PennyMac Mortgage Investment Trust
Form 10-Q
November 12, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

Or

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

For the transition period from __________ to __________

Commission file number: 001-34416

PennyMac Mortgage Investment Trust

(Exact name of registrant as specified in its charter)

Maryland **(State or other jurisdiction of** **incorporation or organization)**	**27-0186273** **(IRS Employer** **Identification No.)**
6101 Condor Drive, Moorpark, California **(Address of principal executive offices)**	**93021** **(Zip Code)**

(818) 224-7442

(Registrant s telephone number, including area code)

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

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

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

Large accelerated filer x	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 x

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date.

Class	**Outstanding at November 6, 2013**
Common Shares of Beneficial Interest, $0.01 par value	**70,453,582**

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PENNYMAC MORTGAGE INVESTMENT TRUST

FORM 10-Q

September 30, 2013

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PART I. FINANCIAL INFORMATION

Item 1. ***Financial Statements***

PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(in thousands, except per share data)

	September 30, 2013	December 31, 2012
ASSETS		
Cash	$ 100,064	$ 33,756
Short-term investments	80,936	39,017
Mortgage-backed securities at fair value	204,914	
Agency debt security at fair value	12,578	
Mortgage loans acquired for sale at fair value (includes $731,717 and $972,079 pledged to secure mortgage loans acquired for sale under agreements to repurchase)	737,114	975,184
Mortgage loans at fair value (includes $1,774,101 and $956,583 pledged to secure repurchase agreements)	1,848,656	1,189,971
Mortgage loans at fair value held by variable interest entity (includes $501,417 collateralized mortgage loans at fair value held by variable interest entity sold under agreement to repurchase and asset-backed secured financing at fair value)	536,776	
Mortgage loans under forward purchase agreements at fair value (includes $228,086 pledged to secure borrowings under forward purchase agreements)	228,086	
Derivative assets	18,415	23,706
Real estate acquired in settlement of loans (includes $67,870 and $23,834 pledged to secure real estate acquired in settlement of loans sold under agreements to repurchase)	99,693	88,078
Real estate acquired in settlement of loans under forward purchase agreements, pledged to secure forward purchase agreements	3,509	
Mortgage servicing rights at lower of amortized cost or fair value	258,678	125,430
Mortgage servicing rights at fair value	10,997	1,346
Excess servicing spread purchased from PennyMac Financial Services, Inc.	2,857	
Principal and interest collections receivable	22,918	29,204
Principal and interest collections receivable under forward purchase agreements	9,817	
Interest receivable	6,022	3,029
Servicing advances	43,741	32,191
Due from PennyMac Financial Services, Inc.	113	4,829
Other assets	23,347	13,922
Total assets	$ 4,249,231	$ 2,559,663

LIABILITIES		
Assets sold under agreements to repurchase:		
Securities	$ 196,032	$
Mortgage loans acquired for sale at fair value	670,311	894,906
Mortgage loans at fair value	797,715	353,805
Mortgage loans at fair value held by variable interest entity	293,772	
Real estate acquired in settlement of loans	22,228	7,391
Borrowings under forward purchase agreements	229,841	
Asset-backed secured financing at fair value	170,008	
Exchangeable senior notes	250,000	
Derivative liabilities	5,898	967
Accounts payable and accrued liabilities	34,649	48,285
Due to PennyMac Financial Services, Inc.	20,030	12,216
Income taxes payable	54,840	36,316
Liability for losses under representations and warranties	9,142	4,441
Total liabilities	2,754,466	1,358,327
Commitments and contingencies		
SHAREHOLDERS EQUITY		
Common shares of beneficial interest authorized, 500,000,000 common shares of $0.01 par value; issued and outstanding, 70,453,326 and 58,904,456 common shares, respectively	705	589
Additional paid-in capital	1,383,082	1,129,858
Retained earnings	110,978	70,889
Total shareholders equity	1,494,765	1,201,336
Total liabilities and shareholders equity	$ 4,249,231	$ 2,559,663

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

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PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(in thousands, except per share data)

	Quarter ended September 30,		Nine months ended September 30,	
	2013	**2012**	**2013**	**2012**
Net Investment Income				
Net gain on mortgage loans acquired for sale	$ 11,031	$ 49,793	$ 84,748	$ 81,210
Loan origination fees	4,559	2,836	14,784	4,880
Net interest income:				
Interest income	35,278	19,730	78,950	52,157
Interest expense	19,497	8,282	44,877	21,659
	15,781	11,448	34,073	30,498
Net gain (loss) on investments:				
Mortgage-backed securities	493	(451)	493	612
Agency debt security	578		578	
Mortgage loans	47,986	26,512	158,800	64,929
Excess servicing spread	29		29	
	49,086	26,061	159,900	65,541
Net loan servicing fees	6,659	(511)	20,562	(1,169)
Results of real estate acquired in settlement of loans	(2,295)	1,288	(7,477)	7,576
Other	1,241	(1)	2,841	56
Net investment income	86,062	90,914	309,431	188,592
Expenses				
Expenses payable to PennyMac Financial Services, Inc.:				
Loan fulfillment fees	18,327	17,258	68,625	31,097
Loan servicing fees	10,738	4,600	27,251	13,163
Management fees	8,539	3,672	23,486	7,964
Professional services	2,149	1,693	5,872	3,321
Compensation	2,292	1,997	5,819	5,042
Other	7,955	2,725	18,472	6,486
Total expenses	50,000	31,945	149,525	67,073
Income before provision for income taxes	36,062	58,969	159,906	121,519
(Benefit) provision for income taxes	(3,639)	18,585	12,412	32,508

Net income	$ 39,701	$ 40,384	$ 147,494	$ 89,011
Earnings per share				
Basic	$ 0.61	$ 0.81	$ 2.40	$ 2.29
Diluted	$ 0.57	$ 0.81	$ 2.29	$ 2.29
Weighted-average shares outstanding				
Basic	64,405	49,078	60,809	38,398
Diluted	73,121	49,463	65,898	38,712
Dividends declared per share	$ 0.57	$ 0.55	$ 1.71	$ 1.65

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

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PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY (UNAUDITED)

(in thousands, except per share data)

	Number of shares	Par value	Additional paid-in capital	Retained earnings	Total
Balance at December 31, 2011	28,404,554	$ 284	$ 518,272	$ 27,461	$ 546,017
Net income				89,011	89,011
Share-based compensation	162,734	2	3,574		3,576
Cash dividends, $1.65 per share				(61,245)	(61,245)
Proceeds from offerings of common shares	30,336,393	303	607,881		608,184
Underwriting and offering costs			(1,340)		(1,340)
Balance at September 30, 2012	58,903,681	589	1,128,387	55,227	1,184,203
Balance at December 31, 2012	58,904,456	$ 589	$ 1,129,858	$ 70,889	$ 1,201,336
Net income				147,494	147,494
Share-based compensation	248,870	3	4,063		4,066
Cash dividends, $1.71 per share				(107,405)	(107,405)
Proceeds from offerings of common shares	11,300,000	113	261,482		261,595
Underwriting and offering costs			(12,321)		(12,321)
Balance at September 30, 2013	70,453,326	$ 705	$ 1,383,082	$ 110,978	$ 1,494,765

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

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PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(in thousands)

	Nine months ended September 30,	
	2013	**2012**
Cash flows from operating activities:		
Net income	$ 147,494	$ 89,011
Adjustments to reconcile net income to net cash used by operating activities:		
Net gain on mortgage loans at fair value	(158,800)	(64,929)
Net gain on mortgage-backed securities at fair value	(5,356)	(612)
Accrual of unearned discounts on mortgage-backed securities at fair value and capitalization of interest and advances on mortgage loans at fair value	(25,017)	(16,558)
Net gain on mortgage loans acquired for sale at fair value	(84,748)	(81,210)
Net gain on excess servicing spread	(29)	
Results of real estate acquired in settlement of loans	7,477	(7,576)
Change in fair value of Agency debt security	(578)	
Change in fair value, amortization and impairment of mortgage servicing rights	17,200	7,456
Amortization of credit facility commitment fees and debt issuance costs	6,280	2,002
Accrual of costs related to forward purchase agreements	3,420	3,421
Share-based compensation expense	4,066	3,576
Purchases of mortgage loans acquired for sale at fair value	(25,996,695)	(11,967,678)
Sales of mortgage loans acquired for sale at fair value to nonaffiliates	13,229,726	6,254,411
Sales of mortgage loans acquired for sale to PennyMac Financial Services, Inc.	12,429,698	5,108,340
Decrease (increase) in principal and interest collections receivable	6,286	(21,352)
(Increase) decrease in principal and interest collections receivable under forward purchase agreements	(9,817)	5,299
Increase in interest receivable	(2,993)	(833)
Decrease (increase) in due from PennyMac Financial Services, Inc.	4,716	(1,657)
Increase in other assets	(18,999)	(10,356)
(Decrease) increase in accounts payable and accrued liabilities	(12,434)	16,257
Increase (decrease) in payable to PennyMac Financial Services, Inc.	8,414	(2,354)
Increase in income taxes payable	18,524	23,163
Net cash used by operating activities	(432,165)	(662,179)
Cash flows from investing activities		
Net increase in short-term investments	(41,919)	(8,003)
Purchase of Agency debt security	(12,000)	
Purchase of excess servicing spread from PennyMac Financial Services, Inc.	(2,828)	
Maturity of United States Treasury security		50,000

Purchases of mortgage-backed securities at fair value	(199,558)	(112,211)
Repayments of mortgage-backed securities at fair value		165,949
Sales of mortgage-back securities at fair value		23,218
Purchases of mortgage loans at fair value	(779,015)	(411,368)
Repayments of mortgage loans at fair value	193,914	128,116
Repayments of mortgage loans under forward purchase agreements at fair value	8,000	14,292
Purchase of real estate acquired in settlement of loans	(82)	(48)
Sales of real estate acquired in settlement of loans	98,103	104,367
Sales of real estate acquired in settlement of loans under forward purchase agreements	65	9,912
Purchases of mortgage servicing rights	(1,881)	(23)
Sales of mortgage servicing rights		104
Increase in margin deposits and restricted cash	(22,314)	(18,776)
Net cash used by investing activities	(759,515)	(54,471)
Cash flows from financing activities		
Sales of securities under agreements to repurchase	196,032	752,343
Repurchases of securities sold under agreements to repurchase		(867,836)
Sales of mortgage loans acquired for sale at fair value under agreements to repurchase	24,190,931	11,018,768
Repurchase of mortgage loans acquired for sale at fair value under agreements to repurchase	(24,415,526)	(10,475,974)
Sales of mortgage loans at fair value and held by variable interest entity under agreements to repurchase	1,428,255	267,074
Repurchases of mortgage loans at fair value and held by variable interest entity sold under agreements to repurchase	(665,432)	(295,111)
Repayments of note payable secured by mortgage loans at fair value		(2,044)
Sales of real estate acquired in settlement of loans financed under agreement to repurchase	12,271	10,753
Repurchases of real estate acquired in settlement of loans financed under agreement to repurchase	(22,575)	(26,532)
Repayments of borrowings under forward purchase agreements	(18,618)	(157,166)
Proceeds from asset-backed secured financing	170,008	
Payment of underwriting fees payable	(1,802)	
Issuance of exchangeable senior notes	250,000	
Payment of exchangeable senior notes issuance costs	(7,425)	
Proceeds from issuance of common shares	261,595	608,184
Payment of common share underwriting and offering costs	(12,321)	(1,340)
Payments of dividends	(107,405)	(61,245)
Net cash provided by financing activities	1,257,988	769,874
Net increase in cash	66,308	53,224
Cash at beginning of period	33,756	14,589
Cash at end of period	$ 100,064	$ 67,813

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

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PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 Organization and Basis of Presentation

PennyMac Mortgage Investment Trust (PMT or the Company) was organized in Maryland on May 18, 2009, and commenced operations on August 4, 2009, when it completed its initial offerings of common shares of beneficial interest (shares). The Company is a specialty finance company, which, through its subsidiaries (all of which are wholly-owned), invests primarily in residential mortgage loans and mortgage-related assets.

The Company operates in two segments: correspondent lending and investment activities:

The correspondent lending segment represents the Company s operations aimed at serving as an intermediary between mortgage lenders and the capital markets by purchasing, pooling and reselling newly originated prime credit quality mortgage loans either directly or in the form of mortgage backed securities (MBS), using the services of PNMAC Capital Management, LLC (PCM or the Manager) and PennyMac Loan Services, LLC (PLS or the Servicer), subsidiaries of PennyMac Financial Services, Inc.

Most of the loans the Company has acquired in its correspondent lending activities have been eligible for sale to government-sponsored entities such as the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) or through government agencies such as the Government National Mortgage Association (Ginnie Mae). Fannie Mae, Freddie Mac and Ginnie Mae are each referred to as an Agency and, collectively, as the Agencies.

The investment activities segment represents the Company s investments mortgage-related assets, including in distressed mortgage loans, real estate acquired in settlement of loans (REO), MBS and mortgage servicing rights (MSRs). The Company seeks to maximize the value of the distressed mortgage loans that it acquires through proprietary loan modification programs, special servicing or other initiatives focused on keeping borrowers in their homes. Where this is not possible, such as in the case of many nonperforming mortgage loans, the Company seeks to effect property resolution in a timely, orderly and economically efficient manner, including through the use of resolution alternatives to foreclosure.

The Company is externally managed by PCM, an investment adviser registered with the Securities and Exchange Commission (the SEC) that specializes in and focuses on residential mortgage loans. Under the terms of a management agreement, PCM is paid a management fee with a base component and a performance incentive component. Determination of the amount of management fees is discussed in Note 3 *Transactions with Related Parties*.

The Company believes that it qualifies, and has elected to be taxed, as a real estate investment trust (REIT) under the Internal Revenue Code of 1986, as amended (the Internal Revenue Code), beginning with its taxable period ended on December 31, 2009. To maintain its tax status as a REIT, the Company has to distribute at least 90% of its taxable income in the form of qualifying distributions to shareholders.

The Company conducts substantially all of its operations and makes substantially all of its investments through its subsidiary, PennyMac Operating Partnership, L.P. (the Operating Partnership), and the Operating Partnership s

subsidiaries. A subsidiary of the Company is the sole general partner, and the Company is the sole limited partner, of the Operating Partnership.

The accompanying consolidated financial statements have been prepared in compliance with accounting principles generally accepted in the United States (U.S. GAAP) for interim financial information and with the SEC s instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, these financial statements and notes do not include all of the information required by U.S. GAAP for complete financial statements. The interim consolidated information should be read together with the Company s Annual Report on Form 10-K for the year ended December 31, 2012 (the Annual Report).

The Company enters into various types of on- and off-balance sheet transactions with special purpose entities (SPEs), which are trusts that are established for a limited purpose. Generally, SPEs are formed in connection with securitization transactions. In a securitization transaction, the Company transfers mortgage loans on its balance sheet to an SPE, which then issues to investors various forms of interests in those assets. In a securitization transaction, the Company typically receives cash and/or interests in an SPE in exchange for the assets the Company transfers.

SPEs are generally considered variable interest entities (VIEs). A VIE is an entity having either a total equity investment that is insufficient to finance its activities without additional subordinated financial support or whose equity investors lack the ability to control the entity s activities. Variable interests are investments or other interests that will absorb portions of a VIE s expected losses or receive portions of the VIE s expected residual returns.

The Company is a variable interest holder in certain VIEs. The Company consolidates the assets and liabilities of VIEs of which the Company is the primary beneficiary. The primary beneficiary is the party that has both the power to direct the activities that most significantly impact the VIE and a variable interest that could potentially be significant to the VIE. To determine whether a variable

interest the Company holds could potentially be significant to the VIE, the Company considers both qualitative and quantitative factors regarding the nature, size and form of its involvement with the VIE. The Company assesses whether it is the primary beneficiary of a VIE on an ongoing basis.

At present, the Company only consolidates a VIE that it established as a statutory trust for the purpose of effecting securitizations of mortgage loans. For financial reporting purposes, the underlying loans and securities owned by the consolidated VIE are shown under *Mortgage loans at fair value held by variable interest entity* on the Company s consolidated balance sheets. The securities issued to third parties by the consolidated VIE are shown as secured borrowings under *Asset-backed secured financing* on the Company s consolidated balance sheets. The Company includes the interest income earned on the loans owned at the VIE and interest expense attributable to the asset-backed securities issued by the VIE on its consolidated income statements.

As disclosed in Note 2 *Concentration of Risks*, the Company also consolidates certain assets held by a third-party VIE.

Preparation of financial statements in compliance with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the reporting period. Actual results will likely differ from those estimates.

In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the periods ended September 30, 2013 are not necessarily indicative of the results for the year ending December 31, 2013.

Reclassification of previously presented balances

Certain prior period amounts have been reclassified to conform to the current presentation. Specifically:

Interest expense is presented along with *Interest income* as a new caption of *Net interest income* is to better reflect the Company s results due to growth in its portfolio of interest-earning assets. This reclassification results in the presentation of *Net interest income*, a reduction in *Net investment income* and a decrease in *Expenses.*

Loan servicing fees payable to PennyMac Financial Services, Inc. is presented without the inclusion of expenses payable to nonaffiliates. Previously, *Loan servicing expense* included amounts payable to PennyMac Financial Services, Inc. and to nonaffiliates. Amounts payable to nonaffiliates have been reclassified to *Other expenses*.

Following is a summary of the reclassifications for the periods presented:

	As reported		As previously reported		Reclassification	
	Quarter ended September 30, 2012	Nine months ended September 30,	Quarter ended September 30, 2012	Nine months ended September 30,	Quarter ended September 30, 2012	Nine months ended September 30,

		2012		**2012**		**2012**
			(in thousands)			
Net interest income (*new caption*):						
Interest income	$ 19,730	$ 52,157	$ 19,730	$ 52,157	$	$
Interest expense	8,282	21,659			8,282	21,659
	$ 11,448	$ 30,498			$ 8,282	$ 21,659
Net investment income	$ 90,914	$ 188,592	$ 99,196	$ 210,251	$ (8,282)	$ (21,659)
Expenses:						
Interest expense	$	$	$ 8,282	$ 21,659	$ (8,282)	$ (21,659)
Loan servicing fees payable to PennyMac Financial Services, Inc.	4,600	13,163	5,208	15,180	(608)	(2,017)
Other	2,725	6,486	2,117	4,469	608	2,017
Total expenses	$ 31,945	$ 67,073	$ 40,227	$ 88,732	($ 8,282)	$ (21,659)

These reclassifications did not change previously reported income before provision for income taxes, tax (benefit) provision, net income, reported consolidated balance sheet amounts, including shareholders equity, or consolidated cash flows.

Note 2 Concentration of Risks

As discussed in Note 1 *Organization and Basis of Presentation* above, PMT s operations and investing activities are centered in mortgage-related assets, a substantial portion of which are distressed at acquisition. Because of the Company s investment strategy, many of the mortgage loans in its targeted asset class are purchased at discounts reflecting their distressed state or perceived higher risk of default, as well as a greater likelihood of collateral documentation deficiencies. Before acquiring loans or other assets, PCM validates key information provided by the sellers that is necessary to determine the value of the acquired asset.

Because of the Company s investment focus, PMT is exposed, to a greater extent than traditional mortgage investors, to the risks that borrowers may be in economic distress and/or may have become unemployed, bankrupt or otherwise unable or unwilling to make payments when due, and to the effects of fluctuations in the residential real estate market on the performance of its investments. Factors influencing these risks include, but are not limited to:

- changes in the overall economy and unemployment rates and residential real estate values in the markets where the properties securing the Company s mortgage loans are located;
- PCM s ability to identify and the Company s loan servicers ability to execute optimal resolutions of problem mortgage loans;
- the accuracy of valuation information obtained during the Company s due diligence activities;
- PCM s ability to effectively model, and to develop appropriate model assumptions that properly anticipate, future outcomes;
- the level of government support for problem loan resolution and the effect of current and future proposed and enacted legislative and regulatory changes on the Company s ability to effect cures or resolutions to distressed loans; and
- regulatory, judicial and legislative support of the foreclosure process, and the resulting effect on the Company s ability to acquire and liquidate the real estate securing its portfolio of distressed mortgage loans in a timely manner or at all.

Due to these uncertainties, there can be no assurance that risk management activities identified and executed on PMT s behalf will prevent significant losses arising from the Company s investments in real estate-related assets.

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A substantial portion of the distressed loans purchased by the Company has been acquired from or through one or more subsidiaries of Citigroup Inc. The following tables present the fair value of mortgage loans and REO purchased (including purchases under forward purchase agreements) for the Company s investment portfolio, and the portion thereof representing assets purchased from or through one or more subsidiaries of Citigroup Inc., for the periods presented:

	Quarter ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Investment portfolio purchases:				
Loans	$ 580,822	$ 150,778	$ 1,024,404	$ 412,438
REO	3,597		3,686	296
	$ 584,419	$ 150,778	$ 1,028,090	$ 412,734
Investment portfolio purchases above through one or more subsidiaries of Citigroup Inc.:				
Loans	$	$ 150,778	$ 443,183	$ 411,373
REO	3,597		3,686	248
	$ 3,597	$ 150,778	$ 446,869	$ 411,621

On July 12, 2011, December 20, 2011, June 14, 2013 and June 28, 2013, the Company entered into forward purchase agreements with Citigroup Global Markets Realty Corp. (CGM), a subsidiary of Citigroup Inc., to purchase certain nonperforming residential mortgage loans and residential real property acquired in settlement of loans (collectively, the CGM Assets). The CGM Assets were acquired by CGM from unaffiliated money center banks. The commitment under the forward purchase agreement dated July 12, 2011 was settled during the quarter ended June 30, 2012. The commitment under the forward purchase agreement dated December 20, 2011 was settled during the quarter ended September 30, 2012. The commitments under the forward purchase agreements dated June 14, 2013 and June 28, 2013 have not yet been settled and have maturity dates of June 16, 2014 and June 30, 2014, respectively.

The CGM Assets are included on the Company s consolidated balance sheet as *Mortgage loans under forward purchase agreements at fair value* and *Real estate acquired in settlement of loans under forward purchase agreements* and the related liabilities are included as *Borrowings under forward purchase agreements*. The CGM Assets are held by CGM within a separate trust entity deemed a VIE. The Company s interests in the CGM Assets are deemed to be contractually segregated from all other interests in the trust. When assets are contractually segregated, they are often referred to as a silo. For these transactions, the silo consists of the CGM Assets and its related liability. The Company directs all of the activities that drive the economic results of the CGM Assets. All of the changes in the fair value and cash flows of the CGM Assets are attributable solely to the Company, and such cash flows can only be used to settle the related liability.

As a result of consolidating the silo, the Company s consolidated statements of income and cash flows for the periods presented include the following amounts related to the silo:

	Quarter ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Statement of income:				
Net gain on mortgage loans	$ 8,378	$ 105	$ 7,688	$ 9,293
Interest income on mortgage loans	$ 1,196	$ 146	$ 1,457	$ 996
Results of REO	$ (41)	$ (4)	$ (41)	$ 1,870
Interest expense	$ 1,763	$ 100	$ 2,013	$ 2,396
Loan servicing fees	$	$ 51	$	$ 1,011
Statement of cash flows:				
Repayments of mortgage loans	$ 8,000	$ 252	$ 8,000	$ 14,292
Sales of REO	$ 65	$	$ 65	$ 9,912
Repayments of borrowings under forward purchase agreements	$ (18,618)	$ (16,859)	$ (18,618)	$ (157,166)

The Company has no other variable interests in the trust entity or other exposure to the creditors of the trust entity that could expose the Company to loss.

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Note 3 Transactions with Related Parties

Management Fees

Before February 1, 2013, under a management agreement, PMT paid PCM a base management fee which was calculated at 1.5% per year of shareholders equity. The management agreement also provided for a performance incentive. The performance incentive fee was calculated at 20% per year of the amount by which core earnings, on a rolling four-quarter basis and before the incentive fee, exceeded an 8% hurdle rate as defined in the management agreement. The Company did not pay a performance incentive fee before February 1, 2013.

Effective February 1, 2013, the management agreement was amended to provide that:

The base management fee is calculated quarterly and is equal to the sum of (i) 1.5% per year of shareholders equity up to $2 billion, (ii) 1.375% per year of shareholders equity in excess of $2 billion and up to $5 billion, and (iii) 1.25% per year of shareholders equity in excess of $5 billion.

The performance incentive fee is calculated at a defined annualized percentage of the amount by which net income, on a rolling four-quarter basis and before deducting the incentive fee, exceeds certain levels of return on equity.

The performance incentive fee is calculated quarterly and is equal to: (a) 10% of the amount by which net income for the quarter exceeds (i) an 8% return on equity plus the high watermark, up to (ii) a 12% return on equity; plus (b) 15% of the amount by which net income for the quarter exceeds (i) a 12% return on equity plus the high watermark, up to (ii) a 16% return on equity; plus (c) 20% of the amount by which net income for the quarter exceeds a 16% return on equity plus the high watermark.

For the purpose of determining the amount of the performance incentive fee:

Net income is defined as net income or loss computed in accordance with U.S. GAAP and certain other non-cash charges determined after discussions between the Company s Manager and our independent trustees and after approval by a majority of PMT s independent trustees.

Equity is the weighted average of the issue price per common share of all of PMT s public offerings, multiplied by the weighted average number of common shares outstanding (including restricted share units) in the four-quarter period.

The high watermark starts at zero and is adjusted quarterly. The quarterly adjustment reflects the amount by which the net income (stated as a percentage of return on equity) in that quarter exceeds or falls short of the lesser of 8% and the Fannie Mae MBS yield (the target yield) for such quarter. If the net income is lower than the target yield, the high watermark is increased by the difference. If the net income is higher than the target yield, the high watermark is reduced by the difference. Each time a performance incentive fee is earned, the high watermark returns to zero. As a result, the threshold amounts required for PMT s Manager to earn a performance incentive fee are adjusted cumulatively based on the performance of our net income over (or under) the target yield, until the net income in excess of the target yield exceeds the then-current cumulative high watermark amount, and a performance incentive fee is earned.

The base management fee and the performance incentive fee are both payable quarterly in arrears. The performance incentive fee may be paid in cash or in PMT s common shares (subject to a limit of no more than 50% paid in common shares), at the Company s option.

Following is a summary of the base management and performance incentive fees recorded by the Company for the periods presented:

	Quarter ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Base management fee	$ 5,104	$ 3,672	$ 14,043	$ 7,964
Performance incentive fee	3,435		9,443	
Total management fee incurred during the period	$ 8,539	$ 3,672	$ 23,486	$ 7,964

In the event of termination, PCM may be entitled to a termination fee in certain circumstances. The termination fee is equal to three times the sum of (a) the average annual base management fee, and (b) the average annual (or, if the period is than 24 months, annualized) performance incentive fee earned by PCM, in each case during the 24-month period before termination.

Mortgage Loan Servicing

The Company, through its Operating Partnership, has a loan servicing agreement with PLS. Before February 1, 2013, the servicing fee rates were based on the risk characteristics of the mortgage loans serviced and total servicing compensation was established at levels that management believed were competitive with those charged by other servicers or specialty servicers, as applicable.

Servicing fee rates for nonperforming loans ranged between 50 and 100 basis points per year on the unpaid principal balance of the mortgage loans serviced on the Company s behalf. PLS was also entitled to certain customary market-based fees and charges, including boarding and deboarding fees, liquidation and disposition fees, assumption, modification and origination fees and late charges, as well as interest on funds on deposit in custodial accounts. In the event PLS either effected a refinancing of a loan on the Company s behalf and not through a third party lender and the resulting loan was readily saleable, or originated a loan to facilitate the disposition of real estate that the Company had acquired in settlement of a loan, PLS was entitled to receive from the Company market-based fees and compensation.

For mortgage loans serviced by the Company as a result of acquisitions and sales with servicing rights retained in connection with the Company s correspondent lending business, PLS was entitled to base subservicing fees and other customary market-based fees and charges as described above.

Effective February 1, 2013, the servicing agreement was amended to provide for servicing fees payable to PLS that changed from being based on a percentage of the loan s unpaid principal balance to fixed per-loan monthly amounts based on the delinquency, bankruptcy and/or foreclosure status of the serviced loan or the REO. PLS also remains entitled to market-based fees and charges including boarding and deboarding, liquidation and disposition fees, assumption, modification and origination fees and late charges relating to loans it services for the Company.

The base servicing fees for distressed whole loans are calculated based on a monthly per-loan dollar amount, with the actual dollar amount for each loan based on the delinquency, bankruptcy and/or foreclosure status of such loan or the related underlying real estate. Presently, the base servicing fees for distressed whole loans range from $30 per month for current loans up to $125 per month for loans that are severely delinquent and in foreclosure.

The base servicing fees for non-distressed loans subserviced by PLS on the Company s behalf are also calculated through a monthly per-loan dollar amount, with the actual dollar amount for each loan based on whether the mortgage loan is a fixed-rate or adjustable-rate loan. The base servicing fees for loans subserviced on the Company s behalf are $7.50 per month for fixed-rate loans and $8.50 per month for adjustable rate mortgage loans. To the extent that these loans become delinquent, PLS is entitled to an additional servicing fee per loan falling within a range of $10 to $75 per month based on the delinquency, bankruptcy and foreclosure status of the loan or the related underlying real estate. PLS is also entitled to customary ancillary income and certain market-based fees and charges, including boarding and deboarding fees, liquidation and disposition fees, assumption, modification and origination fees.

PLS is required to provide a range of services and activities significantly greater in scope than the services provided in connection with a customary servicing arrangement because the Company does not have any employees or infrastructure. For these services, PLS receives a supplemental fee of $25 per month for each distressed whole loan and $3.25 per month for each subserviced loan. PLS is entitled to reimbursement for all customary, good faith reasonable and necessary out-of-pocket expenses incurred in performance of its servicing obligations.

PLS, on behalf of PMT, currently participates in the Home Affordable Modification Program (HAMP) of the U.S. Department of the Treasury and U.S. Department of Housing and Urban Development (HUD) (and other similar mortgage loan modification programs). HAMP establishes standard loan modification guidelines for at risk homeowners and provides incentive payments to certain participants, including loan servicers, for achieving modifications and successfully remaining in the program. The loan servicing agreement entitles PLS to retain any incentive payments made to it and to which it is entitled under HAMP; provided, however, that with respect to any such incentive payments paid to PLS under HAMP in connection with a mortgage loan modification for which the Company previously paid PLS a modification fee, PLS shall reimburse the Company an amount equal to the incentive payments.

Following is a summary of mortgage loan servicing fees payable to PLS for the periods presented:

	Quarter ended September 30,		Nine months ended September 30,	
	2013	**2012**	**2013**	**2012**
	(in thousands)			
Loan servicing fees to PLS:				
Base	$ 7,139	$ 3,518	$ 19,005	$ 9,656
Activity-based	3,599	1,082	8,246	3,507
	$ 10,738	$ 4,600	$ 27,251	$ 13,163

The term of the servicing agreement, as amended, expires on February 1, 2017, subject to automatic renewal for additional 18-month periods, unless terminated earlier in accordance with the terms of the servicing agreement.

Correspondent Lending

Before February 1, 2013, the Company paid PLS a fulfillment fee of 50 basis points of the unpaid principal balance of mortgage loans sold to non-affiliates where the Company is approved or licensed to sell to such non-affiliate. Effective February 1, 2013, the mortgage banking and warehouse services agreement provides for a fulfillment fee paid to PLS based on the type of mortgage loan that the Company acquires. The fulfillment fee is equal to a percentage of the unpaid principal balance of mortgage loans purchased by the Company, with the addition of potential fee rate discounts applicable to the Company s monthly purchase volume in excess of designated thresholds. PLS has also agreed to provide such services exclusively for the Company s benefit, and PLS and its affiliates are prohibited from providing such services for any other third party.

PLS is entitled to a fulfillment fee based on the type of mortgage loan that the Company acquires and equal to a percentage of the unpaid principal balance of such mortgage loan. Presently, the applicable percentages are (i) 0.50% for conventional mortgage loans, (ii) 0.88% for loans sold in accordance with the Ginnie Mae Mortgage-Backed Securities Guide, (iii) 0.80% for the U.S. Department of the Treasury and HUD s Home Affordable Refinance Program (HARP) mortgage loans with a loan-to-value ratio of 105% or less, (iv) 1.20% for HARP mortgage loans with a loan-to-value ratio of greater than 105%, and (v) 0.50% for all other mortgage loans not contemplated above; provided, however, that PLS may, in its sole discretion, reduce the amount of the applicable fulfillment fee and credit the amount of such reduction to the reimbursement otherwise due as described below. This reduction may only be credited to the reimbursement applicable to the month in which the related mortgage was funded.

At this time, the Company does not hold the Ginnie Mae approval required to issue securities guaranteed by Ginnie Mae MBS and act as a servicer. Accordingly, under the mortgage banking and warehouse services agreement, PLS currently purchases loans salable in accordance with the Ginnie Mae Mortgage-Backed Securities Guide as is and without recourse of any kind from the Company at our cost less an administrative fee plus accrued interest and a sourcing fee of three basis points.

In the event that the Company purchases mortgage loans with an aggregate unpaid principal balance in any month greater than $2.5 billion and less than $5 billion, PLS has agreed to discount the amount of such fulfillment fees by reimbursing PMT an amount equal to the product of (i) 0.025%, (ii) the amount of unpaid principal balance in excess of $2.5 billion and (iii) the percentage of the aggregate unpaid principal balance relating to mortgage loans for which PLS collected fulfillment fees in such month. In the event the Company purchases mortgage loans with an aggregate unpaid principal balance in any month greater than $5 billion, PLS has agreed to further discount the amount of fulfillment fees by reimbursing the Company an amount equal to the product of (i) 0.05%, (ii) the amount of unpaid principal balance in excess of $5 billion and (iii) the percentage of the aggregate unpaid principal balance relating to mortgage loans for which PLS collected fulfillment fees in such month.

In consideration for the mortgage banking services provided by PLS with respect to the Company s acquisition of mortgage loans under PLS s early purchase program, PLS is entitled to fees accruing (i) at a rate equal to $25,000 per year, and (ii) in the amount of $50 for each mortgage loan the Company acquires. In consideration for the warehouse services provided by PLS with respect to mortgage loans that the Company finances for its warehouse lending clients, with respect to each facility, PLS is entitled to fees accruing (i) at a rate equal to $25,000 per year, and (ii) in the amount of $50 for each mortgage loan that the Company finances thereunder. Where the Company has entered into both an early purchase agreement and a warehouse lending agreement with the same client, PLS shall only be entitled to one $25,000 per annum fee and, with respect to any mortgage loan that becomes subject to both such agreements, only one $50 per loan fee.

The term of our mortgage banking and warehouse services agreement expires on February 1, 2017, subject to automatic renewal for additional 18-month periods, unless terminated earlier in accordance with the terms of the agreement.

Following is a summary of correspondent lending activity between the Company and PLS for the periods presented:

	Quarter ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Sourcing fees received	$ 1,204	$ 747	$ 3,563	$ 1,448
Fulfillment fees expense	$ 18,327	$ 17,258	$ 68,625	$ 31,097
Unpaid principal balance of loans fulfilled	$ 3,681,771	$ 2,488,443	$ 12,792,482	$ 4,828,117
Fair value of loans sold to PLS	$ 4,147,535	$ 2,650,097	$ 12,429,698	$ 5,108,340
At period end:				
Mortgage loans included in mortgage loans acquired for sale pending sale to PLS at period end	$ 273,007	$ 194,055	$ 273,007	$ 194,055

Investment Activities

Pursuant to the terms of a MSR recapture agreement, effective February 1, 2013, if PLS refinances through its retail lending business loans for which the Company previously held the MSRs, PLS is generally required to transfer and convey to one of the Company s wholly-owned subsidiaries without cost to the Company, the MSRs with respect to new mortgage loans originated in those refinancings (or, under certain circumstances, other mortgage loans) that have an aggregate unpaid principal balance that is not less than 30% of the aggregate unpaid principal balance of all the loans so originated. Where the fair market value of the aggregate MSRs to be transferred for the applicable month is less than $200,000, PLS may, at its option, wire cash to PMT in an amount equal to such fair market value in lieu of transferring such MSRs. MSR recapture amounts are shown in Note 24 *Net loan servicing fees*. The MSR recapture agreement expires, unless terminated earlier in accordance with the agreement, on February 1, 2017, subject to automatic renewal for additional 18-month periods.

Pursuant to a master spread acquisition and MSR servicing agreement, effective February 1, 2013, PMT may acquire from PLS the rights to receive certain excess servicing spread arising from MSRs acquired by PLS, in which case PLS generally would be required to service or subservice the related mortgage loans. The terms of each transaction under the master spread acquisition and MSR servicing agreement will be subject to the terms of such agreement as modified and supplemented by the terms of a confirmation executed in connection with such transaction.

Other Transactions

In connection with the initial public offering of PMT s common shares (IPO) on August 4, 2009, the Company entered into an agreement with PCM pursuant to which the Company agreed to reimburse PCM for the $2.9 million payment that it made to the IPO underwriters if the Company satisfied certain performance measures over a specified period of time (the Conditional Reimbursement). Effective February 1, 2013, the Company amended the terms of the reimbursement agreement to provide for the reimbursement of PCM of the Conditional Reimbursement if the Company is required to pay PCM performance incentive fees under the management agreement at a rate of $10 in reimbursement for every $100 of performance incentive fees earned. The reimbursement of the Conditional Reimbursement is subject to a maximum reimbursement in any particular 12-month period of $1.0 million and the maximum amount that may be reimbursed under the agreement is $2.9 million. During the quarter and nine months ended September 30, 2013, $388,000 and $601,000 was paid to PCM, respectively.

The reimbursement agreement also provides for the payment to the underwriters in such offering of the payment that the Company agreed to make to them at the time of the offering if the Company satisfied certain performance measures over a specified period of time. As PCM earns performance incentive fees under the management agreement, such underwriters will be paid at a rate of $20 of payments for every $100 of performance incentive fees earned by PCM. The payment to the underwriters is subject to a maximum reimbursement in any particular 12-month period of $2.0 million and the maximum amount that may be paid under the agreement is $5.9 million. During the quarter and nine months ended September 30, 2013, $776,000 and $1.2 million was paid to the underwriters, respectively.

In the event the termination fee is payable to PCM under the management agreement and PCM and the underwriters have not received the full amount of the reimbursements and payments under the reimbursement agreement, such amount will be paid in full. The term of the reimbursement agreement expires on February 1, 2019.

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The Company reimburses PCM and its affiliates for other expenses, including common overhead expenses incurred on its behalf by PCM and its affiliates, in accordance with the terms of its management agreement as summarized below:

	Quarter ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Reimbursement of expenses incurred on PMT s behalf	$ 1,934	$ 555	$ 3,767	$ 2,420
Reimbursement of common overhead incurred by PCM and its affiliates	2,552	1,244	8,359	2,474
	$ 4,486	$ 1,799	$ 12,126	$ 4,894
Payments and settlements during the period(1)	$ 29,315	$ 12,239	$ 94,606	$ 28,896

(1) Payments and settlements include payments for management fees and correspondent lending activities itemized in the preceding tables and netting settlements made pursuant to master netting agreements between the Company and PCM and its affiliates.

Amounts due to affiliates are summarized below as of the dates presented:

	September 30, 2013	December 31, 2012
	(in thousands)	
Underwriting fees payable	$ 2,131	$ 2,941
Management fees	8,539	4,499
Servicing fees	5,152	3,670
Allocated expenses	4,208	1,106
	$ 20,030	$ 12,216

Amounts due from affiliates totaling $113,000 and $4.8 million at September 30, 2013 and December 31, 2012, respectively, represent amounts receivable pursuant to loan sales to PLS and reimbursable expenses paid on the affiliates behalf by the Company.

PCM s parent company and a subsidiary of PFSI, Private National Mortgage Acceptance Company, LLC, held 75,000 of the Company s common shares of beneficial interest at both September 30, 2013 and December 31, 2012.

Note 4 Earnings Per Share

Basic earnings per share is determined using net income divided by the weighted-average common shares outstanding during the period. Diluted earnings per share is determined by dividing net income attributable to common

shareholders, which adds back to net income the interest expense, net of applicable income taxes, on exchangeable senior notes for periods presented, by the weighted-average common shares outstanding, assuming all potentially dilutive common shares were issued. In periods in which the Company records a loss, potentially dilutive common shares are excluded from the diluted loss per share calculation, as their effect on loss per share is anti-dilutive.

The Company grants restricted share units which entitle the recipients to receive dividend equivalents during the vesting period on a basis equivalent to the dividends paid to holders of common shares. For purposes of calculating earnings per share, unvested share-based compensation awards containing non-forfeitable rights to receive dividends or dividend equivalents (collectively, dividends) are classified as participating securities and are included in the basic earnings per share calculation using the two-class method. Under the two-class method, all earnings (distributed and undistributed) are allocated to each class of common shares and participating securities, based on their respective rights to receive dividends.

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The following table summarizes the basic and diluted earnings per share calculations:

	Quarter ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
	(in thousands, except per share amounts)			
Basic earnings per share:				
Net income	$ 39,701	$ 40,384	$ 147,494	$ 89,011
Effect of participating securities share-based compensation instruments	(374)	(528)	(1,656)	(947)
Net income attributable to common shareholders	$ 39,327	$ 39,856	$ 145,838	$ 88,064
Weighted-average shares outstanding	64,405	49,078	60,809	38,398
Basic earnings per share	$ 0.61	$ 0.81	$ 2.40	$ 2.29
Diluted earnings per share:				
Net income	$ 39,701	$ 40,384	$ 147,494	$ 89,011
Interest on exchangeable senior notes, net of income taxes	2,075		3,457	
Net income available to diluted shareholders	$ 41,776	$ 40,384	$ 150,951	$ 89,011
Weighted-average shares outstanding	64,405	49,078	60,809	38,398
Dilutive potential common shares:				
Shares issuable pursuant to conversion of exchangeable senior notes	8,379		4,726	
Shares issuable under share-based compensation plan	337	385	363	314
Diluted weighted-average number of common shares outstanding	73,121	49,463	65,898	38,712
Diluted earnings per common share	$ 0.57	$ 0.81	$ 2.29	$ 2.29

Note 5 Loan Sales and Variable Interest Entities

As described in Note 1 *Organization and Basis of Presentation*, the Company is a variable interest holder in various SPEs. The Company has segregated its involvement with VIEs between those VIEs which are consolidated and those VIEs for which the Company does not consolidate.

Unconsolidated VIEs with Continuing Involvement

The Company purchases and sells mortgage loans into the secondary mortgage market without recourse for credit losses. However, the Company maintains continuing involvement with the loans in the form of servicing arrangements and liability under representations and warranties it makes to purchasers and insurers of the loans. The Company determined that it is not the primary beneficiary of the VIEs as the Company does not have the power to direct the activities that will have the most significant economic impact on the entities and/or does not hold a variable interest that could potentially be significant to the VIE.

The following table summarizes cash flows between the Company and transferees upon sale of loans in transactions where the Company maintains continuing involvement with the mortgage loans as well as unpaid principal balance information at period end:

	Quarter ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Cash flows:				
Proceeds from sales	$ 4,185,247	$ 3,573,762	$ 13,229,726	$ 6,254,411
Service fees received	$ 26,204	$ 3,933	$ 64,881	$ 6,294
Period-end information:				
Unpaid principal balance of loans outstanding	$ 23,717,643	$ 6,064,614		
Delinquencies:				
30-89 days	$ 50,746	$ 19,508		
90 or more days or in foreclosure or bankruptcy	$ 8,104	$		

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Consolidated VIEs

On September 30, 2013, the Company completed a securitization transaction in which a wholly-owned SPE issued $537.0 million in offered certificates backed by fixed rate prime jumbo mortgage loans of PMT Loan Trust 2013-J1, at a 3.9% weighted yield. The Company retained $366.8 million of those certificates.

The Company evaluated the securitization trust and determined that the entity is a VIE of which one of the consolidated subsidiaries is the primary beneficiary; therefore, the Company consolidated the entity. The Company is deemed to be the primary beneficiary of the VIE because the Company is part of a related party group that has the power to direct the activities of the VIE that most significantly impact the entity s economic performance and the Company retains the obligation to absorb losses and the right to receive benefits that are potentially significant to the VIE. The Company s power stems from PLS, an affiliate, in its role as servicer of the mortgage loans, directing the activities of the trust that most significantly impact the trust s economic performance. The Company s retained subordinated and residual interest trust certificates expose the Company to potentially significant losses and potentially significant returns.

The asset-backed securities are backed by the expected cash flows from the securitized mortgage loans. Cash inflows from these mortgage loans are distributed to investors and service providers in accordance with the contractual priority of payments and, as such, most of these inflows must be directed first to service and repay the trust senior notes or certificates. After these senior obligations are settled, substantially all cash inflows will be directed to the subordinated notes until fully repaid and, thereafter, to the residual interest that the Company owns in the trust.

The Company retains interests in the securitization transaction, including senior and subordinated securities issued by the VIE and residual interests. The Company retains credit risk in the securitization because the Company s retained interests includes the most subordinated interests in the securitized assets, which are the first to absorb credit losses on the securitized assets. The Company expects that any credit losses in the pools of securitized assets will likely be limited to the Company s subordinated and residual retained interests. The Company has no obligation to repurchase or replace qualified securitized assets that subsequently become delinquent or are otherwise in default other than pursuant breaches of representations and warranties.

Consolidation of the VIE results in the securitization transaction being accounted for as an on-balance sheet secured financing. The securitized mortgage loans remain on the consolidated balance sheets of the Company along with the certificates issued to nonaffiliates by the VIE. The certificates are secured solely by the assets of the VIE and not by any other assets of the Company. The assets of the VIE are the only source of funds for repayment on the notes. The following table presents a summary of the assets and liabilities of the VIE. Intercompany balances have been eliminated for purposes of this presentation.

Assets and Liabilities of Consolidated VIE at September 30, 2013

	September 30, 2013	December 31, 2012
	($ in thousands)	
Assets		
Mortgage loans at fair value held by variable interest entity	$ 536,776	$
Interest receivable	1,702	

Total	$ 538,478	$
Liabilities		
Asset-backed secured financing	$ 170,008	$
Interest payable	492	
Total	$ 170,500	$

In addition, the Company consolidates the assets and liabilities related to the CGM assets as disclosed in Note 2.

Note 6 Netting of Financial Instruments

The Company uses derivative instruments to manage exposure to interest rate risk created by the commitments it makes to correspondent lenders to purchase loans at specified interest rates, also called interest rate lock commitments (IRLCs), mortgage loans acquired for sale at fair value, MBS, and MSRs. All derivative financial instruments are recorded on the balance sheet at fair value. The Company has elected to net derivative asset and liability positions, and cash collateral obtained (or posted) by (or to) its counterparties when subject to a master netting arrangement. In the event of default, all counterparties are subject to legally enforceable master netting agreements. The derivatives that are not subject to a master netting arrangement are IRLCs. As of September 30, 2013 and December 31, 2012, the Company did not enter into reverse repurchase agreements or securities lending transactions that are required to be disclosed in the following table.

Offsetting of Derivative Assets

	September 30, 2013			December 31, 2012		
	Gross amounts of recognized assets	Gross amounts offset in the balance sheet	Net amounts of assets presented in the balance sheet	Gross amounts of recognized assets	Gross amounts offset in the balance sheet	Net amounts of assets presented in the balance sheet
	(in thousands)					
Derivatives:						
MBS put options	$ 36	$	$ 36	$ 977	$	$ 977
Forward purchase contracts	26,086		26,086	2,617		2,617
Forward sale contracts	2		2	3,458		3,458
Netting		(19,185)	(19,185)		(2,825)	(2,825)
Total derivatives, subject to a master netting arrangement	26,124	(19,185)	6,939	7,052	(2,825)	4,227
Total derivatives, not subject to a master netting arrangement	11,476		11,476	19,479		19,479
	$ 37,600	$ (19,185)	$ 18,415	$ 26,531	$ (2,825)	$ 23,706

Derivative Assets and Collateral Held by Counterparty

The following table summarizes by significant counterparty the amount of derivative asset positions after considering master netting arrangements and financial instruments or cash pledged that do not meet the accounting guidance qualifying for netting.

	September 30, 2013				December 31, 2012			
		Gross amounts not offset in the balance sheet				Gross amounts not offset in the balance sheet		
	Net amount of assets in the balance sheet	Financial instruments	Cash collateral received	Net amount	Net amount of assets in the balance sheet	Financial instruments	Cash collateral received	Net amount
	(in thousands)							
Interest rate lock commitments	$ 11,476	$	$	$ 11,476	$ 19,479			$ 19,479

Bank of America, N.A.					1,219			1,219
Daiwa Capital Markets	2,376			2,376				
Barclays					15			15
Citibank					1,009			1,009
Goldman Sachs	1,246			1,246				
Jefferies & Co					21			21
Credit Suisse First Boston Mortgage Capital LLC					820			820
Morgan Stanley Bank, N.A.					316			316
Wells Fargo					99			99
Cantor Fitzgerald LP	924			924	581			581
Other	2,393			2,393	147			147
	$ 18,415	$	$	$ 18,415	$ 23,706	$	$	$ 23,706

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Offsetting of Derivative Liabilities and Financial Liabilities

Following is a summary of net derivative liabilities and assets sold under agreements to repurchase. As discussed above, all derivatives with the exception of IRLCs are subject to master netting arrangements. Assets sold under agreements to repurchase do not qualify for offset.

	September 30, 2013			December 31, 2012		
	Gross amounts of recognized liabilities	Gross amounts offset in the balance sheet	Net amounts of liabilities presented in the balance sheet	Gross amounts of recognized liabilities	Gross amounts offset in the balance sheet	Net amounts of liabilities presented in the balance sheet
	(in thousands)					
Derivatives:						
Forward purchase contracts	$ 2	$	$ 2	$ 1,741	$	$ 1,741
Forward sale contracts	49,108		49,108	4,520		4,520
Netting		(43,242)	(43,242)		(5,294)	(5,294)
Total derivatives, subject to a master netting arrangement	49,110	(43,242)	5,868	6,261	(5,294)	967
Total derivatives, not subject to a master netting arrangement	30		30			
Total derivatives	49,140	(43,242)	5,898	6,261	(5,294)	967
Assets sold under agreements to repurchase:						
Securities	196,032		196,032			
Mortgage loans acquired for sale at fair value	670,311		670,311	894,906		894,906
Mortgage loans at fair value	1,091,487		1,091,487	353,805		353,805
Real estate acquired in settlement of loans	22,228		22,228	7,391		7,391
Total assets sold under agreements to repurchase	1,980,058		1,980,058	1,256,102		1,256,102
	$ 2,029,198	$ (43,242)	$ 1,985,956	$ 1,262,363	$ (5,294)	$ 1,257,069

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Derivative Liabilities, Financial Liabilities and Collateral Held by Counterparty

The following table summarizes by significant counterparty the amount of derivative liabilities and assets sold under agreements to repurchase after considering master netting arrangements and financial instruments or cash pledged that do not meet the accounting guidance qualifying for offset. All assets sold under agreements to repurchase have sufficient collateral or exceed the liability amount recorded on the consolidated balance sheet.

	September 30, 2013				December 31, 2012			
		Gross amounts not offset in the consolidated balance sheet				Gross amounts not offset in the consolidated balance sheet		
	Net liabilities in the balance sheet	Financial instruments	Cash collateral pledged	Net amount	Net liabilities in the balance sheet	Financial instruments	Cash collateral pledged	Net amount
	(in thousands)							
Citibank	$ 727,702	$ (727,208)	$	$ 494	$ 474,625	$ (474,625)	$	$
Credit Suisse First Boston Mortgage Capital LLC	613,085	(612,811)		274	243,525	(243,525)		
Bank of America, N.A.	487,174	(484,664)		2,510	256,711	(256,711)		
Daiwa Capital Markets	99,758	(99,758)						
Morgan Stanley Bank, N.A.	41,376	(40,923)		453	155,321	(155,321)		
Bank of NY Mellon	14,768	(14,694)		74				
Wells Fargo Bank, N.A.	142			142	47,140	(47,140)		
Barclays	60			60	79,253	(78,780)		473
Interest rate lock commitments	30			30				
Other	1,861			1,861	494			494
	$ 1,985,956	$ (1,980,058)	$	$ 5,898	$ 1,257,069	$ (1,256,102)	$	$ 967

Note 7 Fair Value

The Company s consolidated financial statements include assets and liabilities that are measured based on their estimated fair values. The application of fair value estimates may be on a recurring or nonrecurring basis depending on the accounting principles applicable to the specific asset or liability and whether management has elected to carry the item at its estimated fair value as discussed in the following paragraphs.

Fair Value Accounting Elections

Management identified all of its non-cash financial assets, including short-term investments, MBS, excess servicing spread, Agency debt securities, mortgage loans, and excess servicing spread, as well as its MSRs relating to loans with initial interest rates of more than 4.5% that were acquired as a result of its correspondent lending operations, to be accounted for at estimated fair value so such changes in fair value will be reflected in income as they occur and more timely reflect the results of the Company s performance.

For MSRs relating to mortgage loans with initial interest rates of less than or equal to 4.5% that were acquired as a result of the Company s correspondent lending operations, management concluded that such assets present different risks to the Company than MSRs relating to mortgage loans with initial interest rates of more than 4.5% and therefore require a different risk management approach. Management s risk management efforts relating to these assets are aimed at moderating the effects of non-interest rate risks on fair value, such as the effect of changes in home prices on the assets values. Management has identified these assets for accounting at the lower of amortized cost or fair value.

The Company s risk management efforts in connection with MSRs relating to mortgage loans with initial interest rates of more than 4.5% are generally aimed at moderating the effects of changes in interest rates on the assets values. At times during the nine-month period ended September 30, 2013, a portion of the IRLCs, the fair value of which typically increases when prepayment speeds increase, were used to mitigate the effect of changes in fair value of the servicing assets, which typically decreases as prepayment speeds increase.

For loans sold under agreements to repurchase, REO financed through agreements to repurchase and borrowings under forward purchase agreements, management has determined that historical cost accounting is more appropriate because under this method debt issuance costs are amortized over the term of the debt, thereby matching the debt issuance cost to the periods benefiting from the usage of the debt.

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Financial Statement Items Measured at Fair Value on a Recurring Basis

Following is a summary of financial statement items that are measured at estimated fair value on a recurring basis:

	September 30, 2013			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Assets:				
Short-term investments	$ 80,936	$	$	$ 80,936
Mortgage-backed securities at fair value		204,914		204,914
Excess servicing spread purchased from PennyMac Financial Services, Inc.			2,857	2,857
Agency debt securities			12,578	12,578
Mortgage loans acquired for sale at fair value		737,114		737,114
Mortgage loans at fair value			1,848,656	1,848,656
Mortgage loans at fair value held by variable interest entity		536,776		536,776
Mortgage loans under forward purchase agreements at fair value			228,086	228,086
Mortgage servicing rights at fair value			10,997	10,997
Derivative assets:				
Interest rate lock commitments			11,476	11,476
MBS put options		36		36
Forward purchase contracts		26,086		26,086
Forward sales contracts		2		2
Total derivative assets before netting		26,124	11,476	37,600
Netting(1)				(19,185)
Total derivative assets		26,124	11,476	18,415
	$ 80,936	$ 1,504,928	$ 2,114,650	$ 3,681,329
Liabilities:				
Asset-backed secured financing		170,008		170,008
Derivative liabilities:				
Interest rate lock commitments			30	30
Forward purchase contracts		2		2
Forward sales contracts		49,108		49,108
Total derivative liabilities before netting		49,110	30	49,140
Netting(1)				(43,242)
Total derivative liabilities		49,110	30	5,898
Total liabilities	$	$ 219,118	$ 30	$ 175,906

(1) Derivatives are reported net of cash collateral received and paid and, to the extent that the criteria of the accounting guidance covering the offsetting of amounts related to certain contracts are met, positions with the same counterparty are netted as part of a legally enforceable master netting agreement.

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	December 31, 2012			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Assets:				
Short-term investments	$ 39,017	$	$	$ 39,017
Mortgage loans acquired for sale at fair value		975,184		975,184
Mortgage loans at fair value			1,189,971	1,189,971
Mortgage servicing rights at fair value			1,346	1,346
Derivative assets:				
Interest rate lock commitments			19,479	19,479
MBS put options		977		977
Forward purchase contracts		2,617		2,617
Forward sales contracts		3,458		3,458
Total derivative assets before netting		7,052	19,479	26,531
Netting(1)				(2,825)
Total derivative assets		7,052	19,479	23,706
	$ 39,017	$ 982,236	$ 1,210,796	$ 2,229,224
Liabilities:				
Derivative liabilities:				
Forward purchase contracts		1,741		1,741
Forward sales contracts		4,520		4,520
Total derivative liabilities before netting		6,261		6,261
Netting(1)				(5,294)
Total derivative liabilities	$	$ 6,261	$	$ 967

(1) Derivatives are reported net of cash collateral received and paid and, to the extent that the criteria of the accounting guidance covering the offsetting of amounts related to certain contracts are met, positions with the same counterparty are netted as part of a legally enforceable master netting agreement.

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The Company s MBS, Agency debt, excess servicing spread purchased from PennyMac Financial Services, Inc., mortgage loans at fair value, mortgage loans held by VIE, mortgage loans under forward purchase agreements, MSRs, IRLCs and securities sold under agreements to repurchase were measured using Level 3 inputs on a recurring basis. The following is a summary of changes in those items for the periods presented:

	Three months ended September 30, 2013						
	Agency Debt	Excess servicing spread	Mortgage loans at fair value	Mortgage loans under forward purchase agreements	Mortgage servicing rights	Interest rate lock commitments(1)	Total
				(in thousands)			
Assets:							
Balance, June 30, 2013	$	$	$ 1,309,765	$ 242,531	$ 1,827	$ (16,967)	$ 1,537,156
Purchases	12,000	2,828	579,260	1,710	1,696		597,494
Repayments			(59,404)	(8,000)			(67,404)
Interest rate lock commitments issued, net						16,299	16,299
Capitalization of interest			13,203				13,203
Servicing received as proceeds from sales of mortgage loans					7,939		7,939
Changes in fair value included in income arising from:							
Changes in instrument-specific credit risk			18,732	69			18,801
Other factors	578	29	20,876	8,309	(465)	4,841	34,168
	578	29	39,608	8,378	(465)	4,841	52,969
Transfers of mortgage loans under forward agreements			13,018	(13,018)			
Transfers of mortgage loans to REO			(46,794)				(46,794)
Transfers of mortgage loans under forward agreements to REO under forward purchase agreements				(3,515)			(3,515)
Transfers of interest rate lock commitments to mortgage loans acquired for sale						7,273	7,273

Balance, September 30, 2013	$ 12,578	$ 2,857	$ 1,848,656	$ 228,086	$ 10,997	$ 11,446	$ 2,114,620
Changes in fair value recognized during the period relating to assets still held at September 30, 2013	$ 578	$ 29	$ 33,062	$ 6,949	$ (465)	$ 11,446	$ 51,599
Accumulated changes in fair value relating to assets still held at September 30, 2013	$ 578	$ 29	$ 151,111	$ 7,688		$ 11,446	

(1) For the purpose of this table, the interest rate lock asset and liability positions are shown net.

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	Three months ended September 30, 2012					
	Mortgage-backed securities	Mortgage loans at fair value	Mortgage loans under forward purchase agreements	Mortgage servicing rights	Interest rate lock commitments	Total
	(in thousands)					
Assets:						
Balance, June 30, 2012	$ 53,161	$ 969,954	$ 16,881	$ 1,285	$ 12,934	$ 1,054,215
Purchases		150,773	5			150,778
Repayments	(998)	(43,552)	(252)			(44,802)
Interest rate lock commitments issued, net					105,850	105,850
Capitalization of interest		3,399				3,399
Sales	(52,133)					(52,133)
Addition of unpaid interest, impound advances and fees to unpaid balance of mortgage loans						
Accrual of unearned discounts						
Servicing received as proceeds from sales of mortgage loans				363		363
Changes in fair value included in income arising from:						
Changes in instrument-specific credit risk		3,262				3,262
Other factors	(30)	23,145	105	(126)		23,094
	(30)	26,407	105	(126)		26,356
Transfer of mortgage loans to REO		(33,754)				(33,754)
Transfer to mortgage loans acquired for sale					(78,748)	(78,748)
Transfer of mortgage loans under forward purchase agreements to REO under forward purchase agreements						
Transfer of mortgage loans under forward purchase agreements to mortgage loans		16,739	(16,739)			
Balance, September 30, 2012	$	$ 1,089,966	$	$ 1,522	$ 40,036	$ 1,131,524
Changes in fair value recognized during the period relating to assets still held at September 30, 2012	$	$ 16,187	$	$ (126)	$ 40,036	
	$	$ 86,734	$		$ 40,036	

Accumulated changes in fair value relating to assets still held at September 30, 2012

	Nine months ended September 30, 2013						
	Agency Debt	Excess servicing spread	Mortgage loans at fair value	Mortgage loans under forward purchase agreements	Mortgage servicing rights	Interest rate lock commitments(1)	Total
	(in thousands)						
Assets:							
Balance, December 31, 2012	$	$	$ 1,189,971	$	$ 1,346	$ 19,479	$ 1,210,796
Purchases	12,000	2,828	779,746	245,020	1,881		1,041,475
Repayments			(194,645)	(8,000)			(202,645)
Interest rate lock commitments issued, net						71,195	71,195
Capitalization of interest			25,017				25,017
Servicing received as proceeds from sales of mortgage loans					8,043		8,043
Changes in fair value included in income arising from:							
Changes in instrument-specific credit risk			31,176	69			31,245
Other factors	578	29	119,935	7,619	(273)	(25,831)	102,057
	578	29	151,111	7,688	(273)	(25,831)	133,302
Transfer of mortgage loans under forward purchase agreements to mortgage loans			13,018	(13,018)			
Transfers of mortgage loans to REO			(115,562)				(115,562)
Transfer of mortgage loans under forward purchase agreement to REO under forward purchase agreements				(3,604)			(3,604)
Transfers of interest rate lock commitments to mortgage loans acquired for sale						(53,397)	(53,397)
Balance, September 30, 2013	$ 12,578	$ 2,857	$ 1,848,656	$ 228,086	$ 10,997	$ 11,446	$ 2,114,620
	$ 578	29	$ 102,843	$ 6,106	$ (273)	$ 11,446	$ 120,729

Changes in fair value recognized during the period relating to assets still held at September 30, 2013						
Accumulated changes in fair value relating to assets still held at September 30, 2013	$ 578	$ 29	$ 151,111	$ 7,688		$ 11,446

(1) For the purpose of this table, the interest rate lock asset and liability positions are shown net.

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	Nine Months ended September 30, 2012					
	Mortgage-backed securities	Mortgage loans at fair value	Mortgage loans under forward purchase agreements	Mortgage servicing rights	Interest rate lock commitments	Total
	(in thousands)					
Assets:						
Balance, December 31, 2011	$ 72,813	$ 696,266	$ 129,310	$ 749	$ 5,772	$ 904,910
Purchases		411,368	1,076	20		412,464
Repayments	(21,888)	(128,116)	(14,293)			(164,297)
Interest rate lock commitments issued, net					132,188	132,188
Sales	(52,133)			(79)		(52,212)
Accrual of unearned discounts	363					363
Capitalization of interest		16,415				16,415
Servicing received as proceeds from sales of mortgage loans				1,451		1,451
Changes in fair value included in income arising from:						
Changes in instrument-specific credit risk		19,193				19,193
Other factors	845	36,349	9,293	(619)		45,868
	845	55,542	9,293	(619)		65,061
Transfer of mortgage loans to REO		(79,440)				(79,440)
Transfer from mortgage loans acquired for sale		18				18
Transfer to mortgage loans acquired for sale					(97,924)	(97,924)
Transfer of mortgage loans under forward purchase agreements to REO under forward purchase agreement			(7,473)			(7,473)
Transfer of mortgage loans under forward purchase agreements to mortgage loans		117,913	(117,913)			
Balance, September 30, 2012	$	$ 1,089,966	$	$ 1,522	$ 40,036	$ 1,131,524
Changes in fair value recognized during the period relating to assets still held at September 30, 2012	$	$ 32,809	$	$ (619)	$ 40,036	$ 72,226
Accumulated changes in fair value relating to assets still held at	$	$ 86,734	$		$ 40,036	

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		Securities sold under agreements to repurchase (in thousands)
Liabilities:		
Balance, December 31, 2011	$	115,493
Changes in fair value included in income		
Sales		752,343
Repurchases		(867,836)
Balance, September 30, 2012	$	
Changes in fair value recognized during the period relating to liabilities still outstanding at September 30, 2012	$	

Following are the fair values and related principal amounts due upon maturity of mortgage loans accounted for under the fair value option (including mortgage loans acquired for sale, mortgage loans at fair value and mortgage loans under forward purchase agreements at fair value):

	September 30, 2013		
	Fair value	Principal amount due upon maturity (in thousands)	Difference
Mortgage loans acquired for sale:			
Current through 89 days delinquent	$ 737,114	$ 706,116	$ 30,998
90 or more days delinquent(1)			
	737,114	706,116	30,998
Mortgage loans and mortgage loans under forward purchase agreements at fair value:			
Current through 89 days delinquent	$ 548,145	831,817	(283,672)
90 or more days delinquent(1)	1,528,597	2,509,403	(980,806)
	2,076,742	3,341,220	(1,264,478)
Mortgage loans at fair value held by variable interest entity:			
Current through 89 days delinquent	$ 536,776	550,462	(13,686)
90 or more days delinquent(1)			
	536,776	550,462	(13,686)

	$ 3,350,632	$ 4,597,798	$ (1,247,166)

		December 31, 2012	
	Fair value	Principal amount due upon maturity	Difference
		(in thousands)	
Mortgage loans acquired for sale:			
Current through 89 days delinquent	$ 975,184	$ 931,787	$ 43,397
90 or more days delinquent(1)			
	975,184	931,787	43,397
Mortgage loans and mortgage loans under forward purchase agreements at fair value:			
Current through 89 days delinquent	$ 404,016	640,722	(236,706)
90 or more days delinquent(1)	785,955	1,483,311	(697,356)
	1,189,971	2,124,033	(934,062)
	$ 2,165,155	$ 3,055,820	$ (890,665)

(1) Loans delinquent 90 or more days are placed on nonaccrual status and previously accrued interest is reversed.

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Following are the changes in fair value included in current period income by consolidated statement of income line item for financial statement items accounted for under the fair value option:

	Changes in fair value included in current period income Quarter ended September 30, 2013				
	Net gain (loss) on investments	Net interest income	Net gain (loss) on mortgage loans acquired for sale	Net loan servicing income	Total
			(in thousands)		
Assets:					
Short-term investments	$	$	$	$	$
Mortgage-backed securities at fair value	5,356				5,356
Excess servicing spread	29				29
Mortgage loans acquired for sale at fair value			(14,519)		(14,519)
Mortgage loans at fair value	39,608				39,608
Agency debt securities	578				578
Mortgage loans at fair value held by variable interest entity					
Mortgage loans under forward purchase agreements at fair value	8,378				8,378
Mortgage servicing rights at fair value				(465)	(465)
	$ 53,949	$	$ (14,519)	$ (465)	$ 38,965
Liabilities:					
Asset-backed secured financing	$	$	$	$	$
	$	$	$	$	$

	Changes in fair value included in current period income Quarter ended September 30, 2012				
	Net gain (loss) on investments	Net Interest income	Net gain (loss) on mortgage loans acquired for sale	Net loan servicing income	Total
			(in thousands)		
Assets:					

Short-term investments	$	$	$	$	$
Mortgage-backed securities at fair value	(451)	(91)			(542)
Mortgage loans acquired for sale at fair value			49,793		49,793
Mortgage loans at fair value	26,407				26,407
Mortgage loans under forward purchase agreements at fair value	105				105
Mortgage servicing rights at fair value				(126)	(126)
	$ 26,061	$ (91)	$ 49,793	$ (126)	$ 75,637
Liabilities:					
Securities sold under agreements to repurchase at fair value	$	$	$	$	$
	$	$	$	$	$

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	Changes in fair value included in current period income Nine months ended September 30, 2013				
	Net gain on investments	Net Interest income	Net gain on mortgage loans acquired for sale (in thousands)	Net loan servicing income	Total
Assets:					
Short-term investments	$	$	$	$	$
Mortgage-backed securities at fair value	5,356				5,356
Excess servicing spread	29				29
Mortgage loans acquired for sale at fair value			(46,699)		(46,699)
Mortgage loans at fair value	151,111				151,111
Agency debt securities	578				578
Mortgage loans at fair value held by variable interest entity					
Mortgage loans under forward purchase agreements at fair value	7,689				7,689
Mortgage servicing rights at fair value					
	$ 164,763	$	$ (46,699)	$	$ 118,064
Liabilities:					
Asset-backed secured financing	$	$	$	$	$
	$	$	$	$	$

	Changes in fair value included in current period income Nine months ended September 30, 2012				
	Net gain on investments	Net Interest income	Net gain on mortgage loans acquired for sale (in thousands)	Net loan servicing income	Total
Assets:					
Short-term investments	$	$	$	$	$
Mortgage-backed securities at fair value	612	142			754
Mortgage loans acquired for sale at fair value			81,210		81,210
Mortgage loans at fair value	55,636				55,636
Mortgage loans under forward purchase agreements at fair value	9,293				9,293

Mortgage servicing rights at fair value				(619)	(619)
	$ 65,541	$ 142	$ 81,210	$ (619)	$ 146,274
Liabilities:					
Securities sold under agreements to repurchase at fair value	$	$	$	$	$
	$	$	$	$	$

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Financial Statement Items Measured at Fair Value on a Nonrecurring Basis

Following is a summary of financial statement items that are measured at estimated fair value on a nonrecurring basis:

	September 30, 2013			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Assets:				
Real estate asset acquired in settlement of loans	$	$	$ 83,932	$ 83,932
Real estate asset acquired in settlement of loans under forward purchase agreements			2,435	2,435
Mortgage servicing assets at lower of amortized cost or fair value			176,813	176,813
	$	$	$ 263,180	$ 263,180

	December 31, 2012			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Assets:				
Real estate asset acquired in settlement of loans	$	$	$ 56,156	$ 56,156
Mortgage servicing rights at lower of amortized cost or fair value			86,215	86,215
	$	$	$ 142,371	$ 142,371

The following table summarizes the total gains (losses) on assets measured at estimated fair values on a nonrecurring basis:

	Net gains (losses) recognized during the period			
	Quarter ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Real estate asset acquired in settlement of loans	$ (4,554)	$ (3,849)	$ (8,191)	$ (6,876)
Real estate asset acquired in settlement of loans under forward purchase agreements	(29)		(29)	
Mortgage servicing assets at lower of amortized cost or fair value	(212)	(2,881)	3,495	(4,505)
	$ (4,795)	$ (6,730)	$ (4,725)	$ (11,381)

Real Estate Acquired in Settlement of Loans

The Company measures its investment in REO at the respective properties estimated fair values less cost to sell on a nonrecurring basis. The initial carrying value of the REO is established as the lesser of (a) either the fair value of the loan at the date of transfer or the purchase price of the property, as applicable, and (b) the fair value of the real estate less the estimated cost to sell as of the date of transfer. REO may be subsequently revalued due to the Company receiving greater access to the property, the property being held for an extended period or management receiving indications that the property s value may not be supported by developing market conditions. Any subsequent change in fair value to a level that is less than or equal to the value at which the property was initially recorded is recognized in *Results of real estate acquired in settlement of loans* in the consolidated statements of income.

Mortgage Servicing Rights at Lower of Amortized Cost or Fair Value

The Company evaluates its MSRs at lower of amortized cost or fair value for impairment with reference to the assets fair value. For purposes of performing its MSR impairment evaluation, the Company stratifies its MSRs at lower of amortized cost or fair value based on the interest rates borne by the mortgage loans underlying the MSRs. Mortgage loans are grouped into note rate pools of 50 basis point ranges for fixed-rate mortgage loans with note rates between 3% and 4.5% and a single pool for note rates below 3%. MSRs relating to adjustable rate mortgage loans with initial interest rates of 4.5% or less are evaluated in a single pool. If the fair value of MSRs in any of the note rate pools is below the amortized cost of the MSRs for that pool reduced by the existing valuation allowance, those MSRs are impaired.

When MSRs are impaired, the impairment is recognized in current-period income and the carrying value of the MSRs is adjusted using a valuation allowance. If the value of the MSRs subsequently increases, the increase of value is recognized in current period earnings only to the extent of the valuation allowance for the respective stratum.

Management periodically reviews the various impairment strata to determine whether the value of the impaired MSRs in a given stratum is likely to recover. When management deems recovery of the value to be unlikely in the foreseeable future, a write-down of the cost of the MSRs for that stratum to its estimated fair value is charged to the valuation allowance.

Fair Value of Financial Instruments Carried at Amortized Cost

The Company s cash balances as well as certain of its borrowings are carried at amortized cost.

Management has concluded that the estimated fair values of *Cash*, *Mortgage loans acquired for sale at fair value sold under agreements to repurchase, Mortgage loans at fair value sold under agreements to repurchase, Real estate acquired in settlement of loans financed under agreements to repurchase Borrowings under forward purchase agreements* and approximate the agreements carrying values due to the immediate realizability of cash at its carrying amount and to the borrowing agreements short terms and variable interest rates.

As discussed in Note 22, the Company issued Exchangeable Senior Notes, which are carried at amortized cost. The fair value of the Exchangeable Senior Notes at September 30, 2013 was $238.4 million. The fair value of the Exchangeable Senior Notes is estimated using broker indication of value. The Company has classified this financial instrument as a Level 3 financial statement item as of September 30, 2013 due to the lack of current market activity and the reliance on the broker s quote to estimate the instrument s fair value.

Cash is measured using Level 1 inputs. The Company s borrowings carried at amortized cost do not have active markets or observable inputs and the fair value is measured using management s best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation. The Company has classified these financial instruments as Level 3 financial statement items as of September 30, 2013 due to the lack of current market activity and the Company s reliance on unobservable inputs to estimate these instruments fair value.

Valuation Techniques and Assumptions

Most of the Company s assets are carried at fair value with changes in fair value recognized in current period income. A substantial portion of those assets are Level 3 financial statement items which require the use of significant unobservable inputs in the estimation of the assets values. Unobservable inputs reflect the Company s own assumptions about the factors that market participants use in pricing an asset or liability, and are based on the best

information available under the circumstances.

PCM has assigned the responsibility for estimating the fair values of Level 3 financial statement items to its Financial Analysis and Valuation group (the FAV group), which is responsible for valuing and monitoring the Company s investment portfolios and maintenance of its valuation policies and procedures.

The FAV group reports to PCM s valuation committee, which oversees and approves the valuations. The valuation committee includes the chief executive, financial, operating, credit, and asset/liability management officers of PCM. The FAV group monitors the models used for valuation of the Company s Level 3 financial statement items, including the models performance versus actual results and reports those results to the valuation committee. The results developed in the FAV group s monitoring activities are used to calibrate subsequent projections used for valuation.

The FAV group is responsible for reporting to PCM s valuation committee on a monthly basis on the changes in the valuation of the portfolio, including major factors affecting the valuation and any changes in model methods and assumptions. To assess the reasonableness of its valuations, the FAV group presents an analysis of the effect on the valuation of each of the changes to the significant inputs to the models.

The following describes the valuation techniques and assumptions used in estimating the fair values of Level 2 and Level 3 financial statement items:

Mortgage-Backed Securities and Agency Debt Securities

MBS values are presently determined based on whether the securities are issued by one of the Agencies as discussed below:

Agency MBS are categorized as Level 2 financial statement items. Fair value of Agency MBS are estimated based on quoted market prices for similar securities.

Agency debt security and Non-Agency MBS are categorized as Level 3 financial statement items. Fair value of Agency debt securities and non-Agency MBS is estimated using broker indications of value. For indications of value received, the FAV group and a separate Capital Markets group review the price indications provided by non-affiliate brokers for completeness, accuracy and consistency across all similar MBS managed by PCM. Bond-level analytics such as yield, weighted average life and projected prepayment and default speeds of the underlying collateral are computed. The reasonableness of the brokers indications of value and of changes in value from period to period is evaluated in light of the analytical review performed and considering market conditions. The review of the FAV group is reported to PCM s valuation committee as part of its review and approval of monthly valuation results. PCM has not adjusted, and does not intend to adjust, its fair value estimates to amounts different than the brokers indications of value.

The significant unobservable inputs used in the fair value measurement of the Company s Agency issued debt and non-Agency MBS are discount rates, prepayment speeds, default speeds and expected future losses (or collateral remaining loss percentage). Significant changes in any of those inputs in isolation could result in a significant change in fair value measurement. Changes in these assumptions are not directly correlated, as they may be separately affected by changes in collateral characteristics and performance, servicer behavior, legal and regulatory actions, economic and housing market data and market sentiment.

Following is a quantitative summary of key inputs used by the FAV group to evaluate the reasonableness of the fair value of Level 3 Agency debt security:

Security Class	Key Inputs(1)	September 30, 2013	December 31, 2012
Agency debt securities	Discount rate	9.06%	
	Prepayment speed(2)	5.80%	
	Default speed(3)	0.20%	
	Collateral remaining loss percentage(4)	0.32%	

(1) Key inputs are those used to evaluate broker indications of value.
(2) Prepayment speed is measured using Life Voluntary Conditional Prepayment Rate (CPR).
(3) Default speed is measured using Life Constant Default Rate (CDR).
(4) The projected future losses on the loans in the collateral groups paying to each bond expressed as a percentage of the current balance of the loans.

Mortgage Loans

Fair value of mortgage loans is estimated based on whether the mortgage loans are saleable into active markets:

Mortgage loans that are saleable into active markets, comprised of the Company s mortgage loans acquired for sale at fair value, are categorized as Level 2 financial statement items and their fair values are estimated using their quoted market or contracted price or market price equivalent. For mortgage loans at fair value held by variable interest entity, the values of all of the individual securities issued by the securitization trust are used to derive a price for the mortgage loans.

Loans that are not saleable into active markets, comprised of the Company s mortgage loans at fair value and mortgage loans under forward purchase agreements at fair value, are categorized as Level 3 financial statement items and their fair values are estimated using a discounted cash flow approach. Inputs to the discounted cash flow model include current interest rates, loan amount, payment status and property type, and forecasts of future interest rates, home prices, prepayment speeds, default speeds, loss severities and discount rates. The valuation process includes the computation by stratum of loan population and a review for reasonableness of various measures such as weighted average life, projected prepayment and default speeds, and projected default and loss percentages. The FAV group computes the effect on the valuation of changes in input variables such as interest rates, home prices, and delinquency status to assess the reasonableness of changes in the loan valuation. The results of the estimates of fair value of Level 3 mortgage loans are reported to PCM s valuation committee as part of its review and approval of monthly valuation results.

Changes in fair value attributable to changes in instrument-specific credit risk are measured by the change in the respective loan s delinquency status at period-end from the later of the beginning of the period or acquisition date.

The significant unobservable inputs used in the fair value measurement of the Company s mortgage loans at fair value and mortgage loans under forward purchase agreements at fair value are discount rate, home price projections, voluntary prepayment speeds and default speeds. Significant changes in any of those inputs in isolation could result in a significant change to the loans fair value measurement. Increases in home price projections are generally accompanied by an increase in voluntary prepayment speeds.

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Following is a quantitative summary of key inputs used in the valuation of mortgage loans at fair value:

Key Inputs	Range (Weighted average) September 30, 2013	Range (Weighted average) December 31, 2012
Mortgage loans at fair value		
Discount rate	8.6% - 15.6%	8.8% - 20.7%
	(11.8%)	(13.1%)
Twelve-month projected housing price index change	2.9% - 5.0%	0.4% - 1.5%
	(3.7%)	(1.1%)
Prepayment speed(1)	0.0% - 4.4%	0.4% - 4.4%
	(2.4%)	(2.2%)
Total prepayment speed(2)	0.2% - 35.5%	5.9% - 31.2%
	(23.5%)	(20.6%)
Mortgage loans under forward purchase agreements		
Discount rate	9.5% - 13.5%	
	(11.9%)	
Twelve-month projected housing price index change	3.2% - 4.3%	
	(3.9%)	
Prepayment speed(1)	1.2% - 2.8%	
	(2.1%)	
Total prepayment speed(2)	13.5% - 29.5%	
	(22.9%)	

(1) Prepayment speed is measured using Life Voluntary Conditional Prepayment Rate (CPR).
(2) Total prepayment speed is measured using Life Total CPR.

Excess Servicing Spread Purchased from PennyMac Financial Services, Inc.

The Company categorizes excess servicing spread as a Level 3 financial statement item. The Company uses a discounted cash flow approach to estimate the fair value of excess servicing spread. The key assumptions used in the estimation of the fair value of excess servicing spread include prepayment speed and discount rate. Significant changes to those inputs in isolation could result in a significant change in the excess servicing spread fair value measurement. Changes in these key assumptions are not necessarily directly related.

Excess servicing spread is generally subject to loss in value when interest rates decrease. Decreasing mortgage rates normally encourage increased mortgage refinancing activity. Increased refinancing activity reduces the life of the loans underlying the excess servicing spread, thereby reducing excess servicing spread value. Reductions in the value of excess servicing spread investments affect income primarily through change in fair value.

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Interest income for excess servicing spread is accrued using the interest method, based upon the expected income from the excess servicing spread through the expected life of the underlying mortgages. Changes to expected cash flows result in a change in fair value which is recorded in *Net gain (loss) on investments*.

Following are the key inputs used in determining the fair value of excess servicing spread:

Key Inputs	September 30, 2013	December 31, 2012
Pricing spread	6.8%	
Average life	6.7	
Prepayment speed	9.1%	

Derivative Financial Instruments

The Company estimates the fair value of IRLCs based on quoted Agency MBS prices, its estimate of the fair value of the MSRs it expects to receive in the sale of the loans and the probability that the mortgage loan will fund or be purchased as a percentage of the commitments it has made (the pull-through rate). The Company categorized IRLCs as a Level 3 financial statement item.

The significant unobservable inputs used in the fair value measurement of the Company s IRLCs are the pull-through rate and the MSR component of the Company s estimate of the value of the mortgage loans it has committed to purchase. Significant changes in the pull-through rate and the MSR component of the IRLCs, in isolation, could result in a significant change in fair value measurement. The financial effects of changes in these assumptions are generally inversely correlated as increasing interest rates have a positive effect on the fair value of the MSR component of IRLC value, but increase the pull-through rate for loans that have decreased in fair value in comparison to the agreed-upon purchase price.

Following is a quantitative summary of key unobservable inputs used in the valuation of IRLCs:

Key Inputs	September 30, 2013	December 31, 2012
	Range (Weighted average)	
Pull-through rate	48.8% - 98.0%	44.2% - 98.0%
	(83.5%)	(80.6%)
MSR value expressed as:		
Servicing fee multiple	0.9 - 5.1	1.8 - 4.8
	(3.7)	(4.5)
Percentage of unpaid principal balance	0.2% - 1.3%	0.4% - 1.2%
	(0.9%)	(1.1%)

The Company estimates the fair value of commitments to sell loans based on quoted MBS prices. The Company estimates the fair value of the interest rate options and futures it purchases and sells based on observed interest rate volatilities in the MBS market.

Real Estate Acquired in Settlement of Loans

REO is measured based on its fair value on a nonrecurring basis and is categorized as a Level 3 financial statement item. Fair value of REO is estimated by using a current estimate of value from a broker s price opinion or a full appraisal, or the price given in a current contract of sale.

REO values are reviewed by PCM s staff appraisers when the Company obtains multiple indications of value and there is a significant discrepancy between the values received. PCM s staff appraisers will attempt to resolve the discrepancy between the indications of value. In circumstances where the appraisers are not able to generate adequate data to support a value conclusion, the staff appraisers will order an additional appraisal to resolve the property s value.

Mortgage Servicing Rights

MSRs are categorized as Level 3 financial statement items. The Company uses a discounted cash flow approach to estimate the fair value of MSRs. The key assumptions used in the estimation of the fair value of MSRs include prepayment and default rates of the underlying loans, the applicable discount rate, and cost to service loans. The key assumptions used in the Company s discounted cash flow model are based on market factors which management believes are consistent with assumptions and data used by market participants valuing similar MSRs. The results of the estimates of fair value of MSRs are reported to PCM s valuation committee as part of their review and approval of monthly valuation results.

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The significant unobservable inputs used in the fair value measurement of the Company s MSRs are pricing spreads, prepayment speeds (or life) and annual per-loan cost of servicing. Significant changes to any of those inputs in isolation could result in a significant change in the MSR fair value measurement. Changes in these key assumptions are not necessarily directly related.

MSRs are generally subject to loss in value when mortgage rates decrease. Decreasing mortgage rates normally encourage increased mortgage refinancing activity. Increased refinancing activity reduces the life of the loans underlying the MSRs, thereby reducing MSR value. Reductions in the value of MSRs affect income primarily through change in fair value and impairment charges. For MSRs backed by mortgage loans with historically low interest rates, factors other than interest rates (such as housing price changes) take on increasing influence on prepayment behavior of the underlying mortgage loans.

Following are the key inputs used in determining the fair value of MSRs at the time of initial recognition:

	Quarter ended September 30,			
	2013		2012	
	Range (Weighted average)			
Key Inputs	**Amortized cost**	**Fair value**	**Amortized cost**	**Fair value**
Unpaid principal balance of underlying loans	$ 3,404,274	$ 707,891	$ 3,400,928	$ 50,178
Average servicing fee rate (in basis points)	25	25	26	28
Pricing spread(1)	5.4% - 13.9%	7.4% - 9.6%	7.5% - 7.5%	7.5% - 13.5%
	(6.3%)	(8.0%)	(7.5%)	(7.6%)
Life (in years)	2.9 - 6.9	3.8 - 6.9	6.4 - 6.4	3.2 - 6.4
	(6.3)	(6.8)	(6.4)	(6.3)
Annual total prepayment speed(2)	8.5% - 15.6%	8.8% - 20.7%	8.9% - 9.4%	8.9% - 27.1%
	(8.9%)	(9.8%)	(9.1%)	(9.5%)
Annual per-loan cost of servicing	$68 - $68	$68 - $68	$68 - $68	$68 - $140
	($68)	($68)	($68)	($69)

	Nine months ended September 30,			
	2013		2012	
	Range (Weighted average)			
Key Inputs	**Amortized cost**	**Fair value**	**Amortized cost**	**Fair value**
Unpaid principal balance of underlying loans	$ 12,247,940	$ 717,877	$ 5,905,828	$ 156,211
Average servicing fee rate (in basis points)	26	25	25	26
Pricing spread(1)	5.4% - 14.4%	7.4% - 14.4%	7.5% - 22.8%	7.5% - 14.6%
	(6.6%)	(8.0%)	(7.7%)	(8.1%)
Life (in years)	2.6 - 6.9	2.8 - 6.9	2.5 - 6.7	2.5 - 6.7
	(6.4)	(6.8)	(6.4)	(6.2)

Annual total prepayment speed(2)	8.5% - 23.6% (9.0%)	8.8% -27.0% (10.0%)	7.8% - 36.9% (8.9%)	7.8% - 36.9% (10.4%)
Annual per-loan cost of servicing	$68 - $140 ($68)	$68 - $68 ($68)	$68 - $140 ($68)	$68 - $140 ($75)

(1) Pricing spread represents a margin that is applied to a reference interest rate s forward rate curve to develop periodic discount rates. The Company applies a pricing spread to the United States Dollar LIBOR curve for purposes of discounting cash flows relating to MSRs acquired as proceeds from the sale of mortgage loans.

(2) Prepayment speed is measured using Life Total CPR.

Following is a quantitative summary of key inputs used in the valuation of MSRs as of the dates presented, and the effect on the estimated fair value from adverse changes in those assumptions (weighted averages are based upon unpaid principal balance or fair value where applicable):

	September 30, 2013		December 31, 2012	
	Range (Weighted average)			
Key Inputs	**Amortized cost**	**Fair value**	**Amortized cost**	**Fair value**
	(unpaid principal balance and effect on value amounts in thousands)			
Carrying value	$258,678	$10,997	$125,430	$1,346
Unpaid principal balance of underlying loans	$22,681,068	$1,036,575	$11,986,957	$181,783
Weighted average servicing fee rate (in basis points)	26	25	26	27
Weighted average coupon rate	3.66%	4.67%	3.70%	4.79%
Pricing spread(1)	5.35% - 18.55%	6.4% - 14.4%	7.5% - 16.5%	7.5% - 16.5%
	(6.1%)	(8.1%)	(7.7%)	(7.7%)
Effect on value of 5% adverse change	$(4,654)	$(180)	$(2,052)	$(21)
Effect on value of 10% adverse change	$(9,166)	$(354)	$(4,041)	$(40)
Effect on value of 20% adverse change	$(17,786)	$(688)	$(7,845)	$(78)
Weighted average life (in years)	2.8 - 6.9	3.3 - 6.9	1.7 - 6.3	1.4 - 6.3
	(6.4)	(6.8)	(6.3)	(6.0)
Prepayment speed(2)	8.6% - 30.6%	8.8% - 26.5%	10.3% - 47.8%	10.3% - 65.9%
	(9.1%)	(10%)	(10.3%)	(13.2%)
Effect on value of 5% adverse change	$(5,922)	$(261)	$(3,026)	$(52)
Effect on value of 10% adverse change	$(11,639)	$(512)	$(5,937)	$(100)
Effect on value of 20% adverse change	$(22,497)	$(986)	$(11,436)	$(190)
Annual per-loan cost of servicing	$68 - $140	$68 - $140	$68 - $140	$68 - $140
	($68)	($69)	($68)	($74)
Effect on value of 5% adverse change	$(1,621)	$(69)	$(778)	$(12)
Effect on value of 10% adverse change	$(3,242)	$(138)	$(1,556)	$(24)
Effect on value of 20% adverse change	$(6,483)	$(276)	$(3,112)	$(48)

(1) Pricing spread represents a margin that is applied to a reference interest rate s forward rate curve to develop periodic discount rates. The Company applies a pricing spread to the United States Dollar LIBOR curve for purposes of discounting cash flows relating to MSRs acquired as proceeds from the sale of mortgage loans and purchased MSRs not backed by pools of distressed mortgage loans.

(2) Prepayment speed is measured using Life Total CPR.

The preceding sensitivity analyses are limited in that they were performed at a particular point in time; only contemplate the movements in the indicated variables; do not incorporate changes in the variables in relation to other

variables; are subject to the accuracy of various models and assumptions used; and do not incorporate other factors that would affect the Company s overall financial performance in such scenarios, including operational adjustments made by management to account for changing circumstances. For these reasons, the preceding estimates should not be viewed as an earnings forecast.

Securities Sold Under Agreements to Repurchase

Fair value of securities sold under agreements to repurchase is based on the accrued cost of the agreements, which approximates the agreements fair values, due to the agreements short maturities.

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Note 8 Short-Term Investments

The Company s short-term investments are comprised of money market accounts and unrestricted balances maintained in excess of minimum required amounts as deposited with U.S. commercial banks.

Note 9 Mortgage Loans Acquired for Sale at Fair Value

Mortgage loans acquired for sale at fair value is comprised of recently originated mortgage loans purchased by the Company for resale. Following is a summary of the distribution of the Company s mortgage loans acquired for sale at fair value:

	September 30, 2013		December 31, 2012	
	Fair value	Unpaid principal balance	Fair value	Unpaid principal balance
Loan Type	(in thousands)			
Government insured or guaranteed	$ 273,007	$ 260,388	$ 153,326	$ 144,619
Conventional:				
Agency-eligible	430,527	411,785	820,492	785,830
Jumbo loans	33,580	33,944	1,366	1,338
	$ 737,114	$ 706,117	$ 975,184	$ 931,787
Loans pledged to secure loans sold under agreements to repurchase	$ 731,717		$ 972,079	

The Company is not approved by Ginnie Mae as an issuer of Ginnie Mae-guaranteed securities which are backed by government-insured or guaranteed mortgage loans. As discussed in Note 3 *Transactions with Related Parties*, the Company transfers government insured or guaranteed mortgage loans that it purchases from correspondent lenders to PLS, which is a Ginnie Mae-approved issuer, and earns a sourcing fee of three basis points on the unpaid principal balance plus accrued interest of each such loan.

Note 10 Derivative Financial Instruments

The Company is exposed to price risk relative to its mortgage loans acquired for sale as well as to the IRLCs it issues to correspondent lenders. The Company bears price risk from the time an IRLC is issued to a correspondent lender to the time the purchased mortgage loan is sold. During this period, the Company is exposed to losses if mortgage interest rates increase, because the value of the purchase commitment or mortgage loan acquired for sale decreases.

The Company engages in interest rate risk management activities in an effort to reduce the variability of earnings caused by changes in interest rates. To manage this price risk resulting from interest rate risk, the Company uses derivative financial instruments acquired with the intention of moderating the risk that changes in market interest rates will result in unfavorable changes in the value of the Company s IRLCs and inventory of mortgage loans acquired for sale.

The Company is also exposed to risk relative to the fair value of its MSRs. The Company is exposed to loss in value of its MSRs when interest rates decrease. Beginning in the fourth quarter of 2012, the Company included MSRs in its hedging activities, and did so for a portion of 2013.

During the third quarter of 2013, the Company entered into Eurodollar futures, which settle daily, to economically hedge net fair value changes of a portion of fixed-rate mortgage loans at fair value held by variable interest entity and MBS securities at fair value and the related variable LIBOR

rate repurchase agreement liabilities. The Company uses the Eurodollar futures with the intention of moderating the risk of rising market rates that will result in unfavorable changes in the value of the Company s fixed-rate assets and economic performance of its variable LIBOR rate repurchase agreement liabilities.

The Company does not use derivative financial instruments for purposes other than in support of its risk management activities. The Company records all derivative financial instruments at fair value and records changes in fair value in current period income.

The Company had the following derivative assets and liabilities and related margin deposits recorded within the *Derivative assets* and *Derivative liabilities* on the consolidated balance sheets:

Instrument	September 30, 2013 Notional amount	September 30, 2013 Fair value Derivative assets	September 30, 2013 Fair value Derivative liabilities	December 31 2012 Notional amount	December 31 2012 Fair value Derivative assets	December 31 2012 Fair value Derivative liabilities
			(in thousands)			
Derivatives not designated as hedging instruments:						
Free-standing derivatives (economic hedges):						
Interest rate lock commitments	641,971	$ 11,476	$ 30	1,694,739	$ 19,479	$
Forward purchase contracts	2,334,589	26,086	2	2,206,539	2,617	1,741
Forward sales contracts	3,323,843	2	49,108	4,266,983	3,458	4,520
MBS put options	130,000	36		495,000	977	
MBS call options						
Eurodollar futures	9,964,000					
Treasury futures	75,000					
Options on Eurodollar futures	2,200,000					
Total derivative instruments before netting		37,600	49,140		26,531	6,261
Netting		(19,185)	(43,242)		(2,825)	(5,294)
Total		$ 18,415	$ 5,898		$ 23,706	$ 967
Margin deposits with derivatives counterparties		$ 25,311			$ 2,469	

The following table summarizes the notional amount activity for derivative contracts used to hedge the Company s IRLCs and inventory of mortgage loans acquired for sale:

Period/Instrument	Balance, beginning	Additions	Dispositions/ expirations	Balance, end

	of period			of period
		(in thousands)		
Quarter ended September 30, 2013				
MBS put options	460,000	180,000	(510,000)	130,000
MBS call options	725,000	300,000	(1,025,000)	
Forward purchase contracts	5,411,784	18,214,008	(21,291,203)	2,334,589
Forward sales contracts	7,728,066	21,440,627	(25,844,850)	3,323,843

Period/Instrument	Balance, beginning of period	Additions	Dispositions/ expirations	Balance, end of period
		(in thousands)		
Nine months ended September 30, 2013				
MBS put options	495,000	3,205,000	(3,570,000)	130,000
MBS call options		2,200,000	(2,200,000)	
Forward purchase contracts	2,206,539	45,301,457	(45,173,407)	2,334,589
Forward sales contracts	4,266,983	58,817,165	(59,760,305)	3,323,843

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Period/Instrument	Balance, beginning of period	Additions	Dispositions/ expirations	Balance, end of period
		(in thousands)		
Quarter ended September 30, 2012				
MBS put options	245,000	980,000	(700,000)	525,000
MBS call options	35,000	30,000	(65,000)	
Forward purchase contracts	829,407	7,780,756	(5,876,257)	2,733,906
Forward sales contracts	2,133,971	13,150,113	(10,097,143)	5,186,941

Period/Instrument	Balance, beginning of period	Additions	Dispositions/ expirations	Balance, end of period
		(in thousands)		
Nine months ended September 30, 2012				
MBS put options	28,000	1,412,500	(915,500)	525,000
MBS call options	5,000	180,000	(185,000)	
Forward purchase contracts	398,400	11,927,458	(9,591,952)	2,733,906
Forward sales contracts	756,691	21,381,612	(16,951,362)	5,186,941

The Company recorded net gains (losses) on derivative financial instruments used to hedge the Company s IRLCs and inventory of mortgage loans totaling $3.1 million and $(46.1) million for the quarters ended September 30, 2013 and 2012, respectively. The Company recorded net gains (losses) on derivative financial instruments used to hedge the Company s IRLCs and inventory of mortgage loans totaling $143.2 million and $(62.5) million for the nine months ended September 30, 2013 and 2012, respectively. Derivative gains and losses are included in *Net gains on mortgage loans acquired for sale* in the Company s consolidated statements of income.

The Company recorded net losses on derivative financial instruments used as economic hedges of MSRs totaling $0 and $2.0 million for the quarter and nine months ended September 30, 2013. The derivative losses are included in *Net loan servicing fees* in the Company s consolidated statements of income. The Company had no similar economic hedges in place for the quarter and nine months ended September 30, 2012.

The following table summarizes the notional of amount activity for derivative contracts used to hedge the Company s investment activities related to its MBS securities and mortgage loans at fair value held by variable interest entity:

Period/Instrument	Balance, beginning of period	Additions	Dispositions/ expirations	Balance, end of period
		(in thousands)		
Quarter ended September 30, 2013				
Eurodollar futures		19,152,000	(9,188,000)	9,964,000
Treasury futures		75,000		75,000
Options on Eurodollar futures		2,200,000		2,200,000

Period/Instrument	Balance, beginning of period	Additions	Dispositions/ expirations	Balance, end of period
		(in thousands)		
Nine months ended September 30, 2013				
Eurodollar futures		19,152,000	(9,188,000)	9,964,000
Treasury futures		75,000		75,000
Options on Eurodollar futures		2,200,000		2,200,000

The Company recorded net losses on derivative financial instruments used to hedge the net change in fair value of fixed-rate assets and its variable LIBOR rate repurchase agreement liabilities. The Company recorded net losses on derivative financial instruments used as economic hedges of $12.1 million for the quarter ended September 30, 2013. The derivative losses are included in *Net gain on mortgage loans acquired for sale* and *Net gain on mortgage-backed securities* in the Company s consolidated statements of income. The Company had no similar economic hedges in place for the quarter and nine months ended September 30, 2012.

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Note 11 Mortgage Loans at Fair Value

Mortgage loans at fair value are comprised of mortgage loans that are not acquired for sale and may be sold at a later date pursuant to a management determination that such a sale represents the most advantageous liquidation strategy for the identified loan.

Following is a summary of the distribution of the Company s mortgage loans at fair value:

	September 30, 2013		December 31, 2012	
Loan Type	Fair value	Unpaid principal balance	Fair value	Unpaid principal balance
	(in thousands)			
Nonperforming loans	$ 1,344,259	$ 2,223,064	$ 785,955	$ 1,483,311
Performing loans:				
Fixed	262,010	399,310	201,212	322,005
ARM/hybrid	143,955	192,389	134,196	195,381
Interest rate step-up	98,287	168,072	68,475	123,117
Balloon	145	215	133	219
	504,397	759,986	404,016	640,722
	$ 1,848,656	$ 2,983,050	$ 1,189,971	$ 2,124,033
Mortgage loans at fair value pledged to secure borrowings at period end:				
Sales of loans under agreements to repurchase	$ 1,772,788		$ 947,522	
Mortgage loans held in a consolidated subsidiary whose stock is pledged to secure financings of such loans	$ 1,313		$ 1,538	

Following is a summary of certain concentrations of credit risk in the portfolio of mortgage loans at fair value:

Concentration	September 30, 2013	December 31, 2012
Portion of mortgage loans originated between 2005 and 2007	71%	77%
Percentage of fair value of mortgage loans with unpaid-principal-balance-to-current-property-value in excess of 100%	61%	68%
Percentage of mortgage loans secured by California real estate	25%	18%

Additional states contributing 5% or more of mortgage loans	New York Florida New Jersey	New York Florida New Jersey

Note 12 Mortgage loans at fair value held by variable interest entity

Following is a summary of the distribution of the Company s mortgage loans at fair value held by variable interest entity:

	September 30, 2013		December 31, 2012	
Loan Type	**Fair value**	**Unpaid principal balance**	**Fair value**	**Unpaid principal balance**
		(in thousands)		
Nonperforming loans	$	$	$	$
Performing loans:				
Jumbo Fixed	536,776	550,462		
	536,776	550,462		
	$ 536,776	$ 550,462	$	$

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Following is a summary of certain concentrations of credit risk in the portfolio of mortgage loans at fair value held by variable interest entity:

States Comprising more than 5.00% of unpaid principal balance	September 30, 2013	December 31, 2012
California	57%	
Washington	8%	
Texas	6%	
Virginia	6%	
Other	24%	

Note 13 Mortgage Loans Under Forward Purchase Agreements at Fair Value

Mortgage loans under forward purchase agreements at fair value are comprised of mortgage loans not acquired for resale. Such loans may be sold at a later date pursuant to a management determination that such a sale represents the most advantageous liquidation strategy for the identified loan. Following is a summary of the distribution of the Company s mortgage loans under forward purchase agreements at fair value:

	September 30, 2013		December 31, 2012	
Loan Type	Fair value	Unpaid principal balance	Fair value	Unpaid principal balance
	(in thousands)			
Nonperforming loans	$ 184,338	$ 286,339	$	$
Performing loans:				
Fixed	21,592	34,275		
ARM/hybrid	22,156	37,557		
	43,748	71,832		
	$ 228,086	$ 358,171	$	$

Following is a summary of certain concentrations of credit risk in the portfolio of mortgage loans under forward purchase agreements at fair value:

Concentration	September 30, 2013	December 31, 2012
Portion of mortgage loans originated between 2005 and 2007	73%	
Percentage of fair value of mortgage loans with unpaid-principal-balance-to current-property-value in excess of 100%	57%	

Percentage of mortgage loans secured by California real estate	24%
Additional states contributing 5% or more of mortgage loans	New Jersey Washington New York Maryland

At September 30, 2013, the entire balance of mortgage loans under forward purchase agreements was subject to borrowings under forward purchase agreements.

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Note 14 Real Estate Acquired in Settlement of Loans

Following is a summary of the activity in REO for the periods presented:

	Quarter ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Balance at beginning of period	$ 88,682	$ 89,121	$ 88,078	$ 80,570
Purchases	82		82	48
Transfers from mortgage loans at fair value and advances	48,154	33,962	116,957	82,404
Transfers from REO under forward purchase agreements	114	786	114	21,819
Results of REO:				
Valuation adjustments, net	(5,012)	(3,954)	(16,079)	(8,824)
Gain on sale, net	2,759	5,246	8,644	14,530
	(2,253)	1,292	(7,435)	5,706
Sale proceeds	(35,086)	(38,981)	(98,103)	(104,367)
Balance at period end	$ 99,693	$ 86,180	$ 99,693	$ 86,180
At period end:				
REO pledged to secure agreements to repurchase	$ 17,074	$ 10,118	$ 17,074	$ 10,118
REO held in a consolidated subsidiary whose stock is pledged to secure financings of such properties	$ 50,796	$ 23,060	$ 50,796	$ 23,060

Note 15 Real Estate Acquired in Settlement of Loans Under Forward Purchase Agreements

Following is a summary of the activity in REO under forward purchase agreements for the periods presented:

	Quarter ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Balance at beginning of period	$ 89	$ 797	$	$ 22,979
Purchases				248
Transfers from (to) mortgage loans under forward purchase agreements at fair value and servicing advances	3,640	(10)	3,729	6,633
Transfers to REO	(114)	(786)	(114)	(21,819)

Results of REO under forward purchase agreements: