)	(11,371)
Non-cash stock based compensation	346	781	918	1,460
Interest income on cash balances and other income (loss), net	221	47	463	35
Core Earnings (a Non-GAAP financial measure)	\$ 11,401	\$ 26,870	\$ 20,166	\$ 56,353

Table of Contents

**Liquidity and Capital Resources**

*General*

Liquidity is a measure of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund and maintain our assets and operations, make distributions to our stockholders, and other general business needs. To maintain our REIT qualifications under the Internal Revenue Code, we must distribute annually at least 90% of our taxable income, excluding capital gains, such distributions requirements limit our ability to retain earnings and increase capital for operations. We believe that our significant capital resources and access to financing will provide us with financial flexibility at levels sufficient to meet current and anticipated capital requirements, including funding new investment opportunities, paying distributions to our stockholders and servicing our debt obligations.

Our liquidity and capital resources are managed on a daily basis to ensure that we have sufficient liquidity to absorb market events that could negatively impact collateral valuations and result in margin calls as well as to ensure that we have the flexibility to manage our investment portfolio to take advantage of market opportunities. Our principal sources of cash consist of borrowings under repurchase agreements, payments of principal and interest on our investment portfolio and cash generated from operations.

Under our repurchase agreements and derivative contracts, counterparties retain the right to determine the fair value of the collateral pledged, or in the case of cleared swaps the required collateral may be determined by clearinghouse rules. A reduction in the value of the collateral pledged will require us to provide additional collateral or fund cash margin calls. Alternatively, since margins calls for our interest rate swaps and swaptions generally are inversely correlated to those of our repurchase agreements, our interest rate swap and swaptions counterparties would likely be required to post collateral with us during a period in which we were required to post collateral with our repurchase agreement counterparties. Similarly, we would likely be required to post collateral with swap and swaption counterparties during periods in which our repurchase agreement counterparties are required to post collateral with us. In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, we could be required to sell securities, possibly even at a loss to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on our financial position, results of operations and cash flows.

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

At June 30, 2016, our primary sources of cash consisted of borrowings under our repurchase agreements, principal payments and net interest margin generated from our investment portfolio.



Table of Contents**Borrowings Under Agreements**

As of June 30, 2016, we had master repurchase agreements with 28 counterparties. We had borrowings under repurchase agreements with 20 counterparties of approximately \$2.3 billion at June 30, 2016. The following tables present our repurchase agreement borrowings by type of collateral pledged, as of June 30, 2016 and June 30, 2015, and the respective effective cost of funds (Non-GAAP financial measure) for the three and six months ended June 30, 2016 and June 30, 2015, respectively. See Non-GAAP Financial Measures (dollars in thousands):

Collateral	Borrowings Outstanding June 30, 2016	Fair Value of Collateral Pledged (1)	Weighted Average Interest Rate end of period	Weighted Average Cost of Funds for the three months ended June 30, 2016	Weighted Average Effective Cost of Funds (Non-GAAP) for the three months ended June 30, 2016(2)	Weighted Average Cost of Funds for the six months ended June 30, 2016	Weighted Average Effective Cost of Funds (Non-GAAP) for the six months ended June 30, 2016(2)	Weighted Average Haircut end of period
Agency RMBS	\$ 1,547,407	\$ 1,599,803	0.75%	0.76%	0.76%	0.75	0.75	4.34%
Agency CMBS	20,258	23,534	1.81	1.87	1.87	1.86	1.86	24.35
Non-Agency RMBS	279,591	415,307	2.17	2.22	2.22	2.15	2.15	30.06
Non-Agency CMBS(3)	275,021	381,594	2.25	2.19	2.19	2.11	2.11	27.72
Whole-Loans and securitized commercial loan(4)	161,732	202,961	2.47	2.50	2.50	2.55	2.55	21.26
Other securities	26,710	49,265	2.71	2.58	2.58	2.63	2.63	43.30
Interest rate swaps	n/a	n/a	n/a	n/a	1.14	n/a	1.27	n/a
Total	\$ 2,310,719	\$ 2,672,464	1.25%	1.28%	2.44%	1.28	2.59	12.04%

(1) Excludes approximately \$30.7 million of cash collateral posted.

(2) The effective cost of funds for the period presented is calculated on an annualized basis and includes interest expense for the period and net periodic interest payments on interest rate swaps, net of premium amortization on MAC swaps, of approximately \$6.7 million and \$15.2 million for the three and six months ended June 30, 2016, respectively. While interest rate swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are treated as hedges for purposes of satisfying the REIT requirements. See Non-GAAP Financial Measures .

(3) Including Non U.S. CMBS pledged as collateral and Non U.S. repurchase agreement borrowings.

(4) Repurchase agreement borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

Collateral	Borrowings Outstanding June 30, 2015	Fair Value of Collateral Pledged (1)	Weighted Average Interest Rate end of period	Weighted Average Cost of Funds for the three months ended June 30, 2015	Weighted Average Effective Cost of Funds (Non-GAAP) for the three months	Weighted Average Cost of Funds for the six months ended June 30, 2015	Weighted Average Effective Cost of Funds (Non-GAAP) for the six months	Weighted Average Haircut end of period
------------	--------------------------------------	--------------------------------------	--	---	--	---	--	--

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

			ended June 30, 2015(2)		ended June 30, 2015(2)			
Agency RMBS	\$ 2,521,435	\$ 2,608,602	0.43%	0.42%	0.42%	0.41	0.41	5.31%
Agency CMBS	36,280	41,887	1.35	1.22	1.22	1.15	1.15	14.85
Non-Agency RMBS	407,910	585,599	1.64	1.61	1.61	1.56	1.56	31.02
Non-Agency CMBS(3)	327,997	455,084	1.64	1.60	1.60	1.59	1.59	27.24
Whole-Loans and securitized commercial loan(4)	16,995	22,184	1.94	3.35	3.35	2.82	2.82	22.24
Other securities	95,743	128,760	1.89	2.06	2.06	1.89	1.89	25.08
Interest rate swaps	n/a	n/a	n/a	n/a	0.48	n/a	0.31	n/a
Total	\$ 3,406,360	\$ 3,842,116	0.75%	0.71%	1.19%	0.68	0.99	11.24%

(1) Excludes approximately \$57.8 million of cash collateral posted.

(2) The effective cost of funds for the period presented is calculated on an annualized basis and includes interest expense for the period and net periodic interest payments on interest rate swaps, net of premium amortization on MAC swaps, of approximately \$4.2 million and \$5.6 million for the three and six months ended June 30, 2015, respectively. While interest rate swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are treated as hedges for purposes of satisfying the REIT requirements. See Non-GAAP Financial Measures .

(3) Including Non U.S. CMBS pledged as collateral and Non U.S. repurchase agreement borrowings.

(4) Repurchase agreement borrowings collateralized by Whole-Loans and securitized commercial loan owned through trust certificates. The trust certificates are eliminated upon consolidation.

As of June 30, 2016, our repurchase agreements require collateral in excess of the loan amount, or haircuts, ranging from a low of 3.0% to a high of 5.0% for Agency RMBS, exclusive of IOs and IIOs for which the haircuts are as high as 25.0%. For Non-Agency RMBS and Agency and Non-Agency CMBS, haircuts range from a low of 13.0% to a high of 50.0%. Haircuts for other securities and Whole-Loans range from a low of 20.0% to a high of 50.0%. Declines in the value of our portfolio can trigger margin calls by our counterparties under our repurchase agreements. Margin calls could adversely affect our liquidity. Our inability to post adequate collateral for a margin call by the counterparty could result in a condition of default under our repurchase agreements. An event of default or termination event would give some of our counterparties the option to terminate all existing repurchase transactions with us and require any amount due to the counterparties by us to be payable immediately. If this were to occur, we may be forced to sell assets under adverse market conditions or through foreclosure which may have a material adverse consequence on our business, financial position, our results of operations and cash flows. During the six months ended June 30, 2016, we were able to satisfy margin calls using cash on hand and cash from our repurchase agreement borrowings.



Table of Contents

Under the repurchase agreements, the respective counterparties, subject to the terms of the individual agreements, retain the right to determine the fair value of the underlying collateral. A reduction in the value of pledged assets requires us to provide additional collateral or fund margin calls. In addition, certain of the repurchase agreements may be terminated by our counterparties if we do not maintain certain equity and leverage metrics, the most restrictive of which include a limit on leverage based on the composition of our portfolio. We were in compliance with the terms of such financial tests at June 30, 2016. At June 30, 2016, approximately \$2.7 billion of our investments served as collateral for repurchase agreements. At December 31, 2015, approximately \$3.0 billion of our investments served as collateral for repurchase agreements.

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

***Cash Generated from Operations***

For the six months ended June 30, 2016 and June 30, 2015, net cash generated from operating activities was approximately \$12.9 million and \$63.5 million, which was primarily attributable to the net interest income we earned on our investments less operating expenses. The decrease period over period was mainly attributable to a smaller investment portfolio and higher cost of funds.

***Cash Provided by and Used in Investing Activities***

For the six months ended June 30, 2016 and June 30, 2015 net cash generated from investing activities was approximately \$355.0 million and \$538.6 million, respectively. This was primarily attributable to our proceeds from sales and receipt of principal payments on our investments, which was partially offset by investment acquisitions and repayments on reverse repurchase agreements.

***Cash Provided by and Used in Financing Activities***

For the six months ended June 30, 2016 and June 30, 2015 net cash used in financing activities was approximately \$358.8 million and \$627.3 million, respectively. This was primarily attributable to lower weighted average borrowings on our investment portfolio.

***Other Potential Sources of Financing***

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

We held cash of approximately \$33.9 million and \$22.2 million at June 30, 2016 and June 30, 2015, respectively. Our primary sources of cash currently consist of repurchase facility borrowings, investment income, principal repayments on investments and the proceeds of any future securities offering, to the extent available in the capital markets. In the future, we expect our primary sources of liquidity to consist of payments of principal and interest we receive on our investments, unused borrowing capacity under our financing sources and future issuances of equity and debt securities.

Table of Contents**Contractual Obligations and Commitments**

Our contractual obligations as of June 30, 2016 are as follows (dollars in thousands):

	<b>Less than 1 year</b>	<b>1 to 3 years</b>	<b>3 to 5 years</b>	<b>More than 5 years</b>	<b>Total</b>
Borrowings under repurchase agreements(2)	\$ 2,310,719				\$ 2,310,719
Investment related payables	1,581				1,581
TBA long positions	733,191				733,191
Total: Non-GAAP Basis	3,045,491				3,045,491
TBA-long positions	733,191				733,191
Total: GAAP Basis Excluding TBA-long positions	\$ 2,312,300				\$ 2,312,300

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

(2) Excludes unamortized debt issuance cost.

*Repurchase Agreements*

As of June 30, 2016 we have an obligation for approximately \$5.4 million in contractual interest payments related to our repurchase agreements through the respective maturity date of each repurchase agreement.

In addition, at June 30, 2016, we had entered into repurchase agreement borrowings of approximately \$34.5 million, which settled by July 5, 2016, with a weighted average interest rate of 2.62%, a weighted average contractual maturity of 27 days and secured by collateral of approximately \$63.7 million.

*Securitized Debt*

At June 30, 2016, we had securitized debt related to the consolidated VIEs, with a balance of \$11.0 million (and a fair value of \$10.4 million). The securitized debt and related interest payments of the VIEs can only be settled with the securitized commercial loan that serve as collateral of the VIE and is non-recourse to us.

*Management Agreement*

On May 9, 2012, we entered into a management agreement (the *Management Agreement*) with our Manager which describes the services to be provided by our Manager and compensation for such services. Our Manager is responsible for managing our operations, including: (i) performing all of our day-to-day functions; (ii) determining investment criteria in conjunction with our Board of Directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of our Board of Directors. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.50% per annum of our stockholders' equity, (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, stockholders' equity means the sum of the net proceeds from any issuances of our equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of our shares of common stock, excluding any unrealized gains, losses or other non-cash items, including OTTI charges, prior to January 1, 2016, unrealized gain (loss), net and the non-cash portion of gain (loss) on derivative instruments, that have impacted stockholders' equity as reported in our consolidated financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between our Manager and our independent directors and after approval by at least two-thirds (2/3) of our independent directors. However, if our stockholders' equity for any given quarter is negative based on the calculation described above, our Manager will not be entitled to receive any management fee for that quarter. For the quarterly periods subsequent to January 1, 2016, to the extent OTTI reduces our stockholders' equity, it will reduce the management fee for such period. See Recent Developments.

Table of Contents

In addition, under the Management Agreement, we are required to reimburse our Manager for the expenses described below. Expense reimbursements to the Manager are made in cash on a regular basis. Our reimbursement obligation is not subject to any dollar limitation. Because our Manager's personnel perform certain legal, accounting, due diligence tasks and other services that outside professionals or outside consultants otherwise would perform, our Manager may be paid or reimbursed for the documented cost of performing such tasks, provided that such costs and reimbursements are in amounts which are no greater than those which would be payable to outside professionals or consultants engaged to perform such services pursuant to agreements negotiated on an arm's-length basis. We also reimburse our Manager for certain direct costs, such as the travel expenses of our officers, incurred by our Manager on our behalf. We reimburse our Manager for the compensation and benefits provided to our CFO, controller and related staff. For the three and six months ended June 30, 2016, we recorded expenses, paid by the Manager on our behalf, totaling approximately \$292 thousand and \$364 thousand, respectively, related to employee costs and benefits associated with our chief financial officer and controller, respectively and approximately \$657 thousand and \$794 thousand for the three and six months ended June 30, 2015, respectively.

The Management Agreement may be amended, supplemented or modified by agreement between our Manager and us. The Management Agreement currently expires on May 16, 2017. It is automatically renewed for one-year terms on May 15th thereafter unless previously terminated as described below. Our independent directors will review the Manager's performance and any fees payable to the Manager annually and, following the initial term, the Management Agreement may be terminated annually upon the affirmative vote of at least two thirds (2/3) of our independent directors, based upon: (i) our Manager's unsatisfactory performance that is materially detrimental to us; or (ii) our determination that any fees payable to our Manager are not fair, subject to our Manager's right to prevent such termination due to unfair fees by accepting a reduction of management fees agreed to by at least two thirds (2/3) of our independent directors. We are required to provide our Manager 180 days prior notice of any such termination. Unless terminated for cause, we will be required to pay our Manager a termination fee equal to three times the average annual management fee earned by our Manager during the prior 24-month period immediately preceding the date of termination, calculated as of the end of the most recently completed fiscal quarter prior to the date of termination.

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

**Off-Balance Sheet Arrangements**

As of June 30, 2016, we held contracts to purchase ( long position ) and sell ( short position ) TBAs on a forward basis. If a counterparty to one of the TBAs that we enter into defaults on its obligations, we may not receive payments or securities due under the TBA agreement, and thus, we may lose any unrealized gain associated with that TBA transaction.

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

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

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

See Warrants above for a description of our outstanding warrants.

Table of Contents

**Dividends**

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

**Recent Developments**

On August 3, 2016, we entered into an amendment to the Management Agreement with our Manager, which amended the definition of Equity in the Management Agreement. Under the previous definition, OTTI was excluded as a non-cash item and had no impact on the calculation of our management fee. Under the new definition, for all periods beginning on and following January 1, 2016, OTTI will reduce our Equity for any completed fiscal quarter in which OTTI was recognized, which in turn will reduce our management fee. The amendment to the Management Agreement described above is attached to this Quarterly Report on Form 10-Q as Exhibit 10.1.

Table of Contents

**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk.**

We seek to manage the risks related to the credit quality of our assets, interest rates, liquidity, prepayment speeds and market values while, at the same time, seeking to provide an opportunity to stockholders to realize attractive risk-adjusted returns from our assets through ownership of our common stock. While we do not seek to avoid risk completely, our Manager seeks to actively manage risk for us, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

***Credit Risk***

We are subject to varying degrees of credit risk in connection with our assets. Although we do not expect to encounter credit risk in our Agency RMBS, we are exposed to the risk of potential credit losses from general credit spread widening related to Non-Agency RMBS, CMBS and other portfolio investments in addition to unexpected increase in borrower defaults on these securities, as well as our Whole-Loans. Investment decisions are made following a bottom-up credit analysis and specific risk assumptions. As part of the risk management process, our Manager uses detailed proprietary models, applicable to evaluate, depending on the asset class, house price appreciation and depreciation by region, prepayment speeds and foreclosure/default frequency, cost and timing. If our Manager determines that the proposed investment can meet the appropriate risk and return criteria as well as complement our existing asset portfolio, the investment will undergo a more thorough analysis.

As of June 30, 2016, 16 of the counterparties that we had outstanding repurchase agreement borrowings held collateral which we posted as security for such borrowings in excess of 5% of our Stockholders' equity. Prior to entering into a repurchase agreement with any particular institution, our Manager does a thorough review of such potential counterparty. Such review, however, does not assure the creditworthiness of such counterparty nor that the financial wherewithal of the counterparty will not deteriorate in the future.

***Interest Rate Risk***

Interest rates are highly sensitive to many factors, including fiscal and monetary policies and domestic and international economic and political considerations, as well as other factors beyond our control. We are subject to interest rate risk in connection with our assets and our related financing obligations. In general, we expect to finance the acquisition of our assets through financings in the form of repurchase agreements, warehouse facilities, securitizations, resecuritizations, bank credit facilities (including term loans and revolving facilities) and public and private equity and debt issuances in addition to transaction or asset specific funding arrangements. Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, we utilize derivative financial instruments to hedge the interest rate risk associated with our borrowings. We also may engage in a variety of interest rate management techniques that seek to mitigate changes in interest rates or other potential influences on the values of our assets.

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

Our operating results will depend in large part on differences between the income earned on our assets and our borrowing costs. The cost of our borrowings is generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will



increase and the yields earned on our leveraged fixed-rate mortgage assets will remain static. Further, the cost of such financing could increase at a faster pace than the yields earned on our leveraged ARM and hybrid ARM assets. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

*Interest Rate Cap Risk*

To the extent we invest in adjustable-rate RMBS, such securities are generally subject to interest rate caps, which potentially could cause such RMBS to acquire many of the characteristics of fixed-rate securities if interest rates were to rise above the cap levels. This issue is magnified to the extent we acquire ARM and hybrid ARM assets that are not based on mortgages which are fully indexed. In addition, ARM and hybrid ARM assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding or a portion of the incremental interest rate increase being deferred. To the extent we invest in such ARM and/or hybrid ARM assets, we could potentially receive less cash income on such assets than we would need to pay the interest cost on our related borrowings. To mitigate interest rate mismatches, we may utilize the hedging strategies discussed above under Interest Rate Risk.

Table of Contents***Interest Rate Effects on Fair value***

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

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

***Market Risk***

**Market value risk.** Our MBS and other assets are reflected at their fair value with unrealized gains and losses included in earnings. The fair value of our investments fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, the fair value of these assets would be expected to decrease; conversely, in a decreasing interest rate environment, the fair value of these securities would be expected to increase.

The sensitivity analysis table presented below shows the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments, including interest rate swaps, Interest-Only Strips, and net interest income at June 30, 2016, assuming a static portfolio of assets. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager's expectations. The analysis presented utilizes our Manager's assumptions, models and estimates, which are based on our Manager's judgment and experience.

Change in Interest Rates	Percentage Change in Projected	
	Net Interest Income	Portfolio Value
+1.00%	31.43%	(1.36)%
+0.50%	17.11%	(0.57)%
-0.50%	(20.45)%	0.37%
-1.00%	(32.61)%	0.41%

While the table above reflects the estimated immediate impact of interest rate increases and decreases on a static portfolio, we may rebalance our portfolio from time to time either to seek to take advantage of or reduce the impact of changes in interest rates. It is important to note that the impact of changing interest rates on market value and net interest income can change significantly when interest rates change beyond 100 basis points from current levels. Therefore, the volatility in the market value of our assets could increase significantly when interest rates change beyond amounts shown in the table above. In addition, other factors impact the market value of and net interest income from our interest rate-sensitive investments and derivative instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, interest income would likely differ from that shown above and such difference might be material and adverse to our stockholders.

Certain assumptions have been made in connection with the calculation of the information set forth in the table above and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at June 30, 2016. The analysis presented utilizes assumptions and estimates based on our Manager's judgment and experience. Furthermore, while we generally expect to retain such assets and the associated interest rate risk, future purchases and sales of assets could materially change our interest rate risk profile.

Table of Contents

***Prepayment Risk***

The value of our Agency and Non-Agency RMBS and our Residential Whole-Loans may be affected by prepayment rates on the underlying residential mortgage. We acquire RMBS and Residential Whole-Loans and anticipate that the underlying residential mortgages will prepay at a projected rate generating an expected yield. If we purchase assets at a premium to par value, when borrowers prepay their residential mortgage loans faster than expected, the corresponding prepayments may reduce the expected yield on our residential mortgage assets because we will have to amortize the related premium on an accelerated basis and, in the case of Agency RMBS, other than interest-only strips, and certain other investment grade rated securities, we are required to make a retrospective adjustment to historical amortization. Conversely, if we purchase assets at a discount to par value, when borrowers prepay their residential mortgage loans slower than expected, such decrease may reduce the expected yield on such assets because we will not be able to accrete the related discount as quickly as originally anticipated and, in the case of Agency RMBS, other than interest-only strips, and certain other investment grade rated securities, we will be required to make a retrospective adjustment to historical amortization.

The value of our Agency and Non-Agency CMBS, as well as, Commercial Whole-Loans will also be affected by prepayment rates, however, commercial mortgages frequently limit the ability of the borrower to prepay, thereby providing a certain level of prepayment protection. Common restrictions include yield maintenance and prepayment penalties, the proceeds of which are generally at least partially allocable to these securities, as well as defeasance.

Likewise, the value of our ABS and other structured securities will also be affected prepayment rates. The collateral underlying such securities may, similar to most residential mortgages, allow the borrower to prepay at any time or, similar to commercial mortgages, limit the ability of the borrower to prepay by imposing lock-out provisions, prepayment penalties and/or make whole provisions.

***Extension Risk***

Most residential mortgage loans do not prohibit the partial or full prepayment of principal outstanding. Accordingly, while the stated maturity of a residential mortgage loan may be 30 years, or in some cases even longer, historically the vast majority of residential mortgage loans are satisfied prior to their maturity date. In periods of rising interest rates, borrowers have less incentive to refinance their existing mortgages and mortgage financing may not be as readily available. This generally results in a slower rate of prepayments and a corresponding longer weighted average life for RMBS. The increase, or extension, in weighted average life is commonly referred to as *Extension Risk* which can negatively impact our portfolio. To the extent we receive smaller pre-payments of principal; we will have less capital to invest in new assets. This is extremely detrimental in periods of rising interest rates as we will be unable to invest in new higher coupon investments and a larger portion of our portfolio will remain invested in lower coupon investments. Further, our borrowing costs are generally short-term and, even if hedged, are likely to increase in a rising interest rate environment, thereby reducing our net interest margin. Finally, to the extent we acquired securities at a discount to par, a portion of the overall return on such investments is based on the recovery of this discount. Slower principal prepayments will result in a longer recovery period and a lower overall return on our investment.

Prepayment rates on Agency and Non-Agency CMBS, as well as, Commercial Whole-Loans are generally less volatile than residential mortgage assets as commercial mortgages usually limit the ability of the borrower to prepay the mortgage prior to maturity or a period shortly before maturity. Accordingly, extension risk for Agency and Non-Agency CMBS and Commercial Whole-Loans is generally less than RMBS and Residential Whole-Loans as it is presumed that other than defaults (i.e. involuntary prepayments), most commercial mortgages will remain outstanding for the contractual term of the mortgage.

Prepayment rates on ABS and our other structured securities will be determined by the underlying collateral. The extension risk of such securities will generally be less than residential mortgages, but greater than commercial mortgages.

***Counterparty Risk***

The following discussion on counterparty risk reflects how these transactions are structured, rather than how they are presented for financial reporting purposes.

When we engage in repurchase transactions, we generally sell securities to lenders (i.e., repurchase agreement counterparties) and receive cash from the lenders. The lenders are obligated to resell the same securities back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the securities to the lender is less than the value of those securities (this difference is the haircut), if the lender defaults on its obligation to resell the same securities back to us, we could incur a loss on the transaction up to the amount of the haircut (assuming there was no change in the value of the securities).

Table of Contents

If a counterparty to a bi-lateral interest rate swap cannot perform under the terms of the interest rate swap, we may not receive payments due under that agreement, and thus, we may lose any unrealized gain associated with the interest rate swap. We may also risk the loss of any collateral we have pledged to secure our obligations under interest rate swap if the counterparty becomes insolvent or files for bankruptcy. In the case of a cleared swap, if our clearing broker were to default, become insolvent or file for bankruptcy, we may also risk the loss of any collateral we have posted to the clearing broker unless we were able to transfer or port our positions and held collateral to another clearing broker. In addition, the interest rate swap would no longer mitigate the impact of changes in interest rates as intended. Most of our interest swaps are currently cleared through a central clearing house which reduces but does not eliminate the aforementioned risks. Also see Liquidity Risk below.

As of June 30, 2016, we have entered into five master securities forward trading agreements, or MSFTAs, which may govern the trading of some or all TBA transactions. Pursuant to the terms of these MSFTAs, we and our counterparties would be required to post margin to the other when the mark to market exposure of the TBA transactions executed under the agreement exceed certain thresholds. We expect to continue to negotiate and enter into MSFTAs with additional TBA counterparties. The margin provisions of the MSFTA help to mitigate, but do not eliminate, counterparty risk associated with TBA transactions. If a counterparty to a TBA transaction cannot perform under the terms of the trade, we may not receive securities we have agreed to purchase or payment for securities we have agreed to sell, and thus, we may lose any unrealized gain associated with such transaction.

Prior to entering into a trading agreement or transaction with any particular institution where we take on counterparty risk, our Manager does a thorough review of such potential counterparty. Such review, however, does not assure the creditworthiness of such counterparty nor that the financial wherewithal of the counterparty will not deteriorate in the future.

***Funding Risk***

We have financed a substantial majority of our assets with repurchase agreement financing. Over time, as market conditions change, in addition to these financings, we may use other forms of leverage. Changes in the regulatory environment, as well as, weakness in the financial markets, the residential mortgage markets, the commercial mortgage markets, the asset-backed securitization markets and the economy generally could adversely affect one or more of our potential lenders and could cause one or more of our potential lenders to be unwilling or unable to provide us with financing or to increase the costs of that financing.

***Liquidity Risk***

Our liquidity risk is principally associated with the financing of long-maturity assets with short-term borrowings in the form of repurchase agreements. Although the interest rate adjustments of these assets and liabilities fall within the guidelines established by our operating policies, maturities are not required to be, nor are they, matched.

Should the value of our assets pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. Our inability to post adequate collateral for a margin call by the counterparty could result in a condition of default under our repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by us, which may have a material adverse consequence on our business and results of operations.

In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, we could be required to sell securities, possibly even at a loss to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on our financial position, results of operations and cash flows.

Table of Contents

Additionally, if one or more of our repurchase agreement counterparties chose not to provide on-going funding, our ability to finance would decline or exist at possibly less advantageous terms. Further, if we are unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms, it may have a material adverse effect on our business, financial position, results of operations and cash flows, due to the long term nature of our investments and relatively short-term maturities of our repurchase agreements. As such, there is no assurance that we will always be able to roll over our repurchase agreements.

The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate MBS and other fixed rate assets will remain static. Further, certain of our floating rate assets may contain annual or lifetime interest rate caps as well as limit the frequency or timing of changes to the underlying interest rate index. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could have a material adverse effect on our liquidity and results of operations.

In addition, the assets that comprise our investment portfolio are not traded on a public exchange. A portion of these assets may be subject to legal and other restrictions on resale or will otherwise be less liquid than publicly-traded securities. The illiquidity of our assets may make it difficult for us to sell such assets if the need or desire arises, including in response to changes in economic and other conditions. Recent regulatory changes have imposed new capital requirements and other restrictions on banks and other market intermediaries' ability and desire to hold assets on their balance sheets and otherwise make markets in fixed income securities and other assets resulting in reduced liquidity in many sectors of the market. This regulatory trend is expected to continue. As a result of these developments it may become increasingly difficult for us to sell assets in the market, especially in credit oriented sectors such as Non-Agency RMBS and CMBS, ABS and Whole-Loans.

We enter into interest rate swaps to manage our interest rate risk. We are required to pledge cash or securities as collateral as part of a margin arrangement, calculated daily, in connection with the interest rate swaps. The amount of margin that we are required to post will vary and generally reflects collateral required to be posted with respect to interest rate swaps that are in an unrealized loss position to us and is generally based on a percentage of the aggregate notional amount of interest rate swaps per counterparty. Margin calls could adversely affect our liquidity. Our inability to post adequate collateral for a margin call could result in a condition of default under our interest rate swap agreements, thereby resulting in liquidation of the collateral pledged by us, which may have a material adverse consequence on our business, financial position, results of operations and cash flows. Conversely, if our interest rate swaps are in an unrealized gain position, our counterparties to bilateral swaps are required to post collateral with us, under the same terms that we post collateral with them. On occasion we may enter into a MAC interest rate swap in which we may receive or make a payment at the time of entering such interest rate swap to compensate for the out of the market nature of such interest rate swap. Similar to all other interest rate swaps, MAC interest rate swaps are also subject to the margin requirements previously described.

***Inflation***

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more so than does inflation. Changes in interest rates do not necessarily directly correlate with inflation rates or changes in inflation rates. Our consolidated financial statements are prepared in accordance with GAAP and our distributions will be determined by our Board of Directors consistent with our obligation to distribute to our stockholders at least 90% of our net taxable income on an annual basis, in accordance with the REIT regulations, in order to maintain our REIT qualification. In each case, our activities and consolidated balance sheets are measured with reference to historical cost and/or fair market value without considering inflation.



*Foreign Investment risk*

We have invested in Non U.S. CMBS transactions and, in the future, we may make other investments in non U.S. issuers and transactions. These investments present certain unique risks, including those resulting from future political, legal, and economic developments, which could include favorable or unfavorable changes in currency exchange rates, exchange control regulations (including currency blockage), expropriation, nationalization, or confiscatory taxation of assets, adverse changes in investment capital or exchange control regulations (which may include suspension of the ability to transfer currency from a country), political changes, diplomatic developments, difficulty in obtaining and enforcing judgments against non U.S. entities, the possible imposition of the applicable country's governmental laws or restrictions, and the reduced availability of public information concerning issuers. In the event of a nationalization, expropriation, or other confiscation of assets, we could lose our entire investment in a security. Legal remedies available to investors in certain jurisdictions may be more limited than those available to investors in the United States. Issuers of non U.S. securities may not be subject to the same degree of regulation as U.S. issuers.

Table of Contents

Furthermore, non U.S. issuers are not generally subject to uniform accounting, auditing, and financial reporting standards or other regulatory practices and requirements comparable to those applicable to U.S. issuers. There is generally less government supervision and regulation of non U.S. exchanges, brokers, and issuers than there is in the United States, and there is greater difficulty in taking appropriate legal action in Non U.S. courts. There are also special tax considerations that apply to securities of non U.S. issuers and securities principally traded overseas.

To the extent that our investments are denominated in U.S. dollars, the investment is not affected directly by changes in currency exchange rates relative to the dollar and exchange control regulations. We are, however, subject to currency risk with respect to such investments to the extent that a decline in a non U.S. issuer's or borrower's own currency relative to the dollar may impair such issuer's or borrower's ability to make timely payments of principal and/or interest on a loan or other debt security. To the extent that our investments are in non-dollar denominated securities, the value of the investment and the net investment income available for distribution may be affected favorably or unfavorably by changes in currency exchange rates relative to the dollar and exchange control regulations.

Currency exchange rates can be volatile and affected by, among other factors, the general economics of a country, the actions of governments or central banks and the imposition of currency controls and speculation. In addition, a security may be denominated in a currency that is different from the currency where the issuer is domiciled.

***Currency Risk***

We have and may continue in the future to invest in assets which are denominated in a currency other than U.S. dollars and may finance such investments with repurchase financing or other forms of financing which may also be denominated in a currency other than U.S. dollars. To the extent we make such investments and/or enter into such financing arrangements, we may utilize foreign currency swaps, forwards or other derivative instruments to hedge our exposure to foreign currency risk. Despite being economic hedges, we have elected not to treat such derivative instruments as hedges for accounting purposes and therefore the changes in the value of such instruments, including actual and accrued payments, will be included in our Consolidated Statement of Operations. While such transactions are entered into in an effort to minimize our foreign currency risk, there can be no assurance that they will perform as expected. If actual prepayments of the foreign denominated asset are faster, or slower, than expected, the hedge instrument is unlikely to fully protect us from changes in the valuation of such foreign currency. Further, as with interest rate swaps, there is counterparty risk associated with the future creditworthiness of such counterparty.

Table of Contents

**ITEM 4. Controls and Procedures**

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

We have evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our disclosure controls and procedures as of June 30, 2016. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the applicable rules and forms, and that it is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

No change occurred in our internal control over financial reporting (as defined in Rule 13a-15(f) and Rule 15d-15(f) of the Exchange Act) during the quarter ended June 30, 2016 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

**PART II OTHER INFORMATION**

**ITEM 1. Legal Proceedings**

From time to time, the Company may be involved in various claims and legal actions arising in the ordinary course of business. As of June 30, 2016, the Company was not involved in any legal proceedings.

**ITEM 1A. Risk Factors**

There were no material changes during the period covered by this report to the risk factors previously disclosed in our annual report on Form 10-K for the year ended December 31, 2015, as filed with the SEC on March 11, 2016. Additional risks not presently known, or that we currently deem immaterial, also may have a material adverse effect on our business, financial condition and results of operation.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**ITEM 3. Defaults Upon Senior Securities**

None.

**ITEM 4. Mine Safety Disclosures**

Not Applicable.

**ITEM 5. Other Information**

None.

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

### Table of Contents

#### ITEM 6. Exhibits

The following exhibits are filed as part of this report.

Exhibit No.	Description
3.1*	Amended and restated certificate of incorporation of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 3.1 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012
3.2*	Amended and restated bylaws of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 3.2 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012
4.1*	Specimen Common Stock Certificate of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 4.1 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012
10.1	Amendment to the Management Agreement between Western Asset Mortgage Capital Corporation and Western Asset Management Company, dated August 3, 2016.
10.2*	Form of Warrant, incorporated by reference to Exhibit 10.2 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.3*	Management Agreement, dated May 9, 2012, between Western Asset Mortgage Capital Corporation and Western Asset Management Company, incorporated by reference to Exhibit 10.4 to the Quarterly Report on Form 10-Q, filed August 14, 2012.
10.4*	Registration Rights Agreement, dated May 15, 2012, among Western Asset Mortgage Capital Corporation, Western Asset Management Company and certain individual holders named therein, incorporated by reference to Exhibit 10.5 to the Quarterly Report on Form 10-Q, filed August 14, 2012.
10.5*	Western Asset Mortgage Capital Corporation Equity Plan, incorporated by reference to Exhibit 10.5 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.6*	Western Asset Mortgage Capital Corporation Manager Equity Plan, incorporated by reference to Exhibit 10.6 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.7*	Form of Indemnification Agreement between Western Asset Mortgage Capital Corporation and a director, incorporated by reference to Exhibit 10.7 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.8*	Restricted Stock Award Agreement, dated May 15, 2012, for Western Asset Management Company, incorporated by reference to Exhibit 10.9 to the Quarterly Report on Form 10-Q, filed August 14, 2012.
10.9*	Form of Restricted Stock Award Agreement for independent directors, incorporated by reference to Exhibit 10.2 to the Form S-8 dated May 15, 2012 (File No. 1-35543).
31.1	Rule 13a-14(a) / 15d-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) / 15d-14(a) Certification of Interim Chief Financial Officer.
32.1	Section 1350 Certifications of Chief Executive Officer and Interim Chief Financial Officer
101.INS	XBRL Instance Document

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

101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

---

\*Fully or partly previously filed.

Table of Contents

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ JENNIFER W. MURPHY

**Jennifer W. Murphy**  
**President, Chief Executive Officer and Director (Principal Executive Officer)**

August 5, 2016

By: /s/ LISA MEYER

**Lisa Meyer**  
**Chief Financial Officer (Principal Financial and Accounting Officer)**

August 5, 2016