American Capital Agency Corp
Form 10-Q
October 22, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2009

OR

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

Commission file number 001-34057

AMERICAN CAPITAL AGENCY CORP.

(Exact name of registrant as specified in its charter)

Delaware	**26-1701984**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

2 Bethesda Metro Center, 14th Floor

Bethesda, Maryland 20814

(Address of principal executive offices)

(301) 968-9300

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports 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 earlier 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 ¨

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

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

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller Reporting Company ¨

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

The number of shares of the issuer s common stock, $0.01 par value, outstanding as of October 16, 2009, was 19,321,600.

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AMERICAN CAPITAL AGENCY CORP.

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ITEM 1. ***Financial Statements***

AMERICAN CAPITAL AGENCY CORP.

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)

	September 30, 2009 (Unaudited)	December 31, 2008
Assets:		
Agency securities, at fair value (including pledged assets of $3,189,782 and $1,522,001, respectively)	$ 3,438,127	$ 1,573,383
Cash and cash equivalents	103,626	56,012
Restricted cash	9,656	18,692
Interest receivable	20,330	7,851
Receivable for agency securities sold	84,857	
Principal payments receivable	22,705	
Other assets	805	387
Total assets	$ 3,680,106	$ 1,656,325
Liabilities:		
Repurchase agreements	$ 2,949,010	$ 1,346,265
Payable for agency securities purchased	254,305	
Accrued interest payable	1,433	3,664
Derivative liabilities, at fair value	17,493	29,277
Dividend payable	27,050	18,006
Due to Manager	619	714
Accounts payable and other accrued liabilities	669	248
Total liabilities	3,250,579	1,398,174
Stockholders equity:		
Preferred stock, $0.01 par value; 10,000 shares authorized, 0 shares issued and outstanding, respectively		
Common stock, $0.01 par value; 150,000 shares authorized, 19,322 and 15,005 shares issued and outstanding, respectively	193	150
Additional paid-in capital	380,944	285,917
Retained earnings (accumulated deficit)	13,293	(2,310)
Accumulated other comprehensive income (loss)	35,097	(25,606)
Total stockholders equity	429,527	258,151
Total liabilities and stockholders equity	$ 3,680,106	$ 1,656,325

See accompanying notes to consolidated financial statements.

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AMERICAN CAPITAL AGENCY CORP.

CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE INCOME

(unaudited)

(in thousands, except per share data)

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	May 20, 2008 (date operations commenced) through September 30, 2008
Interest income:				
Interest income	$ 32,793	$ 28,071	$ 86,834	$ 37,995
Interest expense	11,551	11,009	29,265	14,606
Net interest income	21,242	17,062	57,569	23,389
Other income, net:				
Gain (loss) on sale of agency securities, net	16,070	(162)	30,418	69
(Loss) gain on derivative instruments, net	(3,435)	4,340	(2,567)	4,557
Total other income, net	12,635	4,178	27,851	4,626
Expenses:				
Management fees	1,166	915	3,008	1,317
General and administrative expenses	1,474	1,424	4,498	2,298
Total expenses	2,640	2,339	7,506	3,615
Net income	$ 31,237	$ 18,901	$ 77,914	$ 24,400
Net income per common share basic and diluted	$ 1.82	$ 1.26	$ 4.95	$ 1.63
Weighted average number of common shares outstanding basic and diluted	17,191	15,005	15,741	15,005
Dividends declared per common share	$ 1.40	$ 1.00	$ 3.75	$ 1.31
Comprehensive income:				
Net income	$ 31,237	$ 18,901	$ 77,914	$ 24,400
Other comprehensive income (loss):				
Unrealized gain (loss) on available-for-sale securities, net	32,593	1,995	75,237	(22,591)
Reclassification adjustment for net (gain) loss included in net income	(6,791)	4,556	(16,604)	4,556
Unrealized (loss) gain on derivative instruments, net	(6,960)	(4,474)	2,070	(4,907)
Other comprehensive income (loss)	18,842	2,077	60,703	(22,942)

Comprehensive income	$ 50,079	$ 20,978	$ 138,617	$ 1,458

See accompanying notes to consolidated financial statements.

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AMERICAN CAPITAL AGENCY CORP.

CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(in thousands)

	Preferred Stock		Common Stock					
	Shares	Amount	Shares	Amount	Additional Paid-in Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2008		$	15,005	$ 150	$ 285,917	$ (2,310)	$ (25,606)	$ 258,151
Net income						16,311		16,311
Other comprehensive income (loss):								
Unrealized gain on available- for-sale securities, net							32,691	32,691
Reclassification adjustment for net gain included in net income							(3,407)	(3,407)
Unrealized loss on derivative instruments, net							(2,038)	(2,038)
Stock-based compensation					7			7
Common dividends declared						(12,754)		(12,754)
Balance, March 31, 2009 (Unaudited)		$	15,005	$ 150	$ 285,924	$ 1,247	$ 1,640	$ 288,961
Net income						30,366		30,366
Other comprehensive income (loss):								
Unrealized gain on available- for-sale securities, net							9,953	9,953
Reclassification adjustment for net gain included in net income							(6,406)	(6,406)
Unrealized gain on derivative instruments, net							11,068	11,068
Stock-based compensation					8			8
Common dividends declared						(22,507)		(22,507)
Balance, June 30, 2009 (Unaudited)		$	15,005	$ 150	$ 285,932	$ 9,106	$ 16,255	$ 311,443
Net income						31,237		31,237
Other comprehensive income (loss):								
Unrealized gain on available- for-sale securities, net							32,593	32,593
Reclassification adjustment for net gain included in net income							(6,791)	(6,791)
Unrealized loss on derivative instruments, net							(6,960)	(6,960)
Issuance of common stock			4,313	43	94,998			95,041
Issuance of restricted common stock			4					
Stock-based compensation					14			14
Common dividends declared						(27,050)		(27,050)
Balance, September 30, 2009 (Unaudited)		$	19,322	$ 193	$ 380,944	$ 13,293	$ 35,097	$ 429,527

See accompanying notes to consolidated financial statements.

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AMERICAN CAPITAL AGENCY CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)

	Nine Months Ended September 30, 2009	For the period from May 20, 2008 (date operations commenced) through September 30, 2008
Operating activities:		
Net income	$ 77,914	$ 24,400
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of agency securities premiums and discounts, net	15,898	3,143
Amortization of swap termination fee	6,671	
Ineffectiveness of derivative instruments	(496)	207
Stock-based compensation	29	10
Gain on sale of agency securities, net	(30,418)	(69)
Loss (gain) on derivative instruments, net	2,290	(4,764)
Increase in interest receivable, net of purchased interest	(10,142)	(7,947)
Increase in other assets	(418)	(613)
(Decrease) increase in accrued interest payable	(2,231)	1,875
(Decrease) increase in due to Manager	(95)	482
Increase in accounts payable and other accrued liabilities	421	758
Net cash provided by operating activities	59,423	17,482
Investing activities:		
Purchases of agency securities	(6,124,679)	(2,654,243)
Proceeds from sale of agency securities	4,097,357	906,133
Net (payments on) proceeds from derivative instruments	(1,592)	1,829
Principal collections on agency securities	380,136	48,982
Net cash used in investing activities	(1,648,778)	(1,697,299)
Financing activities:		
Cash dividends paid	(53,267)	(4,651)
Decrease (increase) in restricted cash	9,036	(18,914)
Payments made on interest rate swap terminations	(16,586)	
Proceeds from repurchase arrangements	20,922,236	7,310,900
Repayments on repurchase arrangements	(19,319,491)	(5,876,537)
Net proceeds from common stock offerings	95,041	286,050
Net cash provided by financing activities	1,636,969	1,696,848
Net change in cash and cash equivalents	47,614	17,031
Cash and cash equivalents at beginning of period	56,012	

Cash and cash equivalents at end of period	$	103,626	$	17,031

See accompanying notes to consolidated financial statements.

AMERICAN CAPITAL AGENCY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1. Unaudited Interim Consolidated Financial Statements

The interim consolidated financial statements of American Capital Agency Corp. (together with its consolidated subsidiary, is referred throughout this report as the Company , we , us and our) are prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

Our unaudited consolidated financial statements include the accounts of our wholly-owned subsidiary, American Capital Agency TRS, LLC. Significant intercompany accounts and transactions have been eliminated. In the opinion of management, all adjustments, consisting solely of normal recurring accruals, necessary for the fair presentation of financial statements for the interim period have been included. The current period s results of operations are not necessarily indicative of results that ultimately may be achieved for the year.

Note 2. Organization

We were organized in Delaware on January 7, 2008 and commenced operations on May 20, 2008 when we completed our initial public offering (IPO) of ten million shares of common stock. Concurrent with our IPO, American Capital, Ltd. (American Capital) purchased five million shares of our common stock in a private placement. In July 2009, through a public secondary offering, American Capital sold 2.5 million shares of our common stock that it had purchased in the private placement. We have elected to be taxed as a real estate investment trust (REIT) under the Internal Revenue Code of 1986, as amended (the Code). As such, we are required to distribute annually 90% of our taxable net income. As long as we qualify as a REIT, we will generally not be subject to U.S. federal or state corporate taxes on our taxable net income to the extent that we distribute all of our annual taxable net income to our stockholders. We are managed by American Capital Agency Management, LLC (our Manager), a subsidiary of a wholly-owned portfolio company of American Capital.

We earn income primarily from investing in single-family residential mortgage pass-through securities and collateralized mortgage obligations (CMOs) on a leveraged basis. These investments consist of securities for which the principal and interest payments are guaranteed by government-sponsored entities such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), or by a U.S. Government agency such as the Government National Mortgage Association (Ginnie Mae). We refer to these types of securities as agency securities and the specific agency securities in which we invest as our investment portfolio.

Note 3. Summary of Significant Accounting Policies

Investments

Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities* codified primarily in Financial Accounting Standards Board (the FASB) Accounting Standards Codification (ASC) 320, *Investments Debt and Equity Securities* (ASC 320), requires that at the time of purchase, we designate a security as held-to-maturity, available-for-sale or trading depending on our ability and intent to hold such security to maturity. Securities classified as trading and available-for-sale are reported at fair value, while securities classified as held-to-maturity are reported at

AMERICAN CAPITAL AGENCY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

amortized cost. Although we generally intend to hold most of our agency securities long-term, we may, from time to time, sell any of our agency securities as part of our overall management of our investment portfolio. Accordingly, we are required to classify all of our agency securities as available-for-sale. All securities classified as available-for-sale are reported at fair value, with unrealized gains and losses excluded from earnings and reported in accumulated other comprehensive income (loss) (OCI), a component of stockholders equity.

In April 2009, the FASB issued FASB Staff Position No. FAS 115-2 and 124-2, *Recognition and Presentation of Other-Than-Temporary Impairment* (FSP FAS 115-2), which is codified in FASB ASC 320-10-35 (ASC 320-10-35). FSP FAS 115-2 changed the other-than-temporary impairment (OTTI) model for debt securities such that an OTTI is triggered if (i) an entity has the intent to sell the security, (ii) it is more likely than not that it will be required to sell the security before recovery, or (iii) it does not expect to recover the entire amortized cost basis of the security. In addition, if there was an OTTI charge, FSP FAS 115-2 generally required that any credit loss component of the OTTI charge be recognized in earnings and the remainder of the OTTI charge remains in OCI. ASC 320-10-35 as it relates to FSP FAS 115-2 is effective for interim and annual reporting periods ending after June 15, 2009 with early adoption permitted for periods ending after March 15, 2009. We adopted the requirements of ASC 320-10-35 as they relate to FSP FAS 115-2 as of March 31, 2009. The adoption did not have a material impact on our consolidated financial statements.

We evaluate securities for OTTI on at least a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. Based on the criteria in ASC 320-10-35, the determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. When a security is impaired, an OTTI is considered to have occurred if (i) we intend to sell the agency security, (ii) it is more likely than not that we will be required to sell the agency security before recovery of its amortized cost basis or (iii) we do not expect to recover its amortized cost basis (i.e. there is a credit loss). If it is more likely than not that we will be required to sell the agency security before recovery of its amortized cost basis, the entire amount of the impairment loss is recognized in earnings as an unrealized loss and the cost basis of the security is adjusted. If we do not intend to sell the agency security but there is a credit loss, the impairment loss is separated into the amount representing the credit loss, which is recognized in earnings, and the amount related to other factors which is recognized in OCI. In determining whether a credit loss exists, consideration is given to (i) the length of time and the extent to which the fair value has been less than amortized cost, (ii) the financial condition and near-term prospects of recovery in the fair value of the agency security, (iii) the historical and implied volatility in the fair value of the agency security, (iv) the payment structure of the agency security and the likelihood of the issuer being able to make payments that increase in the future, (v) failure of the issuer of the agency security to make scheduled interest or principal payments, (vi) any changes to the rating of the agency security by a rating agency and (vii) recoveries or additional declines in fair value subsequent to the balance sheet date.

We did not recognize any OTTI charges on any of our agency securities for the three and nine months ended September 30, 2009 and for the period from May 20, 2008 through September 30, 2008.

Recent Accounting Pronouncements

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* which is codified in FASB ASC 855, *Subsequent Events* (ASC 855). ASC 855 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. We adopted ASC 855 in the second quarter of 2009 and evaluated all events or transactions through the date of this filing. During this period, we did not have any material subsequent events that impacted our consolidated financial statements.

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AMERICAN CAPITAL AGENCY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162*, which is codified in FASB ASC 105, *Generally Accepted Accounting Principles* (ASC 105). ASC 105 establishes the Codification as the source of authoritative GAAP in the United States (the GAAP hierarchy) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. Once the Codification is in effect, all of its content will carry the same level of authority and the GAAP hierarchy will be modified to include only two levels of GAAP, authoritative and non-authoritative. ASC 105 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. We adopted the requirements of ASC 105 in the third quarter of 2009.

In June 2009, the FASB issued SFAS No. 166, *Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140* (SFAS No. 166), which amends the derecognition guidance in SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* eliminates the concept of a qualifying special-purpose entity (QSPE) and requires more information about transfers of financial assets, including securitization transactions as well as a company s continuing exposure to the risks related to transferred financial assets. SFAS No. 166 has not yet been codified and in accordance with ASC 105, remains authoritative guidance until such time that it is integrated in the FASB ASC. SFAS No. 166 is effective for financial asset transfers occurring after the beginning of an entity s first fiscal year that begins after November 15, 2009 and early adoption is prohibited. Management is currently evaluating the impact on our consolidated financial statements of adopting SFAS No. 166.

In June 2009, the FASB issued SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)* (SFAS No. 167), which amends the consolidation guidance applicable to variable interest entities. The amendments will significantly affect the overall consolidation analysis under FASB ASC 810, *Consolidation* (ASC 810) and changes the way entities account for securitizations and special purpose entities as a result of the elimination of the QSPE concept in SFAS No.166. SFAS No. 167 has not yet been codified and in accordance with ASC 105, remains authoritative guidance until such time that it is integrated in the FASB ASC. SFAS No. 167 is effective as of the beginning of the first fiscal year that begins after November 15, 2009 and early adoption is prohibited. Management is currently evaluating the impact on our consolidated financial statements of adopting SFAS No. 167.

In August 2009, the FASB issued Accounting Standards Update (ASU) 2009-05 *Fair Value Measurements and Disclosures (Topic 820): Measuring Liabilities at Fair Value* (ASU 2009-05) which provides guidance on measuring the fair value of liabilities under FASB ASC 820, *Fair Value Measurements and Disclosures* (ASC 820). ASU 2009-05 clarifies that the unadjusted quoted price for an identical liability, when traded as an asset in an active market is a Level 1 measurement for the liability and provides guidance on the valuation techniques to estimate fair value of a liability in the absence of a Level 1 measurement. ASU 2009-05 is effective for the first interim or annual reporting period beginning after its issuance. The adoption of ASU 2009-05 did not have a material effect on our consolidated financial statements.

AMERICAN CAPITAL AGENCY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

Note 4. Agency Securities

The following tables summarize our available-for-sale agency securities as of September 30, 2009 and December 31, 2008 (dollars in thousands):

	As of September 30, 2009			
	Fannie Mae	**Freddie Mac**	**Ginnie Mae**	**Total**
Agency securities, par	$ 2,173,562	$ 1,076,434	$ 13,350	$ 3,263,346
Unamortized discount	(40)			(40)
Unamortized premium	67,582	44,917	382	112,881
Amortized cost	2,241,104	1,121,351	13,732	3,376,187
Gross unrealized gains	49,103	12,460	377	61,940
Gross unrealized losses				
Fair value	$ 2,290,207	$ 1,133,811	$ 14,109	$ 3,438,127
Weighted average coupon	5.52%	5.45%	6.00%	5.50%
Weighted average yield as of September 30, 2009(1)	4.25%	3.86%	5.24%	4.13%
Weighted average yield for the nine months ended September 30, 2009(1)	4.99%	4.61%	4.84%	4.89%

	Amortized Cost	**Gross Unrealized Gain**	**Gross Unrealized Loss**	**Fair Value**
Fixed-Rate	$ 1,238,277	$ 34,130	$	$ 1,272,407
Adjustable-Rate	1,880,943	23,241		1,904,184
CMO	256,967	4,569		261,536
	$ 3,376,187	$ 61,940	$	$ 3,438,127

(1) Incorporates future prepayment assumptions.

	As of December 31, 2008			
	Fannie Mae	**Freddie Mac**	**Ginnie Mae**	**Total**
Agency securities, par	$ 750,547	$ 239,712	$ 548,647	$ 1,538,906
Unamortized discount	(45)			(45)
Unamortized premium	11,457	3,753	16,008	31,218

Amortized cost	761,959	243,465	564,655	1,570,079
Gross unrealized gains	2,949	403	3,219	6,571
Gross unrealized losses	(2,311)	(956)		(3,267)
Fair value	$ 762,597	$ 242,912	$ 567,874	$ 1,573,383
Weighted average coupon	6.07%	6.10%	6.17%	6.11%
Weighted average yield as of December 31, 2008(1)	5.18%	5.27%	4.59%	4.98%
Weighted average yield for period from May 20, 2008 to December 31, 2008(1)	5.25%	5.24%	4.69%	5.04%

AMERICAN CAPITAL AGENCY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
Fixed-Rate	$ 1,570,079	$ 6,571	$ (3,267)	$ 1,573,383
Adjustable-Rate				
CMO				
	$ 1,570,079	$ 6,571	$ (3,267)	$ 1,573,383

(1) Incorporates future prepayment assumptions.

As of September 30, 2009, we had a net liability of $169.4 million for unsettled agency security transactions comprised of a $84.9 million receivable for agency securities sold and a $254.3 million payable for agency securities purchased.

Actual maturities of agency securities are generally shorter than the stated contractual maturities. Actual maturities of the agency securities are affected by the contractual lives of the underlying mortgages, periodic principal payments and principal prepayments. The following table summarizes our agency securities as of September 30, 2009 and December 31, 2008, according to their estimated weighted average life classifications (dollars in thousands):

	As of September 30, 2009			As of December 31, 2008		
Weighted Average Life	**Fair Value**	**Amortized Cost**	**Weighted Average Coupon**	**Fair Value**	**Amortized Cost**	**Weighted Average Coupon**
Less than one year	$	$		$	$	
Greater than one year and less than three years	151,936	149,391	5.12%	1,451,936	1,448,985	6.11%
Greater than three years and less than five years	1,635,541	1,612,512	5.46%	117,055	116,743	6.10%
Greater than or equal to five years	1,650,650	1,614,284	5.58%	4,392	4,351	6.15%
Total	$ 3,438,127	$ 3,376,187	5.50%	$ 1,573,383	$ 1,570,079	6.11%

The weighted average lives of the agency securities as of September 30, 2009 and December 31, 2008 in the table above incorporates anticipated future prepayment assumptions. As of September 30, 2009, our expected constant prepayment rate (CPR) over the remaining life of our aggregate investment portfolio is 17%. Our estimates differ materially for different types of securities and thus individual holdings have a wide range of projected CPRs. We estimate long-term prepayment assumptions for different securities using third-party services, market data and internal estimates. These third-party services estimate prepayment speeds using models that incorporate the current and forward yield curves, current mortgage rates, mortgage rates of the outstanding loans, loan age, volatility and other factors. As market conditions are changing rapidly, we use our judgment in making adjustments to our models for different securities. Various market participants could use materially different assumptions.

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AMERICAN CAPITAL AGENCY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

The following table presents the gross unrealized loss and fair values of our agency securities by length of time that such securities have been in a continuous unrealized loss position as of September 30, 2009 and December 31, 2008 (dollars in thousands):

	Less than 12 Months		Unrealized Loss Position For 12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
September 30, 2009	$	$	$	$	$	$
December 31, 2008	$ 680,048	$ (3,267)	$	$	$ 680,048	$ (3,267)

We did not have any agency securities that were in an unrealized loss position as of September 30, 2009.

During the three months ended September 30, 2009, we sold agency securities with a cost basis of $1,679.5 million for proceeds of $1,610.7 million and a receivable for sold agency securities of $84.9 million realizing a gross gain of $16.9 million and a gross loss of $0.8 million, for a net gain of $16.1 million. During the nine months ended September 30, 2009, we sold agency securities with a cost basis of $4,151.9 million for proceeds of $4,097.4 million and a receivable for sold agency securities of $84.9 million realizing a gross gain of $33.2 million and a gross loss of $2.8 million, for a net gain of $30.4 million.

The following tables summarize our agency securities pledged as collateral under repurchase agreements, derivative agreements and prime broker agreements by type as of September 30, 2009 and December 31, 2008 (dollars in thousands):

	As of September 30, 2009			
Agency Securities Pledged	Fannie Mae	Freddie Mac	Ginnie Mae	Total
Under Repurchase Agreements				
Fair value	$ 2,092,632	$ 1,032,387	$ 14,109	$ 3,139,128
Amortized cost	2,046,138	1,021,554	13,732	3,081,424
Accrued interest on pledged agency securities	8,765	4,432	67	13,264
Under Derivative Agreements				
Fair value	17,696	4,494		22,190
Amortized cost	17,171	4,332		21,503
Accrued interest on pledged agency securities	82	21		103
Under Prime Broker Agreements				
Fair value	9,730	18,734		28,464
Amortized cost	9,380	18,148		27,528
Accrued interest on pledged agency securities	38	88		126

Total Fair Value of Agency Securities Pledged and Accrued Interest	**$ 2,128,943**	**$ 1,060,156**	**$ 14,176**	**$ 3,203,275**

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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Agency Securities Pledged	Fannie Mae	Freddie Mac	Ginnie Mae	Total
	As of December 31, 2008			
Under Repurchase Agreements				
Fair value	$ 684,893	$ 194,920	$ 567,874	$ 1,447,687
Amortized cost	684,099	195,515	564,655	1,444,269
Accrued interest on pledged agency securities	3,403	982	2,823	7,208
Under Derivative Agreements				
Fair value	19,709	10,989		30,698
Amortized cost	19,724	11,052		30,776
Accrued interest on pledged agency securities	100	54		154
Under Prime Broker Agreements				
Fair value	34,185	9,431		43,616
Amortized cost	34,381	9,485		43,866
Accrued interest on pledged agency securities	175	47		222
Total Fair Value of Agency Securities Pledged and Accrued Interest	**$ 742,465**	**$ 216,423**	**$ 570,697**	**$ 1,529,585**

The following table summarizes our agency securities pledged as collateral under repurchase agreements by remaining maturity as of September 30, 2009 and December 31, 2008 (dollars in thousands):

Remaining Maturity	As of September 30, 2009 Fair Value	Amortized Cost	Accrued Interest on Pledged Agency Securities	As of December 31, 2008 Fair Value	Amortized Cost	Accrued Interest on Pledged Agency Securities
30 days or less	$ 2,683,045	$ 2,631,906	$ 11,198	$ 1,117,093	$ 1,113,174	$ 5,556
31 - 59 days	231,193	227,918	1,054	330,594	331,095	1,652
60 - 89 days	224,890	221,600	1,012			
90 days or greater						
Total	$ 3,139,128	$ 3,081,424	$ 13,264	$ 1,447,687	$ 1,444,269	$ 7,208

Note 5. Repurchase Agreements

We pledge certain of our agency securities as collateral under repurchase arrangements with financial institutions, the terms and conditions of which are negotiated on a transaction-by-transaction basis. Interest rates on these borrowings are generally based on LIBOR plus or minus a margin and amounts available to be borrowed are dependent upon the fair value of the agency securities pledged as collateral, which fluctuates with changes in interest rates, type of security and liquidity conditions within the banking, mortgage finance and real estate industries. In response to declines in fair value of pledged agency securities, lenders may require us to post additional collateral or pay down borrowings to re-establish agreed upon collateral requirements, referred to as margin calls. As of September 30, 2009 and December 31, 2008, we have met all margin call requirements. Due to their short-term nature, repurchase agreements are carried at cost, which approximates fair value.

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(unaudited)

The following table summarizes our borrowings under repurchase arrangements and weighted average interest rates classified by original maturities as of September 30, 2009 and December 31, 2008 (dollars in thousands):

	As of September 30, 2009			As of December 31, 2008		
Original Maturity	Borrowings Outstanding	Average Interest Rate	Weighted Average Days to Maturity	Borrowings Outstanding	Average Interest Rate	Weighted Average Days to Maturity
30 days or less	$ 1,346,996	0.35%	18	$ 97,081	3.00%	15
31 - 59 days	925,198	0.34%	15	482,458	2.32%	17
60 - 89 days	225,455	0.33%	23	741,721	2.20%	28
90 days or greater	451,361	0.38%	66	25,005	2.10%	41
Total / Weighted Average	$ 2,949,010	0.35%	25	$ 1,346,265	2.30%	23

As of September 30, 2009, we did not have an amount at risk with any counterparty greater than 10% of our stockholders equity. We do not anticipate any defaults by our repurchase agreement counterparties.

Note 6. Derivative Instruments

In connection with our risk management strategy, we hedge a portion of our interest rate risk by entering into derivative financial instrument contracts. We may enter into interest rate caps, collars, floors, forward contracts, put and call options on securities or securities underlying futures contracts, futures or swaps, or purchase or sell to-be-announced (TBA) agency securities to attempt to manage the overall interest rate risk of the portfolio, reduce fluctuations in book value and generate additional income distributable to stockholders. As of September 30, 2009 and December 31, 2008, our derivative instruments were comprised primarily of interest rate swaps, which have the effect of modifying the repricing characteristics of our repurchase agreements and cash flows on such liabilities. Our interest rate swaps are used to manage the interest rate risk created by our variable rate short-term repurchase agreements. Under our interest rate swaps, we pay a fixed-rate and receive a floating rate based on one month LIBOR with terms ranging from 2 years to 5 years. Our interest rate swaps are generally designated as hedges under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities, as amended* which is codified in FASB ASC 815, *Derivatives and Hedging* (ASC 815). Derivatives not designated as hedges are used to manage the exposure to interest rate movements and other identified risks, but do not meet the hedge accounting requirements of ASC 815.

As of September 30, 2009, we had contracts to purchase and sell TBA agency securities with total notional amounts of $170.0 million and $75.0 million, respectively, and gross fair values of $0.7 million and $0.2 million, respectively, resulting in a net liability of $0.5 million. We use purchases and sales of TBA securities to help manage a portion of our interest rate risk. These transactions supplement our use of interest rate swaps and we do not currently expect our use of TBA agency securities to be the primary protection against interest rate risk for our portfolio. These contracts to purchase and sell TBA securities were accounted for as derivatives but not designated as hedges under ASC 815. Therefore, any changes in the fair values of the contracts to purchase and sell TBA agency securities prior to their settlement date are included in earnings. As of December 31, 2008, we did not have any derivatives outstanding that were not designated as hedges. During the three and nine months ended September 30, 2009, we recorded a net loss of $3.2 million and $2.1 million, respectively in (loss) gain on derivative instruments, net in our consolidated statements of operations and comprehensive income for derivatives not designated as hedging instruments under ASC 815.

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The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings and monitoring positions with individual counterparties. In addition, we may be required to pledge assets as collateral for our interest rate swaps, whose amounts vary over time based on the market value, notional amount and remaining term of the derivative contract. We had agency securities with a fair value of $22.2 million and cash of $5.9 million pledged as collateral against our interest rate swaps as of September 30, 2009. In the event of a default by a counterparty, we may not receive payments provided for under the terms of our derivatives, and may have difficulty obtaining our assets pledged as collateral for our derivatives. We do not anticipate any defaults by our derivative instrument contract counterparties.

The tables below summarize information about our outstanding interest rate swaps as of September 30, 2009 and December 31, 2008 (dollars in thousands):

	As of September 30, 2009				
Remaining Swap Term	Notional Amount	Average Fixed Pay Rate	Weighted Average Receive Rate	Net Estimated Fair Value	Average Maturity (Years)
1 year or less	$			$	
Greater than 1 year and less than 3 years	1,100,000	1.81%	0.25%	(11,464)	2.3
Greater than 3 year and less than 5 years	300,000	2.82%	0.25%	(5,506)	4.5
Greater than 5 Years					
Total	$ 1,400,000	2.02%	0.25%	$ (16,970)	2.8

	As of December 31, 2008				
Remaining Swap Term	Notional Amount	Average Fixed Pay Rate	Weighted Average Receive Rate	Net Estimated Fair Value	Average Maturity (Years)
1 year or less	$			$	
Greater than 1 year and less than 3 years	550,000	3.42%	1.00%	(18,900)	1.4
Greater than 3 year and less than 5 years	100,000	4.46%	1.32%	(10,377)	4.0
Greater than 5 Years					
Total	$ 650,000	3.58%	1.05%	$ (29,277)	1.8

During the three and nine months ended September 30, 2009, we recorded losses of $0.0 million and $1.0 million, respectively, as a result of the reclassification from OCI of hedged forecasted transactions becoming probable not to occur and a loss of $0.2 million and a gain of $0.5 million, respectively, in (loss) gain on derivative instruments, net in our consolidated statements of operations and comprehensive income for hedge ineffectiveness on our outstanding interest rate swaps.

During the three months ended September 30, 2009, we entered into six interest rate swaps with a combined notional amount of $450.0 million. We did not terminate any interest rate swaps during the three months ended September 30, 2009. During the nine months ended September 30, 2009, we entered into 17 interest rate swaps with a combined notional amount of $1,300.0 million and we terminated seven interest rate swaps with a combined notional amount of $550.0 million and a fair value of $16.5 million, resulting in a net settlement payment of $16.6 million. The net settlements are amortized into income over the remaining life of the

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terminated interest rate swaps and included in interest expense on our consolidated statements of operations and comprehensive income. Amortization expense for the terminated swaps was $3.7 million and $6.7 million for the three and nine months ended September 30, 2009, respectively. As of September 30, 2009, the unamortized amount of fees associated with terminated swaps to be amortized through the second quarter of 2010 was $9.9 million.

The table below summarizes the effect of derivative instruments on our consolidated statements of operations and comprehensive income for the three months ended September 30, 2009 (dollars in thousands):

Derivatives in ASC 815 Cash Flow Hedging Relationships	Amount of Gain or (Loss) Recognized in OCI (Effective Portion)	Location of Gain or (Loss) Reclassified from OCI into Earnings (Effective Portion)	Amount of Gain or (Loss) Reclassified from OCI into Earnings (Effective Portion)	Location of Gain or (Loss) Recognized in Earnings (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain or (Loss) Recognized in Earnings (Ineffective Portion and Amount Excluded from Effectiveness Testing)
Interest rate swaps	$ (7,178)	Interest expense	$ (8,720)	(Loss) gain on derivative instruments, net	$ (220)

The table below summarizes the effect of derivative instruments on our consolidated statements of operations and comprehensive income for the nine months ended September 30, 2009 (dollars in thousands):

Derivatives in ASC 815 Cash Flow Hedging Relationships	Amount of Gain or (Loss) Recognized in OCI (Effective Portion)	Location of Gain or (Loss) Reclassified from OCI into Earnings (Effective Portion)	Amount of Gain or (Loss) Reclassified from OCI into Earnings (Effective Portion)(1)	Location of Gain or (Loss) Recognized in Earnings (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain or (Loss) Recognized in Earnings (Ineffective Portion and Amount Excluded from Effectiveness Testing)
Interest rate swaps	$ 2,566	Interest expense	$ (19,175)	(Loss) gain on derivative instruments, net	$ 496

(1) This amount excludes $1.0 million recorded as a loss in (loss) gain on derivative instruments, net in our consolidated statements of operations and comprehensive income as a result of the reclassification from OCI of hedged forecasted transactions becoming probable not to occur.

Credit Risk-Related Contingent Features

Each of our ISDA Master Agreements contain a cross default provision under which a default under certain of our other indebtedness in excess of a certain threshold causes an event of default under the agreement. Threshold amounts range from $5 million to $25 million. As of September 30, 2009 and December 31, 2008, the fair value of derivatives in a liability position related to these agreements was $17.0 million and $29.3 million, respectively. Following an event of default, a termination event may occur and we would be required to settle our obligations under the agreements at their termination values of $17.7 million and $29.9 million as of September 30, 2009 and December 31, 2008, respectively, which includes accrued interest.

Each of our ISDA Master Agreements also contain provisions under which we are required to fully collateralize our obligations under the derivative instrument if at any point the fair value of the derivative represents a liability greater than the minimum transfer amount contained within our agreements. We were also required to post initial collateral upon execution of certain of our derivative transactions. As of September 30, 2009 and December 31, 2008, we have posted agency securities and cash collateral totaling $28.1 million and $30.7 million, respectively, related to these agreements. If we breach any of these provisions we will be required to settle our obligations under the agreements at their termination value of $17.7 million and $29.9 million as of September 30, 2009 and December 31, 2008, respectively, which includes accrued interest.

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One of our ISDA Master Agreements contains an additional termination event that is triggered if our net worth at the end of any calendar quarter declines by 30% or more from the end of any previous calendar quarter or if our net worth declines by 40% or more at any time during any consecutive twelve-month period. As of September 30, 2009 and December 31, 2008, the fair value of derivatives in a liability position related to this agreement was $1.9 million and $5.3 million, respectively. As of September 30, 2009 and December 31, 2008, we were not in violation of this provision.

One of our ISDA Master Agreements contains an additional termination event that is triggered if we fail to maintain minimum stockholders equity of the greater of (a) $200 million or (b) 50% of the highest stockholders equity from the date of the agreement. As of September 30, 2009 and December 31, 2008, the fair value of derivatives in a liability position related to this agreement was $8.5 million and $12.3 million, respectively. As of September 30, 2009 and December 31, 2008, we were not in violation of this provision.

One of our ISDA Master Agreements contains an additional termination event that is triggered if our total stockholders equity declines by 50% or more from our total stockholders equity at our IPO date. As of September 30, 2009, the fair value of derivatives in a liability position related to this agreement was $2.4 million. As of December 31, 2008, there were no outstanding derivative instruments related to this agreement. As of September 30, 2009 and December 31, 2008, we were not in violation of this provision.

Note 7. Fair Value Measurements

SFAS No. 157, *Fair Value Measurements, codified in* ASC 820 defines fair value, establishes a framework for measuring fair value and establishes a three-level valuation hierarchy for disclosure of fair value measurement. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument s categorization within the hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels of hierarchy established by ASC 820 are defined as follows:

Level 1 Inputs Quoted prices (unadjusted) for identical unrestricted assets and liabilities in active markets that are accessible at the measurement date.

Level 2 Inputs 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 3 Inputs Instruments with primarily unobservable market data that cannot be corroborated.

In April 2009, the FASB issued FASB Staff Position No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP FAS 157-4), which is codified in FASB ASC 820-10-35 (ASC 820-10-35). FSP FAS 157-4 provided guidance on (i) estimating the fair value of an asset or liability when the volume and level of activity for the asset or liability have significantly decreased and (ii) identifying transactions that are not orderly. ASC 820-10-35 as it relates to FSP FAS 157-4 is effective prospectively for interim and annual reporting periods ending after June 15, 2009 with early adoption permitted for periods ending after March 15, 2009. We adopted the requirements of ASC 820-10-35 as they relate to FSP FAS 157-4 as of March 31, 2009. The adoption did not have a material impact on our consolidated financial statements.

In April 2009, the FASB issued FASB Staff Position No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments (FSP FAS 107-1)*, which is codified in FASB ASC 825-10-50 (ASC 825-10-50). FSP FAS 107-1 expanded the fair value disclosures required for all financial instruments

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within the scope of SFAS No. 107, *Disclosures about Fair Value of Financial Instrument*s codified in FASB ASC 825, *Financial Instruments* to interim periods for publicly traded entities. FSP FAS 107-1 also required entities to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments in financial statements on an interim basis and to highlight any changes of the methods and significant assumptions from prior periods. ASC 825-10-50 as it relates to FSP FAS 107-1 is effective for interim reporting periods ending after June 15, 2009 with early adoption permitted for periods ending after March 15, 2009. We adopted the requirements of ASC 825-10-50 as they relate to FSP FAS 107-1 as of March 31, 2009. The adoption did not have a material impact on our consolidated financial statements.

Cash and Cash Equivalents and Restricted Cash

Cash and cash equivalents and restricted cash are carried at cost, which approximates their fair value.

Repurchase Agreements

Due to their short-term nature, repurchase agreements are carried at cost, which approximates fair value.

Agency Securities

Agency securities are valued using third-party pricing services and dealer quotes. The third-party pricing services use pricing models that incorporate such factors as coupons, primary and secondary mortgage rates, prepayment speeds, spread to the Treasury and interest rate swap curves, convexity, duration, periodic and life caps and credit enhancement. The dealer quotes incorporate common market pricing methods, including a spread measurement to the Treasury or interest rate swap curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period, issuer, additional credit support and expected life of the security. Management reviews the fair values determined by the third-party pricing models and dealer quotes and compares the results, if available, to values from the repurchase agreement counterparties and internal pricing models on each investment to validate reasonableness.

Derivative Instruments

Interest rate swaps are valued using a third-party pricing model. The third-party pricing model incorporates such factors as the Treasury curve, LIBOR rates and the pay rate on the interest rate swaps. Credit valuation adjustments for nonperformance risk, if any, include a quantitative and/or qualitative evaluation of both our and our counterparty s credit risk including credit risk enhancements, if any.

Contracts to purchase or sell TBA agency securities are valued using third-party pricing services. These third-party pricing services use pricing models that incorporate such factors as coupons, prepayment speeds, spread to the Treasury and interest rate swap curves, convexity, duration, periodic and life caps and credit enhancement.

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(unaudited)

Our financial assets and liabilities as of September 30, 2009 and December 31, 2008, carried at fair value on a recurring basis are valued as follows (in thousands):

	As of September 30, 2009			
	Level 1	Level 2	Level 3	Total
Agency securities:				
Fannie Mae	$	$ 2,290,207	$	$ 2,290,207
Freddie Mac		1,133,811		1,133,811
Ginnie Mae		14,109		14,109
Total agency securities		3,438,127		3,438,127
Derivative instruments:				
Assets				
Liabilities		(523)	(16,970)	(17,493)
Total derivative instruments, net		(523)	(16,970)	(17,493)
Total	$	$ 3,437,604	$ (16,970)	$ 3,420,634

	As of December 31, 2008			
	Level 1	Level 2	Level 3	Total
Agency securities:				
Fannie Mae	$	$ 762,597	$	$ 762,597
Freddie Mac		242,912		242,912
Ginnie Mae		567,874		567,874
Total agency securities		1,573,383		1,573,383
Derivative instruments:				
Assets				
Liabilities			(29,277)	(29,277)
Total derivative instruments, net			(29,277)	(29,277)
Total	$	$ 1,573,383	$ (29,277)	$ 1,544,106

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During the three and nine months ended September 30, 2009, we recognized expense of $8.9 million and $19.6 million, respectively, in our consolidated statements of operations and comprehensive income and an unrealized loss of $7.0 million and unrealized gain of $2.1 million, respectively, recorded in OCI related to our Level 3 interest rate swap assets and liabilities. Of the total net unrealized loss deferred in OCI relating to these interest rate swap assets and liabilities, net expense of $30.8 million is expected to flow through our consolidated statements of operations and comprehensive income over the next twelve months due to expected settlements and amortization expense associated with the termination of interest rate swaps. The following tables set forth a summary of changes in the fair value of our interest rate swap assets and liabilities measured using Level 3 inputs for the three and nine months ended September 30, 2009 (in thousands):

	Beginning Balance	Realized Gains/ (Losses)	Reversal of Prior Period Appreciation/ (Depreciation) on Realization	Appreciation/ (Depreciation)(1)	Purchases, Sales, Issuances & Settlements, Net(2)	Transfers In & Out of Level 3	Ending Balance
Three months ended September 30, 2009	$ (6,116)	$	$	$ (10,854)	$	$	$ (16,970)
Nine months ended September 30, 2009	$ (29,277)	$	$	$ (4,279)	$ 16,586	$	$ (16,970)

(1) For the three months ended September 30, 2009, we recorded a $7.0 million unrealized loss on derivative instruments in OCI, losses of $0.2 million in (loss) gain on derivative instruments, net in our consolidated statements of operations and comprehensive income as a result of hedge ineffectiveness on our outstanding interest rate swaps and interest expense of $3.7 million in our consolidated statements of operations and comprehensive income related to amortization expense associated with the termination of interest rate swaps. For the nine months ended September 30, 2009, we recorded a $2.1 million unrealized gain on derivative instruments in OCI and gains of $0.5 million in (loss) gain on derivative instruments, net in our consolidated statements of operations and comprehensive income as a result of hedge ineffectiveness on our outstanding interest rate swaps, offset by interest expense of $6.7 million in our consolidated statements of operations and comprehensive income related to amortization expense associated with the termination of interest rate swaps.

(2) See Note 6 for additional information related to derivatives which were purchased and terminated during the periods presented.

Note 8. Management Agreement and Related Party Transactions

We are externally managed and advised by our Manager pursuant to the terms of a management agreement which provides for an initial term through May 20, 2011 with automatic one-year extension options and subject to certain termination rights. We pay our Manager a base management fee payable monthly in arrears in an amount equal to 1/12 of 1.25% of our Equity. Our Equity is defined as our month-end stockholders equity, adjusted to exclude the effect of any unrealized gains or losses included in either retained earnings or OCI, each as computed in accordance with GAAP. There is no incentive compensation payable to our Manager pursuant to the management agreement. For the three and nine months ended September 30, 2009, we recorded an expense for management fees of $1.2 million and $3.0 million, respectively. For the three months ended September 30, 2008, we recorded an expense for management fees of $0.9 million. For the period from May 20, 2008 through September 30, 2008, we recorded an expense for management fees of $1.3 million.

We are obligated to reimburse our Manager for its expenses incurred directly related to our operations, excluding employment-related expenses of our Manager s officers and any American Capital employees who provide services to us pursuant to the management agreement. Our Manager has entered into an administrative services agreement with American Capital, pursuant to which American Capital will provide personnel, services and resources necessary for our Manager to perform its obligations under the management agreement. For the three and nine months ended September 30, 2009, we recorded expense reimbursements to our Manager of $0.6 million and $2.2 million, respectively. In addition, we are required to reimburse our Manager, or American

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Capital, for all one-time costs that our Manager, or American Capital, paid on behalf of us that were incurred in connection with our formation, organization and IPO. There were no such costs during the first nine months of 2009. As of September 30, 2009 and December 31, 2008, $0.6 million and $0.7 million, respectively, was payable to our Manager.

We will be required to pay our Manager a termination fee for non-renewal of the management agreement without cause. The termination fee will be equal to three times the average annual management fee earned by the Manager during the prior 24-month period immediately preceding the most recently completed month prior to the effective date of the termination.

Note 9. Shareholders Equity

Long-term Incentive Plan

We sponsor an equity incentive plan to provide for the issuance of equity-based awards, including stock options, restricted stock, restricted stock units and unrestricted stock awards to our independent directors. An aggregate of 100,000 shares of our common stock has been reserved for issuance under this plan. In July 2009, 4,500 shares of restricted common stock were granted to our independent directors pursuant to this plan (grant date fair value of $23.80 per share) that vest annually over three years. As of September 30, 2009, the plan had 91,000 common shares remaining available for future issuance. As of September 30, 2009, we had unrecognized compensation expense of $148,039 related to unvested shares of restricted common stock. We recorded compensation expense of $13,851 and $28,244, respectively, related to restricted common stock awards during the three and nine months ended September 30, 2009.

Equity Offering

In August 2009, we completed a public offering in which 4.3 million shares of our common stock, including the over-allotment, were sold at a public offering price of $23.30 per share. Upon completion of the offering we received proceeds, net of the underwriters discount and other offering costs, of approximately $95 million.

Note 10. Dividends

On September 22, 2009, our Board of Directors declared a dividend of $1.40 per share of our common stock for the third quarter of 2009. The dividend is payable on October 27, 2009 to common stockholders of record as of October 2, 2009.

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

Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is designed to provide a reader of American Capital Agency Corp. consolidated financial statements with a narrative from the perspective of management. Our MD&A is presented in five sections:

- Executive Overview
- Financial Condition
- Results of Operations
- Liquidity and Capital Resources
- Forward-Looking Statements

EXECUTIVE OVERVIEW

American Capital Agency Corp. (together with its consolidated subsidiary, is referred throughout this report as the Company , we , us and our) is a real estate investment trust (REIT) that invests exclusively in single-family residential mortgage pass-through securities and collateralized mortgage obligations on a leveraged basis. These investments consist of securities for which principal and interest are guaranteed by government-sponsored entities such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), or by a U.S. Government agency such as the Government National Mortgage Association (Ginnie Mae). We refer to these types of securities as agency securities and the specific agency securities in which we invest as our investment portfolio.

We were organized on January 7, 2008, and commenced operations on May 20, 2008 following the completion of our initial public offering (IPO). In connection with the IPO, we sold ten million shares of our common stock at $20.00 per share for net proceeds of $186 million, net of the underwriters commission and other offering expenses. Concurrent with our IPO, American Capital, Ltd. (American Capital) purchased five million shares of our common stock in a private placement at $20.00 per share for aggregate proceeds of $100 million. In July 2009, through a public secondary offering, American Capital sold 2.5 million shares of our common stock that it had purchased in the private placement. In August 2009, we completed a follow-on public offering of a total of 4.3 million shares of our common stock, including the over-allotment, at $23.30 per share. Upon completion of the offering we received proceeds, net of the underwriters discount and other offering costs, of approximately $95 million. Our common stock is traded on The NASDAQ Global Market under the symbol AGNC .

We are externally managed by American Capital Agency Management, LLC (our Manager). Our Manager is a wholly-owned subsidiary of American Capital, LLC, which is a wholly-owned portfolio company of American Capital. We do not have any employees.

Our principal objective is to generate net income for distribution to our stockholders through regular quarterly dividends from our net interest income, which is the spread between the interest income earned on our investment portfolio and the interest costs of our borrowings and hedging activities. We fund our investments through short-term borrowings structured as repurchase agreements. Since our IPO, we have declared or paid dividends of $6.26 per share.

We have elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended (the Code), commencing with our taxable year ending December 31, 2008. As long as we qualify as a REIT, we generally will not be subject to federal income taxes on our taxable income to the extent that we annually distribute all of our taxable income to stockholders.

Recent Developments

Our business is affected by general U.S. residential real estate fundamentals and the overall U.S. economic environment. In particular, our strategy and performance is influenced by the specific characteristics of these

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markets, including prepayment rates, interest rates and the interest rate yield curve. Our results of operations primarily depend on, among other things, the level of our interest income and the amount and cost of borrowings we may obtain by pledging our investment portfolio as collateral for the borrowings. Our interest income, which includes the amortization of purchase premiums and accretion of purchase discounts, varies primarily as a result of changes in prepayment speeds of the agency securities and the size and composition of our investment portfolio. Our borrowing costs vary based on changes in interest rates and changes in the amount we can borrow which is generally based on the fair value of our investment portfolio and the advance rate the lenders are willing to lend against the collateral provided.

Since the middle of 2007, banks, investment banks, independent finance companies and insurance companies have announced extensive losses from exposure to the U.S. mortgage market. These losses have reduced financial industry capital leading to reduced liquidity for mortgage assets, more volatile valuations of mortgage assets and in some cases forced selling of mortgage assets. As a result, there was less financing available on attractive terms for mortgage assets in 2007 and 2008.

In response, actions by the U.S. Federal Reserve (FRB) and the U.S. Department of Treasury (U.S. Treasury) appear to have helped to stabilize the investing and financing environment for agency securities. The liquidity facilities created by the FRB during 2007 through 2009 and its lowering of the Federal Funds Rate target to a range of 0.00% to 0.25%, along with the reduction of the 30-day LIBOR to 0.25% as of October 16, 2009, have lowered our financing costs and stabilized the availability of repurchase agreement financing.

Due to increased market concerns about Freddie Mac and Fannie Mae s ability to withstand future credit losses associated with securities held in their investment portfolios, and on which they provide guarantees, without the direct support of the federal government, the government passed the Housing and Economic Recovery Act of 2008 on July 30, 2008. As a result of this legislation, Fannie Mae and Freddie Mac have been placed into the conservatorship of the Federal Housing Finance Agency (FHFA), their federal regulator, pursuant to its powers under The Federal Housing Finance Regulatory Reform Act of 2008, a part of the Housing and Economic Recovery Act of 2008. As the conservator of Fannie Mae and Freddie Mac, the FHFA now controls and directs the operations of Fannie Mae and Freddie Mac and may (i) take over the assets of and operate Fannie Mae and Freddie Mac with all the powers of the stockholders, the directors, and the officers of Fannie Mae and Freddie Mac and conduct all business of Fannie Mae and Freddie Mac; (ii) collect all obligations and money due to Fannie Mae and Freddie Mac; (iii) perform all functions of Fannie Mae and Freddie Mac which are consistent with the conservator s appointment; (iv) preserve and conserve the assets and property of Fannie Mae and Freddie Mac; and (v) contract for assistance in fulfilling any function, activity, action or duty of the conservator.

In addition to FHFA becoming the conservator of Fannie Mae and Freddie Mac, (i) the U.S. Treasury and FHFA have entered into separate preferred stock purchase agreements with Fannie Mae and Freddie Mac pursuant to which the U.S. Treasury will ensure that Fannie Mae and Freddie Mac maintain a positive net worth; (ii) the U.S. Treasury has established a new secured lending credit facility available until December 2009 to Fannie Mae, Freddie Mac and the Federal Home Loan Banks, which is intended to serve as a liquidity backstop; and (iii) the U.S. Treasury has initiated a temporary program to purchase residential mortgage-backed securities (RMBS) issued by Fannie Mae and Freddie Mac. Given the highly fluid and evolving nature of these events, it is unclear how our business will be impacted. Based upon the further activity of the U.S. Government or market response to developments at Fannie Mae or Freddie Mac, our business could be adversely impacted.

The FRB announced on November 25, 2008 that it would initiate a program to purchase the direct obligations of housing-related government-sponsored enterprises and agency securities. On December 30, 2008, the FRB announced beginning in January 2009, it would begin purchasing up to $500 billion of agency securities and that it had selected private investment managers to act as its agents in implementing the program. Subsequently, on March 18, 2009, the FRB announced the expansion of its agency securities purchase program to a total of $1.25 trillion by the end of 2009. As part of this expansion, the FRB also decided to purchase $300

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billion of U.S. Treasury securities as well as an additional $200 billion of debt issued by Fannie Mae and Freddie Mac. On September 23, 2009, the FRB announced that it will gradually slow the pace of its agency securities purchase program to promote a smooth transition in the markets and anticipates that the $1.25 trillion program will be completed by the end of the first quarter of 2010. The FRB has also announced that its program to purchase U.S. Treasury securities is expected to be completed by the end of October 2009. However, the ultimate size and timing of the U.S. Treasury and agency securities purchase programs are subject to the discretion of the U.S. government. The impact of these events remain highly uncertain and we cannot predict whether or when such actions may occur or what impact, if any, such actions could have on our business, results of operations and financial condition.

On February 18, 2009, the U.S. Treasury announced the Homeowner Affordability and Stability Plan (HASP), which was intended to prevent residential mortgage foreclosures by assisting borrowers to restructure or refinance their mortgages to avoid foreclosure by:

- allowing certain homeowners whose homes are encumbered by Fannie Mae or Freddie Mac conforming mortgages to refinance those mortgages into lower interest rate mortgages with either Fannie Mae or Freddie Mac;
- creating the Homeowner Stability Initiative, which is intended to utilize various incentives for banks and mortgage servicers to modify residential mortgage loans with the goal of reducing monthly mortgage principal and interest payments for certain qualified homeowners; and
- allowing judicial modifications of Fannie Mae and Freddie Mac conforming residential mortgages loans during bankruptcy proceedings.

In addition, on July 1, 2009, under HASP, Fannie Mae and Freddie Mac announced that they were expanding the loan-to-value ratios for homeowners eligible to refinance their existing mortgages from 105% to 125%, in order to give homeowners more options to refinance into mortgages with terms that better position them for long-term home ownership.

We expect HASP to increase the availability of mortgage credit to a large number of homeowners in the U.S., which we expect will impact the prepayment rates for the entire mortgage securities market, but primarily for Fannie Mae and Freddie Mac agency securities. While increased prepayment rates negatively impact our interest income, we believe we have sourced agency securities with collateral attributes that improve the prepayment profile of our investment portfolio. However, these are new programs and therefore there is substantial uncertainty around the magnitude of prepayment speed increases and our asset selection process may not provide the desired benefits.

In March 2009, the U.S. Treasury launched the Term Asset-Backed Securities Loan Facility (TALF), which is a lending facility of up to $1 trillion that was created to increase securitization activity for various consumer and commercial loans and other financial assets, including student loans, automobile loans and leases, credit card receivables, Small Business Administration (SBA) small business loans and commercial mortgage-backed securities. In July 2009, the U.S. Treasury expanded the categories of TALF-eligible collateral to include certain high-quality commercial mortgage-backed securities issued before January 1, 2009. The FRB and U.S. Treasury also indicated that they continue to assess whether to expand TALF-eligible collateral to include legacy RMBS as an eligible asset class.

In July 2009, the U.S. Treasury, FRB and FDIC announced the details of the Legacy Securities Public-Private Investment Program (PPIP). Under PPIP, the U.S. Treasury will invest up to $30 billion of equity and debt in public-private investment funds established with private sector fund managers and private investors for the purpose of purchasing legacy securities. Initially, this program will participate in the market for commercial mortgage-backed securities and non-agency RMBS. The U.S. Treasury has pre-qualified nine fund managers in the initial round of the program and has recently announced the initial closings of PPIP funds established under the program.

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Our Manager

We are externally managed and advised by our Manager pursuant to the terms of a management agreement. Because we have no employees or separate facilities, we rely on our Manager to administer our business activities and day-to-day operations, subject to the supervision and oversight of our Board of Directors. Effective July 1, 2009, Gary Kain, our Senior Vice President and Chief Investment Officer, and several other American Capital employees became full-time employees of our Manager. These organizational changes provide our Manager with a dedicated investment team and support personnel. Our Manager has also entered into an administrative services agreement with American Capital, pursuant to which our Manager has access to American Capital s employees, infrastructure, business relationships, management expertise and capital raising capabilities, which allow it to fulfill all of its responsibilities under the management agreement. Certain of our Manager s officers are also members of American Capital s senior management. Effective October 19, 2009, Gary Kain was promoted to President and Malon Wilkus was promoted to Chief Executive Officer of our Manager.

Our Investment Strategy

Our investment strategy is to build an investment portfolio consisting exclusively of agency securities that seeks to generate attractive, risk-adjusted returns. Our Manager has established an investment committee comprised of its officers. The investment committee has established investment guidelines that have been approved by our Board of Directors. The investment committee can change our investment guidelines at any time with the approval of our Board of Directors. The following are our investment guidelines:

- no investment shall be made in any non-agency securities;

- our leverage may not exceed 10 times our stockholders equity (as computed in accordance with accounting principles generally accepted in the United States (GAAP)), which we refer to as our leverage threshold. In the event that our leverage inadvertently exceeds the leverage threshold, we may not utilize additional leverage without prior approval from our Board of Directors or until we are once again in compliance with the leverage threshold;

- no investment shall be made that would cause us to fail to qualify as a REIT for federal income tax purposes;

- no investment shall be made that would cause us to be regulated as an investment company under the Investment Company Act; and

- prior to entering into any proposed investment transaction with American Capital or any of its affiliates, a majority of our independent directors must approve the terms of the transaction.

Agency securities consist of single-family residential pass-through certificates and collateralized mortgage obligations for which the principal and interest are guaranteed by a U.S. Government agency or a U.S. Government sponsored entity.

Single-Family Residential Pass-Through Certificates. Single-family residential pass-through certificates are securities representing interests in pools of mortgage loans secured by residential real property where payments of both interest and principal, plus pre-paid principal, on the securities are made monthly to holders of the security, 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 and servicers of the securities.

Collateralized Mortgage Obligations (CMOs). CMOs are structured instruments comprised of agency securities. Interest and principal, if applicable, plus pre-paid principal, on a CMO are paid on a monthly basis. CMOs consist of multiple classes of securities, with each class bearing different stated maturity dates and other differences in characteristics such as coupons, weighted average lives and rules governing principal and interest distribution. Monthly payments of principal, including prepayments, are

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typically first returned to different classes based on rules described in the offering documents. The principal and interest payments are also often divided between holders of different securities and some securities may only pay interest while others only pay principal.

These securities are collateralized by either fixed-rate mortgage loans (FRMs), adjustable-rate mortgage loans (ARMs), or hybrid ARMs. Hybrid ARMs are mortgage loans that have interest rates that are fixed for an initial period (typically three, five, seven or 10 years) and thereafter reset at regular intervals subject to interest rate caps. Our allocation between securities collateralized by FRMs, ARMs or hybrid ARMs will depend on various factors including, but not limited to, relative value, expected future prepayment trends, supply and demand, costs of financing, costs of hedging, expected future interest rate volatility and the overall shape of the U.S. Treasury and interest rate swap yield curves. We take these factors into account when we make these types of investments.

As of September 30, 2009, our $3.4 billion investment portfolio was financed with $2.9 billion of repurchase agreements and $0.4 billion of equity capital, resulting in a leverage ratio of approximately 6.9 times our stockholders equity. When adjusted for the net payable for agency securities purchased but not yet settled, the leverage ratio was approximately 7.3 times our stockholders equity as of September 30, 2009. Financing spreads (the difference between yields on our investments and rates on related borrowings, including amortization expense related to terminated swaps) averaged 268 basis points during the three months September 30, 2009.

The size and composition of our investment portfolio depends on investment strategies being implemented by management, the availability of investment capital and overall market conditions, including the availability of attractively priced investments and suitable financing to appropriately leverage our investment portfolio. Market conditions are influenced by, among other things, current levels of, and expectations for future levels of, short-term interest rates, mortgage prepayments and market liquidity.

Our Financing Strategy

As part of our investment strategy, we borrow against our investment portfolio pursuant to master repurchase agreements with financial institutions. We expect that our borrowings pursuant to repurchase transactions under such master repurchase agreements generally will have maturities that range from 30 to 90 days, but may have maturities of less than 30 days or up to 364 days. Per our investment guidelines approved by our Board of Directors, we would need Board of Director approval for our leverage to exceed 10 times the amount of our stockholders equity.

Our Hedging Strategy

As part of our risk management strategy, we may hedge our exposure to interest rate and prepayment risk as our Manager determines is in our best interest given our investment strategy, the cost of the hedging transactions and our intention to qualify as a REIT. As a result, we may elect to bear a level of interest rate or prepayment risk that could otherwise be hedged when management believes, based on all relevant facts, that bearing the risk enhances our risk/return profile. We may enter into interest rate caps, collars, floors, forward contracts, put and call options on securities or securities underlying futures contracts, futures or swap agreements or purchase or sell to-be-announced (TBA) agency securities to attempt to manage the overall interest rate risk of the portfolio, reduce fluctuations in book value and generate additional income distributable to stockholders.