

Arlington Asset Investment Corp.
Form 10-Q
May 10, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2016

OR

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

For the transition period from _____ to _____

Commission File Number: 001-34374

ARLINGTON ASSET INVESTMENT CORP.

(Exact name of Registrant as specified in its charter)

Virginia 54-1873198
(State or Other Jurisdiction of (I.R.S. Employer

Incorporation or Organization) Identification No.)

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1001 Nineteenth Street North

Arlington, VA

22209

(Address of Principal Executive Offices) (Zip Code)

(703) 373-0200

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Sec. 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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐ 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 ☒

Number of shares outstanding of each of the registrant's classes of common stock, as of April 29, 2016:

Title	Outstanding
Class A Common Stock	22,879,431 shares
Class B Common Stock	97,604 shares

ARLINGTON ASSET INVESTMENT CORP.

FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 2016

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

ARLINGTON ASSET INVESTMENT CORP.

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

	March 31, 2016 (unaudited)	December 31, 2015 (audited)
ASSETS		
Cash and cash equivalents	\$43,184	\$ 36,987
Interest receivable	9,808	11,936
Mortgage-backed securities, at fair value		
Private-label	129,231	130,435
Agency	3,417,850	3,865,316
Derivative assets, at fair value	5,587	12,991
Deferred tax assets, net	101,480	97,530
Deposits	81,768	29,429
Other assets	2,381	18,315
Total assets	\$3,791,289	\$ 4,202,939
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Repurchase agreements	\$3,062,381	\$ 2,834,780
Federal Home Loan Bank advances	—	786,900
Interest payable	1,365	2,436
Accrued compensation and benefits	1,423	5,170
Dividend payable	14,476	14,504
Derivative liabilities, at fair value	44,719	553
Purchased securities payable	158,261	—
Other liabilities	1,502	1,132
Long-term debt	73,489	73,433
Total liabilities	3,357,616	3,718,908
Commitments and contingencies		
Stockholders' Equity:		
Preferred stock, \$0.01 par value, 25,000,000 shares authorized, none issued and		
outstanding	—	—
Class A common stock, \$0.01 par value, 450,000,000 shares authorized, 22,879,431		
and 22,874,819 shares issued and outstanding, respectively	229	229
Class B common stock, \$0.01 par value, 100,000,000 shares authorized, 97,604 and	1	1

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102,216 shares issued and outstanding, respectively		
Additional paid-in capital	1,898,670	1,898,085
Accumulated other comprehensive income, net of taxes of \$105 and \$3,230, respectively	7,461	12,371
Accumulated deficit	(1,472,688)	(1,426,655)
Total stockholders' equity	433,673	484,031
Total liabilities and stockholders' equity	\$3,791,289	\$ 4,202,939

See notes to consolidated financial statements.

ARLINGTON ASSET INVESTMENT CORP.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in thousands, except per share data)

(Unaudited)

	Three Months Ended March 31,	
	2016	2015
Interest income		
Agency mortgage-backed securities	\$25,655	\$25,460
Private-label mortgage-backed securities	2,971	5,043
Other	128	7
Total interest income	28,754	30,510
Interest expense		
Short-term debt	5,500	3,080
Long-term debt	1,193	648
Total interest expense	6,693	3,728
Net interest income	22,061	26,782
Investment loss, net		
Realized gain on sale of available-for-sale investments, net	—	3,348
Other-than-temporary impairment charges	(99)	—
Gain on trading investments, net	50,950	19,745
Loss from derivative instruments, net	(100,760)	(76,012)
Other, net	19	112
Total investment loss, net	(49,890)	(52,807)
Other expenses		
Compensation and benefits	2,564	2,412
Other expenses	1,771	1,006
Total other expenses	4,335	3,418
Loss before income taxes	(32,164)	(29,443)
Income tax (benefit) provision	(546)	12,742
Net loss	\$(31,618)	\$(42,185)
Basic loss per share	\$(1.38)	\$(1.84)
Diluted loss per share	\$(1.38)	\$(1.84)
Weighted-average shares outstanding (in thousands)		
Basic	22,994	22,973
Diluted	22,994	22,973
Other comprehensive loss, net of taxes		
Unrealized gains (losses) on available-for-sale securities (net of taxes of \$(3,164)		
and \$(2,663), respectively)	\$(4,970)	\$(4,493)
Reclassification		
Included in investment loss, net, related to sales of available-for-sale securities	—	(3,362)

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(net of taxes of \$-0- and \$(380), respectively)		
Included in investment loss, net, related to other-than-temporary impairment		
charges on available-for-sale securities (net of taxes of \$39 and \$-0-, respectively)	60	—
Comprehensive loss	\$(36,528)	\$(50,040)

See notes to consolidated financial statements.

ARLINGTON ASSET INVESTMENT CORP.

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

(Dollars in thousands)

(Unaudited)

	Class A		Class B			Accumulated		
	Common	Class A	Common	Class B	Additional	Other		
	Stock	Amount	Stock	Amount	Paid-In	Comprehensive	Accumulated	
	(#)	(\$)	(#)	(\$)	Capital	Income	Deficit	Total
Balances, December 31, 2014	22,860,922	\$ 229	105,869	\$ 1	\$ 1,897,027	\$ 35,872	\$ (1,287,855)	\$ 645,274
Net loss	—	—	—	—	—	—	(69,403)	(69,403)
Conversion of Class B common stock to								
Class A common stock	3,653	—	(3,653)	—	—	—	—	—
Issuance of Class A common stock								
under stock-based compensation plans	97,651	—	—	—	—	—	—	—
Repurchase of Class A common stock	(48,695)	—	—	—	(593)	—	—	(593)
Repurchase of Class A common stock								
under stock-based compensation plans	(38,712)	—	—	—	(572)	—	—	(572)
Stock-based compensation	—	—	—	—	1,145	—	—	1,145
Income tax benefit from stock-based								
compensation	—	—	—	—	1,078	—	—	1,078
Other comprehensive loss	—	—	—	—	—	(23,501)	—	(23,501)
Dividends declared	—	—	—	—	—	—	(69,397)	(69,397)
Balances, December 31, 2015	22,874,819	229	102,216	1	1,898,085	12,371	(1,426,655)	484,031
Net loss	—	—	—	—	—	—	(31,618)	(31,618)

Conversion of Class B common stock to								
Class A common stock	4,612	—	(4,612)	—	—	—	—	—
Stock-based compensation	—	—	—	—	517	—	—	517
Income tax benefit from stock-based compensation	—	—	—	—	68	—	—	68
Other comprehensive loss	—	—	—	—	—	(4,910)	—	(4,910)
Dividends declared	—	—	—	—	—	—	(14,415)	(14,415)
Balances, March 31, 2016	22,879,431	\$ 229	97,604	\$ 1	\$1,898,670	\$ 7,461	\$(1,472,688)	\$433,673

See notes to consolidated financial statements.

ARLINGTON ASSET INVESTMENT CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Three Months Ended March 31,	
	2016	2015
Cash flows from operating activities:		
Net loss	\$(31,618)	\$(42,185)
Adjustments to reconcile net loss to net cash provided by operating activities		
Net investment loss	49,890	52,807
Net premium amortization on mortgage-backed securities	5,328	3,758
Deferred tax provision	(824)	12,132
Other	517	111
Changes in operating assets		
Interest receivable	2,128	(568)
Other assets	2,051	823
Changes in operating liabilities		
Interest payable and other liabilities	(2,510)	(320)
Accrued compensation and benefits	(3,747)	(4,505)
Net cash provided by operating activities	21,215	22,053
Cash flows from investing activities:		
Purchases of private-label mortgage-backed securities	(5,357)	—
Purchases of agency mortgage-backed securities	(377,604)	(331,514)
Proceeds from sales of private-label mortgage-backed securities	—	20,859
Proceeds from sales of agency mortgage-backed securities	933,927	51,751
Receipt of principal payments on private-label mortgage-backed securities	—	785
Receipt of principal payments on agency mortgage-backed securities	93,459	88,980
Payments for derivatives and deposits, net	(101,528)	(77,378)
Other	15,764	39
Net cash provided by (used in) investing activities	558,661	(246,478)
Cash flows from financing activities:		
Proceeds from repurchase agreements, net	227,601	191,915
Repayments for Federal Home Loan Bank advances	(786,900)	—
Proceeds from long-term debt issuance, net	—	34,188
Excess tax benefits associated with stock-based awards	68	—
Dividends paid	(14,448)	(20,195)
Net cash (used in) provided by financing activities	(573,679)	205,908
Net increase (decrease) in cash and cash equivalents	6,197	(18,517)
Cash and cash equivalents, beginning of period	36,987	33,832
Cash and cash equivalents, end of period	\$43,184	\$15,315
Supplemental cash flow information		
Cash payments for interest	\$7,708	\$3,636

Cash payments for taxes	\$—	\$—
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See notes to consolidated financial statements.

ARLINGTON ASSET INVESTMENT CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

(Unaudited)

Note 1. Organization and Basis of Presentation

Arlington Asset Investment Corp. (“Arlington Asset”) and its consolidated subsidiaries (unless the context otherwise provides, collectively, the “Company”) is an investment firm that acquires and holds residential mortgage-related assets, primarily comprised of residential mortgage-backed securities (“MBS”). The Company’s investments in MBS include (i) residential mortgage pass-through certificates for which the principal and interest payments are guaranteed by a government-sponsored enterprise (“GSE”) such as the Federal National Mortgage Association (“Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“Freddie Mac”), which are collectively referred to as “agency MBS,” and (ii) residential MBS issued by private institutions for which the principal and interest payments are not guaranteed by a GSE, which are referred to as “private-label MBS” or “non-agency MBS.”

The unaudited interim consolidated financial statements 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 Company’s unaudited interim consolidated financial statements and notes thereto should be read in conjunction with the Company’s audited annual consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

The Company’s consolidated financial statements include the accounts of Arlington Asset and all other entities in which the Company has a controlling financial interest. All intercompany accounts and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires the Company to make estimates and assumptions that affect amounts reported in the consolidated financial statements. Although the Company bases these estimates and assumptions on historical experience and all other reasonably available information that the Company believes to be relevant under the circumstances, such estimates frequently require management to exercise significant subjective judgment about matters that are inherently uncertain. Actual results may differ from these estimates.

Certain amounts in the consolidated financial statements and notes for prior periods have been reclassified to conform to the current year’s presentation. These reclassifications had no impact on the previously reported net income, other comprehensive income, total assets or total liabilities.

Note 2. Summary of Significant Accounting Policies

Cash Equivalents

Cash equivalents include demand deposits with banks, money market accounts and highly liquid investments with original maturities of three months or less. As of March 31, 2016 and December 31, 2015, approximately 99% and 98%, respectively, of the Company's cash equivalents were invested in money market funds that invest primarily in U.S. Treasuries and other securities backed by the U.S. government.

Investment Security Purchases and Sales

Purchases and sales of investment securities are recorded on the settlement date of the transfer unless the trade qualifies as a "regular-way" trade and the associated commitment qualifies for an exemption from the accounting guidance applicable to derivative instruments. A regular-way trade is an investment security purchase or sale transaction that is expected to settle within the period of time following the trade date that is prevalent or traditional for that specific type of security. Any amounts payable or receivable for unsettled security trades are recorded as "sold securities receivable" or "purchased securities payable" in the consolidated balance sheets.

Interest Income Recognition for Investments in Agency MBS

Substantially all of the Company's investments in agency MBS are classified as trading securities. On January 1, 2016, the Company elected to change its accounting policy for recognizing interest income on its investments in agency MBS classified as trading securities by amortizing purchase premiums (or accreting purchase discounts) as an adjustment to interest income in accordance with the "interest method" permitted by GAAP. Prior to January 1, 2016, interest income from trading agency MBS was reported based upon each security's stated coupon rate (referred to by the Company as the "coupon rate method").

ARLINGTON ASSET INVESTMENT CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

(Unaudited)

The interest method is applied at the individual security level based upon each security's effective interest rate. The Company calculates each security's effective interest rate at the time of purchase by solving for the discount rate that equates the present value of that security's remaining contractual cash flows (assuming no principal prepayments) to its purchase price. Because each security's effective interest rate does not reflect an estimate of future prepayments, the Company refers to this manner of applying the interest method as the "contractual effective interest method." When applying the contractual effective interest method to its investments in agency MBS, as principal prepayments occur, a proportional amount of the unamortized premium or discount is recognized in interest income such that the effective interest rate on the remaining security balance is unaffected.

The Company believes that the application of the contractual effective interest method, relative to the coupon rate method, to its investments in trading agency MBS results in a reported interest income measure that better reflects the economic yield of its investments, including a better reflection of the economic effect of principal prepayments in the period in which those prepayments occur. In addition, the Company believes that this change in accounting policy enhances the comparability of its reported periodic financial results to those of its peers.

The Company retrospectively applied this change in accounting policy to all historical periods. Because the Company accounts for its investments in trading agency MBS on its consolidated balance sheets at fair value with all periodic changes in fair value reflected in the Company's net income, this change in accounting policy did not have an effect on the Company's historical consolidated balance sheets, net income, or comprehensive income. The change in accounting policy did, however, result in a reclassification between reported "gain (loss) on trading investments, net" and interest income on the Company's historical consolidated statements of comprehensive income. As the Company's agency MBS have generally been acquired at a premium to par value, historical reported interest income was reduced by periodic premium amortization, while periodic investment gains (losses) reported as a component of "gain (loss) on trading investments, net" were increased (decreased) by an equal and offsetting amount. The following table presents the effect of the Company's retrospective application of the change in accounting policy to the annual and quarterly periods of fiscal year 2015:

	Fiscal Year 2015				
	Total Year	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income: agency mortgage-backed securities:					
As previously reported	\$ 139,244	\$ 35,475	\$ 37,325	\$ 34,530	\$ 31,914
Retrospective adjustment	(33,330)	(7,136)	(9,336)	(10,404)	(6,454)
As revised	\$ 105,914	\$ 28,339	\$ 27,989	\$ 24,126	\$ 25,460
Gain (loss) on trading investments, net:					
As previously reported	\$(64,388)	\$(43,383)	\$ 27,553	\$(61,849)	\$ 13,291
Retrospective adjustment	33,330	7,136	9,336	10,404	6,454
As revised	\$(31,058)	\$(36,247)	\$ 36,889	\$(51,445)	\$ 19,745

Effect to previously reported net income (loss)	\$—	\$—	\$—	\$—	\$—
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Interest Income Recognition for Investments in Private-Label MBS

The Company's investments in private-label MBS were generally acquired at significant discounts to their par values due in large part to an expectation that the Company will be unable to collect all of the contractual cash flows of the securities. Investments in private-label MBS acquired prior to 2015 are classified as available-for-sale. The Company has elected to classify its investments in private-label MBS acquired in 2015 or later as trading securities. Interest income from investments in private-label MBS is recognized using a prospective level-yield methodology which is based upon each security's effective interest rate. The amount of periodic interest income recognized is determined by applying the security's effective interest rate to its amortized cost basis or reference amount. At the time of acquisition, the security's effective interest rate is calculated by solving for the single discount rate that equates the present value of the Company's best estimate of the amount and timing of the cash flows expected to be collected from the security to its purchase price. To prepare its best estimate of cash flows expected to be collected, the Company develops a number of assumptions about the future performance of the pool of mortgage loans that serve as collateral for its investment, including assumptions about the timing and amount of prepayments and credit losses.

ARLINGTON ASSET INVESTMENT CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

(Unaudited)

In each subsequent quarterly reporting period, the amount and timing of cash flows expected to be collected from the security are re-estimated based upon current information and events. The following table provides a description of how periodic changes in the estimate of cash flows expected to be collected affect interest income recognition prospectively for investments in private-label MBS that are classified as available-for-sale and trading securities, respectively:

Effect on Interest Income Recognition for Investments in Private-Label MBS

Classified as:		
Scenario:	Available-for-Sale	Trading
A positive change in cash flows occurs.	If the positive change in cash flows is deemed significant, a revised effective interest rate is calculated and applied prospectively such that the positive change is recognized as incremental interest income over the remaining life of the security. This revised effective interest rate is also used in	A revised effective interest rate is calculated and applied prospectively such that the positive change in cash flows is recognized as incremental interest income over the remaining life of the security.
Actual cash flows exceed prior estimates and/or a positive change occurs in the estimate of expected remaining cash flows.	subsequent periods to determine if any declines in the fair value of that security are other-than-temporary.	
An adverse change in cash flows occurs.	The security's effective interest rate is unaffected. If an adverse change in cash flows occurs for a security that is impaired (that is, its fair value is less than its amortized cost basis), the impairment is considered other-than-temporary due to the occurrence of a credit loss. If a credit loss occurs, the Company writes-down the amortized cost basis of the security to an amount equal to the present value of cash flows expected to be collected, discounted at the security's existing effective interest rate, and recognizes a corresponding	The amount of periodic interest income recognized over the remaining life of the security will be reduced accordingly. Specifically, if an adverse change in cash flows occurs for a security that is impaired (that is, its fair value is less than its reference amount), the reference amount to which the security's existing effective interest rate will be prospectively applied will be reduced to the present value of cash flows expected to be collected, discounted at the security's existing effective interest rate. If an adverse change in cash flows occurs for a security that is not
Actual cash flows fall short of prior estimates and/or an adverse change occurs in the estimate of	other-than-temporary impairment charge in earnings as a component of "investment gain (loss), net."	

expected
remaining cash
flows.

impaired, the security's effective interest rate
will be reduced accordingly and applied on a
prospective basis.

Other Comprehensive Income

Comprehensive income includes net income as currently reported by the Company on the consolidated statements of comprehensive income adjusted for other comprehensive income. Other comprehensive income for the Company represents periodic unrealized holding gains and losses related to the Company's investments in MBS classified as available-for-sale. Accumulated unrealized holding gains and losses for available-for-sale MBS are reclassified into net income as a component of "investment gain (loss), net" upon (i) sale or realization, or (ii) the occurrence of an other-than-temporary impairment.

Other Significant Accounting Policies

Certain of the Company's other significant accounting policies are summarized in the following notes:

Investments in agency MBS, subsequent measurement	Note 3
Investments in private-label MBS, subsequent measurement	Note 4
Borrowings	Note 5
To-be-announced agency MBS transactions, including "dollar rolls"	Note 6
Derivative instruments	Note 6
Balance sheet offsetting	Note 7
Fair value measurements	Note 8

ARLINGTON ASSET INVESTMENT CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

(Unaudited)

Refer to the Company's 2015 Annual Report on Form 10-K for a complete inventory and summary of the Company's significant accounting policies.

Recent Accounting Pronouncements

The following table provides a brief description of recently issued accounting pronouncements and their actual or expected effect on the Company's consolidated financial statements:

Standard	Description	Date of Adoption	Effect on the Consolidated Financial Statements
Recently Adopted Accounting Guidance			
ASU No. 2015-02, Amendments to the Consolidation Analysis (Topic 810)	This amendment makes targeted changes to the current consolidation guidance and ends the deferral granted to investment companies from applying variable interest entity guidance.	January 1, 2016	This amendment did not have an impact on the Company's consolidated financial statements.
ASU No. 2015-03, Simplifying the Presentation of Debt Issuance Costs (Subtopic 835-30)	This amendment requires debt issuance costs to be presented in the balance sheet as a direct reduction from the associated debt liability rather than as a separate asset.	January 1, 2016	The adoption of this amendment resulted in an immaterial reclassification of unamortized debt issuance costs from the line item "other assets" to the line item "long-term debt" on the Company's consolidated balance sheets.

Recently Issued Accounting Guidance Not Yet Adopted

ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606)	This amendment defers the effective date of ASU No. 2014-09 for all entities by one year.	January 1, 2018	The Company does not expect that the adoption of ASU No. 2015-14 will have a material impact on its consolidated financial statements.
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ASU No. 2014-09 requires entities to recognize revenue to depict the transfer of promised goods or services to customers in amounts that reflect the consideration

to which the entity expects to be entitled in exchange for those goods or services. Revenue recognition with respect to financial instruments is not within the scope of ASU No. 2014-09.

ASU No. 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities (Subtopic 825-10)	This amendment makes targeted changes to certain aspects of guidance applicable to financial assets and financial liabilities. The amendment primarily affects accounting for certain equity investments, financial liabilities measured under the fair value option, and certain financial instrument presentation and disclosure requirements. Accounting for investments in debt securities and financial liabilities not measured under the fair value option is largely unaffected by this amendment.	January 1, 2018The Company is currently evaluating the impact of this amendment on its consolidated financial statements.
ASU No. 2016-02, Leases (Topic 842)	This amendment replaces the existing lease accounting model with a revised model. The primary change effectuated by the revised lease accounting model is the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases.	January 1, 2018The Company is currently evaluating the impact of this amendment on its consolidated financial statements.

ARLINGTON ASSET INVESTMENT CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

(Unaudited)

		Date of	Effect on the Consolidated
Standard	Description	Adoption	Financial Statements
ASU No. 2016-07, Simplifying the Transition to the Equity Method of Accounting (Topic 323)	This amendment eliminates the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held.	January 1, 2017	The Company does not expect that the adoption of ASU No. 2016-07 will have a material impact on its consolidated financial statements.
ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting (Topic 718)	This amendment was issued with the objective of simplifying several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Some of the areas for simplification apply only to nonpublic entities.	January 1, 2017	The Company is currently evaluating the impact of this amendment on its consolidated financial statements.

Note 3. Investments in Agency MBS

The Company's investments in agency MBS are reported in the accompanying consolidated balance sheets at fair value. Substantially all of the Company's investments in agency MBS are classified as trading securities. The following table provides the fair value of the Company's available-for-sale and trading investments in agency MBS as of the dates indicated:

	Fair Value as of	
	March 31, 2016	December 31, 2015
Agency MBS classified as:		
Available-for-sale	\$25	\$ 26

Trading	3,417,825	3,865,290
Total	\$3,417,850	\$ 3,865,316

All periodic changes in the fair value of trading agency MBS that are not attributed to interest income are recognized as a component of “investment loss, net” in the accompanying consolidated statements of comprehensive income. The following table provides additional information about the gains and losses recognized as a component of “investment loss, net” in the Company’s consolidated statements of comprehensive income for the periods indicated with respect to investments in agency MBS classified as trading securities:

	Three Months Ended March 31,	
	2016	2015
Net gains recognized in earnings for:		
Agency MBS still held at period end	\$43,818	\$19,181
Agency MBS sold during the period	7,001	564
Total	\$50,819	\$19,745

The Company also invests in and finances fixed-rate agency MBS on a generic pool basis through sequential series of to-be-announced security transactions commonly referred to as “dollar rolls.” Dollar rolls are accounted for as a sequential series of derivative instruments. Refer to “Note 6. Derivative Instruments” for further information about dollar rolls.

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(Dollars in thousands, except per share data)

(Unaudited)

Note 4. Investments in Private-Label MBS

The Company's investments in private-label MBS are reported in the accompanying consolidated balance sheets at fair value. Investments in private-label MBS acquired prior to 2015 are classified as available-for-sale. The Company has elected to classify its investments in private-label MBS acquired in 2015 or later as trading securities. The following table provides the fair value of the Company's available-for-sale and trading investments in private-label MBS as of the dates indicated:

	Fair Value as of	
	March 31, 2016	December 31, 2015
Private-label MBS classified as:		
Available-for-sale	\$ 116,026	\$ 127,536
Trading	13,205	2,899
Total	\$ 129,231	\$ 130,435

As of March 31, 2016, the private-label MBS portfolio consists primarily of "re-REMIC" securities. The Company's investments in re-REMIC securities represent "mezzanine" interests in underlying, re-securitized senior class MBS issued by private-label Real Estate Mortgage Investment Conduit ("REMIC") securitization trusts. The senior class REMIC securities that serve as collateral to the Company's investments in re-REMIC securities represent beneficial interests in pools of prime or Alt-A residential mortgage loan collateral that hold the first right to cash flows and absorb credit losses only after their respective subordinate REMIC classes have been fully extinguished. The majority of the trusts that issued the Company's investments in re-REMIC securities employ a "sequential" principal repayment structure, while a minority of the issuing trusts employ a "pro-rata" principal repayment structure. Accordingly, the majority of the Company's mezzanine class re-REMIC securities are not entitled to receive principal repayments until the principal balance of the senior interest in the respective collateral group has been reduced to zero. Principal shortfalls are allocated on a "reverse sequential" basis. Accordingly, any principal shortfalls on the underlying senior class REMIC securities are first absorbed by the Company's mezzanine class re-REMIC securities, to the extent of their respective principal balance, prior to being allocated to the senior interest in the respective collateral pool. Periodic interest accrues on each re-REMIC security's outstanding principal balance at its contractual coupon rate.

The prime and Alt-A residential mortgage loans that serve as collateral to the underlying REMIC securitization trusts of the Company's private-label MBS had the following weighted average characteristics, based on face value, as of the dates indicated:

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	March 31, 2016		December 31, 2015	
Original loan-to-value	66	%	66	%
Original FICO score	723		723	
Three-month voluntary prepayment rate (annualized)	6.9	%	6.1	%
Three-month default rate (annualized)	4.1	%	4.7	%
Three-month loss severity rate ⁽¹⁾	46.3	%	36.9	%
Three-month credit loss rate (annualized) ⁽²⁾	1.9	%	1.7	%

⁽¹⁾Represents a “loss-given-default” rate. Private-label MBS collateral pools which experienced no defaults within the three-month historical period are excluded from the loss severity rate calculation.

⁽²⁾ Calculated as the three-month default rate multiplied by the three-month loss severity rate.

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Available-for-Sale Private-Label MBS

Periodic changes in the fair value of the Company's available-for-sale private-label MBS that are not attributed to interest income or other-than-temporary impairments represent unrealized holding gains and losses. Unrealized holding gains and losses are accumulated in other comprehensive income until the securities are sold. Gross unrealized gains and losses accumulated in other comprehensive income for the Company's investments in available-for-sale private-label MBS were the following as of the dates indicated:

March 31, 2016					
Unpaid		Amortized Cost			
Principal	Net				Fair
Balance	Discounts	Basis	Unrealized	Losses	Value
			Gains		
\$156,093	\$ (47,631)	\$ 108,462	\$7,564	\$ —	\$116,026

December 31, 2015					
Unpaid		Amortized Cost			
Principal	Net				Fair
Balance	Discounts	Basis	Unrealized	Losses	Value
			Gains		
\$164,555	\$ (52,620)	\$ 111,935	\$15,601	\$ —	\$127,536

Upon the sale of available-for-sale private-label MBS, any gains or losses accumulated in other comprehensive income are recognized in earnings as a component of "investment gain (loss), net." The Company uses the specific identification method to determine the realized gain or loss that is recognized in earnings upon the sale of an available-for-sale private-label MBS.

The following table presents the results of sales of available-for-sale private-label MBS for the periods indicated:

	Three Months Ended March 31, 201 6 015
Proceeds from sales	\$—\$20,859

Gross realized gains	— 3,348
Gross realized losses	— —

Accretable Yield

The excess of the Company's estimate of undiscounted future cash flows expected to be collected over the security's amortized cost basis represents that security's accretable yield. The accretable yield is expected to be recognized as interest income over the remaining life of the security on a level-yield basis. The difference between undiscounted future contractual cash flows and undiscounted future expected cash flows represents the non-accretable difference. Based on actual payments received and/or changes in the estimate of future cash flows expected to be collected, the accretable yield and the non-accretable difference can change over time. Actual cash collections that exceed prior estimates and/or positive changes in the Company's periodic estimate of expected future cash flows result in a reclassification of non-accretable difference to accretable yield. Conversely, actual cash collections that fall short of prior estimates and/or adverse changes in the Company's periodic estimate of expected future cash flows result in a reclassification of accretable yield to non-accretable difference.

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The following table presents the changes in the accretable yield solely for available-for-sale private-label MBS for the three months ended March 31, 2016 and 2015:

	Three Months Ended March 31,	
	2016	2015
Beginning balance	\$85,052	\$202,108
Accretion	(2,573)	(5,043)
Reclassifications, net	(11,966)	(9,182)
Eliminations in consolidation	(3,515)	—
Sales	—	(12,585)
Ending balance	\$66,998	\$175,298

Other-than-Temporary Impairments

The Company evaluates available-for-sale MBS for other-than-temporary impairment on a quarterly basis. When the fair value of an available-for-sale security is less than its amortized cost at the quarterly reporting date, the security is considered impaired. Impairments determined to be other-than-temporary are recognized as a direct write-down to the security's amortized cost basis with a corresponding charge recognized in earnings as a component of "investment gain (loss), net." An impairment is considered other-than-temporary when (i) the Company intends to sell the impaired security, (ii) the Company more-likely-than not will be required to sell the impaired security prior to the recovery of its amortized cost basis, or (iii) a credit loss exists. A credit loss exists when the present value of the Company's estimate of the cash flows expected to be collected from the security, discounted at the security's existing effective interest rate, is less than the security's amortized cost basis.

If the Company intends to sell an impaired security or it more-likely-than-not will be required to sell an impaired security before recovery of its amortized cost basis, the Company writes-down the amortized cost basis of the security to an amount equal to the security's fair value and recognizes a corresponding other-than-temporary impairment charge in earnings as a component of "investment gain (loss), net." If a credit loss exists for an impaired security that the Company does not intend to sell nor will it likely be required to sell prior to recovery, the Company writes-down the amortized cost basis of the security to an amount equal to the present value of cash flows expected to be collected, discounted at the security's existing effective interest rate, and recognizes a corresponding other-than-temporary impairment charge in earnings as a component of "investment gain (loss), net."

For the three months ended March 31, 2016, the Company recorded credit related other-than-temporary impairment charges of \$99 as a component of "investment loss, net" on the consolidated statements of comprehensive income on certain available-for-sale private-label MBS. The Company recorded no other-than-temporary impairment charges on available-for-sale private-label MBS during the three months ended March 31, 2015. The following table presents a

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summary of cumulative credit related other-than-temporary impairment charges recognized on the available-for-sale private-label MBS held as of the dates indicated:

	Three Months Ended March 31,	
	2016	2015
Cumulative credit related other-than-temporary impairments,		
beginning balance	\$14,017	\$18,903
Additions for:		
Securities for which other-than-temporary impairments		
have not previously occurred	99	—
Securities with previously recognized other-than-		
temporary impairments	—	—
Reductions for sold or matured securities	—	—
Cumulative credit related other-than-temporary impairments,		
ending balance	\$14,116	\$18,903

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Trading Private-Label MBS

Periodic changes in the fair value of investments in trading private-label MBS that are not attributable to interest income are recognized as a component of “investment gain (loss), net” in the Company’s consolidated statements of comprehensive income. The following table provides additional information about the gains and losses recognized as a component of “investment gain (loss), net” for the periods indicated with respect to investments in private-label MBS classified as trading securities:

	Three Months Ended March 31, 2016 2015	
Net gains recognized in earnings for:		
Private-label MBS still held at period end	\$ 137	\$ —
Private-label MBS sold during the period	—	—
Total	\$ 137	\$ —

Note 5. Borrowings

Repurchase Agreements

The Company finances the purchase of MBS through repurchase agreements, which are accounted for as collateralized borrowing arrangements. In a repurchase transaction, the Company sells MBS to a counterparty under a master repurchase agreement in exchange for cash and concurrently agrees to repurchase the same security at a future date in an amount equal to the cash initially exchanged plus an agreed-upon amount of interest. MBS sold under agreements to repurchase remain on the Company’s consolidated balance sheets because the Company maintains effective control over such securities throughout the duration of the arrangement. Throughout the contractual term of a repurchase agreement, the Company recognizes a “repurchase agreement” liability on its consolidated balance sheets to reflect the obligation to repay to the counterparty the proceeds received upon the initial transfer of the MBS. The difference between the proceeds received by the Company upon the initial transfer of the MBS and the contractually agreed-upon repurchase price is recognized as interest expense over the term of the repurchase arrangement on a level-yield basis.

Amounts borrowed pursuant to repurchase agreements are equal in value to a specified percentage of the fair value of the pledged collateral. The Company retains beneficial ownership of the pledged collateral throughout the term of the

repurchase agreement. The counterparty to the repurchase agreements may require that the Company pledge additional securities or cash as additional collateral to secure borrowings when the value of the collateral declines.

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As of March 31, 2016 and December 31, 2015, the Company had no amount at risk with a single repurchase agreement counterparty or lender greater than 10% of equity. The following table provides information regarding the Company's outstanding repurchase agreement borrowings as of March 31, 2016 and December 31, 2015:

	March 31, 2016	December 31, 2015
Pledged with agency MBS:		
Repurchase agreements outstanding	\$3,029,877	\$ 2,797,561
Agency MBS collateral, at fair value	3,200,829	2,946,684
Net amount ⁽¹⁾	170,952	149,123
Weighted-average rate	0.66 %	0.61 %
Weighted-average term to maturity	16.0 days	12.8 days
Pledged with private-label MBS:		
Repurchase agreements outstanding	\$32,504	\$ 37,219
Private-label MBS collateral, at fair value	57,463	70,511
Net amount ⁽¹⁾	24,959	33,292
Weighted-average rate	2.45 %	2.42 %
Weighted-average term to maturity	2.9 days	16.9 days
Total MBS:		
Repurchase agreements outstanding	\$3,062,381	\$ 2,834,780
MBS collateral, at fair value	3,258,292	3,017,195
Net amount ⁽¹⁾	195,911	182,415
Weighted-average rate	0.68 %	0.64 %
Weighted-average term to maturity	15.9 days	12.8 days

⁽¹⁾Net amount represents the value of collateral in excess of corresponding repurchase obligation. The amount of collateral at-risk is limited to the outstanding repurchase obligation and not the entire collateral balance. The following table provides information regarding the Company's outstanding repurchase agreement borrowings during the three months ended March 31, 2016 and 2015:

	March 31, 2016	March 31, 2015
Weighted-average outstanding balance during the three months ended	\$3,222,396	\$3,219,172
Weighted-average rate during the three months ended	0.66 %	0.38 %

Federal Home Loan Bank Advances

In September 2015, the Company's wholly-owned captive insurance subsidiary, Key Bridge Insurance, LLC ("Key Bridge"), was granted membership to the Federal Home Loan Bank of Cincinnati ("FHLBC"). The FHLBC, like each of the 11 regional Federal Home Loan Banks (collectively, the "FHLB"), is a cooperative that provides its member financial institutions with a number of financial products and services, including short and long-term secured borrowings that are known as "advances." FHLBC advances may be collateralized by a number of real estate related assets, including agency MBS. As a member of the FHLBC, Key Bridge is required to acquire membership stock as well as activity-based stock (the amount of which is based upon a percentage of the dollar amount of its outstanding advances) in the FHLBC. As of March 31, 2016 and December 31, 2015, Key Bridge had \$2 and \$15,740 of capital stock in the FHLBC, which is included in "other assets" in the accompanying consolidated balance sheets. Similar to a repurchase agreement borrowing, the Company pledges agency MBS as collateral to secure the advance to Key Bridge, the amount of which is equal to a specified percentage of the fair value of the pledged collateral. The Company retains beneficial ownership of the pledged collateral throughout the term of the advance arrangement. The FHLBC may require that the Company pledge additional collateral to secure borrowings when the value of the collateral declines.

On January 12, 2016, the regulator of the FHLB system, the Federal Housing Finance Agency ("FHFA"), released a final rule that amends regulations governing FHLB membership, including an amendment which prevents captive insurance companies from being eligible for FHLB membership. Under the terms of the final rule, Key Bridge is required to terminate its membership and repay

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its existing advances within one year following the final rule's effective date of February 19, 2016. In addition, Key Bridge is prohibited from obtaining new advances during the one year transition period. As of March 31, 2016, the Company repaid all of its outstanding FHLBC advances, funded primarily through proceeds obtained from traditional repurchase agreement financing arrangements.

The following table provides information regarding the Company's outstanding FHLB advances as of December 31, 2015:

	December 31, 2015
Pledged with agency MBS:	
FHLB advances outstanding	\$ 786,900
Agency MBS collateral, at fair value	805,163
Net amount ⁽¹⁾	18,263
Weighted-average rate	0.36 %
Weighted-average term to maturity	11.6 days

⁽¹⁾Net amount represents the value of collateral in excess of corresponding FHLB advance. The amount of collateral at-risk is limited to the outstanding FHLB advance and not the entire collateral balance.

Long-Term Debt

As of March 31, 2016 and December 31, 2015, the Company had \$73,489 and \$73,433, respectively, of outstanding long-term debentures, net of unamortized debt issuance costs of \$1,811 and \$1,867, respectively. The Company's long-term debentures consisted of the following as of the dates indicated:

	March 31, 2016				December 31, 2015		
	Senior	Senior	Trust		Senior	Senior	Trust
	Notes Due 2025	Notes Due 2023	Preferred Debt		Notes Due 2025	Notes Due 2023	Preferred Debt
Outstanding Principal	\$35,300	\$ 25,000	\$ 15,000		\$35,300	\$ 25,000	\$ 15,000
Annual Interest Rate			LIBOR+				LIBOR+
	6.75 %	6.625 %	2.25 - 3.00 %		6.75 %	6.625 %	2.25 - 3.00 %
Interest Payment Frequency	Quarterly	Quarterly	Quarterly		Quarterly	Quarterly	Quarterly
Weighted-Average Interest Rate	6.75 %	6.625 %	3.37 %		6.75 %	6.625 %	3.07 %

Maturity	March 15, 2025	March 1, 2023	2033 - 2035	March 15, 2025	March 1, 2023	2033 - 2035
Early Redemption Date	March 15, 2018	May 1, 2016	2008 - 2010	March 15, 2018	May 1, 2016	2008 - 2010

On March 18, 2015, the Company completed a public offering of \$35,300 of 6.75% Senior Notes due in 2025 and received net proceeds of \$34,063 after payment of underwriting discounts, commissions, and expenses.

The Senior Notes due 2023 and the Senior Notes due 2025 are publicly traded on the New York Stock Exchange under the ticker symbols “AIW” and “AIC,” respectively. The Senior Notes due 2023 and Senior Notes due 2025 may be redeemed in whole or in part at any time and from time to time at the Company’s option on or after May 1, 2016 and March 15, 2018, respectively, at a redemption price equal to the principal amount plus accrued and unpaid interest. The indenture governing these Senior Notes contains certain covenants, including limitations on the Company’s ability to merge or consolidate with other entities or sell or otherwise dispose of all or substantially all of the Company’s assets.

Note 6. Derivative Instruments

In the normal course of its operations, the Company is a party to financial instruments that are accounted for as derivative instruments. Derivative instruments are recorded at fair value as either “derivative assets” or “derivative liabilities” in the consolidated balance sheets, with all periodic changes in fair value reflected as a component of “investment gain (loss), net” in the consolidated statements of comprehensive income. Cash receipts or payments related to derivative instruments are classified in the investing section of the consolidated statements of cash flows.

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Types and Uses of Derivative Instruments

Interest Rate Derivatives

Most of the Company's derivative instruments are interest rate derivatives that are intended to economically hedge changes, attributable to changes in benchmark interest rates, in certain MBS fair values and future interest cash flows on the Company's short-term financing arrangements. Interest rate derivatives include centrally cleared interest rate swaps as well as exchange-traded instruments, such as Eurodollar futures, interest rate swap futures, U.S. Treasury note futures, and options on futures. While the Company uses its interest rate derivatives to economically hedge a portion of its interest rate risk, it has not designated such contracts as hedging instruments for financial reporting purposes.

The Company exchanges collateral with the counterparties to its interest rate derivative instruments at least on a daily basis based upon daily changes in fair value (also known as "variation margin") as measured by the central clearinghouse through which those derivatives are cleared. In addition, the central clearinghouse requires market participants to deposit and maintain an "initial margin" amount which is determined by the clearinghouse and is generally intended to be set at a level sufficient to protect the clearinghouse from the maximum estimated single-day price movement in that market participant's contracts. Cash initial and variation margin posted by the Company in respect of interest rate derivatives is included in the line item "deposits" in the accompanying consolidated balance sheets.

To-Be-Announced Agency MBS Transactions, Including "Dollar Rolls"

In addition to interest rate derivatives that are used for interest rate risk management, the Company is a party to derivative instruments that economically serve as investments, such as forward contracts to purchase or sell fixed-rate "pass-through" agency MBS on a non-specified pool basis, which are known as to-be-announced ("TBA") contracts. A TBA contract is a forward contract for the purchase or sale of a fixed-rate agency MBS at a predetermined price, face amount, issuer, coupon, and stated maturity on an agreed upon future date. The specific agency MBS that will be delivered to satisfy the TBA trade is not known at the inception of the trade. The Company accounts for TBA contracts as derivative instruments because the Company cannot assert that it is probable at inception and throughout the term of an individual TBA contract that its settlement will result in physical delivery of the agency MBS, or the individual TBA contract will not settle in the shortest time period possible.

The Company's agency MBS investment portfolio includes net purchase (or "net long") positions in TBA securities, which are primarily the result of executing sequential series of "dollar roll" transactions. The Company executes dollar roll transactions as a means of investing in and financing non-specified fixed-rate agency MBS. Such transactions involve effectively delaying (or "rolling") the settlement of a forward purchase of a TBA agency MBS by entering into an offsetting sale prior to the settlement date, net settling the "paired-off" positions in cash, and contemporaneously entering another forward purchase of a TBA agency MBS of the same characteristics for a later settlement date. TBA securities purchased or sold for a forward settlement month are generally priced at a discount relative to TBA securities purchased for settlement in the current month. This discount, often referred to as the dollar roll "price drop,"

reflects compensation for the net interest income (interest income less financing costs) that is foregone as a result of relinquishing beneficial ownership of the MBS for the duration of the dollar roll (also known as “dollar roll income”). By executing a sequential series of dollar roll transactions, the Company is able to create the economic experience of investing in an agency MBS, financed with a repurchase agreement, over a period of time. Forward purchases and sales of TBA securities are accounted for as derivative instruments in the Company’s financial statements. Accordingly, dollar roll income is recognized as a component of “investment gains (losses), net” along with all other periodic changes in the fair value of TBA commitments.

Cash collateral posted by the Company with respect to TBA transactions is included in the line item “deposits” in the accompanying consolidated balance sheets.

In addition to TBA transactions, the Company may, from time to time, enter into commitments to purchase or sell other types of investment securities that do not qualify as regular-way security trades. Such commitments are also accounted for as derivative instruments.

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Derivative Instrument Population and Fair Value

The following table presents the fair value of the Company's derivative instruments as of the dates indicated:

	March 31, 2016		December 31, 2015	
	Assets	Liabilities	Assets	Liabilities
Interest rate swaps	\$—	\$(44,700)	\$6,153	\$ —
10-year U.S. Treasury note futures	752	(19)	6,813	—
Put options on 10-year U.S. Treasury note futures	781	—	—	—
Put options on Eurodollar futures	—	—	25	—
TBA commitments	4,054	—	—	(553)
Total	\$5,587	\$(44,719)	\$12,991	\$ (553)

Interest Rate Swaps

The following table presents information as of the date indicated about the Company's interest rate swap agreements, all of which represent agreements to make semiannual interest payments based upon a fixed interest rate and receive quarterly variable interest payments based upon the prevailing three-month LIBOR rate on the date of reset:

March 31, 2016					
	Average Fixed		Average Remaining		
	Notional Amount	Pay Rate	Maturity (Years)		Fair Value
Years to maturity:					
Less than 2 years	\$750,000	1.04	%	1.7	\$ (4,983)
2 to 10 years	1,000,000	2.03	%	9.8	(39,717)
Total / weighted-average	\$1,750,000	1.61	%	6.3	\$ (44,700)

December 31, 2015					
	Average Fixed		Average Remaining		
	Notional Amount	Pay Rate	Maturity (Years)		Fair Value
Years to maturity:					

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Less than 2 years	\$750,000	1.04	%	1.9	\$ 1,166
2 to 10 years	750,000	2.12	%	9.9	4,987
Total / weighted-average	\$ 1,500,000	1.58	%	5.9	\$ 6,153

10-year U.S. Treasury Note Futures

The Company's 10-year U.S. Treasury note futures held as of March 31, 2016 are short positions with an aggregate notional amount of \$375,000 that mature in June 2016. Upon the maturity date of these futures contracts, the Company has the option to either net settle each contract in cash in an amount equal to the difference between the then-current fair value of the underlying 10-year U.S. Treasury note and the contractual sale price inherent to the futures contract, or to physically settle the contract by delivering the underlying 10-year U.S. Treasury note.

Put Options on 10-year U.S. Treasury Note Futures

The Company's put options on 10-year U.S. Treasury note futures held as of March 31, 2016 provide the Company with the right, but not the obligation, to sell underlying 10-year U.S. Treasury note futures contracts which have an aggregate notional amount of \$2,000,000. These put options were acquired in exchange for aggregate option premiums of \$2,656 and have a weighted-average strike price that equates to a 10-year U.S. Treasury note rate of approximately 2.45%. These options may be exercised at any time prior to their expiry, which occurs in May 2016, and, if exercised, will be settled in cash.

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TBA Transactions

The following tables present information about the Company's TBA purchase and sale commitments as of the dates indicated:

March 31, 2016				
Notional Amount				
	Net Purchase	Net Sale	Average	
	Commitment	Forward Price	Market Price	Fair Value
30-year 3.5% coupon	\$350,000	\$ 364,073	\$ 366,734	\$ 2,661
30-year 4.0% coupon	340,000	361,717	363,110	1,393
Total	\$690,000	\$ 725,790	\$ 729,844	\$ 4,054

December 31, 2015				
Notional Amount				
	Net Purchase	Net Sale	Average	
	Commitment	Forward Price	Market Price	Fair Value
30-year 3.5% coupon	\$275,000	\$ 283,928	\$ 283,469	\$ (459)
30-year 4.0% coupon	100,000	105,883	105,789	(94)
Total	\$375,000	\$ 389,811	\$ 389,258	\$ (553)

Derivative Instrument Gains and Losses

For the three months ended March 31, 2016 and 2015, the Company recorded net losses of \$(100,760) and \$(76,012), respectively, on its derivative instruments as a component of "investment gain (loss), net." The following tables provide further information about the derivative gains and losses recognized within the periods indicated:

	Three Months Ended	
	March 31,	
	2016	2015
Interest rate derivatives:		

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Interest rate swaps - net interest expense ⁽¹⁾	\$(3,997)	\$—
Interest rate swaps - unrealized losses, net	(45,105)	—
Eurodollar futures, net	—	(39,794)
U.S. Treasury note futures, net	(61,077)	(211)
Put options on U.S. Treasury note futures, net	(1,875)	—
10-year interest rate swap futures and other, net	(25)	(37,154)
Total interest rate derivative losses, net	(112,079)	(77,159)
TBA commitments, net	11,319	1,147
Total derivative losses, net	\$(100,760)	\$(76,012)

⁽¹⁾Represents the periodic net interest settlement incurred during the period (often referred to as "net interest carry").

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Derivative Instrument Activity

The following tables summarize the volume of activity, in terms of notional amount, related to derivative instruments for the periods indicated:

	For the Three Months Ended March 31, 2016				
	Beginning of Period	Additions	Scheduled Settlements	Early Terminations	End of Period
Interest rate swaps	\$1,500,000	\$250,000	\$—	\$—	\$1,750,000
10-year U.S. Treasury note futures	1,335,000	868,500	(1,703,500)	(125,000)	375,000
Put options on 10-year U.S. Treasury note futures	—	2,000,000	—	—	2,000,000
Put options on Eurodollar futures	4,000,000	—	(4,000,000)	—	—
Commitments to purchase (sell) MBS, net	375,000	1,500,000	(1,185,000)	—	690,000

	For the Three Months Ended March 31, 2015				
	Beginning of Period	Additions	Scheduled Settlements	Early Terminations	End of Period
Eurodollar futures	\$41,090,000	\$4,000,000	\$(2,365,000)	\$—	\$42,725,000
10-year interest rate swap futures	1,145,000	480,000	(780,000)	—	845,000
10-year U.S. Treasury note futures	—	50,000	—	—	50,000
Commitments to purchase (sell) MBS, net	200,000	317,544	(200,000)	—	317,544

Cash Collateral Posted for Derivative Instruments

The following table presents information about the cash collateral posted by the Company in respect to its derivative instruments, which is included in the line item “deposits” in the accompanying consolidated balance sheets, for the periods indicated:

	March 31, 2016	December 31, 2015
Interest rate swaps	\$ 77,088	\$ 17,434
U.S. Treasury note futures	4,280	11,197
TBA commitments	400	798
Total cash collateral posted	\$ 81,768	\$ 29,429

Note 7. Offsetting of Financial Assets and Liabilities

The agreements that govern certain of the Company's derivative instruments and short-term financing arrangements provide for a right of setoff in the event of default or bankruptcy with respect to either party to such transactions. The Company presents derivative instruments and short-term financing arrangements, including any associated recognized collateral, in its consolidated balance sheets on a gross basis.

ARLINGTON ASSET INVESTMENT CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

(Unaudited)

The following tables present information, as of the dates indicated, about the Company's derivative instruments and short-term borrowing arrangements, including those subject to master netting (or similar) arrangements:

As of March 31, 2016							
Amount Offset in the				Net Amount Presented in the			
Gross Amount Recognized				Gross Amount Not Offset in the Net			
Consolidated Balance Sheets		Consolidated Balance Sheets		Consolidated Balance Sheets		Consolidated Balance Sheets	
Financial Instruments ⁽¹⁾		Financial Instruments ⁽¹⁾		Collateral ⁽²⁾		Collateral ⁽²⁾	
Assets:							
Derivative instruments:							
10-year U.S. Treasury note futures	\$752	\$	—	\$ 752	\$ (19)	\$ —
Put options on U.S. Treasury note futures	781		—	781	—		—
TBA commitments	4,054		—	4,054	—		—
Total derivative instruments	5,587		—	5,587	(19)	—
Total assets	\$5,587	\$	—	\$ 5,587	\$ (19)	\$ —
Liabilities:							
Derivative instruments:							
Interest rate swaps	\$44,700	\$	—	\$ 44,700	\$ —		\$ (44,700
10-year U.S. Treasury note futures	19		—	19	(19)	—
Total derivative instruments	44,719		—	44,719	(19)	(44,700
Repurchase agreements	3,062,381		—	3,062,381	(3,062,381)	—
Total liabilities	\$3,107,100	\$	—	\$ 3,107,100	\$ (3,062,400)	\$ (44,700

As of December 31, 2015

Gross Amount Offset in the Consolidated Balance Sheets				Net Amount Presented in the Consolidated Balance Sheets			
Recognized		Recognized		Consolidated Balance Sheets		Amount	
in the		in the		Consolidated Balance Sheets		Amount	
Consolidated		Consolidated		Consolidated		Consolidated	

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		Balance Sheet		Balance Sheets			
				Financial		Cash	
				Instruments ⁽¹⁾		Collateral ⁽²⁾	
Assets:							
Derivative instruments:							
Interest rate swaps	\$6,153	\$	—	\$ 6,153	\$ —	\$ —	\$6,153
10-year U.S. Treasury note futures	6,813		—	6,813	—	—	6,813
Put options on Eurodollar futures	25		—	25	—	—	25
Total derivative instruments	12,991		—	12,991	—	—	12,991
Total assets	\$12,991	\$	—	\$ 12,991	\$ —	\$ —	\$12,991
Liabilities:							
Derivative instruments:							
TBA commitments	\$553	\$	—	\$ 553	\$ —	\$ (387)	\$166
Total derivative instruments	553		—	553	—	(387)	166
Repurchase agreements	2,834,780		—	2,834,780	(2,834,780)	—	—
Federal Home Loan Bank advances	786,900		—	786,900	(786,900)	—	—
Total liabilities	\$3,622,233	\$	—	\$ 3,622,233	\$ (3,621,680)	\$ (387)	\$166

⁽¹⁾ Does not include the fair value amount of financial instrument collateral pledged in respect of repurchase agreements or Federal Home Loan Bank advances that exceeds the associated liability presented in the consolidated balance sheets.

⁽²⁾ Does not include the amount of cash collateral pledged in respect of derivative instruments that exceeds the associated derivative liability presented in the consolidated balance sheets.

ARLINGTON ASSET INVESTMENT CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

(Unaudited)

Note 8. Fair Value Measurements

Fair Value of Financial Instruments

The accounting principles related to fair value measurements define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Financial Accounting Standards Board Accounting Standards Codification (“ASC”) Topic 820, Fair Value Measurements and Disclosures (“ASC Topic 820”), establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels, giving the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3) as described below:

- | | |
|---------------------|--|
| Level 1
Inputs - | Unadjusted quoted prices in active markets for identical assets or liabilities that are accessible by the Company at the measurement date; |
| Level 2
Inputs - | Quoted prices in markets that are not active or financial instruments for which all significant inputs are observable, either directly or indirectly; and |
| Level 3
Inputs - | Unobservable inputs for the asset or liability, including significant judgments made by the Company about the assumptions that a market participant would use. |
- The Company measures the fair value of the following assets and liabilities:

Mortgage-backed securities

Agency MBS - The Company’s investments in agency MBS are classified within Level 2 of the fair value hierarchy. Inputs to fair value measurements of the Company’s investments in agency MBS include price estimates obtained from third-party pricing services. The inputs used in the fair value measurements performed by the third-party pricing services are based upon readily observable transactions for securities with similar characteristics (such as issuer/guarantor, coupon rate, stated maturity, and specified pool characteristics) occurring on the measurement date. The Company makes inquiries of the third party pricing sources to understand the significant inputs and assumptions used to determine prices. The Company reviews the various third-party fair value estimates and performs procedures to validate their reasonableness, including comparison to recent trading activity for similar securities and an overall review for consistency with market conditions observed as of the measurement date.

Private-label MBS - The Company’s investments in private-label MBS are classified within Level 3 of the fair value hierarchy as private-label MBS trade infrequently and, therefore, the measurement of their fair value requires the use of significant unobservable inputs. In determining fair value, the Company primarily uses an income approach as well

as market approaches. The Company utilizes present value techniques based on estimated cash flows of the instrument taking into consideration various assumptions derived by management based on their observations of assumptions used by market participants. These assumptions are corroborated by evidence such as historical collateral performance data, evaluation of historical collateral performance data for other securities with comparable or similar risk characteristics, and observed completed or pending transactions in similar instruments, when available. The significant inputs to the Company's valuation process include collateral default, loss severity, prepayment, and discount rates (i.e., the rate of return demanded by market participants as of the measurement date). In general, significant increases (decreases) in default, loss severity, or discount rate assumptions, in isolation, would result in a significantly lower (higher) fair value measurement. However, significant increases (decreases) in prepayment rate assumptions, in isolation, may result in a significantly higher (lower) fair value measurement depending upon the instrument's specific characteristics and the overall payment structure of the issuing securitization vehicle. It is difficult to generalize the interrelationships between these significant inputs as the actual results could differ considerably on an individual security basis. Therefore, each significant input is closely analyzed to ascertain its reasonableness for the Company's purposes of fair value measurement.

Measuring fair value is inherently subjective given the volatile and sometimes illiquid markets for these private-label MBS and requires management to make a number of judgments about the assumptions that a market participant would use, including assumptions about the timing and amount of future cash flows as well as the rate of return demanded by market participants. The assumptions the Company applies are specific to each security. Although the Company relies on its internal calculations to estimate the fair value of these private-label MBS, the Company considers indications of value from actual sales of similar private-label MBS to assist in the valuation process and to calibrate the Company's models.

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(Dollars in thousands, except per share data)

(Unaudited)

Derivative instruments

Exchange-traded derivative instruments - Exchange-traded derivative instruments, which include Eurodollar futures, U.S. Treasury note futures, interest rate swap futures, and options on futures, are classified within Level 1 of the fair value hierarchy as they are measured using quoted prices for identical instruments in liquid markets.

Centrally cleared interest rate swaps - Centrally cleared interest rate swaps are classified within Level 2 of the fair value hierarchy. The fair values of centrally cleared interest rate swaps are measured using the daily valuations reported by the clearinghouse through which the instrument was cleared. In performing its end-of-day valuations, the clearinghouse constructs forward interest rate curves (for example, three-month LIBOR forward rates) from its specific observations of that day's trading activity. The clearinghouse uses the applicable forward interest rate curve to develop a market-based forecast of future remaining contractually required cash flows for each interest rate swap. Each market-based cash flow forecast is then discounted using the overnight index swap rate curve (sourced from the Federal Reserve Bank of New York) to determine a net present value amount which represents the instrument's fair value. The Company reviews the valuations reported by the clearinghouse on an ongoing basis and performs procedures using readily available market data to independently verify their reasonableness.

Forward-settling purchases and sales of TBA securities – Forward-settling purchases and sales of TBA securities are classified within Level 2 of the fair value hierarchy. The fair value of each forward-settling TBA contract is measured using broker or dealer quotations, which are based upon readily observable transaction prices occurring on the measurement date for forward-settling contracts to buy or sell TBA securities with the same guarantor, contractual maturity, and coupon rate for delivery on the same forward settlement date as the contract under measurement.

Other

Long-term debt - As of March 31, 2016 and December 31, 2015, the Company's long-term debt was \$73,489 and \$73,433, respectively, net of unamortized debt issuance costs, and consists of Senior Notes and trust preferred debt issued by the Company. The Company's estimate of the fair value of long-term debt is \$57,638 and \$59,130 as of March 31, 2016 and December 31, 2015, respectively. The Company's Senior Notes, which are publicly traded on the New York Stock Exchange, are classified within Level 1 of the fair value hierarchy. Trust preferred debt is classified within Level 2 of the fair value hierarchy as the fair value is estimated based on the quoted prices of the Company's publicly traded Senior Notes.

FHLBC capital stock - FHLBC capital stock is initially purchased at par and may only be transferred back to the FHLBC or to another FHLBC member, subject to approval by the FHLBC, also at par. Due to the restrictions placed on transferability, it is not practical to determine the fair value of FHLBC capital stock. The par value and carrying amount of the FHLBC capital stock included in the line item "other assets" on the Company's consolidated balance sheets is \$2 and \$15,740 as of March 31, 2016 and December 31, 2015, respectively.

Investments in equity securities of non-public companies and investment funds - As of March 31, 2016 and December 31, 2015, the Company had investments in equity securities and investment funds of \$1,558 which are recorded at

cost, net of impairments, and included in the line item “other assets” in the accompanying consolidated balance sheets. The Company’s estimate of the fair value of investments in equity securities and investment funds is \$6,585 and \$5,989 as of March 31, 2016 and December 31, 2015, respectively. Investments in equity securities and investment funds are classified within Level 3 of the fair value hierarchy. The fair values of the Company’s investments in equity securities and investment funds, which are measured at fair value for the purposes of disclosure only, are not readily determinable. Accordingly, for its investments in equity securities, the Company estimates fair value by estimating the enterprise value of the investee and then waterfalls the enterprise value over the investee’s securities in the order of their preference relative to one another. To estimate the enterprise value of the investee, the Company uses traditional valuation methodologies, including recent investments in or tender offers for the equity securities of the investee. For its investments in investment funds, the Company estimates fair value based upon the investee’s net asset value per share.

Investments in interest-only MBS - The Company’s investments in interest-only MBS are included in the line item “other assets” on the Company’s consolidated balance sheets. The Company’s investments in interest-only MBS are classified within Level 3 of the fair value hierarchy because, like other private-label MBS, they are of an instrument type that trades infrequently and, accordingly, the measurement of fair value requires the use of significant unobservable inputs. The Company measures the fair value of its investments in interest-only MBS using a discounted cash flow technique consistent with that of its other investments in private-label MBS.

ARLINGTON ASSET INVESTMENT CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

(Unaudited)

Financial assets and liabilities for which carrying value approximates fair value - Cash and cash equivalents, deposits, receivables, repurchase agreements, FHLB advances, payables, and other assets and liabilities are reflected in the consolidated balance sheets at their cost, which, due to the short-term nature of these instruments and their limited inherent credit risk, approximates fair value.

Fair Value Hierarchy

Financial Instruments Measured at Fair Value on a Recurring Basis

The following tables set forth financial instruments measured at fair value by level within the fair value hierarchy as of March 31, 2016 and December 31, 2015. Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

	March 31, 2016			
	Total	Level 1	Level 2	Level 3
MBS				
Trading:				
Agency MBS	\$3,417,825	\$—	\$3,417,825	\$—
Private-label MBS	13,205	—	—	13,205
Total trading	3,431,030	—	3,417,825	13,205
Available-for-sale:				
Agency MBS	25	—	25	—
Private-label MBS	116,026	—	—	116,026
Total available-for-sale	116,051	—	25	116,026
Total MBS	3,547,081	—	3,417,850	129,231
Derivative assets	5,587	1,533	4,054	—
Derivative liabilities	(44,719)	(19)	(44,700)	—
Interest-only MBS	105	—	—	105
Total	\$3,508,054	\$1,514	\$3,377,204	\$129,336

	December 31, 2015			
	Total	Level 1	Level 2	Level 3
MBS				
Trading:				
Agency MBS	\$3,865,290	\$—	\$3,865,290	\$—
Private-label MBS	2,899	—	—	2,899

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Total trading	3,868,189	—	3,865,290	2,899
Available-for-sale:				
Agency MBS	26	—	26	—
Private-label MBS	127,536	—	—	127,536
Total available-for-sale	127,562	—	26	127,536
Total MBS	3,995,751	—	3,865,316	130,435
Derivative assets	12,991	6,838	6,153	—
Derivative liabilities	(553)	—	(553)	—
Interest-only MBS	118	—	—	118
Total	\$4,008,307	\$6,838	\$3,870,916	\$130,553

There were no transfers of financial instruments into or out of Levels 1, 2 or 3 during the three months ended March 31, 2016 or the year ended December 31, 2015.

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Level 3 Financial Assets and Liabilities

The following table provides information about the significant unobservable inputs used to measure the fair value of the Company's private-label MBS as of the dates indicated:

	March 31, 2016		December 31, 2015	
	Weighted-		Weighted-	
	average (1)	Range	average (1)	Range
Discount rate	5.47 %	2.20 - 10.00 %	5.57 %	5.50 - 10.00 %
Default rate	3.19 %	1.45 - 6.20 %	2.78 %	1.45 - 6.20 %
Loss severity rate	46.78 %	35.00 - 65.00 %	45.84 %	35.00 - 65.00 %
Total prepayment rate (including defaults)	11.59 %	7.75 - 17.70 %	11.02 %	7.75 - 17.70 %

⁽¹⁾Based on face value.

The tables below set forth a summary of changes in the fair value and gains and losses of the Company's Level 3 investments in private-label MBS that are measured at fair value on a recurring basis for the periods indicated.

	Three Months Ended March 31,	
	2016	2015
Beginning balance	\$130,435	\$267,437
Total net gains (losses)		
Included in investment (loss) gain, net	38	3,432
Included in other comprehensive income	(8,036)	(10,905)
Purchases	5,357	—
Sales	—	(20,859)
Payments, net	(1,534)	(3,131)
Accretion of discount	2,971	5,043
Ending balance	\$129,231	\$241,017
Net unrealized gains (losses) included in earnings for the		
period for Level 3 assets still held at the reporting date	\$38	\$—

Note 9. Income Taxes

Arlington Asset is subject to taxation as a corporation under Subchapter C of the Internal Revenue Code of 1986, as amended (the “Code”). The Company’s consolidated subsidiary, Rosslyn REIT Trust (“Rosslyn REIT”), operates to qualify as a real estate investment trust (“REIT”) under the Code. The investments of Rosslyn REIT primarily consist of a portion of the Company’s private-label MBS portfolio. Arlington Asset owns all of the common shares of Rosslyn REIT and all of the preferred shares of Rosslyn REIT are owned by outside investors. Rosslyn REIT periodically distributes all of its income to its shareholders. The Company’s agency MBS and remaining private-label MBS investment portfolios are held by Arlington Asset.

The Company currently has net operating loss (“NOL”) and net capital loss (“NCL”) carry-forwards that can be applied against the Company’s current taxable ordinary income and net capital gains.

As of March 31, 2016 and December 31, 2015, the Company had a net deferred tax asset of \$101,480 and \$97,530, respectively, net of a valuation allowance on NCL carry-forwards of \$92,618 and \$80,663, respectively. The Company continues to provide a valuation allowance against the portion of NCL carry-forwards for which the Company believes is more likely than not that the benefits will not be realized prior to expiration. During the three months ended March 31, 2016, the Company recorded an increase to its valuation allowance of \$11,955. The increase in the valuation allowance was primarily due to realized and unrealized net capital losses generated during the period from certain of its exchange-traded derivative hedge instruments. The Company will continue to assess the need for a valuation allowance at each reporting date.

As of March 31, 2016, the Company has assessed the need for recording a provision for any uncertain tax position and has made the determination that such provision is not necessary.

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The Company is subject to examination by the U.S. Internal Revenue Service (“IRS”) and state and local taxing jurisdictions where the Company has significant business operations. As of March 31, 2016, there are no on-going examinations.

Note 10. Earnings Per Share

Basic earnings per share includes no dilution and is computed by dividing net income or loss applicable to common stock by the weighted-average number of common shares outstanding for the respective period. Diluted earnings per share includes the impact of dilutive securities such as unvested shares of restricted stock and performance share units. The following tables present the computations of basic and diluted earnings (loss) per share for the periods indicated:

(Shares in thousands)	Three Months Ended March 31,	
	2016	2015
Basic weighted-average shares outstanding	22,994	22,973
Performance share units and unvested restricted stock	—	—
Diluted weighted-average shares outstanding	22,994	22,973
Net loss	\$(31,618)	\$(42,185)
Net loss per common share	\$(1.38)	\$(1.84)

The diluted earnings per share for the three months ended March 31, 2016 and 2015 did not include the antidilutive effect of 46,156 and 123,242 shares, respectively, of unvested shares of restricted stock and performance share units.

Note 11. Stockholders’ Equity

Dividends

Pursuant to the Company’s variable dividend policy, the Board of Directors evaluates dividends on a quarterly basis and, in its sole discretion, approves the payment of dividends. The Company’s dividend payments, if any, may vary significantly from quarter to quarter. The Board of Directors has approved and the Company has declared and paid the

following dividends to date in 2016:

Dividend

Quarter Ended	Amount	Declaration Date	Record Date	Pay Date
March 31	\$ 0.625	March 15	March 31	April 29

The Board of Directors approved and the Company declared and paid the following dividends for 2015:

Dividend

Quarter Ended	Amount	Declaration Date	Record Date	Pay Date
December 31	\$ 0.625	December 17	December 31	January 29, 2016
September 30	0.625	September 17	September 30	October 30
June 30	0.875	June 17	June 30	July 31
March 31	0.875	March 10	March 31	April 30

Conversion of Class B Common Stock to Class A Common Stock

During the three months ended March 31, 2016, holders of the Company's common stock converted an aggregate of 4,612 shares of Class B common stock into 4,612 shares of Class A common stock. Holders of shares of Class A common stock are entitled to one vote for each share on all matters voted on by shareholders, and the holders of shares of Class B common stock are entitled to three votes per share on all matters voted on by shareholders. Under the Company's Articles of Incorporation, shares of Class B common stock are convertible into shares of Class A common stock on a one-for-one basis.

Share Repurchase Program

In October 2015, the Board of Directors authorized an increase in the Company's share repurchase program pursuant to which the Company may repurchase up to 2,000,000 shares of Class A common stock (the "Repurchase Program"). Repurchases under the

ARLINGTON ASSET INVESTMENT CORP.

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(Dollars in thousands, except per share data)

(Unaudited)

Repurchase Program may be made from time to time on the open market and in private transactions at management's discretion in accordance with applicable federal securities laws. The timing of repurchases and the exact number of shares of Class A common stock to be repurchased will depend upon market conditions and other factors. The Repurchase Program is funded using the Company's cash on hand and cash generated from operations. The Repurchase Program has no expiration date and may be suspended or terminated at any time without prior notice. As of March 31, 2016, there remain available for repurchase 1,951,305 shares of Class A common stock under the Repurchase Program.

Shareholder Rights Agreement

The Board of Directors adopted and the Company's shareholders approved a shareholder rights agreement ("Rights Plan"). Under the terms of the Rights Plan, in general, if a person or group acquires or commences a tender or exchange offer for beneficial ownership of 4.9% or more of the outstanding shares of our Class A common stock upon a determination by our Board of Directors (an "Acquiring Person"), all of our other Class A and Class B common shareholders will have the right to purchase securities from us at a discount to such securities' fair market value, thus causing substantial dilution to the Acquiring Person.

The Board of Directors adopted the Rights Plan in an effort to protect against a possible limitation on the Company's ability to use its NOL carry-forwards, NCL carry-forwards, and built-in losses under Sections 382 and 383 of the Code. The Company's ability to use its NOLs, NCLs and built-in losses would be limited if it experienced an "ownership change" under Section 382 of the Code. In general, an "ownership change" would occur if there is a cumulative change in the ownership of the Company's common stock of more than 50% by one or more "5% shareholders" during a three-year period. The Rights Plan was adopted to dissuade any person or group from acquiring 4.9% or more of the Company's outstanding Class A common stock, each, an Acquiring Person, without the approval of the Board of Directors and triggering an "ownership change" as defined by Section 382.

The Rights Plan and any outstanding rights will expire at the earliest of (i) June 4, 2019, (ii) the time at which the rights are redeemed or exchanged pursuant to the Rights Plan, (iii) the repeal of Section 382 and 383 of the Code or any successor statute if the Board of Directors determines that the Rights Plan is no longer necessary for the preservation of the applicable tax benefits, and (iv) the beginning of a taxable year to which the Board of Directors determines that no applicable tax benefits may be carried forward.

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

Unless the context otherwise requires or provides, references in this Quarterly Report on Form 10-Q to "we," "us," "our" and the "Company" refer to Arlington Asset Investment Corp. ("Arlington Asset") and its subsidiaries. This discussion and analysis should be read in conjunction with our financial statements and accompanying notes included in Item 1 of this Quarterly Report on Form 10-Q, as well as our audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2015.

The discussion of our consolidated financial condition and results of operations below may contain forward-looking statements. These statements, which reflect management's beliefs and expectations, are subject to risks and uncertainties that may cause actual results to differ materially. For a discussion of the risks and uncertainties that may affect our future results, please see "Cautionary Statement About Forward-Looking Information" in Item 3 of Part I of this Quarterly Report on Form 10-Q and the risk factors included in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2015.

Our Company

We are a principal investment firm that currently acquires and holds a levered portfolio of residential mortgage-backed securities ("MBS"), consisting of agency MBS and private-label MBS. Agency MBS include residential mortgage pass-through certificates for which the principal and interest payments are guaranteed by a U.S. government agency or government sponsored enterprise ("GSE"), such as the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). Private-label MBS, or non-agency MBS, include residential MBS that are not guaranteed by a GSE or the U.S. government.

We leverage prudently our investment portfolio so as to increase potential returns to our shareholders. We fund our investments primarily through short-term financing arrangements, principally through repurchase agreements. We enter into various hedging transactions to mitigate the interest rate sensitivity of our cost of borrowing and the value of our MBS portfolio.

We are a Virginia corporation and taxed as a C corporation for U.S. federal tax purposes. We are an internally managed company and do not have an external investment advisor.

Factors that Affect our Results of Operations and Financial Condition

Our business is materially affected by a variety of industry and economic factors, including:

- conditions in the global financial markets and economic conditions generally;
- changes in interest rates and prepayment rates;
- actions taken by the U.S. government, U.S. Federal Reserve, the U.S. Treasury and foreign central banks;
- changes in laws and regulations and industry practices; and
- other market developments.

Current Market Conditions and Trends

During the three months ended March 31, 2016, market conditions were characterized by significant continued volatility. Lower global demand and inventory buildups continued to exert downward pressure on oil prices, hedge fund redemptions put pressure on the leveraged credit market generally, and weak international trade data and uncertainty as to bank liquidity added to uncertainty for global growth for the rest of the year. Global economic growth remains tepid, but it is expected the global environment will stabilize and slowly expand over the course of 2016 with many indicators of global manufacturing activity showing signs that global trade and industrial activity may have bottomed.

On December 16, 2015, the Federal Open Market Committee of the U.S. Federal Reserve (the “Federal Reserve”) announced that it was increasing the target Federal Funds rate by 0.25%. In its announcement, the Federal Reserve cautioned capital markets to anticipate the possibility of additional increases in the Federal Funds rate in 2016, depending upon future growth in inflation and other economic indicators. On April 27, 2016, the Federal Reserve announced that it was maintaining a target Federal Funds rate range of 0.25% and 0.50%, initially set in December 2015. Unlike prior statements released after recent committee meetings, the Federal Reserve did not indicate in its April 27, 2016 release that it views global economic and financial developments and conditions as posing immediate risks. Foreign central banks have taken an increasingly accommodative stance over the past few quarters, and many

market participants are increasingly skeptical of the number and amount of any increases in the Federal Funds rate in the foreseeable future. We cannot predict the actions of the Federal Reserve for the rest of 2016, but we believe that any additional increases to the Federal Funds rate will be subject to economic, fiscal and monetary data developments.

We believe that the housing market will continue its slow and steady recovery driven by years of under production, tight inventory levels, attractive interest rates, reasonable affordability levels, high rental occupancy rates and the lowest unemployment levels since 2008 despite recent global economic concerns and volatility in the stock market. The new home market continues to have significant pent-up demand, which we believe positions us well for years to come. Notwithstanding these positive trends, home sales and new single-family home construction remain relatively below pre-financial crisis levels due, in part, to mortgage lending rules implemented under the Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) and bank conservatism in efforts to, among other things, prevent future MBS repurchase requests. These factors have created a decline in new home mortgage origination, resulting in low agency MBS issuance. The Federal Reserve’s purchases of agency MBS through reinvesting principal and interest payments it receives on its existing agency MBS portfolio have continued to influence the agency MBS markets, where many participants perceive a lack of liquidity. While the Federal Reserve has not indicated when it will cease or reduce its agency MBS purchases by reinvesting principal and interest payments, private banks have less incentive to purchase MBS issued by Freddie Mac and Fannie Mae, as the Basel III liquidity coverage ratio rules provide lower quality liquid asset credit for such securities on their balance sheet than for cash, U.S. Treasuries and MBS issued by the Government National Mortgage Association (“Ginnie Mae”).

While there are signs that slow and steady economic growth will continue to persist in the United States, uncertainty continues to dominate the market. We believe the general business environment will continue to be challenging for the rest of 2016. Our growth outlook is dependent, in part, on the strength of the financial markets, the impact of fiscal and monetary policy actions by the United States and other countries, and liquidity in the financial system. We will continue to closely monitor the developments in the market and evaluate the opportunities across the spectrum in the mortgage industry and other types of assets in a continuing effort to seek the highest risk-adjusted returns for our capital.

Recent Government Activity

On January 12, 2016, the Federal Housing Finance Agency (“FHFA”) issued a final rule - RIN 2590-AA39, Members of Federal Home Loan Banks. The final rule, among other things, expressly excludes captive insurance companies, such as our wholly-owned captive insurance subsidiary, Key Bridge Insurance, LLC (“Key Bridge”), from being eligible for membership in the Federal Home Loan Bank (“FHLB”) system. Under the final rule, there is a one-year transition period from the effective date of the final rule of February 19, 2016 within which the FHLBs must wind down their relationships with any captive insurance companies that had been admitted to membership on or after September 12, 2014, including Key Bridge. The final rule also precludes the FHLBs from making any new advances or extending existing advances. In addition, upon the termination of membership, the FHLBs must liquidate all outstanding advances to captive insurance companies, settle all other business transactions, and repurchase or redeem all FHLB stock held by the terminated captive insurance company in accordance with the final rule. Therefore, Key Bridge, along with all other captive insurance companies, must completely wind down all business relationships with the FHLB of Cincinnati (“FHLBC”), including the repayment of all outstanding advances, prior to or simultaneously with the termination of Key Bridge’s membership with the FHLBC. As of March 31, 2016, Key Bridge has repaid all of its

outstanding FHLBC advances.

We expect debate and discussion on residential housing and mortgage reform to continue over the next few years; however, we cannot be certain if or when any housing finance reform bill will emerge from committee or be approved by Congress, and if so, what the effects may be. Historically, significant legislation has been difficult to pass in a presidential election year, and we cannot predict what effect the 2016 election cycle will have on the progress of housing finance reform legislation.

Executive Summary

In the first quarter, the Company changed its accounting policy for recognizing interest income on its investments in agency MBS by amortizing purchase premiums as an adjustment to interest income in accordance with the interest method permitted by GAAP. The Company believes that this change in accounting policy results in a reported interest income measure that better reflects the economic yield of its investments, including a better reflection of the economic effect of principal prepayments in the period in which those prepayments occur, and that this change in accounting policy enhances the comparability of its reported financial results to those of its peers. Also during the first quarter, the Company revised its presentation of non-GAAP core operating income, which now reflects the change in accounting policy for recognizing interest income. The Company believes that its non-GAAP core operating income provides investors with additional insight into the current performance of its investment portfolio and is a key measure used by the Company's Board of Directors in determining the appropriate level of dividends to shareholders.

Since the Company's fixed-rate agency MBS have generally been purchased at a premium to par value, high prepayments can have a meaningful negative impact on the Company's asset yields and interest income, while slow prepayments can have a meaningful

positive impact. In order to manage our exposure to prepayment risk on our agency MBS, the Company continues to invest in specified agency MBS that are specifically selected for their relatively lower propensity for prepayment. The actual constant prepayment rate (“CPR”) for the Company’s agency MBS was 8.14% for the first quarter of 2016, resulting in an average asset yield of 2.93%. The Company also continues to have ample repurchase agreement financing available to fund its agency MBS from multiple counterparties at rates we continue to consider to be attractive.

In addition to investing in specified agency MBS, the Company also purchases to-be-announced (“TBA”) forward contracts as a means of investing in and financing non-specified agency MBS, commonly referred to as TBA “dollar roll” transactions. TBA dollar roll income is considered the economic equivalent of the net interest income that results from investing in specified agency MBS financed with a repurchase agreement. Under GAAP, the Company accounts for its TBA securities as derivative instruments and, as a result, TBA dollar roll income is not included in net interest income determined in accordance with GAAP. However, the Company includes TBA dollar roll income in its computation of non-GAAP core operating income. During the first quarter of 2016, the Company increased the allocation of its agency TBAs within its overall agency investment portfolio, resulting in a greater amount of TBA dollar roll income as compared to prior periods. For the first quarter of 2016, the Company reported TBA dollar roll income of \$3.8 million.

The Company constantly monitors its allocation of its available capital between agency MBS and private-label MBS in an effort to maximize returns to its shareholders. As of March 31, 2016, the Company’s available capital was allocated approximately 77% to agency MBS and 23% to private-label MBS, compared to 80% to agency MBS and 20% to private-label MBS as of December 31, 2015. During the first quarter of 2016, the Company’s private-label MBS generated interest income of \$3.0 million and an average asset yield of 10.3%.

As a result of the relatively benign prepayment environment and the resulting strong and stable yield generated by the Company’s investments, the Company reported non-GAAP core operating income of \$0.80 per diluted share for the first quarter of 2016. The consistent returns generated by its investment portfolio enabled the Company to continue to pay a distribution to shareholders of \$0.625 per share for the first quarter of 2016 despite a \$0.05 per diluted share increase in the Company’s cost of short-term funding relative to the prior quarter following the Federal Reserve’s December rate increase.

During the first quarter, the market experienced persistent interest rate volatility and widening of MBS spreads. The 10-year U.S. Treasury rate experienced its largest quarterly decline in 15 quarters, decreasing from 2.27% as of December 31, 2015 to 1.78% as of March 31, 2016, and experienced significant volatility within the quarter. While the Company maintains a portfolio of interest rate hedging instruments designed and structured to protect the fair value of its agency MBS portfolio from a rise in interest rates, the Company’s hedging instruments are not generally designed to protect the Company’s net book value from spread risk, which is the risk of an increase of the market spread between the yield on agency MBS and the benchmark yield on U.S. Treasury securities or interest rate swaps. The option-adjusted spread (“OAS”), a common measure of the spread between a fixed income security yield and a risk-free rate that takes into consideration the impact of interest rate volatility and prepayment risk in residential MBS, widened significantly during the quarter. For example, the Fannie Mae 4.0% 30-year OAS widened approximately 15 basis points during the quarter.

Due primarily to the significant decrease in long-term interest rates and widening of MBS spreads that occurred during the quarter, the Company experienced a decline in book value. As of March 31, 2016, the Company’s book value was \$18.86 per share compared to \$21.05 per share as of December 31, 2015. The Company’s tangible book value, which is calculated as shareholders’ equity less the Company’s net deferred tax asset, was \$14.45 per share as of March 31, 2016 compared to \$16.81 per share as of December 31, 2015.

The Company continues execute on its consistent interest rate hedging strategy that is well-positioned for a rise in interest rates and is best situated to protect the Company's book value and earnings potential over the long-term. In a falling interest rate and a rising spread environment such as this past quarter, this hedging strategy will likely result in a temporary decline in book value; however, the Company would expect that the temporary decline in book value would be recovered over time either through higher future spread earnings if rates remain low and spreads are wide, or through a reversal of this temporary decline in book value if rates rise and spreads narrow. Conversely, if the Company did not have an adequate interest rate hedge position in a rising interest rate environment, the Company would experience both a substantial decline in book value and higher future cost of funding resulting in a potential permanent loss of book value.

Consistent with its hedging strategy, the Company modified some of the components of its hedge position during the first quarter by purchasing put options on 10-year U.S. Treasury note futures that will continue to provide the Company with protection against a significant rise in interest rates while also reducing future book value volatility in a falling interest rate environment.

Non-GAAP Core Operating Income

In addition to the Company's results of operations determined in accordance with generally accepted accounting principles as consistently applied in the United States ("GAAP"), the Company computed "non-GAAP core operating income" for the three months

ended March 31, 2016. Beginning in the first quarter of 2016, the Company defines core operating income as “economic net interest income” less “core general and administrative expenses.”

Economic Net Interest Income

Economic net interest income is comprised of the following: periodic (i) net interest income determined in accordance with GAAP, (ii) TBA agency MBS “dollar roll” income, and (iii) net interest income or expense incurred from interest rate swap agreements.

- Net interest income determined in accordance with GAAP. Net interest income determined in accordance with GAAP primarily represents the interest income recognized from the Company’s investments in specified agency MBS and private-label MBS (including the amortization of purchase premiums and accretion of purchase discounts), net of the interest expense incurred from repurchase agreement financing arrangements or other short- and long-term borrowing transactions. In the first quarter of 2016, the Company implemented a change in its accounting policy for recognizing interest income on its investments in agency MBS classified as trading securities by amortizing purchase premiums (or accreting purchase discounts) as an adjustment to interest income in accordance with the “interest method” permitted by GAAP.
- TBA agency MBS dollar roll income. Dollar roll income represents the economic equivalent of net interest income (implied interest income net of financing costs) generated from the Company’s investments in non-specified fixed-rate agency MBS, executed through sequential series of forward-settling purchase and sale transactions that are settled on a net basis (known as “dollar roll” transactions). Dollar roll income is generated as a result of delaying, or “rolling,” the settlement of a forward-settling purchase of a TBA agency MBS by entering into an offsetting “spot” sale prior to the settlement date, net settling the “paired-off” positions in cash, and contemporaneously entering another forward-settling purchase of a TBA agency MBS of the same essential characteristics for a later settlement date at a price discount relative to the “spot” sale. The price discount of the forward-settling purchase relative to the “spot” sale represents the economic equivalent of net interest income that is earned ratably over the period beginning on the settlement date of the sale and ending on the settlement date of the forward-settling purchase. In the Company’s consolidated statements of comprehensive income prepared in accordance with GAAP, TBA agency MBS dollar roll income is reported as a component of the overall periodic change in the fair value of TBA forward commitments within the line item “gain (loss) from derivative instruments, net” of the “investment gain (loss), net” section.
- Net interest income or expense incurred from interest rate swap agreements. The Company utilizes centrally-cleared interest rate swap agreements to economically hedge a portion of its exposure to variability in future interest cash flows, attributable to changes in benchmark interest rates, associated with future roll-overs of its short-term financing arrangements. Accordingly, the net interest income or expense (commonly referred to as “net interest carry”) incurred from the Company’s interest rate swap agreements in combination with interest expense recognized in accordance with GAAP represents the Company’s effective “economic interest expense.” In the Company’s consolidated statements of comprehensive income prepared in accordance with GAAP, the net interest income or expense incurred from interest rate swap agreements is reported as a component of the overall periodic change in the

fair value of derivative instruments within the line item “gain (loss) from derivative instruments, net” of the “investment gain (loss), net” section.

Core General and Administrative Expenses

Core general and administrative expenses are non-interest expenses reported within the line item “total other expenses” of the consolidated statements of comprehensive income less stock-based compensation expense. For the three months ended March 31, 2016, core general and administrative expenses also exclude non-recurring expenses related to the 2016 proxy contest that are in excess of those normally incurred for an annual meeting of shareholders. For information about the 2016 proxy contest, refer to “Item 1A. Risk Factors” within this quarterly report.

Non-GAAP Core Operating Income for the Three Months Ended March 31, 2016

The following table presents the Company's computation of core operating income for the three months ended March, 31, 2016 (amounts in thousands, except per share amounts):

	Three Months Ended March 31, 2016
GAAP net interest income	\$ 22,061
TBA dollar roll income	3,795
Interest rate swap net interest expense	(3,997)
Economic net interest income	21,859
Core general and administrative expenses	(3,420)
Non-GAAP core operating income	\$ 18,439
Non-GAAP core operating income per diluted share	\$ 0.80
Weighted average diluted shares outstanding	23,040

The following table provides a reconciliation of GAAP pre-tax net income to non-GAAP core operating income for the three months ended March 31, 2016 (amounts in thousands):

	Three Months Ended March 31, 2016
GAAP loss before income taxes	\$ (32,164)
Less:	
Total investment loss, net	49,890
Stock-based compensation expense	517
Non-recurring proxy contest related expenses	398
Add back:	
TBA dollar roll income	3,795
Interest rate swap net interest expense	(3,997)
Non-GAAP core operating income	\$ 18,439

Non-GAAP core operating income is used by management to evaluate the financial performance of the Company's long-term investment strategy and core business activities over periods of time as well as assist with the determination of the appropriate level of periodic dividends to stockholders. The Company believes that non-GAAP core operating income assists investors in understanding and evaluating the financial performance of the Company's long-term investment strategy and core business activities over periods of time as well as its earnings capacity. A limitation of utilizing this non-GAAP financial measure is that the effect of accounting for "non-core" events or transactions in accordance with GAAP does, in fact, reflect the financial results of our business and these effects should not be ignored when evaluating and analyzing our financial results. For example, the economic cost or benefit of hedging instruments other than interest rate swap agreements, such as U.S. Treasury note futures or options on U.S. Treasury note futures, do not affect the computation of non-GAAP core operating income. Therefore, the Company believes that net income and comprehensive income determined in accordance with GAAP should be considered in conjunction with non-GAAP core operating income.

Non-GAAP Core Operating Income for Fiscal Year 2015

The Company retrospectively applied its revised definition of core operating income to the quarterly and annual periods of fiscal year 2015. The Company notes, however, that the non-GAAP core operating income measures computed for prior year periods are not directly comparable to the results computed for the first quarter of 2016, as the Company solely utilized hedging instruments other than interest rate swap agreements prior to November 2015. The economic costs or benefits of hedging instruments other than interest rate swap agreements do not affect the computation of non-GAAP core operating income.

The results of the Company's retrospective application of its revised definition of core operating income to fiscal year 2015 are presented in the following table (amounts in thousands, except per share amounts):

	Fiscal Year 2015				
	Total Year	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
GAAP net interest income	\$102,374	\$25,807	\$26,074	\$23,711	\$26,782
TBA dollar roll income	6,743	2,353	1,896	2,235	259
Interest rate swap net interest expense	(1,282)	(1,282)	—	—	—
Economic net interest income	107,835	26,878	27,970	25,946	27,041
Core general and administrative expenses	(13,642)	(3,121)	(3,639)	(3,575)	(3,307)
Non-GAAP core operating income	\$94,193	\$23,757	\$24,331	\$22,371	\$23,734
Non-GAAP core operating income per diluted share	\$4.08	\$1.03	\$1.05	\$0.97	\$1.03
Weighted average diluted shares outstanding	23,088	23,066	23,065	23,098	23,096

The following table provides a reconciliation of GAAP pre-tax net income to non-GAAP core operating income for fiscal year 2015 (amounts in thousands):

	Fiscal Year 2015				
	Total Year	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
GAAP income (loss) before income taxes	\$(30,842)	\$23,486	\$(37,133)	\$12,248	\$(29,443)
Less:					
Total investment (gain) loss, net	118,429	(1,653)	59,757	7,518	52,807
Stock-based compensation expense	1,145	853	(189)	370	111
Add back:					
TBA dollar roll income	6,743	2,353	1,896	2,235	259
Interest rate swap net interest expense	(1,282)	(1,282)	—	—	—
Non-GAAP core operating income	\$94,193	\$23,757	\$24,331	\$22,371	\$23,734

Portfolio Overview

The following table summarizes our MBS investment portfolio at fair value as of March 31, 2016 and December 31, 2015 (dollars in thousands):

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	March 31, 2016	December 31, 2015
Agency MBS	\$3,417,850	\$ 3,865,316
Private-label MBS	129,231	130,435
Private-label interest-only MBS	105	118
Net long TBA positions ⁽¹⁾	729,844	389,258
Total MBS investments portfolio	\$4,277,030	\$ 4,385,127

⁽¹⁾Net long TBA positions are reflected on the consolidated balance sheets as a component of “derivative assets, at fair value” and “derivative liabilities, at fair value,” with a net asset carrying value of \$4,054 and a net liability carrying value of \$553 as of March 31, 2016 and December 31, 2015, respectively.

Our agency MBS consisted of the following as of March 31, 2016 (dollars in thousands):

	Face Amount	Fair Value	Market Price	Coupon	Weighted Average Life	
30-year fixed rate:						
3.5%	\$961,398	\$1,012,562	\$105.32	3.50 %	6.0	
4.0%	2,162,322	2,329,172	107.72	4.00 %	4.9	
4.5%	69,422	76,091	109.61	4.50 %	4.1	
5.5%	22	25	112.68	5.50 %	4.8	
Total/weighted-average	\$3,193,164	\$3,417,850	107.04	3.86 %	5.2	

					Weighted
	Face Amount	Fair Value	Market Price	Coupon	Average Life
Fannie Mae	\$ 1,765,160	\$1,889,749	\$ 107.06	3.85 %	5.2
Freddie Mac	1,428,004	1,528,101	107.01	3.87 %	5.1
Total/weighted-average	\$ 3,193,164	\$3,417,850	107.04	3.86 %	5.2

The actual CPR for the Company's agency MBS was 8.14% for the three months ended March 31, 2016. As of March 31, 2016, the Company's agency MBS was comprised of securities specifically selected for their relatively lower propensity for prepayment including approximately 60% in specified pools backed by lower loan balances, approximately 13% in specified pools of loans refinanced through the U.S. Government sponsored Home Affordable Refinance Program ("HARP"), while the remainder includes specified pools of loans originated in certain geographic areas, with low FICO scores or with other characteristics selected for their relatively lower propensity for prepayment.

As of March 31, 2016, we had \$3.0 billion of outstanding repurchase agreement financing secured by \$3.2 billion of agency MBS with a weighted-average cost of funding of 0.66%. During the three months ended March 31, 2016, we sold agency MBS with a face value of \$875.5 million for total proceeds of \$933.9 million, realizing net gains of \$5.6 million.

Our agency MBS investment portfolio also includes net long TBA positions, which are primarily the result of executing sequential series of "dollar roll" transactions. We execute dollar roll transactions as a means of investing in and financing non-specified fixed-rate agency MBS. Such transactions involve effectively delaying (or "rolling") the settlement of a forward purchase of a TBA agency MBS by entering into an offsetting short position prior to the settlement date, net settling the "paired-off" positions in cash, and contemporaneously entering another forward purchase of a TBA agency MBS of the same characteristics for a later settlement date. TBA securities purchased or sold for a forward settlement month are generally priced at a discount relative to TBA securities purchased for settlement in the current month. This "discount," often referred to as the dollar roll "price drop," reflects compensation for the net interest income (interest income less financing costs) that is foregone as a result of relinquishing beneficial ownership of the MBS for the duration of the dollar roll. Forward purchases and sales of TBA securities are accounted for as derivative instruments in our financial statements prepared in accordance with GAAP. Accordingly, dollar roll income is recognized as a component of "investment gains (losses), net" along with all other unrealized and realized gains (losses) on TBA transactions. Information about the Company's net long TBA positions consisted of the following as of March 31, 2016 (dollars in thousands):

	Notional Amount:			Net
	Net Long (Short)	Implied Cost Basis	Implied Fair Value	Carrying Amount
	Position ⁽¹⁾	Basis ⁽²⁾	Value ⁽³⁾	⁽⁴⁾
30-year 3.5% coupon	\$ 350,000	\$364,073	\$366,734	\$ 2,661

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30-year 4.0% coupon	340,000	361,717	363,110	1,393
Total	\$ 690,000	\$725,790	\$729,844	\$ 4,054

(1)“Notional amount” represents the unpaid principal balance of the underlying agency MBS.

(2)“Implied cost basis” represents the contractual forward price for the underlying agency MBS.

(3)“Implied fair value” represents the current fair value of the underlying agency MBS.

(4)“Net carrying amount” represents the difference between the implied cost basis and the current fair value of the underlying MBS. This amount is reflected on the Company’s consolidated balance sheets as a component of “derivative assets, at fair value” and “derivative liabilities, at fair value.”

Our private-label MBS, excluding our interest-only MBS, consisted of the following as of March 31, 2016 (dollars in thousands):

Face Amount	Net Discounts	Amortized Cost	Gross Unrealized Gains	Losses	Fair Value	Weighted-Average GAAP Coupon	Yield
\$172,969	\$(51,797)	\$121,172	\$8,059	\$—	\$129,231	3.01 %	10.32 %

As of March 31, 2016, the private-label MBS portfolio consists primarily of “re-REMIC” securities. The Company’s investments in re-REMIC securities represent “mezzanine” interests in underlying, re-securitized senior class MBS issued by private-label Real Estate Mortgage Investment Conduit (“REMIC”) securitization trusts. The senior class REMIC securities that serve as collateral to the Company’s investments in re-REMIC securities represent beneficial interests in pools of prime or Alt-A residential

mortgage loan collateral that hold the first right to cash flows and absorb credit losses only after their respective subordinate REMIC classes have been fully extinguished. The majority of the trusts that issued the Company's investments in re-REMIC securities employ a "sequential" principal repayment structure, while a minority of the issuing trusts employ a "pro-rata" principal repayment structure. Accordingly, the majority of the Company's mezzanine class re-REMIC securities are not entitled to receive principal repayments until the principal balance of the senior interest in the respective collateral group has been reduced to zero. Principal shortfalls are allocated on a "reverse sequential" basis. Accordingly, any principal shortfalls on the underlying senior class REMIC securities are first absorbed by the Company's mezzanine class re-REMIC securities, to the extent of their respective principal balance, prior to being allocated to the senior interest in the respective collateral pool. Periodic interest accrues on each re-REMIC security's outstanding principal balance at its contractual coupon rate. Our private-label MBS have approximately 1.8% in remaining structural credit enhancement provided by collateral-level subordinate interests, on a weighted-average basis, which, in addition to the substantial discount to par value at which the securities were purchased, provides protection to our invested capital.

As of March 31, 2016, we had \$32.5 million of outstanding repurchase agreement financing secured by \$57.5 million of private-label MBS with a weighted-average cost of funding of 2.45%. We did not sell private-label MBS during the three months ended March 31, 2016. During the three months ended March 31, 2016, we purchased private-label MBS for \$5.4 million with a face amount of \$5.2 million.

The Company attempts to hedge a portion of its exposure to interest rate fluctuations associated with its agency MBS primarily through the use of interest rate derivatives. Specifically, these interest rate derivatives are intended to economically hedge changes, attributable to changes in benchmark interest rates, in agency MBS fair values and future interest cash flows on the Company's short-term financing arrangements. As of March 31, 2016, the interest rate derivative instruments used by the Company were centrally cleared interest rate swap agreements, exchange-traded 10-year U.S. Treasury note futures, and put options on 10-year U.S. Treasury note futures.

The Company's interest rate swap agreements represent agreements to make semiannual interest payments based upon a fixed interest rate and receive quarterly variable interest payments based upon the prevailing three-month LIBOR rate on the date of reset. Information about the Company's outstanding centrally cleared interest rate swap agreements as of March 31, 2016 is as follows (dollars in thousands):

March 31, 2016					
	Average Fixed		Average Remaining		
	Notional Amount	Pay Rate	Maturity (Years)		Fair Value
Years to maturity:					
Less than 2 years	\$750,000	1.04	%	1.7	\$(4,983)
2 to 10 years	1,000,000	2.03	%	9.8	(39,717)
Total / weighted-average	\$1,750,000	1.61	%	6.3	\$(44,700)

The Company's exchange-traded 10-year U.S. Treasury note futures are short positions that mature on a quarterly basis. Upon the maturity date of these futures contracts in June 2016, the Company has the option to either net settle each contract in cash in an amount equal to the difference between the current fair value of the underlying 10-year U.S. Treasury note and the contractual sale price inherent to the futures contract, or to physically settle the contract by delivering the underlying 10-year U.S. Treasury note. Information about the Company's outstanding 10-year U.S. Treasury note futures contracts as of March 31, 2016 is as follows (dollars in thousands):

	Notional	Net
Maturity Date	Amount	Fair Value
June 2016	\$375,000	\$ 733

The Company's exchange-traded put options on 10-year U.S. Treasury note futures held as of March 31, 2016 provide the Company with the right, but not the obligation, to sell underlying 10-year U.S. Treasury note futures contracts which have an aggregate notional amount of \$2.0 billion. These put options were acquired in exchange for aggregate option premiums of \$2.7 million and have a weighted-average strike price that equates to a 10-year U.S. Treasury note rate of approximately 2.45%. These options may be exercised at any time prior to their expiry, which occurs in May 2016, and, if exercised, will be settled in cash. Put options on 10-year U.S. Treasury note futures are intended to offset declines in the market value of the Company's agency MBS portfolio attributable to a significant rise in interest rates. On an on-going basis, the Company will evaluate the economic costs and benefits of rolling-forward this hedge position. Based on its analysis, the Company may elect to roll-forward this hedge position with any adjustments to the notional amount based on the changes in the Company's agency MBS portfolio and/or adjustments to the strike price based upon the Company's evaluation of the potential economic benefit of the options relative to their quoted premiums. Information about the Company's outstanding put options on 10-year U.S. Treasury note futures contracts as of March 31, 2016 is as follows (dollars in thousands):

	Notional	Net
Maturity Date	Amount	Fair Value
May 2016	\$2,000,000	\$ 781

Results of Operations

Net Interest Income

Net interest income determined in accordance with GAAP primarily represents the interest income recognized from our investments in specified agency MBS and private-label MBS (including the amortization of purchase premiums and accretion of purchase discounts), net of the interest expense incurred from repurchase agreement financing arrangements or other short- and long-term borrowing transactions. In the first quarter of 2016, we implemented a change in our accounting policy for recognizing interest income on our investments in agency MBS classified as trading securities by amortizing purchase premiums (or accreting purchase discounts) as an adjustment to interest income in accordance with the "interest method" permitted by GAAP. Prior to January 1, 2016, interest income from trading agency MBS was reported based upon each security's stated coupon rate. Refer to "Note 2. Summary of Significant Accounting Policies" within the notes to the consolidated financial statements for further information about our accounting policies for recognizing interest income for our investments in MBS.

Net interest income determined in accordance with GAAP does not include TBA agency MBS dollar roll income, which represents the economic equivalent of net interest income generated from our investments in non-specified fixed-rate agency MBS, nor does it include the implied net interest income or expense of our interest rate derivative hedging instruments, which are not designated as hedging instruments for financial reporting purposes. In our consolidated statements of comprehensive income prepared in accordance with GAAP, TBA agency MBS dollar roll income and the implied net interest income or expense incurred from our interest rate derivative instruments are reported as a component of the overall periodic change in the fair value of derivative instruments within the line item "gain (loss) from derivative instruments, net" of the "investment gain (loss), net" section.

Investment Gain (Loss), Net

“Investment gain (loss), net” primarily consists of periodic changes in the fair value (whether realized or unrealized) of investments in MBS classified as trading securities, periodic changes in the fair value (whether realized or unrealized) of derivative instruments, gains (losses) realized upon the sale of investments in MBS classified as available-for-sale, and other-than-temporary impairment charges for investments in MBS classified as available-for-sale.

We evaluate available-for-sale securities for other-than-temporary impairment on a quarterly basis. When the fair value of an available-for-sale security is less than its amortized cost at the reporting date, the security is considered impaired. When evaluating whether an impairment is other-than-temporary, consideration is given to (1) the length of time and the extent to which the fair value has been lower than amortized cost, (2) the severity of the decline in fair value, (3) the financial condition and near-term prospects of the issuer, (4) our intent to sell the security, and (5) whether it is more-likely-than-not we would be required to sell the security before anticipated recovery of our amortized cost basis.

For private-label MBS, on a quarterly basis, we re-estimate the amount and timing of cash flows expected to be collected based upon current information and events. For available-for-sale private-label MBS that are impaired, we compare the present value of our revised estimate of the amount and timing of expected cash flows, discounted at the security’s existing effective interest rate used for interest income recognition, to the security’s amortized cost basis. Any shortfall between the present value of cash flows expected to be collected and the security’s amortized cost basis is recognized as an other-than-temporary impairment charge in net income as a component of “investment gain (loss), net.”

Expenses

“Compensation and benefits expense” includes base salaries, annual incentive cash compensation, and non-cash stock-based compensation. Salaries, payroll taxes, and employee benefits are relatively fixed in nature. Annual cash incentive compensation is based on meeting estimated annual performance measures and discretionary components. Non-cash stock-based compensation includes expenses associated with all stock-based awards granted to employees, including the Company’s performance share units to named executive officers.

“Other expenses” primarily consists of the following:

- professional services expenses, including accounting, legal, and consulting fees;
- insurance expenses, including liability and property insurance;
- occupancy and equipment expense, including rental costs for our facilities, and depreciation and amortization of equipment and software;
- Board of Director fees; and
- other operating expenses, including communication expenses, business development costs, printing and copying, business licenses and taxes, offices supplies, and other miscellaneous office expenses.

Three months ended March 31, 2016 compared to three months ended March 31, 2015

We reported a net loss of \$31.6 million, or a loss of \$1.38 per diluted share, for the three months ended March 31, 2016 compared to a net loss of \$42.2 million, or a loss of \$1.84 per diluted share, for the three months ended March 31, 2015 which included the following results for the periods indicated (dollars in thousands, except per share amounts):

	Three Months Ended March 31,	
	2016	2015
Interest income	\$28,754	\$30,510
Interest expense	6,693	3,728
Net interest income	22,061	26,782
Investment loss, net	(49,890)	(52,807)
Other expenses	4,335	3,418
Loss before income taxes	(32,164)	(29,443)
Income tax (benefit) provision	(546)	12,742
Net loss	\$(31,618)	\$(42,185)
Diluted loss per share	\$(1.38)	\$(1.84)
Weighted-average diluted shares outstanding	22,994	22,973

Net Interest Income

Net interest income determined in accordance with GAAP (“GAAP net interest income”) decreased \$4.7 million, or 17.5%, from \$26.8 million for the three months ended March 31, 2015 to \$22.1 million for the three months ended March 31, 2016. The decrease is primarily due to (i) sales of private-label MBS, (ii) a substantial increase in our net long TBA position, and (ii) a 27 basis point, or 71%, increase in the average interest costs of our short-term financing arrangements due primarily to an increase in prevailing benchmark interest rates. As previously noted, TBA dollar roll income is not included in net interest income determined in accordance with GAAP.

The components of GAAP net interest income from our MBS investments portfolio, excluding interest expense on unsecured long-term debt, are summarized in the following table (dollars in thousands):

	Three Months Ended March 31, 2016			2015		
	Average Balance	Income (Expense)	Yield (Cost)	Average Balance	Income (Expense)	Yield (Cost)
Agency-backed MBS	\$3,499,784	\$ 25,655	2.93 %	\$3,352,083	\$ 25,460	3.04 %
Private-label MBS	115,127	2,971	10.32 %	211,233	5,043	9.55 %
Interest-only MBS	162	3	7.52 %	203	6	10.96 %
	\$3,615,073	28,629	3.17 %	\$3,563,519	30,509	3.42 %
Other		125			1	
		28,754			30,510	
Repurchase agreements	\$3,222,396	(5,365)	(0.66)%	\$3,219,172	(3,080)	(0.38)%
FHLB advances	140,458	(135)	(0.38)%	—	—	—
	\$3,362,854	(5,500)	(0.65)%	\$3,219,172	(3,080)	(0.38)%
Net interest income/spread		\$ 23,254	2.52 %		\$ 27,430	3.04 %
Net interest margin			2.57 %			3.08 %

The effects of changes in the composition of our investments on our GAAP net interest income from our MBS investment activities are summarized below (dollars in thousands):

	Three Months Ended March 31, 2016 vs. Three Months Ended March 31, 2015		
	Rate ⁽¹⁾	Volume ⁽¹⁾	Total Change
MBS:			
Agency MBS	\$(905)	\$ 1,100	\$ 195
Private-label MBS	379	(2,451)	(2,072)
Total MBS	(526)	(1,351)	(1,877)
Interest-only MBS and other	—	121	121
Repurchase agreements	(2,319)	34	(2,285)

FHLB advances	—	(135)	(135)
	\$(2,845)	\$(1,331)	\$(4,176)

⁽¹⁾The change in interest income and interest expense due to both rate and volume has been allocated to rate and volume changes in proportion to the relationship of the absolute dollar amounts of the change in each. As previously noted, the decrease in GAAP net interest income from our MBS portfolio of \$4.1 million to \$23.3 million for the three months ended March 31, 2016 from \$27.4 for the comparative period of 2015 is primarily due to a reduction in our private-label MBS portfolio, a substantial increase in our TBA agency MBS portfolio, and an increase the average interest costs of our short-term financing arrangements. The decrease in yield in the overall MBS portfolio is primarily related to the decrease in the higher yielding unlevered private-label MBS portfolio from the prior period.

As a result of the substantial increase in our TBA agency MBS portfolio, TBA dollar roll income increased \$3.5 million to \$3.8 million for the three months ended March 31, 2016 from \$0.3 million for the comparative period of 2015. When adjusting our interest income determined in accordance with GAAP (“GAAP interest income”) to include TBA dollar roll income (which is net of implied financing costs), the total revenue earned from our aggregate investments portfolio for the three months ended March 31, 2016

increased by \$1.8 million, or 5.8%, relative to the comparative period from 2015. However, the increase in aggregate revenue was more than offset by a \$2.4 million increase in the interest costs of our short-term financing arrangements. The following table provides a comparison of GAAP interest income, GAAP net interest income (excluding interest expense from long-term debt), and TBA dollar roll income for the three month periods ended March 31, 2016 and March 31, 2015 (dollars in thousands):

	Three Months Ended March 31,		Increase (Decrease) Expressed in:		
	2016	2015	Amount	Percentage	
GAAP interest income	\$28,754	\$30,510	\$(1,756)	(5.76)	%
TBA dollar roll income ⁽¹⁾	3,795	259	3,536	1365.25	%
GAAP interest income plus TBA dollar roll income	32,549	30,769	1,780	5.79	%
Interest expense on short-term debt	5,500	3,080	2,420	78.57	%
Net interest income plus TBA dollar roll income	\$27,049	\$27,689	\$(640)	(2.31)	%

⁽¹⁾TBA dollar roll income is net of implied financing costs.

Interest expense related to long-term debt was \$1.2 million and \$0.6 million for the three months ended March 31, 2016 and 2015, respectively. The increase in interest expense on long-term debt is primarily attributable to the issuance of \$35.3 million of Senior Notes in March 2015.

Investment Loss, Net

“Total investment loss, net” decreased \$2.9 million from a loss of \$52.8 million for the three months ended March 31, 2015 to a loss of \$49.9 million for the three months ended March 31, 2016. In each of these periods, decreases in interest rates resulted in a net increase in the fair value of our agency MBS and a net decrease in the fair value of our interest rate derivative instruments. MBS spread widening occurred within each of these periods, which resulted in the recognition of net losses on our interest rate derivative instruments (intended to economically hedge our interest rate risk) that exceeded the net gains recognized on our agency MBS investments and TBA transactions, as illustrated in the table to follow (dollars in thousands):

	Three Months Ended March 31,	
	2016	2015
Realized gains on sale of available-for-sale investments, net	\$-	\$3,348
OTTI charges on available-for-sale securities	(99)	-
Gains on trading investments, net	50,950	19,745
Gains from commitments to purchase and sell MBS, net	11,319	1,147
Interest rate swap net interest expense ⁽¹⁾	(3,997)	-
Losses from interest rate derivative instruments, net	(108,082)	(77,159)
Other, net	19	112
Investment loss, net	\$(49,890)	\$(52,807)

⁽¹⁾Represents the periodic net interest settlement incurred during the period (often referred to as "net interest carry").

Available-for-sale investments substantially consist of our private-label MBS acquired prior to 2015. The realized gains on the sale of available-for-sale investments, net, recognized for the three months ended March 31, 2015 were the result of \$20.9 million of proceeds received from the sales of private-label MBS resulting in a realized gain of \$3.3 million. There were no sales of private-label MBS for the three months ended March 31, 2016.

We recorded credit related other-than-temporary impairment charges of \$0.1 million for the three months ended March 31, 2016 on available-for-sale, private-label MBS. We recorded no other-than-temporary impairment charges for the three months ended March 31, 2015 on available-for-sale, private-label MBS. Credit related other-than-temporary impairment charges represent the excess of the amortized cost basis over the present value of expected future cash flows discounted at the security's existing effective interest rate used for interest income recognition.

Investments classified as trading securities primarily consist of agency MBS. The \$51.0 million and \$19.7 million of gains on trading investments, net, recognized for the three months ended March 31, 2016 and March 31, 2015, respectively were primarily the result of net unrealized holding gains as well as net realized gains from sales of trading investments. The key drivers in the net gains on trading investments for each of these periods were decreases in long-term interest rates, partially offset by MBS spread widening. As long-term interest rates decline, the price of fixed-rate agency MBS generally increases. During the three months ended March 31,

2016 and March 31, 2015, the 10-year U.S. Treasury rate decreased by 49 basis points and 23 basis points, respectively. However, MBS mortgage spreads widened during each of these periods, which partially offset the rise in the fair value of fixed-rate agency MBS attributable to the decline in interest rates.

Commitments to purchase and sell MBS consist primarily of forward-settling purchases of TBA agency MBS. We generally utilize TBA dollar roll transactions to finance agency MBS purchases and may also, from time to time, enter into TBA contracts as a means of acquiring and disposing of agency MBS. We recognized net gains from commitments to purchase and sell MBS of \$11.3 million and \$1.1 million for the three months ended March 31, 2016 and 2015, respectively, which consists of both dollar roll income and mark-to-market gains and losses on the TBA transactions.

Our interest rate derivative instruments consist primarily of interest rate swaps, U.S. Treasury note futures, put options on U.S. Treasury note futures, and have historically also included Eurodollar futures, interest rate swap futures, and other put options on futures. While we use interest rate derivatives to economically hedge a portion of our interest rate risk, we have not designated such contracts as hedging instruments for financial reporting purposes. As a result, the implied economic financing costs of our interest rate derivatives are included in the change in fair value of the instruments recognized in “investment loss, net” rather than in net interest income. During periods of falling interest rates, we will generally experience losses on our interest rate derivative instruments and during periods of rising interest rates, we will generally experience gains on our interest rate derivative instruments.

The \$108.1 million and \$77.2 million of losses from interest rate derivative instruments, net, recognized for the three months ended March 31, 2016 and the comparative period from 2015, respectively, were the result of net realized and unrealized mark-to-market adjustments. The key drivers in the net losses from interest rate derivatives for the three months ended March 31, 2016 and the comparative period from 2015, respectively, were (i) the implied economic financing costs of certain of the interest rate derivatives and (ii) the decrease in interest rates during those periods.

The fair value of our hedging instruments is expected to fluctuate inversely relative to the change in fair value of the agency MBS portfolio. However, the degree of correlation between the price movements of our hedging instruments and those of our agency MBS portfolio may vary. While our hedging instruments are designed to protect our agency MBS portfolio from interest rate risk, they are not generally designed to protect our net book value from spread risk, which is the risk of an increase of the market spread between the yield on our agency MBS and the benchmark yield on U.S. Treasury securities or interest rate swaps.

Other Expenses

Other expenses increased by \$0.9 million, or 26.5%, from \$3.4 million for the three months ended March 31, 2015 to \$4.3 million for the three months ended March 31, 2016, primarily due to an increase in expenses for legal and proxy related services as well as the reversal of stock-based compensation recognized in the prior year due to the Company's results falling short of certain performance measurements. During the three months ended March 31, 2016, we incurred \$0.4 million in expenses stemming from the 2016 proxy contest that are in excess of the level of expenses normally incurred for an annual meeting of shareholders. For information about the 2016 proxy contest, refer to “Item 1A. Risk Factors” within this quarterly report. In addition, the compensation and benefits expense for the three months ended March 31, 2015 included the reversal of \$0.3 million of expense recognized in prior years due to a reduction in the expected number of performance share units expected to vest.

Income Tax Benefit and Provision

We recognized an income tax benefit of \$0.5 million and an income tax provision of \$12.7 million for the three months ended March 31, 2016 and 2015, respectively. The income tax benefit and provision recognized for the three

months ended March 31, 2016 and 2015, respectively, are net of increases in the valuation allowance against the deferred tax assets of \$12.0 million and \$25.4 million, respectively, primarily due to net capital losses generated during those periods. The net capital losses for the three months ended March 31, 2016 and 2015 were attributable primarily to realized and unrealized losses on certain of our economic interest rate hedging instruments. The valuation allowance represents the portion of our net capital loss carryforward that is more-likely-than-not to expire unutilized.

Other Comprehensive Loss

Other comprehensive income (loss) represents periodic unrealized holding gains and losses related to our investments in MBS classified as available-for-sale. Accumulated unrealized holding gains and losses for available-for-sale MBS are reclassified into net income as a component of “investment gain (loss), net” upon (i) sale or realization, or (ii) the occurrence of an other-than-temporary impairment. Other comprehensive loss was \$4.9 million and \$7.9 million for the three months ended March 31, 2016 and 2015, respectively. For the three months ended March 31, 2016, other comprehensive loss included net unrealized holding losses of \$8.1 million on the available-for-sale MBS portfolio, net of a tax benefit of \$3.2 million, and \$99.2 thousand of other-than-temporary

impairment charges on available-for-sale securities, net of a tax provision of \$38.6 thousand. For the three months ended March 31, 2015, other comprehensive loss included net unrealized holding losses of \$7.2 million on the available-for-sale MBS portfolio, net of a tax benefit of \$2.7 million and \$3.7 million of reversal of prior period net unrealized gains upon the sale of available-for-sale MBS, net of a tax benefit of \$0.4 million.

Liquidity and Capital Resources

Liquidity is a measurement of our ability to meet potential cash requirements including ongoing commitments to repay borrowings, fund investments, meet margin calls on our short-term borrowings and hedging instruments, and for other general business purposes. Our primary sources of funds for liquidity consist of existing cash balances, short-term borrowings (for example, repurchase agreements), principal and interest payments from our investments in MBS, and proceeds from sales of MBS. Other sources of liquidity include proceeds from the offering of common stock, preferred stock, debt securities, or other securities registered pursuant to our effective shelf registration statement filed with the Securities and Exchange Commission ("SEC").

Liquidity, or ready access to funds, is essential to our business. Perceived liquidity issues may affect our counterparties' willingness to engage in transactions with us. Our liquidity could be impaired due to circumstances that we may be unable to control, such as a general market disruption or an operational problem that affects us or third parties. Further, our ability to sell assets may be impaired if other market participants are seeking to sell similar assets at the same time. If we cannot obtain funding from third parties or from our subsidiaries, our results of operations could be negatively impacted.

As of March 31, 2016, our debt-to-equity leverage ratio was 7.2 to 1. As of March 31, 2016, our "at risk" leverage ratio was 9.9 to 1. Our "at risk" leverage is measured as the ratio of the sum of our total debt (excluding any unamortized issuance costs) and net payable for unsettled securities compared to our tangible stockholders' equity. Tangible stockholders' equity is measured as our stockholders' equity less our net deferred tax asset.

Cash Flows

As of March 31, 2016, our cash and cash equivalents totaled \$43.2 million, representing a net increase of \$6.2 million from \$37.0 million as of December 31, 2015. Cash provided by operating activities of \$21.2 million during the three months ended March 31, 2016 was attributable primarily to net interest income less our expenses. Cash provided by investing activities of \$558.7 million during the three months ended March 31, 2016 was primarily generated by sales of agency MBS and the receipt of principal payments from agency MBS, partially offset by purchases of new agency MBS and funding of deposits for margin calls on our interest rate derivative instruments. Cash used in financing activities of \$573.7 million during the three months ended March 31, 2016 relates primarily to net repayments of FHLBC advances and dividend payments to common stockholders, partially offset by proceeds obtained from repurchase agreements used to finance a portion of our MBS investments portfolio.

Sources of Funding

We believe that our existing cash balances, net investments in MBS, cash flows from operations, borrowing capacity, and other sources of liquidity will be sufficient to meet our cash requirements for at least the next twelve months. We may, however, seek debt or equity financings, in public or private transactions, to provide capital for corporate purposes and/or strategic business opportunities, including possible acquisitions, joint ventures, alliances or other

business arrangements which could require substantial capital outlays. Our policy is to evaluate strategic business opportunities, including acquisitions and divestitures, as they arise. There can be no assurance that we will be able to generate sufficient funds from future operations, or raise sufficient debt or equity on acceptable terms, to take advantage of investment opportunities that become available. Should our needs ever exceed these sources of liquidity, we believe that most of our investments could be sold, in most circumstances, to provide cash. However, we may be required to sell our assets in such instances at depressed prices.

As of March 31, 2016, liquid assets consisted primarily of cash and cash equivalents of \$43.2 million and net investments in MBS of \$326.4 million. Cash equivalents consist primarily of money market funds invested in debt obligations of the U.S. government. The Company's net investments in MBS is calculated as the sum of the Company's total MBS investments at fair value and receivable for sold MBS, less the sum of the repurchase agreements outstanding and payable for purchased MBS. The \$326.4 million net investment in MBS includes \$71.8 million of unpledged private-label MBS.

Long-Term Debt

As of March 31, 2016, we had \$73.5 million of total long-term debt, net of unamortized debt issuance costs of \$1.8 million. Our trust preferred debt obligations with an aggregate principal amount of \$15.0 million outstanding as of March 31, 2016 accrue and

require the payment of interest quarterly at three-month LIBOR plus 2.25% to 3.00% and mature between 2033 and 2035. Our 6.625% Senior Notes due 2023 with a principal amount of \$25.0 million outstanding as of March 31, 2016 accrue and require payment of interest quarterly at an annual rate of 6.625% and mature on May 1, 2023. Our 6.75% Senior Notes due 2025 with a principal amount of \$35.3 million outstanding as of March 31, 2016 accrue and require payment of interest quarterly at an annual rate of 6.75% and mature on March 15, 2025.

Repurchase Agreements

We have short-term financing facilities that are structured as repurchase agreements with various financial institutions to fund our investments in MBS. We have obtained, and believe we will be able to continue to obtain, short-term financing in amounts and at interest rates consistent with our financing objectives. Funding for MBS through repurchase agreements continues to be available to us at rates we consider to be attractive from multiple counterparties.

During 2015, as part of our continuous effort to further expand our funding sources to increase liquidity, flexibility, and profitability, we completed the steps necessary to begin executing repurchase agreements directly with cash lenders rather than through a broker/dealer intermediary. We executed our first direct repurchase agreement borrowing during the fourth quarter of 2015. In addition to expanding our existing pool of funding sources, having the ability to execute repurchase agreements directly with cash lenders provides us with the potential for reduced funding costs and increased profitability by eliminating the “bid/ask spread” generally retained by the broker/dealer intermediary in a traditional repurchase agreement execution.

Our repurchase agreements include provisions contained in the standard master repurchase agreement as published by the Securities Industry and Financial Markets Association and may be amended and supplemented in accordance with industry standards for repurchase facilities. Our repurchase agreements include financial covenants, with which the failure to comply would constitute an event of default under the applicable repurchase agreement. Similarly, each repurchase agreement includes events of insolvency and events of default on other indebtedness as similar financial covenants. As provided in the standard master repurchase agreement as typically amended, upon the occurrence of an event of default or termination, the applicable counterparty has the option to terminate all repurchase transactions under such counterparty’s repurchase agreement and to demand immediate payment of any amount due from us to the counterparty.

Under our repurchase agreements, we may be required to pledge additional assets to our repurchase agreement counterparties in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (commonly referred to as a “margin call”), which may take the form of additional securities or cash. Margin calls on repurchase agreements collateralized by our MBS investments primarily result from events such as declines in the value of the underlying mortgage collateral caused by factors such as rising interest rates or prepayments. Our repurchase agreements generally provide that valuations for MBS securing our repurchase agreements are to be obtained from a generally recognized source agreed to by both parties. However, in certain circumstances and under certain of our repurchase agreements, our lenders have the sole discretion to determine the value of the MBS securing our repurchase agreements. In such instances, our lenders are required to act in good faith in making determinations of value. Our repurchase agreements generally provide that in the event of a margin call, we must provide additional securities or cash on the same business day that the margin call is made if the lender provides us notice prior to the margin notice deadline on such day.

To date, we have not had any margin calls on our repurchase agreements that we were not able to satisfy with either cash or additional pledged collateral. However, should we encounter increases in interest rates or prepayments, margin calls on our repurchase agreements could result in a material adverse change in our liquidity position.

Our repurchase agreements generally mature within 30 to 90 days, but may have maturities as short as one day and as long as one year. In the event that market conditions are such that we are unable to continue to obtain repurchase agreement financing for our investments in MBS in amounts and at interest rates consistent with our financing objectives, we may liquidate such investments and may incur significant losses on any such sales of MBS.

In the event that market conditions are such that we are unable to obtain financing for our investments in MBS in amounts and at interest rates consistent with our financing objectives, to the extent deemed appropriate, we may use cash to finance our investments or we may liquidate such investments. Accordingly, depending upon market conditions, we may incur significant losses on any such sales of MBS.

The following table provides information regarding our outstanding repurchase agreement borrowings as of dates and periods indicated (dollars in thousands):

	March 31, 2016	December 31, 2015		
Pledged with agency MBS:				
Repurchase agreements outstanding	\$3,029,877	\$2,797,561		
Agency MBS collateral, at fair value	3,200,829	2,946,684		
Net amount ⁽¹⁾	170,952	149,123		
Weighted-average rate	0.66	%	0.61	%
Weighted-average term to maturity	16.0 days		12.8 days	
Pledged with private-label MBS:				
Repurchase agreements outstanding	\$32,504	\$37,219		
Private-label MBS collateral, at fair value	57,463	70,511		
Net amount ⁽¹⁾	24,959	33,292		
Weighted-average rate	2.45	%	2.42	%
Weighted-average term to maturity	2.9 days		16.9 days	
Total MBS:				
Repurchase agreements outstanding	\$3,062,381	\$2,834,780		
MBS collateral, at fair value	3,258,292	3,017,195		
Net amount ⁽¹⁾	195,911	182,415		
Weighted-average rate	0.68	%	0.64	%
Weighted-average term to maturity	15.9 days		12.8 days	
Maximum amount outstanding at any month-end				
during the period	\$3,520,978	\$3,911,987		

⁽¹⁾Net amount represents the value of collateral in excess of corresponding repurchase obligation. The amount of collateral at-risk is limited to the outstanding repurchase obligation and not the entire collateral balance. To limit our exposure to counterparty risk, we diversify our repurchase agreement funding across multiple counterparties and by counterparty region. As of March 31, 2016, we had outstanding repurchase agreement balances with 16 counterparties. We currently have master repurchase agreements in place with a total of 18 counterparties located throughout North America, Europe and Asia. As of March 31, 2016, less than 6% of our stockholders' equity was at risk with any one counterparty, with the top five counterparties representing approximately 21% of our stockholders' equity. The table below includes a summary of our repurchase agreement funding by number of counterparties and counterparty region as of March 31, 2016 (dollars in thousands):

	Number of Counterparties	Percentage of Repurchase Agreement Funding	
North America	11	66.9	%
Europe	2	12.9	%

Asia	3	20.2	%
	16	100.0	%

Federal Home Loan Bank Advances

In September 2015, our wholly-owned captive insurance subsidiary, Key Bridge Insurance, LLC (“Key Bridge”), was granted membership to the FHLB of Cincinnati (“FHLBC”). The FHLBC, like each of the 11 regional FHLBs, is a cooperative that provides its member financial institutions with a number of financial products and services, including short and long-term secured borrowings that are known as “advances.” FHLBC advances may be collateralized by a number of real estate related assets, including agency MBS. Similar to a repurchase agreement borrowing, we would pledge agency MBS as collateral to secure the advance to Key Bridge, the amount of which is equal to a specified percentage of the fair value of the pledged collateral. We would retain beneficial ownership of the pledged collateral throughout the term of the advance arrangement.

On January 12, 2016, the regulator of the FHLB system, the Federal Housing Finance Agency (“FHFA”), released a final rule that amends regulations governing FHLB membership, including an amendment which prevents captive insurance companies from being eligible for FHLB membership. Under the terms of the final rule, Key Bridge is required to terminate its membership and repay its existing advances within one year following the final rule’s effective date of February 19, 2016. In addition, Key Bridge is

prohibited from obtaining new advances during the one year transition period. As of March 31, 2016, Key Bridge repaid all of its outstanding FHLBC advances, funded primarily through proceeds the Company obtained from traditional repurchase agreement financing arrangements.

Derivative Instruments

In the normal course of our operations, we are a party to financial instruments that are accounted for as derivative financial instruments including interest rate swaps, Eurodollar futures, interest rate swap futures, U.S. Treasury note futures, put options and forward TBA purchases and sales.

We exchange collateral with the counterparties to our interest rate derivative instruments at least on a daily basis based upon daily changes in fair value (also known as “variation margin”) as measured by the central clearinghouse through which those derivatives are cleared. In addition, the central clearinghouse requires market participants to deposit and maintain an “initial margin” amount which is determined by the clearinghouse and is generally intended to be set at a level sufficient to protect the clearinghouse from the maximum estimated single-day price movement in that market participant’s contracts. The clearing exchanges have the sole discretion to determine the value of derivative instruments. In the event of a margin call, we must generally provide additional collateral on the same business day. To date, we have not had any margin calls on our derivative agreements that we were not able to satisfy. However, if we encounter significant decreases in long-term interest rates, margin calls on our derivative agreements could result in a material adverse change in our liquidity position

As of March 31, 2016, we had outstanding centrally cleared interest rate swaps and exchange traded 10-year U.S. Treasury note futures with the following aggregate notional amount, net fair value and corresponding margin held in collateral deposit with the custodian (in thousands):

	March 31, 2016		
	Notional Amount	Net Fair Value	Collateral Deposit
Interest rate swaps	\$1,750,000	\$(44,700)	\$ 77,088
10-year U.S. Treasury note futures	375,000	733	4,280

Share Repurchase Program

In October 2015, the Board of Directors authorized an increase in our share repurchase program pursuant to which the Company may repurchase up to 2.0 million shares of its Class A common stock. As of March 31, 2016, 1.95 million shares of Class A common stock remained available for repurchase under the repurchase program.

Dividends

Pursuant to our variable dividend policy, our Board of Directors evaluates dividends on a quarterly basis and, in its sole discretion, approves the payment of dividends. Our dividend payments, if any, may vary significantly quarter to quarter. The Board of Directors has approved and the Company has declared and paid the following dividends to date in 2016:

Dividend				
Quarter Ended	Amount	Declaration Date	Record Date	Pay Date

March 31	\$ 0.625	March 15	March 31	April 29
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The Board of Directors approved and the Company declared and paid the following dividends for 2015:

Dividend				
Quarter Ended	Amount	Declaration Date	Record Date	Pay Date
December 31	\$ 0.625	December 17	December 31	January 29, 2016
September 30	0.625	September 17	September 30	October 30
June 30	0.875	June 17	June 30	July 31
March 31	0.875	March 10	March 31	April 30

Off-Balance Sheet Arrangements

As of March 31, 2016 and December 31, 2015, we did not maintain any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, or special purpose or variable interest entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, as of March 31, 2016

and December 31, 2015, we had not guaranteed any obligations of unconsolidated entities or entered into any commitment or intent to provide funding to any such entities.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the exposure to loss resulting from changes in market factors such as interest rates, foreign currency exchange rates, commodity prices, equity prices, and other market changes that affect market risk sensitive instruments. The primary market risks that we are exposed to are interest rate risk (including prepayment risk and extension risk), credit risk, spread risk, liquidity risk, and regulatory risk. See “Item 1 — Business” in our Annual Report on Form 10-K for the year ended December 31, 2015 for a description of our risk management strategies.

Credit Risk

Although we do not expect to encounter credit risk in our agency MBS portfolio assuming Fannie Mae and Freddie Mac remain solvent, we are exposed to credit risk in our private-label MBS portfolio. With respect to our private-label MBS, credit support contained in these MBS deal structures provides a level of protection from losses, as do the our discounted purchase prices in the event of the return of less than 100% of par. We evaluate the impact of credit risk on our investments through a comprehensive investment review and selection process, which is predominantly focused on quantifying and pricing credit risk. We review our private-label MBS based on quantitative and qualitative analysis of the risk-adjusted returns on such investments. Through modeling and scenario analysis, we seek to evaluate each investment’s credit risk. Subsequent to the acquisition of a private-label MBS, we continue to monitor and evaluate its credit risk through ongoing asset surveillance and analysis. Despite the measures that we take to manage our exposure to credit risk, unanticipated credit losses could nonetheless occur, which could adversely impact our operating results.

Our private-label MBS are generally purchased at a discount to par value. Prior to acquisition and on an on-going basis subsequent to acquisition, we estimate the amount and timing of the cash flows expected to be collected from each private-label MBS. In preparing our future cash flow estimates, we develop a number of assumptions about the future performance of the pool of mortgage loans that serve as collateral for our investment, including assumptions about the timing and amount of prepayments and credit losses. In developing these estimates, we consider economic conditions and security-level characteristics including, but not limited to, the following:

- the cash flow structure of the issuing securitization vehicle;
- the current composition and credit characteristics of the security’s pool of mortgage loan collateral;
- current levels of credit enhancements (including structural credit enhancements), including, for resecuritization certificates, the level and type of credit enhancements (for example, subordination) that exist in the underlying structured securitization vehicle;
- prevailing interest rates;
- realized home price appreciation;
- recent historical collateral performance, including voluntary prepayment, default, and loss severity rates;
- forecasts of economic factors, such as interest rates and future home price appreciation; and
- to the extent available, assumptions published by third parties about future voluntary prepayment, default, and loss severity rates for similar private-label MBS collateral pools.

Developing estimates of the amount and timing of the future cash flows from our investments in private-label MBS requires us to exercise significant subjective judgment about matters that are inherently uncertain. Actual results may differ from our estimates, which could have a significant and potentially adverse effect on our financial condition, results of operations, and cash flows.

The following table presents certain characteristics of our investments in private-label MBS as well as the residential mortgage loans that ultimately serve as their collateral as of and for the three months ended March 31, 2016:

	Total Private-Label MBS	
Weighted-average coupon	3.0	%
Delinquencies greater than 60 plus days	12.4	%
Credit enhancement	1.8	%
Three-month voluntary prepayment rate (annualized)	6.9	%
Three-month default rate (annualized)	4.1	%
Three-month loss severity rate ⁽¹⁾	46.3	%
Three-month credit loss rate (annualized) ⁽²⁾	1.9	%

⁽¹⁾Represents a “loss-given-default” rate. Private-label MBS collateral pools which experienced no defaults within the three-month historical period are excluded from the loss severity rate calculation.

⁽²⁾ Calculated as the three-month default rate multiplied by the three-month loss severity rate.

Key credit metrics for our private-label MBS portfolio reflected slight deterioration during the three months ended March 31, 2016 as compared to the prior quarter. Total 60-day plus delinquencies in our private-label MBS portfolio’s collateral pools increased to 12.4% at March 31, 2016 from 11.9% at December 31, 2015 while three-month credit loss rates increased to 1.9% from 1.7%. The increase in three-month credit loss rates is the result of an increase in the three-month loss severity rates on liquidated loans to 46.3% from 36.9%, slightly offset by a decrease in the rate of defaulted loan liquidations. We will continue to monitor the credit performance of each security in our private-label MBS portfolio and assess the impact on the overall performance of the portfolio.

The table that follows illustrates the change in fair value for our current private-label MBS under several hypothetical credit loss scenarios. Our private-label MBS are classified as Level 3 within the fair value hierarchy as private-label MBS trade infrequently and, therefore, the measurement of their fair value requires the use of significant unobservable inputs. In determining fair value, we primarily use present value techniques based on estimated cash flows of the instrument taking into consideration various assumptions that are based on our observations of assumptions used by market participants. The primary credit-related assumptions that are incorporated into the fair value measurement are the default rate, which represents the annual rate of expected defaulted loan liquidation events (such as foreclosure sales or short sales), and loss severity rates (or “loss-given-default”). The table below illustrates the effect that a 10% increase and decrease, respectively, in the default rate and loss severity rate assumptions from those used in our fair value measurements as of March 31, 2016 would have on total assets and stockholders’ equity as of March 31, 2016. Each 10% increase (decrease) in the default rate and loss severity rate assumptions was implemented in isolation (dollars in thousands, except per share amounts):

March 31, 2016

Value

Value

		Value with 10% Increase	Percent Change	Value with 10% Decrease	Percent Change	with 10% Increase in Loss Severity Rate	Percent Change	with 10% Decrease in Loss Severity Rate	Percent Change
Private-label MBS	\$ 129,231	\$ 127,383	(1.43)%	\$ 131,129	1.47 %	\$ 126,751	(1.92)%	\$ 131,715	1.92 %
Stockholders' equity	433,673	431,825	(0.43)%	435,571	0.44 %	431,193	(0.57)%	436,157	0.57 %
Book value per share	\$ 18.86	\$ 18.78	(0.43)%	\$ 18.94	0.44 %	\$ 18.75	(0.57)%	\$ 18.97	0.57 %
Interest Rate Risk									

We are also exposed to interest rate risk in our MBS portfolio. Our investments in MBS are financed with short-term borrowing facilities such as repurchase agreements, which are interest rate sensitive financial instruments. Our exposure to interest rate risk fluctuates based upon changes in the level and volatility of interest rates, mortgage prepayments, and in the shape and slope of the yield curve, among other factors. Through the use of interest rate derivative instruments, we attempt to economically hedge a portion of our exposure to changes, attributable to changes in benchmark interest rates, in certain MBS fair values and future interest cash flows on our short-term financing arrangements. Our primary interest rate derivatives include centrally cleared interest rate swaps as well as exchange-traded instruments, such as U.S. Treasury note futures, and options on U.S. Treasury note futures. Historically, we have also utilized exchange-traded Eurodollar futures, interest rate swap futures, and other options on futures.

Changes in both short- and long-term interest rates affect us in several ways, including our financial position. As interest rates increase, the fair value of fixed-rate agency MBS may be expected to decline, prepayment rates may be expected to decrease and duration may be expected to extend. However, an increase in interest rates results in an increase in the fair value of our interest rate derivative instruments. Conversely, if interest rates decline, the fair value of fixed-rate agency MBS is generally expected to increase while the fair value of our interest rate derivatives is expected to decline.

The table that follows illustrates the expected change in fair value for our current investments in agency MBS and derivative instruments under several hypothetical scenarios of interest rate movements. For the purposes of this illustration, interest rates are defined by the U.S. Treasury yield curve. Changes in fair value are measured as percentage changes from their respective fair values presented in the column labeled "Value." Our estimate of the change in the fair value of agency MBS is based upon the same assumptions we use to manage the impact of interest rates on the portfolio. Actual results could differ significantly from these estimates. The effective durations are based on observed fair value changes, as well as our own estimate of the effect of interest rate changes on the fair value of the investments, including assumptions regarding prepayments based, in part, on age and interest rate of the mortgages underlying the MBS, prior exposure to refinancing opportunities, and an overall analysis of historical prepayment patterns under a variety of historical interest rate conditions.

The interest rate sensitivity analysis illustrated by the table that follows has certain limitations, most notably the following:

- The 100 basis point upward and downward shocks to interest rates that are applied in the analysis represent parallel shocks to the forward yield curve. The analysis does not consider the sensitivity of stockholders' equity to changes in the shape or slope of the forward yield curve.
- The analysis assumes that spreads remain constant and, therefore, does not reflect an estimate of the impact that changes in spreads would have on the value of our MBS investments or our LIBOR-based derivative instruments, such as our interest rate swap agreements.
- The analysis assumes a static portfolio and does not reflect activities and strategic actions that management may take in the future to manage interest rate risk in response to significant changes in interest rates or other market conditions.
- The yield curve that results from applying an instantaneous parallel 100 basis point decrease in interest rates reflects an interest rate of less than 0% in certain earlier portions of the curve. The results of the analysis included in the table to follow reflect the effect of these negative interest rates.

This analysis is not intended to provide a precise forecast. Actual results could differ materially from these estimates (dollars in thousands, except per share amounts):

	March 31, 2016					
	Value	Value with 100 Basis Point Increase in Interest Rates	Percent Change	Value with 100 Basis Point Decrease in Interest Rates	Percent Change	
Agency MBS	\$3,417,850	\$ 3,264,227	(4.49)%	\$ 3,483,609	1.92 %	
TBA commitment assets (liabilities), net	4,054	(26,698)	(758.56)%	12,910	218.45 %	
Interest rate derivative assets (liabilities), net ⁽¹⁾	(43,186)	171,546	497.23 %	(181,029)	(319.18)%	
Stockholders' equity	433,673	464,030	7.00 %	370,445	(14.58)%	
Book value per share	\$18.86	\$ 20.18	7.00 %	\$ 16.11	(14.58)%	

⁽¹⁾Includes interest rate swap agreements, U.S. Treasury note futures, and put options on U.S. Treasury note futures.

Inflation Risk

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our financial position and performance far more than inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and our distributions are determined by our Board of Directors in its sole discretion pursuant to our variable dividend policy; in each case, our activities and balance sheet are measured with reference to fair value without considering inflation.

Cautionary Statement About Forward-Looking Information

When used in this Quarterly Report on Form 10-Q, in future filings with the SEC or in press releases or other written or oral communications, statements which are not historical in nature, including those containing words such as “believe,” “expect,” “anticipate,” “estimate,” “plan,” “continue,” “intend,” “should,” “may” or similar expressions, are intended to identify “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Exchange Act and, as such, may involve known and unknown risks, uncertainties and assumptions. The forward-looking statements we make in this Quarterly Report on Form 10-Q include, but are not limited to, statements about the following:

- the availability and terms of, and our ability to deploy, capital and our ability to grow our business through a strategy focused on acquiring primarily residential MBS that are either issued by U.S. government agencies or guaranteed as to principal and interest by U.S. government agencies or U.S. government sponsored agencies and MBS issued by private organizations;
- our ability to forecast our tax attributes, which are based upon various facts and assumptions, and our ability to protect and use our net operating losses and net capital losses to offset future taxable income, including whether our shareholder rights plan (“Rights Plan”) will be effective in preventing an ownership change that would significantly limit our ability to utilize such losses;
- our business, acquisition, leverage, asset allocation, operational, investment, hedging and financing strategies and the success of these strategies;
- the effect of changes in prepayment rates, interest rates and default rates on our portfolio;
- the effect of governmental regulation and actions;
- our ability to quantify and manage risk;
- our ability to realize any reflation of our assets;
- our liquidity;
- our asset valuation policies;
- our decisions with respect to, and ability to make, future dividends;
- investing in assets other than MBS or pursuing business activities other than investing in MBS;
- our ability to maintain our exclusion from the definition of “investment company” under the Investment Company Act of 1940, as amended (the “1940 Act”); and
- the effect of general economic conditions on our business.

Forward-looking statements are based on our beliefs, assumptions and expectations of our future performance, taking into account information currently in our possession. These beliefs, assumptions and expectations may change as a result of many possible events or factors, not all of which are known to us or are within our control. If a change occurs, the performance of our portfolio and our business, financial condition, liquidity and results of operations may vary materially from those expressed, anticipated or contemplated in our forward-looking statements. You should carefully consider these risks, along with the following factors that could cause actual results to vary from our forward-looking statements, before making an investment in our securities:

- the overall environment for interest rates, changes in interest rates, interest rate spreads, the yield curve and prepayment rates, including the timing of increases in the Federal Funds rate by the Federal Reserve;
- current conditions and further adverse developments in the residential mortgage market and the overall economy;
- potential risk attributable to our mortgage-related portfolios, including changes in fair value;
- our use of leverage and our dependence on repurchase agreements and other short-term borrowings to finance our mortgage-related holdings;
- the availability of certain short-term liquidity sources;
 - competition for investment opportunities, including competition from the U.S. Department of Treasury and the Federal Reserve, for investments in agency MBS, as well as the timing of the termination by the Federal Reserve of its purchases of agency MBS;

· the federal conservatorship of the Fannie Mae and the Freddie Mac and related efforts, along with any changes in laws and regulations affecting the relationship between Fannie Mae and Freddie Mac and the federal government;

- mortgage loan prepayment activity, modification programs and future legislative action;
- changes in, and the success of, our acquisition, hedging and leverage strategies, changes in our asset allocation and changes in our operational policies, all of which may be changed by us without shareholder approval;
- failure of sovereign or municipal entities to meet their debt obligations or a downgrade in the credit rating of such debt obligations;
- fluctuations of the value of our hedge instruments;
- fluctuating quarterly operating results;
- changes in laws and regulations and industry practices that may adversely affect our business;
- volatility of the securities markets and activity in the secondary securities markets in the United States and elsewhere;
- our ability to successfully expand our business into areas other than investing in MBS; and
- the other important factors identified in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2015 under the caption “Item 1A — Risk Factors”.

These and other risks, uncertainties and factors, including those described elsewhere in this Quarterly Report on Form 10-Q, could cause our actual results to differ materially from those projected in any forward-looking statements we make. All forward-looking statements speak only as of the date on which they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Item 4. Controls and Procedures

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, our management, with the participation of our Chief Executive Officer, J. Rock Tonkel, Jr., and our Chief Financial Officer, Richard E. Konzmann, carried out an evaluation of the effectiveness of our disclosure controls and procedures (as defined under Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) pursuant to Rule 13a-15(b) of the Exchange Act. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure 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 SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding disclosure.

Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II

OTHER INFORMATION

Item 1. Legal Proceedings

We are from time to time involved in civil lawsuits, legal proceedings and arbitration matters relating to our business that we consider to be in the ordinary course. There can be no assurance that these matters individually or in aggregate will not have a material adverse effect on our financial condition or results of operations in a future period. We are also subject to the risk of litigation, including litigation that may be without merit. As we intend to actively defend such litigation, significant legal expenses could be incurred. An adverse resolution of any future litigation against us could materially affect our financial condition, results of operations and liquidity. Furthermore, we operate in highly-regulated markets that currently are under intense regulatory scrutiny, and we have received, and we expect in the future that we may receive, inquiries and requests for documents and information from various federal, state and foreign regulators. In addition, one or more of our subsidiaries have received requests to repurchase loans from various parties in connection with the former securitization business conducted by a subsidiary. We believe that the continued scrutiny of MBS, structured financed and derivative market participants increases the risk of additional inquiries and requests from regulatory or enforcement agencies and other parties. We cannot provide any assurance that these inquiries and requests will not result in further investigation of or the initiation of a proceeding against us or that, if any such investigation or proceeding were to arise, it would not materially adversely affect our Company.

Item 1A. Risk Factors

Our business could be negatively affected as a result of actions of Imation Corp. and entities affiliated with the Clinton Group, Inc., which actions could adversely impact the trading value of the Company's Class A common stock and Senior Notes.

We have received a notice from Imation Corp, an IT data storage and data security company, acting in concert with the Clinton Group, Inc. (the "Clinton Group") and an affiliated investment fund (together, "Imation Group"), of the Imation Group's intent to nominate a controlling slate of five candidates to stand for election to our eight-member board of directors at the 2016 annual meeting of shareholders. The Imation Group and certain other persons have filed a proxy statement with the SEC in connection with its solicitation of proxies from our shareholders to vote at our annual meeting. As of the record date for the 2016 annual meeting, the Imation Group owned collectively 11,000 shares of our Class A common stock, representing less than 0.05% of our outstanding common stock.

Responding to actions by activist shareholders like the Imation Group can be costly and time-consuming, disruptive to operations and divert the attention of management and employees. Specifically, a proxy contest for a control slate of directors at our annual meeting of shareholders would require us to incur significant proxy solicitation expenses and legal and other advisor expenses and require significant time and attention by management and our board of directors. The Imation Group has also disclosed in its proxy statement that, if it is successful in its solicitation, it intends to seek to have the Company reimburse the Imation Group's proxy solicitation expenses, and the Clinton Group has sought and obtained reimbursement of proxy solicitation expenses in connection with proxy contests at other companies. As a result, if the Imation Group is successful, we may also bear the costs of the Imation Group's proxy solicitation expenses.

In addition, the Imation Group has disclosed certain plans and initiatives regarding the operation, strategy, structure, management and business of the Company if it is successful in its solicitation that involve significant risk. Among other things, the Imation Group has proposed an externally managed structure and investing in new businesses, each of which would be a significant departure from our current business and strategy, and would, we believe, result in

significant additional costs to the Company. The Imation Group could in the future make additional or different strategic proposals, suggestions or requested changes concerning our operations, strategy, management, business or other matters. The Clinton Group and its director nominees at other companies at which it has conducted successful proxy contests, including Imation Corp., have entered into related party transactions with such companies and taken other actions that have negatively impacted the value of the securities of such companies, and they may seek to do the same at the Company. The Imation Group has not stated that it would not seek to implement similar self-dealing transactions at the Company if it succeeds in obtaining control of our board of directors. Such transactions could include, for example, the payment of additional fees to the Clinton Group, either in cash or common stock of the Company, or causing the Company to enter into asset management agreements, pursuant to which a member of the Clinton Group invests, or directs the investment of, the assets of the Company and charges additional fees. Such arrangements could involve substantial costs, which would be borne by all of the Company's shareholders, even where the investments perform poorly.

We cannot predict, and no assurances can be given, as to the outcome or timing of any matters relating to the foregoing. The perceived uncertainties as to our future direction and the actions that may be taken by the Imation Group may negatively affect the market price and volatility of our Class A common stock or Senior Notes.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Purchases of Equity Securities by the Issuer

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit

Number Exhibit Title

- | | |
|------|---|
| 3.01 | Amended and Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q filed on November 9, 2009). |
| 3.02 | Amended and Restated Bylaws, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed on July 28, 2011). |
| 3.03 | Amendment No. 1 to the Amended and Restated Bylaws (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed on February 4, 2015). |
| 4.01 | Indenture dated as of May 1, 2013 between the Company and Wells Fargo Bank, National Association, as trustee (incorporated by reference to Exhibit 4.1 of the Registrant's Current Report on Form 8-K filed on May 1, 2013). |
| 4.02 | First Supplemental Indenture dated as of May 1, 2013 between the Company and Wells Fargo Bank, National Association, as trustee (incorporated by reference to Exhibit 4.2 of the Registrant's Current Report on Form 8-K filed on May 1, 2013). |
| 4.03 | Form of Subordinated Indenture (incorporated by reference to Exhibit 4.2 of the Registrant's Registration Statement on Form S-3 (333-171537)). |
| 4.04 | Form of Senior Note (incorporated by reference to Exhibit 4.3 of the Registrant's Registration Statement on Form S-3 (133-171537)). |
| 4.05 | |

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Form of 6.625% Senior Notes due 2023 (incorporated by reference to Exhibit 4.3 to the Registrant's Current Report on Form 8-K filed on May 1, 2013).

- 4.06 Form of Certificate for Class A Common Stock (incorporated by reference to Exhibit 4.01 of the Annual Report on Form 10-K filed on February 24, 2010).
- 4.07 Shareholder Rights Agreement, dated June 5, 2009 (incorporated by reference to Exhibit 4.1 of the Registrant's Current Report on Form 8-K filed on June 5, 2009).
- 4.08 Second Supplemental Indenture, dated as of March 18, 2015, between the Registrant, Wells Fargo Bank, National Association, as Trustee and The Bank of New York Mellon, as Series Trustee (incorporated by reference to Exhibit 4.3 to the Registrant's Form 8-A filed on March 18, 2015).
- 4.09 Form of 6.750% Notes due 2025 (incorporated by reference to Exhibit 4.3 to the Current Report on Form 8-K filed by the Registrant on March 17, 2015).
- 12.01 Computation of Ratio of Earnings to Fixed Charges.*
- 18.01 Letter from PricewaterhouseCoopers LLP, independent registered public accounting firm, regarding change in accounting principle.*

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- 31.01 Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
- 31.02 Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
- 32.01 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**
- 32.02 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**
- 101.INS INSTANCE DOCUMENT***
- 101.SCH SCHEMA DOCUMENT***
- 101.CAL CALCULATION LINKBASE DOCUMENT***
- 101.LAB LABELS LINKBASE DOCUMENT***
- 101.PRE PRESENTATION LINKBASE DOCUMENT***
- 101.DEF DEFINITION LINKBASE DOCUMENT***

* Filed herewith.

**Furnished herewith.

*** Submitted electronically herewith. Attached as Exhibit 101 are the following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets at March 31, 2016 and December 31, 2015; (ii) Consolidated Statements of Comprehensive Income for the Three Months Ended March 31, 2016 and 2015; (iii) Consolidated Statements of Changes in Equity for the Three Months Ended March 31, 2016 and the Year Ended December 31, 2015; and (iv) Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2016 and 2015.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ARLINGTON ASSET INVESTMENT CORP.

By: /s/ RICHARD E. KONZMANN

Richard E. Konzmann

Executive Vice President, Chief Financial Officer and Treasurer

(Principal Financial and Accounting Officer)

Date: May 10, 2016

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