

American Capital Agency Corp  
Form 10-Q  
November 08, 2012

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012

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

Commission file number 001-34057

AMERICAN CAPITAL AGENCY CORP.  
(Exact name of registrant as specified in its charter)

Delaware 26-1701984  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)  
2 Bethesda Metro Center, 14th Floor  
Bethesda, Maryland 20814  
(Address of principal executive offices)  
(301) 968-9300  
(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "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  (Do not check if a smaller reporting company) Smaller Reporting Company

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

The number of shares of the issuer's common stock, \$0.01 par value, outstanding as of October 31, 2012 was 341,598,550



AMERICAN CAPITAL AGENCY CORP.  
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## PART I.-FINANCIAL INFORMATION

## Item 1. Financial Statements

AMERICAN CAPITAL AGENCY CORP.  
CONSOLIDATED BALANCE SHEETS  
(in millions, except per share data)

	September 30, 2012 (Unaudited)	December 31, 2011
Assets:		
Agency securities, at fair value (including pledged securities of \$83,600 and \$50,667, respectively)	\$88,020	\$54,625
Agency securities transferred to consolidated variable interest entities, at fair value	1,620	58
U.S. Treasury securities, at fair value (pledged security)	—	101
Cash and cash equivalents	2,569	1,367
Restricted cash	369	336
Derivative assets, at fair value	292	82
Receivable for securities sold (including pledged securities of \$1,466 and \$319, respectively)	2,326	443
Receivable under reverse repurchase agreements	6,712	763
Other assets	269	197
Total assets	\$102,177	\$57,972
Liabilities:		
Repurchase agreements	\$79,254	\$47,681
Debt of consolidated variable interest entities, at fair value	1,008	54
Payable for securities purchased	1,311	1,919
Derivative liabilities, at fair value	1,562	853
Dividends payable	430	314
Obligation to return securities borrowed under reverse repurchase agreements, at fair value	7,265	899
Accounts payable and other accrued liabilities	74	40
Total liabilities	90,904	51,760
Stockholders' equity:		
8.000% Series A Cumulative Redeemable Preferred Stock; \$0.01 par value; 6.9 and 0 shares issued and outstanding, respectively; liquidation preference of \$25 per share (\$173 and \$0, respectively)	167	—
Common stock, \$0.01 par value; 600.0 and 300.0 shares authorized; 341.6 and 224.1 shares issued and outstanding, respectively	3	2
Additional paid-in capital	9,536	5,937
Retained deficit	(672	) (38
Accumulated other comprehensive income	2,239	311
Total stockholders' equity	11,273	6,212
Total liabilities and stockholders' equity	\$102,177	\$57,972

See accompanying notes to consolidated financial statements.



AMERICAN CAPITAL AGENCY CORP.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)  
(in millions, except per share data)

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Interest income:				
Interest income	\$520	\$327	\$1,538	\$756
Interest expense	139	95	365	195
Net interest income	381	232	1,173	561
Other (loss) income, net:				
Gain on sale of agency securities, net	210	263	843	361
Loss on derivative instruments and other securities, net	(460)	(222)	(1,442)	(310)
Total other (loss) income, net	(250)	41	(599)	51
Expenses:				
Management fees	32	16	82	36
General and administrative expenses	8	6	22	13
Total expenses	40	22	104	49
Income before income tax provision	91	251	470	563
Income tax provision, net	5	1	4	1
Net income	86	250	466	562
Dividend on preferred stock	3	—	6	—
Net income available to common shareholders	\$83	\$250	\$460	\$562
Net income	\$86	\$250	\$466	\$562
Other comprehensive income:				
Unrealized gain on available-for-sale securities, net	1,190	536	1,773	815
Unrealized gain (loss) on derivative instruments, net	51	(512)	155	(704)
Other comprehensive income	1,241	24	1,928	111
Comprehensive income	1,327	274	2,394	673
Dividend on preferred stock	3	—	6	—
Comprehensive income available to common shareholders	\$1,324	\$274	\$2,388	\$673
Weighted average number of common shares outstanding - basic and diluted	332.8	180.7	291.6	134.2
Net income per common share - basic and diluted	\$0.25	\$1.39	\$1.58	\$4.19
Comprehensive income per common share - basic and diluted	\$3.98	\$1.52	\$8.19	\$5.01
Dividends declared per common share	\$1.25	\$1.40	\$3.75	\$4.20
See accompanying notes to consolidated financial statements.				

AMERICAN CAPITAL AGENCY CORP.  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY  
(in millions)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Retained (Deficit) Earnings	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount	Shares	Amount				
Balance, December 31, 2011	—	\$—	224.1	\$ 2	\$ 5,937	\$(38 )	\$ 311	\$6,212
Net income	—	—	—	—	—	641	—	641
Other comprehensive (loss) income:								
Unrealized loss on available-for-sale securities, net	—	—	—	—	—	—	(106 )	(106 )
Unrealized gain on derivative instruments, net	—	—	—	—	—	—	52	52
Issuance of common stock	—	—	75.9	1	2,204	—	—	2,205
Common dividends declared	—	—	—	—	—	(286 )	—	(286 )
Balance, March 31, 2012 (Unaudited)	—	—	300.0	3	8,141	317	257	8,718
Net loss	—	—	—	—	—	(261 )	—	(261 )
Other comprehensive income:								
Unrealized gain on available-for-sale securities, net	—	—	—	—	—	—	689	689
Unrealized gain on derivative instruments, net	—	—	—	—	—	—	52	52
Issuance of preferred stock	6.9	167	—	—	—	—	—	167
Issuance of common stock	—	—	4.8	—	155	—	—	155
Preferred dividends declared	—	—	—	—	—	(3 )	—	(3 )
Common dividends declared	—	—	—	—	—	(381 )	—	(381 )
Balance, June 30, 2012 (Unaudited)	6.9	167	304.8	3	8,296	(328 )	998	9,136
Net income	—	—	—	—	—	86	—	86
Other comprehensive income:								
Unrealized gain on available-for-sale securities, net	—	—	—	—	—	—	1,190	1,190
Unrealized gain on derivative instruments, net	—	—	—	—	—	—	51	51
Issuance of common stock	—	—	36.8	—	1,240	—	—	1,240
Preferred dividends declared	—	—	—	—	—	(3 )	—	(3 )
Common dividends declared	—	—	—	—	—	(427 )	—	(427 )
Balance, September 30, 2012 (Unaudited)	6.9	\$ 167	341.6	\$ 3	\$ 9,536	\$(672 )	\$ 2,239	\$11,273

See accompanying notes to consolidated financial statements.

AMERICAN CAPITAL AGENCY CORP.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)  
(in millions)

	Nine months ended September	
	30,	
	2012	2011
Operating activities:		
Net income	\$466	\$562
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of agency securities premiums and discounts, net	515	240
Amortization of accumulated other comprehensive loss on interest rate swaps de-designated as qualifying hedges	155	—
Gain on sale of agency securities, net	(843	) (361
Loss on derivative instruments and other securities, net	1,442	310
Increase in other assets	(79	) (91
Increase in accounts payable and other accrued liabilities	25	9
Accretion of discounts on debt of consolidated variable interest entities	2	—
Net cash provided by operating activities	1,683	669
Investing activities:		
Purchases of agency securities	(86,435	) (56,423
Proceeds from sale of agency securities	44,218	24,351
Principal collections on agency securities	6,906	3,058
Purchases of U.S. Treasury securities	(2,444	) (4,059
Proceeds from sale of U.S. Treasury securities	2,545	3,791
Proceeds from short sales of U.S. Treasury securities	29,698	12,054
Purchases of U.S. Treasury securities to cover short sales	(23,450	) (11,919
Proceeds from reverse repurchase agreements	50,715	28,615
Payments made on reverse repurchase agreements	(56,661	) (28,842
Net payments on other derivative instruments not designated as qualifying hedges	(816	) (194
Increase in restricted cash	(33	) (298
Net cash used in investing activities	(35,757	) (29,866
Financing activities:		
Proceeds from repurchase arrangements	310,225	247,495
Payments made on repurchase agreements	(278,652	) (220,333
Proceeds from debt of consolidated variable interest entities	1,000	—
Repayments on debt of consolidated variable interest entities	(80	) (16
Net proceeds from preferred stock issuances	167	
Net proceeds from common stock issuances	3,600	3,268
Cash dividends paid	(984	) (406
Net cash provided by financing activities	35,276	30,008
Net change in cash and cash equivalents	1,202	811
Cash and cash equivalents at beginning of period	1,367	173
Cash and cash equivalents at end of period	\$2,569	\$984
See accompanying notes to consolidated financial statements.		





AMERICAN CAPITAL AGENCY CORP.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1. Unaudited Interim Consolidated Financial Statements

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

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

Note 2. Organization

We were organized in Delaware on January 7, 2008, and commenced operations on May 20, 2008 following the completion of our initial public offering (“IPO”). Our common stock is traded on The NASDAQ Global Select Market under the symbol “AGNC”.

We operate so as to qualify to be taxed as a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended (the “Internal Revenue Code”). Therefore, substantially all of our assets, other than our taxable REIT subsidiary (“TRS”), consist of qualified real estate assets (as defined under the Internal Revenue Code). As a REIT, we are required to distribute annually 90% of our taxable net income. As long as we qualify as a REIT, we will generally not be subject to U.S. federal or state corporate taxes on our taxable net income to the extent that we distribute all of our annual taxable net income to our stockholders. It is our intention to distribute 100% of our taxable income, after application of available tax attributes, within the limits prescribed by the Internal Revenue Code, which may extend into the subsequent taxable year.

We are externally managed by American Capital AGNC Management, LLC (our “Manager”), an affiliate of American Capital, Ltd. (“American Capital”).

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

Our principal objective is to preserve our net asset value (also referred to as “net book value”, “NAV” and “stockholders’ equity”) while generating attractive risk-adjusted returns for distribution to our stockholders through regular quarterly dividends from the combination of our net interest income and net realized gains and losses on our investments and hedging activities. We fund our investments primarily through short-term borrowings structured as repurchase agreements.

Note 3. Summary of Significant Accounting Policies

Investment Securities

ASC Topic 320, Investments—Debt and Equity Securities (“ASC 320”), requires that at the time of purchase, we designate a security as held-to-maturity, available-for-sale or trading, depending on our ability and intent to hold such security to maturity. Securities classified as trading and available-for-sale are reported at fair value, while securities classified as held-to-maturity are reported at amortized cost. We may, from time to time, sell any of our investment securities as part of our overall management of our investment portfolio. Accordingly, we typically designate our investment securities as available-for-sale. All securities classified as available-for-sale are reported at fair value, with unrealized gains and losses reported in other comprehensive income

("OCI") a separate component of stockholders' equity. Upon the sale of a security, we determine the cost of the security and the amount of unrealized gains or losses to reclassify out of accumulated OCI into earnings based on the specific identification method.

Interest-only securities and inverse interest-only securities (collectively referred to as "interest-only securities") represent our right to receive a specified proportion of the contractual interest flows of specific agency CMO securities. Principal-only securities represent our right to receive the contractual principal flows of specific agency CMO securities. Interest-only and principal-only securities are measured at fair value through earnings in gain (loss) on derivative instruments and other securities, net in our consolidated statements of comprehensive income. Our investments in interest-only and principal-only securities are included in agency MBS securities, at fair value on the accompanying consolidated balance sheets.

We estimate the fair value of our investment securities based on a market approach using Level 2 inputs from third-party pricing services and dealer quotes. The third-party pricing services use pricing models that incorporate such factors as coupons, primary and secondary mortgage rates, prepayment speeds, spread to the Treasury and interest rate swap curves, convexity, duration, periodic and life caps and credit enhancements. The dealer quotes incorporate common market pricing methods, including a spread measurement to the Treasury or interest rate swap curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period, issuer, additional credit support and expected life of the security. Refer to Note 7 for further discussion of fair value measurements.

We evaluate securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. The determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. When an investment security is impaired, an OTTI is considered to have occurred if (i) we intend to sell the investment security (i.e. a decision has been made as the reporting date) or (ii) it is more likely than not that we will be required to sell the investment security before recovery of its amortized cost basis. If we intend to sell the security or if it is more likely than not that we will be required to sell the investment security before recovery of its amortized cost basis, the entire amount of the impairment loss, if any, is recognized in earnings as a realized loss and the cost basis of the security is adjusted to its fair value.

We did not recognize any OTTI charges on any of our investment securities for the three and nine months ended September 30, 2012 and 2011.

#### Interest Income

Interest income is accrued based on the outstanding principal amount of the investment securities and their contractual terms. Premiums and discounts associated with the purchase of investment securities are amortized or accreted into interest income over the projected lives of the securities, including contractual payments and estimated prepayments using the interest method in accordance with ASC Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs ("ASC 310-20").

We estimate long-term prepayment speeds of our agency securities using a third-party service and market data. The third-party service estimates prepayment speeds using models that incorporate the forward yield curve, current mortgage rates, current mortgage rates of the outstanding loans, loan age, volatility and other factors. We review the prepayment speeds estimated by the third-party service and compare the results to market consensus prepayment speeds, if available. We also consider historical prepayment speeds and current market conditions to validate the reasonableness of the prepayment speeds estimated by the third-party service and, based on our Manager's judgment, we may make adjustments to their estimates. Actual and anticipated prepayment experience is reviewed quarterly and effective yields are recalculated when differences arise between (i) our previously estimated future prepayments and (ii) actual prepayments to date plus current estimated future prepayments. If the actual and estimated future prepayment experience differs from our prior estimate of prepayments, we are required to record an adjustment in the current period to the amortization or accretion of premiums and discounts for the cumulative difference in the effective yield through the reporting date.

The yield on our adjustable rate securities further assumes that the securities reset at a rate equal to the underlying index rate in effect as of the date we acquired the security plus the stated margin.

Derivative and other Hedging Instruments

We use a variety of derivative instruments to economically hedge a portion of our exposure to market risks, including interest rate and prepayment risk. The objective of our risk management strategy is to reduce fluctuations in net book value over a range of interest rate scenarios. In particular, we attempt to mitigate the risk of the cost of our variable rate liabilities increasing during a period of rising interest rates. The principal instruments that we use are interest rate swaps and options to enter into interest rate swaps (“interest rate swaptions”). We also purchase or sell to-be-announced agency MBS forward contracts (“TBAs”), specified agency MBS on a forward basis, U.S. Treasury securities and U.S. Treasury futures contracts. We may also purchase or write put or call options on TBA securities and invest in other types of mortgage derivatives, such as interest-only securities, and synthetic

total return swaps, such as the Markit IOS Synthetic Total Return Swap Index ("Markit IOS Index").

We account for derivative instruments in accordance with ASC Topic 815, Derivatives and Hedging ("ASC 815"). ASC 815 requires an entity to recognize all derivatives as either assets or liabilities in the balance sheet and to measure those instruments at fair value. Hedging instruments that are not derivatives under ASC 815 are accounted for as securities in accordance with ASC 320.

The accounting for changes in the fair value of derivative instruments depends on whether the instruments are designated and qualify as part of a hedging relationship pursuant to ASC 815.

Changes in fair value related to derivatives not in hedge designated relationships are recorded in gain (loss) on derivative instruments and other securities, net; whereas changes in fair value related to derivatives in hedge designated relationships are initially recorded in OCI and later reclassified to income at the time that the hedged transactions affect earnings. Any portion of the changes in fair value due to hedge ineffectiveness is immediately recognized in gain (loss) on derivative instruments and other securities, net.

Our derivative agreements and repurchase agreements generally contain provisions that allow for netting or setting off receivables and payables with each counterparty. We report amounts in our consolidated balance sheets on a gross basis without regard for such rights of offset or master netting arrangements.

Derivatives in a gain position are reported as derivative assets at fair value and derivatives in a loss position are reported as derivative liabilities at fair value in our consolidated balance sheets. In our consolidated statements of cash flows, cash receipts and payments related to derivative instruments are classified according to the underlying nature or purpose of the derivative transaction, generally in the operating section for derivatives designated in hedging relationships and the investing section for derivatives not designated in hedging relationships.

The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We attempt to minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings, monitoring positions with individual counterparties and adjusting posted collateral as required.

**Discontinuation of hedge accounting for interest rate swap agreements**

Prior to the third quarter of 2011, we entered into interest rate swap agreements typically with the intention of qualifying for hedge accounting under ASC 815. However, as of September 30, 2011, we elected to discontinue hedge accounting for our interest rate swaps. Our net asset value was not impacted by our election to discontinue hedge accounting since our net asset value is the same irrespective of whether we apply hedge accounting.

Upon discontinuation of hedge accounting, the net deferred loss related to our de-designated interest rate swaps remained in accumulated OCI and is being reclassified from accumulated OCI into interest expense on a straight-line basis over the remaining term of each interest rate swap. Although the reclassification of accumulated OCI into interest expense is similar to as if the interest rate swaps had not been de-designated, the actual net periodic interest costs associated with our de-designated interest rates swaps may be more or less than amounts reclassified into interest expense. The difference, as well as net periodic interest costs on interest rate swaps that were never in a hedge designation, along with subsequent changes in the fair value of our interest rates swaps, is reported in our consolidated statement of comprehensive income in gain (loss) on derivative instruments and other securities, net.

**Interest rate swap agreements**

We use interest rate swaps to economically hedge the variable cash flows associated with borrowings made under our repurchase agreement facilities. Under our interest rate swap agreements, we typically pay a fixed rate and receive a floating rate based on one or three-month LIBOR ("payer swap") with terms up to 10 years, which has the effect of modifying the repricing characteristics of our repurchase agreements and cash flows on such liabilities.

We estimate the fair value of interest rate swaps using a third-party pricing model. The third-party pricing model incorporates such factors as the LIBOR curve and the pay rate on the interest rate swaps. We also incorporate both our own and our counterparties' nonperformance risk in estimating the fair value of our interest rate swaps. In considering the effect of nonperformance risk, we consider the impact of netting and credit enhancements, such as collateral postings and guarantees, and have concluded that our own and our counterparty risk is not significant to the overall valuation of these agreements.



#### Interest rate swaptions

We purchase interest rate swaptions to help mitigate the potential impact of increases or decreases in interest rates on the performance of our investment portfolio (referred to as "convexity risk"). The interest rate swaptions provide us the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and pay and receive interest rates in the future. Our swaption agreements typically provide us the option to enter into a pay fixed rate interest rate swap, which we refer as "payer swaptions". We may also enter into swaption agreements that provide us the option to enter into a receive fixed interest rate swap, which we refer to as "receiver swaptions". The premium paid for interest rate swaptions is reported as an asset in our consolidated balance sheets. The premium is valued at an amount equal to the fair value of the swaption that would have the effect of closing the position adjusted for nonperformance risk, if any. The difference between the premium and the fair value of the swaption is reported in gain (loss) on derivative instruments and other securities, net in our consolidated statement of comprehensive income. If a swaption expires unexercised, the loss on the swaption would be equal to the premium paid. If we sell or exercise a swaption, the realized gain or loss on the swaption would be equal to the difference between the cash or the fair value of the underlying interest rate swap received and the premium paid.

We estimate the fair value of interest rate swaptions using a third-party pricing model based on the fair value of the future interest rate swap that we have the option to enter into as well as the remaining length of time that we have to exercise the option, adjusted for non-performance risk, if any.

#### TBA securities

A TBA security is a forward contract for the purchase ("long position") or sale ("short position") of agency MBS at a predetermined price, face amount, issuer, coupon and stated maturity on an agreed-upon future date. The specific agency MBS delivered into the contract upon the settlement date, published each month by the Securities Industry and Financial Markets Association, are not known at the time of the transaction. The difference between the contract price and the fair value of the TBA security is reported in gain (loss) on derivative instruments and other securities, net in our consolidated statement of comprehensive income. Upon settlement of the TBA contract, the realized gain or loss on the TBA contract is equal to the difference between the fair value of the underlying agency MBS physically received/delivered and the contract price, or if cash settled, is equal to the net cash amount paid or received.

We estimate the fair value of TBA securities based on similar methods used to value our agency MBS securities.

#### Forward commitments to purchase or sell specified agency MBS

We enter into forward commitments to purchase or sell specified agency MBS from time to time as a means of acquiring assets or as a hedge against short-term changes in interest rates. We account for contracts for the purchase or sale of specified agency MBS securities as derivatives if the delivery of the specified agency MBS and settlement extends beyond the shortest period possible for that type of security. Realized and unrealized gains and losses associated with forward commitments accounted for as derivatives are recognized in our consolidated statements of comprehensive income in gain (loss) on derivative instruments and other securities, net.

We estimate the fair value of forward commitments to purchase or sell specified agency MBS based on similar methods used to value agency MBS, as well as the remaining length of time of the forward commitment.

#### U.S. Treasury securities

We purchase or sell short U.S. Treasury securities and U.S. Treasury futures contracts to help mitigate the potential impact of changes in interest rates on the performance of our portfolio. We borrow securities to cover short sales of U.S. Treasury securities under reverse repurchase agreements. We account for these as securities borrowing transactions and recognize an obligation to return the borrowed securities at fair value on the balance sheet based on the value of the underlying borrowed securities as of the reporting date. Gains and losses associated with purchases and short sales of U.S. Treasury securities are recognized in gain (loss) on derivative instruments and other securities, net in our consolidated statements of comprehensive income.

#### Total return swaps

We enter into total return swaps to obtain exposure to a security or market sector without owning such security or investing directly in that market sector. Total return swaps are agreements in which there is an exchange of cash flows whereby one party commits to make payments based on the total return (coupon plus the mark-to-market movement) of an underlying instrument or index in exchange for fixed or floating rate interest payments. To the extent the total



return of the instrument or index underlying the transaction exceeds or falls short of the offsetting interest rate obligation, we will receive a payment from or make a payment to the counterparty.

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The primary total return swap index in which we invest is the Markit IOS Index. Total return swaps based on the Markit IOS Index are intended to synthetically replicate the performance of interest-only securities. We determine the fair value of our total return swaps based on published index prices. Gains and losses associated with changes in market value of the underlying index and coupon interest are recognized in gain (loss) on derivative instruments and other securities, net in our consolidated statements of comprehensive income.

#### Variable Interest Entities

ASC Topic 810, Consolidation (“ASC 810”), requires an enterprise to consolidate a variable interest entity (“VIE”) if it is deemed the primary beneficiary of the VIE. Further, ASC 810 requires a qualitative assessment to determine the primary beneficiary of a VIE and ongoing assessments of whether an enterprise is the primary beneficiary of a VIE as well as additional disclosures for entities that have variable interests in VIEs.

We have entered into transactions involving CMO trusts (e.g. a VIE) whereby, in each case, we transferred agency MBS to an investment bank in exchange for cash proceeds and at the same time entered into a commitment with the same investment bank to purchase to-be-issued securities collateralized by the agency MBS transferred, which resulted in our consolidation of the CMO trusts. We will consolidate a CMO trust if we are the CMO trust’s primary beneficiary; that is, if we have a variable interest that provides us with a controlling financial interest in the CMO trust. An entity is deemed to have a controlling financial interest if the entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance and the obligation to absorb losses of or right to receive benefits from the VIE that could potentially be significant to the VIE. As part of the qualitative assessment in determining if we have a controlling financial interest, we evaluate whether we control the selection of financial assets transferred to the CMO trust.

Agency MBS transferred to consolidated VIEs are reported on our consolidated balance sheets in agency securities transferred to consolidated variable interest entities, at fair value and can only be used to settle the obligations of each respective VIE.

We report debt issued in connection with the CMO trusts on our consolidated balance sheets in debt of consolidated VIEs, at fair value, which represents tranches within the trusts sold to third-parties and excludes tranches acquired by us that eliminate in consolidation. The third-party beneficial interest holders in the VIEs have no recourse against our general credit. For transactions entered into subsequent to December 31, 2011, we have elected the option to account for the consolidated debt at fair value, with changes in fair value reflected in earnings during the period in which they occur. We believe this election more appropriately reflects our financial position as both the consolidated assets and consolidated debt are presented in a consistent manner on our consolidated balance sheets. We estimate the fair value of the consolidated debt based on a market approach using Level 2 inputs from third-party pricing services and dealer quotes.

#### Recent Accounting Pronouncements

In December 2011, the FASB issued ASU No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities (“ASU 2011-11”). The update requires new disclosures about balance sheet offsetting and related arrangements. For derivatives and financial assets and liabilities, the amendments require disclosure of gross asset and liability amounts, amounts offset on the balance sheet, and amounts subject to the offsetting requirements but not offset on the balance sheet. The guidance is effective January 1, 2013 and is to be applied retrospectively. This guidance does not amend the existing guidance on when it is appropriate to offset. As a result, we do not expect this guidance to have a material effect on our financial statements.

#### Reclassifications

Certain prior period amounts in the consolidated financial statements have been reclassified to conform to the current period presentation.

#### Note 4. Investment Securities

As of September 30, 2012, we had agency MBS at fair value of \$89.6 billion, with a total cost basis of \$86.9 billion. The net unamortized premium balance on our investment portfolio as of September 30, 2012 was \$4.4 billion, including interest-only and principal-only strips. The following tables summarize our investments in agency MBS as

of September 30, 2012 (dollars in millions):

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Agency MBS	September 30, 2012				
	Fannie Mae	Freddie Mac	Ginnie Mae	Total	
Available-for-sale agency MBS:					
Agency MBS, par	\$64,352	\$17,512	\$260	\$82,124	
Unamortized premium	3,319	827	12	4,158	
Amortized cost	67,671	18,339	272	86,282	
Gross unrealized gains	2,161	617	6	2,784	
Gross unrealized losses	(1 )	—	—	(1 )	
Total available-for-sale agency MBS, at fair value	69,831	18,956	278	89,065	
Agency MBS remeasured at fair value through earnings:					
Interest-only and principal-only strips, amortized cost <sup>(1)</sup>	508	60	—	568	
Gross unrealized gains	30	1	—	31	
Gross unrealized losses	(12 )	(12 )	—	(24 )	
Total agency MBS remeasured at fair value through earnings	526	49	—	575	
Total agency MBS, at fair value	\$70,357	\$19,005	\$278	\$89,640	
Weighted average coupon as of September 30, 2012 <sup>(2)</sup>	3.74	% 3.88	% 3.78	% 3.77	%
Weighted average yield as of September 30, 2012 <sup>(3)</sup>	2.56	% 2.82	% 1.60	% 2.61	%
Weighted average yield for the three months ended September 30, 2012 <sup>(3)</sup>	2.53	% 2.62	% 1.54	% 2.55	%
Weighted average yield for the nine months ended September 30, 2012 <sup>(3)</sup>	2.82	% 2.85	% 1.64	% 2.82	%

Interest-only agency MBS strips represent the right to receive a specified portion of the contractual interest flows of the underlying unamortized principal balance (“UPB” or “par value”) of specific agency CMO securities. Principal-only agency MBS strips represent the right to receive contractual principal flows of the UPB of specific agency CMO securities. The UPB of our interest-only agency MBS strips was \$1.8 billion and the weighted average contractual interest we are entitled to receive was 5.70% of this amount as of September 30, 2012. The par value of our principal-only agency MBS strips was \$309 million as of September 30, 2012.

The weighted average coupon includes the interest cash flows from our interest-only agency MBS strips taken together with the interest cash flows from our fixed-rate, adjustable-rate and CMO agency MBS as a percentage of the par value of our agency MBS (excluding the UPB of our interest-only securities) as of September 30, 2012.

Incorporates a weighted average future constant prepayment rate assumption of 14% based on forward rates as of September 30, 2012 and a weighted average reset rate for adjustable rate securities of 2.67%, which is equal to a weighted average underlying index rate of 0.96% based on the current spot rate in effect as of the date we acquired the securities and a weighted average margin of 1.71%.

Agency MBS	September 30, 2012			
	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
Fixed-Rate	\$85,136	\$2,747	\$(1 )	\$87,882
Adjustable-Rate	960	32	—	992
CMO	186	5	—	191
Interest-only and principal-only strips	568	31	(24 )	575
Total agency MBS	\$86,850	\$2,815	\$(25 )	\$89,640

As of December 31, 2011, we had agency MBS at fair value of \$54.7 billion, with a total cost basis of \$53.7 billion. The net unamortized premium balance on our investment portfolio as of December 31, 2011 was \$2.4 billion,

including interest-only and principal-only strips. The following tables summarize our investments in agency MBS as of December 31, 2011 (dollars in millions):

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	December 31, 2011				
	Fannie Mae	Freddie Mac	Ginnie Mae	Total	
Agency MBS					
Available-for-sale agency MBS:					
Agency MBS, par	\$37,232	\$13,736	\$258	\$51,226	
Unamortized premium	1,659	606	12	2,277	
Amortized cost	38,891	14,342	270	53,503	
Gross unrealized gains	680	324	3	1,007	
Gross unrealized losses	(4	) (2	) —	(6	)
Available-for-sale agency MBS, at fair value	39,567	14,664	273	54,504	
Agency MBS remeasured at fair value through earnings:					
Interest-only and principal-only strips, amortized cost (1)	124	67	—	191	
Gross unrealized gains	6	3	—	9	
Gross unrealized losses	(8	) (13	) —	(21	)
Agency MBS remeasured at fair value through earnings	122	57	—	179	
Total agency MBS, at fair value	\$39,689	\$14,721	\$273	\$54,683	
Weighted average coupon as of December 31, 2011 (2)	4.18	% 4.39	% 3.74	% 4.23	%
Weighted average yield as of December 31, 2011 (3)	3.03	% 3.20	% 1.71	% 3.07	%
Weighted average yield for the year ended December 31, 2011 (3)	3.19	% 3.20	% 2.05	% 3.19	%

The UPB of our interest-only securities was \$1.1 billion and the weighted average contractual interest we are entitled to receive was 5.52% of this amount as of December 31, 2011. The par value of our principal-only agency MBS strips was \$40 million as of December 31, 2011.

The weighted average coupon includes the interest cash flows from our interest-only securities taken together with the interest cash flows from our fixed-rate, adjustable-rate and CMO securities as a percentage of the par value of our agency securities (excluding the UPB of our interest-only securities) as of December 31, 2011.

Incorporates a weighted average future constant prepayment rate assumption of 14% based on forward rates as of December 31, 2011 and a weighted average reset rate for adjustable rate securities of 2.71%, which is equal to a weighted average underlying index rate of 0.94% based on the current spot rate in effect as of the date we acquired the securities and a weighted average margin of 1.77%.

Agency MBS	December 31, 2011			
	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
Fixed-Rate	\$50,535	\$952	\$(4	) \$51,483
Adjustable-Rate	2,725	51	(2	) 2,774
CMO	243	4	—	247
Interest-only strips	191	9	(21	) 179
Total agency MBS	\$53,694	\$1,016	\$(27	) \$54,683

As of September 30, 2012 and December 31, 2011, we did not have investments in agency debenture securities.

The actual maturities of our agency MBS securities are generally shorter than the stated contractual maturities. Actual maturities are affected by the contractual lives of the underlying mortgages, periodic contractual principal payments and principal prepayments. As of September 30, 2012 and December 31, 2011, our weighted average expected

constant prepayment rate (“CPR”) over the remaining life of our aggregate agency MBS portfolio was 14%. Our estimates differ materially for different types of securities and thus individual holdings have a wide range of projected CPRs. We estimate long-term prepayment assumptions for different securities using a third-party service and market data. The third-party service estimates prepayment speeds using models that incorporate the forward yield curve, current mortgage rates, mortgage rates of the outstanding loans, loan age, volatility and other factors. We review the prepayment speeds estimated by the third-party service and compare the results to market consensus prepayment speeds, if available. We also consider historical prepayment speeds and current market conditions to validate reasonableness. As market conditions may change rapidly, we may make adjustments for different securities based on our Manager's judgement. Various market participants could use materially different assumptions.

The following table summarizes our agency MBS classified as available-for-sale as of September 30, 2012 and December 31, 2011 according to their estimated weighted average life classification (dollars in millions):

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Estimated Weighted Average Life of Agency MBS Classified as Available-for-Sale	September 30, 2012				December 31, 2011			
	Fair Value	Amortized Cost	Weighted Average Coupon		Fair Value	Amortized Cost	Weighted Average Coupon	
Less than or equal to 1 year	\$—	\$—	—	%	\$214	\$210	4.61	%
Greater than 1 year and less than/equal to 3 years	9,902	9,656	3.17	%	3,392	3,338	4.38	%
Greater than 3 years and less than/equal to 5 years	39,737	38,442	3.66	%	26,168	25,616	3.99	%
Greater than 5 years and less than/equal to 10 years	38,832	37,600	3.80	%	24,710	24,320	4.19	%
Greater than 10 years	594	584	3.55	%	20	19	5.02	%
Total	\$89,065	\$86,282	3.66	%	\$54,504	\$53,503	4.11	%

The weighted average life of our interest-only agency MBS strips was 4.8 and 3.0 years as of September 30, 2012 and December 31, 2011, respectively. The weighted average life of our principal-only agency MBS strips was 5.6 and 2.6 years as of September 30, 2012 and December 31, 2011, respectively.

Our agency securities classified as available-for-sale are reported at fair value, with unrealized gains and losses excluded from earnings and reported in OCI, a component of stockholders' equity. The following table summarizes changes in accumulated OCI for our available-for-sale securities for the three and nine months ended September 30, 2012 and 2011 (in millions):

Agency Securities Classified as Available-for-Sale	Beginning OCI Balance	Unrealized Gains and (Losses), Net	Reversal of Prior Period Unrealized (Gains) and Losses, Net on Realization	Ending OCI Balance
Three months ended September 30, 2012	\$1,585	1,400	(210)	\$2,775
Three months ended September 30, 2011	\$251	802	(266)	\$787
Nine months ended September 30, 2012	\$1,002	2,616	(843)	\$2,775
Nine months ended September 30, 2011	\$(28)	1,178	(363)	\$787

The following table presents the gross unrealized loss and fair values of our available-for-sale agency securities by length of time that such securities have been in a continuous unrealized loss position as of September 30, 2012 and December 31, 2011 (in millions):

Agency Securities Classified as Available-for-Sale	Unrealized Loss Position For				Total Estimated Fair Value	Unrealized Loss
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss		
September 30, 2012	\$436	\$(1)	\$—	\$—	\$436	\$(1)
December 31, 2011	\$1,135	\$(6)	\$—	\$—	\$1,135	\$(6)

As of September 30, 2012, we did not intend to sell any of these agency securities and we do not believe it is more likely than not we will be required to sell the agency securities before recovery of their amortized cost basis. The unrealized losses on these agency securities are not due to credit losses given the government-sponsored entity or government guarantees, but are rather due to changes in interest rates and prepayment expectations.



Gains and Losses

The following table is a summary of our net gain from the sale of agency MBS for the three and nine months ended September 30, 2012 and 2011 (in millions):

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Agency MBS	Three Months Ended		Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Agency MBS sold, at cost	\$(10,172 )	\$(14,046 )	\$(45,258 )	\$(26,429 )
Proceeds from agency MBS sold <sup>(1)</sup>	10,382	14,309	46,101	26,790
Net gains on sale of agency MBS	\$210	\$263	\$843	\$361
Gross gains on sale of agency MBS	\$210	\$268	\$855	\$377
Gross losses on sale of agency MBS	—	(5 )	(12 )	(16 )
Net gains on sale of agency MBS	\$210	\$263	\$843	\$361

1. Proceeds include cash received during the period, plus receivable for agency MBS sold during the period as of period end.

For the three and nine months ended September 30, 2012, we recognized an unrealized gain of \$20 million and \$19 million, respectively, and for the three and nine months ended September 30, 2011, we recognized an unrealized gain of \$28 million and \$24 million, respectively, in gain (loss) on derivative instruments and other securities, net in our consolidated statements of comprehensive income for the change in value of investments in interest-only and principal-only agency MBS strips, net of prior period reversals. For the three and nine months ended September 30, 2012, we recognized no realized gain or loss, and for the three and nine months ended September 30, 2011, we recognized a realized loss of \$3 million in gain on sale of agency securities, net, in our consolidated statements of operations and comprehensive income for the sales of interest-only and principal-only securities.

Pledged Assets

The following tables summarize our assets pledged as collateral under repurchase agreements, debt of consolidated VIEs, derivative agreements and prime broker agreements by type, including securities pledged related to securities sold but not yet settled, as of September 30, 2012 and December 31, 2011 (in millions):

Assets Pledged	September 30, 2012				
	Repurchase Agreements	Debt of Consolidated VIEs	Derivative Agreements	Prime Broker Agreements	Total
Agency MBS - fair value	\$83,654	\$1,620	\$1,255	\$157	\$86,686
Accrued interest on pledged securities	234	5	4	—	243
Restricted cash	—	—	369	—	369
Total	\$83,888	\$1,625	\$1,628	\$157	\$87,298

Assets Pledged	December 31, 2011				
	Repurchase Agreements	Debt of Consolidated VIEs	Derivative Agreements	Prime Broker Agreements	Total
Agency MBS - fair value	\$50,255	\$58	\$644	\$87	\$51,044
U.S. Treasury securities - fair value	101	—	—	—	101
Accrued interest on pledged securities	161	—	2	—	163
Restricted cash	—	—	336	—	336
Total	\$50,517	\$58	\$982	\$87	\$51,644

The following table summarizes our securities pledged as collateral under repurchase agreements and debt of consolidated VIEs by remaining maturity, including securities pledged related to sold but not yet settled securities, as of September 30, 2012 and December 31, 2011 (dollars in millions):



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Securities Pledged by Remaining Maturity of Repurchase Agreements and Debt of Consolidated VIEs	September 30, 2012			December 31, 2011		
	Fair Value of Pledged Securities	Amortized Cost of Pledged Securities	Accrued Interest on Pledged Securities	Fair Value of Pledged Securities	Amortized Cost of Pledged Securities	Accrued Interest on Pledged Securities
Agency MBS:						
Less than 30 days	\$30,861	\$29,867	\$86	\$19,772	\$19,361	\$63
31 - 59 days	17,739	17,134	51	16,964	16,648	55
60 - 90 days	17,822	17,242	50	8,337	8,179	26
Greater than 90 days	18,852	18,348	52	5,240	5,154	17
Total agency MBS	85,274	82,591	239	50,313	49,342	161
U.S. Treasury securities:						
1 day	—	—	—	101	101	—
Total securities	\$85,274	\$82,591	\$239	\$50,414	\$49,443	\$161

As of September 30, 2012 and December 31, 2011, none of our repurchase agreement borrowings backed by agency MBS were due on demand or mature overnight.

#### Securizations

All of our CMO securities are backed by fixed or adjustable-rate agency MBS. Fannie Mae or Freddie Mac guarantees the payment of interest and principal and acts as the trustee and administrator of their respective securitization trusts. Accordingly, we are not required to provide the beneficial interest holders of the CMO securities any financial or other support. Our maximum exposure to loss related to our involvement with CMO trusts is the fair value of the CMO securities and interest-only and principal-only securities held by us, less principal amounts guaranteed by Fannie Mae and Freddie Mac.

As of September 30, 2012 and December 31, 2011, the fair value of all of our CMO securities, interest-only securities and principal-only securities, excluding the consolidated CMO trusts discussed below, was \$766 million and \$426 million, respectively, or \$1.4 billion and \$429 million, respectively, including the net asset value of the consolidated CMO trusts discussed below. Our maximum exposure to loss related to our CMO securities and interest-only and principal-only securities, including the consolidated CMO trust, was \$375 million and \$155 million as of September 30, 2012 and December 31, 2011, respectively.

We have consolidated CMO trusts for which we have determined we are the primary beneficiary of the trusts. In connection with the consolidated trusts, as of September 30, 2012 and December 31, 2011, we recognized agency securities with a total fair value of \$1.6 billion and \$58 million, respectively, and a principal balance of \$1.5 billion and \$55 million, respectively, and debt with a carrying value of \$1.0 billion and \$54 million, respectively, in our accompanying consolidated balance sheets. The total fair value of debt for which we have elected the option to account for at fair value was \$968 million as of September 30, 2012, with a principal balance \$939 million (or \$936 million, net of discounts). For the three and nine months ended September 30, 2012, we recognized an unrealized loss of \$24 million and \$32 million in gain (loss) on derivative instruments and other securities, net in our consolidated statements of comprehensive income for the change in value of debt of our consolidated VIEs. Our involvement with the consolidated trusts is limited to the agency securities transferred to the trusts and the CMO securities subsequently held by us. There are no arrangements that could require us to provide financial support to the trusts.

#### Note 5. Repurchase Agreements and Other Debt

We pledge certain of our agency securities as collateral under repurchase arrangements with financial institutions, the terms and conditions of which are negotiated on a transaction-by-transaction basis. Interest rates on these borrowings are generally based on LIBOR plus or minus a margin and amounts available to be borrowed are dependent upon the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates, type of security and liquidity conditions within the banking, mortgage finance and real estate industries. In response to declines in fair value of pledged securities, lenders may require us to post additional collateral or pay down borrowings to re-establish agreed upon collateral requirements, referred to as margin calls. As of September 30, 2012 and December 31, 2011,

we have met all margin call requirements.

The following table summarizes our borrowings under repurchase arrangements and weighted average interest rates classified by original maturities as of September 30, 2012 and December 31, 2011 (dollars in millions):

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Original Maturity	September 30, 2012			December 31, 2011		
	Repurchase Agreements	Weighted Average Interest Rate	Weighted Average Days to Maturity	Repurchase Agreements	Weighted Average Interest Rate	Weighted Average Days to Maturity
Agency MBS:						
1 month or less	\$4,724	0.43	% 12	\$2,558	0.43	% 10
1-3 months	31,253	0.43	% 37	24,518	0.39	% 32
4-6 months	25,571	0.45	% 72	16,475	0.37	% 53
7-9 months	8,641	0.49	% 92	2,423	0.45	% 141
10-12 months	7,547	0.57	% 266	1,006	0.53	% 244
13-24 months	693	0.67	% 613	600	0.51	% 268
25-36 months	825	0.72	% 992	—	—	—
Total agency MBS	79,254	0.46	% 89	47,580	0.40	% 51
U.S. Treasury securities:						
1 day	—	—	—	101	0.40	% 1
Total / Weighted Average	\$79,254	0.46	% 89	\$47,681	0.40	% 51

As of September 30, 2012 and December 31, 2011, we did not have an amount at risk with any repurchase agreement counterparty greater than 4% of our stockholders' equity.

As of September 30, 2012 and December 31, 2011, we had other debt consisting of debt of consolidated VIEs outstanding with a carrying value of \$1.0 billion and \$54 million, respectively, and a principal balance of \$979 million (or \$976 million, net of original issue discounts) and \$54 million, respectively. Debt of consolidated VIEs consists of variable rate debt outstanding in connection with the consolidation of structured transactions for which we are the primary beneficiary of in our accompanying financial statements. As of September 30, 2012, debt of consolidated VIEs carried a weighted average interest rate of LIBOR plus 42 basis points. The actual maturities of debt of consolidated VIEs are generally shorter than the stated contractual maturities. The actual maturities are affected by the contractual lives of the underlying agency MBS securitizing the debt of consolidated VIEs and periodic principal prepayments of such underlying securities. The estimated weighted average life of debt of consolidated VIEs as of September 30, 2012 was 3.8 years.

#### Note 6. Derivative and Other Hedging Instruments

In connection with our risk management strategy, we hedge a portion of our interest rate risk by entering into derivative and other hedging instrument contracts. We may enter into agreements for interest rate swaps, interest rate swaptions, interest rate cap or floor contracts and futures or forward contracts. We may also purchase or short TBA and U.S. Treasury securities, purchase or write put or call options on TBA securities or we may invest in other types of mortgage derivative securities, such as interest-only securities, and synthetic total return swaps, such as the Markit IOS Index. Our risk management strategy attempts to manage the overall risk of the portfolio, reduce fluctuations in book value and generate additional income distributable to stockholders. For additional information regarding our derivative instruments and our overall risk management strategy, please refer to the discussion of derivative and other hedging instruments in Note 3.

As of September 30, 2012 and December 31, 2011, our derivative and other hedging instruments were comprised primarily of interest rate swaps, which have the effect of economically modifying the repricing characteristics of our repurchase agreements and cash flows on such liabilities. Our interest rate swaps are used to manage the interest rate risk created by our variable rate short-term repurchase agreements. Under our interest rate swaps, we typically pay a fixed-rate and receive a floating rate based on one-month LIBOR with terms up to 10 years.

Derivative and other hedging instruments entered into in addition to interest rate swap agreements are intended to supplement our use of interest rate swaps and we do not currently expect our use of these instruments to be the primary protection against interest rate risk for our portfolio. These instruments are accounted for as derivatives, but

are not generally designated as hedges under ASC 815, or as other securities, with any changes in the fair values of the contracts prior to their settlement date included in earnings in gain (loss) on derivative instruments and other securities, net in our consolidated statements of comprehensive income. We do not use derivative or other hedging instruments for speculative purposes.

Derivatives Designated as Hedging Instruments

Prior to September 30, 2011, our interest rate swaps were typically designated as cash flow hedges under ASC 815; however, as of September 30, 2011, we elected to discontinue hedge accounting for our interest rate swaps in order to increase our funding flexibility. For further information regarding our discontinuation of hedge accounting please refer to Note 3.

For the three and nine months ended September 30, 2012, we reclassified \$51 million and \$155 million, respectively, of net deferred losses from accumulated OCI into interest expense related to our de-designated interest rate swaps and recognized an equal, but offsetting, amount in other comprehensive income. Our total net periodic interest costs on our swap portfolio was \$125 million and \$330 million for the three and nine months ended September 30, 2012, respectively. The difference of \$74 million and \$175 million for the three and nine months ended September 30, 2012, respectively, are reported in our accompanying consolidated statement of comprehensive income in gain (loss) on derivative instruments and other securities, net. As of September 30, 2012, the net deferred loss in accumulated OCI related to de-designated interest rate swaps was \$536 million and the weighted average remaining contractual term was 2.5 years. The net deferred loss expected to be reclassified from OCI into interest expense over the next twelve months is \$194 million.

The following tables summarize information about our outstanding interest rate swaps designated as hedging instruments under ASC 815 and their effect on our consolidated statement of comprehensive income for the three and nine months ended September 30, 2011 (dollars in millions).

Interest Rate Swaps Designated as Hedging Instruments	Beginning Notional Amount	Additions	Expirations / Terminations	Hedge De-Designations	Ending Notional Amount	Amount of Gain or (Loss) Recognized in Earnings (Ineffective Portion and Amount Excluded from Effectiveness Testing)
Three months ended September 30, 2011	\$22,000	2,100	(200 )	(23,900 )	\$—	
Nine months ended September 30, 2011	\$6,450	17,900	(450 )	(23,900 )	\$—	

  

Interest Rate Swaps Designated as Hedging Instruments:	Amount of Gain or (Loss) Recognized in OCI (Effective Portion)	Location of Gain or (Loss) Reclassified from OCI into Earnings (Effective Portion)	Amount of (Gain) or Loss Reclassified from OCI into Earnings (Effective Portion)	Location of Gain or (Loss) Recognized in Earnings (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount Excluded from Effectiveness Testing
Three Months Ended September 30, 2011	\$ (512 )	Interest expense	(71 )	Gain (loss) on derivative instruments and other securities, net	\$ (1 )
Nine Months Ended September 30, 2011	\$ (707 )	Interest expense	(140 )	Gain (loss) on derivative instruments and other securities, net	\$ (2 )

During the nine months ended September 30, 2011, we also held forward contracts to purchase TBA and specified agency securities that were designated as cash flow hedges pursuant to ASC 815. The following tables summarize information about these securities and their effect on our consolidated statement of comprehensive income for the nine months ended September 30, 2011 (dollars in millions). We did not designate any such agreements as cash flow hedges during the three months ended September 30, 2011 and the three and nine months ended September 30, 2012.

Purchases of TBAs and Forward Settling Agency Securities Designated as Hedging Instruments	Beginning Notional Amount	Additions	Settlement / Expirations	Ending Notional Amount	Fair Value as of Period End	Average Maturity as of
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						Period End (Months)
Nine Months Ended September 30, 2011	\$245	\$—	\$(245	) \$—	\$—	—

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Purchases of TBAs and Forward Settling Agency Securities Designated as Hedging Instruments	Amount of Gain or (Loss) Recognized in OCI for Cash Flow Hedges (Effective Portion)	Amount of (Gain) or Loss Recognized in OCI for Cash Flow Hedges and Reclassified to OCI for Available-for-Sale Securities (Effective Portion)	Location of Gain or (Loss) Recognized in Earnings (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain or (Loss) Recognized in Earnings (Ineffective Portion and Amount Excluded from Effectiveness Testing)
Nine months ended September 30, 2011	\$ —	\$ (3 )	Gain (loss) on derivative instruments and other securities, net	\$ —

Derivatives Not Designated as Hedging Instruments

The table below summarizes fair value information about our derivatives outstanding that were not designated as hedging instruments as of September 30, 2012 and December 31, 2011 (in millions).

Derivatives Not Designated as Hedging Instruments	Balance Sheet Location	September 30, 2012	December 31, 2011
Interest rate swaps	Derivative assets, at fair value	\$6	\$13
Payer swaptions	Derivative assets, at fair value	57	11
Purchase of TBA and forward settling agency securities	Derivative assets, at fair value	186	54
Sale of TBA and forward settling agency securities	Derivative assets, at fair value	43	3
Markit IOS total return swaps - long	Derivative assets, at fair value	—	1
		\$292	\$82
Interest rate swaps	Derivative liabilities, at fair value	\$(1,442 )	\$(795 )
U.S. Treasury futures - short	Derivative liabilities, at fair value	—	(14 )
Purchase of TBA and forward settling agency securities	Derivative liabilities, at fair value	(20 )	—
Sale of TBA and forward settling agency securities	Derivative liabilities, at fair value	(100 )	(44 )
		\$(1,562 )	\$(853 )

Additionally, as of September 30, 2012 and December 31, 2011, we had obligations to return U.S. Treasury securities borrowed under reverse repurchase agreements accounted for as securities borrowing transactions at a fair value of \$7.3 billion and \$899 million, respectively. The borrowed securities were used to cover short sales of U.S. Treasury securities from which we received total proceeds of \$7.2 billion and \$880 million, respectively. The change in fair value of the borrowed securities is recorded in gain (loss) on derivative instruments and other securities, net in our consolidated statements of comprehensive income.

The tables below summarize the effect of derivative instruments not designated as hedges under ASC 815 on our consolidated statements of comprehensive income for the three and nine months ended September 30, 2012 and 2011 (in millions):

Derivatives Not Designated as Hedging Instruments	Three Months Ended September 30, 2012				Amount of Gain/(Loss) Recognized in
	Notional Amount as of	Additions	Settlement, Termination, Expiration or	Notional Amount as of	

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	June 30, 2012		Exercise	September 30, 2012	Income on Derivatives <sup>(1)</sup>
Purchase of TBA and forward settling agency securities	\$7,447	36,956	(26,234	) \$18,169	\$ 222
Sale of TBA and forward settling agency securities	\$10,851	53,318	(49,774	) \$14,395	(173 )
Interest rate swaps	\$48,550	3,450	(3,150	) \$48,850	(438 )
Payer swaptions	\$8,800	2,000	(2,250	) \$8,550	(25 )
Short sales of U.S. Treasury securities	\$1,250	11,550	(5,505	) \$7,295	(15 )
U.S. Treasury futures - short	\$1,919	—	(1,919	) \$—	(27 )
Markit IOS total return swaps - long	\$37	—	(37	) \$—	—
Markit IOS total return swaps - short	\$181	—	(181	) \$—	—
					\$ (456 )

- 
1. Excludes a gain of \$20 million from interest-only and principal-only securities and a loss of \$24 million from debt of consolidated VIEs re-measured

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at fair value through earnings recognized in gain (loss) on derivative instruments and other securities, net in our consolidated statement of comprehensive income for the three months ended September 30, 2012.

Derivatives Not Designated as Hedging Instruments	Three Months Ended September 30, 2011					Amount of Gain/(Loss) Recognized in Income on Derivatives <sup>(1)</sup>
	Notional Amount as of June 30, 2011	Additions	Additions Due to Hedge De-Designations	Settlement, Termination, Expiration or Exercise	Notional Amount as of September 30, 2011	
Purchase of TBA and forward settling agency securities	\$3,432	19,881	—	(17,877 )	\$5,436	\$ 73
Sale of TBA and forward settling agency securities	\$4,282	37,867	—	(35,895 )	\$6,254	(146 )
Interest rate swaps	\$150	2,900	23,900	—	\$26,950	(3 )
Payer swaptions	\$4,050	250	—	(1,050 )	\$3,250	(33 )
Short sales of U.S. Treasury securities	\$1,464	3,450	—	(4,449 )	\$465	(92 )
US Treasury futures - long	\$—	350	—	—	\$350	2
Markit IOS total return swaps - long	\$683	65	—	(683 )	\$65	(19 )
Markit IOS total return swaps - short	\$309	323	—	(309 )	\$323	20
						\$ (198 )

<sup>1</sup> Excludes a loss of \$28 million from interest-only and principal-only securities re-measured at fair value through earnings, a loss of \$1 million for hedge ineffectiveness on our outstanding interest rate swaps and a gain of \$5 million from U.S. Treasury securities in gain (loss) on derivative instruments and other securities, net in our consolidated statement of comprehensive income for the three months ended September 30, 2011.

Derivatives Not Designated as Hedging Instruments	Nine Months Ended September 30, 2012					Amount of Gain/(Loss) Recognized in Income on Derivatives <sup>(1)</sup>
	Notional Amount as of December 31, 2011	Additions	Settlement, Expiration or Exercise	Notional Amount as of September 30, 2012		
Purchase of TBA and forward settling agency securities	\$3,699	90,498	(76,028 )	\$18,169	\$ 343	
Sale of TBA and forward settling agency securities	\$3,803	131,030	(120,438 )	\$14,395	(402 )	
Interest rate swaps	\$30,250	23,300	(4,700 )	\$48,850	(1,067 )	
Payer swaptions	\$3,200	12,150	(6,800 )	\$8,550	(96 )	
Short sales of U.S. Treasury securities	\$880	30,480	(24,065 )	\$7,295	(115 )	
U.S. Treasury futures - short	\$783	3,838	(4,621 )	\$—	(91 )	
Markit IOS total return swaps - long	\$41	—	(41 )	\$—	—	
Markit IOS total return swaps - short	\$206	—	(206 )	\$—	—	
					\$ (1,428 )	

<sup>1</sup> Excludes a loss of \$1 million from U.S. Treasury securities, a gain of \$19 million from interest-only and principal-only securities and a loss of \$32 million from debt of consolidated VIEs re-measured at fair value through earnings recognized in gain (loss) on derivative instruments and other securities, net in our consolidated statement

of comprehensive income for the nine months ended September 30, 2012

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Derivatives Not Designated as Hedging Instruments	Nine Months Ended September 30, 2011					Amount of Gain/(Loss) Recognized in Income on Derivatives <sup>(1)</sup>
	Notional Amount as of December 31, 2010	Additions	Additions Due to Hedge De-Designations	Settlement, Expiration or Exercise	Notional Amount as of September 30, 2011	
Purchase of TBA and forward settling agency securities	\$512	42,222	—	(37,298 )	\$5,436	\$ 119
Sale of TBA and forward settling agency securities	\$1,361	88,795	—	(83,902 )	\$6,254	(291 )
Interest rate swaps	\$50	2,900	23,900	100	\$26,950	(8 )
Payer swaptions	\$850	4,450	—	(2,050 )	\$3,250	(58 )
Receiver Swaptions	\$—	250	—	(250 )	\$—	(1 )
Short sales of U.S. Treasury securities	\$250	11,974	—	(11,759 )	\$465	(92 )
Put Options	\$—	(200 )	—	200	\$—	1
U.S. Treasury futures - long	\$—	400	—	(50 )	\$350	2
Markit IOS total return swaps - long	\$—	1,154	—	(1,089 )	\$65	(6 )
Markit IOS total return swaps - short	\$—	636	—	(313 )	\$323	17
						\$ (317 )

Excludes a loss of \$24 million from interest-only securities re-measured at fair value through earnings, a loss of \$2 million for hedge ineffectiveness on our outstanding interest rate swaps and a gain of \$33 million from U.S.

<sup>1</sup> Treasury securities recognized in gain (loss) on derivative instruments and other securities, net in our consolidated statement of comprehensive income for the nine months ended September 30, 2011.

The following tables summarize our interest rate swap agreements outstanding as of September 30, 2012 and December 31, 2011 (dollars in millions).

Payer Interest Rate Swaps Not Designated as Hedging Instruments <sup>(1)</sup>	September 30, 2012				
	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Net Estimated Fair Value	Average Maturity (Years)
Three years or less	\$17,150	1.15	% 0.30	% \$(308 )	2.0
Greater than 3 years and less than/equal to 5 years	19,400	1.55	% 0.35	% (767 )	4.2
Greater than 5 years and less than/equal to 7 years	7,100	1.41	% 0.43	% (203 )	6.1
Greater than 7 years and less than/equal to 10 years	5,200	1.89	% 0.45	% (158 )	9.4
Total Payer Interest Rate Swaps	\$48,850	1.43	% 0.35	% \$(1,436 )	4.3

<sup>1</sup> Amounts include forward starting swaps of \$3.1 billion ranging up to six months from September 30, 2012.

Payer Interest Rate Swaps Not Designated as Hedging Instruments <sup>(1)</sup>	December 31, 2011				
	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Net Estimated Fair Value	Average Maturity (Years)
Three years or less	\$11,350	1.22	% 0.30	% \$(148 )	2.1
Greater than 3 years and less than/equal to 5 years	16,700	1.77	% 0.35	% (607 )	3.9

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Greater than 5 years and less than/equal to 7 years	950	1.56	% 0.57	% (9	) 5.7
Greater than 7 years and less than/equal to 10 years	1,250	1.99	% 0.55	% (18	) 8.2
Total Payer Interest Rate Swaps	\$30,250	1.57	% 0.35	% \$(782	) 3.5

1. Amounts include forward starting swaps of \$2.6 billion ranging up to five months from December 31, 2011.

The following table summarizes our interest rate swaption agreements outstanding as of September 30, 2012 and December 31, 2011 (dollars in millions).

Payer Swaptions	Option		Average Months to Expiration	Underlying Swap			
	Cost	Fair Value		Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Term (Years)
As of September 30, 2012	\$152	\$57	19	\$8,550	3.30	% 1M / 3M LIBOR	7.7
As of December 31, 2011	\$49	\$11	7	\$3,200	3.41	% 1M / 3M LIBOR	7.7

The following table summarizes our contracts to purchase and sell TBA and specified agency securities on a forward basis as of September 30, 2012 and December 31, 2011 (in millions):

Purchase and Sale Contracts for TBAs and Forward Settling Securities Not Designated as Hedging Instruments	September 30, 2012		December 31, 2011	
	Notional Amount	Fair Value	Notional Amount	Fair Value
TBA securities:				
Purchase contracts	\$17,844	\$161	\$3,188	\$49
Sale contracts	(13,210)	(54)	(3,803)	(41)
TBA securities, net <sup>(1)</sup>	4,634	107	(615)	8
Forward settling securities:				
Purchase contracts	325	5	512	5
Sale contracts	(1,185)	(3)	—	—
Forward settling securities, net <sup>(2)</sup>	(860)	2	512	5
Total TBA and forward settling securities, net	\$3,774	\$109	\$(103)	\$13

1. Includes 15-year and 30-year TBA securities of varying coupons

2. Includes 20-year and 30-year fixed securities of varying coupons

#### Credit Risk-Related Contingent Features

The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings and monitoring positions with individual counterparties. In addition, we may be required to pledge assets as collateral for our derivatives, whose amounts vary over time based on the market value, notional amount and remaining term of the derivative contract. In the event of a default by a counterparty we may not receive payments provided for under the terms of our derivative agreements, and may have difficulty obtaining our assets pledged as collateral for our derivatives. The cash and cash equivalents and agency securities pledged as collateral for our derivative instruments is included in restricted cash and agency securities, respectively, on our consolidated balance sheets.

Each of our International Swaps and Derivatives Association ("ISDA") Master Agreements contains provisions under which we are required to fully collateralize our obligations under the swap instrument if at any point the fair value of the swap represents a liability greater than the minimum transfer amount contained within our agreements. We were also required to post initial collateral upon execution of certain of our swap transactions. If we breach any of these provisions, we will be required to settle our obligations under the agreements at their termination values.

Further, each of our ISDA Master Agreements also contains a cross default provision under which a default under certain of our other indebtedness in excess of a certain threshold causes an event of default under the agreement. Threshold amounts vary by lender. Following an event of default, we could be required to settle our obligations under the agreements at their termination values. Additionally, under certain of our ISDA Master Agreements, we could be required to settle our obligations under the agreements at their termination values if we fail to maintain certain minimum shareholders' equity thresholds or our REIT status or if we fail to comply with limits on our leverage above



certain specified levels.

As of September 30, 2012, the fair value and termination value of our interest rate swaps in a liability position related to these agreements was \$1.4 billion. We had agency securities with fair values of \$1.3 billion and restricted cash of \$332 million pledged as collateral against our interest rate swaps, including initial collateral posted upon execution of interest rate swap and total return swap transactions.

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## Note 7. Fair Value Measurements

We determine the fair value of our agency securities and debt of consolidated VIEs based upon fair value estimates obtained from multiple third party pricing services and dealers. In determining fair value, third party pricing sources use various valuation approaches, including market and income approaches. Factors used by third party sources in estimating the fair value of an instrument may include observable inputs such as coupons, primary and secondary mortgage rates, pricing information, credit data, volatility statistics, and other market data that are current as of the measurement date. The availability of observable inputs can vary by instrument and is affected by a wide variety of factors, including the type of instrument, whether the instrument is new and not yet established in the marketplace and other characteristics particular to the instrument. Third party pricing sources may also use certain unobservable inputs, such as assumptions of future levels of prepayment, defaults and foreclosures, especially when estimating fair values for securities with lower levels of recent trading activity. We make inquiries of third party pricing sources to understand the significant inputs and assumptions they used to determine their prices. For further information regarding valuation of our derivative instruments, please refer to the discussion of derivative and other hedging instruments in Note 3.

We review the various third party fair value estimates and perform procedures to validate their reasonableness, including an analysis of the range of third party estimates for each position, comparison to recent trade activity for similar securities, and management review for consistency with market conditions observed as of the measurement date. While we do not adjust prices we obtain from third party pricing sources, we will exclude third party prices for securities from our determination of fair value if we determine (based on our validation procedures and our market knowledge and expertise) that the price is significantly different than observable market data would indicate and we cannot obtain an understanding from the third party source as to the significant inputs used to determine the price.

The validation procedures described above also influence our determination of the appropriate fair value measurement classification. We utilize a three-level valuation hierarchy for disclosure of fair value measurement. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument's categorization within the hierarchy is based upon the lowest level of input that is significant to the fair value measurement. There were no transfers between hierarchy levels during the nine months ended September 30, 2012. The three levels of hierarchy are defined as follows:

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

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

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

The following table provides a summary of our assets and liabilities that are measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011 (dollars in millions):

	Fair Value Hierarchy		
	Level 1	Level 2	Level 3
September 30, 2012			
Assets:			
Agency securities	\$—	\$89,640	\$—
Interest rate swaps	—	6	—
Other derivative instruments	—	286	—
Total	\$—	\$89,932	\$—
Liabilities:			
Debt of consolidated VIEs	\$—	\$968	\$—
Obligation to return U.S. Treasury securities borrowed under reverse repurchase agreements	7,265	—	—
Interest rate swaps	—	1,442	—
Other derivative instruments	—	120	—
Total	\$7,265	\$2,530	\$—
December 31, 2011			
Assets:			
Agency securities	\$—	\$54,683	\$—
U.S. Treasury securities	101	—	—
Interest rate swaps	—	13	—
Other derivative instruments	—	69	—
Total	\$101	\$54,765	\$—
Liabilities:			
Obligation to return U.S. Treasury securities borrowed under reverse repurchase agreements	\$899	\$—	\$—
U.S. Treasury futures	14	—	—
Interest rate swaps	—	795	—
Other derivative instruments	—	44	—
Total	\$913	\$839	\$—

## Note 8. Stockholders' Equity

### Preferred Stock Offering

Pursuant to our amended and restated certificate of incorporation, we are authorized to designate and issue up to 10.0 million shares of preferred stock in one or more classes or series. Our board of directors has designated 6.9 million shares as 8.000% Series A Cumulative Redeemable Preferred Stock ("Series A Preferred Stock"). As of September 30, 2012, we have 3.1 million of authorized but unissued shares of preferred stock. Our board of directors may designate additional series of authorized preferred stock ranking junior to or in parity with the Series A Preferred Stock or designate additional shares of the Series A Preferred Stock and authorize the issuance of such shares. In April 2012, we completed a public offering in which 6.9 million shares of our Series A Preferred Stock were sold to the underwriters at a price of \$24.21 per share. Upon completion of the offering we received proceeds, net of offering expenses, of approximately \$167 million. Our Series A Preferred Stock has no stated maturity and is not subject to any sinking fund or mandatory redemption. Under certain circumstances upon a change of control, the Series A Preferred Stock is convertible to shares of our common stock. Holders of Series A Preferred Stock have no voting rights, except under limited conditions, and holders are entitled to receive cumulative cash dividends at a rate of 8.00% per annum of the \$25.00 per share liquidation preference before holders of our common stock are entitled to receive any dividends. Shares of our Series A Preferred Stock are redeemable at \$25.00 per share plus accumulated

and unpaid dividends (whether or not declared) exclusively at our option commencing on April 5, 2017, or earlier under certain circumstances intended to preserve our qualification as a REIT for Federal income tax purposes.

Dividends

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are payable quarterly in arrears on the 15th day of each January, April, July and October. As of September 30, 2012, we had declared all required quarterly dividends on our Series A Preferred Stock.

#### Common Stock Offering

In March 2012, we completed a public offering in which 71.2 million shares of our common stock were sold to the underwriters at a price of \$29.00 per share. Upon completion of the March offering, we received proceeds, net of offering expenses, of approximately \$2.1 billion. In July 2012, we completed a public offering in which 36.8 million shares of our common stock were sold to the underwriters at a price of \$33.70 per share. Upon completion of the July offering, we received proceeds, net of offering expenses, of approximately \$1.2 billion. In both instances, the underwriters in the offering sold the shares of our common stock in one or more transactions on the NASDAQ Global Select Market, in the over-the-counter market, through negotiated transactions or otherwise at market prices prevailing at the time of sale.

#### At-the-Market Offering Program

We have sales agreements with sales agents to publicly offer and sell shares of our common stock in privately negotiated and/or at-the-market transactions from time to time. During the nine months ended September 30, 2012, we sold 9.5 million shares of our common stock under such a sales agreement at an average price of \$31.41 per share for proceeds, net of program costs, of \$298 million. For the three months ended September 30, 2012, we did not sell any shares under the sales agreements. As of September 30, 2012, 16.7 million shares remain under the sales agreements.

#### Dividend Reinvestment and Direct Stock Purchase Plan

We sponsor a dividend reinvestment and direct stock purchase plan through which stockholders may purchase additional shares of our common stock by reinvesting some or all of the cash dividends received on shares of our common stock. Stockholders may also make optional cash purchases of shares of our common stock subject to certain limitations detailed in the plan prospectus. During the three and nine months ended September 30, 2012, there were no shares issued under the plan. As of September 30, 2012, 4.7 million shares remain under the plan.

#### Note 9. Subsequent Event

In October 2012, our Board of Directors adopted a plan that may provide for stock repurchases of up to \$500 million of our outstanding shares of common stock through December 31, 2013. Shares of our common stock may be purchased in the open market, including through block purchases, or through privately negotiated transactions, or pursuant to any trading plan that may be adopted in accordance with Rule 10b5-1 of the Securities and Exchange Commission. The timing, manner, price and amount of any repurchases will be determined at our discretion and the program may be suspended, terminated or modified at any time for any reason. We intend to repurchase shares only when the purchase price is less than our estimate of our current net asset value per share of our common stock. Generally, when we repurchase our common stock at a discount to our net asset value, the net asset value of our remaining shares of common stock outstanding increases. In addition, we do not intend to repurchase any shares from directors, officers or other affiliates. The program does not obligate us to acquire any specific number of shares, and all repurchases will be made in accordance with SEC Rule 10b-18, which sets certain restrictions on the method, timing, price and volume of stock repurchases.

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

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

Executive Overview

Financial Condition

Results of Operations

Liquidity and Capital Resources

Forward-Looking Statements

### EXECUTIVE OVERVIEW

American Capital Agency Corp. ("AGNC", the "Company", "we", "us" and "our") was organized on January 7, 2008 and commenced operations on May 20, 2008 following the completion of our initial public offering. Our common stock is traded on The NASDAQ Global Select Market under the symbol "AGNC". We are externally managed by American Capital AGNC Management, LLC (our "Manager"), an affiliate of American Capital, Ltd. ("American Capital").

We operate so as to qualify to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986, as amended (the "Internal Revenue Code"). As such, we are required to distribute annually 90% of our taxable net income. As long as we qualify as a REIT, we will generally not be subject to U.S. federal or state corporate taxes on our taxable net income to the extent that we distribute all of our annual taxable net income to our stockholders. It is our intention to distribute 100% of our taxable income, after application of available tax attributes, within the limits prescribed by the Internal Revenue Code, which may extend into the subsequent taxable year.

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

Our principal objective is to preserve our net book value (also referred to as "net asset value", "NAV" and "stockholders' equity") while generating attractive risk-adjusted returns for distribution to our stockholders through regular quarterly dividends from the combination of our net interest income and net realized gains and losses on our investments and hedging activities. We fund our investments primarily through borrowings structured as repurchase agreements.

#### Our Investment Strategy

Our investment strategy is designed to:

• manage an investment portfolio consisting of agency securities that seeks to generate attractive risk-adjusted returns;

• capitalize on discrepancies in the relative valuations in the agency securities market;

• manage financing, interest and prepayment rate risks;

• preserve our net book value;

• provide regular quarterly distributions to our stockholders;

• qualify as a REIT; and

• remain exempt from the requirements of the Investment Company Act of 1940, as amended (the "Investment Company Act").

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

prepayments, market liquidity, housing prices, unemployment rates, general economic conditions, government participation in the mortgage market, evolving regulations or legal settlements that impact servicing practices or other mortgage related activities.

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## Trends and Recent Market Impacts

On September 13, 2012, the Federal Reserve announced their third quantitative easing program, commonly known as QE3, and extended their guidance to keep the federal funds rate at "exceptional low levels" through at least mid-2015. QE3 entails large-scale purchases of agency MBS at the pace of \$40 billion per month in addition to the Federal Reserve's existing policy of reinvesting principal payments from its holdings of agency MBS into new agency MBS purchases. The program is open-ended in nature, and is intended to put downward pressure on longer-term interest rates, support mortgage markets, and help make the broader financial conditions more accommodative. The Federal Reserve plans to continue their purchases of agency MBS and employ other policy tools, as appropriate, until they foresee substantial improvement in the outlook for the U.S. labor market.

The Federal Reserve's purchases will likely be concentrated in newly-issued, fixed-rate agency MBS (i.e., the part of the mortgage market with the greatest impact on mortgage rates offered to borrowers). We expect that the combined total purchases of agency MBS by the Federal Reserve will be \$65 billion to \$75 billion per month, which will likely be more than 50% of the average gross agency MBS new issue volume during the fourth quarter of 2012. As of September 30, 2012, prices across the agency MBS spectrum had generally increased following the Federal Reserve's QE3 announcement, with the lowest coupon, 30-year and 15-year fixed-rate agency MBS outperforming higher coupon agency MBS. The table below summarizes interest rates and prices of generic fixed-rate agency MBS for the nine month period ended September 30, 2012.

Interest Rate/Security Price <sup>(1)</sup>	September 30, 2012	June 30, 2012	March 31, 2012	December 31, 2011	September 30, 2012 Versus June 30, 2012	September 30, 2012 Versus December 31, 2011
<b>LIBOR:</b>						
1-Month	0.21%	0.25%	0.24%	0.30%	-0.04	-0.09
3-Month	0.36%	0.46%	0.47%	0.58%	-0.10	-0.22
<b>U.S. Treasury Security Rate:</b>						
2-Year U.S. Treasury	0.23%	0.30%	0.33%	0.24%	-0.07	-0.01
5-Year U.S. Treasury	0.63%	0.72%	1.04%	0.83%	-0.09	-0.20
10-Year U.S. Treasury	1.63%	1.65%	2.21%	1.88%	-0.02	-0.25
<b>Interest Rate Swap Rate:</b>						
2-Year Swap	0.37%	0.55%	0.58%	0.73%	-0.18	-0.36
5-Year Swap	0.76%	0.97%	1.27%	1.22%	-0.21	-0.46
10-Year Swap	1.70%	1.78%	2.29%	2.03%	-0.08	-0.33
<b>30-Year Fixed Rate MBS Price</b>						
3.0%	\$105.58	\$102.55	\$99.67	\$100.22	+\$3.03	+\$5.36
3.5%	\$107.25	\$105.11	\$102.72	\$102.88	+\$2.14	+\$4.37
4.0%	\$107.75	\$106.44	\$104.86	\$105.03	+\$1.31	+\$2.72
4.5%	\$108.25	\$107.28	\$106.38	\$106.42	+\$0.97	+\$1.83
5.0%	\$109.06	\$108.23	\$108.03	\$108.03	+\$0.83	+\$1.03
5.5%	\$109.63	\$109.08	\$108.97	\$108.89	+\$0.55	+\$0.74
6.0%	\$110.44	\$109.91	\$110.20	\$110.16	+\$0.53	+\$0.28
<b>15-Year Fixed Rate MBS Price</b>						
2.5%	\$105.13	\$103.09	\$101.42	\$101.34	+\$2.04	+\$3.79
3.0%	\$106.00	\$104.77	\$103.56	\$103.28	+\$1.23	+\$2.72
3.5%	\$106.41	\$105.66	\$104.92	\$104.58	+\$0.75	+\$1.83
4.0%	\$106.91	\$106.34	\$106.00	\$105.50	+\$0.57	+\$1.41



4.5%	\$107.84	\$107.17	\$107.20	\$106.59	+\$0.67	+\$1.25
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Price information is for generic instruments only and is not reflective of our specific portfolio holdings. Price information can vary by source. Prices in the table above obtained from a combination of Bloomberg and dealer indications. Interest rates obtained from Bloomberg.

We expect during periods in which the Federal Reserve purchases significant volumes of mortgages, yields on agency MBS will be lower than and refinancing volumes will be higher than would have been absent QE3. Since returns on agency MBS are highly sensitive to prepayment speeds we have positioned our investment portfolio towards agency MBS that we believe have favorable prepayment attributes. As of September 30, 2012, 71% of our fixed-rate investment portfolio was comprised of agency securities backed by lower loan balance mortgages (pools backed by original loan balances of up to

\$150,000) and loans originated under the U.S. Government sponsored Home Affordable Refinance Program ("HARP") (pools backed by 100% refinance loans with original loan-to-values of  $\geq 80\%$ ), which we believe have a lower risk of prepayment relative to generic agency securities. The remainder of our portfolio as of September 30, 2012 was primarily comprised of low coupon, new issuance fixed-rate agency securities. (See Financial Condition below for further details of our portfolio composition as of September 30, 2012).

The following table illustrates the impact of favorable prepayment characteristics on constant prepayment rates ("CPR"), comparing the actual annualized monthly CPR for our portfolio to the Fannie Mae 2011 30-year 4.0% fixed-rate TBA for the nine months ended September 30, 2012.

Annualized Monthly Constant Prepayment Rates <sup>(1)</sup>	January 2012	February 2012	March 2012	April 2012	May 2012	June 2012	July 2012	August 2012	September 2012
AGNC portfolio	8%	8%	12%	12%	10%	8%	8%	9%	11%
Fannie Mae 2011 30-year 4.0% fixed rate TBA <sup>(2)</sup>	11%	13%	19%	21%	14%	15%	21%	29%	35%

<sup>1</sup> Weighted average actual one-month annualized CPR released at the beginning of the month based on securities held/outstanding as of the preceding month-end.

<sup>2</sup> Source: JP Morgan.

In addition to strategic asset selection, we attempt to protect our net asset value against significant fluctuations due to market risks, including interest rate and prepayment risk, through the use of economic hedges. We utilize a variety of hedging strategies to aid us in this objective, which are summarized in Notes 3 and 6 of the accompanying financial statements.

#### FINANCIAL CONDITION

As of September 30, 2012 and December 31, 2011, our investment portfolio consisted of \$89.6 billion and \$54.7 billion, respectively, of agency mortgage-backed securities ("agency MBS"). The following tables summarize certain characteristics of our agency MBS investment portfolio as of September 30, 2012 and December 31, 2011 (dollars in millions):

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Agency MBS Classified as Available-for-Sale ("AFS")	September 30, 2012				Weighted Average		September 2012 Projected Life CPR <sup>(2)</sup>
	Par Value	Amortized Cost	Amortized Cost Basis	Fair Value	Coupon	Yield <sup>(1)</sup>	
AFS Investments By Issuer: Fannie Mae	\$64,352	\$67,671	105.2%	\$69,831	3.63%	2.54%	