

PennyMac Mortgage Investment Trust  
Form 10-K  
February 28, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**Form 10-K**

(Mark One)

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2012

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)

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**Maryland**  
(State or other jurisdiction of

**27-0186273**  
(IRS Employer  
Identification No.)

incorporation or organization)

**6101 Condor Drive, Moorpark, California**  
(Address of principal executive offices)

**93021**  
(Zip Code)

**(818) 224-7442**

(Registrant's telephone number, including area code)

**Securities registered pursuant to Section 12(b) of the Act:**

**Title of Each Class**  
**Common Shares of Beneficial Interest, \$0.01**  
**Par Value**

**Name of Each Exchange on Which Registered**  
**New York Stock Exchange**

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☒ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

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

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐ (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 ☒

As of June 30, 2012 the aggregate market value of the registrant's common shares of beneficial interest, \$0.01 par value (common shares), held by non-affiliates was \$801,056,084 based on the closing price as reported on the New York Stock Exchange on that date.

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As of February 26, 2013, there were 58,906,706 common shares of the registrant outstanding.

### Documents Incorporated By Reference

| Document   | Parts Into Which Incorporated |
|--|-------------------------------|
| Definitive Proxy Statement for 2013 Annual Meeting of Shareholders | Part III                      |

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**PENNYMAC MORTGAGE INVESTMENT TRUST**

**FORM 10-K**

**December 31, 2012**

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**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This Annual Report on Form 10-K ( Report ) contains certain forward-looking statements that are subject to various risks and uncertainties. Forward-looking statements are generally identifiable by use of forward-looking terminology such as may, will, should, potential, intend, expect, seek, anticipate, estimate, approximately, believe, could, project, predict, continue, plan or other similar words or expressions.

Forward-looking statements are based on certain assumptions, discuss future expectations, describe future plans and strategies, contain financial and operating projections or state other forward-looking information. Examples of forward-looking statements include the following:

projections of our revenues, income, earnings per share, capital structure or other financial items;

descriptions of our plans or objectives for future operations, products or services;

forecasts of our future economic performance, interest rates, profit margins and our share of future markets; and

descriptions of assumptions underlying or relating to any of the foregoing expectations regarding the timing of generating any revenues.

Our ability to predict results or the actual effect of future events, actions, plans or strategies is inherently uncertain. Although we believe that the expectations reflected in such forward-looking statements are based on reasonable assumptions, our actual results and performance could differ materially from those set forth in the forward-looking statements. There are a number of factors, many of which are beyond our control, that could cause actual results to differ significantly from management's expectations. Some of these factors are discussed below.

You should not place undue reliance on any forward-looking statement and should consider the following uncertainties and risk factors, as well as the risks, risk factors and uncertainties discussed elsewhere in this Report and any subsequent Quarterly Reports on Form 10-Q.

Factors that could cause actual results to differ materially from historical results or those anticipated include, but are not limited to:

changes in our investment objectives or investment or operational strategies, including any new lines of business or new products and services that may subject us to additional risks;

volatility in our industry, the debt or equity markets, the general economy or the residential finance and real estate markets specifically, whether the result of market events or otherwise;

events or circumstances which undermine confidence in the financial markets or otherwise have a broad impact on financial markets, such as the sudden instability or collapse of large depository institutions or other significant corporations, terrorist attacks, natural or man-made disasters, or threatened or actual armed conflicts;

changes in general business, economic, market, employment and political conditions, or in consumer confidence and spending habits from those expected;

continued declines in residential real estate or significant changes in U.S. housing prices or activity in the U.S. housing market;

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the availability of, and level of competition for, attractive risk-adjusted investment opportunities in residential mortgage loans and mortgage-related assets that satisfy our investment objectives;

the inherent difficulty in winning bids to acquire distressed loans or correspondent loans, and our success in doing so;

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the concentration of credit risks to which we are exposed;

the degree and nature of our competition;

changes in personnel and lack of availability of qualified personnel;

our dependence on our manager and servicer, potential conflicts of interest with such entities, and the performance of such entities;

the availability, terms and deployment of short-term and long-term capital;

the adequacy of our cash reserves and working capital;

our ability to match the interest rates and maturities of our assets with our financing;

the timing and amount of cash flows, if any, from our investments;

unanticipated increases or volatility in financing and other costs, including a rise in interest rates;

the performance, financial condition and liquidity of borrowers;

incomplete or inaccurate information or documentation provided by customers or counterparties, or adverse changes in the financial condition of our customers and counterparties;

the quality and enforceability of the collateral documentation evidencing our ownership and rights in the assets in which we invest;

increased rates of delinquency, default and/or decreased recovery rates on our investments;

our ability to foreclose on our investments in a timely manner or at all;

increased prepayments of the mortgages and other loans underlying our mortgage-backed securities and other investments;

the degree to which our hedging strategies may or may not protect us from interest rate volatility;

the effect of the accuracy of or changes in the estimates we make about uncertainties and contingencies when measuring and reporting upon our financial condition and results of operations;

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our failure to maintain appropriate internal controls over financial reporting;

our ability to obtain and/or maintain licenses and other approvals in those jurisdictions where required to conduct our business;

our ability to comply with various federal, state and local laws and regulations that govern our business;

developments in the secondary markets for our mortgage loan products;

legislative and regulatory changes that impact the mortgage loan industry or housing market;

changes in regulations or the occurrence of other events that impact the business, operations or prospects of government agencies such as the Government National Mortgage Association (Ginnie Mae), the Federal Housing Administration (the FHA) or the Veterans Administration (the VA), or government-sponsored entities such as the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac) (Fannie Mae, Freddie Mac and Ginnie Mae are each referred to as an Agency and, collectively, as the Agencies), or such changes that increase the cost of doing business with such entities;

the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and its implementing regulations and regulatory agencies, and any other legislative and regulatory changes that impact the business, operations or governance of mortgage lenders and/or publicly-traded companies;

the creation of the Consumer Financial Protection Bureau (CFPB), its recently issued and future rules and the enforcement thereof by the CFPB;

changes in government support of homeownership;



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changes in government or government-sponsored home affordability programs;

changes in governmental regulations, accounting treatment, tax rates and similar matters (including changes to laws governing the taxation of real estate investment trusts ( REITs ), or the exclusions from registration as an investment company);

limitations imposed on our business and our ability to satisfy complex rules for us to qualify as a REIT for U.S. federal income tax purposes and qualify for an exclusion from the Investment Company Act of 1940 (the Investment Company Act ) and the ability of certain of our subsidiaries to qualify as REITs or as taxable REIT subsidiaries ( TRSs ) for U.S. federal income tax purposes, as applicable, and our ability and the ability of our subsidiaries to operate effectively within the limitations imposed by these rules;

estimates relating to our ability to make distributions to our shareholders in the future;

the effect of public opinion on our reputation; and

the occurrence of natural disasters or other events or circumstances that could impact our operations.

Other factors that could also cause results to differ from our expectations may not be described in this Report or any other document. Each of these factors could by itself, or together with one or more other factors, adversely affect our business, results of operations and/or financial condition.

Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made.

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### PART I

#### **Item 1. Business**

*The following description of our business should be read in conjunction with the information included elsewhere in this Report. This description contains forward-looking statements that involve risks and uncertainties. Actual results could differ significantly from the projections and results discussed in the forward-looking statements due to the factors described under the caption "Risk Factors" and elsewhere in this Report. References in this Report to we, our, us, PMT, or the Company refer to PennyMac Mortgage Investment Trust and its consolidated subsidiaries, unless otherwise indicated.*

#### **Our Company**

We are a specialty finance company that invests primarily in residential mortgage loans and mortgage-related assets. We were organized in Maryland on May 18, 2009, and began operations on August 4, 2009. We conduct substantially all of our operations, and make substantially all of our investments, through PennyMac Operating Partnership, L.P. (our Operating Partnership), and its subsidiaries. A wholly-owned subsidiary of ours is the sole general partner, and we are the sole limited partner, of our Operating Partnership.

The management of our business and execution of our operations is performed on our behalf by subsidiaries of Private National Mortgage Acceptance Company, LLC (PNMAC or PennyMac), which was designed specifically to address the opportunities created in the markets for residential mortgage assets. Specifically:

We are managed by PNMAC Capital Management, LLC (PCM or our Manager), a wholly-owned subsidiary of PennyMac and an investment adviser registered with the Securities and Exchange Commission (SEC) that specializes in, and focuses on, residential mortgage assets.

All of the loans we acquire in our correspondent lending operations are acquired, pooled for sale, sold and/or securitized on our behalf by another wholly-owned PennyMac subsidiary, PennyMac Loan Services, LLC (PLS or our Servicer), which also subservices most of the loans we hold in our investment portfolio and all of the loans for which we retain the obligation to service as a result of our correspondent lending operations.

Our objective is to provide attractive risk-adjusted returns to our investors over the long-term, primarily through dividends and secondarily through capital appreciation. Our targeted investments are in the U.S. residential mortgage market. We are presently focused on investing in the historically large volume of distressed mortgage loans available for acquisition from financial institutions and engaging in correspondent lending, whereby we acquire, pool and sell or securitize newly originated mortgage loans.

Correspondent lending includes the acquisition of newly originated, prime credit quality, first-lien residential mortgage loans that have been underwritten to investor guidelines, pooling loans into mortgage-backed securities (MBS) and resale of the resulting securities into the secondary markets. We purchase government and government-sponsored entity (GSE) eligible loans and jumbo loans. A jumbo loan is a loan in an amount that exceeds the maximum loan amount for eligible loans under GSE guidelines. We then sell or securitize GSE eligible loans, which we sell or securitize through the GSEs on a servicing-retained basis whereby we retain the related mortgage servicing rights (MSR); government loans (insured by the FHA or guaranteed by the VA), which we sell to PLS, a Ginnie Mae approved issuer and servicer; and jumbo mortgage loans, which we sell to third parties, generally on a servicing-retained basis.

Our correspondent lending business has grown through purchases from approved mortgage originators that meet specific criteria related to management experience, financial strength, risk management controls and loan quality. The management team of PLS and PCM has prior experience with the majority of these mortgage originators. As of December 31, 2012, 140 sellers have been approved, primarily independent mortgage originators and small banks located across the United States. We purchased approximately \$22.4 billion at fair

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value of loans in 2012, including \$13.4 billion of conventional loans and \$9.0 billion of government-insured loans. In the third quarter of 2012, with \$6.3 billion in production, PMT was the fifth largest correspondent lender in the United States as ranked by Inside Mortgage Finance.

In our distressed investment activities, many of the mortgage loans are purchased at discounts reflecting their distressed state or perceived higher risk of default, as well as a greater likelihood of collateral documentation deficiencies. Prior to the acquisition of loans or other assets, our Manager validates key information provided by the sellers that is necessary to determine the value of the asset. We then seek to maximize the value of the mortgage loans that we acquire. The objective for performing loans is value enhancement through effective high touch servicing, which is based on significant levels of borrower outreach and contact, and the ability to implement long-term, sustainable loan modification and restructuring programs that address borrowers' ability and willingness to pay their mortgage loans. Alternatively, for nonperforming loans and real estate assets, the ability to effect property resolution in a timely, orderly and economically efficient manner is essential to generating attractive returns.

Through our management agreement with PCM and our loan servicing agreements with our loan servicers (primarily our affiliate, PLS), we work with borrowers to perform loss mitigation activities. For both performing and nonperforming loans we use loan modification programs (such as the U.S. Departments of the Treasury and Housing and Urban Development's Home Affordable Modification Program (HAMP)) and workout options that we believe have the highest probability of successful resolution for both borrowers and our Company. Loan modification or resolution may include our accepting a reduction of the principal balances of certain mortgage loans in our investment portfolio. We expect these methods to increase our portfolio of performing loans, reduce default rates and enhance the value of loans in our portfolio. We believe that by using these methods, we can provide borrowers with long-term solutions that address their willingness and ability to pay their mortgage loans. Once we have improved the credit quality of a loan, we intend to monetize the enhanced value through various disposition strategies. When loan modifications and other efforts are unable to cure distressed loans, our objective is to effect timely acquisition and liquidation of the property securing the mortgage loan.

Our Manager specializes in acquiring distressed residential mortgage assets that are sold by financial institutions including banks, thrifts, and non-bank mortgage lenders. Since late 2009, our Manager has seen substantial volumes of nonperforming residential mortgage loans available for purchase from certain U.S. banks at significant discounts to their unpaid principal balances. Our Manager believes that there are several reasons these banks are motivated to sell nonperforming loans, including the following: the ability to release capital tied to nonperforming assets; the ability to relieve strain on their operations resulting from managing nonperforming loans and real estate acquired in settlement of loans (REO); the ability to reduce the percentages of their assets that are nonperforming, a key measure monitored by the banks' regulators, investors, and other stakeholders; and the ability for these banks to manage perceptions of the continued drag on their overall performance from legacy distressed assets through controlled sales of nonperforming assets.

We have elected to be taxed as a REIT for U.S. federal income tax purposes and we intend to maintain our exclusion from regulation under the Investment Company Act. Therefore, we are required to invest a substantial majority of our assets in loans secured by real estate and in real estate-related assets. Subject to maintaining our REIT qualification and our Investment Company Act exclusion, we do not have any limitations on the amounts we may invest in any of our targeted asset classes.

As our Manager, PCM conducts activities including developing our investment strategies, sourcing and acquiring mortgage loans and mortgage-related assets for our investment portfolio, and developing the appropriate approach to be taken by PLS for each loan as it performs its specialty servicing. As our loan servicer, PLS subservices the mortgage loans we acquire. PLS performs prime servicing with respect to the loans underlying our MSRs, which are generally prime credit quality with low delinquency and default rates. PLS also performs special servicing for the distressed whole loans we have acquired. Special servicing utilizes a high touch model to establish and maintain borrower contact and facilitate loss mitigation.

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strategies. As part of its execution of PCM's portfolio strategy, PLS may modify or refinance loans in our investment portfolio and originate loans to finance the sale of real estate we acquire in settlement of our loans. In addition, PLS provides mortgage banking services in support of our correspondent lending activities.

Our internet address is [www.pennymacmortgageinvestmenttrust.com](http://www.pennymacmortgageinvestmenttrust.com). We make available free of charge, on or through the investor relations section of our web site, annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as well as proxy statements, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

### **Our Manager and Our Servicer**

We are externally managed and advised by PCM pursuant to a management agreement. PCM specializes in and focuses on residential mortgage loans. PCM also serves as the investment manager to two private investment funds, which we refer to as the PennyMac funds, with investment objectives and policies relating to distressed mortgage loans that are substantially similar to ours. The combined net assets of the entities managed by PCM, including our shareholders' equity, amounted to approximately \$1.8 billion as of December 31, 2012.

PCM is responsible for administering our business activities and day-to-day operations. Pursuant to the terms of the management agreement, PCM provides us with our senior management team, including our officers, along with appropriate support personnel. PCM is subject to the supervision and oversight of our board of trustees and has the functions and authority specified in the management agreement.

We also have a loan servicing agreement with PLS, pursuant to which PLS provides primary and special servicing for our portfolio of residential mortgage loans. PLS' loan servicing activities include collecting principal, interest and escrow account payments, if any, with respect to mortgage loans, as well as managing loss mitigation, which may include, among other things, collection activities, loan workouts, modifications and refinancings, foreclosures, short sales, sales of REO and financings to facilitate such sales. Servicing fee rates are based on the delinquency status and other characteristics of the mortgage loans serviced and total servicing compensation is established at levels that management believes are competitive with those charged by other primary servicers and specialty servicers.

PLS' servicing platform provides for significant borrower contact, which we refer to as "high touch," and is designed to enable us to effectively implement programs that address borrower needs and maximize the value of our portfolio. PLS was established in February 2008 and also provides primary servicing and special servicing to the PennyMac funds and entities in which they have invested as well as third parties. PLS acted as the servicer for loans with an aggregate unpaid principal balance of approximately \$28.2 billion as of December 31, 2012.

Our Manager's senior management team has extensive experience in the residential mortgage industry and expertise across each of the critical capabilities that we believe are required to successfully acquire and manage both performing and nonperforming mortgage loans, including sourcing, valuation, due diligence, portfolio strategy, servicing (including modification and refinance fulfillment of outstanding loans and acquisition and liquidation of properties securing settled mortgage loans) and secondary marketing of restructured and re-performing loans. Our senior management team is supported by a dedicated team of employees at PLS and PCM.

We have no employees, and we do not pay our officers any cash compensation. Rather, under the management agreement, we pay PCM management fees quarterly in arrears, which include a "base" component and an "incentive" component. In addition, we pay PLS fees for servicing our loans and providing mortgage banking services in support of our correspondent lending activities, and we reimburse PCM and its affiliates for certain direct costs incurred on our behalf and for certain overhead expenses.

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Our management fees are calculated on a quarterly basis. The management fees that we pay PCM have two components: a base component and a performance incentive component. Under our prior management agreement with PCM, which was effective during the periods presented in this Report, the terms of the two components were as follows:

*Base component.* The base component was calculated at the annual rate of 1.5% of shareholders' equity (as defined in the management agreement). Effective May 16, 2012, we amended our management agreement with PCM to change the way that shareholders' equity was measured for purposes of calculating the base component of our management fee. Previously, the measure of our shareholders' equity excluded unrealized gains, losses or other non-cash items reflected in our financial statements. To better align the base component of the management fee with our investment strategy, we amended the management agreement to base the management fee on shareholders' equity computed using United States generally accepted accounting principles, or U.S. GAAP. The effect of this modification had been to increase the base management fee that we pay to PCM since the agreement was amended.

*Performance incentive component.* The performance incentive fee was calculated at 20% per year of the amount by which core earnings (as defined in the management agreement, core earnings generally represented our net income, adjusted for the effects of unrealized gains and losses recognized in earnings), on a rolling four-quarter basis and before the incentive fee, exceeded an 8% hurdle rate. Our core earnings did not exceed the 8% hurdle rate and we therefore did not recognize the incentive component of our management fees.

Effective February 1, 2013, we amended the terms of our management agreement with PCM. The amendment reduced the annual rate of the base component of the management fee applicable to shareholders' equity in excess of \$2.0 billion. It also changed the basis on which the performance incentive portion of our management fee is calculated from core earnings, as defined under the prior agreement, to a percentage of earnings as determined in accordance with U.S. GAAP exceeding a series of hurdles starting at 8%. As a result of this change, we expect to incur the performance incentive portion of our management fee in future periods. The management agreement is more fully described elsewhere in this Report in *Off-Balance Sheet Arrangements and Aggregate Contractual Obligations - Contractual Obligations Management Agreement*.

Effective February 1, 2013, we also amended and restated our servicing agreement with PLS. The primary purpose of the amendment was to change the nature of the fees that we pay to PLS for loan servicing to fixed per-loan monthly amounts based on the delinquency, bankruptcy and/or foreclosure status of the serviced loan or the REO. The servicing agreement is more fully described elsewhere in this Report in *Off-Balance Sheet Arrangements and Aggregate Contractual Obligations - Contractual Obligations Servicing Agreement*.

## **Investment Strategy**

Our objective is to provide attractive risk-adjusted returns to our investors over the long-term, primarily through dividends and secondarily through capital appreciation. We seek to achieve this objective primarily by investing in mortgage loans, a substantial portion of which may be distressed and acquired at discounts to their unpaid principal balances.

### *Correspondent Lending*

Over the past few years, a number of large banks have exited or reduced the size of their correspondent lending businesses, creating an opportunity for non-bank entities to gain market share. We believe that we are well positioned to take advantage of this opportunity based on the management expertise of PLS and PCM in the correspondent lending business, the relationships with correspondent sellers, and the supporting systems and processes of PLS.

### *Distressed Assets*

We seek to maximize the value of the mortgage loans that we acquire through proprietary loan modification programs, special servicing and other initiatives focused on keeping borrowers in their homes. Where this is not

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possible, such as in the case of many nonperforming mortgage loans, we seek to effect property resolution in a timely, orderly and economically efficient manner. We also invest in mortgage-related securities and other mortgage-related, real estate and financial assets. A substantial portion of our investments are not rated by any rating agency.

The pools of loans that we acquire consist primarily of U.S. residential mortgage loans. These loans may be performing or nonperforming and of varying credit quality, including subprime, Alt-A and prime. PCM, in its sole discretion, and in accordance with its policies and procedures, determines the composition of our portfolio of loans, including its size, loan types and credit quality.

We rely on PCM's expertise in identifying pools of distressed mortgage loans and other assets for acquisition. PCM's sourcing and evaluation processes for potential acquisitions of residential mortgage loans and for mortgage-related assets are substantially similar. PCM makes investment decisions based on various factors, including expected cash yield, relative value, risk-adjusted returns, current and projected credit fundamentals, current and projected macroeconomic considerations, current and projected supply and demand, market risk, portfolio diversification, liquidity and availability and terms of financing, as well as maintaining our REIT qualification and our exclusion from registration under the Investment Company Act. The evaluation process with respect to residential mortgage-backed securities (RMBS) and other MBS also includes relative value analyses based on yield, credit rating, average life, effective duration, option-adjusted spreads, prepayment assumptions and credit expectations. Investment decisions with regard to the acquisition or disposition of any of our targeted assets are generally made by PCM's investment committee. Our assets are not subject to any geographic diversification or concentration limitations except that we are concentrated in residential mortgage-related investments. We have established no limitations on the maturity, duration or credit rating of our assets.

PCM and its affiliates evaluate new opportunities based on their relative expected returns compared to comparable assets held in our portfolio. We re-evaluate our investment strategy as market conditions change with a view toward maximizing the returns from our investment portfolio and identifying dislocations and opportunities in the mortgage market.

## Targeted Asset Classes

We invest primarily in residential mortgage loans and mortgage-related assets. Our targeted asset classes and the principal investments we make and/or expect to make in each class are as follows:

| Asset class                            | Principal investments  |
|--|--|
| Residential Mortgage Loans             | Newly originated mortgage loans<br>Seasoned performing and nonperforming residential mortgage loans  |
| Residential Mortgage-Backed Securities | Agency RMBS<br>Non-Agency RMBS, including investment-grade, non-investment grade classes and non-rated classes   |
| Other assets and other MBS             | Real estate and real estate acquired in settlement of loans<br>MSRs<br>Excess servicing spread arising from MSRs<br>Loans to finance mortgage loan inventory for mortgage lenders<br>Mortgage-related derivatives, including, but not limited to, credit default swaps, options, futures and derivatives on MBS<br>Commercial mortgage-backed securities (CMBS)<br>United States Treasury securities |

Over time, our targeted asset classes may change as a result of changes in the opportunities that are available in the market, among other factors. We may not invest in certain of the investments described above if we believe those types of investments will not provide us with attractive opportunities or if we believe other types of our targeted assets provide us with better opportunities.

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### Our Portfolios

#### Correspondent Lending

During the year ended December 31, 2012, we significantly increased our participation in the secondary mortgage market through the purchase for resale of newly originated mortgage loans ( correspondent lending ). In our correspondent lending activities, we acquire newly originated loans from mortgage lenders, sell the loans to an Agency or other third party, sell the loans to PLS in the case of government loans, or otherwise pool loans into MBS, sell the resulting securities into the MBS markets and retain the MSRs. During 2012, we purchased \$22.4 billion at fair value of newly originated mortgage loans, compared to \$1.3 billion during 2011.

Following is a summary of our correspondent lending activities:

|  | Year ended December 31, |              |           | Period from<br>August 4, 2009<br>(commencement of<br>operations) to<br>December 31, 2009 |
|--|-------------------------|--------------|-----------|--|
|  | 2012                    | 2011         | 2010      |  |
|  | (in thousands)          |              |           |  |
| Fair value of correspondent lending loans purchased:                 |                         |              |           |  |
| Agency eligible  | \$ 13,463,121           | \$ 660,862   | \$ 9,249  | \$   |
| Government insured or guaranteed                                     | 8,969,220               | 623,540      | 20,810    |  |
| Jumbo  | 10,795                  | 34,361       |           |  |
|  | \$ 22,443,136           | \$ 1,318,763 | \$ 30,059 | \$   |
| Fair value of correspondent lending loans in inventory at period-end | \$ 975,184              | \$ 232,016   | \$ 3,966  | \$   |
| Gain on mortgage loans acquired for sale(1)                          | \$ 147,675              | \$ 7,633     | \$ 18     | \$   |

- (1) Gain on mortgage loans acquired for sale includes changes in the value of commitments to purchase loans or interest rate lock commitments ( IRLC ), changes in the value of mortgage loans purchased during the period from purchase through the date of sale and changes in the value of financial instruments purchased and sold to manage the risk of changes in value of our inventory of mortgage loans and IRLCs.

#### Investment Activities

Following is a summary of our acquisitions of mortgage investments (excluding purchases for resale of newly originated mortgage loans):

|                                 | Year ended December 31, |           |           | Period from<br>August 4, 2009<br>(commencement<br>of<br>operations) to<br>December 31, 2009 |
|---------------------------------|-------------------------|-----------|-----------|---|
|                                 | 2012                    | 2011      | 2010      |   |
|                                 | (in thousands)          |           |           |   |
| MBS                             | \$ 112,211              | \$ 21,420 | \$ 91,141 | \$ 93,049   |
| Distressed mortgage loans(1)(2) |                         |           |           |   |
| Performing                      | 128,221                 | 52,256    | 33,745    | 26,046  |
| Nonperforming                   | 414,545                 | 595,353   | 383,466   |   |

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|      |            |            |            |            |
|------|------------|------------|------------|------------|
|      | 542,766    | 647,609    | 417,211    | 26,046     |
| REO  | 297        | 2,475      | 1,238      |            |
| MSRs | 134,702    | 6,079      |            |            |
|      | \$ 789,976 | \$ 677,583 | \$ 509,590 | \$ 119,095 |



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- (1) Performance status as of the date of acquisition.
  - (2) \$504.8 million and \$577.6 million of our distressed asset purchases during the year ended December 31, 2012 and 2011, respectively, were acquired from or through one or more subsidiaries of Citigroup Inc.
- Our portfolio of mortgage investments was comprised of the following:

|                            | 2012         | December 31,<br>2011<br>(in thousands) | 2010       | 2009       |
|----------------------------|--------------|--|------------|------------|
| MBS                        | \$           | \$ 72,813                              | \$ 119,872 | \$ 83,771  |
| Distressed mortgage loans: |              |  |            |            |
| Performing                 | 404,016      | 209,599                                | 86,242     | 26,046     |
| Nonperforming              | 785,955      | 615,977                                | 278,008    |            |
|                            | 1,189,971    | 825,576                                | 364,250    | 26,046     |
| REO                        | 88,078       | 103,549                                | 29,685     |            |
| MSRs                       | 126,776      | 6,031                                  |            |            |
|                            | \$ 1,404,825 | \$ 1,007,969                           | \$ 513,807 | \$ 109,817 |

Our acquisitions have been primarily comprised of nonperforming loans rather than distressed performing loans. During the period from August 4, 2009 (commencement of operations) through December 31, 2011, PCM encountered a relatively higher volume of available nonperforming mortgage loan portfolios than distressed performing loan portfolios. In addition, the risk-adjusted returns for nonperforming loan portfolios have been more attractive than those for distressed performing loan portfolios.

PCM has worked to expand our sources of assets to position us to take advantage of market opportunities and market changes, such as when the mortgage market achieves more active levels of non-Agency securitization and when delinquency and foreclosure levels reduce closer to historical levels. Examples of such investments include:

Acquisition of MSRs or excess servicing spread from MSRs from financial institutions. We believe that MSR investments may allow us to earn attractive current returns and to leverage the loan servicing and origination capabilities of PLS to improve the assets' value. We also intend to continue to retain the MSRs that we receive as a portion of the proceeds from our sale or securitization of mortgage loans through our correspondent lending operation.

Pursuant to the terms of the MSR recapture agreement entered into with PLS effective February 1, 2013, if PLS refinances loans for which we previously created and held the MSRs through our correspondent lending activities, PLS is generally required to transfer and convey to us, without cost to us, 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.

Providing inventory financing of mortgage loans for mortgage lenders. We believe this activity results in attractive investment assets and will supplement and make our correspondent lending business more attractive to lenders from which we acquire newly originated loans.

To the extent that we transfer correspondent lending loans into private label securitizations in the future, we may retain a portion of the securities and residual interests created in such securitization transactions.



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### **Our Financing Strategy**

We have pursued growth of our investment portfolio by using a combination of equity and borrowings. We have made borrowings in the form of borrowings under forward purchase agreements, sales of securities and nonperforming assets under agreements to repurchase, and lines of credit to finance loans purchased through our correspondent lending activities. We use borrowings to finance our investments and not to speculate on changes in interest rates.

During 2011 and 2012, we issued 11.5 million and 30.3 million of our common shares and received net proceeds totaling \$197.4 million and \$606.5 million, respectively, through a combination of underwritten share offerings and controlled equity offerings. We used the proceeds of these offerings to fund a portion of the purchase price of portfolios of residential mortgage whole loans, to fund the continued growth of the correspondent lending business and for general corporate purposes.

Since 2010, we entered into or amended three master repurchase agreements with three money center banks totaling \$700.0 million, to finance our investments in distressed assets. We also entered into a secured lending facility, which has since expired, with a money center bank in an aggregate amount of \$40 million. Our objective is to use these facilities to finance nonperforming mortgage loan and real estate investments pending liquidation, sale, securitization or other structured financing. The aggregate principal amount outstanding under these facilities was \$361.2 million as of December 31, 2012.

Since 2010, we also entered into six master repurchase agreements with five money center banks totaling \$1.4 billion (of which \$1.2 billion is committed), in order to fund newly originated prime mortgage loans purchased from correspondent lenders. The principal balance outstanding under these facilities was \$894.9 million as of December 31, 2012.

During 2011, we entered into forward purchase agreements pursuant to which we agreed to purchase certain nonperforming assets and residential real property acquired in settlement of loans from one money center bank which purchased these assets from unaffiliated money center banks. We assumed all of the money center bank's rights and obligations under its separate agreements with the unaffiliated money center banks. We recorded the transactions as purchases of loans. All borrowings under forward purchase agreements were repaid during the year ended December 31, 2012.

Our borrowings are made under agreements that include various covenants, including profitability, the maintenance of specified levels of cash, adjusted tangible net worth and overall leverage limits. Our ability to borrow under these facilities is limited by the amount of qualifying assets that we hold and that are eligible to be pledged to secure such borrowings. We are not otherwise required to maintain any specific debt-to-equity ratio, and we believe the appropriate leverage for the particular assets we finance depends on, among other things, the credit quality and risk of such assets. Our declaration of trust and bylaws do not limit the amount of indebtedness we can incur, and our board of trustees has discretion to deviate from or change our financing strategy at any time.

Subject to maintaining our qualification as a REIT and exclusion from registration under the Investment Company Act, we may hedge the interest rate risk associated with the financing of our portfolio.

### **Investment Policies**

Our board of trustees has adopted the policies set forth below for our investments and borrowings. PCM will review our compliance with the investment policies regularly and will report periodically to our board of trustees regarding such compliance.

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No investment shall be made that would cause us to fail to qualify as a REIT for U.S. federal income tax purposes;

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

With the exception of real estate and housing, no single industry shall represent greater than 20% of the investments or aggregate risk exposure in our portfolio.

These investment policies may be changed by a majority of our board of trustees without the approval of, or prior notice to, our shareholders.

### **Investment Allocation Policy**

Investment opportunities in pools of mortgage loans that are consistent with our investment objectives, on the one hand, and the investment objectives of the PennyMac funds and other future entities or accounts managed by PCM, on the other hand, are allocated among us and the PennyMac funds and the other entities or accounts generally *pro rata*. This is and has been based upon relative amounts of investment capital (including undrawn capital commitments) available for new investments by us, the PennyMac funds and any other relevant entities or accounts, or by assigning opportunities among the relevant entities such that investments assigned among us, such funds, entities or accounts are fair and equitable over time; *provided* that PCM, in its sole discretion, may allocate investment opportunities in any other manner that it deems to be fair and equitable. As of December 31, 2012, the commitment periods for the PennyMac funds had ended and the ability of the PennyMac funds to make new investments has therefore been reduced.

In the case of the allocation of investment opportunities, PCM considers a number of factors. These factors include:

investment objectives or strategies for particular entities or accounts;

tax considerations of an entity or account;

risk or investment concentration parameters for an entity or account;

supply or demand for an investment at a given price level;

size of available investment;

cash availability and liquidity requirements for an entity or account;

minimum investment size of an entity or account;

relative size or buying power of an entity or account;

regulatory considerations, including the potential impact on an entity's status under the Investment Company Act, and, in our case, our REIT status; and

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such other factors as may be relevant to a particular transaction.

In the case of *pro rata* purchases of pools of loans where the pool is allocated among us and other entities or accounts, PCM, at the time of purchase, seeks to allocate the individual mortgage loans in the pools among us and the other entities or accounts such that the overall allocation of acquired mortgage loans in the pools will target reasonable symmetry with reference to, among other factors, the following:

unpaid principal balances;

delinquency status;

purchase price;

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lien position;

expected cash flows;

geography; and

such other factors as may be relevant to a particular transaction.

As the investment programs of the various entities and accounts managed by PCM change and develop over time, additional issues and considerations may affect PCM's and our allocation policy and PCM's and our expectations with respect to the allocation of investment opportunities among the various entities and accounts managed by PCM. Notwithstanding PCM's intention to effect fair and equitable allocations of investment opportunities, we expect that our performance will differ from the performance of the PennyMac funds and any other PennyMac-managed entity or account for many reasons, including differences in the legal or regulatory characteristics, or tax classification, of the entities or accounts or due to differing fee structures or the idiosyncratic differences in the outcome of individual mortgage loans.

We have not adopted a policy that expressly prohibits our trustees, officers, shareholders or affiliates from having a direct or indirect financial interest in any investment to be acquired or disposed of by us or in any transaction to which we are a party or have an interest. We do not have a policy that expressly prohibits any such persons from engaging for their own account in business activities of the types conducted by us. However, our code of business conduct and ethics contains a conflicts of interest policy that prohibits our trustees, officers and employees, as well as employees of PCM who provide services to us, from engaging in any transaction that involves an actual or apparent conflict of interest with us without the appropriate approval. We also have written policies and procedures for the review and approval of related party transactions.

## **Operating and Regulatory Structure**

### ***REIT Qualification***

We have elected to be treated as a REIT under Sections 856 through 859 of the Internal Revenue Code of 1986 (the "Internal Revenue Code") beginning with our taxable year ended December 31, 2009. Our qualification as a REIT depends upon our ability to meet on a continuing basis, through actual investment and operating results, various complex requirements under the Internal Revenue Code relating to, among other things, the sources of our gross income, the composition and values of our assets, our distribution levels and the diversity of ownership of our common shares. We believe that we are organized in conformity with the requirements for qualification and taxation as a REIT under the Internal Revenue Code, and that our manner of operation enables us to meet the requirements for qualification and taxation as a REIT.

As a REIT, we generally are not subject to U.S. federal income tax on our REIT taxable income we distribute to our shareholders. If we fail to qualify as a REIT in any taxable year and do not qualify for certain statutory relief provisions, we will be subject to U.S. federal income tax at regular corporate rates and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year during which we lost our REIT qualification. Accordingly, our failure to qualify as a REIT could have a material adverse impact on our results of operations and amounts available for distribution to our shareholders.

Even though we have elected to be taxed as a REIT, we are subject to some U.S. federal, state and local taxes on our income or property. A portion of our business is conducted through, and a portion of our income is earned in, our TRS that is subject to corporate income taxation. In general, a TRS of ours may hold assets and engage in activities that we cannot hold or engage in directly and may engage in any real estate or non-real estate related business. A TRS is subject to U.S. federal, state and local corporate income taxes. To maintain our REIT election, at the end of each quarter no more than 25% of the value of a REIT's assets may consist of stock or securities of one or more TRSs.

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If our TRS generates net income, our TRS can declare dividends to us, which will be included in our taxable income and necessitate a distribution to our shareholders. Conversely, if we retain earnings at the TRS level, no distribution is required and we can increase shareholders equity of the consolidated entity. As discussed in Section 1A of this Report entitled *Risk Factors*, the combination of the requirement to maintain no more than 25% of our assets in the TRS coupled with the effect of TRS dividends on our income tests creates compliance complexities for us in the maintenance of our qualified REIT status.

The dividends paid deduction of a REIT for qualifying dividends to its shareholders is computed using our taxable income as opposed to net income reported on our financial statements. Taxable income generally differs from net income reported on our financial statements because the determination of taxable income is based on tax laws and regulations and not financial accounting principles.

### ***Licensing***

We and PLS are required to be licensed to conduct business in certain jurisdictions. PLS is, or is taking steps to become, licensed in those jurisdictions and for those activities where it believes it is cost effective and appropriate to become licensed. Through our wholly owned subsidiaries, we are also licensed, or are taking steps to become licensed, in those jurisdictions and for those activities where we believe it is cost effective and appropriate to become licensed. In jurisdictions in which neither we nor PLS is licensed, we do not conduct activity for which a license is required. Our failure or the failure by PLS to obtain any necessary licenses promptly, comply with applicable licensing laws or satisfy the various requirements or to maintain them over time could materially and adversely impact our business.

### **Competition**

In our correspondent lending activities, we compete with large financial institutions and with other independent residential mortgage loan producers and servicers. We compete on the basis of product offerings, technical knowledge, manufacturing quality, speed of execution, rate and fees.

In acquiring distressed mortgage assets, we compete with specialty finance companies, private funds, other mortgage REITs, thrifts, banks, mortgage bankers, insurance companies, mutual funds, institutional investors, investment banking firms, governmental bodies and other entities. A number of these competitors may also be focused on acquiring distressed mortgage loans, and therefore may increase competition for the available supply of mortgage assets suitable for purchase. Many of our competitors are significantly larger than we are and have stronger balance sheets and greater access to capital and other resources than we have and may have other advantages over us. Such advantages include the ability to obtain lower-cost financing, such as deposits, and operational efficiencies arising from their larger size. Some of our competitors may have higher risk tolerances or different risk assessments and may not be subject to the operating restraints associated with REIT tax compliance or maintenance of an exclusion from the Investment Company Act, any of which could allow them to consider a wider variety of investments and funding strategies and to establish more relationships than we can.

Because the availability of pools of distressed mortgage assets may fluctuate, the competition for assets and sources of financing may increase. Increased competition for assets may result in our accepting lower returns for acquisitions of residential mortgage loans and other assets or adversely influence our ability to win our bids for such assets. An increase in the competition for sources of funding could adversely affect the availability and terms of financing, and thereby adversely affect the market price of our common shares.

In the face of this competition, we have access to PCM's professionals and their industry expertise, which we believe provides us with a competitive advantage and helps us assess investment risks and determine appropriate pricing for certain potential investments. We expect these relationships to enable us to compete more effectively for attractive investment opportunities. Furthermore, we believe that our access to PLS's special servicing expertise helps us to maximize the value of our residential mortgage loans and provides us with a

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competitive advantage over other companies with a similar focus. We believe that current market conditions may have adversely affected the financial condition and operations of certain owners of mortgage assets. Further, regulatory and capital issues have contributed to the decision by certain financial institutions to exit or curtail their correspondent lending business and to reduce their portfolios of mortgage servicing rights. Not having a legacy portfolio or the same regulatory or capital issues may enable us to compete more effectively for attractive business or investment opportunities. However, we cannot assure you that we will be able to achieve our business goals or expectations due to the competitive and other risks that we face.

### **Staffing**

We are managed by PCM pursuant to a management agreement. PLS provides servicing and special servicing for our portfolio of residential mortgage loans pursuant to a loan servicing agreement and fulfillment services in connection with our correspondent lending activities pursuant to a mortgage banking and warehouse services agreement. All of our officers are employees of PCM or its affiliates. We have no employees. As of December 31, 2012, PennyMac had 907 employees. See *Our Manager and Our Servicer* above.

### **Item 1A. Risk Factors**

#### **Risks Associated with Our Management and Relationship with Our Manager and Its Affiliates**

*We are dependent upon PCM, PLS and their resources and may not find suitable replacements if any of our service agreements with PCM or PLS is terminated.*

In accordance with our management agreement, we are externally advised and managed by PCM, which makes all or substantially all of our investment, financing and risk management decisions, and has significant discretion as to the implementation of our operating policies and strategies. Under our loan servicing agreement with PLS, PLS provides primary servicing and special servicing for our portfolio of residential mortgage loans, and under our mortgage banking and warehouse services agreement with PLS, PLS provides fulfillment and disposition-related services in connection with our correspondent lending business. The costs of these services increase our operating costs and may adversely affect our net income, but we rely on PCM and PLS to provide these services under these agreements because we have no in-house capability to handle the services independently.

No assurance can be given that the strategies of PCM, PLS or their affiliates under any of these agreements will be successful, that any of them will conduct complete and accurate due diligence or provide sound advice, or that any of them will act in our best interests with respect to the allocation of resources to our business. The failure of any of them to do any of the above, conduct the business in accordance with applicable laws and regulations or hold all licenses or registrations necessary to conduct the business as currently operated would materially and adversely affect our ability to continue to execute our business plan.

In addition, the terms of these agreements extend until February 1, 2017 (subject to automatic renewals for 18-month terms), but any of the agreements may be terminated earlier under certain circumstances or otherwise non-renewed. If any agreement is terminated or non-renewed and a suitable replacement is not secured in a timely manner, it would materially and adversely affect our ability to continue to execute our business plan.

If our management agreement or loan servicing agreement is terminated or non-renewed, we will have to obtain the services from another service provider. We may not be able to replace these services in a timely manner or on favorable terms, or at all. With respect to our mortgage banking and warehouse services agreement, the services provided by PLS are inherently unique and not widely available, if at all. This is particularly true because we are not a Ginnie Mae licensed issuer or servicer yet we are able to acquire government mortgage loans from our correspondent sellers that we know will ultimately be purchased from us by PLS. While we generally have exclusive rights to these services from PLS during the term of our mortgage banking and



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warehouse services agreement, in the event of a termination we may not be able to replace these services in a timely manner or on favorable terms, or at all, and we ultimately would be required to compete against PLS for the correspondent business we currently enjoy.

***PennyMac, the parent company of PCM and PLS, is undergoing significant growth and its development and integration of new operations may not be effective.***

PennyMac's significant growth since it commenced operations has caused significant demands on its operational, accounting and legal infrastructure, and increased expenses. The ability of PCM and PLS to provide us with the services we require to be successful depends, among other things, on the ability of PennyMac, including PCM and PLS, to maintain an operating platform and management system sufficient to address its growth. This may require PennyMac to incur significant additional expenses and to commit additional senior management and operational resources. There can be no assurance that PennyMac will be able to effectively integrate its expanding operations or that PennyMac will continue to grow successfully. PennyMac's failure to do so could adversely affect the ability of PCM and PLS to manage us and service our mortgage loan portfolio, respectively, which would materially and adversely affect us.

***The management fee structure could cause disincentive and/or create greater investment risk.***

Pursuant to our management agreement, PCM is entitled to receive a base management fee that is based on our shareholders' equity (as defined in our management agreement) at the end of each quarter. As a result, significant base management fees would be payable to PCM for a given quarter even if we experience a net loss during that quarter. PCM's right to non-performance-based compensation may not provide sufficient incentive to PCM to devote its time and effort to source and maximize risk-adjusted returns on our investment portfolio, which could, in turn, materially and adversely affect our ability to make distributions to our shareholders and the market price of our common shares.

Conversely, PCM is also entitled to receive incentive compensation under our management agreement based on our performance in each quarter. In evaluating investments and other management strategies, the opportunity to earn incentive compensation based on our net income may lead PCM to place undue emphasis on the maximization of short-term income at the expense of other criteria, such as preservation of capital, maintenance of sufficient liquidity and/or management of market risk, in order to achieve higher incentive compensation. Investments with higher yield potential are generally riskier and more speculative.

***The servicing fee structure could create a conflict of interest.***

For its services under our loan servicing agreement, PLS is entitled to base servicing fees that we believe are competitive with those charged by primary servicers and specialty servicers and are calculated as fixed per-loan monthly amounts based on the delinquency, bankruptcy and/or foreclosure status of the serviced loan or the real estate acquired in settlement of a loan. PLS is 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 or escrow accounts. In addition, to the extent we participate in HAMP (or other similar mortgage loan modification programs), PLS may be entitled to retain any incentive payments made to it in connection with our participation therein. Because certain of these fees are earned upon reaching a specific milestone, this fee structure may provide PLS with an incentive to foreclose more aggressively or liquidate assets for less than their fair value.

On our behalf, PLS also refinances performing and nonperforming loans and originates new loans to facilitate the disposition of real estate that we acquire through foreclosure. In order to provide PLS with an incentive to produce such loans, we have agreed to pay PLS fees and other compensation based on market-based pricing and terms that are consistent with the pricing and terms offered by PLS to unaffiliated third parties on a

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retail basis. This may provide PLS with an incentive to refinance a greater proportion of our loans than it otherwise would and/or to refinance loans on our behalf instead of arranging the refinancings with a third party lender.

### ***Termination of our management agreement is difficult and costly.***

It is difficult and costly to terminate, without cause, our management agreement. Our management agreement provides that it may be terminated by us without cause under limited circumstances and the payment to PCM of a significant termination fee. The cost to us of terminating our management agreement may adversely affect our desire or ability to terminate our management agreement with PCM without cause. PCM may also terminate our management agreement upon at least 60 days' prior written notice if we default in the performance of any material term of our management agreement and the default continues for a period of 30 days after written notice to us, or where we terminate our loan servicing agreement, our mortgage banking and warehouse services agreement or certain other agreements with PCM or PLS without cause (at any time other than at the end of the current term or any automatic renewal term), whereupon in either case we would be required to pay to PCM a significant termination fee.

### ***PCM and PLS both have limited liability and indemnity rights.***

Our agreements with PCM and PLS provide that PCM and PLS will not assume any responsibility other than to provide the services specified in the applicable agreements. Our management agreement further provides that PCM will not be responsible for any action of our board of trustees in following or declining to follow its advice or recommendations. In addition, each of PCM and PLS and their respective affiliates, managers, officers, trustees, directors, employees and members will be held harmless from, and indemnified by us against, certain liabilities on customary terms.

### ***Existing or future entities or accounts managed by PCM may compete with us for PCM's time and services, and they may compete with us for, or may participate in, investments, any of which could result in conflicts of interest. BlackRock and HC Partners, PennyMac's strategic investors, could compete with us or transact business with us.***

Pursuant to our management agreement, PCM is obligated to supply us with our senior management team, and the members of that team are required to devote such time to us as is necessary and appropriate, commensurate with the level of our activity. The members of our senior management team may have conflicts in allocating their time and services between us and other entities or accounts managed by PCM now or in the future, including the PennyMac funds. The failure of our senior managers to allocate appropriate time and services to us, or the loss of services of our senior managers for any reason, could adversely affect our business.

Although our agreements with PCM and PLS provide us with certain exclusivity and other rights and we and PCM have adopted an allocation policy to specifically address some of the conflicts relating to our investment opportunities, there is no assurance that these measures will be adequate to address all of the conflicts that may arise or will address such conflicts in a manner that is favorable to us. We are also limited in our ability to acquire assets that are not qualifying real estate assets and/or real estate related assets, whereas the PennyMac funds and other entities or accounts that PCM manages now or may manage in the future are not, or may not be, as applicable, so limited. In addition, PCM and/or the PennyMac funds and the other entities or accounts managed by PCM now or in the future may participate in some of our investments, which may not be the result of arm's length negotiations and may involve or later result in potential conflicts between our interests in the investments and those of PCM or such other entities.

In addition, PennyMac's strategic investors, BlackRock and HC Partners, each own significant investments in PennyMac. Affiliates of each of BlackRock and HC Partners currently manage investment vehicles and separate accounts that may compete directly or indirectly with us. BlackRock and HC Partners are under no

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obligation to provide us with any financial or operational assistance, or to present opportunities to us for matters in which they may become involved. We may enter into transactions with BlackRock or HC Partners or with market participants with which BlackRock or HC Partners has business relationships, and such transactions and/or relationships could influence the decisions made by PCM with respect to the purchase or sale of assets and the terms of such purchase or sale. Such activities could have an adverse effect on the value of the positions held by us, or may result in BlackRock and/or HC Partners having interests adverse to ours.

***Negative publicity and media attention involving Countrywide Financial Corporation and certain of its former officers could have an adverse impact on PennyMac and us.***

Certain of our and PennyMac's officers, including Stanford L. Kurland, our chairman and chief executive officer, are former employees of Countrywide Financial Corporation, or Countrywide, which has been the subject of various investigations and lawsuits and ongoing negative publicity. We cannot assure you that any existing or future investigations, litigation or negative publicity involving Countrywide will not generate negative publicity or media attention for us or adversely impact us or PCM's and PLS's ability to conduct their respective businesses.

## **Risks Related to Our Business**

***We operate in a highly regulated industry and the continually changing federal, state and local laws and regulation could materially adversely affect our business, financial condition and results of operations.***

Due to the highly regulated nature of the residential mortgage industry, we are required to comply with a wide array of federal, state and local laws and regulations that regulate, among other things, the manner in which we conduct our businesses. These regulations directly impact our business and require constant compliance, monitoring and internal and external audits. A material failure to comply with any of these laws or regulations could subject us to lawsuits or governmental actions and damage our reputation, which could materially adversely affect our business, financial condition and results of operations.

Federal, state and local governments have recently proposed or enacted numerous new laws, regulations and rules related to mortgage loans. Laws, regulations, rules and judicial and administrative decisions relating to mortgage loans include those pertaining to real estate settlement procedures, equal credit opportunity, fair lending, fair credit reporting, truth in lending, fair debt collection practices, service members protections, compliance with net worth and financial statement delivery requirements, compliance with federal and state disclosure and licensing requirements, the establishment of maximum interest rates, finance charges and other charges, qualified mortgages, secured transactions, payment processing, escrow, loss mitigation, collection, foreclosure, repossession and claims-handling procedures, and other trade practices and privacy regulations providing for the use and safeguarding of non-public personal financial information of borrowers. PLS and service providers they use, including outside foreclosure counsel retained to process foreclosures, must also comply with these legal requirements.

In particular, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, or Dodd-Frank Act, represents a comprehensive overhaul of the financial services industry in the United States and includes, among other things (i) the creation of a Financial Stability Oversight Council to identify emerging systemic risks posed by financial firms, activities and practices, and to improve cooperation among federal agencies, (ii) the creation of the CFPB authorized to promulgate and enforce consumer protection regulations relating to financial products and services, including mortgage lending and servicing, (iii) the establishment of strengthened capital and prudential standards for banks and bank holding companies, (iv) enhanced regulation of financial markets, including the derivatives and securitization markets, and (v) amendments to the Truth in Lending Act, or TILA, aimed at improving consumer protections with respect to mortgage originations, including disclosures, originator compensation, minimum repayment standards, prepayment considerations appraisals and servicing requirements.

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Our failure or the failure of PLS to comply with these laws, regulations and rules may result in reduced payments by borrowers, modification of the original terms of mortgage loans, permanent forgiveness of debt, delays in the foreclosure process, increased servicing advances, litigation, enforcement actions, and repurchase and indemnification obligations.

In addition, although they have not yet been enacted, the Federal Housing Finance Agency, or FHFA, proposed changes to mortgage servicing compensation structures in 2011 for servicing with GSEs, including reducing servicing fees and channeling funds toward reserve accounts for delinquent loans. Also, there continue to be changes in legislation, rulemaking and licensing in an effort to simplify the consumer mortgage experience which requires technology changes and additional implementation costs for loan originators. We expect that legislative and regulatory changes will continue in the foreseeable future, which may increase our operating expenses, either to comply with applicable law or to satisfy our lenders and investors that we are in compliance with those laws, regulations and rules that are applicable to our business model. Any of these new, or changes in, laws, regulations or rules could adversely affect our business, financial condition and results of operations.

***We may not be able to successfully operate our business or generate sufficient operating cash flows to make or sustain distributions to our shareholders. The supply of distressed residential mortgage loans will likely recede as the economy improves.***

There can be no assurance that we will be able to generate sufficient returns to pay our operating expenses and make distributions to our shareholders. The results of our operations and our ability to make or sustain distributions to our shareholders depends on many factors, including the availability of attractive risk-adjusted investment opportunities that satisfy our investment strategies and our success in identifying and consummating them on favorable terms, the level and expected movement of home prices, the level and volatility of interest rates, readily accessible short-term and long-term financing on favorable terms, and conditions in the financial markets, real estate market and the economy, as to which no assurance can be given. We cannot assure you that we will be able to make investments with attractive risk-adjusted returns or will not seek investments with greater risk to obtain the same level of returns or that the value of our investments in the future will not decline substantially. We also face substantial competition in acquiring attractive investments, both in our investment activities and correspondent lending activities.

In addition, as the current conditions in the mortgage market, the financial markets and the economy stabilize and/or improve, the availability of distressed residential mortgage loans that meet our investment objectives and strategies will likely recede, which could reduce our ability to invest in distressed mortgage assets. While we continue to pursue our correspondent lending activities and reevaluate our investment strategies with a view of maximizing the returns from our investment portfolio and identifying dislocations and opportunities in the mortgage market, there can be no assurance that any of our strategies will be successful.

***As a result of difficult conditions in the financial markets and the economy generally, the risks to our business strategies are high and there are no assurances that we will be successful in implementing those business strategies.***

The success of our business strategies and our results of operations are materially affected by current conditions in the mortgage market, the financial markets and the economy generally. Continuing concerns over factors including inflation, deflation, unemployment, personal and business income taxes, energy costs, geopolitical issues, the availability and cost of credit, the mortgage market and a declining real estate market have contributed to increased volatility and unclear expectations for the economy and markets going forward. The residential mortgage market has been severely affected by changes in the lending landscape and has experienced defaults, credit losses and significant liquidity concerns. There is no assurance that these conditions have stabilized or that they will not worsen. A continuation or increase in the volatility and deterioration in the broader residential mortgage and RMBS markets may adversely affect the performance and market value of our investments. Although we intend to purchase distressed mortgage loans at discounts to their unpaid principal balances, further deterioration in home prices or the value of our investments could require us to take charges that may be material.

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***The actions of the U.S. government, the Federal Reserve and the U.S. Treasury may materially and adversely affect our business.***

The U.S. government, the Federal Reserve, the U.S. Treasury and other governmental and regulatory bodies have taken and continue to take various actions to address the recent financial crisis. There can be no assurances that such actions will have a beneficial impact on the financial markets. In addition to the foregoing, the U.S. Congress and/or various states and local legislatures may enact additional legislation or regulatory action designed to address the current economic climate or for other purposes that could have a material adverse effect on our ability to continue to execute our business strategies.

To the extent the market does not respond favorably to these initiatives or they do not function as intended, they may not have a positive impact on our business. We can provide no assurance that we will be eligible to use any government programs or, if eligible, that we will be able to utilize them successfully. Further, the incentives provided by such programs may increase competition for, and the pricing of, our targeted assets.

***Mortgage loan modification and refinance programs, future legislative action, and other actions and changes may materially and adversely affect the value of, and the returns on, the assets in which we intend to invest.***

The U.S. government, through the FHA, the Federal Deposit Insurance Corporation and the U.S. Treasury, has commenced or proposed implementation of programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. These loan modification and refinance programs, future U.S. federal, state and/or local legislative or regulatory actions that result in the modification of outstanding mortgage loans, as well as changes in the requirements necessary to qualify for refinancing mortgage loans with Fannie Mae, Freddie Mac or Ginnie Mae, may adversely affect the value of, and the returns on, residential mortgage loans, RMBS, real estate-related securities and various other asset classes in which we invest. In addition to the foregoing, the U.S. Congress and/or various states and local legislators may enact additional legislation or regulatory action designed to address the current economic climate or for other purposes that could have a material adverse effect on our ability to continue to execute our business strategies.

***We are highly dependent on U.S. government-sponsored entities, and any changes in these entities or their current roles could materially and adversely affect our business, liquidity, financial position and results of operations.***

Our ability to generate revenues through mortgage loan sales depends to a significant degree on programs administered by GSEs, government agencies, including Ginnie Mae, and others that facilitate the issuance of MBS, in the secondary market. These GSEs and Agencies play a critical role in the residential mortgage industry and we have significant business relationships with many of them. Presently, almost all of the newly originated conforming loans that we acquire from mortgage lenders through our correspondent lending activities qualify under existing standards for inclusion in mortgage securities backed by the GSEs or Ginnie Mae. We also derive other material financial benefits from these relationships, including the assumption of credit risk by these GSEs on loans included in such mortgage securities in exchange for our payment of guarantee fees and the ability to avoid certain loan inventory finance costs through streamlined loan funding and sale procedures.

There is significant uncertainty regarding the future of Fannie Mae and Freddie Mac, including with respect to how long they will continue to be in existence, the extent of their roles in the market and what forms they will have. Although the U.S. Treasury has committed capital to Fannie Mae and Freddie Mac since they were placed into conservatorship, there can be no assurance that additional funding will be provided within the required time periods or that the actions of the U.S. Treasury will be adequate for their needs. If such funding is not provided as required, the FHFA would be obligated to place Fannie Mae and Freddie Mac into receivership. Further, Fannie Mae or Freddie Mac could be placed into receivership at the discretion of the FHFA at any time under certain circumstances. If the actions of the U.S. Treasury are inadequate or pending repurchase requests by Fannie Mae and Freddie Mac to lenders prove unsuccessful, or if Fannie Mae and Freddie Mac are adversely affected by events such as ratings downgrades, foreclosure problems and delays and problems with mortgage insurers, Fannie Mae and Freddie Mac could continue to

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suffer losses and could fail to honor their guarantees and other obligations. In addition, the future roles of Fannie Mae and Freddie Mac remain uncertain. Their roles could be significantly reduced or eliminated and the nature of the guarantees could be considerably limited relative to historical measurements. The elimination of the traditional roles of Fannie Mae and Freddie Mac, or any changes to the nature or extent of the guarantees provided by Fannie Mae and Freddie Mac or the fees, terms and guidelines that govern our selling and servicing relationships with the GSEs, such as continued increases in the guarantee fees we are required to pay to the GSEs or possible limits on delivery volumes imposed upon us and other seller/servicers by one or more of the GSEs, could adversely affect our business, including our ability to sell and securitize GSE-eligible loans in our correspondent lending activities, and the performance, liquidity and market value of our investments.

Our ability to generate revenues from newly originated loans that we acquire through our correspondent lending activities is highly dependent on the fact that the GSEs have not historically acquired such loans directly from mortgage lenders, but have instead relied on banks and non-bank aggregators such as us to acquire, aggregate and securitize or otherwise sell such loans to investors in the secondary market. If one or more of the GSEs were to start making these purchases and sales for their own accounts, our business and results of operations could be adversely affected.

Any discontinuation of, or significant reduction in, the operation of these GSEs or any significant adverse change in the level of activity of these GSEs in the primary or secondary mortgage markets or in the underwriting criteria of these GSEs could materially and adversely affect our business, liquidity, financial position and results of operations.

***We leverage our investments, which may materially and adversely affect our return on our investments and may reduce cash available for distribution to our shareholders.***

We currently leverage and, to the extent available, we intend to continue to leverage our investments through borrowings, the level of which may vary based on the particular characteristics of our investment portfolio and on market conditions. We have leveraged certain of our investments through repurchase agreements. When we enter into repurchase agreements, we sell securities or mortgage loans to lenders (i.e., repurchase agreement counterparties) and receive cash from the lenders. The lenders are obligated to resell the same assets back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the assets to the lender is less than the value of those assets (this difference is referred to as the haircut), if the lender defaults on its obligation to resell the same assets back to us we could incur a loss on the transaction equal to the amount of the haircut (assuming there was no change in the value of the assets). In addition, repurchase agreements generally allow the counterparties, to varying degrees, to determine a new market value of the collateral to reflect current market conditions. If such counterparties determine that the value of the collateral has decreased, it may initiate a margin call and require us to either post additional collateral to cover such decrease or repay a portion of the outstanding borrowing. Should this occur, in order to obtain cash to satisfy a margin call, we may be required to liquidate assets at a disadvantageous time, which could cause us to incur further losses. In the event we are unable to satisfy a margin call, our counterparty may sell the collateral, which may result in significant losses to us.

The lenders under our repurchase agreements require us and/or our subsidiaries to comply with various financial covenants, including those relating to tangible net worth, profitability and our ratio of total liabilities to tangible net worth. Certain of our lenders also require us to maintain minimum amounts of cash or cash equivalents sufficient to maintain a specified liquidity position. In the event that we are unable to maintain these liquidity levels, we could be forced to sell additional investments at a loss and our financial condition could deteriorate rapidly.

As the servicer under our repurchase agreements, PLS is also subject to various financial covenants, including those relating to tangible net worth, liquidity, profitability and its ratio of total liabilities to tangible net worth. PLS's failure to comply with any of these covenants would generally result in a servicer termination event or event of default under one or more of our repurchase agreements. Thus, in addition to relying upon PCM to manage our financial covenants, we rely upon PLS to manage its own financial covenants in order to ensure our

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compliance with our repurchase agreements and our continued access to liquidity and capital. A servicer termination event or event of default resulting from PLS's breach of its financial or other covenants could materially adversely impact our business, financial condition, liquidity, results of operations and our ability to make distributions to shareholders.

Our repurchase agreements to finance nonperforming loans and other distressed mortgage assets are complex and difficult to manage. This is due in part to the nature of the underlying assets securing such financings, which do not produce consistent cash flows and which require specific activities to be performed at specific points in time in order to preserve value. Our inability to comply with the terms and conditions of these facilities could materially and adversely impact us.

In addition, the repurchase agreements contain events of default (subject to certain materiality thresholds and grace periods), including payment defaults, breaches of financial and other covenants and/or certain representations and warranties, cross-defaults, servicer termination events, guarantor defaults, bankruptcy or insolvency proceedings and other events of default customary for these types of facilities. The remedies for such events of default are also customary for these types of facilities and include the acceleration of the principal amount outstanding and the liquidation by the lender of the assets then subject to the respective facilities. If we default on one of our obligations under a repurchase agreement, the lender may be able to terminate the transaction, accelerate any amounts outstanding and cease entering into any other repurchase transactions with us. Because our repurchase agreements typically contain cross-default provisions, a default that occurs under any one agreement could allow the lenders under our other agreements to also declare a default. Our other secured borrowings are subject to similar risks as those that apply to our repurchase agreements. Any losses we incur on our repurchase agreements and other secured borrowings could materially and adversely affect our earnings, financial condition and our cash available for distribution to our shareholders.

We may in the future utilize other sources of borrowings, including bank credit facilities and structured financing arrangements, among others. The percentage of leverage we employ varies depending on the asset class being financed, our available capital, our ability to obtain and access financing arrangements with lenders and the lenders' and rating agencies' estimate of the stability of our investment portfolio's cash flow. There can be no assurance that new sources of financing will be available to us in the future or that existing sources of financing will continue to be available to us. We also own REO, for which there is currently limited financing available and no assurance of available financing in the future.

Our governing documents contain no limitation on the amount of debt we may incur. There can be no assurance that new sources of financing will be available to us in the future or that existing sources of financing will continue to be available to us. Our return on our investments and cash available for distribution to our shareholders may be reduced to the extent that changes in market conditions increase the cost of our financing relative to the income that can be derived from the investments acquired. Our debt service payments will reduce cash flow available for distribution to shareholders. We may not be able to meet our debt service obligations and, to the extent that we cannot, we risk the loss of some or all of our assets to foreclosure or sale to satisfy the obligations.

***As non-recourse long-term financing structures become available to us and are utilized, such structures expose us to risks which could result in losses to us.***

We may use securitization and other non-recourse long-term financing for our investments to the extent available. In such structures, our lenders typically would have only a claim against the assets included in the securitizations rather than a general claim against us as an entity. Prior to any such financing, we would seek to finance our investments with relatively short-term facilities until a sufficient portfolio is accumulated. As a result, we would be subject to the risk that we would not be able to acquire, during the period that any short-term facilities are available, sufficient eligible assets or securities to maximize the efficiency of a securitization.

We also bear the risk that we would not be able to obtain new short-term facilities or would not be able to renew any short-term facilities after they expire should we need more time to seek and acquire sufficient eligible

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assets or securities for a securitization. In addition, conditions in the capital markets may make the issuance of any such securitization less attractive to us even when we do have sufficient eligible assets or securities. While we would intend to retain the unrated equity component of securitizations and, therefore, still have exposure to any investments included in such securitizations, our inability to enter into such securitizations may increase our overall exposure to risks associated with direct ownership of such investments, including the risk of default.

Our inability to refinance any short-term facilities would also increase our risk because borrowings thereunder would likely be recourse to us as an entity. If we are unable to obtain and renew short-term facilities or to consummate securitizations to finance our investments on a long-term basis, we may be required to seek other forms of potentially less attractive financing or to liquidate assets at an inopportune time or price.

***We may not be able to raise the debt or equity capital required to finance our assets and grow our businesses.***

The growth of our businesses requires continued access to debt and equity capital that may or may not be available on favorable terms or at the desired times, or at all. In addition, we invest in certain assets, including distressed loans, real estate acquired in settlement of loans, and MSRs, for which financing has historically been difficult to obtain. Our inability to continue to maintain debt financing for distressed loans and real estate acquired in settlement of loans, or our inability in the future to obtain debt financing for MSRs, could require us to seek equity capital that may be more costly or unavailable to us.

We cannot assure you that we will have access to any debt or equity capital on favorable terms or at the desired times, or at all. Our inability to obtain raise such capital or obtain financing on favorable terms could materially adversely impact our business, financial condition, liquidity, results of operations and our ability to make distributions to shareholders.

***Future issuances of debt securities, which would rank senior to our common shares, and future issuances of equity securities, which would dilute the holdings of our existing shareholders and may be senior to our common shares, may materially and adversely affect the market price of our common shares.***

In order to grow our business, we may rely on additional equity issuances, which may rank senior and/or be dilutive to our shareholders, or on less efficient forms of debt financing that rank senior to our shareholders and require a larger portion of our cash flow from operations, thereby reducing funds available for our operations, future business opportunities, cash distributions to our shareholders and other purposes.

Upon liquidation, holders of our debt securities and other loans and preferred shares would receive a distribution of our available assets before holders of our common shares. Subject to applicable law, our board of trustees has the authority, without further shareholder approval, to issue additional common shares and to issue preferred shares on the terms and for the consideration it deems appropriate. We have issued, and intend to issue, additional common shares and securities convertible into, or exchangeable or exercisable for, common shares under our equity incentive plan. We have also filed a shelf registration statement, from which we have issued and may in the future issue additional common shares, including, without limitation through our at-the-market equity program.

We also may issue from time to time additional common shares in connection with property, portfolio or business acquisitions and may grant demand or piggyback registration rights in connection with such issuances. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict the effect, if any, of future issuances of our common shares, preferred shares or other equity-based securities or the prospect of such issuances on the market price of our common shares. Issuances of a substantial amount of such securities, or the perception that such issuances might occur, could depress the market price of our common shares. Our preferred shares, if issued, would likely have a preference on distribution payments, including liquidating distributions, which could limit our ability to make distributions, including liquidating distributions, to holders of our common shares.

Thus, holders of our common shares bear the risk that our future issuances of debt or equity securities or other borrowings will reduce the market price of our common shares and dilute their ownership in us.



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### ***Interest rate fluctuations could significantly decrease our results of operations and cash flows and the market value of our investments.***

Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Interest rate fluctuations present a variety of risks to our operations. Our primary interest rate exposures relate to the yield on our investments, their market value and the financing cost of our debt, as well as any interest rate swaps that we utilize for hedging purposes. Changes in interest rates affect our net interest income, which is the difference between the interest income we earn on our interest earning investments and the interest expense we incur in financing these investments. Interest rate fluctuations resulting in our interest expense exceeding interest income may result in operating losses for us. An increase in prevailing interest rates could adversely affect the volume of newly originated mortgages available for purchase in our correspondent lending activities. Changes in the level of interest rates also may affect our ability to make investments, the value of our investments (including our pipeline of mortgage loan commitments) and any related hedging instruments, and our ability to realize gains from the disposition of assets. Changes in interest rates may also affect borrower default rates and may impact our ability to refinance or modify loans and/or to sell REO. In addition, with respect to the MSRs we own, decreasing interest rates may cause a large number of borrowers whose loans are being serviced by PLS to refinance, which may result in the loss of any such mortgage servicing business and associated write-downs of such MSRs. Any such scenario could materially and adversely affect us.

### ***Hedging against interest rate exposure may materially and adversely affect our results of operations and cash flows.***

We pursue hedging strategies to reduce our exposure to changes in interest rates. Our hedging activity varies in scope based on the level of interest rates, the type of investments held, and other changing market conditions. However, while we enter into such transactions seeking to reduce interest rate risk, unanticipated changes in interest rates may result in poorer overall investment performance than if we had not engaged in any such hedging transactions. Interest rate hedging may fail to protect or could adversely affect us because, among other things, it may not fully eliminate interest rate risk, it could expose us to counterparty and default risk that may result in greater losses or the loss of unrealized profits, and it will create additional expense, while any income it generates to offset losses may be limited by federal tax provisions applicable to REITs. Thus hedging activity, while intended to limit losses, may materially and adversely affect our results of operations and cash flows.

### ***We utilize derivative instruments, which could subject us to risk of loss.***

We utilize derivative instruments for hedging purposes, which may include swaps, options and futures. However, the prices of derivative instruments, including futures and options, are highly volatile, as are payments made pursuant to swap agreements. As a result, the cost of utilizing derivatives may reduce our income that would otherwise be available for distribution to shareholders or for other purposes, and the derivative instruments that we utilize may fail to effectively hedge our positions. We are also subject to credit risk with regard to the counterparties involved in the derivative transactions.

### ***Competition for distressed assets may limit the availability of desirable investments and result in reduced risk-adjusted returns.***

Our profitability depends, in part, on our ability to continue to acquire our targeted investments at favorable prices. As described in greater detail elsewhere in this Report, we compete in our distressed investment activities with other mortgage REITs, specialty finance companies, private funds, thrifts, banks, mortgage bankers, insurance companies, mutual funds, institutional investors, investment banking firms, depository institutions, governmental bodies and other entities, many of which focus on acquiring distressed mortgage loans. Many of our competitors also have competitive advantages over us, including size, financial strength, access to capital, cost of funds, federal pre-emption and risk tolerance. Competition may result in fewer investments, higher prices, acceptance of greater risk, lower yields and a narrower spread of yields over our financing costs.

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***Our board of trustees has approved very broad investment policies for PCM and will not review or approve each investment decision. We may change our investment strategies and policies without shareholder consent, which may materially and adversely affect the market value of our common shares and our ability to make distributions to our shareholders.***

PCM is authorized to follow very broad investment policies and, therefore, has great latitude in determining the types of assets that are proper investments for us, as well as the individual investment decisions. In the future, PCM may make investments with lower rates of return than those anticipated under current market conditions and/or may make investments with greater risks to achieve those anticipated returns. Our board of trustees will periodically review our investment policies and our investment portfolio but will not review or approve each proposed investment by PCM unless it falls outside our investment policies or constitutes a related party transaction.

In addition, in conducting periodic reviews, our board of trustees will rely primarily on information provided to it by PCM. Furthermore, PCM may use complex strategies, and transactions entered into by PCM may be costly, difficult or impossible to unwind by the time they are reviewed by our board of trustees. In addition, we may change our investment strategies and policies and targeted asset classes at any time without the consent of our shareholders, and this could result in our making investments that are different in type from, and possibly riskier than our current investments or the investments currently contemplated. Changes in our investment strategies and policies and targeted asset classes may increase our exposure to interest rate risk, counterparty risk, default risk and real estate market fluctuations, which could materially and adversely affect the market value of our common shares and our ability to make distributions to our shareholders.

***We are not an approved Ginnie Mae issuer and servicer, and an increase in the percentage of government loans we acquire could be detrimental to us.***

We are not currently approved as a Ginnie Mae issuer and servicer. As long as we are unable to obtain approval as a Ginnie Mae issuer and servicer, we will be unable to produce or acquire Ginnie Mae MSRs. While PLS has agreed to negotiate in good faith with us to structure alternative arrangements whereby we can participate in the economics associated with government MSRs, there can be no assurance that any such arrangement will obtain government approval on favorable terms, or at all. In the absence of approval as a Ginnie Mae issuer and servicer or government approval of an alternative arrangement, we may continue to earn significantly less income in connection with our acquisition of government loans as opposed to conventional loans. Further, PLS may offer pricing to our approved correspondent sellers for government loans that is more competitive in the market than pricing for conventional loans, the result of which may be our acquisition of a greater proportion of government loans. Any significant increase in the percentage of government loans we acquire could adversely impact our business, financial condition, liquidity, results of operations and our ability to make distributions to shareholders.

***Our correspondent lending activities could subject us to increased risk of loss.***

In our correspondent lending activities, we acquire newly originated loans, including jumbo loans, from mortgage lenders and sell or securitize those loans to or through the Agencies or other third party investors. We also sell the resulting securities into the MBS markets. However, there can be no assurance that PCM will continue to be successful in operating this business on our behalf or that we will continue to be able to capitalize on these opportunities on favorable terms or at all. In particular, we have committed, and expect to continue to commit, capital and other resources to this operation; however, PCM may not be able to continue to source sufficient investment opportunities to justify the expenditure of such capital and other resources. In the event that PCM is unable to continue to source sufficient investment opportunities for this operation, there can be no assurance that we would be able to acquire such investments on favorable terms or at all, or that such investments, if acquired, would be profitable to us. In addition, we may be unable to finance the acquisition of these investments and/or may be unable to sell the resulting MBS in the secondary mortgage market on favorable terms or at all. We are also subject to the risk that the value of the acquired loans may decrease prior to their disposition. The occurrence of any one or more of these risks could adversely impact our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

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Our failure or the failure by PLS to obtain any necessary licenses, comply with applicable licensing laws or satisfy the various requirements to maintain them over time could restrict our direct business activities, result in civil and other monetary penalties, or cause us to default under certain of our lending arrangements, any of which could materially and adversely impact our business.

We and PLS are also required to hold Agency approvals in order to sell mortgage loans to the Agencies and service such mortgage loans on their behalf. Our failure, or the failure of PLS, to satisfy the various requirements necessary to maintain such Agency approvals over time would also restrict our direct business activities and could adversely impact our business.

In addition, we and PLS are subject to periodic examinations by state and other regulators, which can result in increases in our administrative costs, and we or PLS may be required to pay substantial penalties imposed by these regulators due to compliance errors, or we or PLS may lose our licenses. Fines and penalties incurred in one jurisdiction may cause investigations or other actions by regulators in other jurisdictions.

***We and/or PLS are required to have various Agency approvals and state licenses in order to conduct our business and there is no assurance we and/or PLS will be able to obtain or maintain those Agency approvals or state licenses.***

Because we are not depository institutions, we and PLS do not benefit from exemptions to state mortgage banking, loan servicing or debt collection licensing and regulatory requirements. Accordingly, we and PLS are required to be licensed to conduct business in certain jurisdictions. PLS is licensed, or is taking steps to become licensed, in those jurisdictions, and for those activities, where it believes it is cost effective and appropriate to become licensed. Through our wholly owned subsidiaries, we are licensed or are taking steps to become licensed, in those jurisdictions, and for those activities, where we believe it is cost effective and appropriate to become licensed.

Our failure or the failure by PLS to obtain any necessary licenses, comply with applicable licensing laws or satisfy the various requirements to maintain them over time could restrict our direct business activities, result in civil and other monetary penalties, or cause us to default under certain of our lending arrangements, any of which could materially and adversely impact our business.

We and PLS are also required to hold Agency approvals in order to sell mortgage loans to the Agencies and service such mortgage loans on their behalf. Our failure, or the failure of PLS, to satisfy the various requirements necessary to maintain such Agency approvals over time would also restrict our direct business activities and could adversely impact our business.

In addition, we and PLS are subject to periodic examinations by state and other regulators, which can result in increases in our administrative costs, and we or PLS may be required to pay substantial penalties imposed by these regulators due to compliance errors, or we or PLS may lose our licenses. Fines and penalties incurred in one jurisdiction may cause investigations or other actions by regulators in other jurisdictions.

***A disruption in the MBS market could materially adversely affect our business, financial condition and results of operations.***

In our correspondent lending activities, we deliver newly originated GSE-eligible mortgage loans that we acquire to Fannie Mae or Freddie Mac to be pooled into Agency MBS securities or transfer government loans that we acquire to PLS, which pools them into Ginnie Mae MBS securities. Disruptions in the general MBS market have occurred in the past. Any significant disruption or period of illiquidity in the general MBS market would directly affect our liquidity because no existing alternative secondary market would likely be able to accommodate on a timely basis the volume of loans that we typically acquire and sell in any given period. Accordingly, if the MBS market experiences a period of illiquidity, we might be prevented from selling the loans that we acquire into the secondary market in a timely manner or at favorable prices, which could materially adversely affect our business, financial condition and results of operations.

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***The industry in which we operate is highly competitive, and is likely to become more competitive, and our inability to compete successfully or decreased margins resulting from increased competition could adversely affect our business, financial condition and results of operations.***

We operate in a highly competitive industry that could become even more competitive as a result of economic, legislative, regulatory and technological changes. Competition in acquiring newly originated mortgage loans comes from large commercial banks and savings institutions and other independent mortgage lenders and servicers. Many of these institutions generally have significantly greater resources and access to capital than we do, which gives them the benefit of a lower cost of funds. Additionally, our existing and potential competitors may decide to modify their business models to compete more directly with our correspondent lending business. For example, non-bank loan servicers may try to leverage their servicing operations to develop or expand a correspondent lending business. Since the withdrawal of a number of large participants from these markets following the financial crisis in 2008, there have been relatively few large non-bank participants. As more non-bank entities enter these markets, our correspondent lending activities may generate lower margins in order to effectively compete.

***We may be subject to liability for potential violations of various lending laws, which could adversely impact our results of operations, financial condition and business.***

Residential mortgage loan originators and servicers operate in a highly regulated industry and are required to comply with various federal, state and local laws and regulations, including anti-predatory lending laws and laws and regulations imposing certain restrictions and requirements on high cost loans. To the extent these originators or servicers fail to comply with applicable law and any of their residential mortgage loans become part of our assets, it could subject us, as an assignee or purchaser of the related residential mortgage loans, to monetary penalties or other losses and could result in the borrowers rescinding the affected residential mortgage loans. Further, if any of our loans are found to have been originated, serviced or owned by us or a third party in violation of applicable law, we could be subject to lawsuits or governmental actions, or we could be fined or incur losses, any of which could adversely impact our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

***Compliance with changing regulation of corporate governance and public disclosure has and will continue to result in increased compliance costs and pose challenges for our management team.***

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Dodd-Frank Act and the rules, regulations and agencies promulgated thereunder, the Sarbanes-Oxley Act of 2002 and SEC regulations, have created uncertainty for public companies and significantly increased the compliance requirements, costs and risks associated with accessing the U.S. public markets. Our management team has and will continue to devote significant time and financial resources to comply with both existing and evolving standards for public companies; however, this will continue to lead to increased general and administrative expenses and a diversion of management time and attention from revenue generating activities to compliance activities.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us and, more generally, the financial services and mortgage industries. Additionally, we cannot predict whether there will be additional proposed laws or reforms that would affect us, whether or when such changes may be adopted, how such changes may be interpreted and enforced or how such changes may affect us. However, the costs of complying with any additional laws or regulations could have a material adverse effect on our financial condition and results of operations.

***Technology failures could damage our business operations and increase our costs, which could adversely affect our business, financial condition and results of operations.***

The financial services industry as a whole is characterized by rapidly changing technologies, and system disruptions and failures caused by fire, power loss, telecommunications failures, unauthorized intrusion,

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computer viruses and disabling devices, natural disasters and other similar events may interrupt or delay the ability of PCM or PLS to provide services to our customers on our behalf. Security breaches, acts of vandalism and developments in computer capabilities could result in a compromise or breach of the technology used to protect our customers' personal information and transaction data. Despite efforts by PCM or PLS to ensure the integrity of their systems, it is possible that they may not be able to anticipate or implement effective preventive measures against all security breaches, especially because the methods of attack change frequently or are not recognized until launched, and because security attacks can originate from a wide variety of sources, including third parties such as persons involved with organized crime or associated with external service providers. Those parties may also attempt to fraudulently induce employees, customers or other users of these systems to disclose sensitive information in order to gain access to our data or that of our customers or clients. These risks may increase in the future along with the industry's increase in its reliance on the Internet and use of web-based product offerings.

A successful penetration or circumvention of the security of our systems or a defect in the integrity of PCM's or PLS's systems or cyber security could cause serious negative consequences for our business, including significant disruption of our activities, misappropriation of our confidential information or that of our customers, or damage to PCM's or PLS's computers or operating systems and to those of our customers and counterparties. Any of the foregoing events could result in violations of applicable privacy and other laws, financial loss to us, to PCM or PLS, or to our customers, loss of confidence in us, customer dissatisfaction, significant litigation exposure and harm to our reputation, all of which could adversely affect our business, financial condition and results of operations.

***The success and growth of our correspondent lending activities will depend upon PLS's ability to adapt to and implement technological changes.***

Our correspondent lending activities are currently dependent upon the ability of PLS to effectively interface with our mortgage lenders and other third parties and to efficiently process loan fundings and closings. The correspondent lending process is becoming more dependent upon technological advancement. Maintaining and improving new technology and becoming proficient with it may also require significant capital expenditures by PLS. As these requirements increase in the future, PLS will have to fully develop these technological capabilities to remain competitive and its failure to do so could adversely affect our business, financial condition and results of operations.

***Our entry into the warehouse lending business could subject us to increased risk of loss.***

We intend to enter into the warehouse lending business through one or more of our subsidiaries. In connection with such activity, we will generally finance a mortgage loan originated by a correspondent lender under a master repurchase agreement, pursuant to which we will purchase the loan at a discount to its unpaid principal balance. Upon its sale of the loan to us or a third party, the correspondent lender would then repurchase the loan from us in an amount equal to our purchase price plus accrued interest through the date of repurchase.

The ability of the correspondent lender to repurchase a loan from us may be contingent on its ability to sell such loan in an amount sufficient to pay us the full repurchase price. There can be no assurance that the correspondent lender will be able to sell the loan for an amount sufficient to repay its borrowings from us, or at all. As a result, we are subject to the credit risk of our correspondent lenders. If the correspondent lender is unable to sell the loan and unable to repay its borrowings from us, there can be no assurance that any value we are able to realize through a sale or liquidation of the underlying loan will be sufficient to avoid a loss of all or a portion of the amount of the borrowing. Such losses could harm our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

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***If we fail to maintain an effective system of internal controls, we may not be able to accurately determine our financial results or prevent fraud.***

Effective internal controls are necessary for us to provide reliable financial reports and effectively prevent fraud. We may in the future discover areas of our internal controls that need improvement. Section 404 of the Sarbanes-Oxley Act of 2002 requires us to evaluate and report on our internal controls over financial reporting and have our independent auditors annually attest to our evaluation, as well as issue their own opinion on our internal control over financial reporting. While we have undertaken substantial work to comply with Section 404, we cannot be certain that we will be successful in maintaining adequate control over our financial reporting and financial processes. Furthermore, as we grow our business, our internal controls will become more complex, and we will require significantly more resources to ensure our internal controls remain effective. If we or our independent auditors discover a material weakness, the disclosure of that fact, even if quickly remedied, could reduce the market value of our common shares. Additionally, the existence of any material weakness or significant deficiency would require management to devote significant time and incur significant expense to remediate any such material weakness or significant deficiency and management may not be able to remediate any such material weakness or significant deficiency in a timely manner, or at all.

***Terrorist attacks and other acts of violence or war may materially and adversely affect the real estate industry generally and our business, financial condition, liquidity and results of operations.***

The terrorist attacks on September 11, 2001 disrupted the U.S. financial markets, including the real estate capital markets, and negatively impacted the U.S. economy in general. Any future terrorist attacks, the anticipation of any such attacks, the consequences of any military or other response by the U.S. and its allies, and other armed conflicts could cause consumer confidence and spending to decrease or result in increased volatility in the U.S. and worldwide financial markets and economy. The economic impact of these events could also materially and adversely affect the collectability of some of our loans and the credit quality of our loans and investments and the properties underlying our interests. We may suffer losses as a result of the adverse impact of any future attacks and these losses may adversely impact our performance and may cause the market value of our common shares to decline or be more volatile. We cannot predict the severity of the effect that potential future armed conflicts and terrorist attacks would have on us. Losses resulting from these types of events may not be fully insurable.

## **Risks Related to Our Investments**

***The mortgage loans in which we invest and the mortgage loans underlying the MBS in which we invest subject us to delinquency, foreclosure and loss, as well as the risks associated with residential real estate and residential real estate-related investments, any of which could result in losses to us.***

We invest in performing and nonperforming residential mortgage loans, and newly originated prime credit quality residential mortgage loans through our correspondent lending business. Residential mortgage loans are typically secured by single-family residential property and are subject to risks of delinquency and foreclosure and risks of loss. These risks are greater for nonperforming loans. In addition, we invest in RMBS that are not guaranteed by federally chartered entities such as Fannie Mae and Freddie Mac or, in the case of Ginnie Mae, the U.S. government. The ability of borrowers to repay residential mortgage loans that we own, or underlying RMBS that we own, is dependent upon the income or assets of these borrowers.

We are authorized to invest in CMBS and may also invest in commercial mortgage loans. Commercial mortgage loans are secured by multifamily or commercial property and are subject to risks of delinquency and foreclosure, and risks of loss that are greater than similar risks associated with loans made on the security of single-family residential property. The ability of a borrower to repay a loan secured by an income-producing property typically is dependent primarily upon the successful operation of such property rather than upon the existence of independent income or assets of the borrower. Net operating income of an income producing property can be affected by a variety of factors, and if the net operating income of the property is reduced, the

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borrower's ability to repay the loan may be impaired. In the event of any default under a mortgage loan held directly by us, we will bear a risk of loss of principal to the extent of any deficiency between the value of the collateral and the price we paid for the loan and any accrued interest of the mortgage loan plus advances made, which could have a material adverse effect on our cash flow from operations.

In the event of the bankruptcy of a mortgage loan borrower, the mortgage loan to such borrower will be deemed to be secured only to the extent of the value of the underlying collateral at the time of bankruptcy (as determined by the bankruptcy court), and the lien securing the mortgage loan will be subject to the avoidance powers of the bankruptcy trustee or debtor-in-possession to the extent the lien is unenforceable under state law.

Our investments in mortgage loans and MBS also subject us to the risks of residential real estate and residential real estate-related investments, including, among others: (i) continued declines in the value of residential real estate; (ii) risks related to general and local economic conditions; (iii) possible lack of availability of mortgage funds for borrowers to refinance or sell their homes; (iv) overbuilding; (v) the general deterioration of the borrower's ability to keep a rehabilitated nonperforming mortgage loan current; (vi) increases in property taxes and operating expenses; (vii) changes in zoning laws; (viii) costs resulting from the clean-up of, and liability to third parties for damages resulting from, environmental problems, such as indoor mold; (ix) casualty or condemnation losses; (x) uninsured damages from floods, earthquakes or other natural disasters; (xi) limitations on and variations in rents; (xii) fluctuations in interest rates; (xiii) fraud by borrowers, originators and/or sellers of mortgage loans; (xiv) undetected deficiencies and/or inaccuracies in underlying mortgage loan documentation and calculations; and (xv) failure of the borrower to adequately maintain the property, particularly during times of financial difficulty. To the extent that assets underlying our investments are concentrated geographically, by property type or in certain other respects, we may be subject to certain of the foregoing risks to a greater extent. Additionally, we may be required to foreclose on a mortgage loan and such actions would subject us to greater concentration of the risks of the residential real estate markets and risks related to the ownership and management of real property.

***A significant portion of the residential mortgage loans that we acquire are or may become nonperforming loans, which increases our risk of loss of our investment.***

We acquire distressed residential mortgage loans and mortgage-related assets where the borrower has failed to make timely payments of principal and/or interest. We also acquire performing loans that subsequently become nonperforming. Under current market conditions, it is likely that many of these loans will have current loan-to-value ratios in excess of 100%, meaning the amount owed on the loan exceeds the value of the underlying real estate. Further, the borrowers on such loans may be in economic distress and/or may have become unemployed, bankrupt or otherwise unable or unwilling to make payments when due. If PLS as our primary and special servicer is not able to address the issues concerning these loans, we may incur significant losses. There are no limits on the percentage of nonperforming assets we may hold. Any loss we incur may be significant and may reduce distributions to our shareholders and materially and adversely affect the market value of our common shares.

***We invest in subprime residential mortgage loans or RMBS collateralized by subprime mortgage loans, which are subject to increased risks.***

As part of our investment activities, we invest in subprime residential mortgage loans or RMBS backed by collateral pools of subprime residential mortgage loans, which are mortgage loans originated using underwriting standards that are less restrictive than the underwriting standards for other first and junior lien mortgage loan purchase programs, such as the programs of Fannie Mae and Freddie Mac. Because of the higher delinquency rates and losses associated with subprime mortgage loans, the performance of subprime mortgage loans or RMBS backed by subprime mortgage loans in which we invest could be correspondingly adversely affected, which could materially and adversely impact our business, financial condition, liquidity, and results of operations.

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***A significant portion of our investments is and will continue to be in the form of whole loan mortgages, which are subject to increased risks.***

A significant portion of our investments is and will continue to be in the form of whole loan mortgages, which are directly exposed to losses resulting from default and foreclosure. In the event of a foreclosure, we may assume direct ownership of the underlying real estate. The liquidation proceeds upon sale of such real estate may not be sufficient to recover our investment in the loan, resulting in a loss to us. In addition, the foreclosure process may be lengthy and expensive, and any delays or costs involved in the effectuation of a foreclosure of the loan or a liquidation of the underlying property may further reduce the proceeds and thus increase the loss.

***Our acquisition of mortgage servicing rights exposes us to significant risks.***

MSRs arise from contractual agreements between us and the investors (or their agents) in mortgage securities and mortgage loans. We generally acquire MSRs from the sale of mortgage loans where we assume the obligation to service the loan in connection with the sale transaction or we may purchase MSRs. Any MSRs we acquire are recorded at fair value on our balance sheet based upon significant estimates and assumptions. The determination of the fair value of MSRs requires our management to make numerous estimates and assumptions. Such estimates and assumptions include, without limitation, estimates of future cash flows associated with MSRs based upon assumptions involving interest rates as well as the prepayment rates, delinquencies and foreclosure rates of the underlying serviced mortgage loans. The ultimate realization of the value of MSRs may be materially different than the fair values of such MSRs as may be reflected in our consolidated balance sheet as of any particular date. The use of different estimates or assumptions in connection with the valuation of these assets could produce materially different fair values for such assets, which could have a material adverse effect on our business, financial condition, results of operations and cash flows. Accordingly, there may be material uncertainty about the fair value of any MSRs we acquire.

Changes in interest rates are a key driver of the performance of MSRs since the values of MSRs are highly sensitive to changes in interest rates. Historically, the value of MSRs has increased when interest rates rise and decreased when interest rates decline due to the effect those changes in interest rates have on prepayment estimates. We may pursue various hedging strategies to seek to reduce our exposure to adverse changes in interest rates. Our hedging activity will vary in scope based on the level and volatility of interest rates, the type of assets held and other changing market conditions. Interest rate hedging may fail to protect or could adversely affect us. To the extent we do not utilize derivatives to hedge against changes in fair value of MSRs, our balance sheet, financial condition and results of operations would be susceptible to volatility due to changes in the fair value of, or cash flows from, MSRs as interest rates change.

Prepayment speeds significantly affect MSRs. Prepayment speed is the measurement of how quickly borrowers pay down the unpaid principal balance of their loans or how quickly loans are otherwise brought current, modified, liquidated or charged off. We base the price we pay for MSRs and the rate of amortization of those assets on, among other things, our projection of the cash flows from the related pool of mortgage loans. Our expectation of prepayment speeds is a significant assumption underlying those cash flow projections. If prepayment speeds are significantly greater than expected, the fair value of the MSRs could decline and we may be required to record a non-cash charge, which would have a negative impact on our financial results. Furthermore, a significant increase in prepayment speeds could materially reduce the ultimate cash flows we receive from MSRs, and we could ultimately receive substantially less than what we paid for such assets. Moreover, delinquency rates have a significant impact on the valuation of any MSRs. An increase in delinquencies generally results in lower revenue because typically we only collect servicing fees from GSEs or mortgage owners for performing loans. We base the price we pay for MSRs on, among other things, our projections of the cash flows from related pools of mortgage loans. Our expectation of delinquencies is a significant assumption underlying those cash flow projections. If delinquencies are significantly greater than we expect, the estimated fair value of the MSRs could be diminished. When the estimated fair value of MSRs is reduced, we could suffer a loss, which could have a negative impact on our financial results.



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Furthermore, MSRs and the related servicing activities are subject to numerous federal, state and local laws and regulations and may be subject to various judicial and administrative decisions imposing various requirements and restrictions on our business. Our failure to comply, or the failure of the servicer to comply, with the laws, rules or regulations to which we or they are subject by virtue of ownership of MSRs, whether actual or alleged, could expose us to fines, penalties or potential litigation liabilities, including costs, settlements and judgments, any of which could have a material adverse effect on our business, financial condition and results of operations.

***We cannot independently protect our MSR asset from borrower refinancing and are dependent upon PLS to do so for our benefit.***

While PLS has agreed pursuant to the terms of an MSR recapture agreement to transfer to us a portion of the MSRs relating to mortgage loans it refinances, we are not independently capable of protecting our MSR asset from borrower refinancing through targeted solicitations to, and origination of, refinance loans for borrowers in our servicing portfolio. Accordingly, unlike traditional mortgage originators and many servicers, we must rely on PLS to refinance mortgage loans in our servicing portfolio that would otherwise be targeted by third party lenders. There can be no assurance that PLS will either have or allocate the time and resources required to effectively and efficiently solicit our servicing portfolio. Its failure to do so, or the termination of our MSR recapture agreement, could result in accelerated runoff of our MSR asset, decreasing its value and adversely impacting our business, financial condition and results of operations.

***RMBS and CMBS investments are subject to significant risks.***

We invest in RMBS and may invest in CMBS. RMBS evidence interests in or secured by pools of residential mortgage loans and CMBS evidence interests in or secured by a single commercial mortgage loan or a pool of commercial mortgage loans. Accordingly, RMBS and CMBS are subject to all of the risks of the respective underlying mortgage loans. In addition, the market value of mortgage securities will generally vary inversely with changes in market interest rates, declining when interest rates rise and rising when interest rates decline. However, mortgage securities, while having comparable risk of decline during periods of rising rates, usually have less potential for capital appreciation than other investments of comparable maturities due to the likelihood of increased prepayments of mortgages as interest rates decline.

***Investments in subordinated loans and subordinated MBS could subject us to increased risk of losses.***

We invest in subordinated loans and may invest in subordinated MBS. In the event a borrower defaults on a subordinated loan and lacks sufficient assets to satisfy such loan, we may lose all or a significant part of our investment. In the event a borrower becomes subject to bankruptcy proceedings, we will not have any recourse to the assets, if any, of the borrower that are not pledged to secure our loan, and the unpledged assets of the borrower may not be sufficient to satisfy our loan. If a borrower defaults on our subordinated loan or on its senior debt (*i.e.*, a first-lien loan, in the case of a residential mortgage loan, or a contractually or structurally senior loan, in the case of a commercial mortgage loan), or in the event of a borrower bankruptcy, our subordinated loan will be satisfied only after all senior debt is paid in full. As a result, we may not recover all or even a significant part of our investment, which could result in losses. In the case of commercial mortgage loans where senior debt exists, the presence of intercreditor arrangements may also limit our ability to amend our loan documents, assign our loan, accept prepayments, exercise our remedies and control decisions made in bankruptcy proceedings relating to borrowers.

In general, losses on an asset securing a mortgage loan included in a securitization will be borne first by the equity holder of the property, then by a cash reserve fund or letter of credit provided by the borrower, if any, and then by the first loss subordinated security holder and then by the second loss subordinated security holder. In the event of default and the exhaustion of any equity support, reserve fund, letter of credit and any classes of securities junior to those in which we invest, we may not recover all or even a significant part of our investment, which could result in losses.

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In addition, if the underlying mortgage portfolio has been serviced ineffectively by the loan servicer or overvalued by the originator, or if the values of the assets subsequently decline and, as a result, less collateral is available to satisfy interest and principal payments due on the related MBS, the securities in which we invest may suffer significant losses. The prices of these types of lower credit quality investments are generally more sensitive to adverse actual or perceived economic downturns or individual issuer developments than more highly rated investments. An economic downturn or a projection of an economic downturn, for example, could cause a decline in the price of lower credit quality investments because the ability of obligors to make principal and interest payments or to refinance may be impaired.

***Our investments in loans to and debt securities of real estate companies will be subject to the specific risks relating to the particular borrower or issuer of the securities and to the general risks of investing in real estate-related loans and securities, which could result in significant losses.***

We may invest in loans to and debt securities of real estate companies, including REITs. These investments involve special risks relating to the particular borrower or issuer of the securities, including the financial condition, liquidity, results of operations, business and prospects of the borrower or issuer. Investments in REIT debt securities may also be subject to risks relating to transfer restrictions, substantial market price volatility resulting from changes to prevailing interest rates, and, in the case of subordinated investments, the seniority of claims of banks and other senior lenders to the issuer. In addition, real estate companies often invest, and REITs generally are required to invest substantially, in real estate or real estate-related assets and are subject to some or all of the risks inherent with real estate and real estate-related investments referred to in this Report. These risks may adversely affect the value of our debt securities of real estate companies and the ability of the issuers thereof to make principal and interest payments in a timely manner, or at all, which could result in significant losses for us.

***The failure of PLS or any other servicer to effectively service our portfolio of mortgage loans would materially and adversely affect us.***

Pursuant to our loan servicing agreement, PLS provides us with primary and special servicing. PLS loan servicing activities include collecting principal, interest and escrow account payments, if any, with respect to mortgage loans, as well as managing loss mitigation, which may include, among other things, collection activities, loan workouts, modifications and refinancings, foreclosures, short sales, sales of REO and financings to facilitate such sales. The ability of PLS or any other servicer or subservicer to effectively service our portfolio of mortgage loans is critical to our success, particularly given our strategy of maximizing the value of the mortgage loans that we acquire through proprietary loan modification programs, special servicing and other initiatives focused on keeping borrowers in their homes; or in the case of nonperforming loans, effecting property resolutions in a timely, orderly and economically efficient manner. The failure of PLS or any other servicer or subservicer to effectively service our portfolio of mortgage loans would adversely impact our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

***The increasing number of proposed U.S. federal, state and local laws may affect certain mortgage-related assets in which we intend to invest and could increase our cost of doing business.***

Legislation has been enacted and proposed which, among other provisions, could hinder the ability of a servicer to foreclose promptly on defaulted mortgage loans or would permit limited assignee liability for certain violations in the mortgage loan origination process, which could result in us being held responsible for such violations. We cannot predict whether or in what form the U.S. Congress or the various state and local legislatures may enact legislation affecting our business. We will evaluate the potential impact of any initiatives which, if enacted, could materially and adversely affect our practices and results of operations. We are unable to predict whether U.S. federal, state or local authorities will enact laws, rules or regulations that will require changes in our practices in the future, and any such changes could materially and adversely affect our cost of doing business and profitability.

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***Our inability to promptly foreclose upon defaulted mortgage loans could increase our cost of doing business and/or diminish our expected return on investments.***

Our ability to promptly foreclose upon defaulted mortgage loans and liquidate the underlying real property plays a critical role in our valuation of the assets in which we invest and our expected return on those investments. There are a variety of factors that may inhibit our ability, through PLS, to foreclose upon a mortgage loan and liquidate the real property within the time frames we model as part of our valuation process. These factors include, without limitation: federal, state or local legislative action or initiatives designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures and that serve to delay the foreclosure process; HAMP and similar programs that require specific procedures to be followed to explore the refinancing of a mortgage loan prior to the commencement of a foreclosure proceeding; and continued declines in real estate values and sustained high levels of unemployment that increase the number of foreclosures and place additional pressure on the already overburdened judicial and administrative systems.

In addition, certain issues, including robo-signing, have been identified recently throughout the mortgage industry that relate to affidavits used in connection with the mortgage loan foreclosure process. A substantial portion of our investments are nonperforming mortgage loans, many of which are already subject to foreclosure proceedings at the time of purchase. While we have obtained assurances from PLS about its own practices relative to foreclosure proceedings and its proper use of affidavits, there can be no assurance that similar practices have been followed in connection with mortgage loans that are already subject to foreclosure proceedings at the time of purchase. To the extent we determine that any of these loans are impacted by these issues, we may be required to re-commence the foreclosure proceedings relating to such loans, thereby resulting in additional delay that could have the effect of increasing our cost of doing business and/or diminishing our expected return on our investments. The uncertainty surrounding these issues could also result in legal, regulatory or industry changes to the foreclosure process as a whole, any or all of which could lengthen the foreclosure process and negatively impact our business.

***Challenges to the MERS<sup>®</sup> System could materially and adversely affect our business, results of operations and financial condition.***

MERSCORP, Inc. is a privately held company that maintains an electronic registry, referred to as the MERS System, that tracks servicing rights and ownership of loans in the United States. Mortgage Electronic Registration Systems, Inc. ( MERS ), a wholly owned subsidiary of MERSCORP, Inc., can serve as a nominee for the owner of a mortgage loan and in that role initiate foreclosures and/or become the mortgagee of record for the loan in local land records. We, or PLS on our behalf, may choose to use MERS as a nominee. The MERS System is widely used by participants in the mortgage finance industry.

Several legal challenges have been made disputing MERS' legal standing to initiate foreclosures and/or act as nominee in local land records. These challenges have focused public attention on MERS and on how loans are recorded in local land records. As a result, these challenges could negatively affect MERS' ability to serve as the mortgagee of record in some jurisdictions. In addition, where MERS is the mortgagee of record, it must execute assignments of mortgages, affidavits and other legal documents in connection with foreclosure proceedings. As a result, investigations by governmental authorities and others into the servicer foreclosure process deficiencies referenced above may impact MERS. Failures by MERS to apply prudent and effective process controls and to comply with legal and other requirements in the foreclosure process could pose operational, reputational and legal risks that may materially and adversely affect us.

***A decline in the value of the real estate underlying our mortgage loans may result in reduced risk-adjusted returns.***

The value of the real estate that underlies mortgage loans is subject to market conditions. Changes in the real estate market may adversely affect the value of the collateral and thereby lower the value to be derived from its

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liquidation. In addition, adverse changes in the real estate market increase the probability of default, as the incentive of the borrower to retain and protect equity in the property declines. Distressed loans may require a substantial amount of workout negotiations and/or restructuring, which may entail, among other things, a substantial reduction in the interest rate, capitalization of interest payments, and a substantial write-down of the principal of the loan. However, even if such restructuring were successfully accomplished, a risk exists that the borrower will not be able or willing to maintain the restructured payments or refinance the restructured mortgage upon maturity.

***Changes in prepayment rates could affect the value of our investment portfolio, which could result in losses or reduced earnings and materially and adversely affect the cash available for distribution to our shareholders.***

The value of our investment portfolio may be materially and adversely affected by prepayment rates on mortgage loans. Prepayment rates on loans are influenced by changes in market interest rates and a variety of economic, geographic and other factors beyond our control. Consequently, we cannot predict with certainty such prepayment rates, and no strategy can completely insulate us from prepayment or other such risks. Changes in prepayment rates may materially and adversely affect our ability to maintain targeted amounts of leverage on our portfolio and may result in losses or reduced earnings for us and materially and adversely affect the cash available for distribution to our shareholders.

***Many of our investments are illiquid and we may not be able to vary our portfolio in response to changes in economic and other conditions.***

Our investments in mortgage loans are, and our investments in securities may be, illiquid. As a result, it may be difficult or impossible to obtain or validate third party pricing on the investments we purchase. Illiquid investments typically experience greater price volatility, as a ready market does not exist, and can be more difficult to value. The illiquidity of our investments may make it difficult for us to sell such investments if the need or desire arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the recorded value.

***Many of our investments are unrated or, where any credit ratings are assigned to our investments, they will be subject to ongoing evaluations and revisions and we cannot assure you that those ratings will not be downgraded.***

Many of our current investments are, and many of our future investments will not be, rated by any rating agency. Therefore, PCM's assessment of the value and pricing of our investments may be difficult and the accuracy of such assessment is inherently uncertain. However, certain of our investments may be rated. If rating agencies assign a lower-than expected rating or reduce or withdraw, or indicate that they may reduce or withdraw, their ratings of our investments in the future, the value of these investments could significantly decline, which would materially and adversely affect the value of our investment portfolio and could result in losses upon disposition or the failure of borrowers to satisfy their debt service obligations to us.

***We may not realize gains or income from our investments.***

While we seek to generate both current income and capital appreciation from our investments, our investments may not appreciate and, in fact, may decline in value. In addition, the obligors on our investments may default on, or be delayed in making, interest and/or principal payments, especially given that our current investment strategies focus, in part, on distressed opportunities and that we acquire nonperforming residential mortgage loans. Accordingly, we are subject to an increased risk of loss and may not be able to realize gains or income from our investments. Any gains that we do realize may not be sufficient to offset our losses and expenses.

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### ***Insurance on real estate securing mortgage loans and real estate securities collateral may not cover all losses.***

There are certain types of losses, generally of a catastrophic nature, that result from such events as earthquakes, floods, hurricanes, terrorism or acts of war, and that may be uninsurable or not economically insurable. Inflation, changes in building codes and ordinances, environmental considerations and other factors, including terrorism or acts of war, also might make the insurance proceeds insufficient to repair or replace a property if it is damaged or destroyed. Under these circumstances, the insurance proceeds received might not be adequate to restore our economic position with respect to the affected real property. Any uninsured loss could result in the loss of cash flow from, and the asset value of, the affected property.

### ***We may be materially and adversely affected by risks affecting borrowers or the asset or property types in which our investments may be concentrated at any given time, as well as from unfavorable changes in the related geographic regions.***

Our assets are not subject to any geographic, diversification or concentration limitations except that we will be concentrated in residential mortgage-related investments. Accordingly, our investment portfolio may be concentrated by geography, asset, property type and/or borrower, increasing the risk of loss to us if the particular concentration in our portfolio is subject to greater risks or undergoing adverse developments. In addition, adverse conditions in the areas where the properties securing or otherwise underlying our investments are located (including business layoffs or downsizing, industry slowdowns, changing demographics and other factors) and local real estate conditions (such as oversupply or reduced demand) may have an adverse effect on the value of our investments. A material decline in the demand for real estate in these areas may materially and adversely affect us. Lack of diversification can increase the correlation of non-performance and foreclosure risks among our investments.

### ***A prolonged economic slowdown, recession or declining real estate values could materially and adversely affect us.***

The risks associated with our investments are more acute during periods of economic slowdown or recession, especially if these periods are accompanied by high unemployment and declining real estate values. A weakening economy, high unemployment and declining real estate values significantly increase the likelihood that borrowers will default on their debt service obligations to us and that we will incur losses on our investments with them in the event of a default on a particular investment because the value of any collateral we foreclose upon may be insufficient to cover the full amount of such investment or may require a significant amount of time to realize. They may also increase the likelihood of re-default rates even after we have completed loan modifications. Any period of increased payment delinquencies, foreclosures or losses could adversely affect the net interest income generated from our portfolio and our ability to make and finance future investments, which would materially and adversely affect our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

### ***Fair values of our investments are imprecise and may materially and adversely affect periodic reported results and credit availability, which may reduce earnings and, in turn, cash available for distribution to our shareholders.***

The values of some of our investments are not readily determinable. We measure the fair value of these investments monthly, but the fair value at which our assets are recorded may not be an indication of their realizable value. Ultimate realization of the value of an asset depends to a great extent on economic and other conditions that are beyond the control of PCM, our company or our board of trustees. Further, fair value is only an estimate based on good faith judgment of the price at which an investment can be sold since market prices of investments can only be determined by negotiation between a willing buyer and seller. In certain cases, PCM's estimation of the fair value of our investments includes inputs provided by third-party dealers and pricing services, and valuations of certain securities or other assets in which we invest are often difficult to obtain and are subject to judgments that may vary among market participants. Changes in the estimated fair values of those

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assets are directly charged or credited to earnings for the period. If we were to liquidate a particular asset, the realized value may be more than or less than the amount at which such asset was recorded. Accordingly, in either event, the value of our common shares could be materially and adversely affected by our determinations regarding the fair value of our investments, and such valuations may fluctuate over short periods of time.

***PCM utilizes analytical models and data in connection with the valuation of our investments, and any incorrect, misleading or incomplete information used in connection therewith would subject us to potential risks.***

Given the complexity of our investments and strategies, PCM must rely heavily on models and data, including analytical models (both proprietary models developed by PCM and those supplied by third parties) and information and data supplied by third parties. Models and data are used to value investments or potential investments and also in connection with hedging our investments. In the event models and data prove to be incorrect, misleading or incomplete, any decisions made in reliance thereon expose us to potential risks. For example, by relying on incorrect models and data, especially valuation models, PCM may be induced to buy certain investments at prices that are too high, to sell certain other investments at prices that are too low or to miss favorable opportunities altogether. Similarly, any hedging based on faulty models and data may prove to be unsuccessful.

***Liability relating to environmental matters may impact the value of properties that we may acquire or the properties underlying our investments.***

Under various U.S. federal, state and local laws, an owner or operator of real property may become liable for the costs of removal of certain hazardous substances released on its property. These laws often impose liability without regard to whether the owner or operator was responsible for, or aware of, the release of such hazardous substances. The presence of hazardous substances may also adversely affect an owner's ability to sell real estate, borrow using real estate as collateral or make debt payments to us. In addition, if we take title to a property, the presence of hazardous substances may adversely affect our ability to sell the property, and we may become liable to a governmental entity or to third parties for various fines, damages or remediation costs. Any of these liabilities or events may materially and adversely affect the value of the relevant asset and/or our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

***We are subject to counterparty risk and may be unable to seek indemnity or require our counterparties to repurchase mortgage loans if they breach representations and warranties, which could cause us to suffer losses.***

When we purchase nonperforming assets or newly originated loans through our correspondent lending activities, our counterparty typically makes customary representations and warranties to us about such assets or loans. Our residential mortgage loan purchase agreements may entitle us to seek indemnity or demand repurchase or substitution of the loans in the event our counterparty breaches a representation or warranty given to us. However, there can be no assurance that our mortgage loan purchase agreements will contain appropriate representations and warranties, that we will be able to enforce our contractual right to repurchase or substitution, or that our counterparty will remain solvent or otherwise be able to honor its obligations under our mortgage loan purchase agreements. Further, the majority of our nonperforming assets owned as of December 31, 2012 were purchased from or through one or more subsidiaries of Citigroup Inc., creating a concentration of risk and a potential conflict of interest with one of our key sources of financing. Our inability to obtain indemnity or require repurchase of a significant number of loans could materially and adversely affect our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

***We depend on the accuracy and completeness of information about borrowers and counterparties and any misrepresented information could adversely affect our business, financial condition and results of operations.***

In connection with our correspondent lending activities, we may rely on information furnished by or on behalf of borrowers and counterparties, including financial statements and other financial information. We also

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may rely on representations of borrowers and counterparties as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. If any of this information is intentionally or negligently misrepresented and such misrepresentation is not detected prior to loan funding, the value of the loan may be significantly lower than expected. Whether a misrepresentation is made by the loan applicant or another third party, we generally bear the risk of loss associated with the misrepresentation. Our controls and processes may not have detected or may not detect all misrepresented information in our loan acquisitions or from our business clients. Any such misrepresented information could adversely affect our business, financial condition and results of operations.

***We may be required to repurchase mortgage loans or indemnify investors if we breach representations and warranties, which could materially and adversely affect our earnings.***

As part of our correspondent lending activities, PLS re-underwrites a percentage of the loans that we acquire, and we rely upon PLS to ensure quality underwriting by our correspondent sellers, accurate third party appraisals, and strict compliance with the representations and warranties that we require from our correspondent sellers and that are required from us by our investors.

When we sell loans, we are required to make customary representations and warranties about such loans to the loan purchaser. Our residential mortgage loan sale agreements may require us to repurchase or substitute loans in the event we breach a representation or warranty given to the loan purchaser. In addition, we may be required to repurchase loans as a result of borrower fraud or in the event of early payment default on a mortgage loan. Likewise, we may be required to repurchase or substitute loans if we breach a representation or warranty in connection with our securitizations. The remedies available to the GSEs and other purchasers of mortgage loans are generally broader than those available to us against the originator or correspondent lender, and if a purchaser enforces its remedies against us, we may not be able to enforce the remedies we have against the sellers. The repurchased loans typically can only be financed at a steep discount to their repurchase price, if at all. They are also typically sold at a significant discount to the unpaid principal balance. Significant repurchase activity could materially and adversely affect our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

## **Risks Related to Our Organization and Structure**

***Certain provisions of Maryland law, our staggered board of trustees and certain provisions in our declaration of trust could each inhibit a change in our control.***

Certain provisions of the Maryland General Corporation Law (the "MGCL"), applicable to a Maryland real estate investment trust may have the effect of inhibiting a third party from making a proposal to acquire us or of impeding a change in our control under circumstances that otherwise could provide the holders of our common shares with the opportunity to realize a premium over the then prevailing market price of such common shares.

In addition, our board of trustees is divided into three classes of trustees. Trustees of each class will be elected for three-year terms upon the expiration of their current terms, and each year one class of trustees will be elected by our shareholders. The staggered terms of our trustees may reduce the possibility of a tender offer or an attempt at a change in control, even though a tender offer or change in control might be in the best interests of our shareholders.

Further, our declaration of trust authorizes us to issue additional authorized but unissued common shares and preferred shares. Our board of trustees may, without shareholder approval, increase the aggregate number of our authorized common shares or the number of shares of any class or series that we have authority to issue and classify or reclassify any unissued common shares or preferred shares and may set the preferences, rights and other terms of the classified or reclassified shares. As a result, our board may establish a class or series of common shares or preferred shares or take other actions that could delay or prevent a transaction or a change in our control that might involve a premium price for our common shares or otherwise be in the best interests of our shareholders.

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### ***Compliance with our Investment Company Act exclusion imposes limits on our operations.***

We intend to conduct our operations so that we are not required to register as an investment company under the Investment Company Act. However, our qualification for exclusion from registration under the Investment Company Act will limit our ability to make certain investments, as discussed below.

### ***Failure to maintain our exclusion from registration under the Investment Company Act could materially and adversely affect us.***

Because we are organized as a holding company that conducts its businesses primarily through our Operating Partnership and its wholly-owned subsidiaries, our status under the Investment Company Act is dependent upon the status of our Operating Partnership which, as a holding company, in turn, will have its status determined by the status of its subsidiaries. The securities issued to our Operating Partnership by subsidiaries excepted from the definition of investment company under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, together with any other investment securities owned by our Operating Partnership, may not have a value in excess of 40% of the value of our Operating Partnership's total assets on an unconsolidated basis. While we will monitor our holdings to ensure continuing and ongoing compliance with this asset test, if the value of such securities exceeds such 40% threshold, or if one or more of such subsidiaries fail to maintain their exceptions or exclusions from the Investment Company Act and we do not have available to us another basis on which we may avoid registration, we may have to register under the Investment Company Act. This could subject us to substantial regulation with respect to our capital structure (including our ability to use leverage), management, operations, transactions with affiliated persons (as defined in the Investment Company Act), portfolio composition, including restrictions with respect to diversification and industry concentration, and other matters. It could also cause the breach of covenants we have made under certain of our financing arrangements, which could result in an event of default, acceleration of debt and/or termination.

In August 2011, the SEC solicited public comment through a concept release on a wide range of issues relating to the Section 3(c)(5)(C) exemption from the Investment Company Act, including the nature of the assets that qualify for purposes of the exemption and whether mortgage-related REITs should be regulated in a manner similar to investment companies. There can be no assurance that the laws and regulations governing the Investment Company Act status of REITs, including guidance and interpretations from the Division of Investment Management of the SEC regarding the exceptions and exclusions therefrom, will not change in a manner that adversely affects our operations. If the SEC takes action that could result in our or our subsidiaries' failure to maintain an exception or exclusion from the Investment Company Act, we could, among other things, be required to (a) restructure our operations to avoid being required to register as an investment company, (b) effect sales of our assets in a manner that, or at a time when, we would not otherwise choose to do so or (c) register as an investment company (which, among other things, would require us to comply with the leverage constraints applicable to investment companies), any of which could negatively affect the value of our common shares, the sustainability of our business model, and our ability to make distributions to our shareholders, which could, in turn, materially and adversely affect our business and the market price of our common shares.

Further, a loss of our Investment Company Act exclusion would allow PCM to terminate our management agreement with us, and our loan servicing agreement with PLS is subject to early termination in the event our management agreement is terminated for any reason. If either of these agreements is terminated, we will have to obtain the services on our own, and we may not be able to replace these services in a timely manner or on favorable terms, or at all. This would have a material adverse effect on our ability to continue to execute our business strategy.

### ***Rapid changes in the values of our investments may make it more difficult for us to maintain our REIT qualification or exclusion from the Investment Company Act.***

If the market value or income potential of our residential mortgage loans and other real estate-related assets declines as a result of increased interest rates, prepayment rates or other factors, we may need to increase certain



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real estate investments and income and/or liquidate our non-qualifying assets in order to maintain our REIT qualification or exclusion from the Investment Company Act. If the decline in real estate asset values and/or income occurs quickly, this may be especially difficult to accomplish, particularly given the illiquid nature of our investments. We may have to make investment decisions that we otherwise would not make absent our REIT and Investment Company Act considerations.

***Our rights and the rights of our shareholders to take action against our trustees and officers are limited, which could limit your recourse in the event of actions not in your best interest.***

Our declaration of trust limits the liability of our present and former trustees and officers to us and our shareholders for money damages to the maximum extent permitted under Maryland law. Under current Maryland law, our present and former trustees and officers will not have any liability to us or our shareholders for money damages other than liability resulting from either (a) actual receipt of an improper benefit or profit in money, property or services or (b) active and deliberate dishonesty by the trustee or officer that was established by a final judgment and is material to the cause of action.

Our declaration of trust authorizes us to indemnify our present and former trustees and officers for actions taken by them in those capacities to the maximum extent permitted by Maryland law. Our bylaws require us to indemnify each present and former trustee or officer, to the maximum extent permitted by Maryland law, in the defense of any proceeding to which he or she is made, or threatened to be made, a party by reason of his or her service to us. In addition, we may be obligated to pay or reimburse the expenses incurred by our present and former trustees and officers without requiring a preliminary determination of their ultimate entitlement to indemnification. As a result, we and our shareholders may have more limited rights against our present and former trustees and officers than might otherwise exist absent the current provisions in our declaration of trust and bylaws or that might exist with other companies, which could limit your recourse in the event of actions not in your best interest.

***Our declaration of trust contains provisions that make removal of our trustees difficult, which could make it difficult for our shareholders to effect changes to our management.***

Our declaration of trust provides that, subject to the rights of holders of any series of preferred shares, a trustee may be removed only for cause (as defined in our declaration of trust), and then only by the affirmative vote of at least two-thirds of the votes entitled to be cast generally in the election of trustees. Vacancies generally may be filled only by a majority of the remaining trustees in office, even if less than a quorum, for the full term of the class of trustees in which the vacancy occurred. These requirements make it more difficult to change our management by removing and replacing trustees and may prevent a change in our control that is in the best interests of our shareholders.

## **Risks Related to Taxation**

***Our failure to qualify as a REIT would result in higher taxes and reduced cash available for distribution to our shareholders.***

We are organized and operate in a manner so as to qualify as a REIT for U.S. federal income tax purposes. Our qualification as a REIT depends on our satisfaction of certain asset, income, organizational, distribution, shareholder ownership and other requirements on a continuing basis. If we were to fail to qualify as a REIT in any taxable year, we would be subject to U.S. federal income tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates, and distributions to our shareholders would not be deductible by us in computing our taxable income. Any such corporate tax liability could be substantial and would reduce the amount of cash available for distribution to our shareholders, which in turn would have an adverse impact on the value of our common shares. Unless we were entitled to relief under certain Internal Revenue Code provisions, we also would be disqualified from taxation as a REIT for the four taxable years following the year during which we ceased to qualify as a REIT.

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***Even if we qualify as a REIT, we face tax liabilities that reduce our cash flow, and a significant portion of our income may be earned through TRSs that are subject to U.S. federal income taxation.***

Even if we qualify for taxation as a REIT, we may be subject to certain U.S. federal, state and local taxes on our income and assets, including taxes on any undistributed income, tax on income from some activities conducted as a result of a foreclosure, and state or local income, property and transfer taxes, such as mortgage recording taxes. Any of these taxes would decrease cash available for distribution to our shareholders.

We also engage in business activities that are required to be conducted in a TRS. In order to meet the REIT qualification requirements, or to avert the imposition of a 100% tax that applies to certain gains derived by a REIT from dealer property or inventory, we hold a significant portion of our assets through, and derive a significant portion of our taxable income and gains in, a TRS, subject to the limitation that securities in TRSs may not represent more than 25% of our assets in order for us to remain qualified as a REIT. All taxable income and gains derived from the assets held from time to time in our TRS are subject to regular corporate income taxation.

***The percentage of our assets represented by a TRS and the amount of our income that we can receive in the form of TRS dividends are subject to statutory limitations that could jeopardize our REIT status.***

No more than 25% of the value of a REIT's assets may consist of stock or securities of one or more TRSs (at the end of each quarter). While we intend to manage our affairs so as to satisfy this requirement, there can be no assurance that we will be able to do so in all market circumstances. Although a TRS is subject to U.S. federal, state and local income tax on its taxable income, we may from time to time need to make distributions of such after-tax income in order to keep the value of our TRS below 25% of our total assets. However, for purposes of one of the tests we must satisfy to qualify as a REIT, at least 75% of our gross income must in each taxable year generally be from real estate assets. While we monitor our compliance with both this income test and the limitation on the percentage of our assets represented by TRS securities, the two may at times be in conflict with one another. That is, it is possible that we may wish to distribute a dividend from a TRS in order to reduce the value of our TRS below 25% of our assets, but be unable to do so without violating the requirement that 75% of our gross income in the taxable year be derived from real estate assets. There can be no assurance that we will be able to comply with both of these tests in all market conditions.

***Dividends payable by REITs do not generally qualify for the reduced tax rates applicable to certain corporate dividends.***

Recently enacted legislation provides for a 20% maximum tax rate for dividends paid by corporations to eligible domestic shareholders that are individuals, trusts or estates. Dividends paid by REITs, however, are generally not eligible for the reduced rates. The more favorable rates applicable to regular corporate dividends could cause investors who are individuals, trusts and estates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could materially and adversely affect the value of the stock of REITs, including our common shares.

***We have not established a minimum distribution payment level and no assurance can be given that we will be able to make distributions to our shareholders in the future at current levels or at all.***

We are generally required to distribute to our shareholders at least 90% of our taxable income each year for us to qualify as a REIT under the Internal Revenue Code, which requirement we currently intend to satisfy. To the extent we satisfy the 90% distribution requirement but distribute less than 100% of our taxable income, we will be subject to U.S. federal corporate income tax on our undistributed taxable income. We have not established a minimum distribution payment level, and our ability to make distributions to our shareholders may

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be materially and adversely affected by the risk factors discussed in this Report and any subsequent Quarterly Reports on Form 10-Q. Although we have made, and anticipate continuing to make, quarterly distributions to our shareholders, our board of trustees has the sole discretion to determine the timing, form and amount of any future distributions to our shareholders, and such determination will depend upon, among other factors, our historical and projected results of operations, financial condition, cash flows and liquidity, maintenance of our REIT qualification and other tax considerations, capital expenditure and other expense obligations, debt covenants, contractual prohibitions or other limitations and applicable law and such other matters as our board of trustees may deem relevant from time to time. Among the factors that could impair our ability to continue to make distributions to our shareholders are:

our inability to invest the net proceeds from our equity offerings;

our inability to make attractive risk-adjusted returns on our current and future investments;

non-cash earnings or unanticipated expenses that reduce our cash flow;

defaults in our investment portfolio or decreases in its value; and

the fact that anticipated operating expense levels may not prove accurate, as actual results may vary from estimates.

As a result, no assurance can be given that we will be able to continue to make distributions to our shareholders in the future or that the level of any future distributions will achieve a market yield or increase or even be maintained over time, any of which could materially and adversely affect the market price of our common shares.

***The REIT distribution requirements could materially and adversely affect our ability to execute our business strategies.***

We intend to continue to make distributions to our shareholders to comply with the requirements of the Internal Revenue Code and to avoid paying corporate tax on undistributed income. However, differences in timing between the recognition of taxable income and the actual receipt of cash could require us to sell assets, borrow funds on a short-term or long-term basis, or issue equity to meet the distribution requirements of the Internal Revenue Code. We may find it difficult or impossible to meet distribution requirements in certain circumstances. Due to the nature of the assets in which we invest and may invest, we may be required to recognize taxable income from those assets in advance of our receipt of cash flow on or proceeds from disposition of such assets. As a result, to the extent such income is not realized within a TRS, the requirement to distribute a substantial portion of our net taxable income could cause us to: (i) sell assets in adverse market conditions, (ii) borrow on unfavorable terms, (iii) distribute amounts that would otherwise be invested in future acquisitions, capital expenditures or repayment of debt or (iv) make a taxable distribution of our shares as part of a distribution in which shareholders may elect to receive shares or (subject to a limit measured as a percentage of the total distribution) cash, in order to comply with REIT requirements.

***We may be required to report taxable income early in our holding period for certain investments in excess of the economic income we ultimately realize from them.***

We acquire and/or expect to acquire in the secondary market debt instruments for less than their face amount, MBS issued with original issue discount, or debt instruments or MBS that are delinquent as to mandatory principal and interest payments. In each case, we may be required to report income regardless of whether corresponding cash payments are received or are ultimately collectible. If we eventually collect less than we had previously reported as income, there may be a bad debt deduction available to us at that time, but our ability to benefit from that bad debt deduction would depend on our having taxable income in that later taxable year. This possible income early, losses later phenomenon could materially and adversely affect us and our shareholders if it were persistent and in significant amounts.

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***The share ownership limits applicable to us that are imposed by the Internal Revenue Code for REITs and our declaration of trust may restrict our business combination opportunities.***

In order for us to maintain our qualification as a REIT under the Internal Revenue Code, not more than 50% in value of our outstanding shares may be owned, directly or indirectly, by five or fewer individuals (as defined in the Internal Revenue Code to include certain entities) at any time during the last half of each taxable year following our first year. Our declaration of trust, with certain exceptions, authorizes our board of trustees to take the actions that are necessary and desirable to preserve our qualification as a REIT. Under our declaration of trust, no person may own more than 9.8% by vote or value, whichever is more restrictive, of our outstanding common shares or more than 9.8% by vote or value, whichever is more restrictive, of our outstanding shares of beneficial interest. Our board may grant an exemption to the share ownership limits in its sole discretion, subject to certain conditions and the receipt of certain representations and undertakings. These share ownership limits are based upon direct or indirect ownership by individuals, which term includes certain entities.

Ownership limitations are common in the organizational documents of REITs and are intended, among other purposes, to provide added assurance of compliance with the tax law requirements and to minimize administrative burdens. However, our share ownership limits might also delay or prevent a transaction or a change in our control that might involve a premium price for our common shares or otherwise be in the best interests of our shareholders.

***Complying with the REIT requirements can be difficult and may cause us to forego otherwise attractive opportunities or liquidate otherwise attractive investments.***

To qualify as a REIT for U.S. federal income tax purposes, we must continually satisfy tests concerning, among other things, the sources of our income, the nature and diversification of our assets, the amounts we distribute to our shareholders and the ownership of our shares. We may be required to make distributions to our shareholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with the REIT requirements may hinder our ability to make certain attractive investments or require us to liquidate from our portfolio otherwise attractive investments. If we are compelled to liquidate our investments, we may be unable to comply with these requirements, ultimately jeopardizing our qualification as a REIT, or we may be subject to a 100% tax on any resultant gain if we sell assets that are treated as dealer property or inventory. These actions could have the effect of reducing our income and amounts available for distribution to our shareholders.

***Complying with the REIT requirements may limit our ability to hedge effectively.***

The REIT provisions of the Internal Revenue Code may limit our ability to hedge our assets and operations. Under current law, any income that we generate from transactions intended to hedge our interest rate or currency risks will be excluded from gross income for purposes of the REIT gross income tests in certain instances. Generally, income derived from other types of hedging transactions will not be treated as qualifying income for purposes of the REIT gross income tests. As a result of these rules, we may have to limit our use of hedging techniques that might otherwise be advantageous, which could result in greater risks associated with interest rate or other changes than we would otherwise be subject to.

***If our Operating Partnership failed to qualify as a partnership for U.S. federal income tax purposes, we could fail to qualify as a REIT and suffer other adverse consequences.***

We believe that our Operating Partnership is organized and operated in a manner so as to be treated as a partnership or an entity that is disregarded, and not an association or publicly traded partnership taxable as a corporation, for U.S. federal income tax purposes. As a partnership, it is not subject to U.S. federal income tax on its income. Instead, each of its partners, including us, is allocated its share of our Operating Partnership's income. No assurance can be provided, however, that the Internal Revenue Service (the "IRS") will not challenge its

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status as a partnership or disregarded entity for U.S. federal income tax purposes, or that a court would not sustain such a challenge. If the IRS were successful in treating our Operating Partnership as an association or publicly-traded partnership taxable as a corporation for U.S. federal income tax purposes, we could fail to meet the gross income tests and certain of the asset tests applicable to REITs and, accordingly, could cease to qualify as a REIT. Also, the failure of our Operating Partnership to qualify as a partnership would cause it to become subject to U.S. federal corporate income tax, which would reduce significantly the amount of its cash available for debt service and for distribution.

***The tax on prohibited transactions limits our ability to engage in transactions, including certain methods of securitizing mortgage loans, that would be treated as sales for U.S. federal income tax purposes.***

A REIT's net income from prohibited transactions is subject to a 100% tax. In general, prohibited transactions are sales or other dispositions of property, other than foreclosure property, but including mortgage loans, held primarily for sale to customers in the ordinary course of business. We might be subject to this tax if we were to dispose of or securitize loans in a manner that was treated as a sale of the loans for U.S. federal income tax purposes. Therefore, in order to avoid the prohibited transactions tax, we may choose to engage in certain sales of loans through a TRS and not at the REIT level, and may limit the structures we utilize for our securitization transactions, even though the sales or structures might otherwise be beneficial to us. We may hold a substantial amount of assets in one or more TRSs that are subject to corporate income tax on its earnings, which may reduce the cash flow generated by us and our subsidiaries in the aggregate, and our ability to make distributions to our shareholders.

***The taxable mortgage pool ( TMP ) rules may increase the taxes that we or our shareholders may incur, and may limit the manner in which we effect future securitizations.***

Certain of our securitizations may likely be considered to result in the creation of TMPs for U.S. federal income tax purposes. A TMP is always classified as a corporation for U.S. federal income tax purposes. However, as long as a REIT owns 100% of a TMP, such classification generally does not result in the imposition of corporate income tax, because the TMP is a qualified REIT subsidiary. Prior to September 1, 2012, the requirement that a TMP be wholly-owned by a REIT to be a qualified REIT subsidiary means that we would be precluded from holding equity interests in such a TMP through our Operating Partnership if the TMP were a U.S. entity that would be subject to taxation as a domestic corporation, unless our Operating Partnership itself formed another subsidiary REIT to own the TMP. On August 31, 2012, the general partner of the Operating Partnership and the REIT jointly elected to revoke the general partner's TRS election. As a result, after August 31, 2012, the general partner is no longer an entity that is regarded for income tax purposes and all of the interests in the Operating Partnership are treated as being owned by the REIT. Thus after August 31, 2012, the Operating Partnership is also treated as a disregarded entity for income tax purposes and any assets that it owns are treated as if they are directly owned by the REIT.

In the case of such wholly-REIT owned TMPs, certain categories of our shareholders, such as foreign shareholders otherwise eligible for treaty benefits, shareholders with net operating losses, and tax exempt shareholders that are subject to unrelated business income tax, could be subject to increased taxes on a portion of their dividend income received from us that is attributable to the TMP or excess inclusion income. In addition, to the extent that our shares are owned in record name by tax exempt disqualified organizations, such as certain government-related entities that are not subject to tax on unrelated business income, we may incur a corporate level tax on our allocable portion of excess inclusion income from such a wholly-REIT owned TMP. In that case and to the extent feasible, we may reduce the amount of our distributions to any disqualified organization whose share ownership gave rise to the tax, or we may bear such tax as a general corporate expense. To the extent that our shares owned by disqualified organizations are held in record name by a broker/dealer or other nominee, the broker/dealer or other nominee would be liable for the corporate level tax on the portion of our excess inclusion income allocable to the shares held by the broker/dealer or other nominee on behalf of disqualified organizations. While we intend to attempt to minimize the portion of our distributions that is subject to these rules, the law is unclear concerning computation of excess inclusion income, and its amount could be significant.

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In the case of any TMP that would be taxable as a domestic corporation if it were not wholly-REIT owned, we would be precluded from selling equity interests in these securitizations to outside investors, or selling any debt securities issued in connection with these securitizations that might be considered to be equity interests for tax purposes. This marketing limitation may prevent us from selling more junior or non-investment grade debt securities in such securitizations and maximizing our proceeds realized in those offerings.

*New legislation or administrative or judicial action, in each instance potentially with retroactive effect, could make it more difficult or impossible for us to qualify as a REIT.*

The present U.S. federal income tax treatment of REITs may be modified, possibly with retroactive effect, by legislative, judicial or administrative action at any time, which could affect the U.S. federal income tax treatment of an investment in our common shares. The U.S. federal tax rules that affect REITs constantly are under review by persons involved in the legislative process, the IRS and the U.S. Treasury, which results in statutory changes as well as frequent revisions to Treasury Regulations and interpretations. Revisions in U.S. federal tax laws and interpretations thereof could cause us to change our investments and commitments, which could also affect the tax considerations of an investment in our common shares.

*An IRS administrative pronouncement with respect to investments by REITs in distressed debt secured by both real and personal property, if interpreted adversely to us, could cause us to pay penalty taxes or potentially to lose our REIT status.*

Most of the mortgage loans that we acquire are acquired by us at a discount from their outstanding principal amount, because our pricing is generally based on the value of the underlying real estate that secures those mortgage loans.

Treasury Regulation Section 1.856-5(c) (the "interest apportionment regulation") provides rules for determining what portion of the interest income from mortgage loans that are secured by both real and personal property is treated as interest on obligations secured by mortgages on real property or on interests in real property. Under the interest apportionment regulation, if a mortgage covers both real property and other property, a REIT is required to apportion its annual interest income to the real property security based on a fraction, the numerator of which is the value of the real property securing the loan, determined when the REIT commits to acquire the loan, and the denominator of which is the highest principal amount of the loan during the year. The IRS has recently issued a revenue procedure, Revenue Procedure 2011-16, that contains an example regarding the application of the interest apportionment regulation. The example interprets the principal amount of the loan to be the face amount of the loan, despite the Internal Revenue Code requiring taxpayers to treat any market discount, that is the difference between the purchase price of the loan and its face amount, for all purposes (other than certain withholding and information reporting purposes) as interest rather than principal.

The interest apportionment regulation applies only if the debt in question is secured both by real property and personal property. We believe that all of the mortgage loans that we acquire are secured only by real property and no other property value is taken into account in our underwriting and pricing. Accordingly, we believe that the interest apportionment regulation does not apply to our portfolio.

Nevertheless, if the IRS were to assert successfully that our mortgage loans were secured by property other than real estate, that the interest apportionment regulation applied for purposes of our REIT testing, and that the position taken in Revenue Procedure 2011-16 should be applied to our portfolio, then depending upon the value of the real property securing our loans and their face amount, and the sources of our gross income generally, we might not be able to meet the 75% REIT gross income test, and possibly the asset tests applicable to REITs. If we did not meet this test, we could potentially either lose our REIT status or be required to pay a tax penalty to the IRS.

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With respect to the 75% REIT asset test, Revenue Procedure 2011-16 provides a safe harbor under which the IRS will not challenge a REIT's treatment of a loan as being a real estate asset in an amount equal to the lesser of (1) the fair market value of the real property securing the loan determined as of the date the REIT committed to acquire the loan or (2) the fair market value of the loan on the date of the relevant quarterly REIT asset testing date. This safe harbor, if it applied to us, would help us comply with the REIT asset tests following the acquisition of distressed debt if the value of the real property securing the loan were to subsequently decline. However, if the value of the real property securing the loan were to increase, the safe harbor rule of Revenue Procedure 2011-16, read literally, could have the peculiar effect of causing the corresponding increase in the value of the loan to not be treated as a real estate asset. We do not believe, however, that this was the intended result in situations in which the value of a loan has increased because the value of the real property securing the loan has increased, or that this safe harbor rule applies to debt that is secured solely by real property. Nevertheless, if the IRS took the position that the safe harbor rule applied in these scenarios, then we might not be able to meet the various quarterly REIT asset tests if the value of the real estate securing our loans increased, and thus the value of our loans increased by a corresponding amount. If we did not meet one or more of these tests, then we could potentially either lose our REIT status or be required to pay a tax penalty to the IRS.

### ***Qualifying as a REIT involves highly technical and complex provisions of the Internal Revenue Code.***

Qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which only limited judicial and administrative authorities exist. Even a technical or inadvertent violation could jeopardize our REIT qualification. Our qualification as a REIT will depend on our satisfaction of certain asset, income, organizational, distribution, stockholder ownership and other requirements on a continuing basis.

### **Item 1B. *Unresolved Staff Comments***

None.

### **Item 2. *Properties***

We do not own or lease any property. Our operations are carried out on our behalf at the principal executive offices of PennyMac, at 6101 Condor Road, Moorpark, California, 93021.

### **Item 3. *Legal Proceedings***

From time to time, we may be involved in various claims and legal actions arising in the ordinary course of business. As of December 31, 2012, we were not involved in any material legal proceedings.

### **Item 4. *Mine Safety Disclosures***

Not applicable.

**Table of Contents****PART II****Item 5. Market for the Company's Common Stock, Related Stockholder Matters and Issuer Purchase of Equity Securities**

Our common shares began trading publicly on July 30, 2009, and are listed on the New York Stock Exchange (Symbol: PMT). As of February 19, 2013, our common shares were held by 53,866 beneficial holders. The following table sets forth the high and low sales prices (as reported by the New York Stock Exchange) for our common shares and the amount of cash dividends declared during the last two years:

**For the year ended December 31, 2012**

| Period Ended       | Stock price |          | Cash dividends declared |
|--------------------|-------------|----------|-------------------------|
|                    | High        | Low      |                         |
| March 31, 2012     | \$ 19.23    | \$ 16.69 | \$ 0.55                 |
| June 30, 2012      | \$ 20.67    | \$ 17.46 | \$ 0.55                 |
| September 30, 2012 | \$ 23.52    | \$ 19.72 | \$ 0.55                 |
| December 31, 2012  | \$ 25.78    | \$ 21.69 | \$ 0.57                 |

**For the year ended December 31, 2011**

| Period Ended       | Stock price |          | Cash dividends declared |
|--------------------|-------------|----------|-------------------------|
|                    | High        | Low      |                         |
| March 31, 2011     | \$ 19.04    | \$ 17.93 | \$ 0.42                 |
| June 30, 2011      | \$ 18.62    | \$ 16.14 | \$ 0.42                 |
| September 30, 2011 | \$ 17.26    | \$ 15.82 | \$ 0.50                 |
| December 31, 2011  | \$ 17.50    | \$ 15.14 | \$ 0.50                 |

We intend to pay quarterly dividends and to distribute to our shareholders at least 90% of our taxable income in each year (subject to certain adjustments). This will enable us to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. We have not established a minimum dividend payment level and our ability to pay dividends may be adversely affected for the reasons described in Item 1A of this Report in the section entitled *Risk Factors*. All distributions are made at the discretion of our board of trustees and depend on our earnings, our financial condition, maintenance of our REIT status and such other factors as our board of trustees may deem relevant from time to time.

**Equity Compensation Plan Information**

We have adopted an equity incentive plan which provides for the issuance of equity based awards, including share options, restricted shares, restricted share units, unrestricted common share awards, LTIP units (a special class of partnership interests in our Operating Partnership) and other awards based on our shares that may be made by us directly to our officers and trustees, and the members, officers, trustees, directors and employees of PCM, PLS, or their affiliates and to PCM, PLS and other entities that provide services to us and the employees of such other entities. The equity incentive plan is administered by our compensation committee, pursuant to authority delegated by our board of trustees, which has the authority to make awards to the eligible participants referenced above, and to determine what form the awards will take, and the terms and conditions of the awards. Our equity incentive plan allows for grants of equity-based awards up to an aggregate of 8% of our issued and outstanding common shares on a diluted basis at the time of the award. However, the total number of shares available for issuance under the plan cannot exceed 40 million.



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The following table provides information as of December 31, 2012 concerning our common shares authorized for issuance under our equity incentive plan:

|   | (a)   | (b)   | (c)   |
|---|---|---|---|
| Plan category   | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
| Equity compensation plans approved by security holders(1)     | 665,617   | \$  | 4,100,000   |
| Equity compensation plans not approved by security holders(2) |   |   |   |
| <b>Total</b>  | <b>665,617</b>  | <b>\$</b>   | <b>4,100,000</b>  |

(1) Represents our 2009 equity incentive plan.

(2) We do not have any equity plans that have not been approved by our shareholders.

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### Item 6. Selected Financial Data

|   | Year ended December 31,               |              |            | Period from<br>August 4, 2009<br>(commencement of<br>operations) to<br>December 31, 2009 |
|---|---------------------------------------|--------------|------------|--|
|   | 2012                                  | 2011         | 2010       |  |
|   | (in thousands, except per share data) |              |            |  |
| <b>Condensed Statements of Operations:</b>                                    |                                       |              |            |  |
| Net investment income:  |                                       |              |            |  |
| Net gain on mortgage loans acquired for sale                                  | \$ 147,675                            | \$ 7,633     | \$ 18      | \$   |
| Net gain on investments   | 103,649                               | 82,643       | 27,428     | 152  |
| Interest income   | 72,441                                | 36,148       | 14,574     | 2,149  |
| Loan origination fees   | 10,545                                | 1,085        | 23         |  |
| Other   | 858                                   | 1,105        | 2,011      |  |
|   | 335,168                               | 128,614      | 44,054     | 2,301  |
| <b>Expenses:</b>  |                                       |              |            |  |
| Loan fulfillment fees   | 62,906                                | 1,747        |            |  |
| Interest  | 31,642                                | 16,946       | 826        |  |
| Loan servicing  | 20,180                                | 15,364       | 3,200      |  |
| Management fees   | 12,436                                | 6,740        | 4,878      | 1,981  |
| Other   | 21,182                                | 15,322       | 8,124      | 2,203  |
|   | 148,346                               | 56,119       | 17,028     | 4,184  |
| Income (loss) before provision for income taxes                               | 186,822                               | 72,495       | 27,026     | (1,883)  |
| Provision for income taxes  | 48,573                                | 8,056        | 2,543      |  |
| Net income (loss)   | \$ 138,249                            | \$ 64,439    | \$ 24,483  | \$ (1,883)   |
| <b>Condensed Balance Sheets:</b>  |                                       |              |            |  |
| Investments:  |                                       |              |            |  |
| Short-term investments  | \$ 39,017                             | \$ 30,319    | \$         | \$ 213,628   |
| United States Treasury security   |                                       | 50,000       |            |  |
| Mortgage-backed securities at fair value                                      |                                       | 72,813       | 119,872    | 83,771   |
| Mortgage loans acquired for sale at fair value                                | 975,184                               | 232,016      | 3,966      |  |
| Mortgage loans at fair value  | 1,189,971                             | 696,266      | 364,250    | 26,046   |
| Mortgage loans under forward purchase agreements at fair value                |                                       | 129,310      |            |  |
| Real estate acquired in settlement of loans                                   | 88,078                                | 80,570       | 29,685     |  |
| Real estate acquired in settlement of loans under forward purchase agreements |                                       | 22,979       |            |  |
| Mortgage servicing rights   | 126,776                               | 6,031        |            |  |
|   | 2,419,026                             | 1,320,304    | 517,773    | 323,445  |
| Other assets  | 140,637                               | 65,758       | 71,322     | 1,001  |
| Total assets  | \$ 2,559,663                          | \$ 1,386,062 | \$ 589,095 | \$ 324,446   |
| <b>Borrowings:</b>  |                                       |              |            |  |
| Assets sold under agreements to repurchase                                    | \$ 1,256,102                          | \$ 631,313   | \$ 248,624 | \$   |
| Note payable secured by mortgage loans at fair value                          |                                       | 28,617       |            |  |
| Borrowings under forward purchase agreements                                  |                                       | 152,427      |            |  |
|   | 1,256,102                             | 812,357      | 248,624    |  |
| Other liabilities   | 102,225                               | 27,688       | 20,558     | 10,648   |
| Total liabilities   | 1,358,327                             | 840,045      | 269,182    | 10,648   |

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|  |              |              |            |            |
|--|--------------|--------------|------------|------------|
| Shareholders' equity                       | 1,201,336    | 546,017      | 319,913    | 313,798    |
| Total liabilities and shareholders' equity | \$ 2,559,663 | \$ 1,386,062 | \$ 589,095 | \$ 324,446 |

### Per Share Data:

|                  |          |          |          |           |
|------------------|----------|----------|----------|-----------|
| Earnings (loss): |          |          |          |           |
| Basic            | \$ 3.14  | \$ 2.41  | \$ 1.46  | \$ (0.11) |
| Diluted          | \$ 3.14  | \$ 2.41  | \$ 1.44  | \$ (0.11) |
| Cash dividends:  |          |          |          |           |
| Declared         | \$ 2.22  | \$ 1.42  | \$ 1.19  | \$        |
| Paid             | \$ 2.22  | \$ 1.84  | \$ 0.77  | \$        |
| Period-end:      |          |          |          |           |
| Share price      | \$ 25.29 | \$ 16.62 | \$ 18.15 | \$ 17.18  |
| Book value       | \$ 20.39 | \$ 19.22 | \$ 19.01 | \$ 18.75  |

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### **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This discussion includes forward-looking statements concerning future events and performance of the Company, which are subject to certain risks and uncertainties as discussed above in the section entitled *Special Note Regarding Forward-Looking Statements* and in Item 1A of this Report, entitled *Risk Factors*.

#### **Overview**

We are a specialty finance company that invests primarily in residential mortgage loans and mortgage-related assets. Our objective is to provide attractive risk-adjusted returns to our investors over the long-term, principally through dividends and secondarily through capital appreciation. We intend to achieve this objective largely by investing in distressed mortgage assets and acquiring, pooling, securitizing and/or selling newly originated prime credit quality residential mortgage loans (correspondent lending).

We believe that there is a need for mortgage originators to find outlets to sell government-sponsored entity (GSE) eligible, government-insured, and jumbo loans. A jumbo loan is a loan in an amount that exceeds the maximum loan amount for eligible loans under GSE guidelines. These opportunities include the purchase from mortgage lenders of newly originated mortgage loans that are eligible for (a) sale to participating GSEs such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and (b) the securitization through 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 opportunities also include the purchase and sale or securitization of jumbo conventional loans underwritten to GSE guidelines other than with respect to the maximum loan amount. Accordingly, our Manager, PCM, has built a correspondent lending operation whereby we purchase newly originated GSE eligible loans, which we sell or securitize through the GSEs on a servicing-retained basis and whereby we retain the related MSR; government-insured loans (insured by the FHA or guaranteed by the VA), which we sell to PLS, a Ginnie Mae approved issuer and servicer; and jumbo mortgage loans, which we sell to third parties, generally on a servicing-retained basis.

During the year ended December 31, 2012, we purchased mortgage loans with fair values totaling \$22.4 billion in furtherance of our correspondent lending strategy. We received MSRs as proceeds on sale of mortgage loans with fair values totaling \$134.7 million during the year ended December 31, 2012 and held MSRs with carrying values of \$126.8 million as of December 31, 2012. To the extent that we purchase loans that conform to standards to be FHA-insured or VA-guaranteed, we sell such loans to PLS, which is a Ginnie Mae approved issuer and seller/servicer. We receive a sourcing fee from PLS of three basis points on the unpaid principal balance of each loan that we sell to PLS under such arrangement. We held an inventory of mortgage loans acquired for sale totaling \$975.2 million at December 31, 2012. To the extent that we transfer these loans into securitizations in the future, we intend to retain a portion of the securities and residual interests created in the securitization transaction.

We acquire distressed mortgage loans through direct acquisitions of mortgage loan portfolios from institutions such as banks, mortgage companies and insurance companies and direct acquisitions or participations in structured transactions. A substantial portion of the nonperforming loans we have purchased has been acquired from or through one or more subsidiaries of Citigroup Inc.

We seek to maximize the value of the distressed mortgage loans that we acquire using means that are appropriate for the particular loan, including both proprietary and nonproprietary loan modification programs (such as the U.S. Departments of the Treasury and Housing and Urban Development's Home Affordable Modification Program (HAMP)), special servicing and other initiatives focused on avoiding foreclosure, when possible. When we are unable to effect a cure for a mortgage delinquency, our objective is to effect timely acquisition and/or liquidation of the property securing the loan. During the year ended December 31, 2012, we purchased \$542.8 million of distressed mortgage loans and received proceeds from payoffs and sales from our portfolio of distressed mortgage loans totaling \$184.2 million.

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We supplement these activities through participation in other mortgage-related activities, which are in various states of analysis, planning or implementation including:

Acquisition of MSRs or excess servicing spread from MSRs from financial institutions. We believe that MSR investments may allow us to earn attractive current returns and to leverage the loan servicing and origination capabilities of PLS to improve the assets' value. We also intend to continue to retain the MSRs that we receive as a portion of the proceeds from our sale or securitization of mortgage loans through our correspondent lending operation.

Pursuant to the terms of the MSR recapture agreement entered into with PLS effective February 1, 2013, if PLS refinances loans for which we previously created and held the MSRs through our correspondent lending activities, PLS is generally required to transfer and convey to us, without cost to us, 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.

Acquisition of REIT-eligible MBS. We purchased \$112.2 million of MBS during the year ended December 31, 2012. We also sold all of our investment in MBS during the year ended December 31, 2012. We held no MBS at December 31, 2012.

Providing inventory financing of mortgage loans for mortgage lenders. We believe this activity may result in attractive investment assets and will supplement and make our correspondent lending business more attractive to lenders from which we acquire newly originated loans.

We are externally managed by PCM, an investment adviser that specializes in, and focuses on, residential mortgage loans. Most of our mortgage loan portfolio is serviced by PLS, an affiliate of PCM.

We conduct substantially all of our operations, and make substantially all of our investments, through our Operating Partnership and its subsidiaries. One of our subsidiaries is the sole general partner, and we are the sole limited partner, of our Operating Partnership.

We believe that we qualify to be taxed as a REIT. We believe that we will not be subject to federal income tax on that portion of our income that is distributed to shareholders as long as we meet certain asset, income and share ownership tests. If we fail to qualify as a REIT, and do not qualify for certain statutory relief provisions, our profits will be subject to income taxes and we may be precluded from qualifying as a REIT for the four tax years following the year we lose our REIT qualification. A portion of our activities are conducted in a TRS, which is subject to corporate federal and state income taxes. Accordingly, we have made a provision for income taxes with respect to the operations of our TRS. We expect that the effective rate for the provision for income taxes will be volatile in future periods. Our goal is to manage the business to take full advantage of the tax benefits afforded to us as a REIT.

## **Observations on Current Market Opportunities**

Our business is affected by macroeconomic conditions in the United States, including economic growth, unemployment rates, the residential housing market and interest rate levels and expectations. During 2012, the U.S. economy continued its pattern of modest growth as reflected in recent economic data. Real U.S. gross domestic product, as reported by the Bureau of Economic Analysis, expanded at an annual rate of 2.2% for 2012 as compared to a revised 1.8% annual rate for 2011. The seasonally adjusted national unemployment rate, as reported by the Bureau of Labor Statistics, was 7.8% at December 31, 2012, the fourth consecutive month the rate was below 8% and equaling the previous lowest rate for the year, and compares to an unemployment rate of 8.5% at December 31, 2011. Declining unemployment may, however, be partially reflective of a declining workforce labor participation rate. Before declining below 8% as of September, 2012, the persistently high monthly unemployment rate above 8% since February 2009 continues to be reflected in high delinquency rates.

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on single family residential mortgage loans. As reported by the Federal Reserve, during the first three quarters of 2012 charge-off and delinquency rates on loans and leases at commercial banks ranged from a low of 10.28% for the first quarter to a high of 10.77% for the third quarter, a modest reduction from the recent high of 11.25% during the first quarter of 2010.

Residential real estate activity appears to be modestly improving. The seasonally adjusted annual rate of existing home sales for December 2012, as reported by the National Association of Realtors® ( NAR ), was 12.8% higher than for December 2011. The national median existing home price for all housing types in December 2012, as reported by the NAR, was \$180,800, an 11.5% increase from December 2011, and represents the 10<sup>th</sup> consecutive month of year-over-year price gains as well as the largest year-over-year price increase reported in any one month since November 2005. Foreclosure filings, as reported by RealtyTrac, on a national level decreased 3% during 2012 as compared to 2011 and 36% from the foreclosure filings peak in 2010 with December 2012 filings representing a 68 month low. However, foreclosure activity in 2012 increased from 2011 in 25 states, primarily those states with longer judicial foreclosure processes as lenders began catching up with their foreclosure backlogs. Nationwide, the average time to foreclose increased to 414 days during the fourth quarter of 2012 from 348 days in the fourth quarter of 2011. As of January, 2013, 26% of all homes with outstanding mortgages had a balance owed that was at least 25% more than the value of the homes collateralizing such loans, down from 28% of all homes with outstanding mortgages in January, 2012 as reported by RealtyTrac.

Thirty-year fixed rate mortgage interest rates ranged from a high of 4.08% to a low of 3.31% during 2012 with the low of 3.31% representing an all-time record low for the thirty-year fixed rate mortgage (Source: Freddie Mac's Weekly Primary Mortgage Market Survey). The average annual interest rate for the thirty-year fixed rate mortgages in 2012 was 3.66% compared to 4.45% in 2011.

Our Manager continues to see substantial volumes of distressed residential mortgage loan sales (sales of loan pools that consist of either nonperforming loans, troubled but performing loans or a combination thereof) offered for sale by a limited number of sellers. During 2012, our Manager reviewed 96 mortgage loan pools with unpaid principal balances totaling approximately \$19.7 billion and one pool of real estate acquired in settlement of loans totaling approximately \$30.1 million. This compares to our Manager's review of 88 mortgage loan pools with unpaid principal balances totaling approximately \$13.6 billion during 2011. We acquired distressed mortgage loans with fair values totaling \$542.8 million and \$647.6 million during the years ended December 31, 2012 and 2011, respectively.

We believe that the shifting investment and operational priorities of banks and other traditional mortgage lenders have created additional opportunities for our business. Under current market conditions, these opportunities include the purchase from mortgage lenders of newly originated mortgage loans that are eligible for sale to an Agency. These opportunities also include the purchase of newly originated mortgage loans that can be resold in the non-Agency whole loan market or securitized in the private label market as well as providing inventory financing to originators of such loans. Residential mortgage originations increased in 2012 due to, among other things, government quantitative easing programs that have helped drive primary mortgage interest rates to historic lows, government refinance programs such as HARP, and a recovering housing market. However, despite this recent growth, origination volumes remain well below pre-recession levels (high of \$3.8 trillion in 2003). According to the Mortgage Bankers Association, total residential mortgage originations in the United States were expected to reach \$1.8 trillion in 2012, 71% of which were expected to be refinancings. This represents an increase of 22% over the originations in 2011. The refinance-driven origination growth is expected to change in the next two years as refinance volume drops and purchase volume gradually recovers. During the years ended December 31, 2012 and 2011, we acquired approximately \$22.4 billion and \$1.3 billion, respectively, in fair value of newly originated mortgage loans and received proceeds of approximately \$21.7 billion and \$1.1 billion, respectively, on the sale of loans.

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### ***Reporting Metrics and Prospective Trends***

We expect our results of operations to be affected by various factors, many of which are beyond our control. Our primary sources of income are from:

Gains on mortgage loans acquired for sale, including commitments to purchase or originate mortgage loans and the related hedging instruments

Net gains on investments

Interest income

Loan origination fees

Net servicing income

### ***Gain on Mortgage Loans Acquired for Sale***

When we sell our mortgage loans, we record a gain or loss which is determined by the nature and terms of the transaction. The gain or loss that we realize on the sale of loans acquired through our mortgage lending activities is primarily determined by the price paid for purchased loans or the terms of originated loans, the effect of any hedging and other risk management activities that we undertake, the sales price of the loan and the value of any MSRs received in the transaction. Gain on mortgage loans acquired for sale is significantly influenced by mortgage loan prepayment activity which is, in turn, significantly influenced by the level and direction of mortgage interest rates. Certain of these factors are beyond our control.

Our gain on mortgage loans acquired for sale includes both cash and non-cash elements. We receive proceeds on sale that include both cash and our estimate of the value of MSRs. We also provide an estimate of the losses we expect to incur relating to representations and warranties that we make to the investors.

We recognize the fair value of loan commitments we make to correspondent lenders to purchase loans. We refer to these commitments as IRLCs. We recognize the value of these commitments upon their issuance, which is generally before we purchase the mortgage loans subject to the commitment. We presently issue IRLCs with commitment periods ranging to sixty days. The value that we assign to an IRLC is estimated based on our estimated gain on sale of a mortgage loan funded under the commitment, adjusted for the probability that the loan will be purchased within the terms of the IRLC. The IRLC is subject to changes in fair value as the loan approaches funding, as market interest rates for similar loans change and as our assessment of the probability of the funding of mortgage loans at similar points in the origination process changes. The value of an IRLC can be either positive or negative, depending on the relationship of the mortgage loan's interest rates to current market rates for similar mortgage loans.

The primary factor influencing the probability that the loan will fund within the terms of the IRLC is the change, if any, in mortgage interest rates subsequent to the commitment date. In general, the probability of funding increases if current rates rise and decreases if current rates fall. This is due primarily to the relative attractiveness of current mortgage interest rates compared to the correspondent lender's committed rate. The probability that a loan will fund within the terms of the IRLC is also influenced by the source of the application, age of the application, purpose of the loan (purchase or refinance) and the application approval rate. We have developed closing ratio estimates using empirical data that take into account all of these variables, as well as renegotiations of rate and point commitments that tend to occur when mortgage interest rates fall. These closing ratio estimates are used to calculate the aggregate balance of loans that we expect to fund within the terms of the IRLCs.

We manage the risk created by IRLCs relating to mortgage loans and by our inventory of mortgage loans acquired for sale by entering into forward sale agreements to sell the mortgage loans and by the purchase and sale of interest rate options and futures. Such agreements are accounted for as derivative financial instruments.





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We account for our derivative financial instruments as free-standing derivatives. We do not designate our forward sale agreements or options and futures for hedge accounting. We recognize all of our derivative financial instruments on the balance sheet at fair value with changes in the fair value being reported in current period income as a component of net gain on mortgage loans acquired for sale.

We also provide for our estimate of the fair value of future losses that we may be required to incur as a result of our breach of representations and warranties provided to the purchasers of the loans we have sold. The representations and warranties require adherence to investor or insurer origination and underwriting guidelines, including but not limited to the validity of the lien securing the loan, property eligibility, borrower credit, income and asset requirements, and compliance with applicable federal, state and local law.

In the event of a breach of our representations and warranties, we may be required to either repurchase the mortgage loans with the identified defects or indemnify the investor or insurer from its related losses. In such cases, we bear any subsequent credit loss on the mortgage loans. Our losses from representations and warranties may be reduced by any recourse that we have to correspondent lenders that, in turn, had sold such mortgage loans to us and breached similar or other representations and warranties. In such event, we generally have the right to seek a repurchase or indemnity from that originator.

We record a provision for losses relating to representations and warranties as part of our loan sale transactions. The method we use to estimate our liability for representations and warranties is a function of the representations and warranties given and considers a combination of factors, including, but not limited to, estimated future defaults and loan repurchase rates, the potential severity of loss in the event of defaults and the probability of reimbursement by the correspondent loan seller. We establish a liability at the time loans are sold and continually update our liability estimate.

The level of the liability for losses from representations and warranties is difficult to estimate and requires considerable management judgment. The level of mortgage loan repurchase losses is dependent on economic factors, investor repurchase demand strategies, and other external conditions that may change over the lives of the underlying loans. Our representations and warranties are generally not subject to stated limits of exposure. However, we believe that the current unpaid principal balance of loans that we have sold to date represents the maximum exposure to repurchases related to representations and warranties.

We evaluate the adequacy of our liability for losses from representations and warranties based on our loss experience and our assessment of future losses to be incurred relating to loans that we have previously sold and which remain outstanding at the balance sheet date. As our portfolio of loans sold subject to representations and warranties grows and as economic fundamentals change, such adjustments can be material. However, we believe that our current estimates adequately approximate the future losses to be incurred on our servicing portfolio of mortgage loans sold subject to such representations and warranties.

### *Net Gains on Investments*

*Realized Gain or Loss.* When we sell our mortgage loans, REO or securities, we record a gain or loss which is determined by the nature and terms of the disposition transaction. When a mortgage loan is satisfied through a full or partial payoff, the amount of gain or loss recorded represents the difference between the amount received and the fair value of the loan at the beginning of the month in which the payoff is received. Gain or loss on the sale of REOs is determined by the difference between the net proceeds and the carrying value of the property at the date the property is sold.

We are generally not in a position to dispose of our mortgage loans following modification until adequate time has passed to establish a satisfactory payment history. As a result, our ability to realize gain on our modified loans is correspondingly deferred and our initial periods of operations have not included material levels of disposition transactions with regard to modified loans. As a result of our fair value accounting, in the event of a significant loan modification, we record a realized gain (or loss) to the extent that the fair value of the modified loan exceeded (or was less than) the fair value of the loan before modification.

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*Unrealized Gain or Loss.* Many of our assets, including our mortgage loans and securities, are carried at fair value. Accordingly, changes in the fair value affect the results of our operations for the period in which such change in value occurs, and these changes may be material. Changes, and the expectation of future changes, in home prices are major determinants of the value of residential mortgage loans. These factors are beyond our control.

### *Interest Income*

Interest income represents interest earned on our residential mortgage loans and mortgage-related assets. We anticipate that the primary contributing elements of our interest income (some of which are beyond our control) will be the size of our mortgage loan and securities portfolio, the timing of purchases and prices paid for such assets, the level and changes of interest rates, prepayment speeds and the payment performance of borrowers.

### *Loan origination fees*

Loan origination fees represent fees we charge to correspondent lenders as part of our loan acquisition activities. We deduct the loan origination fees from the proceeds we pay the correspondent lenders on the date of purchase of the respective loans.

### *Net Servicing Income*

Net servicing income includes the fees that we earn as well as the amortization, impairment and changes in fair value that we recognize from holding MSR's. A significant component of our net servicing income is driven by the changes in the fair value of the MSR's that we hold. Changes in the fair value of MSR's are significantly influenced by prepayment expectations and actual prepayments relating to the underlying loans that are, in turn, primarily influenced by mortgage interest rate expectations.

### *Valuation, Amortization, Impairment and Change in Estimated Fair Value of Mortgage Servicing Rights*

MSR's represent the value of a contract that obligates us to service the mortgage loans on behalf of the owner of the loan in exchange for servicing fees and the right to collect certain ancillary income from the borrower. We recognize MSR's at our estimate of the fair value of the contract to service the loans.

How much of the MSR we realize in cash depends upon how our initial estimates of the future cash flows accruing to the MSR's are realized. As economic fundamentals influencing the loans change, our estimate of the fair value of the related MSR we retain will also change. As a result, we will record changes in fair value as a component of net servicing income for the MSR's we carry at fair value, and we may recognize changes in fair value relating to our MSR's carried at the lower of amortized cost or fair value depending on the relationship of the asset's fair value to its amortized cost at the measurement date.

After the initial recognition of MSR's, we account for such assets based on the initial interest rates of the mortgage loans underlying the respective MSR's. We account for MSR's differently based on whether the interest rates of the mortgage loans underlying such assets are above 4.5% because we have concluded that mortgage loans with initial interest rates of 4.5% or less present different risks to us than MSR's relating to mortgage loans with initial interest rates of more than 4.5% and, therefore, require a different risk management approach. Our risk management efforts in connection with MSR's relating to mortgage loans with initial interest rates of 4.5% or less are generally 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. Our risk management efforts in connection with MSR's relating to mortgage loans with initial interest rates of more than 4.5% are aimed at moderating the effects of changes in interest rates on the assets' values.

We account for MSR's relating to mortgage loans with initial interest rates of more than 4.5% at estimated fair value. Changes in the fair value of MSR's carried at fair value are included in current period income as a component of net servicing income.

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We account for MSR accounting relating to mortgage loans with initial interest rates of less than or equal to 4.5% using the amortization method. Under the amortization method, we amortize the cost of MSRs in proportion to, and over the period of, net servicing income for the mortgage loans underlying the respective assets.

We also evaluate MSRs accounted for using the amortization method with reference to the assets' fair value at the measurement date. Impairment occurs when the current fair value of the MSR falls below the asset's carrying value (carrying value is the amortized cost reduced by any related valuation allowance). If MSRs are impaired, the impairment is recognized in current period income and the carrying value of the MSRs is adjusted through a valuation allowance. If the value of impaired MSRs subsequently increases, we recognize the increase in value in current period earnings and, through a reduction in the valuation allowance, adjust the carrying value of the MSRs to a level not in excess of amortized cost.

When evaluating MSRs for impairment, we stratify the assets by predominant risk characteristic including loan type (fixed-rate or adjustable-rate) and note rate. We stratify fixed-rate loans into note rate pools of 50 basis points for note rates between 3.0% and 4.5% and a single pool for note rates below 3%. We evaluate adjustable-rate mortgage loans with initial interest rates of 4.5% or less in a single pool.

We periodically review the various impairment strata to determine whether the value of the impaired MSRs in a given stratum is likely to recover. When we deem 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 recoverable value is charged to the valuation allowance.

Amortization and impairment of MSRs accounted for using the amortization method are included in current period income as a component of net servicing income.

We manage the impairment risk created by holding MSRs in part through the purchase and sale of MBS options and futures. Such agreements are accounted for as derivative instruments.

We account for our derivative financial instruments as free-standing derivatives. We do not designate our forward sale agreements or options and futures for hedge accounting. We recognize all of our derivative financial instruments on the balance sheet at fair value with changes in the fair value being reported in current period income as a component of net gain on mortgage loans acquired for sale.

### *Expenses*

Under our management agreement with PCM, we incur base management and performance incentive fees that are determined based upon our equity and profitability, among other factors. Under our loan servicing agreement with PLS, we incur loan servicing, origination and other fees that are determined by the size of our mortgage loan portfolio, the delinquency status and characteristics of our loans, and the volumes of mortgage loan and property resolution events, among other factors. In connection with our correspondent lending business, we procure certain mortgage banking services from PLS, including fulfillment and disposition-related services, for a fulfillment fee based on a percentage of the unpaid principal balance of the mortgage loans we sell to non-affiliates.

We also incur ongoing operating and administrative expenses necessary to conduct our business. In connection with investigating portfolios for investment, we are obligated to reimburse PCM's upfront expenses related to due diligence, credit and collateral evaluation and the costs to board the loans onto PCM's and PLS's systems. In some cases, these costs may not be recoverable from the selling party if PCM's bidding efforts are not successful.

### *Other Factors Influencing Our Results*

*Prepayment Speeds.* Prepayment speeds, as reflected by the constant prepayment rate, vary according to interest rates, the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty. In general, when interest rates rise, it is relatively less attractive for

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borrowers to refinance their mortgage loans and, as a result, prepayment speeds tend to decrease. This can extend the period over which we earn loan servicing fees and interest income. When interest rates fall, prepayment speeds tend to increase, thereby decreasing the period over which we earn loan servicing fees and interest income.

***Rising Interest Rate Environment.*** Rising interest rates increase our financing costs which may result in a net negative impact on our net interest income. With respect to our floating rate investments, such interest rate increases should result in increases in our net interest income because our floating rate assets will likely be greater in amount than the related floating rate liabilities. Similarly, such an increase in interest rates should generally result in an increase in our net interest income on future fixed-rate investments made by us because our fixed-rate assets would be greater in amount than our fixed-rate liabilities. We expect, however, that our fixed-rate assets would decline in value in a rising interest rate environment and that our net interest spreads on fixed rate assets could decline in a rising interest rate environment to the extent such assets are financed with floating rate debt.

***Changing Home Prices.*** The state of the real estate market/home prices will determine proceeds from sale of real estate acquired in settlement of loans and the value of distressed loans. While we make extensive efforts at anticipating real estate price trends and estimate those trends' effects on the valuations of our portfolios of mortgage loans and real estate acquired in settlement of loans, future real estate values are subject to influences beyond our control. Generally, rising home prices are expected to positively affect our results of real estate acquired in settlement of loans. Conversely, declining real estate prices are expected to negatively affect our results of real estate acquired in settlement of loans. Likewise, expectations of rising home prices generally positively influence our estimates of the fair value of our distressed mortgage loans and declining home prices generally negatively influence our estimates of the fair value of our distressed mortgage loans. We cannot predict future home prices with any certainty.

***Risk Management Effectiveness Credit Risk.*** We are subject to the risk of potential credit losses on all of the residential mortgage loans we hold in our portfolio, particularly those that are nonperforming. Additionally, we may purchase all classes of certain RMBS securities for the purpose of maintaining our exclusion from the Investment Company Act, and thereby will have the credit exposure on all of the loans underlying these RMBS. Before the purchase of these securities, we intend to conduct due diligence that allows us to identify loans that do not meet our credit standards based on loan-to-value ratios, borrowers' credit scores, income and asset documentation and other criteria that we believe to be important indications of credit risk. In the event that we identify such loans, we intend to either price the securities to our expectation of value or decline to purchase the RMBS.

***Risk Management Effectiveness Interest Rate Risk.*** Since changes in interest rates may significantly affect our activities, our operating results will depend, in large part, upon our ability to effectively manage interest rate risks and prepayment risks while maintaining our status as a REIT and our exclusion from the Investment Company Act. Such risks include the risk arising from the change in value of our inventory of mortgage loans acquired for sale and commitments to fund mortgage loans and related hedging derivative instruments, as well as the effects of changes in interest rates on the value of our investment in MSRs.

***Liquidity.*** Our ability to operate profitably is dependent on both our access to capital to finance our assets, our ability to profitably sell mortgage loans acquired through our correspondent lending activities and our ability to manage distressed assets acquired through our investment activities. An important source of capital for the residential mortgage industry is warehouse financing facilities. These facilities provide funding to mortgage loan producers until the loans are sold to investors or securitized in the secondary mortgage loan market. Our ability to hold loans pending sale and/or securitization and loans held for investment depends, in part, on the availability to us of adequate financing lines of credit at suitable interest rates.

***Size of Investment Portfolio.*** The size of our investment portfolio, as measured by the aggregate unpaid principal balance of our mortgage loans and aggregate principal balance of our mortgage-related securities and the other assets we own will also be a key revenue driver. Generally, as the size of our investment portfolio grows, the amount of interest income we receive will increase. The larger investment portfolio, however, will drive increased expenses, including servicing and related fees payable to PLS. We may also incur additional interest expense to finance the purchase of our assets.

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### **Critical Accounting Policies**

We have identified what we believe are our most critical accounting policies to be the following:

#### *Valuation of Financial Instruments*

We have elected to record our financial assets at fair value and group them in three levels, based on the markets in which the assets are traded and the observability of the assumptions used to determine fair value. These levels are:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Prices determined using other significant observable inputs. Observable inputs are inputs that other market participants would use in pricing an asset or liability and are developed based on market data obtained from sources independent of us. These may include quoted prices for similar assets or liabilities, interest rates, prepayment speeds, credit risk and others.

Level 3 Prices determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used. Unobservable inputs reflect our own assumptions about the factors that market participants use in pricing an asset or liability, and are based on the best information available in the circumstances.

The valuation method used to estimate fair value may produce a fair value measurement that may not be indicative of ultimate realizable value. Furthermore, while we believe our valuation methods are appropriate and consistent with those used by other market participants, the use of different methods or assumptions to estimate the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Those estimated values may differ significantly from the values that would have been used had a readily available market for such loans or investments existed, or had such loans or investments been liquidated, and those differences could be material to the financial statements.

We incorporate lack of liquidity into its fair value estimates based on the type of asset or liability measured and the valuation method used. For example, for mortgage loans where the significant inputs have become unobservable due to illiquidity in the markets for distressed loans or non-Agency, non-conforming mortgage loans, we use a discounted cash flow technique to estimate fair value. This technique incorporates forecasting of expected cash flows discounted at an appropriate market discount rate that is intended to reflect the lack of liquidity in the market.

#### *Mortgage-Backed Securities*

MBS fair 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 is estimated based on quoted market prices for similar securities.

Non-Agency MBS are categorized as Level 3 financial statement items. We categorize our investments in non-Agency MBS as Level 3 fair value financial statement items due to their illiquidity and the present lack of an active market for such securities. Fair value of non-Agency MBS is estimated using nonaffiliate broker indications of value. For indications of value received, the our Manager's Financial Analysis and Valuation group (the FAV group) reviews the price indications provided by non-affiliate brokers for completeness, accuracy and consistency across all similar MBS managed by the Manager. 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



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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 our Manager's valuation committee as part of its review and approval of monthly valuation results. Our Manager 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 our non-Agency MBS are discount rates, prepayment speeds, default speeds and the total expected future loss in comparison to the current balance of outstanding collateral (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 related, 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.

We recognize interest income on MBS over the life of the security using the interest method. Changes in fair value arising from amortization of purchase premiums and accrual of unearned discounts are recognized as a component of interest income. We estimate, at the time of purchase, the future expected cash flows and determine the effective interest rate based on these estimated cash flows and our purchase price. We update our estimates of future cash flows monthly. In estimating these cash flows, there are a number of assumptions that are subject to uncertainties. These include the rate and timing of principal payments (including prepayments, repurchases, defaults and liquidations), the pass-through or coupon rate, interest rate fluctuations, interest payment shortfalls due to delinquencies on the underlying mortgage loans, the likelihood of modification and the timing of the magnitude of credit losses on the mortgage loans underlying the securities. These estimates are difficult to predict and are subject to future events that will likely affect the realization of our estimates and interest income. Changes in fair value arising from other factors are recognized as a component of *Net gain (loss) on investments*.

### *Mortgage Loans*

Mortgage loans are carried at their estimated fair values. Changes in the estimated fair value of mortgage loans are recognized in current period income. All changes in fair value, including changes arising from the passage of time, are recognized as a component of *Net gain on investments*. Fair value of mortgage loans is estimated based on whether the mortgage loans are saleable into active markets with established counterparties and transparent pricing.

Mortgage loans that are saleable into active markets are categorized as Level 2 fair value financial statement items and their fair values are estimated using their quoted market price or market price equivalent.

Loans that are not saleable into active markets are categorized as Level 3 fair value financial statement items, and their fair values are estimated using a discounted cash flow valuation model. Inputs to the model include current interest rates, loan amount, payment status and property type, and forecasts of future interest rates, home prices, prepayment speeds, defaults and loss severities. The estimates of value are developed by our Manager's FAV group and are reviewed and approved by PCM's senior management valuation committee.

### *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 fair value financial statement item. Fair value of REO is determined by using a current estimate of value from a broker's price opinion, a full appraisal or the price given in a current contract of sale of the property. Changes in fair value and gains and losses on sale of REO is recognized in the consolidated statement of operations under the caption *Results of real estate acquired in settlement of loans*.

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### *Mortgage Servicing Rights*

We recognize MSRIs initially at their estimated fair values, either as proceeds from sales of mortgage loans where we assume the obligation to service the loan in the sale transaction, or from the purchase of MSRIs. MSRIs arise from contractual agreements between us and the investors (or their agents) in mortgage securities and mortgage loans. Under these contracts, we are responsible for loan servicing functions in exchange for fees and other remuneration. The servicing functions typically performed include, among other responsibilities, collecting and remitting loan payments; responding to borrower inquiries; accounting for principal and interest, holding custodial (impound) funds for payment of property taxes and insurance premiums; counseling delinquent mortgagors; and supervising the acquisition of real estate in settlement of the loans and property dispositions.

The value of MSRIs is derived from the net positive cash flows associated with the servicing contracts. We receive a servicing fee generally of 0.25% annually on the remaining outstanding principal balances of the loans. The servicing fees are collected from the monthly payments made by the mortgagors. We generally receive other remuneration including rights to various mortgagor-contracted fees such as late charges, collateral reconveyance charges and loan prepayment penalties and we are generally entitled to retain the interest earned on funds held pending remittance for mortgagor principal, interest, tax and insurance payments. We also generally have the right to solicit the mortgagors for other products and services, such as second mortgages and insurance, as well as for new mortgages for those considering refinancing or purchasing a new home.

The precise fair value of MSRIs cannot be readily determined because MSRIs are not actively traded in stand-alone markets. Considerable judgment is required to estimate the fair values of these assets and the exercise of such judgment can significantly affect our earnings. MSR values are estimated by our Manager's FAV group and are reviewed and approved by its senior management valuation committee. Therefore, we classify our MSRIs as Level 3 fair value financial statement items.

We use a discounted cash flow approach to estimate the fair value of MSRIs. This approach consists of projecting servicing cash flows discounted at a rate that our Manager assumes market participants would use in their determinations of value. The cash flow and prepayment assumptions used in our discounted cash flow model are based on market factors which our Manager believes are consistent with assumptions and data used by market participants valuing similar MSRIs.

The key assumptions used in the valuation of MSRIs include mortgage prepayment speeds, cost to service the loans and discount rates. These variables can, and generally do, change from period to period as market conditions change.

Our subsequent accounting for MSRIs is based on the class of MSRIs. Our Manager has identified two classes of MSRIs: MSRIs backed by mortgage loans with initial interest rates of less than or equal to 4.5% and MSRIs backed by mortgage loans with initial interest rates of more than 4.5%. MSRIs backed by mortgage loans with initial interest rates of less than or equal to 4.5% are accounted for using the amortization method. MSRIs backed by loans with initial interest rates of more than 4.5% are accounted for at fair value with changes in fair value recorded in current period income.

### *MSRs Accounted for Using the MSR Amortization Method*

We amortize MSRIs accounted for using the amortization method. MSR amortization is determined by applying the ratio of the net MSR cash flows projected for the current period to the estimated total remaining net MSR cash flows. The estimated total net MSR cash flows are determined at the beginning of each month using prepayment assumptions applicable at that time.

We periodically assess MSRIs accounted for using the amortization method for impairment. Impairment occurs when the current fair value of the MSR falls below the asset's carrying value (carrying value is the amortized cost reduced by any related valuation allowance). If MSRIs are impaired, we recognize the impairment.



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in current-period earnings and adjust the carrying value of the MSR through a valuation allowance. If the value of impaired MSR subsequently increases, we recognize the increase in value in current-period earnings and we adjust the carrying value of the MSR through a reduction in the valuation allowance. Value is not increased above amortized cost.

We stratify our MSR by predominate risk characteristic when evaluating for impairment. For purposes of performing our MSR impairment evaluation, we stratify our servicing portfolio on the basis of certain risk characteristics including loan type (fixed-rate or adjustable-rate) and note rate. We stratify fixed-rate loans into note rate pools of 50 basis points for note rates between 3.0% and 4.5% and a single pool for note rates below 3%. If the fair value of MSR in any of the note rate pools is below the carrying value of the MSR for that pool, we recognize impairment to the extent of the difference between the estimated fair value and the existing valuation allowance for that pool.

Our Manager periodically reviews the various impairment strata to determine whether the value of the impaired MSR in a given stratum is likely to recover. When our Manager deems recovery of the value to be unlikely in the foreseeable future, a write-down of the cost of the MSR for that stratum to its estimated recoverable value is charged to the valuation allowance to adjust the carrying value to a level not in excess of amortized cost.

Amortization and impairment of MSR are included in current period income as a component of *Net servicing income*.

### *MSRs Accounted for at Fair Value*

Changes in fair value of MSR accounted for at fair value are recognized in current period income as a component of *Net servicing income*.

### *Recourse Liability*

Our agreements with the Agencies include representations and warranties related to the loans we sell to the Agencies. The representations and warranties require adherence to Agency origination and underwriting guidelines, including but not limited to the validity of the lien securing the loan, property eligibility, borrower credit, income and asset requirements, and compliance with applicable federal, state and local law.

In the event of a breach of our representations and warranties, we may be required to either repurchase the mortgage loans with the identified defects or indemnify the investor or insurer. In such cases, we bear any subsequent credit loss on the mortgage loans. Our credit loss may be reduced by any recourse we have to correspondent lenders that, in turn, have sold such mortgage loans to us and breached similar or other representations and warranties. In such event, we have the right to seek a recovery of related repurchase losses from that originator.

We record a provision for losses relating to our representations and warranties as part of our loan sale transactions. The method we use to estimate the liability for representations and warranties is a function of the representations and warranties given and considers a combination of factors, including, but not limited to, estimated future defaults and loan repurchase rates and the potential severity of loss in the event of defaults and the probability of reimbursement by the correspondent loan seller. We establish a liability at the time loans are sold and continually update our liability estimate.

The level of the liability for representations and warranties is difficult to estimate and requires considerable management judgment. The level of mortgage loan repurchase losses is dependent on economic factors, investor demand strategies, and other external conditions that may change over the lives of the underlying loans. Our representations and warranties are generally not subject to stated limits of exposure. However, we believe the current unpaid principal balance of loans sold by us to date represents the maximum exposure to repurchases related to representations and warranties.

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We evaluate the adequacy of our liability for losses from representations and warranties based on our loss experience and our assessment of future losses to be incurred relating to loans that we have previously sold and which remain outstanding at the balance sheet date. As our portfolio of loans sold subject to representations and warranties grows and as economic fundamentals change, such adjustments can be material. However, we believe the amount and range of reasonably possible losses in relation to the recorded liability is not material to our financial condition or results of operations.

### *Investment Consolidation*

We evaluate every investment with reference to the underlying entity that issued the loans or securities we acquire to determine whether to include the investment in our consolidated reporting group. We perform a similar analysis for each entity with which we make an agreement for management, servicing or similar services. Where voting rights do not effectively identify the investor with a controlling financial interest, the entity is classified as a variable interest entity ( VIE ).

With certain exceptions, VIEs are subject to consolidation if the investors do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support, or are unable to direct the entity's activities or are not exposed to the entity's losses or entitled to its residual returns. VIEs are consolidated by the entity that is deemed the primary beneficiary of the VIE as indicated by the entity that has both the power to direct the activities of the VIE that most significantly impacts its economic performance and the obligation to absorb losses or the right to receive benefits that could potentially be significant to the entity. We did not have variable interests in our affiliated service providers or our investments as of December 31, 2012.

### *Income Taxes*

We have elected to be taxed as a REIT and we believe that we comply with the provisions of the Internal Revenue Code applicable to REITs. Accordingly, we believe that we will not be subject to federal income tax on that portion of our REIT taxable income that is distributed to shareholders as long as certain asset, income and share ownership tests are met. If we fail to qualify as a REIT, and do not qualify for certain statutory relief provisions, we will be subject to income taxes and may be precluded from qualifying as a REIT for the four tax years following the year of loss of our REIT qualification.

Our TRS is subject to federal and state income taxes. Income taxes are provided for using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted rates expected to apply to taxable income in the years in which we expect those temporary differences to be recovered or settled.

The effect on deferred taxes of a change in tax rates is recognized in income in the period in which the change occurs. Subject to our judgment, a valuation allowance is established if realization of deferred tax assets is not more likely than not.

We recognize tax benefits relating to tax positions we take only if it is more likely than not that the position will be sustained upon examination by the appropriate taxing authority. A tax position that meets this standard is recognized as the largest amount that exceeds 50 percent likelihood of being realized upon settlement. We will classify any penalties and interest as a component of income tax expense.

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### Results of Operations Comparison Years Ended December 31, 2012 ( 2012 ), 2011 ( 2011 ), 2010 ( 2010 )

The following is a summary of our key performance measures:

|  | Year ended December 31,                  |              |            |
|--|--|--------------|------------|
|  | 2012                                     | 2011         | 2010       |
|  | (in thousands, except per share amounts) |              |            |
| Net investment income                                    | \$ 335,168                               | \$ 128,614   | \$ 44,054  |
| Pre-tax income by segment:                               |  |              |            |
| Correspondent lending                                    | \$ 100,727                               | \$ 7,272     | \$         |
| Investment   | 86,095                                   | 65,223       | 27,026     |
|  | \$ 186,822                               | \$ 72,495    | \$ 27,026  |
| Net income   | \$ 138,249                               | \$ 64,439    | \$ 24,483  |
| Earnings per share:                                      |  |              |            |
| Basic  | \$ 3.14                                  | \$ 2.41      | \$ 1.46    |
| Diluted  | \$ 3.14                                  | \$ 2.41      | \$ 1.44    |
| Dividends per share:                                     |  |              |            |
| Declared   | \$ 2.22                                  | \$ 1.42      | \$ 1.19    |
| Paid   | \$ 2.22                                  | \$ 1.84      | \$ 0.77    |
| Cash Flow:   |  |              |            |
| Investment activities:                                   |  |              |            |
| Correspondent lending:                                   |  |              |            |
| Purchases of mortgage loans for sale                     | \$ 22,443,136                            | \$ 1,318,763 | \$ 43,841  |
| Proceeds from sales of mortgage loans acquired for sale: |  |              |            |
| Cash:  |  |              |            |
| Sales to nonaffiliated investors                         | \$ 12,834,002                            | \$ 512,447   | \$ 36,458  |
| Sales of government-insured and guaranteed loans to PLS  | 8,864,264                                | 577,852      | 3,395      |
|  | 21,698,266                               | 1,090,299    | 39,853     |
| MSRs   | 134,682                                  | 6,073        |            |
|  | \$ 21,832,948                            | \$ 1,096,372 | \$ 39,853  |
| Distressed mortgage loans and REO:                       |  |              |            |
| Purchases  | \$ 543,063                               | \$ 454,834   | \$ 418,449 |
| Cash proceeds from liquidation activities                | \$ 320,580                               | \$ 211,752   | \$ 79,828  |
| MBS:   |  |              |            |
| Purchases  | \$ 112,211                               | \$ 21,420    | \$ 91,141  |
| Cash proceeds from repayment and sales                   | \$ 189,167                               | \$ 67,660    | \$ 58,560  |
| Share price:   |  |              |            |
| High   | \$ 25.52                                 | \$ 19.04     | \$ 18.25   |
| Low  | \$ 16.75                                 | \$ 15.14     | \$ 15.68   |
| At year end  | \$ 25.29                                 | \$ 16.62     | \$ 18.15   |
| At year end:   |  |              |            |
| Total assets   | \$ 2,559,663                             | \$ 1,386,062 | \$ 589,095 |
| Book value per share                                     | \$ 20.39                                 | \$ 19.22     | \$ 19.01   |

During 2012, we recorded net income of \$138.2 million, or \$3.14 per diluted share. Our net income for 2012 reflects net gains on our investments in financial instruments totaling \$251.3 million (comprised of net gain on investments and net gain on mortgage loans acquired for sale), including \$84.7 million of valuation gains on MBS and mortgage loans excluding mortgage loans acquired for sale, supplemented by \$72.4 million of interest income. Our results reflect the growth in our correspondent lending segment. During 2012, we purchased \$22.4 billion in fair value of newly originated mortgage loans. We recognized gains on such loans totaling approximately \$147.7 million. At December 31, 2012, we held mortgage loans acquired for sale with fair values totaling \$975.2 million.



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During 2011, we recorded net income of \$64.4 million, or \$2.41 per diluted share. Our net income for 2011 reflects net gains on our investments in financial instruments totaling \$90.3 million (comprised of net gain on investments and net gain on mortgage loans acquired for sale), including \$62.1 million of valuation gains on MBS and mortgage loans excluding mortgage loans acquired for sale, supplemented by \$36.1 million of interest income. Our results also reflect the growth in our correspondent lending segment. During 2011, we purchased \$1.3 billion in fair value of newly originated mortgage loans, \$1.0 billion of which were purchased during the fourth quarter. We recognized gains on such loans totaling approximately \$7.6 million. At December 31, 2011, we held mortgage loans acquired for sale with fair values totaling \$232.0 million.

During 2010, we recorded net income of \$24.5 million, or \$1.44 per diluted share. Our net income reflects net gains on our investments in financial instruments totaling \$27.4 million, including \$11.1 million of valuation gains on MBS and mortgage loans excluding mortgage loans acquired for sale, supplemented by \$14.6 million of interest income. We did not engage in correspondent lending activities to a material extent in 2010. Our net income for 2010 does not include provision for approximately \$500,000 of common overhead costs relating to the quarter ended March 31, 2010 that were otherwise due to PCM because PCM waived recovery of such costs through the first quarter of 2010 as discussed below.

PCM management waived recovery of common overhead during our startup period through March 31, 2010. From March 31, 2010, PCM has not waived, and we believe that PCM does not intend to waive in the future, recovery of common overhead costs. Our results for the years ended December 31, 2012, 2011 and 2010 include provision for reimbursement of \$4.2 million, \$3.8 million and \$1.4 million, respectively, of common overhead expenses.

## **Net Investment Income**

During 2012, we recorded net investment income of \$335.2 million, comprised primarily of net gains on investments in financial instruments of \$251.3 million supplemented by \$72.4 million of interest income, \$10.5 million of loan origination fees and \$1.4 million from results of REO. This compares to net investment income of \$128.6 million recognized during 2011, comprised primarily of \$90.3 million of net gains on investments in financial instruments, supplemented by \$36.1 million of interest income, \$1.1 million of loan origination fees and \$1.1 million of gains from results of REO. During 2010, we recorded net investment income of \$44.1 million, comprised primarily of \$27.4 million of net gains on investments in financial instruments, supplemented by \$14.6 million of interest income and \$2.0 million of gains from results of REO.

The growth in net investment income reflects the introduction of and growth in our correspondent lending activities as well as continued growth in our investment activities, all facilitated by issuances of common shares and increases in our borrowing capacity.

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Net investment income on financial instruments is summarized below:

|  | Year ended December 31, 2012 |                         |                  |                        |                       | Annualized %     |                     | Total return(2) |
|--|------------------------------|-------------------------|------------------|------------------------|-----------------------|------------------|---------------------|-----------------|
|  | Net gain (loss)              | Interest income/expense |                  | Total interest         | Total revenue/expense | Average balance  | Interest yield/cost |                 |
|  |                              | Coupon                  | Discount/fees(1) | (dollars in thousands) |                       |                  |                     |                 |
| <b>Assets:</b>                                       |                              |                         |                  |                        |                       |                  |                     |                 |
| Short-term investments                               | \$                           | \$ 42                   | \$               | \$ 42                  | \$ 42                 | \$ 49,880        | 0.08%               | 0.08%           |
| United States Treasury security                      |                              |                         |                  |                        |                       | 2,459            | 0.00%               | 0.01%           |
| <b>Mortgage-backed securities:</b>                   |                              |                         |                  |                        |                       |                  |                     |                 |
| Fannie Mae 30-year fixed                             | (233)                        | 1,476                   | (222)            | 1,254                  | 1,021                 | 44,713           | 2.76%               | 2.25%           |
| Non-Agency subprime                                  | 496                          | 181                     | 378              | 559                    | 1,055                 | 29,048           | 1.89%               | 3.57%           |
| Non-Agency Alt-A                                     | 211                          | 221                     | (32)             | 189                    | 400                   | 3,779            | 4.92%               | 10.42%          |
| Non-Agency prime jumbo                               | 138                          | 64                      | 18               | 82                     | 220                   | 2,464            | 3.25%               | 8.73%           |
| <b>Total mortgage-backed securities</b>              | <b>612</b>                   | <b>1,942</b>            | <b>142</b>       | <b>2,084</b>           | <b>2,696</b>          | <b>80,004</b>    | <b>2.56%</b>        | <b>3.31%</b>    |
| <b>Mortgage loans:</b>                               |                              |                         |                  |                        |                       |                  |                     |                 |
| <b>Correspondent lending:</b>                        |                              |                         |                  |                        |                       |                  |                     |                 |
| Acquired for sale at fair value                      | 147,675                      | 19,731                  |                  | 19,731                 | 167,406               | 452,824          | 4.29%               | 36.36%          |
| <b>Investment portfolio:</b>                         |                              |                         |                  |                        |                       |                  |                     |                 |
| At fair value  | 93,744                       | 49,462                  |                  | 49,462                 | 143,206               | 807,301          | 6.03%               | 17.45%          |
| Under forward purchase agreements at fair value      | 9,293                        | 997                     |                  | 997                    | 10,290                | 46,295           | 2.12%               | 21.86%          |
| <b>Total investment portfolio</b>                    | <b>103,037</b>               | <b>50,459</b>           |                  | <b>50,459</b>          | <b>153,496</b>        | <b>853,596</b>   | <b>5.81%</b>        | <b>17.69%</b>   |
| <b>Total mortgage loans</b>                          | <b>250,712</b>               | <b>70,190</b>           |                  | <b>70,190</b>          | <b>320,902</b>        | <b>1,306,420</b> | <b>5.28%</b>        | <b>24.16%</b>   |
| <b>Other interest</b>                                |                              | <b>125</b>              |                  | <b>125</b>             | <b>125</b>            |                  |                     |                 |
|  | \$ 251,324                   | \$ 72,299               | \$ 142           | \$ 72,441              | \$ 323,765            | \$ 1,438,763     | 4.95%               | 22.13%          |
| <b>Liabilities:</b>                                  |                              |                         |                  |                        |                       |                  |                     |                 |
| <b>Assets sold under agreements to repurchase:</b>   |                              |                         |                  |                        |                       |                  |                     |                 |
| Securities   | \$                           | \$ 488                  | \$               | \$ 488                 | \$ 488                | \$ 74,560        | 0.64%               |                 |
| Mortgage loans acquired for sale at fair value       |                              | 9,725                   | 3,255            | 12,980                 | 12,980                | 412,242          | 3.10%               |                 |
| Mortgage loans at fair value                         |                              | 11,597                  | 1,579            | 13,176                 | 13,176                | 300,285          | 4.32%               |                 |
| Real estate acquired in settlement of loans          |                              | 714                     | 500              | 1,214                  | 1,214                 | 16,666           | 7.16%               |                 |
| Note payable secured by warehouse notes receivable   |                              |                         | 167              | 167                    | 167                   |                  |                     |                 |
| Note payable secured by mortgage loans at fair value |                              | 121                     | (8)              | 113                    | 113                   | 1,708            | 6.47%               |                 |
| Borrowings under forward purchase agreements         |                              | 2,396                   |                  | 2,396                  | 2,396                 | 58,719           | 4.01%               |                 |
| <b>Interest bearing liabilities</b>                  |                              | <b>25,041</b>           | <b>5,493</b>     | <b>30,534</b>          | <b>30,534</b>         | <b>864,180</b>   | <b>3.48%</b>        |                 |
| <b>Other interest - servicing related</b>            |                              | <b>1,108</b>            |                  | <b>1,108</b>           | <b>1,108</b>          |                  |                     |                 |

## Edgar Filing: PennyMac Mortgage Investment Trust - Form 10-K

|    |           |          |           |           |            |
|----|-----------|----------|-----------|-----------|------------|
| \$ | \$ 26,149 | \$ 5,493 | \$ 31,642 | \$ 31,642 | \$ 864,180 |
|----|-----------|----------|-----------|-----------|------------|

- (1) Amounts in this column represent accrual of unearned discounts for assets and amortization of facility commitment fees for liabilities.
- (2) Total return includes the net gain (loss) and interest income relating to the asset and does not include the cost of managing the asset or indirect costs incurred in PCM's management of us.

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|  | Year ended December 31, 2011 |                         |                      |                        |                              |                    |                        |                    |
|--|------------------------------|-------------------------|----------------------|------------------------|------------------------------|--------------------|------------------------|--------------------|
|  | Net gain<br>(loss)           | Interest income/expense |                      | Total<br>interest      | Total<br>revenue/<br>expense | Annualized %       |                        | Total<br>return(2) |
|  |                              | Coupon                  | Discount/<br>fees(1) | (dollars in thousands) |                              | Average<br>balance | Interest<br>yield/cost |                    |
| <b>Assets:</b>                                       |                              |                         |                      |                        |                              |                    |                        |                    |
| Short-term investments                               | \$                           | \$ 100                  | \$                   | \$ 100                 | \$ 100                       | \$ 44,686          | 0.22%                  | 0.22%              |
| United States Treasury security                      |                              |                         |                      |                        |                              | 548                | 0.00%                  | 0.00%              |
| Mortgage-backed securities:                          |                              |                         |                      |                        |                              |                    |                        |                    |
| Non-Agency subprime                                  | (2,643)                      | 380                     | 1,746                | 2,126                  | (517)                        | 72,027             | 2.91%                  | (0.71)%            |
| Non-Agency Alt-A                                     | 40                           | 648                     | 218                  | 866                    | 906                          | 11,602             | 7.36%                  | 7.70%              |
| Non-Agency prime jumbo                               | (209)                        | 208                     | 29                   | 237                    | 28                           | 7,639              | 3.06%                  | 0.36%              |
| Total mortgage-backed securities                     | (2,812)                      | 1,236                   | 1,993                | 3,229                  | 417                          | 91,268             | 3.49%                  | 0.45%              |
| <b>Mortgage loans:</b>                               |                              |                         |                      |                        |                              |                    |                        |                    |
| Correspondent lending:                               |                              |                         |                      |                        |                              |                    |                        |                    |
| Acquired for sale at fair value                      | 7,633                        | 2,085                   |                      | 2,085                  | 9,718                        | 47,931             | 4.29%                  | 20.00%             |
| Investment portfolio:                                |                              |                         |                      |                        |                              |                    |                        |                    |
| At fair value  | 71,098                       | 29,603                  |                      | 29,603                 | 100,701                      | 568,922            | 5.13%                  | 17.46%             |
| Under forward purchase agreements at fair value      | 14,357                       | 1,131                   |                      | 1,131                  | 15,488                       | 66,308             | 1.68%                  | 23.04%             |
| Total investment portfolio                           | 85,455                       | 30,734                  |                      | 30,734                 | 116,189                      | 635,230            | 4.77%                  | 18.04%             |
| Total mortgage loans                                 | 93,088                       | 32,819                  |                      | 32,819                 | 125,907                      | 683,161            | 4.74%                  | 18.18%             |
|  | \$ 90,276                    | \$ 34,155               | \$ 1,993             | \$ 36,148              | \$ 126,424                   | \$ 819,663         | 4.35%                  | 15.22%             |
| <b>Liabilities:</b>                                  |                              |                         |                      |                        |                              |                    |                        |                    |
| Assets sold under agreements to repurchase:          |                              |                         |                      |                        |                              |                    |                        |                    |
| Securities   | \$                           | \$ 873                  | \$                   | \$ 873                 | \$ 873                       | \$ 78,021          | 1.10%                  |                    |
| Mortgage loans acquired for sale at fair value       |                              | 1,167                   | 1,259                | 2,426                  | 2,426                        | 43,713             | 5.47%                  |                    |
| Mortgage loans at fair value                         |                              | 8,901                   | 741                  | 9,642                  | 9,642                        | 233,594            | 4.07%                  |                    |
| Real estate acquired in settlement of loans          |                              | 360                     | 275                  | 635                    | 635                          | 8,341              | 7.52%                  |                    |
| Note payable secured by mortgage loans at fair value |                              | 212                     | 42                   | 254                    | 254                          | 8,265              | 3.03%                  |                    |
| Borrowings under forward purchase agreements         |                              | 3,116                   |                      | 3,116                  | 3,116                        | 74,864             | 4.11%                  |                    |
|  | \$                           | \$ 14,629               | \$ 2,317             | \$ 16,946              | \$ 16,946                    | \$ 446,798         | 3.74%                  |                    |

- (1) Amounts in this column represent accrual of unearned discounts for assets and amortization of facility commitment fees for liabilities.
- (2) Total return includes the net gain (loss) and interest income relating to the asset and does not include the cost of managing the asset or indirect costs incurred in PCM's management of us.



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|  | Year ended December 31, 2010 |              |   |                   |                              |                                    |                        |                 |
|--|------------------------------|--------------|---|-------------------|------------------------------|------------------------------------|------------------------|-----------------|
|  | Net gain<br>(loss)           | Coupon       | Interest income/expense<br>Discount/<br>fees(1) | Total<br>interest | Total<br>revenue/<br>expense | Annualized %<br>Average<br>balance | Interest<br>yield/cost | Total<br>return |
| (dollars in thousands)                             |                              |              |   |                   |                              |                                    |                        |                 |
| <b>Assets:</b>                                     |                              |              |   |                   |                              |                                    |                        |                 |
| Short-term investments                             | \$                           | \$ 86        | \$  | \$ 86             | \$ 86                        | \$ 69,405                          | 0.13%                  | 0.13%           |
| <b>Mortgage-backed securities:</b>                 |                              |              |   |                   |                              |                                    |                        |                 |
| Non-Agency subprime                                | (271)                        | 320          | 2,606   | 2,926             | 2,655                        | 61,390                             | 4.70%                  | 4.26%           |
| Non-Agency Alt-A                                   | 254                          | 1,136        | 643   | 1,779             | 2,033                        | 21,383                             | 8.21%                  | 9.38%           |
| Non-Agency prime jumbo                             | 250                          | 443          | 38  | 481               | 731                          | 14,242                             | 3.33%                  | 5.06%           |
| <b>Total mortgage-backed securities</b>            | <b>233</b>                   | <b>1,899</b> | <b>3,287</b>                                    | <b>5,186</b>      | <b>5,419</b>                 | <b>97,015</b>                      | <b>5.27%</b>           | <b>5.51%</b>    |
| <b>Mortgage loans:</b>                             |                              |              |   |                   |                              |                                    |                        |                 |
| <b>Correspondent lending:</b>                      |                              |              |   |                   |                              |                                    |                        |                 |
| Acquired for sale at fair value                    | 18                           | 52           |   | 52                | 70                           | 1,881                              | 2.73%                  | 3.74%           |
| <b>Investment portfolio:</b>                       |                              |              |   |                   |                              |                                    |                        |                 |
| At fair value                                      | 27,195                       | 9,250        |   | 9,250             | 36,445                       | 176,238                            | 5.18%                  | 20.40%          |
| <b>Total mortgage loans</b>                        | <b>27,213</b>                | <b>9,302</b> |   | <b>9,302</b>      | <b>36,515</b>                | <b>178,119</b>                     | <b>5.15%</b>           | <b>20.22%</b>   |
|  | \$ 27,446                    | \$ 11,287    | \$ 3,287  | \$ 14,574         | \$ 42,020                    | \$ 344,539                         | 4.17%                  | 12.03%          |
| <b>Liabilities:</b>                                |                              |              |   |                   |                              |                                    |                        |                 |
| <b>Assets sold under agreements to repurchase:</b> |                              |              |   |                   |                              |                                    |                        |                 |
| Securities   | \$                           | \$ 620       | \$  | \$ 620            | \$ 620                       | \$ 44,590                          | 1.39%                  |                 |
| Mortgage loans acquired for sale at fair value     |                              |              |   |                   |                              | 20                                 | 3.66%                  |                 |
| Mortgage loans at fair value                       |                              | 206          |   | 206               | 206                          | 6,148                              | 3.35%                  |                 |
|  | \$                           | \$ 826       | \$  | \$ 826            | \$ 826                       | \$ 50,758                          | 1.63%                  |                 |

(1) Amounts in this column represent accrual of unearned discounts for assets and amortization of facility commitment fees for liabilities.  
*Net Gain on Mortgage Loans Acquired for Sale*

During the year ended December 31, 2012, we recorded a net gain of \$147.7 million on mortgage loans acquired for sale which included approximately \$134.7 million in fair values of MSRs received as part of the proceeds from those sales. During the year ended December 31, 2011, we recorded a net gain of \$7.6 million on mortgage loans acquired for sale which included approximately \$6.1 million in fair values of MSRs received as part of the proceeds from those sales. During the year ended December 31, 2010, we recorded a gain of \$18,000 on mortgage loans acquired for sale which arose from the sale of a portion of a pool of distressed loans that was contemplated in the acquisition of those loans.

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We recognized gains on mortgage loans acquired for sale as summarized below:

|  | 2012          | Year ended December 31,<br>2011<br>(in thousands) | 2010      |
|--|---------------|---|-----------|
| Cash gain (loss):  |               |   |           |
| Sales proceeds   | \$ 13,918     | \$ (1,571)  | \$ 78     |
| Hedging activities   | (57,040)      | (4,794)   | 20        |
|  | (43,122)      | (6,365)   | 98        |
| Non cash gain:   |               |   |           |
| Change in fair value of commitments to purchase loans                                  | 13,707        | 5,772   |           |
| Receipt of MSR in loan sale transactions   | 134,682       | 6,073   |           |
| Provision for losses relating to representations and warranties provided in loan sales | (4,236)       | (205)   | (12)      |
| Change in fair value relating to loans and hedging derivatives held at year-end:       |               |   |           |
| Mortgage loans   | 43,691        | 6,192   | (24)      |
| Hedging derivatives  | 2,953         | (3,834)   | (44)      |
|  | 46,644        | 2,358   | (68)      |
|  | \$ 147,675    | \$ 7,633  | \$ 18     |
| Effect on gain on sale of mortgage loans acquired for sale of:                         |               |   |           |
| Change in volume of loans sold   | \$ 140,225    | *   |           |
| Change in gain on sale margin  | (183)         | *   |           |
|  | \$ 140,042    | *   |           |
| Interest rate lock commitments issued during the year:                                 |               |   |           |
| Conventional mortgage loans  | \$ 15,692,828 | \$ 954,634  | \$        |
| Government-insured or guaranteed loans   | 10,163,889    | 824,831   |           |
| Interest rate lock commitments issued during year                                      | \$ 25,856,717 | \$ 1,779,465                                      | \$        |
| Purchase price of mortgage loans acquired for sale sold during the year:               |               |   |           |
| Conventional mortgage loans  | \$ 12,846,452 | \$ 517,980  | \$ 21,552 |
| Government-insured or guaranteed loans   | 8,861,755     | 577,697   | 3,109     |
|  | \$ 21,708,207 | \$ 1,095,677                                      | \$ 24,661 |
| Fair value of mortgage loans acquired for sale held at year end                        |               |   |           |
| Conventional mortgage loans  | \$ 153,326    | \$ 46,266   |           |
| Government-insured or guaranteed loans   | 821,858       | 185,750   |           |
|  | \$ 975,184    | \$ 232,016  |           |

\* The change in gain on sale during 2011 as compared to 2010 is not meaningful as our loan sales activity was just beginning at the end of 2010.

Our gain on mortgage loans acquired for sale includes both cash and non cash elements. We receive proceeds on sale that include both cash and our estimate of the value of MSRs. MSRs represent the value of a contract that obligates us to service the mortgage loans we sell on behalf of the purchaser of the loan in exchange for servicing fees and the right to collect certain ancillary income from the borrower. We recognize MSRs at

our estimate of the fair value of the contract to service the loans.

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

| Key Inputs                        | 2012           |              | Year ended December 31,<br>2011 |       |                |            | 2010           |            |
|-----------------------------------|----------------|--------------|---------------------------------|-------|----------------|------------|----------------|------------|
|                                   | Amortized cost | Fair value   | Range<br>(Weighted average)     |       | Amortized cost | Fair value | Amortized cost | Fair value |
| Pricing spread(1)                 | 7.5% - 22.8%   | 7.5% - 16.5% | 7.5%                            | 18.0% | 7.5%           | 15.3%      |                |            |
|                                   | (7.5%)         | (7.9%)       | (7.7%)                          |       | (9.5%)         |            |                |            |
| Life (in years)                   | 1.9 - 7.0      | 2.4 - 7.0    | 3.0 - 8.1                       |       | 2.0 - 8.2      |            |                |            |
|                                   | (6.4)          | (6.1)        | (6.9)                           |       | (6.0)          |            |                |            |
| Annual total prepayment speed(2)  | 6.7% - 45.0%   | 7.9% - 51.5% | 5.8%                            | 24.4% | 6.8%           | 27.8%      |                |            |
|                                   | (9.1%)         | (12.7%)      | (7.7%)                          |       | (13.7%)        |            |                |            |
| Annual per-loan cost of servicing | \$68 - \$140   | \$68 - \$140 | \$53                            | \$140 | \$53           | \$140      |                |            |
|                                   | (\$68)         | (\$74)       | (\$69)                          |       | (\$85)         |            |                |            |

(1) Pricing spread represents a margin that is applied to a reference interest rate's forward rate curve to develop periodic discount rates. We apply 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) Annual total prepayment speed is measured using Life Total CPR.

We also provide for our estimate of the future losses that we may be required to incur as a result of our breach of representations and warranties provided to the purchasers of the loans we sold. We evaluate the adequacy of our estimate based on our loss experience and our assessment of future losses to be incurred relating to loans we have previously sold and which remain outstanding at the balance sheet date. As our portfolio of loans sold subject to representations and warranties grows and as economic fundamentals change, such adjustments can be material. However, we believe our current estimates represent the future losses to be incurred on our servicing portfolio of mortgage loans sold subject to representations and warranties.

Our hedging activities primarily involve forward sales of our inventory and IRLCs as well as purchases of options to sell and options to purchase MBS. Following is a summary of the notional activity in our hedging derivatives:

| Period/instrument                   | Balance,<br>beginning<br>of year | Additions     | Dispositions/<br>expirations | Balance,<br>end<br>of year |
|-------------------------------------|----------------------------------|---------------|------------------------------|----------------------------|
| (in thousands)                      |                                  |               |                              |                            |
| <b>Year ended December 31, 2012</b> |                                  |               |                              |                            |
| MBS put options                     | \$ 28,000                        | \$ 2,585,000  | \$ (2,118,000)               | \$ 495,000                 |
| MBS call options                    | \$ 5,000                         | \$ 90,000     | \$ (95,000)                  | \$                         |
| Interest rate swaptions             | \$                               | \$ 170,000    | \$ (170,000)                 | \$                         |
| MBS forward purchase contracts      | \$ 398,400                       | \$ 23,800,622 | \$ (21,992,483)              | \$ 2,206,539               |
| MBS forward sales contracts         | \$ 756,691                       | \$ 38,995,923 | \$ (35,485,631)              | \$ 4,226,983               |
| <b>Year ended December 31, 2011</b> |                                  |               |                              |                            |
| MBS put options                     | \$                               | \$ 66,000     | \$ (38,000)                  | \$ 28,000                  |
| MBS call options                    | \$                               | \$ 13,000     | \$ (8,000)                   | \$ 5,000                   |
| Interest rate swaptions             | \$                               | \$            | \$                           | \$                         |
| MBS forward purchase contracts      | \$                               | \$ 2,191,713  | \$ (1,793,313)               | \$ 398,400                 |
| MBS forward sales contracts         | \$                               | \$ 1,139,247  | \$ (382,556)                 | \$ 756,691                 |

We did not have any hedging derivative contracts on or before December 31, 2010.

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### Net Gain (Loss) on Investments

During 2012, we recognized net gains on financial instruments totaling \$251.3 million compared to \$90.3 million in 2011. The increase in 2012 is primarily related to our correspondent lending operations. We recognized higher fair value returns on our mortgage loans acquired for sale at fair value as compared to mortgage loans at fair value, and our average investment in mortgage loans acquired for sale increased from 7% of the average balance of mortgage loans in 2011 to 35% of the average balance of mortgage loans in 2012. Our average portfolio balance of mortgage loans increased \$623.3 million or 91% during 2012 as compared to 2011.

During 2011, we recognized net gains on financial instruments totaling \$90.3 million compared to \$27.4 million in 2010. The increase in 2011 as compared to 2010 is due primarily to growth in our portfolio of investments in financial instruments, compounded by a change in the mix of our investments toward a higher concentration of mortgage loans at fair value. We recognized higher fair value returns on our investment in mortgage loans at fair value as compared to MBS, and our average investment in mortgage loans at fair value increased from 51% of the average balance of our investments in 2010 to 78% of the average balance of our investments in 2011. Our average portfolio balance increased \$474.6 million or 138% during 2011 as compared to 2010.

During 2012, we recognized net valuation gains on our portfolios of MBS totaling \$0.6 million compared to net valuation losses of \$2.8 million in 2011. The valuation gains represent the change in value through the date of sale of the respective securities. We sold all of our MBS during the year ended December 31, 2012. At December 31, 2012, we did not hold any MBS.

During 2011, we recognized net valuation losses on our portfolios of MBS totaling \$2.8 million compared to net valuation gains of \$233,000 in 2010. The valuation losses reflect, in part, marketplace concerns regarding the potentially growing supply of MBS similar to those we held as a result of sales by the Federal Reserve Bank and other entities, marketplace discounting of distressed MBS resulting from expectations that involuntary prepayments of mortgages underlying the securities would remain slow or slow further due to regulatory actions relating to servicers foreclosure activities, and marketplace concern regarding servicers behavior with respect to advancing and modification practices. Valuation of certain MBS also decreased due to reduced credit support from subordinate tranches. The weighted average discount rate of the non-Agency subprime MBS, the most sizable component of our MBS portfolio, increased from 4.5% at December 31, 2010 to 8.0% at December 31, 2011, reflective of those market factors.

Net gains on mortgage loans at fair value and mortgage loans under forward purchase agreements under fair value are summarized below:

|                       | Year ended December 31, |           |           |
|-----------------------|-------------------------|-----------|-----------|
|                       | 2012                    | 2011      | 2010      |
|                       | (in thousands)          |           |           |
| Valuation changes(1): |                         |           |           |
| Performing loans      | \$ 2,592                | \$ 9,542  |           |
| Nonperforming loans   | 81,225                  | 55,730    |           |
|                       | 83,817                  | 65,272    | \$ 10,754 |
| Payoffs               | 19,341                  | 19,950    | 12,036    |
| Sales                 | (121)                   | 233       | 4,405     |
|                       | \$ 103,037              | \$ 85,455 | \$ 27,195 |

(1) Comparative prior period information was not maintained for the year ended December 31, 2010.

The net gains on mortgage loans arising from valuation changes were due primarily to changes in home prices during 2012 and 2011 that were more positive than had been projected and to changes in value of loans as the loans moved through the resolution process and as nonperforming loans were modified and/or brought

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current. The increase in the valuation gains in 2012 as compared to 2011 reflects the growth in our investment in mortgage loans at fair value in 2012 as compared to 2011. Our valuation gains for the year ended December 31, 2011 also reflect an increase in the collectability of claims on government-insured loans as well as increasing demand for distressed mortgage loans as reflected in increased transaction prices. As a result of this market observation, the discount rates we use to estimate the fair value of certain of our mortgage loans were reduced.

The increase in valuation changes in 2012 as compared to 2011 is due to the growth and seasoning of our portfolio of mortgage loans at fair value (including mortgage loans under forward purchase agreements). Our average investment in mortgage loans at fair value increased \$218.4 million or 34% from 2011 to 2012.

The increase in valuation changes in 2011 as compared to 2010 is due to the growth and seasoning of our portfolio of mortgage loans at fair value (including mortgage loans under forward purchase agreements). Our average investment in mortgage loans at fair value increased \$459.0 million or 260% from 2010 to 2011. Furthermore, our initial acquisitions of mortgage loans at fair value occurred in December of 2009 and were only beginning to move through the resolution process during 2010.

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Following is a comparison of the valuation techniques and key inputs we use in the valuation of our financial assets that are measured using Level 3 inputs:

| Financial statement item                                       | Valuation technique  | Key inputs(1)                                     | Range<br>(Weighted average) |                   |
|--|----------------------|---|-----------------------------|-------------------|
|  |                      |   | December 31, 2012           | December 31, 2011 |
| Mortgage-backed securities(1):                                 | Broker quote(2)      |   |                             |                   |
| Agency MBS   |                      | Discount rate                                     |                             |                   |
|  |                      | Prepayment speed(3)                               |                             |                   |
|  |                      | Default speed(4)                                  |                             |                   |
|  |                      | Collateral remaining loss percentage(5)           |                             |                   |
| Non-Agency subprime  |                      | Discount rate                                     | 3.1%                        | 23.0%             |
|  |                      |   | (8.0%)                      |                   |
|  |                      | Prepayment speed(3)                               | 0.1%                        | 8.4%              |
|  |                      |   | (4.4%)                      |                   |
|  |                      | Default speed(4)                                  | 3.6%                        | 19.8%             |
|  |                      |   | (12.3%)                     |                   |
|  |                      | Collateral remaining loss percentage(5)           | 23.9%                       | 63.7%             |
|  |                      |   | (47.0%)                     |                   |
| Non-Agency Alt-A   |                      | Discount rate                                     | 4.4%                        | 10.0%             |
|  |                      |   | (6.2%)                      |                   |
|  |                      | Prepayment speed(3)                               | 0.5%                        | 8.9%              |
|  |                      |   | (5.4%)                      |                   |
|  |                      | Default speed(4)                                  | 3.0%                        | 11.5%             |
|  |                      |   | (9.7%)                      |                   |
|  |                      | Collateral remaining loss percentage(5)           | 11.4%                       | 36.4%             |
|  |                      |   | (26.0%)                     |                   |
| Non-Agency prime jumbo   |                      | Discount rate                                     | 6.5%                        | 6.5%              |
|  |                      |   | (6.5%)                      |                   |
|  |                      | Prepayment speed(3)                               | 14.3%                       | 14.3%             |
|  |                      |   | (14.3%)                     |                   |
|  |                      | Default speed(4)                                  | 1.5%                        | 1.5%              |
|  |                      |   | (1.5%)                      |                   |
|  |                      | Collateral remaining loss percentage(5)           | 0.4%                        | 0.4%              |
|  |                      |   | (0.4%)                      |                   |
| Mortgage loans at fair value                                   | Discounted cash flow | Discount rate                                     | 8.8%                        | 20.7%             |
|  |                      |   | (13.1%)                     | (14.4%)           |
|  |                      | Twelve-month projected housing price index change | 0.4%                        | 1.5%              |
|  |                      |   | (1.1%)                      | (-0.3%)           |
|  |                      | Prepayment speed(6)                               | 0.4%                        | 4.4%              |
|  |                      |   | (2.2%)                      | (2.3%)            |
|  |                      | Total prepayment speed (Life total CPR)           | 5.9%                        | 31.2%             |
|  |                      |   | (20.6%)                     | (25.4%)           |
| Mortgage loans under forward purchase agreements at fair value | Discounted cash flow | Discount rate                                     | 16.3%                       | 20.8%             |
|  |                      |   | (17.1%)                     |                   |
|  |                      | Twelve-month projected housing price index change | -0.5%                       | -0.4%             |
|  |                      |   | (-0.5%)                     |                   |
|  |                      | Prepayment speed(6)                               | 0.7%                        | 0.8%              |
|  |                      |   | (0.8%)                      |                   |
|  |                      | Total prepayment speed (Life total CPR)           | 30.1%                       | 33.3%             |
|  |                      |   | (32.7%)                     |                   |





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- (1) With respect to mortgage-backed securities, key inputs are those used to evaluate broker indications of value.
- (2) For indications of value received, PCM's FAV group reviews the price indications provided by non-affiliate brokers for completeness, accuracy and consistency across all similar bonds 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.
- (3) Prepayment speed is measured using one year Voluntary Conditional Prepayment Rate (CPR).
- (4) Default speed is measured using one year constant default rate.
- (5) The projected future losses on the loans in the collateral groups paying to each bond as a percentage of the current balance of the loans.
- (6) Prepayment speed is measured using Life CPR.

We monitor and value our investments in pools of distressed mortgage loans. Most of the measures we use to value and monitor the loan portfolio, such as projected prepayment and default speeds and discount rates, are applied or output at the pool level. The characteristics of the individual loans, such as loan size, loan-to-value ratio, and geography, can vary widely within a pool.

The weighted average discount rate used in the valuation of mortgage loans at fair value decreased slightly from 14.4% at December 31, 2011 to 13.1% at December 31, 2012 due to a combination of lower yielding portfolio acquisitions and to the effect on discount rates of increasing market demand for distressed mortgage loans.

The weighted average twelve month projected Housing Price Index (HPI) of mortgage loans at fair value improved from -0.3% at December 31, 2011 to 1.1% at December 31, 2012. This improvement primarily reflects the movement of the portfolio toward the projected housing price bottom with the passage of time.

The total prepayment speed of mortgage loans at fair value decreased from 25.4% at December 31, 2011 to 20.6% at December 31, 2012, primarily due to a greater than expected volume of reinstatements of nonperforming loans and lower than expected rates of defaults of distressed performing loans as well as lengthening of expected liquidation timelines.

While we believe that the Company's current fair value estimates are representative of fair value at the reporting date, the market for our mortgage assets is illiquid with very few market participants. Furthermore, our business strategy is to enhance value during the period in which the loans are held; any resulting appreciation or depreciation in the fair value of the loans is recorded during such holding period and ultimately realized at the end of the holding period.

Gains on mortgage loan payoffs are summarized below:

|                           | Year ended December 31, |            |           |
|---------------------------|-------------------------|------------|-----------|
|                           | 2012                    | 2011       | 2010      |
| Number of loans           | 836                     | 674        | 258       |
| Unpaid principal balance  | \$ 259,469              | \$ 226,338 | \$ 63,090 |
| Gain recognized at payoff | \$ 19,341               | \$ 19,950  | \$ 12,036 |

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The lower gain on payoff observed in 2012 compared to 2011 is driven by a combination of lower overall payoff activity on a relative basis than in 2011 in combination with a greater estimate of value embedded in those loans likely to payoff, thus reducing the realized gain when the payoff event occurs.

The increase in gains recognized at payoff in 2011 reflects the significant growth in the average balance of our mortgage loan portfolio of \$459.0 million, or 260%, for the year ended December 31, 2011 compared to the year ended December 31, 2010, partly offset by certain of the acquisitions we made during 2010 that provided large gains on payoffs very early in the acquisition and holding period. Acquisitions made during 2011 did not result in similar gains.

Gains on sales of distressed mortgage loans are summarized below:

|                                | Year ended December 31, |          |           |
|--------------------------------|-------------------------|----------|-----------|
|                                | 2012                    | 2011     | 2010      |
| Number of loans                |                         | 13       | 188       |
| Unpaid principal balance       | \$                      | \$ 5,524 | \$ 62,549 |
| Gain (loss) recognized at sale | \$ (121)                | \$ 233   | \$ 4,405  |

The following table presents a summary of loan modifications completed:

| Modification type(1)                | Year ended December 31, |                     |                 |                     |                 |                     |
|-------------------------------------|-------------------------|---------------------|-----------------|---------------------|-----------------|---------------------|
|                                     | 2012                    |                     | 2011            |                     | 2010            |                     |
|                                     | Number of loans         | Balance of loans(2) | Number of loans | Balance of loans(2) | Number of loans | Balance of loans(2) |
| (dollar amounts in thousands)       |                         |                     |                 |                     |                 |                     |
| Rate reduction                      | 449                     | \$ 115,175          | 276             | \$ 66,812           | 34              | \$ 9,313            |
| Term extension                      | 287                     | \$ 74,315           | 114             | \$ 30,848           | 16              | \$ 4,925            |
| Capitalization of interest and fees | 706                     | \$ 170,523          | 365             | \$ 88,815           | 34              | \$ 9,657            |
| Principal forbearance               | 81                      | \$ 25,117           | 34              | \$ 11,089           | 6               | \$ 2,165            |
| Principal reduction                 | 293                     | \$ 75,886           | 193             | \$ 46,375           | 2               | \$ 907              |
| Total                               | 706                     | \$ 170,523          | 365             | \$ 88,815           | 35              | \$ 9,891            |

(1) Modification type categories are not mutually exclusive, and a modification of a single loan may be counted in multiple categories if applicable. The total number of modifications noted in the table is therefore less than the sum of all of the categories.

(2) Before modification.

The following table summarizes the average effect of the modifications noted above to the terms of the loans modified:

| Category                      | 2012                |                    | 2011                |                    | 2010                |                    |
|-------------------------------|---------------------|--------------------|---------------------|--------------------|---------------------|--------------------|
|                               | Before modification | After modification | Before modification | After modification | Before modification | After modification |
| (Dollar amounts in thousands) |                     |                    |                     |                    |                     |                    |
| Loan balance                  | \$ 242              | \$ 227             | \$ 243              | \$ 220             | \$ 283              | \$ 297             |
| Remaining term (months)       | 304                 | 362                | 311                 | 354                | 315                 | 369                |
| Interest rate                 | 6.44%               | 4.10%              | 6.77%               | 3.86%              | 6.79%               | 2.77%              |
| Forbeared principal           | \$                  | \$ 6               | \$                  | \$ 4               | \$                  | \$ 10              |

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### Interest Income

At December 31, 2012, approximately 66% of the fair value of our portfolio of mortgage loans was nonperforming, which compares to 71% at December 31, 2011. We do not accrue interest on nonperforming loans and generally do not recognize revenues other than changes in the properties' values during the period we hold REO. We calculate the yield on our mortgage loan portfolio based on the portfolio's average fair value, which most closely reflects our investment in the mortgage loans. Accordingly, the yield we realize is substantially higher than would be recorded based on the loans' unpaid balances as we purchase our mortgage loans at substantial discounts to their unpaid principal balances.

The revenue benefits of nonperforming loans and REO generally take longer to realize than those of performing loans due to the time required to work with borrowers to resolve payment issues through our modification programs and to acquire and liquidate the property securing the mortgage loans. The value and returns we realize from these assets are determined by our ability to cure the borrowers' defaults, or when curing of borrower defaults is not a viable solution, by our ability to effectively manage the liquidation process. As a participant in HAMP, we are required to comply with the process specified by the HAMP program before liquidating a loan, and this may extend the liquidation process. At December 31, 2012, we held \$786.0 million in fair value of nonperforming loans and \$88.1 million in carrying value of REO.

In 2012, we earned interest income of \$72.4 million, compared to \$36.1 million and \$14.6 million in 2011 and 2010, respectively. The effects of changes in the composition of our investments on our interest income are summarized below:

|   | 2012 vs. 2011<br>Increase (decrease)<br>due to changes in |           |                                   | 2011 vs. 2010<br>Increase (decrease)<br>due to changes in |           |                 |
|---|---|-----------|-----------------------------------|---|-----------|-----------------|
|   | Rate  | Volume    | Total<br>change<br>(in thousands) | Rate  | Volume    | Total<br>change |
| Short-term investments                          | \$ (69)   | \$ 11     | \$ (58)                           | \$ 52   | \$ (38)   | \$ 14           |
| Mortgage-backed securities:                     |   |           |                                   |   |           |                 |
| FNMA conventional                               |   | 1,254     | 1,254                             |   |           |                 |
| Non-Agency subprime                             | (579)   | (988)     | (1,567)                           | (1,247)   | 447       | (800)           |
| Non-Agency Alt-A                                | (223)   | (454)     | (677)                             | (168)   | (745)     | (913)           |
| Non-Agency prime jumbo                          | 14  | (169)     | (155)                             | (36)  | (208)     | (244)           |
| Total mortgage-backed securities                | (788)   | (357)     | (1,145)                           | (1,451)   | (506)     | (1,957)         |
| Mortgage loans:                                 |   |           |                                   |   |           |                 |
| Investment portfolio:                           |   |           |                                   |   |           |                 |
| At fair value                                   | 5,833   | 14,026    | 19,859                            | (80)  | 20,433    | 20,353          |
| Under forward purchase agreements at fair value | 253   | (387)     | (134)                             |   | 1,131     | 1,131           |
| Total investment portfolio                      | 6,086   | 13,639    | 19,725                            | (80)  | 21,564    | 21,484          |
| Acquired for sale at fair value                 | (2)   | 17,648    | 17,646                            | 47  | 1,986     | 2,033           |
| Total mortgage loans                            | 6,084   | 31,287    | 37,371                            | (33)  | 23,550    | 23,517          |
| Other interest                                  |   | 125       | 125                               |   |           |                 |
|   | \$ 5,227  | \$ 31,066 | \$ 36,293                         | \$ (1,432)  | \$ 23,006 | \$ 21,574       |

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### **Mortgage-backed securities**

We invest in MBS as a complement to our investments in mortgage loans and as a means of ensuring our compliance with REIT tax regulations governing our asset composition. At December 31, 2012, we had no MBS in our portfolio. During the period we held MBS in 2012, our portfolio of MBS consisted primarily of currently cash flowing, senior priority MBS.

During 2012, interest income on MBS decreased \$1.1 million compared to 2011. The decrease was attributable to a decrease in yield to 2.56% from 3.49%, coupled with an \$11.2 million or 12% decrease in the average balance of MBS.

In 2011, we earned interest income of \$3.2 million and recognized net fair value losses totaling \$2.8 million on our portfolio of MBS. The decrease of \$2.0 million in interest income on our MBS during 2011 compared to 2010 is attributable to a decrease in the yield on our portfolio of MBS from 5.27% to 3.49%. This decrease was compounded by a \$5.8 million decrease in the average investment in MBS during 2011 as compared to 2010. These comparisons reflect the growth of our investment in MBS during 2010, followed by net repayments of the securities as investments in mortgage loans became our primary investment activity later in 2010 through December 31, 2011.

In 2010, we earned interest income of \$5.2 million and recognized net fair value gains totaling \$233,000 on our portfolio of MBS. During 2010, we purchased \$91.1 million of MBS, increasing our average investment in MBS by \$33.7 million. This increase contributed a \$1.7 million increase to interest income. This increase was partially offset by a decrease in yields of these securities from 7.33% to 5.27%. Both the decrease in yield on MBS and appreciation in the securities' fair values were primarily due to increased demand for non-Agency MBS in the marketplace that were not being matched by increased securitization volumes. Gains on MBS were the result of valuation changes as we did not sell any MBS during 2010.

### **Mortgage loans**

In 2012, we recognized interest income on mortgage loans at fair value of \$70.2 million, which compares to \$32.8 million in 2011. Interest income on our investment portfolio (excluding mortgage loans acquired for sale at fair value) increased \$19.7 million or 64% to \$50.5 million based on a \$218.4 million or 34% increase in average balance, coupled with an increase in yield to 5.81% from 4.77%, which reflects the increased level of performing loans in our portfolio. The percentage of our portfolio comprised of performing loans increased from 25% to 34%, or a 36% increase in the performing portion of the portfolio. At December 31, 2012, our investment in performing mortgage loans had a weighted-average coupon of 4.13%, compared to 4.61% at December 31, 2011.

Interest income on our mortgage loans acquired for sale increased \$17.6 million or 846% to \$19.7 million in 2012 based on a \$404.9 million or 845% increase in average balance, while the yield remained consistent at 4.29%.

In 2011 we recognized interest income on mortgage loans at fair value of \$32.8 million, which compares to \$9.3 million in 2010. During the year ended December 31, 2011, we recognized annualized interest of 4.77% on our portfolio of mortgage loans (excluding mortgage loans acquired for sale at fair value) as measured by the portfolio's average fair value. This compares to 5.18% for the year ended December 31, 2010.

The increase in interest income is due primarily to growth in the average balance of our mortgage loan portfolio of \$459.0 million or 260% for the year ended December 31, 2011 when compared to the year ended December 31, 2010. This growth in interest income for the year ended December 31, 2011 was partially offset by a decrease in the yield on the loans from 5.15% in 2010 to 4.74% in 2011. The decrease in yield in 2011 as compared to 2010 is due primarily to the addition of pools of loans with lower interest rates during the period from September 30, 2010 through December 31, 2011. At December 31, 2010, our investment in performing mortgage loans had a weighted-average coupon of 5.73%; at December 31, 2011, our investment in performing mortgage loans had a weighted-average coupon of 4.61%.

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### Results of Real Estate Acquired in Settlement of Loans

The following table summarizes results of real estate acquired in settlement of loans:

|   | 2012       | Year ended December 31,<br>2011<br>(in thousands) | 2010      |
|---|------------|---|-----------|
| During the year:  |            |   |           |
| Proceeds from sales of REO                              | \$ 136,411 | \$ 64,461   | \$ 19,402 |
| Results of real estate acquired in settlement of loans: |            |   |           |
| Gain on sale, net                                       | \$ 18,759  | \$ 11,604   | \$ 3,167  |
| Valuation adjustments                                   | (17,391)   | (10,525)  | (1,269)   |
|   | \$ 1,368   | \$ 1,079  | \$ 1,898  |
| Number of properties sold                               | 973        | 480   | 111       |
| Year-end:   |            |   |           |
| Carrying value  | \$ 88,078  | \$ 103,549  |           |
| Number of properties in inventory                       | 608        | 772   |           |

Results from REO includes the gains or losses we record upon sale of the properties as well as valuation adjustments we record during the period we hold those properties. During the year ended December 31, 2012, we recorded net gains of \$1.4 million in results of real estate acquired in settlement of loans as compared to net gains totaling \$1.1 million for the year ended December 31, 2011. The increase in gain between the year ended December 31, 2011 and the year ended December 31, 2012 is primarily due to the increase in volume of acquisition of properties in settlement of loans along with generally improving real estate conditions during the period we held such properties.

During the year ended December 31, 2011, we recorded net gains of \$1.1 million in results of real estate acquired in settlement of loans as compared to net gains totaling \$2.0 million for the year ended December 31, 2010. The decrease in gain between the year ended December 31, 2010 and the year ended December 31, 2011 is primarily due to valuation adjustments recorded during 2011 as compared to 2010 due to the longer period the properties were held during 2011 as compared to 2010.

### Net Loan Servicing Fees

When we sell mortgage loans, we generally enter into a contract to service the mortgage loans and recognize the value of such contracts as MSR. Under these contracts, we perform loan servicing functions in exchange for fees and the right to other compensation. The servicing functions typically performed include, among other responsibilities, collecting and remitting loan payments; responding to borrower inquiries; accounting for principal and interest, holding custodial (impound) funds for payment of property taxes and insurance premiums; counseling delinquent mortgagors; and supervising foreclosures and property dispositions. Through our Operating Partnership, we also have a loan servicing agreement with PLS by which PLS subcontracts to perform the servicing obligations on our behalf. Under the servicing agreement, PLS is entitled to base subservicing fees and other customary market-based fees and charges. Such fees are included in the *Loan servicing* expenses on our *Consolidated Statements of Income*.

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Net loan servicing fees are summarized below:

|   | Year ended December 31, |           |      |
|---|-------------------------|-----------|------|
|   | 2012                    | 2011      | 2010 |
|   | (in thousands)          |           |      |
| Servicing fees(1)   | \$ 11,172               | \$ 62     | \$   |
| Effect of MSR:  |                         |           |      |
| Amortization  | (5,460)                 | (17)      |      |
| Provision for impairment of MSRs carried at lower of amortized cost or fair value | (7,547)                 |           |      |
| Change in fair value of MSRs carried at fair value                                | (852)                   | (25)      |      |
| Gains on hedging derivatives  | 2,123                   |           |      |
|   | (11,736)                | (42)      |      |
| Net loan servicing fees   | \$ (564)                | \$ 20     | \$   |
| Average unpaid balance of mortgage loans serviced                                 | \$ 3,667,941            | \$ 34,463 | \$   |

(1) Includes contractually specified servicing fees.

The value of MSRs is derived from the net positive cash flows associated with the servicing contracts. We receive a servicing fee ranging generally from 0.250% to 0.375% annually on the remaining outstanding principal balances of the loans.

Amortization, impairment and changes in fair value of MSRs have a significant effect on net loan servicing fees. The effect of MSRs on net loan servicing fees is driven primarily by our monthly re-estimation of the fair value of MSRs. As our investment in MSRs grows, we expect that the effect of amortization, impairment and changes in fair value will have an increasing influence on our net income. The precise fair value of MSRs cannot be readily determined because MSRs are not actively traded in standalone markets. Considerable judgment is required to estimate the fair values of these assets and the exercise of such judgment can significantly affect our earnings.

Our MSR valuation process combines the use of a discounted cash flow model and analysis of current market data to arrive at an estimate of fair value at each balance sheet date. The cash flow and prepayment assumptions used in our Manager's discounted cash flow model are based on market factors and include the historical performance of our MSRs, which the Manager believes are consistent with assumptions and data used by market participants valuing similar MSRs. The key assumptions used in the valuation of MSRs include mortgage prepayment speeds and discount rates. These variables can, and generally do, change from period to period as market conditions change. Therefore our estimate of the fair value of MSRs changes from period to period. PCM's valuation committee reviews and approves the fair value estimates of our MSRs.

We account for MSRs at either our estimate of the asset's fair value with changes in fair value recorded in current period earnings or using the amortization method carried at the lower of estimated amortized cost or fair value based on whether we view the underlying mortgages as being sensitive to prepayments resulting from changing market interest rates. We have identified an initial mortgage interest rate of 4.5% as the threshold for whether such mortgage loans are sensitive to changes in interest rates:

Our risk management efforts in connection with MSRs relating to mortgage loans with initial interest rates of more than 4.5% are aimed at moderating the effects of changes in interest rates on the assets' values.

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 our correspondent lending operations, we have concluded that such assets present different risks than MSRs relating to mortgage loans with initial interest rates of more than 4.5% and therefore require a different risk management approach. Our risk management efforts relating



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to these assets are generally 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. We have identified these assets for accounting using the amortization method. Our MSR values are summarized by the basis on which we account for the assets below:

| Basis of Accounting                              | December 31,   |            |
|--|----------------|------------|
|  | 2012           | 2011       |
|  | (in thousands) |            |
| Fair value                                       | \$ 1,346       | \$ 749     |
| Lower of amortized cost or fair value:           |                |            |
| Amortized cost                                   | \$ 132,977     | \$ 5,282   |
| Valuation allowance                              | (7,547)        |            |
| Carrying value                                   | \$ 125,430     | \$ 5,282   |
| Fair value                                       | \$ 129,995     | \$ 5,341   |
| Total MSR:                                       |                |            |
| Carrying value                                   | \$ 126,776     | \$ 6,031   |
| Fair value                                       | \$ 131,341     | \$ 6,090   |
| Unpaid balance of mortgage loans underlying MSRs | \$ 12,168,940  | \$ 495,031 |

Key assumptions used in determining the fair value of MSRs and estimates of the sensitivity of MSR values to changes in these assumptions are as follows:

| Key Inputs                            | December 31, 2012 |          |  |       | December 31, 2011 |       |            |       |
|---------------------------------------|-------------------|----------|--|-------|-------------------|-------|------------|-------|
|                                       | Amortized cost    |          | Fair value                             |       | Amortized cost    |       | Fair value |       |
|                                       |                   |          | Range                                  |       |                   |       |            |       |
|                                       |                   |          | (Weighted average)                     |       |                   |       |            |       |
|                                       |                   |          | (effect on value amounts in thousands) |       |                   |       |            |       |
| Pricing spread(1)                     | 7.5%              | 16.5%    | 7.5%                                   | 16.5% | 7.5%              | 16.5% | 7.5%       | 16.5% |
|                                       | (7.5%)            |          | (7.8%)                                 |       | (7.5%)            |       | (8.6%)     |       |
| Effect on value of 5% adverse change  | \$                | (2,052)  | \$                                     | (21)  | \$                | (89)  | \$         | (10)  |
| Effect on value of 10% adverse change | \$                | (4,041)  | \$                                     | (40)  | \$                | (176) | \$         | (20)  |
| Effect on value of 20% adverse change | \$                | (7,845)  | \$                                     | (78)  | \$                | (341) | \$         | (39)  |
| Average life (in years)               | 1.7 - 6.8         |          | 1.4 - 6.7                              |       | 3.0 - 6.9         |       | 1.7 - 6.9  |       |
|                                       | (6.3)             |          | (5.8)                                  |       | (6.7)             |       | (5.3)      |       |
| Prepayment speed(2)                   | 8.6%              | 47.8%    | 11.4%                                  | 65.9% | 6.9%              | 30.8% | 8.4%       | 59.0% |
|                                       | (10.2%)           |          | (18.0%)                                |       | (8.2%)            |       | (16.3%)    |       |
| Effect on value of 5% adverse change  | \$                | (3,026)  | \$                                     | (52)  | \$                | (90)  | \$         | (16)  |
| Effect on value of 10% adverse change | \$                | (5,937)  | \$                                     | (100) | \$                | (178) | \$         | (31)  |
| Effect on value of 20% adverse change | \$                | (11,436) | \$                                     | (190) | \$                | (343) | \$         | (60)  |
| Annual per-loan cost of servicing     | \$68              | \$140    | \$68                                   | \$140 | \$68              | \$140 | \$68       | \$140 |
|                                       | \$68              |          | \$74                                   |       | \$69              |       | \$89       |       |
| Effect on value of 5% adverse change  | \$                | (778)    | \$                                     | (12)  | \$                | (30)  | \$         | (4)   |
| Effect on value of 10% adverse change | \$                | (1,556)  | \$                                     | (24)  | \$                | (61)  | \$         | (9)   |
| Effect on value of 20% adverse change | \$                | (3,112)  | \$                                     | (48)  | \$                | (122) | \$         | (17)  |



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- (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.

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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. The preceding sensitivity analyses are limited in that they were performed as of 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 inputs used; and do not take into account other factors that would affect our overall financial performance in such scenarios, including operational adjustments made by our Manager to account for changing circumstances. For these reasons, the preceding estimates should not be viewed as earnings forecasts.

## Expenses

Following is a summary of our expenses:

|                       | Year ended December 31, |           |           |
|-----------------------|-------------------------|-----------|-----------|
|                       | 2012                    | 2011      | 2010      |
|                       | (in thousands)          |           |           |
| Loan fulfillment fees | \$ 62,906               | \$ 1,747  | \$        |
| Interest              | 31,642                  | 16,946    | 826       |
| Loan servicing        | 20,180                  | 15,364    | 3,200     |
| Management fees       | 12,436                  | 6,740     | 4,878     |
| Compensation          | 7,144                   | 5,161     | 2,627     |
| Professional services | 6,053                   | 4,434     | 2,581     |
| Other                 | 7,985                   | 5,727     | 2,916     |
|                       | \$ 148,346              | \$ 56,119 | \$ 17,028 |

Increased expenses during the year ended December 31, 2012 compared to the same period in 2011 and 2010 were primarily a result of the growth in the Company's investment portfolio and the substantial growth in our correspondent lending activities.

A significant portion of the increase in expenses during 2012 was related to loan fulfillment fees, which totaled \$62.9 million. Loan fulfillment fees payable to an affiliate represent fees we pay to PLS for the services it performs on our behalf in connection with our acquisition, packaging and sale of mortgage loans. The fee is calculated as a percentage of the unpaid principal balance of the mortgage loans at sale to nonaffiliates. The increase in fees during 2012 is due to the substantial growth in the volume of Agency-eligible and jumbo mortgage loans we purchased in our correspondent lending activities. During the year ended December 31, 2012, we sold Agency-eligible and jumbo mortgage loans to nonaffiliates with fair values totaling approximately \$12.8 billion compared to \$518.0 million in 2011.

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The effects of changes in the composition of our borrowings on our interest expense during the periods presented are summarized below:

|  | 2012 vs. 2011                            |           |                                   | 2011 vs. 2010                            |           |                 |
|--|--|-----------|-----------------------------------|--|-----------|-----------------|
|  | Increase (decrease)<br>due to changes in |           |                                   | Increase (decrease)<br>due to changes in |           |                 |
|  | Rate                                     | Volume    | Total<br>change<br>(in thousands) | Rate                                     | Volume    | Total<br>change |
| Assets sold under agreements to repurchase:          |  |           |                                   |  |           |                 |
| Securities   | \$ (348)                                 | \$ (37)   | \$ (385)                          | \$ (149)                                 | \$ 402    | \$ 253          |
| Mortgage loans acquired for sale at fair value       | (1,487)                                  | 12,041    | 10,554                            | 1  | 2,425     | 2,426           |
| Mortgage loans at fair value                         | 615                                      | 2,919     | 3,534                             | 54                                       | 9,382     | 9,436           |
| Real estate acquired in settlement of loans          | (30)                                     | 609       | 579                               |  | 635       | 635             |
| Note payable secured by mortgage loans at fair value | 154                                      | (295)     | (141)                             |  | 254       | 254             |
| Note payable secured by warehouse notes receivable   |  | 167       | 167                               |  |           |                 |
| Borrowings under forward purchase agreements         | (68)                                     | (652)     | (720)                             |  | 3,116     | 3,116           |
|  | \$ (1,164)                               | \$ 14,752 | \$ 13,588                         | \$ (94)                                  | \$ 16,214 | \$ 16,120       |

During the year ended December 31, 2012, we incurred interest expense totaling \$31.6 million as compared to \$16.9 million during the year ended December 31, 2011. The increase in interest expense was due primarily to growth in our average inventory of mortgage loans acquired for sale resulting from the growth in our correspondent lending operations. Our interest cost was 3.48% for 2012 as compared to 3.74% for 2011. The decrease in interest cost reflects the changing nature of assets we are financing. As a result of growth in our correspondent lending business in 2012, a larger portion of our borrowings were used to finance mortgage loans acquired for sale compared to 2011. Financing for mortgage loans acquired for sale is generally available at lower rates than the rates for distressed mortgage loans. Therefore, our cost of funds decreased from 2011.

During the year ended December 31, 2011, we incurred interest expense totaling \$16.9 million as compared to \$826,000 during the year ended December 31, 2010. Our interest cost was 3.74% for 2011 as compared to 1.63% for 2010. The increase in interest cost reflects the changing nature of assets we financed. During 2010, we financed MBS, for which financing is available at lower rates as compared to nonperforming mortgage loans, which represented most of the assets we financed during 2011. The increase in interest expense during 2011 reflected our strategy to employ leverage in our efforts to increase our investing capacity after fully deploying the proceeds of our initial equity offerings.

Loan servicing fees also grew substantially by \$4.8 million or 31.3% to \$20.2 million in 2012, from \$15.4 million in 2011 and \$3.2 million in 2010. Loan servicing fees increased as our average investment in mortgage loans at fair value increased by 34% during 2012 and 260% during 2011. Included in loan servicing fees in 2012, 2011 and 2010 were activity-based fees of \$5.1 million, \$4.4 million and \$1.3 million, respectively, generally relating to the liquidation of loans.

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Loan servicing expenses are summarized below:

|                     | Year ended December 31, |           |          |
|---------------------|-------------------------|-----------|----------|
|                     | 2012                    | 2011      | 2010     |
|                     | (in thousands)          |           |          |
| Servicing fees      |                         |           |          |
| Base                | \$ 14,332               | \$ 9,741  | \$ 1,712 |
| Activity-based      | 5,054                   | 4,445     | 1,275    |
|                     | 19,386                  | 14,186    | 2,987    |
| Collection expenses | 794                     | 1,178     | 213      |
|                     | \$ 20,180               | \$ 15,364 | \$ 3,200 |

Compensation expense increased during 2012 as the result of additional grants of restricted share units to our officers and trustees as well as certain employees of PCM and its affiliates during the quarter ended June 30, 2012. Compensation expense increased during 2011 as the result of additional grants of restricted share units to our officers and trustees as well as certain employees of PCM and its affiliates during the quarter ended March 31, 2011. Professional services expense increased during the years ended December 31, 2012 and 2011 as compared to the year ended December 31, 2010 due to our heightened level of mortgage investment acquisition activity and to costs related to obtaining financing for our acquisitions.

### Income Taxes

We had elected to treat two of our subsidiaries as TRSs. In the quarter ended September 30, 2012, we revoked the election to treat our wholly owned subsidiary that is the sole general partner of our Operating Partnership as a TRS. As a result, beginning September 1, 2012, one subsidiary, PennyMac Corp. ( PMC ), is treated as a TRS. Income from a TRS is only included as a component of REIT taxable income to the extent that the TRS makes dividend distributions of income to the REIT. No such dividend distributions were made in 2012, 2011 or 2010. A TRS is subject to corporate federal and state income tax. Accordingly, a provision for income taxes for PMC and, for the period for which TRS treatment had been elected, the sole general partner of our Operating Partnership is included in the accompanying *Consolidated Statements of Income*.

In general, cash dividends declared by us will be considered ordinary income to shareholders for income tax purposes. Some portion of the dividends may be characterized as capital gain distributions or a return of capital. Of the 2012 distributions, approximately 83% were characterized as ordinary income and 17% were characterized as a return of capital.

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Below is a reconciliation of U.S. GAAP net income to tax income for the year and the allocation between the TRS and the REIT:

| Year ended December 31, 2012                           | U.S. GAAP<br>net<br>income | GAAP/Tax<br>differences | Taxable<br>income<br>(in thousands) | Distribution of<br>taxable income |           |
|--|----------------------------|-------------------------|-------------------------------------|-----------------------------------|-----------|
|  |                            |                         |                                     | Taxable<br>subsidiaries           | REIT      |
| Net gain on mortgage loans acquired for sale           | \$ 147,675                 | \$ (130,447)            | \$ 17,228                           | \$ 17,228                         | \$        |
| Net gain (loss) on investments                         | 103,649                    | (8,020)                 | 95,629                              | 59,160                            | 36,469    |
| Interest income  | 72,441                     | 30,924                  | 103,365                             | 66,283                            | 37,082    |
| Loan origination fees                                  | 10,545                     |                         | 10,545                              | 10,545                            |           |
| Results of real estate acquired in settlement of loans | 1,368                      | 13,235                  | 14,603                              | 12,587                            | 2,016     |
| Net loan servicing fees                                | (564)                      | 13,959                  | 13,395                              | 13,240                            | 155       |
| Other  | 54                         | (32)                    | 22                                  | 22                                |           |
| Net investment income                                  | 335,168                    | (80,381)                | 254,787                             | 179,065                           | 75,722    |
| Operating expenses                                     | 148,346                    | 22,322                  | 170,668                             | 163,539                           | 7,129     |
| Income before provision for income taxes               | 186,822                    | (102,703)               | 84,119                              | 15,526                            | 68,593    |
| Provision for income taxes                             | 48,573                     | (42,127)                | 6,446                               | 6,446                             |           |
| Net income   | \$ 138,249                 | \$ (60,576)             | \$ 77,673                           | \$ 9,080                          | \$ 68,593 |

**Table of Contents****Balance Sheet Analysis**

Following are condensed balance sheets:

|   | December 31,   |              |
|---|----------------|--------------|
|   | 2012           | 2011         |
|   | (in thousands) |              |
| <b>ASSETS</b>   |                |              |
| Cash  | \$ 33,756      | \$ 14,589    |
| Investments:  |                |              |
| Short-term investments  | 39,017         | 30,319       |
| United States Treasury security   |                | 50,000       |
| Mortgage-backed securities at fair value                                      |                | 72,813       |
| Mortgage loans acquired for sale at fair value                                | 975,184        | 232,016      |
| Mortgage loans at fair value  | 1,189,971      | 696,266      |
| Mortgage loans under forward purchase agreements at fair value                |                | 129,310      |
| Real estate acquired in settlement of loans                                   | 88,078         | 80,570       |
| Real estate acquired in settlement of loans under forward purchase agreements |                | 22,979       |
| Mortgage servicing rights   | 126,776        | 6,031        |
|   | 2,419,026      | 1,320,304    |
| Other assets  | 106,881        | 51,169       |
| Total assets  | \$ 2,559,663   | \$ 1,386,062 |
| <b>LIABILITIES</b>  |                |              |
| Assets sold under agreements to repurchase:                                   |                |              |
| Securities  | \$             | \$ 115,493   |
| Mortgage loans acquired for sale at fair value                                | 894,906        | 212,677      |
| Mortgage loans at fair value  | 353,805        | 275,649      |
| Real estate acquired in settlement of loans                                   | 7,391          | 27,494       |
| Note payable secured by mortgage loans at fair value                          |                | 28,617       |
| Borrowings under forward purchase agreements                                  |                | 152,427      |
|   | 1,256,102      | 812,357      |
| Other liabilities   | 102,225        | 27,688       |
| Total liabilities   | 1,358,327      | 840,045      |
| <b>SHAREHOLDERS' EQUITY</b>   | 1,201,336      | 546,017      |
| Total liabilities and shareholders' equity                                    | \$ 2,559,663   | \$ 1,386,062 |

Total assets increased \$1.2 billion, or 85%, during the period from December 31, 2011 to December 31, 2012. Growth in total assets reflects growth of investments totaling \$1.1 billion or 83% during the period. We financed our asset growth through additional borrowings of \$443.7 million and through issuance of additional common shares for net proceeds of \$606.8 million. We made investments (excluding the purchase of correspondent lending loans and increases in short-term investments) totaling \$654.0 million and received proceeds from sales and repayments of our investments totaling \$555.9 million. We also purchased newly-originated mortgage loans totaling approximately \$22.4 billion and received proceeds (including MSRs) from the sale of those loans totaling approximately \$21.7 billion in our correspondent lending operations. Our acquisitions are summarized below.

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### Asset Acquisitions

#### Correspondent Lending

Following is a summary of our correspondent lending acquisitions:

|  | 2012          | Year ended December 31,<br>2011<br>(in thousands) | 2010      |
|--|---------------|---|-----------|
| Fair value of correspondent lending loans purchased:               |               |   |           |
| Agency eligible  | \$ 13,463,121 | \$ 660,862  | \$ 9,249  |
| Government insured or guaranteed                                   | 8,969,220     | 623,540   | 20,810    |
| Jumbo  | 10,795        | 34,361  |           |
|  | \$ 22,443,136 | \$ 1,318,763                                      | \$ 30,059 |
| Fair value of correspondent lending loans in inventory at year-end | \$ 975,184    | \$ 232,016  | \$ 3,966  |

During 2012, we purchased for sale \$22.4 billion at fair value of recently funded mortgage loans compared to \$1.3 billion during 2011. Of the \$22.4 billion of recently funded mortgage loans we purchased for sale during the year ended December 31, 2012, approximately \$10.5 billion were purchased during the fourth quarter of 2012. Our ability to continue the expansion of our correspondent lending business is subject to our ability to obtain additional inventory financing and our ability to fund the portion of the loans not financed, either through cash flows from business activities or the raising of additional equity capital. There can be no assurance that we will be successful in increasing our borrowing capacity or in obtaining the additional equity capital necessary or that we will be able to identify additional sources of mortgage loans.

#### Investment Portfolio

Following is a summary of our acquisitions of mortgage investments other than correspondent lending acquisitions as shown in the preceding table:

|                                 | 2012       | Year ended December 31,<br>2011<br>(in thousands) | 2010       |
|---------------------------------|------------|---|------------|
| MBS                             | \$ 112,211 | \$ 21,420   | \$ 91,141  |
| Distressed mortgage loans(1)(2) |            |   |            |
| Performing                      | 128,221    | 52,256  | 33,745     |
| Nonperforming                   | 414,545    | 595,353   | 383,466    |
|                                 | 542,766    | 647,609   | 417,211    |
| REO                             | 297        | 2,475   | 1,238      |
| MSRs                            | 134,702    | 6,079   |            |
|                                 | \$ 789,976 | \$ 677,583  | \$ 509,590 |

(1) Performance status as of the date of acquisition.

(2) \$504.8 million and \$577.6 million of our distressed asset purchases during the years ended December 31, 2012 and 2011, respectively, were acquired from or through one or more subsidiaries of Citigroup Inc.

Our acquisitions during the years ended December 31, 2012 and 2011 were financed primarily by subsequent underwritten public offerings completed and the use of borrowings to leverage our equity. Our acquisitions during the year ended December 31, 2010 reflect continuing

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investment of the proceeds from our initial public offering which we completed during August 2009. We continue to identify additional means of increasing our investment portfolio through cash flow from existing investments, borrowings and transactions that minimize current cash outlays. However, we expect that, over time, our ability to continue our non-correspondent lending portfolio growth will depend on our ability to raise additional equity capital.



**Table of Contents****Investment Portfolio Composition***Mortgage Backed Securities*

During the years ended December 31, 2011 and 2010, we acquired portfolios of senior priority MBS, backed by non-Agency subprime, Alt-A and prime jumbo loans, to supplement our investments in mortgage loans and to help ensure compliance with the REIT tax regulations relating to our asset composition. During the year ended December 31, 2012, we sold our entire portfolio of MBS.

The following is a summary of our portfolio of MBS:

|                           | December 31, 2011 |           |                        |                |              |
|---------------------------|-------------------|-----------|------------------------|----------------|--------------|
|                           | Fair value        | Principal | Life (in years)        | Average Coupon | Market yield |
|                           |                   |           | (dollars in thousands) |                |              |
| Security collateral type: |                   |           |                        |                |              |
| Non-Agency subprime       | \$ 58,634         | \$ 63,712 | 1.60                   | 0.64%          | 8.01%        |
| Non-Agency Alt-A          | 8,710             | 8,910     | 1.69                   | 5.63%          | 6.23%        |
| Non-Agency prime jumbo    | 5,469             | 5,624     | 0.72                   | 2.72%          | 6.51%        |
|                           | \$ 72,813         | \$ 78,246 | 1.55                   | 1.36%          | 7.70%        |

*Mortgage Loans*

The relationship of the fair value of our mortgage loans at fair value (excluding mortgage loans acquired for sale at fair value) to the fair value of the real estate collateral underlying the loans is summarized below:

|                     | December 31, 2012 |                        | December 31, 2011 |              |
|---------------------|-------------------|------------------------|-------------------|--------------|
|                     | Loan              | Fair values Collateral | Loan              | Collateral   |
|                     |                   | (in thousands)         |                   |              |
| Performing loans    | \$ 404,016        | \$ 608,833             | \$ 209,599        | \$ 306,978   |
| Nonperforming loans | 785,955           | 1,179,737              | 615,977           | 905,940      |
|                     | \$ 1,189,971      | \$ 1,788,570           | \$ 825,576        | \$ 1,212,918 |

The collateral values presented above do not represent our assessment of the amount of future cash flows to be realized from the mortgage loans and/or underlying collateral. Future cash flows will be influenced by, among other considerations, our asset disposition strategies with respect to individual loans, the costs and expenses we incur in the disposition process and changes in borrower performance and the underlying collateral values.

Collateral values summarized above are estimated and may change over time due to various factors including our level of access to the properties securing the loans, changes in the real estate market or the condition of individual properties. Collateral values noted do not include any costs that would typically be incurred in obtaining the property in settlement of the loan, readying the property for sale or in the sale of a property.

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Following is a summary of the distribution of our mortgage loans at fair value (excluding mortgage loans acquired for sale at fair value):

| Loan type     | December 31, 2012 |         |                        |                     |         |                   | December 31, 2011 |         |                   |                     |         |                   |
|---------------|-------------------|---------|------------------------|---------------------|---------|-------------------|-------------------|---------|-------------------|---------------------|---------|-------------------|
|               | Performing loans  |         |                        | Nonperforming loans |         |                   | Performing loans  |         |                   | Nonperforming loans |         |                   |
|               | Fair value        | % total | Average note rate      | Fair value          | % total | Average note rate | Fair value        | % total | Average note rate | Fair value          | % total | Average note rate |
|               |                   |         | (dollars in thousands) |                     |         |                   |                   |         |                   |                     |         |                   |
| Fixed         | \$ 201,212        | 50%     | 5.01%                  | \$ 463,657          | 59%     | 6.23%             | \$ 100,898        | 48%     | 5.56%             | \$ 294,723          | 48%     | 6.33%             |
| ARM/Hybrid    | 134,196           | 33%     | 3.91%                  | 315,905             | 40%     | 5.97%             | 77,131            | 37%     | 4.34%             | 319,558             | 52%     | 6.17%             |
| Interest rate |                   |         |                        |                     |         |                   |                   |         | 0%                |                     |         | 0%                |
| step-up       | 68,475            | 17%     | 2.18%                  | 5,969               | 1%      | 2.26%             | 31,384            | 15%     | 2.23%             | 1,430               | 0%      | 4.36%             |
| Balloon       | 133               | 0%      | 2.00%                  | 424                 | 0%      | 8.12%             | 186               | 0%      | 4.32%             | 266                 | 0%      | 7.97%             |
|               | \$ 404,016        | 100%    | 4.13%                  | \$ 785,955          | 100%    | 6.10%             | \$ 209,599        | 100%    | 4.61%             | \$ 615,977          | 100%    | 6.25%             |

| Lien position | December 31, 2012 |         |                        |                     |         |                   | December 31, 2011 |         |                   |                     |         |                   |
|---------------|-------------------|---------|------------------------|---------------------|---------|-------------------|-------------------|---------|-------------------|---------------------|---------|-------------------|
|               | Performing loans  |         |                        | Nonperforming loans |         |                   | Performing loans  |         |                   | Nonperforming loans |         |                   |
|               | Fair value        | % total | Average note rate      | Fair value          | % total | Average note rate | Fair value        | % total | Average note rate | Fair value          | % total | Average note rate |
|               |                   |         | (dollars in thousands) |                     |         |                   |                   |         |                   |                     |         |                   |
| 1st lien      | \$ 403,870        | 100%    | 4.12%                  | \$ 785,846          | 100%    | 6.09%             | \$ 209,565        | 100%    | 4.60%             | \$ 615,977          | 100%    | 6.25%             |
| 2nd lien      | 146               | 0%      | 6.80%                  | 109                 | 0%      | 10.90%            | 33                | 0%      | 9.75%             |                     | 0%      | 0%                |
| Unsecured     |                   | 0%      | 0.00%                  |                     | 0%      | 0.00%             | 1                 | 0%      | 0.01%             |                     | 0%      | 0%                |
|               | \$ 404,016        | 100%    | 4.13%                  | \$ 785,955          | 100%    | 6.10%             | \$ 209,599        | 100%    | 4.61%             | \$ 615,977          | 100%    | 6.25%             |

| Occupancy           | December 31, 2012 |         |                        |                     |         |                   | December 31, 2011 |         |                   |                     |         |                   |
|---------------------|-------------------|---------|------------------------|---------------------|---------|-------------------|-------------------|---------|-------------------|---------------------|---------|-------------------|
|                     | Performing loans  |         |                        | Nonperforming loans |         |                   | Performing loans  |         |                   | Nonperforming loans |         |                   |
|                     | Fair value        | % total | Average note rate      | Fair value          | % total | Average note rate | Fair value        | % total | Average note rate | Fair value          | % total | Average note rate |
|                     |                   |         | (dollars in thousands) |                     |         |                   |                   |         |                   |                     |         |                   |
| Owner occupied      | \$ 346,301        | 86%     | 4.07%                  | \$ 563,058          | 72%     | 6.00%             | \$ 185,779        | 89%     | 4.55%             | \$ 465,425          | 76%     | 6.16%             |
| Investment property | 50,801            | 12%     | 4.58%                  | 222,138             | 28%     | 6.35%             | 23,488            | 11%     | 5.10%             | 150,215             | 24%     | 6.49%             |
| Other               | 6,914             | 2%      | 3.94%                  | 759                 | 0%      | 4.94%             | 332               | 0%      | 4.05%             | 337                 | 0%      | 7.96%             |
|                     | \$ 404,016        | 100%    | 4.13%                  | \$ 785,955          | 100%    | 6.10%             | \$ 209,599        | 100%    | 4.61%             | \$ 615,977          | 100%    | 6.25%             |

| Loan age       | December 31, 2012 |         |                        |                     |         |                   | December 31, 2011 |         |                   |                     |         |                   |
|----------------|-------------------|---------|------------------------|---------------------|---------|-------------------|-------------------|---------|-------------------|---------------------|---------|-------------------|
|                | Performing loans  |         |                        | Nonperforming loans |         |                   | Performing loans  |         |                   | Nonperforming loans |         |                   |
|                | Fair value        | % total | Average note rate      | Fair value          | % total | Average note rate | Fair value        | % total | Average note rate | Fair value          | % total | Average note rate |
|                |                   |         | (dollars in thousands) |                     |         |                   |                   |         |                   |                     |         |                   |
| Less than      |                   |         |                        |                     |         |                   |                   |         |                   |                     |         |                   |
| 12 months      | \$ 99             | 0%      | 5.56%                  | \$                  | 0%      | 5.20%             | \$ 33             | 0%      | 5.17%             | \$                  | 0%      |                   |
| 12 - 35 months | 1,000             | 0%      | 2.85%                  | 808                 | 0%      | 4.97%             | 2,253             | 1%      | 4.39%             | 10,134              | 1%      | 5.04%             |
| 36 - 59 months | 24,250            | 6%      | 4.41%                  | 101,699             | 13%     | 6.22%             | 94,112            | 45%     | 5.11%             | 287,578             | 47%     | 6.43%             |

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|                   |            |      |       |            |      |       |            |      |       |            |      |       |
|-------------------|------------|------|-------|------------|------|-------|------------|------|-------|------------|------|-------|
| 60 months or more | 378,667    | 94%  | 4.11% | 683,448    | 87%  | 6.09% | 113,201    | 54%  | 4.18% | 318,265    | 52%  | 6.11% |
|                   | \$ 404,016 | 100% | 4.13% | \$ 785,955 | 100% | 6.10% | \$ 209,599 | 100% | 4.61% | \$ 615,977 | 100% | 6.25% |

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| Origination<br>FICO score | December 31, 2012 |            |                         |                     |            |                         | December 31, 2011 |            |                         |                     |            |                         |
|---------------------------|-------------------|------------|-------------------------|---------------------|------------|-------------------------|-------------------|------------|-------------------------|---------------------|------------|-------------------------|
|                           | Performing loans  |            |                         | Nonperforming loans |            |                         | Performing loans  |            |                         | Nonperforming loans |            |                         |
|                           | Fair<br>value     | %<br>total | Average<br>note<br>rate | Fair<br>value       | %<br>total | Average<br>note<br>rate | Fair<br>value     | %<br>total | Average<br>note<br>rate | Fair<br>value       | %<br>total | Average<br>note<br>rate |
|                           |                   |            |                         |                     |            |                         |                   |            |                         |                     |            |                         |
|                           |                   |            | (dollars in thousands)  |                     |            |                         |                   |            |                         |                     |            |                         |
| Less than 600             | \$ 94,917         | 24%        | 4.78%                   | \$ 173,808          | 22%        | 6.50%                   | \$ 46,766         | 22%        | 5.40%                   | \$ 98,819           | 16%        | 6.54%                   |
| 600-649                   | 78,652            | 19%        | 4.47%                   | 154,809             | 20%        | 6.27%                   | 40,219            | 19%        | 5.04%                   | 110,113             | 18%        | 6.44%                   |
| 650-699                   | 101,173           | 25%        | 3.91%                   | 213,095             | 27%        | 6.07%                   | 58,166            | 28%        | 4.33%                   | 172,296             | 28%        | 6.19%                   |
| 700-749                   | 84,145            | 21%        | 3.57%                   | 165,042             | 21%        | 5.72%                   | 43,881            | 21%        | 4.08%                   | 161,166             | 26%        | 5.98%                   |
| 750 or greater            | 45,129            | 11%        | 3.66%                   | 79,201              | 10%        | 5.73%                   | 20,567            | 10%        | 3.70%                   | 73,583              | 12%        | 6.22%                   |
|                           | \$ 404,016        | 100%       | 4.13%                   | \$ 785,955          | 100%       | 6.10%                   | \$ 209,599        | 100%       | 4.61%                   | \$ 615,977          | 100%       | 6.25%                   |

| Current loan-value(1)  | December 31, 2012 |         |         |                     |         |                        | December 31, 2011 |         |         |                     |         |         |
|------------------------|-------------------|---------|---------|---------------------|---------|------------------------|-------------------|---------|---------|---------------------|---------|---------|
|                        | Performing loans  |         |         | Nonperforming loans |         |                        | Performing loans  |         |         | Nonperforming loans |         |         |
|                        | Fair value        | % total | Average | Fair value          | % total | Average                | Fair value        | % total | Average | Fair value          | % total | Average |
|                        |                   |         | note    |                     |         | note                   |                   |         | note    |                     |         | note    |
|                        |                   |         | rate    |                     |         | rate                   |                   |         | rate    |                     |         | rate    |
| (dollars in thousands) |                   |         |         |                     |         | (dollars in thousands) |                   |         |         |                     |         |         |
| Less than 80%          | 69,139            | 17%     | 5.14%   | \$ 85,294           | 11%     | 6.28%                  | 37,063            | 18%     | 5.54%   | \$ 62,042           | 10%     | 6.49%   |
| 80% - 99.99%           | 83,571            | 21%     | 4.74%   | 139,272             | 18%     | 6.21%                  | 33,837            | 16%     | 5.44%   | 93,949              | 15%     | 6.32%   |
| 100% - 119.99%         | 95,313            | 23%     | 4.03%   | 171,569             | 22%     | 6.20%                  | 40,133            | 19%     | 5.06%   | 127,591             | 21%     | 6.20%   |
| 120% or greater        | 155,993           | 39%     | 3.65%   | 389,820             | 49%     | 6.03%                  | 98,566            | 47%     | 4.06%   | 332,395             | 54%     | 6.22%   |
|                        | \$ 404,016        | 100%    | 4.13%   | \$ 785,955          | 100%    | 6.10%                  | \$ 209,599        | 100%    | 4.61%   | \$ 615,977          | 100%    | 6.25%   |

(1) Current loan-to-value is calculated based on the unpaid principal balance of the mortgage loan and our estimate of the value of the mortgaged property.

| Geographic distribution | December 31, 2012 |      |         |                     |      |         | December 31, 2011 |      |         |                     |      |         |
|-------------------------|-------------------|------|---------|---------------------|------|---------|-------------------|------|---------|---------------------|------|---------|
|                         | Performing loans  |      |         | Nonperforming loans |      |         | Performing loans  |      |         | Nonperforming loans |      |         |
|                         | Fair value        | %    | Average | Fair value          | %    | Average | Fair value        | %    | Average | Fair value          | %    | Average |
|                         |                   |      | note    |                     |      | note    |                   |      | note    |                     |      | note    |
|                         |                   |      | rate    |                     |      | rate    |                   |      | rate    |                     |      | rate    |
| (dollars in thousands)  |                   |      |         |                     |      |         |                   |      |         |                     |      |         |
| California              | \$ 112,544        | 28%  | 3.45%   | \$ 106,667          | 13%  | 5.11%   | \$ 61,784         | 30%  | 3.97%   | \$ 144,943          | 24%  | 5.72%   |
| Florida                 | 21,834            | 6%   | 3.91%   | 124,557             | 16%  | 6.26%   | 15,805            | 8%   | 4.44%   | 80,195              | 13%  | 6.57%   |
| New York                | 29,289            | 7%   | 3.74%   | 112,179             | 14%  | 6.49%   | 11,399            | 5%   | 4.36%   | 88,345              | 14%  | 6.34%   |
| New Jersey              | 13,354            | 3%   | 3.63%   | 61,177              | 8%   | 6.07%   | 8,846             | 4%   | 4.23%   | 27,132              | 4%   | 5.97%   |
| Other                   | 226,995           | 56%  | 4.59%   | 381,375             | 49%  | 6.20%   | 111,765           | 53%  | 5.08%   | 275,362             | 45%  | 6.42%   |
|                         | \$ 404,016        | 100% | 4.13%   | \$ 785,955          | 100% | 6.10%   | \$ 209,599        | 100% | 4.61%   | \$ 615,977          | 100% | 6.25%   |

| Payment status         | December 31, 2012 |         |         |                     |         |         | December 31, 2011 |         |         |                     |         |         |
|------------------------|-------------------|---------|---------|---------------------|---------|---------|-------------------|---------|---------|---------------------|---------|---------|
|                        | Performing loans  |         |         | Nonperforming loans |         |         | Performing loans  |         |         | Nonperforming loans |         |         |
|                        | Fair value        | % total | Average | Fair value          | % total | Average | Fair value        | % total | Average | Fair value          | % total | Average |
|                        |                   |         | note    |                     |         | note    |                   |         | note    |                     |         | note    |
|                        |                   |         | rate    |                     |         | rate    |                   |         | rate    |                     |         | rate    |
| (dollars in thousands) |                   |         |         |                     |         |         |                   |         |         |                     |         |         |
| Current                | \$ 313,852        | 78%     | 3.91%   | \$                  | 0%      | 0.00%   | \$ 149,233        | 71%     | 4.43%   | \$                  | 0%      | 0.00%   |
| 30 days delinquent     | 52,651            | 13%     | 4.75%   |                     | 0%      | 0.00%   | 37,171            | 18%     | 4.89%   |                     | 0%      | 0.00%   |
| 60 days delinquent     | 37,513            | 9%      | 4.96%   |                     | 0%      | 0.00%   | 23,195            | 11%     | 5.21%   |                     | 0%      | 0.00%   |

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|                            |            |       |         |            |       |       |            |       |         |            |       |       |
|----------------------------|------------|-------|---------|------------|-------|-------|------------|-------|---------|------------|-------|-------|
| 90 days or more delinquent | 0%         | 0.00% | 326,073 | 41%        | 5.82% |       | 0%         | 0.00% | 168,011 | 27%        | 6.11% |       |
| In foreclosure             | 0%         | 0.00% | 459,882 | 59%        | 6.31% |       | 0%         | 0.00% | 447,966 | 73%        | 6.30% |       |
|                            | \$ 404,016 | 100%  | 4.13%   | \$ 785,955 | 100%  | 6.10% | \$ 209,599 | 100%  | 4.61%   | \$ 615,977 | 100%  | 6.25% |

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Following is a summary of our REO by attribute:

| Property type            | December 31, 2012 |                                   | December 31, 2011 |         |
|--------------------------|-------------------|-----------------------------------|-------------------|---------|
|                          | Fair value        | % total<br>(dollars in thousands) | Fair value        | % total |
| 1 - 4 dwelling units     | \$ 66,882         | 76%                               | \$ 75,463         | 73%     |
| Planned unit development | 9,971             | 11%                               | 15,110            | 15%     |
| Condominium/Co-op        | 7,375             | 8%                                | 10,317            | 10%     |
| 5+ dwelling units        | 3,850             | 5%                                | 2,659             | 2%      |
|                          | \$ 88,078         | 100%                              | \$ 103,549        | 100%    |

| Geographic distribution | December 31, 2012 |                                   | December 31, 2011 |         |
|-------------------------|-------------------|-----------------------------------|-------------------|---------|
|                         | Fair value        | % total<br>(dollars in thousands) | Fair value        | % total |
| California              | \$ 26,650         | 30%                               | \$ 46,959         | 45%     |
| Florida                 | 8,549             | 10%                               | 4,887             | 5%      |
| Illinois                | 5,045             | 6%                                | *                 | *       |
| Connecticut             | 4,168             | 5%                                | *                 | *       |
| Washington              | 2,861             | 3%                                | 2,982             | 3%      |
| Colorado                | *                 | *                                 | 4,703             | 4%      |
| Arizona                 | *                 | *                                 | 2,912             | 3%      |
| North Carolina          | *                 | *                                 | 2,834             | 3%      |
| Other                   | 40,805            | 46%                               | 38,272            | 37%     |
|                         | \$ 88,078         | 100%                              | \$ 103,549        | 100%    |

\* Not included in the states representing the largest balances as of the date presented.

Following is a summary of the current status of our portfolio of acquisitions by quarter acquired (excluding acquisitions for the quarter ended December 31, 2012 due to close proximity of the acquisition date to the reporting date):

|                          | September 30, 2012 |                      | Acquisitions for the quarter ended<br>June 30, 2012 |                      | March 31, 2012 |                      |
|--------------------------|--------------------|----------------------|---|----------------------|----------------|----------------------|
|                          | At<br>purchase     | December 31,<br>2012 | At<br>purchase<br>(dollars in millions)             | December 31,<br>2012 | At<br>purchase | December 31,<br>2012 |
| Unpaid principal balance | \$ 357.2           | \$ 349.9             | \$ 402.5  | \$ 371.6             | \$             | \$                   |
| Pool factor*             | 1.00               | 0.98                 | 1.00  | 0.92                 |                |                      |
| Collection status:       |                    |                      |   |                      |                |                      |
| Delinquency              |                    |                      |   |                      |                |                      |
| Current                  | 0.0%               | 1.2%                 | 45.0%   | 47.0%                | 0.0%           | 0.0%                 |
| 30 days                  | 0.0%               | 0.0%                 | 4.0%  | 4.5%                 | 0.0%           | 0.0%                 |
| 60 days                  | 0.1%               | 0.1%                 | 4.3%  | 2.7%                 | 0.0%           | 0.0%                 |
| over 90 days             | 49.1%              | 47.6%                | 31.3%   | 23.0%                | 0.0%           | 0.0%                 |
| In foreclosure           | 50.8%              | 48.4%                | 15.3%   | 20.2%                | 0.0%           | 0.0%                 |
| REO                      | 0.0%               | 2.7%                 | 0.1%  | 2.5%                 | 0.0%           | 0.0%                 |



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|                          | Acquisitions for the quarter ended |                   |                    |                   |               |                   |                |                   |
|--------------------------|------------------------------------|-------------------|--------------------|-------------------|---------------|-------------------|----------------|-------------------|
|                          | December 31, 2011                  |                   | September 30, 2011 |                   | June 30, 2011 |                   | March 31, 2011 |                   |
|                          | At purchase                        | December 31, 2012 | At purchase        | December 31, 2012 | At purchase   | December 31, 2012 | At purchase    | December 31, 2012 |
| Unpaid principal balance | \$ 49.0                            | \$ 42.9           | \$ 542.6           | \$ 327.0          | \$ 259.8      | \$ 183.0          | \$ 515.1       | \$ 321.6          |
| Pool factor*             | 1.00                               | 0.88              | 1.00               | 0.60              | 1.00          | 0.70              | 1.00           | 0.62              |
| Collection status:       |                                    |                   |                    |                   |               |                   |                |                   |
| Delinquency              |                                    |                   |                    |                   |               |                   |                |                   |
| Current                  | 0.2%                               | 18.3%             | 0.6%               | 11.1%             | 11.5%         | 29.8%             | 2.0%           | 25.6%             |
| 30 days                  | 0.1%                               | 1.8%              | 1.3%               | 3.7%              | 6.5%          | 6.2%              | 1.9%           | 5.4%              |
| 60 days                  | 0.2%                               | 1.6%              | 2.0%               | 2.3%              | 5.2%          | 4.2%              | 3.9%           | 2.7%              |
| over 90 days             | 70.4%                              | 32.9%             | 22.6%              | 19.2%             | 31.2%         | 16.6%             | 25.9%          | 13.7%             |
| In foreclosure           | 29.0%                              | 43.2%             | 73.0%              | 50.9%             | 43.9%         | 33.5%             | 66.3%          | 43.7%             |
| REO                      | 0.0%                               | 2.2%              | 0.4%               | 12.8%             | 1.7%          | 9.8%              | 0.0%           | 8.9%              |

\* Ratio of unpaid principal balance remaining to unpaid principal balance at acquisition.

### Cash Flows

Our cash flows resulted in a net increase in cash of \$19.2 million during the year ended December 31, 2012. The increase in cash flows arose primarily due to growth in our operations. Cash used by operating activities totaled \$820.4 million during the year ended December 31, 2012. This use of cash was primarily due to the cash requirements related to the growth in our operating balance sheet, primarily mortgage loans acquired for sale, which tracked our overall growth. Cash used by operating activities during the years ended December 31, 2011 and 2010 also reflects the effects of growth in our operating balance sheet accounts.

Net cash used by investing activities was \$111.4 million for the year ended December 31, 2012. This use of cash reflects the growth of our investment portfolio. We used cash to purchase mortgage loans and MBS with fair values of \$541.7 million and \$112.2 million, respectively, during the year ended December 31, 2012. Offsetting these uses in cash were cash inflows from the maturity of a United States Treasury security and the sales and repayments from MBS, mortgage loans and REO totaling \$50.0 million, \$189.2 million, \$184.2 million and \$136.4 million, respectively. This contrasts with cash used by investing activities totaling \$277.8 million during the year ended December 31, 2011. We accomplished the 2012 acquisitions primarily through secondary equity offerings during the year, supplemented by the use of additional borrowings.

Approximately 62% of our investments, comprised of non-correspondent lending mortgage loans, MBS, REO and MSRs, were nonperforming assets as of December 31, 2012. Nonperforming assets include mortgage loans delinquent 90 or more days and REO. Accordingly, we expect that these assets will require a longer period to begin producing cash flow and the timing and amount of cash flows from these assets is less certain than for performing assets. During the year ended December 31, 2012, we transferred \$119.3 million of mortgage loans to REO and realized cash proceeds from the repayments and sale of mortgage-backed securities, mortgage loans at fair values and REO totaling \$189.2 million, \$184.2 million and \$136.4 million, respectively.

Our investing activities include the purchase of long-lived assets which are not presently cash flowing or are at risk of interruption of cash flows in the near future. Furthermore, much of the investment income we recognize is in the form of valuation adjustments we record recognizing our estimates of the net appreciation in value of the assets as we work with borrowers to either modify their loans or acquire the property securing their loans in settlement thereof. Accordingly, a substantial portion of our revenues is often realized as part of the proceeds of the liquidation of the assets, either through payoff or sale of the mortgage loan or through acquisition and sale of the property securing the loans, many months after we record the revenues.



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The following tables illustrate the net gain (loss) in value that we accumulated over the period during which we owned the liquidated assets, as compared to the proceeds actually received and the additional net gain (loss) realized upon liquidation of such assets:

|                | 2012       |                               |                        | Year ended December 31, 2011 |   |                        | 2010      |                               |                        |
|----------------|------------|-------------------------------|------------------------|------------------------------|---|------------------------|-----------|-------------------------------|------------------------|
|                | Proceeds   | Accumulated gains (losses)(1) | Gain on liquidation(2) | Proceeds                     | Accumulated gains (losses)(1)<br>(in thousands) | Gain on liquidation(2) | Proceeds  | Accumulated gains (losses)(1) | Gain on liquidation(2) |
| Mortgage loans | \$ 172,664 | \$ 19,524                     | \$ 19,340              | \$ 144,771                   | \$ 11,644                                       | \$ 19,972              | \$ 4,453  | \$ 147                        | \$ 642                 |
| REO            | 136,410    | (17,391)                      | 18,759                 | 64,461                       | (10,525)  | 11,604                 | 19,402    | (1,269)                       | 3,167                  |
|                | \$ 309,074 | \$ 2,133                      | \$ 38,099              | \$ 209,232                   | \$ 1,119  | \$ 31,576              | \$ 23,855 | \$ (1,122)                    | \$ 3,809               |

(1) Represents valuation gains and losses recognized during the period we held the respective asset but excludes the gain or loss recorded upon sale or repayment of the respective asset.

(2) Represents the gain or loss recognized as of the date of sale or repayment of the respective asset.

The amounts included in accumulated gains and gain on liquidation do not include the cost of managing the liquidated assets. Rather, they include the amount of accumulated valuation gains and losses recognized throughout the holding period which may be substantial depending on the collection status of the loan at acquisition and on our success in working with the borrower to resolve the source of distress in the loan and in the case of REO, includes direct transaction costs incurred in the sale of the property. Accordingly, the preceding amounts do not represent periodic earnings on a cash basis and the amount of gain will have accumulated over varying periods depending on the liquidation period for individual assets.

Net cash provided by financing activities was \$951.0 million for the year ended December 31, 2012. These funds were procured primarily to finance the acquisition of additional mortgage loans. Cash provided by financing activities was primarily due to a secondary equity offering supported by additional borrowings. As discussed below in *Liquidity and Capital Resources*, our Manager continues to evaluate and pursue additional sources of financing to provide us with future investing capacity.

Our cash flows resulted in a net decrease in cash of \$30.9 million during the year ended December 31, 2011. The negative cash flows arose primarily due to growth in our operations. Cash used by operating activities totaled \$275.1 million during the year ended December 31, 2011. This use of cash was primarily due to the cash requirements related to the growth in our operating balance sheet, primarily mortgage loans acquired for sale, which tracked our overall growth. Cash used by operating activities during the year ended December 31, 2010 also reflects the effects of growth in our operating balance sheet accounts.

Net cash used by investing activities was \$277.8 million for the year ended December 31, 2011. This use of cash reflects the growth of our investment portfolio. We used cash to purchase a United States Treasury security, mortgage loans, MBS and REO with fair values of \$50.0 million, \$453.3 million, \$21.4 million and \$1.5 million, respectively, during the year ended December 31, 2011. This contrasts with cash used by investing activities totaling \$167.3 million during the year ended December 31, 2010. We accomplished the 2011 acquisitions primarily through the use of additional borrowings supported by an equity offering during the year.

Approximately 71% of our investments, comprised of non-correspondent lending mortgage loans, MBS, REO and MSRs, were nonperforming assets as of December 31, 2011. Nonperforming assets include mortgage loans delinquent 90 or more days and REO. Accordingly, we expect that these assets will require a longer period to begin producing cash flow and the timing and amount of cash flows from these assets is less certain than for performing assets. During the year ended December 31, 2011, we transferred \$134.8 million of mortgage loans to REO and realized cash proceeds from the repayments and sale of mortgage-backed securities and mortgage loans at fair values and REO totaling \$67.7 million and \$147.3 million and \$64.5 million, respectively.

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Net cash provided by financing activities was \$522.1 million for the year ended December 31, 2011. These funds were procured primarily to finance the acquisition of additional mortgage loans. Cash provided by financing activities was primarily due to additional borrowings supported by a secondary equity offering. We also obtained non-cash financing through the use of forward purchase agreements to purchase pools of nonperforming loans amounting to \$194.3 million in fair value and REOs amounting to \$964,000.

Our cash flows resulted in a net increase in cash of \$45.4 million during the year ended December 31, 2010. The positive cash flows arose primarily due to cash provided by financing activities exceeding cash used by investing and operating activities. Cash used by operating activities totaled \$22.8 million during 2010. This use of cash was primarily due to the cash requirements related to the growth in our balance sheet accounts relating to our operations.

Net cash used by investing activities was \$167.3 million for the year ended December 31, 2010. This use of cash reflects the conversion of our short-term investments to mortgage loans and MBS, with additional purchases financed by loans and securities sold under agreements to repurchase. We purchased MBS, mortgage loans and real estate acquired in settlement of loans with fair values of \$91.1 million, \$417.2 million and \$1.2 million, respectively, during 2010. Approximately 60% of our investments, comprised of non-correspondent lending mortgage loans, MBS and REO, were nonperforming assets as of December 31, 2010. During the period, we transferred \$46.0 million of mortgage loans to REO and realized cash proceeds from the sale of REO totaling \$19.4 million.

Net cash provided by financing activities was \$235.5 million for the year ended December 31, 2010. These funds were procured to finance the acquisition of additional loans and MBS.

## **Liquidity and Capital Resources**

Our liquidity reflects our ability to meet our current obligations (including our operating expenses and, when applicable, retirement of, and margin calls relating to, our debt and margin calls relating to hedges on our interest rate lock commitments), fund correspondent loan purchases, make investments as our Manager identifies them and make distributions to our shareholders. We generally need to distribute at least 90% of our taxable income each year (subject to certain adjustments) to our shareholders to qualify as a REIT under the Internal Revenue Code. This distribution requirement limits our ability to retain earnings and thereby replenish or increase capital to support our activities.

We expect our primary sources of liquidity to be proceeds from earnings on our investments, through cash flows from business activities, proceeds from borrowings and/or additional equity offerings. Assuming that we are able to renew or increase our warehouse facilities and credit financing in the ordinary course of business, we believe that our current liquidity is sufficient to meet our liquidity needs for at least the next twelve months. However, no assurance can be given that we will be able to do so.

Our current leverage strategy is to finance our assets where we believe such borrowing is prudent and appropriate. We have made borrowings in the form of borrowings under forward purchase agreements, sales of assets under agreements to repurchase, and a note payable secured by mortgage loans at fair value. To the extent available to us, we expect in the future to obtain long-term financing for assets with estimated future lives of more than one year. This may include term financing and securitization of nonperforming and/or re-performing mortgage loans.

Until attractive long-term financing is procured, we will continue to finance our assets on a short-term basis through agreements to repurchase and other secured lending and structured finance facilities, pending the ultimate disposition of the assets, whether through sale, securitization or liquidation. Because our current debt facilities consist solely of short-term borrowings, we expect to renew these facilities in advance of maturity in order to ensure our ongoing liquidity and access to capital or otherwise allow ourselves sufficient time to replace any necessary financing.

During the year ended December 31, 2012, we received proceeds from the issuance of common shares as follows:

On May 11, 2012, we issued and sold 10,000,000 common shares in an underwritten public offering and received \$193.5 million of net proceeds, after the underwriting discount and estimated offering expenses and the reimbursement of certain expenses.

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On May 17, 2012, we issued and sold an additional 287,706 common shares pursuant to the exercise of an option to purchase additional shares by the public offering's underwriters and received \$5.4 million of proceeds after the underwriting discount and reimbursement of certain expenses.

On August 22, 2012, the Company issued and sold 17,250,000 common shares in an underwritten public offering and received \$357.2 million of proceeds, after the underwriting discount and estimated offering expenses and the reimbursement of certain expenses.

On December 31, 2012, we issued 2,800,710 common shares under a Controlled Equity Offering Sales Agreement with Cantor Fitzgerald & Co. and under an ATM Equity Offering<sup>SM</sup> Sales Agreement with Merrill Lynch, Pierce, Fenner & Smith Incorporated. We received \$51.0 million, net of sales commissions.

Proceeds from the issuance of these shares were used to fund a portion of the purchase price of portfolios of residential mortgage whole loans, to fund the continued growth of the correspondent lending business, to acquire additional mortgage loans or other investments, including those under existing forward purchase agreements, and for general corporate purposes.

During 2011, we increased our use of debt financing as a means of extending our balance sheet capacity through the use of repurchase agreements and forward purchase agreements. During the year ended December 31, 2012, we continued to increase our borrowing capacity under our repurchase agreement facilities. Our repurchase agreements represent the sales of assets together with agreements for us to buy back the assets at a later date. During the year ended December 31, 2011, the average balance outstanding under agreements to repurchase MBS and mortgage loans and REO financed under agreements to repurchase totaled \$363.7 million, and the maximum daily amount outstanding under such agreements totaled \$718.3 million. During the year ended December 31, 2012, the average balance outstanding under agreements to repurchase MBS and mortgage loans and REO financed under agreements to repurchase totaled \$803.8 million and the maximum daily amount outstanding for each such agreement totaled \$1.7 billion. The difference between the maximum and average daily amounts outstanding was due to increased utilization of our existing facilities and our entry into a new credit facility during the years ended December 31, 2012 and 2011, all in support of growth in our investments and correspondent lending.

The forward purchase agreements represent agreements between us and Citigroup Global Markets Realty Corp. (CGM), pursuant to which we agreed to purchase from CGM 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 large money center banks (the Initial Sellers). As part of the agreements and in connection with our purchase of the CGM Assets, CGM assigned, and we assumed, all of CGM's rights and obligations under separate purchase agreements with the Initial Sellers. We recorded the transactions as purchases of loans. The CGM Assets were serviced primarily by PLS. On the settlement date for any CGM Asset, in addition to the payment of the purchase price, we reimbursed CGM for certain out-of-pocket costs and other expenses, including servicing fees and servicing advances, and a cost of carry incurred by CGM for such CGM Asset. The commitments under the forward purchase agreements were settled during the year ended December 31, 2012.

Repurchase agreements represent a significant source of funding for our investment portfolio. As of December 31, 2012, we financed our investments in mortgage loans at fair value and REO, and our inventory of mortgage loans acquired for sale at fair value, under agreements to repurchase as follows:

|  | December 31,<br>2012 | 2011         |
|--|----------------------|--------------|
|  | (in thousands)       |              |
| Assets financed                            | \$ 1,944,973         | \$ 1,222,845 |
| Total assets in classes of assets financed | \$ 2,253,233         | \$ 1,283,954 |
| Borrowings                                 | \$ 1,256,102         | \$ 812,357   |
| Percentage of invested assets pledged      | 86%                  | 95%          |
| Advance rate against pledged assets        | 65%                  | 66%          |
| Unused borrowing capacity(1)               | \$ 843,898           | \$ 395,563   |

- (1) The amount we are able to borrow under repurchase agreements is tied to the fair value of unencumbered assets eligible to secure those agreements and our ability to fund the agreements' margin requirements.



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The decrease in percentage of invested assets pledged is primarily due to a decrease in the amount of pledged mortgage loans to total mortgage loans.

As discussed above, all of our borrowings have short-term maturities:

The transactions relating to mortgage loans under agreements to repurchase mature between March 29, 2013 and June 5, 2013 and provide for sale to major financial institution counterparties based on the estimated fair value of the mortgage loans sold. The agreements provide for terms of approximately one year.

The transactions relating to mortgage loans acquired for sale under agreements to repurchase mature between January 4, 2013 and November 19, 2013 and provide for sale to major financial institution counterparties based on the estimated fair value of the mortgage loans sold. The agreements provide for terms of approximately one year.

The transactions relating to REO are secured financings that mature on June 5, 2013 and provide for sale to major financial institution counterparties at advance rates based on the estimated fair value of the REO.

Our debt financing agreements require us and certain of our subsidiaries to comply with various financial covenants. These financial covenants currently include the following:

profitability at each of the Company and two of our subsidiaries, the Operating Partnership and PennyMac Mortgage Investment Trust Holdings I, LLC ( PMITH ), for at least one (1) of the previous two consecutive fiscal quarters, as of the end of each fiscal quarter, and at our subsidiary, PMC, for the prior consecutive six-month period, measured on the last day of each quarter;

a minimum of \$20 million in unrestricted cash and cash equivalents at the Company on a consolidated basis; a minimum of \$12.5 million in unrestricted cash and cash equivalents at the Operating Partnership; a minimum of \$7.75 million in unrestricted cash and cash equivalents at PMC and PMITH (combined); and a minimum of \$7.5 million in unrestricted cash and cash equivalents at PMC;

a minimum tangible net worth for the Company of \$862 million; a minimum tangible net worth for the Operating Partnership of \$550 million; a minimum tangible net worth for PMITH of \$195 million; and a minimum tangible net worth for PMC of \$140 million;

a maximum ratio of total liabilities to tangible net worth of less than 3:1 for the Company, 10:1 for PMC and 5:1 for the Operating Partnership and PMITH;

a maximum ratio of liabilities to tangible net worth, in each case related to other than newly originated mortgage loans, of less than 3:1 for PMC; and

at least one other warehouse or repurchase facility with finance amounts and assets similar to those being financed under our existing debt financing agreements.

Although these financial covenants limit the amount of indebtedness we may incur and impact our liquidity through minimum cash reserve requirements, we believe that these covenants currently provide us with sufficient flexibility to successfully operate our business and obtain the financing necessary to achieve that purpose.

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When we have transactions relating to securities sold under agreements to repurchase, such transactions contain margin call provisions that, upon notice from the applicable lender at its option, require us to transfer cash or additional securities in an amount sufficient to eliminate any margin deficit. A margin deficit will generally result from any decline in the market value (as determined by the applicable lender) of the assets subject to an agreement to repurchase, although in some instances we may agree with the lender upon certain thresholds (in dollar amounts or percentages based on the market value of the assets) that must be exceeded before a margin deficit will arise. Upon notice from the applicable lender, we will generally be required to satisfy the margin call on the day of such notice or within one business day thereafter, depending on the timing of the notice.

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The transactions relating to mortgage loans and/or equity interests in special purpose entities holding real property under agreements to repurchase contain margin call provisions that, upon notice from the applicable lender at its option, require us to transfer cash or additional mortgage loans or real property, as applicable, in an amount sufficient to eliminate any margin deficit. A margin deficit will generally result from any decline in the market value (as determined by the applicable lender) of the assets subject to an agreement to repurchase. Upon notice from the applicable lender, we will generally be required to satisfy the margin call on the day of such notice or within one business day thereafter, depending on the timing of the notice.

Our Manager continues to explore a variety of additional means of financing our continued growth, including debt financing through bank warehouse lines of credit, additional repurchase agreements, term financing, securitization transactions and additional equity offerings. However, there can be no assurance as to how much additional financing capacity such efforts will produce, what form the financing will take or that such efforts will be successful. Further, counterparty credit sensitivity and collateral documentation requirements have made it difficult to obtain financing for REO, the result of which could place stress on our capital and liquidity positions at certain times during the foreclosure cycles of the related nonperforming loans.

### **Off-Balance Sheet Arrangements and Aggregate Contractual Obligations**

#### ***Off-Balance Sheet Arrangements and Guarantees***

As of December 31, 2012, we have not entered into any off-balance sheet arrangements or guarantees.

#### ***Contractual Obligations***

As of December 31, 2012, all of our known contractual obligations mature within one year. As of December 31, 2012, we had on-balance sheet contractual obligations of \$1.26 billion to finance assets under agreements to repurchase with maturities between January 4, 2013 and November 19, 2013. All agreements to repurchase that matured between December 31, 2012 and the date of this Report have been renewed or extended and are described in Note 20 *Mortgage Loans Acquired for Sale Sold Under Agreements to Repurchase*, Note 21 *Mortgage Loans at Fair Value Under Agreements to Repurchase* and Note 22 *Real Estate Acquired in Settlement of Loans Financed Under Agreements to Repurchase* in the accompanying consolidated financial statements.

The amount at risk (the fair value of the assets pledged plus the related margin deposit, less the amount advanced by the counterparty and accrued interest) relating to the Company's assets sold under agreements to repurchase is summarized by counterparty below as of December 31, 2012:

| <b>Counterparty</b>                             | <b>Amount at risk<br/>(in thousands)</b> |
|---|--|
| Citibank, N.A.                                  | \$ 530,643                               |
| Wells Fargo Bank, N.A.                          | 70,615                                   |
| Credit Suisse First Boston Mortgage Capital LLC | 49,671                                   |
| Bank of America, N.A.                           | 24,445                                   |
| Morgan Stanley Bank, N.A.                       | 9,887                                    |
| Barclays Bank PLC                               | 6,756                                    |
|   | <b>\$ 692,017</b>                        |

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*Management Agreement.* On February 1, 2013, we amended our management agreement with PCM in order to better align the base and performance incentive components of our management fee with our investment strategy. Pursuant to the terms of the management agreement, as amended, PCM collects a base management fee and may collect a performance incentive fee, both payable quarterly and in arrears. The term of the management 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.

The base management fee is calculated at a defined annualized percentage of shareholders' equity. Shareholders' equity is defined as the sum of the net proceeds from any issuances of our equity securities since our inception (weighted for the time outstanding during the measurement period); plus our retained earnings at the end of the quarter; less any amount that we pay for repurchases of our common shares (weighted for the time held during the measurement period); and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between PCM and our independent trustees and approval by a majority of our independent trustees.

Pursuant to the management agreement, the base management fee is equal to the sum of (i) 1.5% per annum of shareholders' equity up to \$2 billion, (ii) 1.375% per annum of shareholders' equity in excess of \$2 billion and up to \$5 billion, and (iii) 1.25% per annum of shareholders' equity in excess of \$5 billion. The base management fee is paid in cash.

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 the incentive fee, exceeds certain levels of return on equity. Net income, for purposes of determining the amount of the performance incentive fee, is defined as net income or loss computed in accordance with GAAP and certain other non-cash charges determined after discussions between PCM and our independent trustees and approval by a majority of our independent trustees. Equity is the weighted average of the issue price per common share of all of our public offerings, multiplied by the weighted average number of common shares outstanding (including restricted share units) in the four-quarter period.

The performance incentive fee is calculated quarterly and escalates as net income (stated as a percentage of return on equity) increases over certain thresholds. On each calculation date, the threshold amounts represent a stated return on equity, plus or minus a high watermark adjustment. The performance fee payable for any quarter 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.

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 PCM 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 performance incentive fee may be paid in cash or in our common shares (subject to a limit of no more than 50% paid in common shares), at our option.

Under the management agreement, PCM continues to be entitled to reimbursement of its organizational and operating expenses, including third-party expenses, incurred on our behalf.



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In general, we have agreed with PCM to negotiate in good faith to amend the provisions of the management agreement relating to the compensation of PCM in order to cause such compensation to be materially consistent with market rates of compensation for services comparable to those provided under the management agreement if (a) we or PCM requests such negotiation after a determination by us or PCM that the rates of compensation payable to PCM differ materially from such market rates of compensation and (b) various conditions relating to the timing and frequency of such requests are satisfied, including the condition that no request be made before the second anniversary of the execution of the management agreement. If the parties are unable to reach agreement on the terms of a fee amendment within thirty (30) days of the delivery of the relevant fee negotiation request, the terms of such fee amendment will be determined by final and binding arbitration procedures set forth in the management agreement.

Under the management agreement, PCM may be entitled to a termination fee under certain circumstances. Specifically, the termination fee is payable for (1) our termination of the management agreement without cause, (2) PCM's termination of the management agreement upon a default by us in the performance of any material term of the agreement that has continued uncured for a period of 30 days after receipt of written notice thereof or (3) PCM's termination of the agreement after the termination by us without cause (excluding a non-renewal) of the MBWS Agreement, the MSR recapture agreement, or the servicing agreement (each as defined below). 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 less than 24 months, annualized) performance incentive fee, in each case earned by PCM during the 24-month period before termination.

We may terminate the management agreement without the payment of any termination fee under certain circumstances, including, among other circumstances, in the event of uncured material breaches by PCM of the management agreement, upon a change in control of PCM (defined to include a 50% change in the shareholding of PCM in a single transaction or related series of transactions or Mr. Stanford L. Kurland's failure to continue as chief executive officer of PCM to the extent his suitable replacement (in our discretion) has not been retained by PCM within six months thereof) or upon the termination of the MBWS Agreement or the MSR recapture agreement by PLS without cause.

The management agreement also provides that, prior to the undertaking by PCM or its affiliates of any new investment opportunity or any other business opportunity requiring a source of capital with respect to which PCM or its affiliates will earn a management, advisory, consulting or similar fee, PCM shall present to us such new opportunity and the material terms on which PCM proposes to provide services to us before pursuing such opportunity with third parties.

*Servicing Agreement.* On February 1, 2013, we amended our servicing agreement with PLS. The servicing agreement establishes servicing fees that change the nature of the fees that we pay to PLS for loan servicing to fixed per-loan monthly amounts based on the delinquency, bankruptcy and/or foreclosure status of the serviced loan or the real estate acquired in settlement of a loan. 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 agreement.

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 loans subserviced by PLS on our 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 our behalf are \$7.50 per

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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 and 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, and assumption, modification and origination fees.

Except as otherwise provided in the MSR recapture agreement, when PLS effects a refinancing of a loan on our behalf and not through a third-party lender and the resulting loan is readily saleable, or PLS originates a loan to facilitate the disposition of the real estate acquired by us in settlement of a loan, PLS is entitled to receive from us market-based fees and compensation consistent with pricing and terms PLS offers unaffiliated third parties on a retail basis.

To the extent that PLS participates in HAMP (or other similar mortgage loan modification programs), PLS is entitled to retain any incentive payments made to it and to which it is entitled under HAMP, provided that, with respect to any incentive payments paid to PLS in connection with a mortgage loan modification for which we previously paid PLS a modification fee, PLS is required to reimburse us an amount equal to the incentive payments.

In addition, because we do not have any employees or infrastructure, 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. For these services, PLS receives a supplemental fee of \$25 per month for each distressed whole loan and \$3.25 per month for each other subserviced loan.

PLS continues to be entitled to reimbursement for all customary, bona fide reasonable and necessary out-of-pocket expenses incurred by PLS in connection with the performance of its servicing obligations.

In general, we have agreed with PLS to negotiate in good faith to amend the provisions of the servicing agreement relating to the compensation of PLS in order to cause such compensation to be materially consistent with market rates of compensation for services comparable to those provided under the servicing agreement if (a) either party requests such negotiation after a determination by either party that the rates of compensation payable to PLS differ materially from such market rates of compensation and (b) various conditions relating to the timing and frequency of such requests are satisfied, including the condition that no request be made before the second anniversary of the execution of the servicing agreement. If the parties are unable to reach agreement on the terms of a fee amendment within thirty (30) days of the delivery of the relevant fee negotiation request, the terms of such fee amendment will be determined by final and binding arbitration procedures set forth in the servicing agreement.

No automatic renewal of the servicing agreement will occur upon the conclusion of the term or any renewal period if our Operating Partnership or PLS delivers to the other party a notice of nonrenewal at least 180 days in advance. In addition, (i) PLS has the right to terminate the servicing agreement without cause if either of the MBWS Agreement or the MSR recapture agreement is terminated by PMC without cause as provided in each such agreement or the management agreement is terminated by us without cause as provided in such agreement and (ii) our Operating Partnership has the right to terminate the servicing agreement without cause if either of the MBWS Agreement or the MSR recapture agreement is terminated by PLS without cause or the management agreement is terminated by PCM as provided in such agreement. The servicing agreement is further subject to termination under other circumstances, generally including (a) in whole, at the election of either party following a specified default or other for-cause event on the part of the other, (b) in part with respect to one or more individual loans, at the election of our Operating Partnership in connection with a sale of such loan(s) or if such loan(s) become seriously delinquent or the real estate is acquired on behalf of the lender, and (c) in whole at the election of PLS or our Operating Partnership if PMC or PLS, respectively, defaults in its obligations under the MSR recapture agreement. Our Operating Partnership is required to pay release fees to PLS in connection with certain terminations.

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*Mortgage Banking and Warehouse Services Agreement.* Effective February 1, 2013, we terminated our Amended and Restated Mortgage Banking Services Agreement, dated as of November 1, 2010 (as amended, supplemented or otherwise modified), between us and PLS, mutually waiving any and all notice and timing requirements applicable to such termination. On the same date, we entered into a mortgage banking and warehouse services agreement (the "MBWS Agreement"), pursuant to which PLS provides us with certain mortgage banking services, including fulfillment and disposition-related services, with respect to loans acquired by us from correspondent lenders, and certain warehouse lending services, including fulfillment and administrative services, with respect to loans financed by us for our warehouse lending clients.

In accordance with the terms of the MBWS Agreement, PLS has agreed to provide such services exclusively for our benefit, and PLS and its affiliates are prohibited from providing such services for any other third party. However, such exclusivity and prohibition shall not apply, and certain other duties instead will be imposed upon PLS, if we are unable to purchase or finance mortgage loans as contemplated under the MBWS Agreement for any reason. The term of the MBWS 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.

In consideration for the mortgage banking services provided by PLS with respect to our acquisition of mortgage loans, PLS is entitled to a fulfillment fee based on the type of mortgage loan that we acquire 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 underwritten in accordance with the Ginnie Mae Mortgage-Backed Securities Guide, (iii) 0.80% for HARP mortgage loans with a loan-to-value ratio of 105% or less, and (iv) 1.20% for HARP mortgage loans with a loan-to-value ratio of greater than 105%. At this time, we do not hold the Ginnie Mae approval required to issue Ginnie Mae MBS and act as a servicer. Accordingly, under the MBWS Agreement, PLS currently purchases loans underwritten in accordance with the Ginnie Mae Mortgage-Backed Securities Guide as is and without recourse of any kind from us at our cost less an administrative fee plus accrued interest and a sourcing fee of three basis points.

In the event that we purchase 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 us 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 that we purchase mortgage loans with an aggregate unpaid principal balance in any month greater than \$5 billion, PLS has agreed to discount the amount of such fulfillment fees by reimbursing us 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 our 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 annum, and (ii) in the amount of \$50 for each mortgage loan that we acquire.

In consideration for the warehouse services provided by PLS with respect to mortgage loans that we finance for our warehouse lending clients, with respect to each facility, PLS is entitled to fees accruing (i) at a rate equal to \$25,000 per annum, and (ii) in the amount of \$50 for each mortgage loan that we finance thereunder.

Notwithstanding any provision of the MBWS Agreement to the contrary, if it becomes reasonably necessary or advisable for PLS to engage in additional services in connection with post-breach or post-default resolution activities for the purposes of a correspondent lending agreement, a warehouse agreement or a re-warehouse agreement, then we have generally agreed with PLS to negotiate in good faith for additional compensation and reimbursement of expenses to be paid to PLS for the performance of such additional services.

In general, we have agreed with PLS to negotiate in good faith to amend the provisions of the MBWS Agreement relating to the compensation of PLS or its affiliates in order to cause such compensation to be

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materially consistent with market rates of compensation for services comparable to those provided under the MBWS Agreement if (a) either party requests such negotiation after a determination by either party that the rates of compensation differ materially from such market rates of compensation and (b) various conditions relating to the timing and frequency of such requests are satisfied, including the condition that no request be made before the second anniversary of the execution of the MBWS Agreement. If the parties are unable to reach agreement on the terms of a fee amendment within thirty (30) days of the delivery of the relevant fee negotiation request, the terms of such fee amendment will be determined by final and binding arbitration procedures set forth in the MBWS Agreement.

No automatic renewal of the MBWS Agreement will occur upon the conclusion of the term or any renewal period if PMC or PLS delivers to the other party a notice of nonrenewal at least 180 days in advance. In addition, (i) PLS has the right to terminate the MBWS Agreement without cause if the MSR recapture agreement is terminated by PMC without cause as provided in such agreement, the servicing agreement is terminated by our Operating Partnership without cause as provided in such agreement or the management agreement is terminated by us without cause as provided in such agreement, and (ii) PMC has the right to terminate the MBWS Agreement without cause if the MSR recapture agreement or the servicing agreement is terminated by PLS without cause as provided in each such agreement or the management agreement is terminated by PCM without cause as provided in such agreement. The MBWS Agreement is further subject to termination under other circumstances, generally including at the election of either party following a specified default or other for-cause event on the part of the other. In the case of a non-renewal or termination of the MBWS Agreement, PMC will be entitled under certain circumstances to require that PLS continue to provide correspondent lending services for a specified number of months following the scheduled expiration or termination, in which case the then current fee structure and exclusivity obligations applicable to such services would remain in effect.

*MSR Recapture Agreement.* Effective February 1, 2013, we entered into an MSR recapture agreement with PLS. Pursuant to the terms of the MSR recapture agreement, if PLS refinances via its retail lending business loans for which we previously held the MSRs, PLS is generally required to transfer and convey to us, without cost to us, 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. The initial term of the MSR recapture agreement expires, unless terminated earlier in accordance with the terms of the agreement, on February 1, 2017, subject to automatic renewal for additional 18-month periods, unless terminated in accordance with the terms of the agreement.

In general, we have agreed with PLS to negotiate in good faith to amend the provisions of the MSR recapture agreement relating to the compensation of PLS in order to cause such compensation to be materially consistent with market rates of compensation for services comparable to those provided under the MSR recapture agreement if (a) either party requests such negotiation after a determination by either party that the rates of compensation payable to PLS differ materially from such market rates of compensation and (b) various conditions relating to the timing and frequency of such requests are satisfied, including the condition that no request be made before the second anniversary of the execution of the MSR recapture agreement. If the parties are unable to reach agreement on the terms of a fee amendment within thirty (30) days of the delivery of the relevant fee negotiation request, the terms of such fee amendment will be determined by final and binding arbitration procedures set forth in the MSR recapture agreement.

No automatic renewal of the MSR recapture agreement will occur upon the conclusion of the term or any renewal period if we or PLS delivers to the other party a notice of nonrenewal at least 180 days in advance. In addition, (i) PLS has the right to terminate the MSR recapture agreement without cause if the MBWS Agreement is terminated by PMC without cause as provided in such agreement, the servicing agreement is terminated by our Operating Partnership without cause as provided in such agreement or the management agreement is terminated by us without cause as provided in such agreement, and (ii) PMC has the right to terminate the MSR recapture agreement without cause if the MBWS Agreement or the servicing agreement is terminated by PLS without

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cause as provided in each such agreement or the management agreement is terminated by PCM without cause as provided in such agreement. In addition, if our Operating Partnership exercises its right to terminate the servicing agreement without cause in connection with sales of one or more mortgage loans serviced thereunder, PLS will be entitled to terminate the MSR recapture agreement solely with respect to such mortgage loans. Following any termination of the MSR recapture agreement, PLS is prohibited from taking action with respect to the refinancing of the mortgage loans involved in the termination, subject to various exceptions, including an exception with respect to generalized advertising not targeted exclusively to the borrowers under such mortgage loans.

*Reimbursement Agreement.* In connection with the initial public offering of our common shares ( IPO ), on August 4, 2009, we entered into an agreement with PCM pursuant to which we agreed to reimburse PCM for the \$2.9 million payment that it made to the underwriters for the IPO (the Conditional Reimbursement ) if we satisfied certain performance measures over a specified period of time. Effective February 1, 2013, we amended the terms of the reimbursement agreement to provide for the reimbursement of PCM of the Conditional Reimbursement if we are 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. The reimbursement agreement also provides for the payment to the IPO underwriters of the payment that we agreed to make to them at the time of the IPO if we satisfied certain performance measures over a specified period of time. As PCM earns performance incentive fees under the management agreement, the IPO 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.

The reimbursement agreement is intended to align the reimbursement of PCM and the payment of the underwriters with our financial performance. 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.

## **Quantitative and Qualitative Disclosures About Market Risk**

Market risk is the exposure to loss resulting from changes in interest rates, foreign currency exchange rates, commodity prices, equity prices, real estate values and other market-based risks. The primary market risks that we are exposed to are real estate risk, credit risk, interest rate risk, prepayment risk, inflation risk and market value risk. A substantial portion of our investments are comprised of nonperforming loans. We believe that such assets' fair values respond primarily to changes in the fair value of the real estate securing such loans.

### ***Real Estate Risk***

Residential property values are subject to volatility and may be affected adversely by a number of factors, including, but not limited to, national, regional and local economic conditions (which may be adversely affected by industry slowdowns and other factors); local real estate conditions (such as an oversupply of housing); construction quality, age and design; demographic factors; and retroactive changes to building or similar codes. Decreases in property values reduce the value of the collateral and the potential proceeds available to a borrower to repay our loans, which could cause us to suffer losses.

### ***Credit Risk***

We are subject to credit risk in connection with our investments. A significant portion of our assets is comprised of nonperforming residential mortgage loans. The credit risk related to these investments pertains to the ability and willingness of the borrowers to pay, which is assessed before credit is granted. We believe that residual loan credit quality is primarily determined by the borrowers' credit profiles and loan characteristics.

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### ***Interest Rate Risk***

Interest rate risk is highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Changes in interest rates affect the fair value of, interest income and net servicing income we earn from our mortgage-related investments. This effect is most pronounced with fixed-rate investments and MSRs. In general, rising interest rates negatively affect the fair value of our investments in MBS and mortgage loans.

Our operating results will depend, in part, on differences between the income from our investments and our financing costs. Presently our debt financing is based on a floating rate of interest calculated on a fixed spread over the relevant index, as determined by the particular financing arrangement.

In the event of a significant rising interest rate environment and/or economic downturn, defaults could increase and result in credit losses to us, which could materially and adversely affect our business, financial condition, liquidity, results of operations and prospects. Furthermore, such defaults could have an adverse effect on the spread between our interest earning assets and interest bearing liabilities.

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 interest rate lock commitments, inventory of mortgage loans acquired for sale and MSRs. The Company does not use derivative financial instruments for purposes other than in support of its risk management activities.

### ***Prepayment Risk***

To the extent that the actual prepayment rate on our mortgage loans differs from what we projected when we purchased the loans and when we measured fair value as of the end of each reporting period, our unrealized gain or loss will be affected. As we receive prepayments of principal on our MBS investments, any premiums paid for such investments will be amortized against interest income using the interest method through the expected maturity dates of the investments. In general, an increase in prepayment rates will accelerate the amortization of purchase premiums, thereby reducing the interest income earned on the MBS investments and will accelerate the amortization of MSRs thereby reducing net servicing income. Conversely, as we receive prepayments of principal on our investments, any discounts realized on the purchase of such investments will be accrued into interest income using the interest method through the expected maturity dates of the investments. In general, an increase in prepayment rates will accelerate the accrual of purchase discounts, thereby increasing the interest income earned on the MBS investments.

### ***Inflation Risk***

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors will influence our performance more so than inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Furthermore, our consolidated financial statements are prepared in accordance with U.S. GAAP and any distributions we may make to our shareholders will be determined by our board of trustees based primarily on our taxable income and, in each case, our activities and balance sheet are measured with reference to historical cost and/or fair value without considering inflation.

### ***Market Value Risk***

Our mortgage loans and MBS are reported at their estimated fair values. The fair value of these assets fluctuates primarily due to changes in real estate values and other factors such as interest rates, the credit performance relating to the loans underlying our investments and the effectiveness and servicing practices of the servicers associated with each investment.

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Generally, in a real estate market where values are rising or are expected to rise, the fair value of our mortgage loans would be expected to appreciate, whereas in a real estate market where values are generally dropping or are expected to drop, mortgage loan values would be expected to decrease.

The following table summarizes the estimated change in fair value of our portfolio of mortgage loans as of December 31, 2012, given several hypothetical (instantaneous) changes in home values from those used in the determination of fair value:

| Property value shift  | -15%                          | -10%         | -5%          | +5%          | +10%         | +15%         |
|-----------------------|-------------------------------|--------------|--------------|--------------|--------------|--------------|
|                       | (dollar amounts in thousands) |              |              |              |              |              |
| Fair value            | \$ 1,063,439                  | \$ 1,108,071 | \$ 1,150,333 | \$ 1,226,965 | \$ 1,261,196 | \$ 1,292,724 |
| Change in fair value: |                               |              |              |              |              |              |
| \$                    | \$ (126,437)                  | \$ (81,806)  | \$ (39,543)  | \$ 37,089    | \$ 71,320    | \$ 102,847   |
| %                     | (10.63)%                      | (6.88)%      | (3.32)%      | 3.12%        | 5.99%        | 8.64%        |

These sensitivity analyses are limited in that they were performed at a particular point in time; only contemplate certain movements in real estate values as they relate to mortgage loans; do not incorporate changes in interest rate volatility or changes in the relationship of one interest rate index to another; are subject to the accuracy of various models and assumptions used, including prepayment forecasts and discount rates; and do not incorporate other factors that would affect our 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.

### Mortgage Servicing Rights

The following tables summarize the estimated change in fair value of MSRs accounted for using the amortization method as of December 31, 2012, given several shifts in pricing spreads, prepayment speed and annual per-loan cost of servicing:

| Pricing spread shift in % | -20%                          | -10%       | -5%        | +5%        | +10%       | +20%       |
|---------------------------|-------------------------------|------------|------------|------------|------------|------------|
|                           | (dollar amounts in thousands) |            |            |            |            |            |
| Fair value                | \$ 135,877                    | \$ 131,295 | \$ 129,111 | \$ 124,943 | \$ 122,954 | \$ 119,150 |
| Change in fair value:     |                               |            |            |            |            |            |
| \$                        | \$ 8,882                      | \$ 4,300   | \$ 2,116   | \$ (2,052) | \$ (4,041) | \$ (7,845) |
| %                         | 6.99%                         | 3.39%      | 1.67%      | -1.62%     | -3.18%     | -6.18%     |

| Prepayment speed shift in % | -20%                          | -10%       | -5%        | +5%        | +10%       | +20%        |
|-----------------------------|-------------------------------|------------|------------|------------|------------|-------------|
|                             | (dollar amounts in thousands) |            |            |            |            |             |
| Fair value                  | \$ 140,375                    | \$ 133,416 | \$ 130,141 | \$ 123,969 | \$ 121,058 | \$ 115,558  |
| Change in fair value:       |                               |            |            |            |            |             |
| \$                          | \$ 13,380                     | \$ 6,421   | \$ 3,147   | \$ (3,026) | \$ (5,937) | \$ (11,436) |
| %                           | 10.54%                        | 5.06%      | 2.48%      | -2.38%     | -4.67%     | -9.01%      |

| Per-loan servicing cost shift in % | -20%                          | -10%       | -5%        | +5%        | +10%       | +20%       |
|------------------------------------|-------------------------------|------------|------------|------------|------------|------------|
|                                    | (dollar amounts in thousands) |            |            |            |            |            |
| Fair value                         | \$ 130,107                    | \$ 128,551 | \$ 127,773 | \$ 126,217 | \$ 125,439 | \$ 123,883 |
| Change in fair value:              |                               |            |            |            |            |            |
| \$                                 | \$ 3,112                      | \$ 1,556   | \$ 778     | \$ (778)   | \$ (1,556) | \$ (3,112) |
| %                                  | 2.45%                         | 1.23%      | 0.61%      | -0.61%     | -1.23%     | -2.45%     |

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The following tables summarize the estimated change in fair value of MSR's accounted for using the fair value option method as of December 31, 2012, given several shifts in pricing spreads, prepayment speed and annual per-loan cost of servicing:

| Pricing spread shift in %          | -20%                          | -10%     | -5%      | +5%      | +10%     | +20%     |
|------------------------------------|-------------------------------|----------|----------|----------|----------|----------|
|                                    | (dollar amounts in thousands) |          |          |          |          |          |
| Fair value                         | \$ 1,466                      | \$ 1,420 | \$ 1,398 | \$ 1,357 | \$ 1,337 | \$ 1,299 |
| Change in fair value:              |                               |          |          |          |          |          |
| \$                                 | \$ 89                         | \$ 43    | \$ 21    | \$ (21)  | \$ (40)  | \$ (78)  |
| %                                  | 6.44%                         | 3.12%    | 1.54%    | -1.49%   | -2.93%   | -5.70%   |
| Prepayment speed shift in %        | -20%                          | -10%     | -5%      | +5%      | +10%     | +20%     |
|                                    | (dollar amounts in thousands) |          |          |          |          |          |
| Fair value                         | \$ 1,616                      | \$ 1,490 | \$ 1,432 | \$ 1,326 | \$ 1,277 | \$ 1,187 |
| Change in fair value:              |                               |          |          |          |          |          |
| \$                                 | \$ 239                        | \$ 112   | \$ 55    | \$ (52)  | \$ (100) | \$ (190) |
| %                                  | 17.32%                        | 8.15%    | 3.96%    | -3.74%   | -7.28%   | -13.79%  |
| Per-loan servicing cost shift in % | -20%                          | -10%     | -5%      | +5%      | +10%     | +20%     |
|                                    | (dollar amounts in thousands) |          |          |          |          |          |
| Fair value                         | \$ 1,426                      | \$ 1,401 | \$ 1,389 | \$ 1,365 | \$ 1,353 | \$ 1,329 |
| Change in fair value:              |                               |          |          |          |          |          |
| \$                                 | \$ 48                         | \$ 24    | \$ 12    | \$ (12)  | \$ (24)  | \$ (48)  |
| %                                  | 3.52%                         | 1.76%    | 0.88%    | -0.88%   | -1.76%   | -3.52%   |

## Accounting Developments

In December 2011, the Financial Accounting Standards Board ( FASB ) issued an Accounting Standards Update, ( ASU ), ASU 2011-11 to the *Balance Sheet* topic of its Accounting Standards Codification ( ASC or the Codification ). The amendments in this ASU affect all entities that have financial instruments and derivative instruments that are either (1) offset in accordance with the *Offsetting Presentation* section of the *Balance Sheet* topic or the *Presentation* section of the *Derivatives and Hedging* topic of the Codification or (2) subject an enforceable master netting arrangement or similar agreement.

The amendments in this ASU require the Company to disclose information about offsetting and related arrangement to enable users of financial statements to understand the effect of netting to an entity's financial position.

In January 2013, the FASB issued ASU 2013-01, *Clarifying the Scope of Disclosures About Offsetting Assets and Liabilities*, which clarifies which instruments and transactions are subject to the offsetting disclosure requirements established by ASU 2011-11. The ASU clarifies the scope applied to derivatives accounted for in accordance with the *Derivatives and Hedging* topic, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with the *Offsetting Presentation* section of the *Balance Sheet* topic or the *Presentation* section of the *Derivatives and Hedging* topic or subject to an enforceable master netting arrangement or similar agreement.

The ASU amendment and the subsequent clarification of the amendment are effective for periods beginning on or after January 1, 2013, and must be shown for all periods shown on the balance sheet. The adoption of these ASU amendments is not expected to have a material effect on our financial condition or results of operations.



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### **Item 7A. *Quantitative and Qualitative Disclosures About Market Risk***

In response to this Item 7A, the information set forth on pages 102 to 105 is incorporated herein by reference.

### **Item 8. *Financial Statements and Supplementary Data***

The information called for by this Item 8 is hereby incorporated by reference from our Financial Statements and Auditors' Report beginning at page F-1 of this Report.

### **Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None

### **Item 9A. *Controls and Procedures* Disclosure Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 (the "Exchange Act") is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures. However, no matter how well a control system is designed and operated, it can provide only reasonable, not absolute, assurance that it will detect or uncover failures within the Company to disclose material information otherwise required to be set forth in our periodic reports.

Our management has conducted an evaluation, with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Report as required by paragraph (b) of Rules 13a-15 and 15d-15 under the Exchange Act. Based on our evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective, as of the end of the period covered by this Report, to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the applicable rules and forms, and that it is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

### **Internal Control over Financial Reporting**

#### ***Management's Annual Report on Internal Control over Financial Reporting***

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Exchange Act Rule 13a-15(f). Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Management assessed the effectiveness of its internal control over financial reporting based on the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework. Based on those criteria, management concluded that our internal control over financial reporting was effective as of December 31, 2012.

The effectiveness of our internal control over financial reporting as of December 31, 2012 has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report which appears herein.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Trustees and Shareholders of

PennyMac Mortgage Investment Trust:

We have audited the internal control over financial reporting of PennyMac Mortgage Investment Trust and subsidiaries ( the Company ) as of December 31, 2012, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of trustees, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2012 of the Company and our report dated February 28, 2013 expressed an unqualified opinion on those financial statements.

/s/ DELOITTE & TOUCHE LLP

Los Angeles, California

February 28, 2013

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### ***Changes to Internal Control over Financial Reporting***

There has been no change in our internal control over financial reporting during the quarter ended December 31, 2012, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### **Item 9B. *Other Information***

## **PART III**

### **Item 10. *Directors, Executive Officers and Corporate Governance***

The information required by this Item 10 is hereby incorporated by reference from our definitive proxy statement, or will be contained in an amendment to this Report, in either case to be filed by April 30, 2013, which is within 120 days after the end of fiscal year 2012.

### **Item 11. *Executive Compensation***

The information required by this Item 11 is hereby incorporated by reference from our definitive proxy statement, or will be contained in an amendment to this Report, in either case to be filed by April 30, 2013, which is within 120 days after the end of fiscal year 2012.

### **Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required by this Item 12 is hereby incorporated by reference from our definitive proxy statement, or will be contained in an amendment to this Report, in either case to be filed by April 30, 2013, which is within 120 days after the end of fiscal year 2012.

### **Item 13. *Certain Relationships and Related Transactions, and Director Independence***

The information required by this Item 13 is hereby incorporated by reference from our definitive proxy statement, or will be contained in an amendment to this Report, in either case to be filed by April 30, 2013, which is within 120 days after the end of fiscal year 2012.

### **Item 14. *Principal Accountant Fees and Services***

The information required by this Item 14 is hereby incorporated by reference from our definitive proxy statement, or will be contained in an amendment to this Report, in either case to be filed by April 30, 2013, which is within 120 days after the end of fiscal year 2012.

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**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

| <b>Exhibit Number</b> | <b>Exhibit Description</b>   |
|-----------------------|--|
| 3.1                   | Declaration of Trust of PennyMac Mortgage Investment Trust, as amended and restated (incorporated by reference to Exhibit 3.1 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).  |
| 3.2                   | Bylaws of PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 3.2 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).   |
| 4.1                   | Specimen Common Share Certificate of PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 4.1 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).  |
| 10.1                  | Registration Rights Agreement, dated as of August 4, 2009, among PennyMac Mortgage Investment Trust, Stanford L. Kurland, David A. Spector, BlackRock Holdco II, Inc., Highfields Capital Investments LLC and Private National Mortgage Acceptance Company, LLC (incorporated by reference to Exhibit 10.1 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009). |
| 10.2                  | Underwriting Fee Reimbursement Agreement, dated as of August 4, 2009, among PennyMac Mortgage Investment Trust, PennyMac Operating Partnership, L.P. and PNMAC Capital Management, LLC (incorporated by reference to Exhibit 10.7 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).  |
| 10.3                  | Amended and Restated Limited Partnership Agreement of PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.2 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).  |
| 10.4                  | Management Agreement, dated as of August 4, 2009, among PennyMac Mortgage Investment Trust, PennyMac Operating Partnership, L.P. and PNMAC Capital Management, LLC (incorporated by reference to Exhibit 10.3 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).  |
| 10.5                  | Amendment No. 1 to Management Agreement, dated March 3, 2010, among PennyMac Mortgage Investment Trust, PennyMac Operating Partnership, L.P. and PNMAC Capital Management, LLC (incorporated by reference to Exhibit 10.4 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2010).  |
| 10.6                  | Amendment No. 2 to Management Agreement, dated May 16, 2012, among PennyMac Mortgage Investment Trust, PennyMac Operating Partnership, L.P. and PNMAC Capital Management, LLC (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on May 22, 2012).  |
| 10.7                  | Flow Servicing Agreement, dated as of August 4, 2009, between PennyMac Operating Partnership, L.P. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.4 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).  |
| 10.8                  | Amendment No. 1 to Flow Servicing Agreement, dated as of March 3, 2010, between PennyMac Operating Partnership, L.P. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.6 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2010).  |
| 10.9                  | Amendment No. 2 to Flow Servicing Agreement, dated as of March 8, 2011, between PennyMac Operating Partnership, L.P. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.8 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2011).  |

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| <b>Exhibit Number</b> | <b>Exhibit Description</b>   |
|-----------------------|--|
| 10.10                 | Amendment No. 3 to Flow Servicing Agreement, dated as of May 17, 2011, by and between PennyMac Operating Partnership, L.P. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.9 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2011).   |
| 10.11                 | PennyMac Mortgage Investment Trust 2009 Equity Incentive Plan (incorporated by reference to Exhibit 10.5 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).   |
| 10.12                 | Form of Restricted Share Unit Award Agreement under the PennyMac Mortgage Investment Trust 2009 Equity Incentive Plan (incorporated by reference to Exhibit 10.8 to Amendment No. 3 to the Company's Registration Statement on Form S-11, filed with the SEC on July 24, 2009).  |
| 10.13                 | Master Repurchase Agreement, dated as of November 2, 2010, among PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC, and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.11 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2010).                                |
| 10.14                 | Amendment Number One to Master Repurchase Agreement, dated as of August 18, 2011, among PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC, and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.13 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).         |
| 10.15                 | Amendment Number Two to Master Repurchase Agreement, dated as of September 28, 2011, among PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC, and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.14 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).      |
| 10.16                 | Amendment Number Three to Master Repurchase Agreement, dated as of December 30, 2011, among PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC, and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.15 of our Annual Report on Form 10-K for the year ended December 31, 2011).            |
| 10.17                 | Amendment Number Four to Master Repurchase Agreement, dated as of December 28, 2012, among PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC, and Wells Fargo Bank, National Association.   |
| 10.18                 | Guaranty Agreement, dated as of November 2, 2010, by PennyMac Mortgage Investment Trust in favor of Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.12 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2010).   |
| 10.19                 | Amendment Number One to Guaranty Agreement, dated as of August 18, 2011, by PennyMac Mortgage Investment Trust in favor of Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.16 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).  |
| 10.20                 | Amendment Number Two to Guaranty Agreement, dated as of September 28, 2011, by PennyMac Mortgage Investment Trust in favor of Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.17 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).   |
| 10.21                 | Master Repurchase Agreement, dated as of November 2, 2010, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.13 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2010). |

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| <b>Exhibit Number</b> | <b>Exhibit Description</b>   |
|-----------------------|--|
| 10.22                 | Amendment Number One to Master Repurchase Agreement, dated as of May 20, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.15 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2011).           |
| 10.23                 | Amendment Number Two to Master Repurchase Agreement, dated as of July 14, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.20 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).     |
| 10.24                 | Amendment Number Three to Master Repurchase Agreement, dated as of October 7, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.21 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011). |
| 10.25                 | Amendment Number Four to Master Repurchase Agreement, dated as of November 1, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.22 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011). |
| 10.26                 | Amendment Number Five to Master Repurchase Agreement, dated as of November 30, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on November 30, 2011).                   |
| 10.27                 | Amendment Number Six to Master Repurchase Agreement, dated as of March 29, 2012, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.25 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2012).        |
| 10.28                 | Amendment Number Seven to Master Repurchase Agreement, dated as of July 25, 2012, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on July 31, 2012).                          |
| 10.29                 | Amendment Number Eight to Master Repurchase Agreement, dated as of September 26, 2012, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on October 1, 2012).                   |
| 10.30                 | Amendment Number Nine to Master Repurchase Agreement, dated as of October 29, 2012, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on October 29, 2012).                     |
| 10.31                 | Guaranty, dated as of November 2, 2010, by PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. and Credit Suisse First Boston Mortgage Capital, LLC (incorporated by reference to Exhibit 10.14 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2010).  |
| 10.32                 | Master Repurchase Agreement, dated as of December 9, 2010, among PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC, and PennyMac Loan Services, LLC, and Citibank, N.A. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on December 15, 2010).  |

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| <b>Exhibit Number</b> | <b>Exhibit Description</b>  |
|-----------------------|---|
| 10.33                 | Amendment Number One to Master Repurchase Agreement, dated as of February 25, 2011, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on March 3, 2011).   |
| 10.34                 | Amendment Number Two to Master Repurchase Agreement, dated as of December 8, 2011, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.28 of our Annual Report on Form 10-K for the year ended December 31, 2011).  |
| 10.35                 | Amendment Number Three to Master Repurchase Agreement, dated as of February 24, 2012, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.30 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2012).  |
| 10.36                 | Amendment Number Four to Master Repurchase Agreement, dated as of April 13, 2012, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.32 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012).   |
| 10.37                 | Amendment Number Five to Master Repurchase Agreement, dated as of April 20, 2012, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.33 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012).   |
| 10.38                 | Amendment Number Six to Master Repurchase Agreement, dated as of May 31, 2012, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on June 5, 2012).   |
| 10.39                 | Amendment Number Seven to Master Repurchase Agreement, dated as of November 13, 2012, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC.   |
| 10.40                 | Amendment Number Eight to Master Repurchase Agreement, dated as of December 31, 2012, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC.   |
| 10.41                 | Guaranty Agreement, dated as of December 9, 2010, by PennyMac Mortgage Investment Trust in favor of Citibank, N.A. (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on December 15, 2010).   |
| 10.42                 | Master Repurchase Agreement, dated as of June 8, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on June 14, 2011).  |
| 10.43                 | Amended and Restated Master Repurchase Agreement, dated as of August 25, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 10.28 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).             |
| 10.44                 | Amendment No. 1 to Amended and Restated Master Repurchase Agreement, dated as of June 6, 2012, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 10.38 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012). |

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| <b>Exhibit Number</b> | <b>Exhibit Description</b>  |
|-----------------------|---|
| 10.45                 | Guaranty, dated as of June 8, 2011, of PennyMac Mortgage Investment Trust in favor of Credit Suisse First Boston Mortgage Capital LLC (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on June 14, 2011).  |
| 10.46                 | Master Loan and Security Agreement, dated as of September 28, 2011, by and between PCNPL Trust and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on October 4, 2011).  |
| 10.47                 | Limited Guaranty Agreement, dated as of September 28, 2011, of PennyMac Mortgage Investment Trust in favor of Wells Fargo Bank, National Association (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on October 4, 2011).   |
| 10.48                 | Master Repurchase Agreement, dated as of November 7, 2011, among Bank of America, N.A., PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on November 14, 2011).  |
| 10.49                 | Amendment No. 1 to Master Repurchase Agreement, dated as of August 17, 2012, among Bank of America, N.A., PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.45 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2012).   |
| 10.50                 | Guaranty, dated as of November 7, 2011, by PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P., in favor of Bank of America, N.A. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on November 14, 2011).  |
| 10.51                 | Letter Agreement, dated as of July 21, 2011, by and between PennyMac Corp. and Citigroup Global Markets Realty Corp. (incorporated by reference to Exhibit 10.32 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).*   |
| 10.52                 | Amendment Number One, dated as of January 6, 2012, to Letter Agreement, dated as of July 12, 2011, by and between PennyMac Corp. and Citigroup Global Markets Realty Corp. (incorporated by reference to Exhibit 10.40 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2012).*   |
| 10.53                 | Amendment Number Two, dated as of February 1, 2012, to Letter Agreement, dated as of July 12, 2011, by and between PennyMac Corp. and Citigroup Global Markets Realty Corp. (incorporated by reference to Exhibit 10.41 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2012).*  |
| 10.54                 | Letter Agreement, dated as of December 20, 2011, by and between PennyMac Corp. and Citigroup Global Markets Realty Corp. (incorporated by reference to Exhibit 10.38 of our Annual Report on Form 10-K filed on March 9, 2012).*  |
| 10.55                 | Master Repurchase Agreement, dated as of March 29, 2012, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Mortgage Investment Trust Holdings I, LLC, PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on March 29, 2012).                              |
| 10.56                 | Amendment Number One to Master Repurchase Agreement, dated as of July 25, 2012, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Mortgage Investment Trust Holdings I, LLC, PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on July 31, 2012).        |
| 10.57                 | Amendment Number Two to Master Repurchase Agreement, dated as of September 26, 2012, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Mortgage Investment Trust Holdings I, LLC, PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on October 1, 2012). |



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| <b>Exhibit Number</b> | <b>Exhibit Description</b>   |
|-----------------------|--|
| 10.58                 | Amendment Number Three to Master Repurchase Agreement, dated as of October 29, 2012, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Mortgage Investment Trust Holdings I, LLC, PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on October 29, 2012). |
| 10.59                 | Guaranty, dated as of March 29, 2012, by PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. in favor of Credit Suisse First Boston Mortgage Capital, LLC (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on March 29, 2012).  |
| 10.60                 | Master Repurchase Agreement, dated as of May 24, 2012, among Citibank, N.A., PennyMac Corp. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on May 30, 2012).  |
| 10.61                 | Amendment Number One to Master Repurchase Agreement, dated as of October 15, 2012, among Citibank, N.A., PennyMac Corp. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on October 16, 2012).  |
| 10.62                 | Amendment Number Two to Master Repurchase Agreement, dated as of November 13, 2012, among Citibank, N.A., PennyMac Corp. and PennyMac Loan Services, LLC.  |
| 10.63                 | Guaranty, dated as of May 24, 2012, by PennyMac Mortgage Investment Trust in favor of Citibank, N.A. (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on May 30, 2012).   |
| 10.64                 | Master Repurchase Agreement, dated as of July 2, 2012, among Barclays Bank PLC, PennyMac Corp., PennyMac Loan Services, LLC and PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on July 10, 2012).  |
| 10.65                 | Amended and Restated Mortgage Banking Services Agreement, dated as of November 1, 2010, between PennyMac Corp. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.53 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012).  |
| 10.66                 | Amendment No. 1 to Amended and Restated Mortgage Banking Services Agreement, dated as of July 1, 2011, between PennyMac Corp. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.54 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012).   |
| 10.67                 | Amendment No. 2 to Amended and Restated Mortgage Banking Services Agreement, dated as of February 29, 2012, between PennyMac Corp. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.55 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012).  |
| 10.68                 | Amendment No. 3 to Amended and Restated Mortgage Banking Services Agreement, dated as of May 16, 2012, between PennyMac Corp. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.56 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012).   |
| 10.69                 | Master Repurchase Agreement, dated as of September 28, 2012, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Operating Partnership, L.P. and PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on October 3, 2012).  |
| 10.70                 | Guaranty, dated as of September 28, 2012, by PennyMac Mortgage Investment Trust in favor of Credit Suisse First Boston Mortgage Capital, LLC (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on October 3, 2012).  |

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| <b>Exhibit Number</b> | <b>Exhibit Description</b>  |
|-----------------------|---|
| 10.71                 | Master Repurchase Agreement, dated as of November 20, 2012, among PennyMac Corp., Morgan Stanley Bank, N.A. and Morgan Stanley Mortgage Capital Holdings LLC (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on November 26, 2012).   |
| 10.72                 | Guaranty, dated as of November 20, 2012, by PennyMac Mortgage Investment Trust in favor of Morgan Stanley Bank, N.A. and Morgan Stanley Mortgage Capital Holdings LLC (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on November 26, 2012).  |
| 21.1                  | Subsidiaries of PennyMac Mortgage Investment Trust.   |
| 23.1                  | Consent of Deloitte & Touche LLP.   |
| 31.1                  | Certification of Stanford L. Kurland pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2                  | Certification of Anne D. McCallion pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1                  | Certification of Stanford L. Kurland pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 32.2                  | Certification of Anne D. McCallion pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 101                   | Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Balance Sheets as of December 31, 2012 and December 31, 2011, (ii) the Consolidated Statements of Income for the years ended December 31, 2012, 2011 and 2010, (iii) the Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2012, 2011 and 2010, (iv) the Consolidated Statements of Cash Flows for the years ended December 31, 2012, 2011 and 2010 and (v) the Notes to the Consolidated Financial Statements.** |

\* Certain terms have been redacted pursuant to requests for confidential treatment that were granted by the Securities and Exchange Commission.

\*\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is otherwise not subject to liability under those sections.

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**PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2012**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Trustees and Shareholders of

PennyMac Mortgage Investment Trust:

We have audited the accompanying consolidated balance sheets of PennyMac Mortgage Investment Trust and subsidiaries (the Company) as of December 31, 2012 and 2011, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2012. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of PennyMac Mortgage Investment Trust and subsidiaries at December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2012, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 28, 2013, expressed an unqualified opinion on the Company's internal control over financial reporting.

**/s/ DELOITTE & TOUCHE LLP**

Los Angeles, California

February 28, 2013

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

|   | December 31, |              |
|---|--------------|--------------|
|   | 2012         | 2011         |
| <b>ASSETS</b>   |              |              |
| Cash  | \$ 33,756    | \$ 14,589    |
| Short-term investments  | 39,017       | 30,319       |
| United States Treasury security   |              | 50,000       |
| Mortgage-backed securities at fair value  |              | 72,813       |
| Mortgage loans acquired for sale at fair value  | 975,184      | 232,016      |
| Mortgage loans at fair value  | 1,189,971    | 696,266      |
| Mortgage loans under forward purchase agreements at fair value  |              | 129,310      |
| Real estate acquired in settlement of loans   | 88,078       | 80,570       |
| Real estate acquired in settlement of loans under forward purchase agreements   |              | 22,979       |
| Mortgage servicing right at lower of amortized cost or fair value   | 125,430      | 5,282        |
| Mortgage servicing right at fair value  | 1,346        | 749          |
| Principal and interest collections receivable   | 29,204       | 8,664        |
| Principal and interest collections receivable under forward purchase agreements   |              | 5,299        |
| Interest receivable   | 3,029        | 2,099        |
| Derivative assets   | 23,706       | 1,938        |
| Servicing advances  | 32,191       | 18,870       |
| Due from affiliates   | 4,829        | 347          |
| Other assets  | 13,922       | 13,952       |
| Total assets  | \$ 2,559,663 | \$ 1,386,062 |
| <b>LIABILITIES</b>  |              |              |
| Assets sold under agreements to repurchase:   |              |              |
| Securities  | \$           | \$ 115,493   |
| Mortgage loans acquired for sale at fair value  | 894,906      | 212,677      |
| Mortgage loans at fair value  | 353,805      | 275,649      |
| Real estate acquired in settlement of loans   | 7,391        | 27,494       |
| Note payable secured by mortgage loans at fair value  |              | 28,617       |
| Borrowings under forward purchase agreements  |              | 152,427      |
| Derivative liabilities  | 967          |              |
| Recourse liability  | 4,441        | 205          |
| Accounts payable and accrued liabilities  | 42,402       | 8,993        |
| Contingent underwriting fees payable  | 5,883        | 5,883        |
| Payable to affiliates   | 12,216       | 12,166       |
| Income taxes payable  | 36,316       | 441          |
| Total liabilities   | 1,358,327    | 840,045      |
| Commitments and contingencies   |              |              |
| <b>SHAREHOLDERS' EQUITY</b>   |              |              |
| Common shares of beneficial interest authorized, 500,000,000 common shares of \$0.01 par value; issued and outstanding, 58,904,456 and 28,404,554 common shares, respectively | 589          | 284          |
| Additional paid-in capital  | 1,129,858    | 518,272      |
| Retained earnings   | 70,889       | 27,461       |

## Edgar Filing: PennyMac Mortgage Investment Trust - Form 10-K

|  |              |              |
|--|--------------|--------------|
| Total shareholders' equity                 | 1,201,336    | 546,017      |
| Total liabilities and shareholders' equity | \$ 2,559,663 | \$ 1,386,062 |

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

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**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME**

(in thousands, except per share data)

|  | Year ended December 31, |           |           |
|--|-------------------------|-----------|-----------|
|  | 2012                    | 2011      | 2010      |
| <b>Net investment income</b>                           |                         |           |           |
| Net gain on mortgage loans acquired for sale           | \$ 147,675              | \$ 7,633  | \$ 18     |
| Net gain (loss) on investments:                        |                         |           |           |
| Mortgage-backed securities                             | 612                     | (2,812)   | 233       |
| Mortgage loans   | 103,037                 | 85,455    | 27,195    |
|  | 103,649                 | 82,643    | 27,428    |
| Interest income:                                       |                         |           |           |
| Short-term investments                                 | 42                      | 100       | 86        |
| Mortgage-backed securities                             | 2,084                   | 3,229     | 5,186     |
| Mortgage loans   | 70,190                  | 32,819    | 9,302     |
| Other  | 125                     |           |           |
|  | 72,441                  | 36,148    | 14,574    |
| Loan origination fees                                  | 10,545                  | 1,085     | 23        |
| Results of real estate acquired in settlement of loans | 1,368                   | 1,079     | 2,002     |
| Net loan servicing fees                                | (564)                   | 20        |           |
| Other  | 54                      | 6         | 9         |
| Net investment income                                  | 335,168                 | 128,614   | 44,054    |
| <b>Expenses</b>  |                         |           |           |
| Loan fulfillment fees                                  | 62,906                  | 1,747     |           |
| Interest   | 31,642                  | 16,946    | 826       |
| Loan servicing   | 20,180                  | 15,364    | 3,200     |
| Management fees  | 12,436                  | 6,740     | 4,878     |
| Compensation   | 7,144                   | 5,161     | 2,627     |
| Professional services                                  | 6,053                   | 4,434     | 2,581     |
| Other  | 7,985                   | 5,727     | 2,916     |
| Total expenses   | 148,346                 | 56,119    | 17,028    |
| Income before provision for income taxes               | 186,822                 | 72,495    | 27,026    |
| Provision for income taxes                             | 48,573                  | 8,056     | 2,543     |
| Net income   | \$ 138,249              | \$ 64,439 | \$ 24,483 |
| <b>Earnings per share</b>                              |                         |           |           |
| Basic  | \$ 3.14                 | \$ 2.41   | \$ 1.46   |
| Diluted  | \$ 3.14                 | \$ 2.41   | \$ 1.44   |
| <b>Weighted-average shares outstanding</b>             |                         |           |           |
| Basic  | 43,553                  | 26,396    | 16,775    |
| Diluted  | 43,876                  | 26,679    | 17,048    |

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|                                     |         |         |         |
|-------------------------------------|---------|---------|---------|
| <b>Dividends declared per share</b> | \$ 2.22 | \$ 1.42 | \$ 1.19 |
|-------------------------------------|---------|---------|---------|

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**

(in thousands, except share data)

|   | Number<br>of<br>shares | Par<br>value | Additional<br>paid-in<br>capital | Retained<br>earnings | Total        |
|---|------------------------|--------------|----------------------------------|----------------------|--------------|
| <b>Balance at December 31, 2009</b>       | 16,735,317             | \$ 167       | \$ 315,514                       | \$ (1,883)           | \$ 313,798   |
| Net income                                |                        |              |                                  | 24,483               | 24,483       |
| Share-based compensation                  | 97,026                 | 1            | 1,811                            |                      | 1,812        |
| Cash dividends declared, \$1.19 per share |                        |              |                                  | (20,030)             | (20,030)     |
| Underwriting and offering costs           |                        |              | (150)                            |                      | (150)        |
| <b>Balance at December 31, 2010</b>       | 16,832,343             | 168          | 317,175                          | 2,570                | 319,913      |
| Net income                                |                        |              |                                  | 64,439               | 64,439       |
| Share-based compensation                  | 88,711                 | 1            | 3,737                            |                      | 3,738        |
| Cash dividends declared, \$1.42 per share |                        |              |                                  | (39,548)             | (39,548)     |
| Proceeds from offerings of common shares  | 11,483,500             | 115          | 205,941                          |                      | 206,056      |
| Underwriting and offering costs           |                        |              | (8,581)                          |                      | (8,581)      |
| <b>Balance at December 31, 2011</b>       | 28,404,554             | 284          | 518,272                          | 27,461               | 546,017      |
| Net income                                |                        |              |                                  | 138,249              | 138,249      |
| Share-based compensation                  | 163,509                | 2            | 5,066                            |                      | 5,068        |
| Cash dividends declared, \$2.22 per share |                        |              |                                  | (94,821)             | (94,821)     |
| Proceeds from offerings of common shares  | 30,336,393             | 303          | 607,881                          |                      | 608,184      |
| Underwriting and offering costs           |                        |              | (1,361)                          |                      | (1,361)      |
| <b>Balance at December 31, 2012</b>       | 58,904,456             | \$ 589       | \$ 1,129,858                     | \$ 70,889            | \$ 1,201,336 |

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

(in thousands)

|  | Year ended December 31, |             |           |
|--|-------------------------|-------------|-----------|
|  | 2012                    | 2011        | 2010      |
| <b>Cash flows from operating activities:</b>   |                         |             |           |
| Net income   | \$ 138,249              | \$ 64,439   | \$ 24,483 |
| Adjustments to reconcile net income to net cash used by operating activities:  |                         |             |           |
| Net gain on mortgage loans acquired for sale at fair value   | (147,675)               | (7,633)     | (18)      |
| Net (gain) loss on mortgage-backed securities at fair value  | (612)                   | 2,812       | (233)     |
| Net gain on mortgage loans at fair value   | (103,037)               | (85,455)    | (27,195)  |
| Accrual of unearned discounts on mortgage-backed securities at fair value and capitalization of interest and advance on mortgage loans at fair value | (19,887)                | (1,993)     | (3,287)   |
| Results of real estate acquired in settlement of loans   | (1,368)                 | (1,079)     | (2,002)   |
| Change in fair value, amortization and impairment of mortgage servicing rights   | 11,730                  | 48          |           |
| Amortization of credit facility commitment fees  | 2,952                   | 1,842       |           |
| Accrual of costs related to forward purchase agreements  | 3,421                   | 4,406       |           |
| Share-based compensation expense   | 5,067                   | 3,738       | 1,812     |
| Purchases of mortgage loans acquired for sale at fair value  | (22,443,136)            | (1,318,763) | (43,841)  |
| Sales of mortgage loans acquired for sale at fair value  | 21,698,266              | 1,090,299   | 39,853    |
| Increase in principal and interest collections receivable  | (20,540)                | (415)       | (8,145)   |
| (Increase) decrease in principal and interest collections receivable under forward purchase agreements   | 5,299                   | (5,299)     |           |
| Increase in interest receivable  | (930)                   | (1,121)     | (641)     |
| Decrease (increase) in due from affiliates   | (4,482)                 | 1,768       | (2,095)   |
| Increase in servicing advances   | (13,321)                | (16,165)    | (2,705)   |
| Decrease (increase) in other assets  | 861                     | (10,910)    | (1,615)   |
| Increase (decrease) in accounts payable and accrued liabilities  | 32,818                  | (2,662)     | 1,483     |
| Increase in payable to affiliates  | 50                      | 6,571       | 1,357     |
| Increase in income taxes payable   | 35,875                  | 441         |           |
| Net cash used by operating activities  | (820,400)               | (275,131)   | (22,789)  |
| <b>Cash flows from investing activities</b>  |                         |             |           |
| Net (increase) decrease in short-term investments  | (8,698)                 | (30,319)    | 213,628   |
| Repayment (purchase) of United States Treasury security  | 50,000                  | (50,000)    |           |
| Purchases of mortgage-backed securities at fair value  | (112,211)               | (21,420)    | (91,141)  |
| Sales of mortgage-backed securities at fair value  | 165,949                 | 7,994       |           |
| Repayments of mortgage-backed securities at fair value   | 23,218                  | 59,666      | 58,560    |
| Purchases of mortgage loans at fair value  | (541,696)               | (453,323)   | (417,211) |
| Repayments of mortgage loans at fair value   | 169,877                 | 111,624     | 55,198    |
| Sales of mortgage loans at fair value  |                         | 2,570       | 5,228     |
| Repayments of mortgage loans under forward purchase agreements at fair value   | 14,292                  | 33,097      |           |
| Purchases of real estate acquired in settlement of loans   | (48)                    | (1,511)     | (1,238)   |
| Sales of real estate acquired in settlement of loans   | 126,499                 | 63,203      | 19,402    |
| Sales of real estate acquired in settlement of loans under forward purchase agreements   | 9,912                   | 1,258       |           |
| Purchases of mortgage servicing rights   | (23)                    |             |           |
| Sales of mortgage servicing rights   | 104                     |             |           |
| Increase in margin deposits and restricted cash  | (8,617)                 | (632)       | (9,758)   |
| Net cash used by investing activities  | (111,442)               | (277,793)   | (167,332) |
| <b>Cash flows from financing activities</b>  |                         |             |           |
| Sales of securities under agreements to repurchase   | 752,343                 | 1,423,615   | 513,141   |
| Repurchases of securities sold under agreements to repurchase  | (867,836)               | (1,409,324) | (411,939) |
| Sales of loans acquired for sale at fair value under agreements to repurchase  | 21,085,673              | 1,531,744   | 147,422   |
| Repurchases of loans acquired for sale at fair value sold under agreements to repurchase   | (20,327,332)            | (1,190,840) |           |
| Advances from note payable secured by mortgage loans at fair value   |                         | 33,386      |           |

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|   |               |               |               |
|---|---------------|---------------|---------------|
| Repayments of note payable secured by mortgage loans at fair value                                | (26,573)      | (4,769)       |               |
| Repayments of borrowings under forward purchase agreements  | (157,166)     | (47,167)      |               |
| Sales of real estate acquired in settlement of loans financed under agreement to repurchase       | 10,753        | 37,587        |               |
| Repurchases of real estate acquired in settlement of loans financed under agreement to repurchase | (30,855)      | (10,093)      |               |
| Proceeds from issuance of common shares   | 608,184       | 206,056       |               |
| Payment of common share underwriting and offering costs   | (1,361)       | (8,581)       | (150)         |
| Payment of common share dividends   | (94,821)      | (39,548)      | (12,960)      |
| <br>Net cash provided by financing activities   | <br>951,009   | <br>522,066   | <br>235,514   |
| <br>Net increase (decrease) in cash   | <br>19,167    | <br>(30,858)  | <br>45,393    |
| Cash at beginning of year   | 14,589        | 45,447        | 54            |
| <br>Cash at end of year   | <br>\$ 33,756 | <br>\$ 14,589 | <br>\$ 45,447 |

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**

**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 ( "common 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's primary investment objective is to maximize the value of the mortgage loans that it acquires, a substantial portion of which may be distressed and acquired at discounts to their unpaid principal balances, either through loan modification programs, special servicing and other initiatives focused on keeping borrowers in their homes, or, when necessary, through timely acquisition and liquidation of the property securing the loan.

The Company operates two segments: correspondent lending and investment activities. The correspondent lending segment focuses on the purchase for resale of newly originated mortgage loans and the investment activities segment focuses on mortgage assets that are acquired and held for investment purposes.

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 an affiliated company, PennyMac Loan Services, LLC ( "PLS" ).

The investment activities segment represents the Company's investments in distressed mortgage loans, real estate acquired in settlement of loans ( "REO" ), MBS and mortgage servicing rights ( "MSRs" ). Management seeks to maximize the value of the distressed mortgage loans acquired by the Company through proprietary loan modification programs, special servicing and 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 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 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 4 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 plans to distribute at least 90% of its taxable income in the form of qualifying distributions to shareholders.

The accompanying consolidated financial statements have been prepared in compliance with accounting principles generally accepted in the United States ( "U.S. GAAP" ) as codified in the Financial Accounting

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### **PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

#### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Standards Board's (FASB) Accounting Standards Codification (the Codification). All significant intercompany accounts and transactions have been eliminated. 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.

Certain prior period amounts have been reclassified to conform to the current presentation. Specifically, *Servicing advances* and *Derivative assets* are presented separately from other assets and *Derivative liabilities* are presented separately from accounts payable and accrued liabilities in the consolidated balance sheets. Additionally, amounts for *Loan fulfillment fees* are presented separately from *Other expenses* and servicing advance losses are now included with *Servicing expenses* in the consolidated statements of income. These reclassifications did not impact any prior amounts of reported total assets, total liabilities, shareholders' equity, results of operations or 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 real estate-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. A substantial portion of the non-correspondent lending loans purchased by the Company has been acquired from or through one or more subsidiaries of Citigroup, Inc.

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, unemployment 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.



**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

On July 12, 2011 and December 20, 2011, 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 CGM Assets were 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 were included as *Borrowings under forward purchase agreements*. The CGM Assets were held by CGM within a separate trust entity deemed a variable interest entity. The Company's interests in the CGM Assets were 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 consisted of the CGM Assets and its related liability. The Company directed 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 were attributable solely to the Company, and such cash flows could 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 includes the following amounts related to the silo:

|  | Year ended December 31, |             |      |
|--|-------------------------|-------------|------|
|  | 2012                    | 2011        | 2010 |
|  | (in thousands)          |             |      |
| <b>Income:</b>   |                         |             |      |
| Net gain on mortgage loans                                 | \$ 46,295               | \$ 14,357   | \$   |
| Interest income on mortgage loans                          | \$ 996                  | \$ 1,131    | \$   |
| Results of REO   | \$ 1,870                | \$ 171      | \$   |
| Interest expense   | \$ 2,396                | \$ 3,116    | \$   |
| Loan servicing fees  | \$ 1,011                | \$ 744      | \$   |
| <b>Cash flows:</b>   |                         |             |      |
| Repayments of mortgage loans                               | \$ 14,292               | \$ 33,097   | \$   |
| Sales of REO   | \$ 9,912                | \$ 1,258    | \$   |
| Repayments of borrowings under forward purchase agreements | \$ (157,166)            | \$ (47,167) | \$   |

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

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table presents the fair value of mortgage loans and real estate acquired in settlement of loans ( REO ) purchased for its investment portfolio, including the CGM Assets:

|   | Year ended December 31, |            |            |
|---|-------------------------|------------|------------|
|   | 2012                    | 2011       | 2010       |
|   | (in thousands)          |            |            |
| Investment portfolio purchases:   |                         |            |            |
| Loans   | \$ 542,766              | \$ 647,609 | \$ 417,211 |
| REO   | 297                     | 2,475      | 1,238      |
|   | \$ 543,063              | \$ 650,084 | \$ 418,449 |
| Investment portfolio purchases above through one or more subsidiaries of Citigroup, Inc.: |                         |            |            |
| Loans   | \$ 504,710              | \$ 575,460 | \$ 406,980 |
| REO   | 48                      | 2,160      |            |
|   | \$ 504,758              | \$ 577,620 | \$ 406,980 |

**Note 3 Significant Accounting Policies**

PMT's significant accounting policies are summarized below.

***Valuation of Financial Instruments***

PMT groups its assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the observability of the assumptions used to determine fair value. These levels are:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Prices determined using other significant observable inputs. Observable inputs are inputs that other market participants would use in pricing an asset or liability and are developed based on market data obtained from sources independent of the Company. These may include quoted prices for similar assets and liabilities, interest rates, prepayment speeds, credit risk and others.

Level 3 Prices determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used. 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 in the circumstances.

The valuation method used to estimate fair value may produce a fair value measurement that may not be indicative of ultimate realizable value. Furthermore, while management believes its valuation methods are appropriate and consistent with those used by other market participants, the use of different methods or assumptions to estimate the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Those estimated values may differ significantly from the values that would have been used had a readily available market



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for such loans or investments existed, or had such loans or investments been liquidated, and those differences could be material to the financial statements.

Management incorporates lack of liquidity into its fair value estimates based on the type of asset or liability measured and the valuation method used. For example, for mortgage loans where the significant inputs have become unobservable due to illiquidity in the markets for distressed loans or non-Agency, non-conforming mortgage loans, PMT uses a discounted cash flow technique to estimate fair value. This technique incorporates forecasting of expected cash flows discounted at an appropriate market discount rate that is intended to reflect the lack of liquidity in the market.

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**PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Government-sponsored entities referred to in this document, include the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are each referred to as an Agency and, collectively, as the Agencies ).

***Short-Term Investments***

Short-term investments are carried at fair value with changes in fair value recognized in current period income. Short-term investments represent money market deposit accounts. The Company's short-term investments are classified as a Level 1 fair value financial statement item.

***United States Treasury Security***

The purchase of the United States Treasury Security is recorded as of the trade date. The Company's United States Treasury Security is carried at fair value with changes in fair value recognized in current period income. The fair value of the Company's investment in the United States Treasury Security is based on its quoted market price and is therefore classified as a Level 1 fair value financial statement item.

***Mortgage-Backed Securities***

Purchases and sales of MBS are recorded as of the trade date. The Company's investments in MBS are carried at fair value with changes in fair value recognized in current period income. Changes in fair value arising from amortization of purchase premiums and accrual of unearned discounts are recognized using the interest method as a component of *Interest income*. Changes in fair value arising from other factors are recognized as a component of *Net gain (loss) on investments*.

The Company's investments in MBS may include Agency and non-Agency MBS. Agency MBS refers to securities issued by the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, and the Government National Mortgage Association. The Company categorizes its investments in non-Agency MBS as Level 3 fair value financial statement items due to their illiquidity and the present lack of an active market for such securities.

***Interest Income Recognition***

Interest income on MBS is recognized over the life of the security using the interest method. Management estimates, at the time of purchase, the future expected cash flows and determines the effective interest rate based on the estimated cash flows and the MBS purchase price. Management updates its cash flow estimates monthly.

Estimating cash flows is subject to a number of assumptions that are subject to uncertainties, including the rate and timing of principal payments (including prepayments, repurchases, defaults and liquidations), the pass-through or coupon interest rate, interest rate fluctuations, interest payment shortfalls due to delinquencies on the underlying mortgage loans, the likelihood of modification and the timing of the magnitude of credit losses on the mortgage loans underlying the securities. Management applies its judgment in developing its estimates. However, these uncertainties are difficult to predict and are subject to future events whose outcomes will affect the Company's estimates and interest income.

***Mortgage Loans***

Mortgage loans are carried at their estimated fair values. Changes in the estimated fair value of mortgage loans are recognized in current period income. All changes in fair value, including changes arising from the

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### **PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

#### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

passage of time, are recognized as a component of *Net gain (loss) on investments* for mortgage loans classified as mortgage loans at fair value and mortgage loans under forward purchase agreements at fair value and *Net gain on mortgage loans acquired for sale* for mortgage loans classified as mortgage loans acquired for sale at fair value.

#### *Recognition of Sales of Mortgage Loans*

The Company recognizes transfers of mortgage loans as sales when it surrenders control over the mortgage loans. Control over transferred assets is deemed to be surrendered when (i) the assets have been isolated from the Company, (ii) the transferee has the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (iii) the Company does not maintain effective control over the transferred assets through either (a) an agreement that entitles and obligates the Company to repurchase or redeem them before their maturity or (b) the ability to unilaterally cause the holder to return specific assets.

#### *Interest Income Recognition*

Interest income on loans is recognized over the life of the loan using their contractual interest rates. Income recognition is suspended for loans when they become 90 days delinquent, or when, in management's opinion, a full recovery of income and principal becomes doubtful. Income recognition is resumed when the loan becomes contractually current.

#### *Derivative Financial Instruments*

In its loan origination activities, the Company makes contractual commitments to loan applicants to originate mortgages at specified interest rates ( interest rate lock commitments or IRLC ). These commitments are accounted for as derivative financial instruments. The Company manages the risk created by IRLC relating to mortgage loans acquired for sale by entering into forward sale agreements to sell the mortgage loans and by the purchase and sale of interest rate options and futures. Such agreements are also accounted for as derivative instruments. These instruments are also used to manage the risk created by changes in interest rates on certain of the MSRs the Company holds. The Company classifies its IRLCs as Level 3 financial statement items and the derivative financial instruments it acquires to manage the risks created by IRLCs and holding mortgage loans pending sale as Level 2 fair value financial statement items.

The Company accounts for its derivative financial instruments as free-standing derivatives. The Company does not designate its forward sale agreements or options and futures for hedge accounting. All derivative financial instruments are recognized on the balance sheet at fair value with changes in the fair values being reported in current period income. The fair value of the Company's derivative financial instruments is included in *Derivative assets* and *Derivative liabilities* and changes in fair value are included in *Net gain on mortgage loans acquired for sale* or in *Net servicing fee* income, as applicable, in the Company's consolidated statements of income.

When the Company has master netting agreements with its derivatives counterparties, the Company nets its counterparty positions along with any cash collateral received or delivered

#### *Mortgage Servicing Rights*

MSRs arise from contractual agreements between the Company and investors (or their agents) in mortgage securities and mortgage loans. Under these contracts, the Company is obligated to provide loan servicing functions in exchange for fees and other remuneration. The servicing functions typically performed include, among other responsibilities, collecting and remitting loan payments; responding to borrower inquiries;

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**PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

accounting for principal and interest, holding custodial (impound) funds for payment of property taxes and insurance premiums; counseling delinquent mortgagors; and supervising the acquisition of REO and property dispositions. The Company has engaged PLS to provide these services on its behalf.

The value of MSR is derived from the net positive cash flows associated with the servicing contracts. The Company receives a servicing fee ranging generally from 0.250% to 0.375% annually on the remaining outstanding principal balances of the loans. The servicing fees are collected from the monthly payments made by the mortgagors. The Company generally receives other remuneration including rights to various mortgagor-contracted fees such as late charges, collateral reconveyance charges and loan prepayment penalties and the Company is generally entitled to retain the interest earned on funds held pending remittance of mortgagor principal, interest, tax and insurance payments.

The Company recognizes MSR initially at their estimated fair values, either as proceeds from sales of mortgage loans where the Company assumes the obligation to service the loan in the sale transaction, or from the purchase of MSR. The precise fair value of MSR cannot be readily determined because MSR are not actively traded in stand-alone markets. Considerable judgment is required to estimate the fair values of these assets and the exercise of such judgment can significantly affect the Company's earnings. Therefore, the Company classifies its MSR as Level 3 fair value financial statement items.

The Company's subsequent accounting for MSR is based on the class of MSR. The Company has identified two classes of MSR: MSR backed by mortgage loans with initial interest rates of less than or equal to 4.5% and MSR backed by mortgage loans with initial interest rates of more than 4.5%. The Company distinguishes between these classes of MSR due to their differing sensitivities to change in value as the result of changes in market interest rates. MSR backed by mortgage loans with initial interest rates of less than or equal to 4.5% are accounted for using the amortization method. MSR backed by loans with initial interest rates of more than 4.5% are accounted for at fair value with changes in fair value recorded in current period income.

*MSRs Accounted for Using the MSR Amortization Method*

The Company amortizes MSR that are accounted for using the MSR amortization method. MSR amortization is determined by applying the ratio of the net MSR cash flows projected for the current period to the estimated total remaining net MSR cash flows. The estimated total net MSR cash flows are determined at the beginning of each month using prepayment assumptions applicable at that time.

The Company periodically assesses MSR accounted for using the amortization method for impairment. Impairment occurs when the current fair value of the MSR falls below the asset's carrying value (carrying value is the amortized cost reduced by any related valuation allowance). If MSR are impaired, the impairment is recognized in current-period earnings and the carrying value of the MSR is adjusted through a valuation allowance. If the value of impaired MSR subsequently increases, the Company recognizes the increase in value in current-period earnings and adjusts the carrying value of the MSR through a reduction in the valuation allowance to adjust the carrying value to a level not in excess of amortized cost.

The Company stratifies its MSR by predominate risk characteristic when evaluating for impairment. For purposes of performing its MSR impairment evaluation, the Company stratifies its servicing portfolio on the basis of certain risk characteristics including loan type (fixed-rate or adjustable-rate) and note rate. Fixed-rate loans are stratified into note rate pools of 50 basis points for note rates between 3.0% and 4.5% and a single pool for note rates below 3%. Adjustable rate mortgage loans with initial interest rates of 4.5% or less are evaluated in

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### **PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

#### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

a single pool. If the fair value of MSRs in any of the note rate pools is below the carrying value of the MSRs for that pool, impairment is recognized to the extent of the difference between the estimated fair value and the existing valuation allowance for that pool.

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 recoverable value is charged to the valuation allowance.

Amortization and impairment of MSRs are included in current period income as a component of *Net servicing income*.

#### *MSRs Accounted for at Fair Value*

Changes in fair value of MSRs accounted for at fair value are recognized in current period income as a component of *Net servicing income*.

#### *Real Estate Acquired in Settlement of Loans*

Real estate acquired in settlement of loans is measured at the lower of the acquisition cost of the property (as measured by the fair value of the loan immediately before the property is acquired in settlement of the loan) or its purchase price or its fair value reduced by estimated costs to sell. Real estate acquired in settlement of loans is categorized as a Level 3 fair value financial statement item. Changes in fair value and gains or losses on sale of real estate acquired in settlement of loans are recognized in the consolidated statements of income under the caption *Results of real estate acquired in settlement of loans*.

#### *Loans and Securities Sold Under Agreements to Repurchase*

Loans and securities sold under agreements to repurchase are measured based on whether management has designated the agreements to be accounted for under the fair value option or at historical cost. Under both options, the carrying value of loans and securities sold under agreements to repurchase is based on the accrued cost of the agreements, which approximates fair value, due to the agreements' short maturities. Loans and securities sold under agreements to repurchase are categorized as Level 3 fair value financial statement items.

When loans and securities sold under agreements to repurchase are carried at their estimated fair values, the costs of creating the facilities underlying the agreements are expensed as incurred. When loans and securities sold under agreements to repurchase are carried at historical cost, the costs of creating the facilities underlying the agreements are recognized as deferred charges in *Other assets* and amortized to *Interest expense* over the term of the borrowing facility.

#### *Recourse Liability*

The Company's agreements with the Agencies include representations and warranties related to the loans the Company sells to the Agencies. The representations and warranties require adherence to Agency origination and underwriting guidelines, including but not limited to the validity of the lien securing the loan, property eligibility, borrower credit, income and asset requirements, and compliance with applicable federal, state and local law.

In the event of a breach of its representations and warranties, the Company may be required to either repurchase the mortgage loans with the identified defects or indemnify the investor or insurer. In such cases, the Company bears any subsequent credit loss on the mortgage loans. The Company's credit loss may be reduced by

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**PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

any recourse it has to correspondent lenders that, in turn, had sold such mortgage loans to the Company and breached similar or other representations and warranties. In such event, the Company has the right to seek a recovery of related repurchase losses from that correspondent lender.

The Company records a provision for losses relating to such representations and warranties as part of its loan sale transactions. The method used to estimate the liability for representations and warranties is a function of the representations and warranties given and considers a combination of factors, including, but not limited to, estimated future defaults and loan repurchase rates and the potential severity of loss in the event of defaults and the probability of reimbursement by the correspondent loan seller. The Company establishes a liability at the time loans are sold and continually updates its liability estimate.

The level of the liability for representations and warranties is difficult to estimate and requires considerable management judgment. The level of mortgage loan repurchase losses is dependent on economic factors, investor demand strategies, and other external conditions that may change over the lives of the underlying loans. The Company's representations and warranties are generally not subject to stated limits of exposure. However, management believes that the current unpaid principal balance of loans sold by the Company to date represents the maximum exposure to repurchases related to representations and warranties. Management believes the amount and range of reasonably possible losses in relation to the recorded liability is not material to the Company's financial condition or results of operations.

***Investment Consolidation***

The consolidated financial statements include the accounts of PMT and all wholly-owned subsidiaries. PMT has whole ownership of all of its subsidiaries, and therefore has no significant equity method or cost-basis investments. All significant intercompany accounts and transactions have been eliminated upon consolidation.

The Company evaluates every investment with reference to the underlying entity that issued the loans or securities it acquires to determine whether to include the investment in its consolidated reporting group. A similar analysis is performed for each entity with which the Company makes an agreement for management, servicing or similar services. Where voting rights do not effectively identify the investor with a controlling financial interest, the entity is classified as a variable interest entity ( VIE ). With certain exceptions, VIEs are subject to consolidation if the investors either do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support, are unable to direct the entity's activities or are not exposed to the entity's losses or entitled to its residual returns. VIEs are consolidated by the entity that absorbs a majority of the entity's expected losses, its expected returns, or both. The Company did not have variable interests in its affiliated service providers or its investments as of December 31, 2012 and 2011.

***Underwriting Commissions and Offering Costs***

Underwriting commissions and offering costs incurred in connection with the Company's share offerings are reflected as a reduction of additional paid-in capital. Contingent offering costs that are deemed by management as probable of being paid are recorded as a reduction of additional paid-in capital.

***Loan Servicing Fees***

Loan servicing fees and other remuneration are received by the Company for servicing residential mortgage loans. Loan servicing fees are recorded net of Agency guarantee fees paid by the Company. Loan servicing fees are recognized as earned over the life of the loans in the servicing portfolio.

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**PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Share-Based Compensation***

The Company estimates the value of restricted share units awarded with reference to the value of its common shares on the date of the award. The Company amortizes the fair value of previously granted share-based awards to compensation expense over the vesting period using the graded vesting method. Expense relating to awards is included in *Compensation* in the consolidated statements of income.

The Company estimates the value of restricted share units awarded with reference to the value of its common shares on the date of the award. How the value of Company common shares is used in determining restricted share unit awards' values depends on whether the restricted share units participate in Company dividends in the form of dividend equivalents.

Restricted share unit awards that participate in dividends in the form of dividend equivalents are valued at the Company's closing share price on the date of the award.

Restricted share unit awards that do not participate in dividends are valued by reducing the closing price of the Company's common shares on the date of the award by the value of expected shareholder distributions that the grantees will not receive during the vesting period, discounted at an appropriate risk-free rate of return. The amount of the reduction for anticipated distributions is based on amounts included in management's earnings forecast.

The Company determines the fair value of its share-based compensation awards depending on whether the awards are made to its trustees and officers or to non-employees such as officers and employees of affiliated entities:

Compensation cost is generally fixed at the estimated fair value of the award date for awards to officers and trustees of the Company.

Compensation cost for share-based compensation awarded to non-officers or trustees of the Company is adjusted to reflect changes in the estimated fair value of awards in each subsequent reporting period until the award has vested, the service being provided is subsequently completed, or, under certain circumstances, is likely to be completed, whichever occurs first.

Management's estimates of compensation costs reflect the expected portion of share-based compensation awards that management expects to vest.

***Income Taxes***

The Company has elected to be taxed as a REIT and management believes the Company complies with the provisions of the Internal Revenue Code applicable to REITs. Accordingly, management believes the Company will not be subject to federal income tax on that portion of its REIT taxable income that is distributed to shareholders as long as certain asset, income and share ownership tests are met. If PMT fails to qualify as a REIT, and does not qualify for certain statutory relief provisions, it will be subject to income taxes and may be precluded from qualifying as a REIT for the four tax years following the year of loss of the Company's REIT qualification.

The Company's taxable REIT subsidiaries (TRSs) are subject to federal and state income taxes. Income taxes are provided for using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted rates expected to apply to taxable income in the years in which management expects those temporary





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**PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

differences to be recovered or settled. The effect on deferred taxes of a change in tax rates is recognized in income in the period in which the change occurs. Subject to management's judgment, a valuation allowance is established if realization of deferred tax assets is not more likely than not. Management recognizes tax a benefit relating to tax positions it takes only if it is more likely than not that the position will be sustained upon examination by the appropriate taxing authority. A tax position that meets this standard is recognized as the largest amount that exceeds 50 percent likelihood of being realized upon settlement. The Company will classify any penalties and interest as a component of income tax expense.

As of December 31, 2012 and 2011, the Company was not subject to examination by any federal or state taxing authority.

**Note 4 Transactions with Related Parties**

The Company is managed externally by PCM and at December 31, 2012, was managed under the terms of a management agreement that expired on August 4, 2013, subject to automatic renewal for a one-year term each anniversary date thereafter unless previously terminated. The management agreement provided for an annual review of PCM's performance under the management agreement by the Company's independent trustees. PMT's board of trustees reviews the Company's financial results, policy compliance and strategic direction.

PMT paid PCM a base management fee and a performance incentive fee, both payable quarterly and in arrears. This agreement was amended, effective February 1, 2013, as described in Note 37 *Subsequent Events*. During the periods presented, the base management fee was calculated at the annual rate of 1.5% of shareholders' equity (as defined in the management agreement). 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.

Core earnings, for purposes of determining the amount of the performance incentive fee, was defined as U.S. GAAP net income (loss) adjusted to exclude non-cash equity compensation expense, unrealized gains and losses or other non-cash items recognized during the period, any conditional payment amounts relating to PMT's initial public offering (IPO) paid to PCM and the underwriters of PMT's share offering, and any one-time events pursuant to changes in U.S. GAAP and certain other non-cash charges after discussions as agreed between PCM and our independent trustees and approval by a majority of PMT's independent trustees.

The hurdle rate was calculated as the product of (1) the weighted average of the issue price per share of all of the Company's public offerings multiplied by the weighted average number of common shares outstanding (including, for the avoidance of doubt, restricted share units) in the four-quarter period and (2) 8%.

For purposes of calculating the incentive fee, to the extent PMT had a net loss in core earnings from a period before the rolling four-quarter period that had not been offset by core earnings in a subsequent period, such loss would continue to be included in the rolling four-quarter calculation until it had been fully offset. This term was not applicable for purposes of determining whether the conditional payment of the underwriting discount, as discussed in Note 27 *Shareholders' Equity*, was payable.

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Following is a summary of management fee expense and the related liability recorded by the Company:

|   | Year ended December 31, |          |          |
|---|-------------------------|----------|----------|
|   | 2012                    | 2011     | 2010     |
|   | (in thousands)          |          |          |
| Base management fee                           | \$ 12,436               | \$ 6,740 | \$ 4,878 |
| Performance incentive fee                     |                         |          |          |
| Total management fee incurred during the year | 12,436                  | 6,740    | 4,878    |
| Fee paid during the year                      | (9,032)                 | (6,873)  | (4,819)  |
| Fee outstanding at beginning of year          | 1,095                   | 1,228    | 1,169    |
| Fee outstanding at year end                   | \$ 4,499                | \$ 1,095 | \$ 1,228 |

If the Company terminated the management agreement without cause, or PCM terminated the management agreement upon a default in the Company's performance of any material term in the management agreement, PMT would pay a termination fee to PCM. The termination fee would have been equal to three times (a) the average annual base management fee and (b) the average annual (or, if the period was less than 24 months, annualized) incentive fee earned by PCM during the prior 24-month period before termination. Under circumstances where the termination fee was payable, PMT would pay to PCM its portion of the conditional payment of the underwriting discount discussed in Note 27 *Shareholders' Equity*.

The Company, through its Operating Partnership, also had a loan servicing agreement with PLS. This agreement was replaced, effective February 1, 2013, as described in Note 37 *Subsequent Events*. Servicing fee rates during the years presented are 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 is 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 effects a refinancing of a loan on the Company's behalf and not through a third party lender and the resulting loan is readily saleable, or originates a loan to facilitate the disposition of real estate that the Company has acquired in settlement of a loan, PLS is entitled to receive from the Company market-based fees and compensation.

PLS, on behalf of the Company, currently participates in HAMP (and other similar mortgage loan modification programs), which 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 lesser of such modification fee or such incentive payments.

In connection with the Company's correspondent lending business, through which the Company acquires mortgage loans originated by correspondent lenders for resale to the government-sponsored agencies such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

( FHLMC ) (Fannie Mae and FHLMC, along with the Government National Mortgage Association ( GNMA ) are each referred to as an Agency and, collectively, as the Agencies ) and other investors, PLS is entitled to base subservicing fees, and other customary market-based fees and charges as described above.

Pursuant to the terms of a mortgage banking services agreement, PLS also provides certain mortgage banking services, including fulfillment and disposition-related services, to the Company for a fulfillment fee based on a percentage of the unpaid principal balance of the mortgage loans sold to non-affiliates where the Company is approved or licensed to sell to such non-affiliate. The fulfillment fee for such services is currently 50 basis points.

The Company is not an approved issuer of GNMA securities and therefore is not able to sell government-guaranteed or insured loans into such securities. As a result, the Company and PLS have agreed that PLS will fulfill and purchase the government-guaranteed or insured loans it acquires from correspondent lenders. This arrangement has enabled the Company to compete with other correspondent lenders that purchase both government and conventional loans. For these government-guaranteed or insured loans, the Company does not pay a fulfillment fee, but collects interest income and a sourcing fee of three basis points for each mortgage loan it purchases from a correspondent and sells to PLS for ultimate disposition to GNMA. As described in Note 37 *Subsequent Events*, the agreement was terminated and replaced by a new agreement, effective February 1, 2013.

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

|   | Year ended December 31, |            |          |
|---|-------------------------|------------|----------|
|   | 2012                    | 2011       | 2010     |
|   | (in thousands)          |            |          |
| Sourcing fees received  | \$ 2,505                | \$ 166     | \$       |
| Fulfillment fees relating to loans sold to nonaffiliates                                    | \$ 62,906               | \$ 1,747   | \$       |
| Fair value of loans sold to PLS   | \$ 8,864,264            | \$ 577,852 | \$ 3,106 |
| Mortgage loans included in mortgage loans acquired for sale pending sale to PLS at year end | \$ 153,326              | \$ 46,266  | \$       |

The Company paid fulfillment and servicing fees to PLS as described above and as provided in its loan servicing agreement and recorded other expenses, including common overhead expenses incurred on its behalf by PCM and its affiliates, in accordance with the terms of its management agreement.

Following is a summary of those expenses:

|   | Year ended December 31, |           |          |
|---|-------------------------|-----------|----------|
|   | 2012                    | 2011      | 2010     |
|   | (in thousands)          |           |          |
| Fulfillment fees payable to PLS                                     | \$ 62,906               | \$ 1,747  | \$       |
| Loan servicing fees to PLS  | 20,180                  | 15,364    | 3,200    |
| Reimbursement of expenses incurred on PMT s behalf                  | 3,146                   | 2,219     | 895      |
| Reimbursement of common overhead incurred by PCM and its affiliates | 4,183                   | 4,086     | 1,418    |
|   | \$ 90,415               | \$ 23,416 | \$ 5,513 |
| Payments during the year(1)   | \$ 85,554               | \$ 12,656 | \$ 3,852 |

- (1) Payments include payments for correspondent lending activities itemized in the preceding table.

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**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

During the Company's startup period and through the quarter ended March 31, 2010, PCM and its affiliates did not charge the Company for its proportionate share of common overhead expenses. Such expenses totaled approximately \$500,000 for the year ended December 31, 2010. No other charges were waived by PCM during the Company's startup period and through the quarter ended March 31, 2010. Management believes that PCM does not intend to waive recovery of common overhead costs in the future.

Following is a summary of amounts due to affiliates:

|                           | <b>December 31,</b>   |                  |
|---------------------------|-----------------------|------------------|
|                           | <b>2012</b>           | <b>2011</b>      |
|                           | <b>(in thousands)</b> |                  |
| Contingent offering costs | \$ 2,941              | \$ 2,941         |
| Management fee            | 4,499                 | 1,096            |
| Other expenses            | 4,776                 | 8,129            |
|                           | <b>\$ 12,216</b>      | <b>\$ 12,166</b> |

Amounts due from affiliates totaled \$4,829,000 and \$347,000 at December 31, 2012 and 2011, respectively, and represent amounts receivable pursuant to loan sales to PLS and reimbursable expenses paid on the affiliates' behalf by the Company.

PCM's parent company, Private National Mortgage Acceptance Company, LLC, held 75,000 of the Company's common shares at both December 31, 2012 and 2011.

**Note 5 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 computed by dividing net income attributable to common shareholders 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.

During the years ended December 31, 2012 and 2011, the Company made grants of 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 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.

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

|  | Year ended December 31,                  |           |           |
|--|--|-----------|-----------|
|  | 2012                                     | 2011      | 2010      |
|  | (in thousands, except per share amounts) |           |           |
| <b>Basic earnings per share:</b>   |  |           |           |
| Net income   | \$ 138,249                               | \$ 64,439 | \$ 24,483 |
| Effect of participating securities share-based compensation instruments              | (1,433)                                  | (699)     |           |
| Net income attributable to common shareholders                                       | \$ 136,816                               | \$ 63,740 | \$ 24,483 |
| Weighted-average shares outstanding  | 43,553                                   | 26,396    | 16,775    |
| Basic earnings per share   | \$ 3.14                                  | \$ 2.41   | \$ 1.46   |
| <b>Diluted earnings per share:</b>   |  |           |           |
| Net income   | \$ 138,249                               | \$ 64,439 | \$ 24,483 |
| Weighted-average shares outstanding  | 43,553                                   | 26,396    | 16,775    |
| Dilutive potential common shares shares issuable under share-based compensation plan | 323                                      | 283       | 273       |
| Diluted weighted-average number of common shares outstanding                         | 43,876                                   | 26,679    | 17,048    |
| Diluted earnings per common share  | \$ 3.14                                  | \$ 2.41   | \$ 1.44   |

**Note 6 Loan Sales**

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 the potential liability under representations and warranties it makes to purchasers and insurers of the loans.

The following table summarizes cash flows between the Company and transferees upon sale of loans in transactions whereby the Company maintains continuing involvement with the mortgage loan:

|   | Year ended December 31, |            |      |
|---|-------------------------|------------|------|
|   | 2012                    | 2011       | 2010 |
|   | (in thousands)          |            |      |
| <b>Cash flows:</b>  |                         |            |      |
| Proceeds from sales   | \$ 12,834,002           | \$ 518,567 | \$   |
| Service fees received(1)                                    | \$ 17,481               | \$ 213     | \$   |
| <b>Period-end information:</b>                              |                         |            |      |
| Unpaid principal balance of loans outstanding at period-end | \$ 12,168,740           | \$ 495,031 | \$   |
| <b>Delinquencies:</b>                                       |                         |            |      |
| 30-89 days  | \$ 45,021               | \$         | \$   |

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|   |    |       |    |    |
|---|----|-------|----|----|
| 90 or more days or in foreclosure or bankruptcy | \$ | 1,386 | \$ | \$ |
|---|----|-------|----|----|

(1) Service fees received represent amounts received before payment of guaranty fees.

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**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 7 Netting of Financial Instruments**

The Company uses derivative instruments to manage exposure to interest rate risk for its IRLCs and MSRs. All derivative financial instruments are recorded on the balance sheet at fair value. The Company has elected to net derivatives asset and liability positions, and cash collateral obtained (or posted) by its counterparties when subject to an enforceable 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, which are commitments made to correspondent lenders to purchase mortgage loans for sale. As of December 31, 2012 and 2011, 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*

|  | December 31, 2012                           |  |  | December 31, 2011                           |  |  |
|--|---|--|--|---|--|--|
|  | Gross<br>amounts of<br>recognized<br>assets | Gross<br>amounts<br>offset<br>in the<br>balance<br>sheet | Net<br>amounts<br>of assets<br>presented<br>in the<br>balance<br>sheet<br>(in thousands) | Gross<br>amounts of<br>recognized<br>assets | Gross<br>amounts<br>offset<br>in the<br>balance<br>sheet | Net<br>amounts<br>of assets<br>presented<br>in the<br>balance<br>sheet |
| Derivatives:   |   |  |  |   |  |  |
| MBS put options  | \$ 977                                      | \$   | \$ 977   | \$  | \$   | \$   |
| MBS forward purchase contracts                                 | 2,617                                       | (1,035)  | 1,582  |   |  |  |
| MBS forward sale contracts                                     | 3,458                                       | (3,115)  | 343  |   |  |  |
| Cash collateral  |   | 1,325  | 1,325  |   |  |  |
| Total derivatives, subject to a master netting arrangement     | 7,052                                       | (2,825)  | 4,227  |   |  |  |
| Total derivatives, not subject to a master netting arrangement | 19,479                                      |  | 19,479   | 1,938                                       |  | 1,938  |
| Total  | \$ 26,531                                   | \$ (2,825)   | \$ 23,706  | \$ 1,938                                    | \$   | \$ 1,938   |



**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***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 does not meet the accounting guidance qualifying for netting. The balance in Other is comprised of balances with various small balance counterparties made to correspondent lenders to purchase newly originated mortgage loans for sale.

|  | December 31, 2012<br>Offset in the<br>balance sheet      |                          |                                | December 31, 2011<br>Offset in the<br>balance sheet      |                          |                                |
|--|--|--------------------------|--------------------------------|--|--------------------------|--------------------------------|
|  | Net<br>amount<br>of assets<br>in the<br>balance<br>sheet | Financial<br>instruments | Cash<br>collateral<br>received | Net<br>amount<br>of assets<br>in the<br>balance<br>sheet | Financial<br>instruments | Cash<br>collateral<br>received |
|  | Net<br>amount<br>(in thousands)                          |                          |                                | Net<br>amount<br>(in thousands)                          |                          |                                |
| Interest rate lock commitments                     | \$ 19,479  | \$                       | \$                             | \$ 19,479  | \$ 5,772                 | \$                             |
| Bank of America, N.A.                              | 1,219  |                          |                                | 1,219  |                          |                                |
| Citibank   | 1,009  |                          |                                | 1,009  |                          |                                |
| Credit Suisse First Boston Mortgage<br>Capital LLC | 820  |                          |                                | 820  |                          |                                |
| Cantor Fitzgerald LP                               | 581  |                          |                                | 581  |                          |                                |
| Morgan Stanley Bank, N.A.                          | 316  |                          |                                | 316  |                          |                                |
| Other  | 282  |                          |                                | 282  | (3,834)                  |                                |
| Total  | \$ 23,706  | \$                       | \$                             | \$ 23,706  | \$ 1,938                 | \$                             |

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***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. The assets sold under agreements to repurchase do not qualify for offset.

|  | December 31, 2012                                   |  |   | December 31, 2011                                   |  |  |
|--|---|--|---|---|--|--|
|  | Gross<br>amounts<br>of<br>recognized<br>liabilities | Gross<br>amounts<br>offset<br>in the<br>balance<br>sheet | Net<br>amounts<br>of liabilities<br>presented<br>in the<br>balance<br>sheet<br>(in thousands) | Gross<br>amounts<br>of<br>recognized<br>liabilities | Gross<br>amounts<br>offset<br>in the<br>balance<br>sheet | Net<br>amounts<br>of<br>liabilities<br>presented<br>in the<br>balance<br>sheet |
| Derivatives:   |   |  |   |   |  |  |
| MBS forward purchase contracts                                 | \$ 1,741  | \$ (1,036)   | \$ 705  | \$  | \$   | \$   |
| MBS forward sale contracts                                     | 4,520   | (3,116)  | 1,404   |   |  |  |
| Cash collateral  |   | (1,142)  | (1,142)   |   |  |  |
| Total derivatives, subject to a master netting arrangement     | 6,261   | (5,294)  | 967   |   |  |  |
| Total derivatives, not subject to a master netting arrangement |   |  |   |   |  |  |
| Total derivatives  | 6,261   | (5,294)  | 967   |   |  |  |
| Assets sold under agreements to repurchase:                    |   |  |   |   |  |  |
| Mortgage loans acquired for sale at fair value                 | 894,906   |  | 894,906   | 212,677   |  | 212,677  |
| Mortgage loans at fair value                                   | 353,805   |  | 353,805   | 275,649   |  | 275,649  |
| Securities   |   |  |   | 115,493   |  | 115,493  |
| Real estate acquired in settlement of loans                    | 7,391   |  | 7,391   | 27,494  |  | 27,494   |
| Total assets sold under agreements to repurchase               | 1,256,102   |  | 1,256,102   | 631,313   |  | 631,313  |
| Total  | \$ 1,262,363  | \$ (5,294)   | \$ 1,257,069  | \$ 631,313  | \$   | \$ 631,313   |

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***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 does not meet the accounting guidance qualifying for offset. All assets sold under agreements to repurchase have sufficient collateral or exceeds the liability amount recorded on the balance sheet.

|  | December 31, 2012<br>Gross amounts<br>not offset in the<br>balance sheet |                          |                               | December 31, 2011<br>Gross amounts<br>not offset in the<br>balance sheet        |                          |                               |
|--|--|--------------------------|-------------------------------|---|--------------------------|-------------------------------|
|  | Net amount<br>of liabilities<br>in the<br>balance<br>sheet               | Financial<br>instruments | Cash<br>collateral<br>pledged | Net<br>amount<br>of liabilities<br>in the<br>balance<br>sheet<br>(in thousands) | Financial<br>instruments | Cash<br>collateral<br>pledged |
| Citibank   | \$ 474,625   | \$ (474,625)             | \$                            | \$ 203,936  | \$ (203,936)             | \$                            |
| Bank of America, N.A.                              | 256,711  | (256,711)                |                               | 161,222   | (161,222)                |                               |
| Credit Suisse First Boston Mortgage<br>Capital LLC | 243,525  | (243,525)                |                               | 142,819   | (142,819)                |                               |
| Morgan Stanley Bank, N.A.                          | 155,321  | (155,321)                |                               |   |                          |                               |
| Barclays   | 79,253   | (78,780)                 |                               | 473   |                          |                               |
| Wells Fargo Bank, N.A.                             | 47,140   | (47,140)                 |                               | 123,336   | (123,336)                |                               |
| Other  | 494  |                          |                               | 494   |                          |                               |
| Total  | \$ 1,257,069   | \$ (1,256,102)           | \$                            | \$ 967  | \$ 631,313               | \$ (631,313)                  |

**Note 8 Fair Value**

The Company's 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, United States Treasury security, MBS and mortgage loans, as well as its securities sold under agreements to repurchase and its MSR's 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 investment performance.

For MSR's 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 has concluded that such assets present different risks to the Company than MSR's 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. Management's risk management efforts in connection with MSR's 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.



**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

For loans sold under agreements to repurchase subject to agreements made beginning in December 2010, REO financed through agreements to repurchase beginning in June 2011 and borrowings under forward purchase agreements beginning in July 2011, 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 expense to the periods benefiting from the usage of the debt.

**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:

|   | Level 1   | Level 2    | December 31, 2012<br>Level 3<br>(in thousands) | Netting    | Total        |
|---|-----------|------------|--|------------|--------------|
| <b>Assets:</b>  |           |            |  |            |              |
| 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        |
| <b>Derivative assets:</b>   |           |            |  |            |              |
| Interest rate lock commitments  |           |            | 19,479   |            | 19,479       |
| MBS put options   |           | 977        |  |            | 977          |
| Forward purchase contracts  |           | 2,617      |  | (1,035)    | 1,582        |
| Forward sales contracts   |           | 3,458      |  | (3,115)    | 343          |
| Total derivative financial instruments before cash collateral netting |           | 7,052      | 19,479   | (4,150)    | 22,381       |
| Cash collateral(1)  |           |            |  | 1,325      | 1,325        |
| Total derivative financial assets                                     |           | 7,052      | 19,479   | (2,825)    | 23,706       |
|   | \$ 39,017 | \$ 982,236 | \$ 1,210,796                                   | \$ (2,825) | \$ 2,229,224 |
| <b>Liabilities:</b>   |           |            |  |            |              |
| <b>Derivative liabilities:</b>  |           |            |  |            |              |
| Forward purchase contracts  | \$        | \$ 1,741   | \$   | \$ (1,036) | \$ 705       |
| Forward sales contracts   |           | 4,520      |  | (3,116)    | 1,404        |
| Total derivative financial instruments before cash collateral netting |           | 6,261      |  | (4,152)    | 2,109        |
| Cash collateral(1)  |           |            |  | (1,142)    | (1,142)      |
| Total derivative financial liabilities                                | \$        | \$ 6,261   | \$   | \$ (5,294) | \$ 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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### PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

|  | Level 1   | Level 2    | December 31, 2011<br>Level 3<br>(in thousands) | Netting | Total        |
|--|-----------|------------|--|---------|--------------|
| <b>Assets:</b>   |           |            |  |         |              |
| Short-term investments   | \$ 30,319 | \$         | \$   | \$      | \$ 30,319    |
| United States Treasury security                                | 50,000    |            |  |         | 50,000       |
| Mortgage-backed securities at fair value                       |           |            | 72,813   |         | 72,813       |
| Mortgage loans acquired for sale at fair value                 |           | 232,016    |  |         | 232,016      |
| Mortgage loans at fair value                                   |           |            | 696,266  |         | 696,266      |
| Mortgage loans under forward purchase agreements at fair value |           |            | 129,310  |         | 129,310      |
| Mortgage servicing rights at fair value                        |           |            | 749  |         | 749          |
| Derivative financial assets                                    |           | (3,834)    | 5,772  |         | 1,938        |
|  | \$ 80,319 | \$ 228,182 | \$ 904,910                                     | \$      | \$ 1,213,411 |
| <b>Liabilities:</b>  |           |            |  |         |              |
| Securities sold under agreements to repurchase                 | \$        | \$         | \$ 115,493                                     | \$      | \$ 115,493   |
|  | \$        | \$         | \$ 115,493                                     | \$      | \$ 115,493   |

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company's MBS, mortgage loans at fair value, mortgage loans under forward purchase agreements at fair value, 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:

|   | Mortgage-backed securities | Mortgage loans | Mortgage loans under forward purchase agreements<br>(in thousands) | Mortgage servicing rights | Interest rate lock commitments | Total        |
|---|----------------------------|----------------|--|---------------------------|--------------------------------|--------------|
| <b>Assets:</b>  |                            |                |  |                           |                                |              |
| Balance, December 31, 2011  | \$ 72,813                  | \$ 696,266     | \$ 129,310   | \$ 749                    | \$ 5,772                       | \$ 904,910   |
| Purchases   |                            | 541,696        | 1,075  | 20                        |                                | 542,791      |
| Interest rate lock commitments issued, net  |                            |                |  |                           | 212,555                        | 212,555      |
| Repayments  | (21,888)                   | (169,877)      | (14,292)   |                           |                                | (206,057)    |
| Accrual of unearned discounts   | 363                        |                |  |                           |                                | 363          |
| Capitalization of interest  |                            | 19,745         |  |                           |                                | 19,745       |
| Sales   | (52,133)                   |                |  | (79)                      |                                | (52,212)     |
| Servicing received as proceeds from sales of mortgage loans   |                            |                |  | 1,508                     |                                | 1,508        |
| Changes in fair value included in income arising from:  |                            |                |  |                           |                                |              |
| Changes in instrument-specific credit risk  |                            | 24,878         |  | (708)                     |                                | 24,170       |
| Other factors   | 845                        | 68,772         | 9,293  | (144)                     |                                | 78,766       |
|   | 845                        | 93,650         | 9,293  | (852)                     |                                | 102,936      |
| <b>Transfers of mortgage loans under forward purchase agreements to mortgage loans</b>                        |                            |                |  |                           |                                |              |
|   |                            | 117,913        | (117,913)  |                           |                                |              |
| Transfers of mortgage loans to REO  |                            | (109,440)      |  |                           |                                | (109,440)    |
| <b>Transfers of mortgage loans under forward purchase agreements to REO under forward purchase agreements</b> |                            |                |  |                           |                                |              |
|   |                            |                | (7,473)  |                           |                                | (7,473)      |
| Transfers from mortgage loans acquired for sale   |                            | 18             |  |                           |                                | 18           |
| Transfers of interest rate lock commitments to mortgage loans acquired for sale                               |                            |                |  |                           | (198,848)                      | (198,848)    |
| Balance, December 31, 2012  | \$                         | \$ 1,189,971   | \$   | \$ 1,346                  | \$ 19,479                      | \$ 1,210,796 |
| <b>Changes in fair value recognized during the period relating to assets still held at December 31, 2012</b>  |                            |                |  |                           |                                |              |
|   | \$                         | \$ 51,022      | \$   | \$ (852)                  | \$ 19,479                      | \$ 69,649    |
| <b>Accumulated changes in fair value relating to assets still held at December 31, 2012</b>                   |                            |                |  |                           |                                |              |
|   | \$                         | \$ 106,468     | \$   |                           | \$ 19,479                      |              |





**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

|  | Mortgage-<br>backed<br>securities | Mortgage<br>loans | Mortgage<br>loans under<br>forward<br>purchase<br>agreements<br>(in thousands) | Mortgage<br>servicing<br>rights | Interest<br>rate lock<br>commitments | Total      |
|--|-----------------------------------|-------------------|--|---------------------------------|--------------------------------------|------------|
| Assets:  |                                   |                   |  |                                 |                                      |            |
| Balance, December 31, 2010   | \$ 119,872                        | \$ 364,250        | \$   | \$                              | \$                                   | \$ 484,122 |
| Purchases  | 21,420                            | 453,323           | 194,286  |                                 |                                      | 669,029    |
| Interest rate lock commitments issued, net   |                                   |                   |  |                                 | 15,955                               | 15,955     |
| Repayments   | (59,666)                          | (111,577)         | (33,097)   |                                 |                                      | (204,340)  |
| Accrual of unearned discounts  | 1,993                             |                   |  |                                 |                                      | 1,993      |
| Sales  | (7,994)                           | (2,570)           |  |                                 |                                      | (10,564)   |
| Servicing received as proceeds from sales of<br>mortgage loans   |                                   |                   |  | 774                             |                                      | 774        |
| Changes in fair value included in income arising<br>from:  |                                   |                   |  |                                 |                                      |            |
| Changes in instrument-specific credit risk   |                                   | 28,400            | 3,682  |                                 |                                      | 32,082     |
| Other factors  | (2,812)                           | 45,445            | 10,676   | (25)                            |                                      | 53,284     |
|  | (2,812)                           | 73,845            | 14,358   | (25)                            |                                      | 85,366     |
| Transfers of mortgage loans under forward<br>purchase agreements to mortgage loans                           |                                   | 23,198            | (23,198)   |                                 |                                      |            |
| Transfers of mortgage loans to REO   |                                   | (104,203)         |  |                                 |                                      | (104,203)  |
| Transfers of mortgage loans under forward<br>purchase agreements to REO under forward<br>purchase agreements |                                   |                   | (23,039)   |                                 |                                      | (23,039)   |
| Transfers of interest rate lock commitments to<br>mortgage loans acquired for sale                           |                                   |                   |  |                                 | (10,183)                             | (10,183)   |
| Balance, December 31, 2011   | \$ 72,813                         | \$ 696,266        | \$ 129,310   | \$ 749                          | \$ 5,772                             | \$ 904,910 |

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Changes in fair value recognized during the period  
relating to assets still held at December 31, 2011

|            |           |          |         |          |           |
|------------|-----------|----------|---------|----------|-----------|
| \$ (2,812) | \$ 41,633 | \$ 5,928 | \$ (25) | \$ 5,772 | \$ 50,496 |
|------------|-----------|----------|---------|----------|-----------|

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## PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

|  | Securities<br>sold under<br>agreements to<br>repurchase<br>(in thousands) |
|--|---|
| Liabilities:   |   |
| Balance, December 31, 2010   | \$ 101,202  |
| Changes in fair value included in income   |   |
| Sales  | 1,423,615   |
| Repurchases  | (1,409,324)   |
| Balance, December 31, 2011   | \$ 115,493  |
| Changes in fair value recognized during the period relating to liabilities<br>still outstanding at December 31, 2011 | \$  |

|  | Year ended December 31, 2010      |                                     |            |
|--|-----------------------------------|-------------------------------------|------------|
|  | Mortgage-<br>backed<br>securities | Mortgage<br>loans<br>(in thousands) | Total      |
| Assets:  |                                   |                                     |            |
| Balance, December 31, 2009   | \$ 83,771                         | \$ 26,046                           | \$ 109,817 |
| Purchases  | 91,141                            | 417,211                             | 508,352    |
| Repayments   | (58,560)                          | (55,198)                            | (113,758)  |
| Accrual of unearned discounts  | 3,287                             |                                     | 3,287      |
| Addition of unpaid interest to mortgage loan balances in loan<br>modifications                           |                                   | 155                                 | 155        |
| Sales  |                                   | (5,228)                             | (5,228)    |
| Changes in fair value included in income arising from:   |                                   |                                     |            |
| Changes in instrument-specific credit risk   |                                   | 5,714                               | 5,714      |
| Other factors  | 233                               | 21,501                              | 21,734     |
|  | 233                               | 27,215                              | 27,448     |
| Transfers of mortgage loans to REO   |                                   | (45,951)                            | (45,951)   |
| Balance, December 31, 2010   | \$ 119,872                        | \$ 364,250                          | \$ 484,122 |
| Changes in fair value recognized during the period relating to<br>assets still held at December 31, 2010 | \$ 233                            | \$ 13,316                           | \$ 13,549  |

Securities  
sold under  
agreements to  
repurchase  
(in thousands)

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|   |    |           |
|---|----|-----------|
| Liabilities:  |    |           |
| Balance, December 31, 2009  | \$ |           |
| Changes in fair value included in income  |    |           |
| Sales   |    | 513,141   |
| Repurchases   |    | (411,939) |
| Balance, December 31, 2010  | \$ | 101,202   |
| Changes in fair value recognized during the period relating to liabilities still outstanding at December 31, 2010 |    |           |
|   | \$ |           |

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**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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):

|                                     | Fair value   | December 31, 2012<br>Principal<br>amount due<br>upon maturity<br>(in thousands) | Difference   |
|-------------------------------------|--------------|---|--------------|
| 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       |
| Other mortgage loans 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) |

|  | Fair value   | December 31, 2011<br>Principal<br>amount due<br>upon maturity<br>(in thousands) | Difference   |
|--|--------------|---|--------------|
| Mortgage loans acquired for sale:      |              |   |              |
| Current through 89 days delinquent     | \$ 232,016   | \$ 222,399  | \$ 9,617     |
| 90 or more days delinquent(1)          |              |   |              |
|  | 232,016      | 222,399   | 9,617        |
| Other mortgage loans at fair value(2): |              |   |              |
| Current through 89 days delinquent     | 209,599      | 345,140   | (135,541)    |
| 90 or more days delinquent(1)          | 615,977      | 1,184,687   | (568,710)    |
|  | 825,576      | 1,529,827   | (704,251)    |
|  | \$ 1,057,592 | \$ 1,752,226  | \$ (694,634) |

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

(2) Includes mortgage loans at fair value and mortgage loans under forward purchase agreements at fair value.



**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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:

|  | Year ended December 31, 2012         |                    |  |                               |            |
|--|--------------------------------------|--------------------|--|-------------------------------|------------|
|  | Net gain<br>(loss) on<br>investments | Interest<br>income | Net gain on<br>mortgage<br>loans<br>acquired<br>for sale<br>(in thousands) | Net loan<br>servicing<br>fees | Total      |
| <b>Assets:</b>   |                                      |                    |  |                               |            |
| Short-term investments   | \$                                   | \$                 | \$   | \$                            | \$         |
| Mortgage-backed securities at fair value                       | 2,925                                | 142                |  |                               | 3,067      |
| Mortgage loans acquired for sale at fair value                 |                                      |                    | 188,055  |                               | 188,055    |
| Mortgage loans at fair value                                   | 95,615                               |                    |  |                               | 95,615     |
| Mortgage loans under forward purchase agreements at fair value | 9,687                                |                    |  |                               | 9,687      |
| Mortgage servicing rights at fair value                        |                                      |                    |  | (852)                         | (852)      |
|  | \$ 108,227                           | \$ 142             | \$ 188,055   | \$ (852)                      | \$ 295,572 |
| <b>Liabilities:</b>  |                                      |                    |  |                               |            |
| Securities sold under agreements to repurchase at fair value   | \$                                   | \$                 | \$   | \$                            | \$         |
|  | \$                                   | \$                 | \$   | \$                            | \$         |

|  | Year ended December 31, 2011         |                    |  |                                  |           |
|--|--------------------------------------|--------------------|--|----------------------------------|-----------|
|  | Net gain<br>(loss) on<br>investments | Interest<br>income | Net gain on<br>mortgage<br>loans<br>acquired<br>for sale<br>(in thousands) | Net<br>loan<br>servicing<br>fees | Total     |
| <b>Assets:</b>   |                                      |                    |  |                                  |           |
| Short-term investments   | \$                                   | \$                 | \$   | \$                               | \$        |
| Mortgage-backed securities at fair value                       | (2,812)                              | 1,993              |  |                                  | (819)     |
| Mortgage loans acquired for sale at fair value                 |                                      |                    | 7,633  |                                  | 7,633     |
| Mortgage loans at fair value                                   | 71,098                               |                    |  |                                  | 71,098    |
| Mortgage loans under forward purchase agreements at fair value | 14,357                               |                    |  |                                  | 14,357    |
| Mortgage servicing rights at fair value                        |                                      |                    |  | (31)                             | (31)      |
|  | \$ 82,643                            | \$ 1,993           | \$ 7,633   | \$ (31)                          | \$ 92,238 |
| <b>Liabilities:</b>  |                                      |                    |  |                                  |           |
| Securities sold under agreements to repurchase at fair value   | \$                                   | \$                 | \$   | \$                               | \$        |
|  | \$                                   | \$                 | \$   | \$                               | \$        |





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## PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

|  | Year ended December 31, 2010  |                    |  |                               |           |
|--|-------------------------------|--------------------|--|-------------------------------|-----------|
|  | Net gain<br>on<br>investments | Interest<br>income | Net gain on<br>mortgage<br>loans<br>acquired<br>for sale<br>(in thousands) | Net loan<br>servicing<br>fees | Total     |
| Assets:  |                               |                    |  |                               |           |
| Short-term investments                                       | \$                            | \$                 | \$   | \$                            | \$        |
| Mortgage-backed securities at fair value                     | 233                           | 3,287              |  |                               | 3,520     |
| Mortgage loans acquired for sale at fair value               |                               |                    | 18   |                               | 18        |
| Mortgage loans at fair value                                 | 27,195                        |                    |  |                               | 27,195    |
|  | \$ 27,428                     | \$ 3,287           | \$ 18  | \$                            | \$ 30,733 |
| Liabilities:   |                               |                    |  |                               |           |
| Securities sold under agreements to repurchase at fair value | \$                            | \$                 | \$   | \$                            | \$        |
|  | \$                            | \$                 | \$   | \$                            | \$        |

### 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:

|   | Level 1                             | Level 2 | Level 3    | Total      |
|---|-------------------------------------|---------|------------|------------|
|   | December 31, 2012<br>(in thousands) |         |            |            |
| Assets:   |                                     |         |            |            |
| Real estate asset acquired in settlement of loans                                   | \$                                  | \$      | \$ 56,156  | \$ 56,156  |
| Mortgage servicing assets at lower of amortized cost or fair value                  |                                     |         | 86,215     | 86,215     |
|   | \$                                  | \$      | \$ 142,371 | \$ 142,371 |
|   | Level 1                             | Level 2 | Level 3    | Total      |
|   | December 31, 2011<br>(in thousands) |         |            |            |
| Assets:   |                                     |         |            |            |
| Real estate asset acquired in settlement of loans                                   | \$                                  | \$      | \$ 32,356  | \$ 32,356  |
| Real estate asset acquired in settlement of loans under forward purchase agreements |                                     |         | 19,836     | 19,836     |
|   | \$                                  | \$      | \$ 52,192  | \$ 52,192  |

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### PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

|   | Year ended December 31, |            |          |
|---|-------------------------|------------|----------|
|   | 2012                    | 2011       | 2010     |
|   | (in thousands)          |            |          |
| Real estate asset acquired in settlement of loans                                   | \$ (12,168)             | \$ (3,182) | \$ (806) |
| Real estate asset acquired in settlement of loans under forward purchase agreements |                         | (241)      |          |
| Mortgage servicing assets at lower of amortized cost or fair value                  | (7,547)                 |            |          |
|   | \$ (19,715)             | \$ (3,423) | \$ (806) |

#### *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 value of the REO is initially established as the lesser of (a) either the fair value of the loan at the date of transfer, (b) the fair value of the real estate less estimated costs to sell as of the date of transfer or (c) the purchase price of the property. 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 MSR at lower of amortized cost or fair value with reference to the asset's fair value. For purposes of performing its MSR impairment evaluation, the Company stratifies its MSR at lower of amortized cost or fair value based on the mortgage loans' underlying interest rates. Mortgage loans are grouped into note rate pools of 50 basis points for note rates between 3% and 4.5% and a single pool for note rates below 3%. 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 any existing valuation allowance, those MSRs are impaired.

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

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 recoverable value is charged to the valuation allowance.

#### *Fair Value of Financial Instruments Carried at Amortized Cost*

The Company's cash balances as well as its borrowings secured by its inventory of mortgage loans acquired for sale and its investments in nonperforming loans and REO and its borrowings in the form of repurchase agreements and borrowings under forward purchase agreements are carried at amortized costs.



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### **PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

#### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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*, *Note payable secured by mortgage loans at fair value* and *Borrowings under forward purchase agreements* 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.

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 December 31, 2012 and 2011 due to the lack of current market activity and the Company's reliance on unobservable inputs to estimate the 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 results of operations. 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.

The Manager has assigned the responsibility for estimating the fair values of Level 3 financial statement items to a specialized valuation group and has developed procedures and controls governing the valuation process relating to these assets. The estimation of fair values of the Company's financial assets are assigned to the Manager's 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 the Manager's senior management valuation committee, which oversees and approves the valuations. The valuation committee includes the chief executive, financial, investment and credit officers of the Manager. 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 the valuation committee on a monthly basis on the changes in the valuation of the portfolio, including major drivers 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 methods used to estimate the fair values of Level 2 and Level 3 financial statement items:

#### ***Mortgage-Backed Securities***

MBS fair 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 is estimated based on quoted market prices for similar securities.

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Non-Agency MBS are categorized as Level 3 financial statement items. Fair value of non-Agency MBS is estimated using nonaffiliate 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 the Manager. 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 the Manager's valuation committee as part of its review and approval of monthly valuation results. The Manager 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 non-Agency MBS are discount rates, prepayment speeds, default speeds and the total expected future loss in comparison to the current balance of outstanding collateral (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 related, 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 unobservable inputs used by PCM's valuation staff to evaluate the reasonableness of the fair value of MBS:

| Security class         | Key inputs(1)                           | Range<br>(Weighted average) |                   |
|------------------------|---|-----------------------------|-------------------|
|                        |   | December 31, 2012           | December 31, 2011 |
| Non-Agency subprime    | Discount rate                           | 3.1%                        | 23.0%<br>(8.0)%   |
|                        | Prepayment speed(2)                     | 0.1%                        | 8.4%<br>(4.4)%    |
|                        | Default speed(3)                        | 3.6%                        | 19.8%<br>(12.3)%  |
|                        | Collateral remaining loss percentage(4) | 23.9%                       | 63.7%<br>(47.0)%  |
|                        |   |                             |                   |
| Non-Agency Alt-A       | Discount rate                           | 4.4%                        | 10.0%<br>(6.2)%   |
|                        | Prepayment speed(2)                     | 0.5%                        | 8.9%<br>(5.4)%    |
|                        | Default speed(3)                        | 3.0%                        | 11.5%<br>(9.7)%   |
|                        | Collateral remaining loss percentage(4) | 11.4%                       | 36.4%<br>(26.0)%  |
|                        |   |                             |                   |
| Non-Agency prime jumbo | Discount rate                           | 6.5%                        | 6.5%<br>(6.5)%    |
|                        | Prepayment speed(2)                     | 14.3%                       | 14.3%<br>(14.3)%  |
|                        | Default speed(3)                        | 1.5%                        | 1.5%<br>(1.5)%    |
|                        | Collateral remaining loss percentage(4) | 0.4%                        | 0.4%<br>(0.4)%    |
|                        |   |                             |                   |

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**PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

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 and loss severities. 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.

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

| Key inputs  | Range<br>(Weighted average) |       |                   |       |
|---|-----------------------------|-------|-------------------|-------|
|   | December 31, 2012           |       | December 31, 2011 |       |
| <i>Mortgage loans at fair value</i>                     |                             |       |                   |       |
| Discount rate   | 8.8%                        | 20.7% | 9.1%              | 20.7% |
|   | (13.1%)                     |       | (14.4%)           |       |
| Twelve-month projected housing price index change       | 0.4%                        | 1.5%  | 0.9%              | 2.3%  |
|   | (1.1%)                      |       | (-0.3%)           |       |
| Prepayment speed(1)                                     | 0.4%                        | 4.4%  | 0.2%              | 6.2%  |
|   | (2.2%)                      |       | (2.3%)            |       |
| Total prepayment speed(2)                               | 5.9%                        | 31.2% | 1.0%              | 33.8% |
|   | (20.6%)                     |       | (25.4%)           |       |
| <i>Mortgage loans under forward purchase agreements</i> |                             |       |                   |       |
| Discount rate   |                             |       | 16.3%             | 20.8% |
|   |                             |       | (17.1%)           |       |
| Twelve-month projected housing price index change       |                             |       | 0.5%              | 0.4%  |
|   |                             |       | (-0.5%)           |       |
| Prepayment speed(1)                                     |                             |       | 0.7%              | 0.8%  |
|   |                             |       | (0.8%)            |       |
| Total prepayment speed(2)                               |                             |       | 30.1%             | 33.3% |
|   |                             |       | (32.7%)           |       |

(1) Prepayment speed is measured using Life Voluntary Conditional Prepayment Rate.

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

*Derivative Financial Instruments*

The Company estimates the fair value of an interest rate lock commitment based on quoted Agency MBS prices, its estimate of the fair value of the MSR it expects to receive in the sale of the loans and the probability that the mortgage loan will be purchased within the terms of the interest rate lock commitment.

The significant unobservable inputs used in the fair value measurement of the Company's interest rate lock commitments are the pull-through rate, the percentage of loans that the Company ultimately funds as a percentage of the commitments it has made, and the MSR component of the Company's estimate of the value of the mortgage loans it has committed to purchase. Significant changes in any of those inputs, in isolation, could result in a significant change in fair value measurement. Changes in these assumptions are generally inversely correlated as increasing interest rates have a negative effect on the fair value of mortgage loans and a positive effect on the fair value of MSRs that are created in the sale of such mortgage loans.



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### PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Following is a quantitative summary of key unobservable inputs used in the valuation of interest rate lock commitments:

| Key inputs                             | December 31,                |       |         |       |
|--|-----------------------------|-------|---------|-------|
|  | 2012                        |       | 2011    |       |
|  | Range<br>(Weighted average) |       |         |       |
| Pull-through rate                      | 44.2%                       | 98.0% | 55.0%   | 98.0% |
|  | (80.6%)                     |       | (78.0%) |       |
| MSR value expressed as:                |                             |       |         |       |
| Servicing fee multiple                 | 1.8                         | 4.8   | 2.8     | 5.7   |
|  | (4.5)                       |       | (5.2)   |       |
| Percentage of unpaid principal balance | 0.4%                        | 1.2%  | 0.7%    | 1.4%  |
|  | (1.1%)                      |       | (1.3%)  |       |

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. The Company estimates the fair value of its MBS interest rate swaptions based on quoted market prices.

#### 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 determined by using a current estimate of value from a broker's price opinion, 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 generally subject to loss in value when mortgage rates decline. Declining mortgage rates normally encourage increased mortgage refinancing activity. Increased refinancing activity reduces the life of the loans underlying the MSRs, thereby reducing their value. Reductions in the value of these assets affect earnings 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 mortgage loans underlying MSRs.

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.

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.

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### PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

| Key Inputs                        | Year ended December 31, |            |                             |            |                |            |
|-----------------------------------|-------------------------|------------|-----------------------------|------------|----------------|------------|
|                                   | 2012                    |            | 2011                        |            | 2010           |            |
|                                   |                         |            | Range<br>(Weighted average) |            |                |            |
|                                   | Amortized cost          | Fair value | Amortized cost              | Fair value | Amortized cost | Fair value |
| Pricing spread(1)                 | 7.5% 22.8%              | 7.5% 16.5% | 7.5% 18.0%                  | 7.5% 15.3% |                |            |
|                                   | (7.5%)                  | (7.9%)     | (7.7%)                      | (9.5%)     |                |            |
| Life (in years)                   | 1.9 7.0                 | 2.4 7.0    | 3.0 8.1                     | 2.0 8.2    |                |            |
|                                   | (6.4)                   | (6.1)      | (6.9)                       | (6.0)      |                |            |
| Annual total prepayment speed(2)  | 6.7% 45.0%              | 7.9% 51.5% | 5.8% 24.4%                  | 6.8% 27.8% |                |            |
|                                   | (9.1%)                  | 12.7%      | (7.7%)                      | (13.7%)    |                |            |
| Annual per-loan cost of servicing | \$68 \$140              | \$68 \$140 | \$53 \$140                  | \$53 \$140 |                |            |
|                                   | (\$68)                  | (\$74)     | (\$69)                      | (\$85)     |                |            |

(1) Pricing spread represents a margin that is applied to a reference interest rate's forward rate curve to develop periodic discount rates. We apply 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 CPR.

Following is a quantitative summary of key inputs used in the valuation of MSRs, 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):

| Key Inputs                            | December 31, 2012 |             |  |            | December 31, 2011 |            |                |            |
|---------------------------------------|-------------------|-------------|--|------------|-------------------|------------|----------------|------------|
|                                       |                   |             | Range<br>(Weighted average)            |            |                   |            |                |            |
|                                       | Amortized cost    | Fair value  | Amortized cost                         | Fair value | Amortized cost    | Fair value | Amortized cost | Fair value |
|                                       |                   |             | (effect on value amounts in thousands) |            |                   |            |                |            |
| Pricing spread(1)                     | 7.5% 16.5%        | 7.5% 16.5%  | 7.5% 16.5%                             | 7.5% 16.5% | 7.5% 16.5%        | 7.5% 16.5% | 7.5% 16.5%     | 7.5% 16.5% |
|                                       | (7.5%)            | (7.7%)      | (7.5%)                                 | (8.6%)     |                   |            |                |            |
| Effect on value of 5% adverse change  | \$ (2,052)        | \$ (21)     | \$ (89)                                | \$ (10)    |                   |            |                |            |
| Effect on value of 10% adverse change | \$ (4,041)        | \$ (40)     | \$ (176)                               | \$ (20)    |                   |            |                |            |
| Effect on value of 20% adverse change | \$ (7,845)        | \$ (78)     | \$ (341)                               | \$ (39)    |                   |            |                |            |
| Average life (in years)               | 1.7 6.3           | 1.4 6.3     | 3.0 6.9                                | 1.7 6.9    |                   |            |                |            |
|                                       | (6.3)             | (6.0)       | (6.7)                                  | (5.3)      |                   |            |                |            |
| Prepayment speed(2)                   | 10.3% 47.8%       | 10.3% 65.9% | 6.9% 30.8%                             | 8.4% 59.0% |                   |            |                |            |
|                                       | (10.3%)           | (13.2%)     | (8.2%)                                 | (16.3%)    |                   |            |                |            |
| Effect on value of 5% adverse change  | \$ (3,026)        | \$ (52)     | \$ (90)                                | \$ (16)    |                   |            |                |            |
| Effect on value of 10% adverse change | \$ (5,937)        | \$ (100)    | \$ (178)                               | \$ (31)    |                   |            |                |            |
| Effect on value of 20% adverse change | \$ (11,436)       | \$ (190)    | \$ (343)                               | \$ (60)    |                   |            |                |            |
| Annual per-loan cost of servicing     | \$68 \$140        | \$68 \$140  | \$68 \$140                             | \$68 \$140 |                   |            |                |            |
|                                       | \$68              | \$74        | \$69                                   | \$89       |                   |            |                |            |
| Effect on value of 5% adverse change  | \$ (778)          | \$ (12)     | \$ (30)                                | \$ (4)     |                   |            |                |            |
| Effect on value of 10% adverse change | \$ (1,556)        | \$ (24)     | \$ (61)                                | \$ (9)     |                   |            |                |            |
| Effect on value of 20% adverse change | \$ (3,112)        | \$ (48)     | \$ (122)                               | \$ (17)    |                   |            |                |            |

- (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

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**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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 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.

**Note 9 Short-Term Investments**

The Company's short-term investments are comprised of money market accounts deposited with U.S. commercial banks.

**Note 10 United States Treasury Security**

The Company's investment in a U.S. Treasury security of \$50.0 million as of December 31, 2011 matured on January 19, 2012 and had a coupon interest rate of 0.00%.

**Note 11 Mortgage-Backed Securities at Fair Value**

The Company sold its investments in MBS during 2012 and therefore had no MBS at December 31, 2012. MBS at December 31, 2011 were as follows:

| Security collateral type | Unpaid<br>Balance | Total     | December 31, 2011<br>Fair value by credit rating |          |          | Non-<br>investment<br>grade | Yield |
|--------------------------|-------------------|-----------|--|----------|----------|-----------------------------|-------|
|                          |                   |           | AAA  | AA       | BBB      |                             |       |
|                          |                   |           | (dollar amounts in thousands)                    |          |          |                             |       |
| Non-Agency:              |                   |           |  |          |          |                             |       |
| Non-Agency subprime      | \$ 63,712         | \$ 58,634 | \$   | \$       | \$ 920   | \$ 57,714                   | 8.01% |
| Non-Agency Alt-A         | 8,910             | 8,710     | 440  |          | 5,362    | 2,908                       | 6.23% |
| Non-Agency prime jumbo   | 5,624             | 5,469     |  | 5,469    |          |                             | 6.51% |
|                          | \$ 78,246         | \$ 72,813 | \$ 440   | \$ 5,469 | \$ 6,282 | \$ 60,622                   | 7.70% |

All of the Company's MBS had remaining contractual maturities of more than ten years at December 31, 2011. At December 31, 2011, the Company had pledged all of its MBS to secure agreements to repurchase.

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 12 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:

| Loan Type  | December 31, 2012 |  | December 31, 2011 |                          |
|--|-------------------|--|-------------------|--------------------------|
|  | Fair value        | Unpaid principal balance<br>(in thousands) | Fair value        | Unpaid principal balance |
| Government insured or guaranteed   | \$ 153,326        | \$ 144,619                                 | \$ 46,266         | \$ 44,229                |
| Fixed-rate:  |                   |  |                   |                          |
| Agency-eligible  | 820,492           | 785,830                                    | 173,457           | 166,174                  |
| Jumbo loans  | 1,366             | 1,338                                      | 12,293            | 11,996                   |
|  | \$ 975,184        | \$ 931,787                                 | \$ 232,016        | \$ 222,399               |
| Loans pledged to secure sales of loans sold under agreements to repurchase | \$ 972,079        |  | \$ 231,704        |                          |

The Company is not approved by GNMA as an issuer of GNMA-guaranteed securities which are backed by government-insured or guaranteed mortgage loans. As discussed in Note 4 *Transactions with Related Parties*, the Company transfers such government insured or guaranteed mortgage loans that it purchases from correspondent lenders to PLS, which is a GNMA-approved issuer, for a sourcing fee of three basis points on the unpaid principal balance of each such loan.

**Note 13 Derivative Financial Instruments**

The Company is exposed to price risk relative to its mortgage loans acquired for sale as well as to the commitments it makes to acquire loans from correspondent lenders. The Company bears price risk from the time a commitment to purchase a loan is made 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 rise, because the value of the purchase commitment or mortgage loan acquired for sale declines.

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 IRLC and inventory of mortgage loans acquired for sale.

The Company is 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 began including MSRs in its hedging activities.

The Company does not use derivative financial instruments for purposes other than in support of its risk management activities.

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The Company records all derivative financial instruments at fair value. The Company had the following derivative financial instruments and related margin deposits recorded within the *Derivative assets* and *Derivative liabilities* on the consolidated balance sheets:

| Instrument   | December 31 2012 |                                 |  | December 31, 2011 |                                 |                        |
|--|------------------|---------------------------------|--|-------------------|---------------------------------|------------------------|
|  | Notional amount  | Fair value<br>Derivative assets | Derivative liabilities<br>(in thousands) | Notional amount   | Fair value<br>Derivative assets | Derivative liabilities |
| Derivatives not designated as hedging instruments: |                  |                                 |  |                   |                                 |                        |
| Free-standing derivatives (economic hedges):       |                  |                                 |  |                   |                                 |                        |
| Interest rate lock commitments                     | \$ 1,694,739     | \$ 19,479                       | \$                                       | \$ 563,487        | \$ 5,772                        | \$                     |
| Forward purchase contracts                         | 2,206,539        | 2,617                           | 1,741                                    |                   |                                 |                        |
| Forward sales contracts                            | 4,266,983        | 3,458                           | 4,520                                    | 358,291           |                                 | 3,917                  |
| MBS put options                                    | 495,000          | 977                             |  | 28,000            | 26                              |                        |
| MBS call options                                   |                  |                                 |  | 5,000             | 57                              |                        |
| Total derivative instruments before netting        | 8,663,261        | 26,531                          | 6,261                                    | 954,778           | 5,855                           | 3,917                  |
| Netting  |                  | (2,825)                         | (5,294)                                  |                   |                                 |                        |
| Total  | \$ 8,663,261     | \$ 23,706                       | \$ 967                                   | \$ 954,778        | \$ 5,855                        | \$ 3,917               |
| Margin deposits with derivatives counterparties    |                  | \$ 2,469                        |  |                   | \$ 1,545                        |                        |

The Company did not have any hedging derivative contracts on or before December 31, 2010.

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

| Period/instrument                   | Balance,<br>beginning<br>of year | Additions     | Dispositions/<br>expirations<br>(in thousands) | Balance, end<br>of year | Fair value<br>asset (liability)<br>at year-end |
|-------------------------------------|----------------------------------|---------------|--|-------------------------|--|
| <b>Year ended December 31, 2012</b> |                                  |               |  |                         |  |
| MBS put options                     | \$ 28,000                        | \$ 2,585,000  | \$ (2,118,000)                                 | \$ 495,000              | \$ 977   |
| MBS call options                    | \$ 5,000                         | \$ 90,000     | \$ (95,000)                                    | \$                      | \$   |
| Interest rate swaptions             | \$                               | \$ 170,000    | \$ (170,000)                                   | \$                      | \$   |
| MBS forward purchase contracts      | \$ 398,400                       | \$ 23,800,622 | \$ (21,992,483)                                | \$ 2,206,539            | \$ 876   |
| MBS forward sales contracts         | \$ 756,691                       | \$ 38,995,923 | \$ (35,485,631)                                | \$ 4,226,983            | \$ (1,062)                                     |
| <b>Year ended December 31, 2011</b> |                                  |               |  |                         |  |
| MBS put options                     | \$                               | \$ 66,000     | \$ (38,000)                                    | \$ 28,000               | \$ 26  |
| MBS call options                    | \$                               | \$ 13,000     | \$ (8,000)                                     | \$ 5,000                | \$ 57  |
| Interest rate swaptions             | \$                               | \$            | \$   | \$                      | \$   |
| MBS forward purchase contracts      | \$                               | \$ 2,191,713  | \$ (1,793,313)                                 | \$ 398,400              | \$ 2,123                                       |
| MBS forward sales contracts         | \$                               | \$ 1,139,247  | \$ (382,556)                                   | \$ 756,691              | \$ (6,040)                                     |

**Note 14 Mortgage Loans at Fair Value**

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Mortgage loans 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.

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

| Loan Type  | December 31, 2012 |  | December 31, 2011 |                          |
|--|-------------------|--|-------------------|--------------------------|
|  | Fair value        | Unpaid principal balance<br>(in thousands) | Fair value        | Unpaid principal balance |
| Nonperforming loans  | \$ 785,955        | \$ 1,483,311                               | \$ 494,711        | \$ 952,473               |
| Performing loans:  |                   |  |                   |                          |
| Fixed  | 201,212           | 322,005                                    | 97,582            | 162,145                  |
| ARM/hybrid   | 134,196           | 195,381                                    | 73,166            | 116,693                  |
| Interest rate step-up  | 68,475            | 123,117                                    | 30,621            | 52,507                   |
| Balloon  | 133               | 219  | 186               | 316                      |
|  | 404,016           | 640,722                                    | 201,555           | 331,661                  |
|  | \$ 1,189,971      | \$ 2,124,033                               | \$ 696,266        | \$ 1,284,134             |
| Mortgage loans at fair value pledged to secure borrowings at year end:                                     |                   |  |                   |                          |
| sales of loans under agreements to repurchase  | \$ 947,522        |  | \$ 656,409        |                          |
| Mortgage loans held in a consolidated subsidiary whose stock is pledged to secure financings of such loans | \$ 1,538          |  | \$ 1,886          |                          |

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

| Concentration  | December 31,                      |                                   |
|--|-----------------------------------|-----------------------------------|
|  | 2012                              | 2011                              |
| Portion of mortgage loans originated between 2005 and 2007   | 77%                               | 72%                               |
| Percentage of fair value of mortgage loans with unpaid-principal-balance-to current-property-value in excess of 100% | 68%                               | 72%                               |
| Percentage of mortgage loans secured by California real estate   | 18%                               | 24%                               |
| Other states contributing 5% or more of mortgage loans   | New York<br>Florida<br>New Jersey | New York<br>Florida<br>New Jersey |
|  | Illinois                          |                                   |

**Note 15 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.





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### PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company did not have mortgage loans under forward purchase agreements at December 31, 2012. Following is a summary of the distribution of the Company's mortgage loans under forward purchase agreements at fair value:

| Loan type             | December 31, 2011 |                          |
|-----------------------|-------------------|--------------------------|
|                       | Fair value        | Unpaid principal balance |
|                       | (in thousands)    |                          |
| Nonperforming loans   | \$ 121,266        | \$ 232,213               |
| Performing loans:     |                   |                          |
| Fixed                 | 3,316             | 6,084                    |
| ARM/hybrid            | 3,965             | 6,002                    |
| Interest rate step-up | 763               | 1,393                    |
|                       | 8,044             | 13,479                   |
|                       | \$ 129,310        | \$ 245,692               |

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

| Concentration   | December 31, 2011 |
|---|-------------------|
| Portion of mortgage loans originated between 2005 and 2007  | 74%               |
| Percentage of fair value of mortgage loans with unpaid-principal- balance-to current-property-value in excess of 100% | 74%               |
| Percentage of mortgage loans secured by California real estate  | 33%               |
| Other states contributing 5% or more of mortgage loans  | Florida           |

New York  
New Jersey

At December 31, 2011, the entire balance of mortgage loans under forward purchase agreements at fair value was subject to borrowings under forward purchase agreements.

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 16 Real Estate Acquired in Settlement of Loans**

Following is a summary of the activity in REO:

|  | Year ended December 31, |           |           |
|--|-------------------------|-----------|-----------|
|  | 2012                    | 2011      | 2010      |
|  | (in thousands)          |           |           |
| Balance at beginning of year   | \$ 80,570               | \$ 29,685 | \$        |
| Purchases  | 48                      | 1,511     | 1,238     |
| Transfers from mortgage loans at fair value and advances   | 112,642                 | 110,891   | 45,951    |
| Transfers from REO under forward purchase agreements   | 21,819                  | 778       |           |
| Results of REO:  |                         |           |           |
| Valuation adjustments, net   | (16,942)                | (10,281)  | (1,269)   |
| Gain on sale, net  | 16,440                  | 11,189    | 3,167     |
|  | (502)                   | 908       | 1,898     |
| Sale proceeds  | (126,499)               | (63,203)  | (19,402)  |
| Balance at year end  | \$ 88,078               | \$ 80,570 | \$ 29,685 |
| At year end:   |                         |           |           |
| REO pledged to secure agreements to repurchase   | \$ 9,061                | \$ 5,787  |           |
| REO held in a consolidated subsidiary whose stock is pledged to secure financings of such properties | \$ 14,773               | \$ 54,212 |           |

**Note 17 Real Estate Acquired in Settlement of Loans Under Forward Purchase Agreements**

The Company did not have REO under forward purchase agreements before the year ended December 31, 2011. Following is a summary of the activity in REO under forward purchase agreements:

|  | Year ended December 31 |        |
|--|------------------------|--------|
|  | 2012                   | 2011   |
|  | (in thousands)         |        |
| Balance at beginning of year   | \$ 22,979              | \$     |
| Purchases  | 249                    |        |
| Purchases financed through forward purchase agreements                                     |                        | 964    |
| Transfers from mortgage loans under forward purchase agreements at fair value and advances | 6,633                  | 23,880 |
| Transfers to REO   | (21,819)               | (778)  |
| Results of REO under forward purchase agreements:  |                        |        |
| Valuation adjustments, net   | (449)                  | (244)  |
| Gain on sale, net  | 2,319                  | 415    |
|  | 1,870                  | 171    |

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|                     |         |           |
|---------------------|---------|-----------|
| Sale proceeds       | (9,912) | (1,258)   |
| Balance at year end | \$      | \$ 22,979 |

At December 31, 2011, all REO under forward purchase agreements were pledged to secure forward purchase agreements.

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**PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 18 Mortgage Servicing Rights**

*Carried at Fair Value:*

The Company did not have MSRs at fair value before the year ended December 31, 2011. The activity in MSRs carried at fair value is as follows:

|  | Year ended December 31,<br>2012                      2011<br>(in thousands) |        |
|--|---|--------|
| Balance at beginning of year   | \$ 749  | \$     |
| Additions:   |   |        |
| Purchases  | 20  |        |
| MSRs received as proceeds from loan sales                                    | 1,508   | 774    |
| Total additions  | 1,528   | 774    |
| Change in fair value:  |   |        |
| Due to changes in valuation inputs or assumptions used in valuation model(1) | (708)   |        |
| Other changes in fair value(2)   | (144)   | (25)   |
|  | (852)   | (25)   |
| Sales  | (79)  |        |
| Balance at year end  | \$ 1,346  | \$ 749 |

(1) Principally reflects changes in discount rates and prepayment speed assumptions, primarily due to changes in interest rates.

(2) Represents changes due to realization of expected cash flows.

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Carried at Amortized Cost:*

The Company did not have MSR's at amortized cost before the year ended December 31, 2011. The activity in MSR's carried at amortized cost is summarized below:

|   | <b>Year ended December 31,</b> |             |
|---|--------------------------------|-------------|
|   | <b>2012</b>                    | <b>2011</b> |
|   | <b>(in thousands)</b>          |             |
| Amortized cost:   |                                |             |
| Balance before valuation allowance at beginning of year                                     | \$ 5,282                       | \$          |
| MSR's received as proceeds from loan sales  | 133,159                        | 5,299       |
| Purchases   | 15                             |             |
| Sales   | (19)                           |             |
| Amortization  | (5,460)                        | (17)        |
| Application of valuation allowance to write down MSR's with other-than temporary impairment |                                |             |
| Balance before valuation allowance at year end  | 132,977                        | 5,282       |
| Valuation allowance for impairment of MSR's:  |                                |             |
| Balance at beginning of year  |                                |             |
| Additions   | (7,547)                        |             |
| Application of valuation allowance to write down MSR's with other-than temporary impairment |                                |             |
| Balance at year end   | (7,547)                        |             |
| Mortgage servicing rights, net  | \$ 125,430                     | \$ 5,282    |
| Estimated fair value of MSR's at year end   | \$ 129,995                     | \$ 5,341    |

The following table summarizes the Company's estimate of amortization of its existing MSR's carried at amortized cost. This projection was developed using the assumptions made by management in its December 31, 2012 valuation of MSR's. The assumptions underlying the following estimate will change as market conditions and portfolio composition and behavior change, causing both actual and projected amortization levels to change over time. Therefore, the following estimates will change in a manner and amount not presently determinable by management.

| <b>Year ended December 31,</b> | <b>Estimated MSR<br/>amortization<br/>(in thousands)</b> |
|--------------------------------|--|
| 2013                           | \$ 15,880  |
| 2014                           | 14,213   |
| 2015                           | 12,666   |
| 2016                           | 11,454   |
| 2017                           | 10,472   |
| Thereafter                     | 68,292   |

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|       |    |         |
|-------|----|---------|
| Total | \$ | 132,977 |
|-------|----|---------|

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**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 19 Securities Sold Under Agreements to Repurchase at Fair Value**

Following is a summary of financial information relating to securities sold under agreements to repurchase at fair value:

|   | 2012                          | Year ended December 31,<br>2011 | 2010       |
|---|-------------------------------|---------------------------------|------------|
|   | (dollar amounts in thousands) |                                 |            |
| Year end:   |                               |                                 |            |
| Balance   | \$                            | \$ 115,493                      | \$ 101,202 |
| Weighted-average interest rate                                    | 0.00%                         | 0.67%                           | 1.34%      |
| Fair value of securities securing agreements to repurchase        | \$                            | \$ 122,813                      | \$ 119,872 |
| During the year:  |                               |                                 |            |
| Weighted-average interest rate                                    | 0.64%                         | 1.10%                           | 1.39%      |
| Average balance of securities sold under agreements to repurchase | \$ 74,560                     | \$ 78,021                       | \$ 44,590  |
| Total interest expense  | \$ 488                        | \$ 873                          | \$ 620     |
| Maximum daily amount outstanding                                  | \$ 160,334                    | \$ 115,493                      | \$ 121,047 |

The Company is subject to margin calls during the period the agreements are outstanding and therefore may be required to repay a portion of the borrowings before the respective agreements mature if the value (as determined by the applicable lender) of the MBS or mortgage loans securing those agreements decreases. As of December 31, 2011, the Company had \$3.8 million on deposit with its securities repurchase agreement counterparties. Margin deposits are included in *Other assets* in the consolidated balance sheets.

**Note 20 Mortgage Loans Acquired for Sale Sold Under Agreements to Repurchase**

Following is a summary of financial information relating to loans acquired for sale sold under agreements to repurchase:

|  | 2012                          | Year ended December 31,<br>2011 | 2010      |
|--|-------------------------------|---------------------------------|-----------|
|  | (dollar amounts in thousands) |                                 |           |
| Year end:  |                               |                                 |           |
| Balance  | \$ 894,906                    | \$ 212,677                      | \$ 2,494  |
| Unused amount(1)   | \$ 505,094                    | \$ 137,323                      | \$ 72,506 |
| Weighted-average interest rate   | 2.31%                         | 2.06%                           | 3.66%     |
| Fair value of mortgage loans acquired for sale securing agreements to repurchase | \$ 972,079                    | \$ 231,704                      | \$ 2,684  |
| During the year:   |                               |                                 |           |
| Weighted-average interest rate during the year(2)                                | 2.32%                         | 2.63%                           | 3.66%     |
| Average balance of loans sold under agreements to repurchase                     | \$ 412,242                    | \$ 43,713                       | \$ 20     |
| Total interest expense   | \$ 12,981                     | \$ 2,426                        | \$        |
| Maximum daily amount outstanding   | \$ 1,028,290                  | \$ 288,972                      | \$ 2,494  |

- (1) The amount the Company is able to borrow under loan repurchase agreements is tied to the fair value of unencumbered mortgage loans eligible to secure those agreements and the Company's ability to fund the agreements' margin requirements relating to the collateral sold.
- (2) Weighted-average interest rate during the year excludes the effect of amortization of debt issuance costs of \$3.3 million and \$1.3 million during the years ended December 31, 2012 and 2011, respectively.





**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Following is a summary of maturities of repurchase agreements by maturity date:

| Remaining maturity at December 31, 2012 | Balance<br>(in thousands) |
|---|---------------------------|
| Within 30 days                          | \$ 24,001                 |
| Over 30 to 90 days                      | 870,905                   |
| Over 90 days to 180 days                |                           |
| Over 180 days to 1 year                 |                           |
|   | \$ 894,906                |

Weighted average maturity (in months)

2.3

The Company is subject to margin calls during the period the agreements are outstanding and therefore may be required to repay a portion of the borrowings before the respective agreements mature if the value (as determined by the applicable lender) of the mortgage loans securing those agreements decreases. The Company had \$4.1 million and \$1.6 million on deposit with its loan repurchase agreement counterparties at December 31, 2012 and 2011, respectively. Margin deposits are included in *Other assets* in the consolidated balance sheets.

The amount at risk (the fair value of the assets pledged plus the related margin deposit, less the amount advanced by the counterparty and accrued interest) relating to the Company's mortgage loans acquired for sale sold under agreements to repurchase is summarized by counterparty below as of December 31, 2012:

| Counterparty                                    | Amount at risk<br>(in thousands) | Weighted-average<br>repurchase agreement<br>maturity |
|---|----------------------------------|--|
| Citibank, N.A.                                  | \$ 15,724                        | May 23, 2013   |
| Credit Suisse First Boston Mortgage Capital LLC | \$ 23,538                        | October 29, 2013                                     |
| Bank of America, N.A.                           | \$ 24,445                        | January 4, 2013                                      |
| Morgan Stanley Bank, N.A.                       | \$ 9,887                         | November 19, 2013                                    |
| Barclays Bank PLC                               | \$ 6,756                         | July 1, 2013   |

**Note 21 Mortgage Loans at Fair Value Sold Under Agreements to Repurchase**

Following is a summary of financial information relating to loans sold under agreements to repurchase:

|  | 2012                          | Year ended December 31,<br>2011 | 2010       |
|--|-------------------------------|---------------------------------|------------|
|  | (dollar amounts in thousands) |                                 |            |
| Year end:  |                               |                                 |            |
| Balance  | \$ 353,805                    | \$ 275,649                      | \$ 144,928 |
| Unused amount(1)   | \$ 246,195                    | \$ 174,351                      | \$ 80,072  |
| Weighted-average interest rate   | 3.35%                         | 3.96%                           | 3.32%      |
| Fair value of mortgage loans at fair value and REO securing agreements to repurchase | \$ 956,583                    | \$ 613,051                      | \$ 326,947 |
| During the year:   |                               |                                 |            |
| Weighted-average interest rate(2)  | 3.80%                         | 3.76%                           | 3.35%      |

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|  |            |            |            |
|--|------------|------------|------------|
| Average balance of loans sold under agreements to repurchase | \$ 300,285 | \$ 233,594 | \$ 6,148   |
| Total interest expense                                       | \$ 13,176  | \$ 9,642   | \$ 206     |
| Maximum daily amount outstanding                             | \$ 439,976 | \$ 285,532 | \$ 144,928 |

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**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

- (1) The amount the Company is able to borrow under loan repurchase agreements is tied to the fair value of unencumbered mortgage loans eligible to secure those agreements and the Company's ability to fund the agreements' margin requirements relating to the collateral sold.
- (2) Weighted-average interest rate during the period excludes the effect of amortization of debt issuance costs of \$1.6 million and \$741,000 during the years ended December 31, 2012 and 2011, respectively.

Following is a summary of maturities of repurchase agreements by maturity date:

| <b>Remaining maturity at December 31, 2012</b> | <b>Balance<br/>(in thousands)</b> |
|--|-----------------------------------|
| Within 30 days                                 | \$                                |
| Over 30 to 90 days                             | 47,140                            |
| Over 90 days to 180 days                       | 306,665                           |
| Over 180 days to 1 year                        |                                   |
|  | \$ 353,805                        |

Weighted average maturity (in months) 3.6

The Company is subject to margin calls during the period the agreements are outstanding and therefore may be required to repay a portion of the borrowings before the respective agreements mature if the value (as determined by the applicable lender) of the loans securing those agreements decreases. The Company had \$379,000 and \$471,000 on deposit with its loan repurchase agreement counterparties at December 31, 2012 and 2011, respectively. Margin deposits are included in *Other assets* in the consolidated balance sheets.

The amount at risk (the fair value of the assets pledged plus the related margin deposit, less the amount advanced by the counterparty and accrued interest) relating to the Company's mortgage loans at fair value sold under agreements to repurchase is summarized by counterparty below as of December 31, 2012:

| <b>Counterparty</b>                             | <b>Amount at risk<br/>(in thousands)</b> | <b>Weighted-average<br/>repurchase agreement<br/>maturity</b> |
|---|--|---|
| Citibank, N.A.                                  | \$ 514,919                               | April 19, 2013  |
| Wells Fargo Bank, N.A.                          | \$ 70,615                                | March 29, 2013  |
| Credit Suisse First Boston Mortgage Capital LLC | \$ 17,223                                | June 5, 2013  |

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 22 Real Estate Acquired in Settlement of Loans Financed Under Agreements to Repurchase**

The Company had no REO financed under agreements to repurchase before 2011. Following is a summary of financial information relating to REO financed under agreements to repurchase:

|   | <b>Year ended December 31,</b>       |             |
|---|--------------------------------------|-------------|
|   | <b>2012</b>                          | <b>2011</b> |
|   | <b>(dollar amounts in thousands)</b> |             |
| Year end:   |                                      |             |
| Balance   | \$ 7,391                             | \$ 27,494   |
| Unused amount(1)  | \$ 92,609                            | \$ 72,506   |
| Weighted-average interest rate  | 3.96%                                | 4.26%       |
| Fair value of loans and REO held in a consolidated subsidiary whose stock is pledged to secure agreements to repurchase | \$ 16,311                            | \$ 54,212   |
| During the year:  |                                      |             |
| Weighted-average interest rate(2)   | 4.21%                                | 4.26%       |
| Average balance of REO sold under agreements to repurchase  | \$ 16,666                            | \$ 8,341    |
| Total interest expense  | \$ 1,214                             | \$ 636      |
| Maximum daily amount outstanding  | \$ 27,494                            | \$ 28,260   |

- (1) The amount the Company is able to borrow under repurchase agreements is tied to the fair value of unencumbered REO eligible for contribution to the subsidiary, the stock of which secures those agreements, and the Company's ability to fund the agreements' margin requirements relating to the collateral so contributed.
- (2) Weighted-average interest rate during the period excludes the effect of amortization of debt issuance costs of \$500,000 and \$276,000 during the years ended December 31, 2012 and 2011, respectively.

The repurchase agreement collateralized by REO has a remaining term of approximately 5.2 months at December 31, 2012.

The Company is subject to margin calls during the period the agreements are outstanding and therefore may be required to repay a portion of the borrowings before the respective agreements mature if the value (as determined by the applicable lender) of the REOs decreases.

The amount at risk (the fair value of the assets pledged plus the related margin deposit, less the amount advanced by the counterparty and accrued interest) relating to the Company's REO held in a consolidated subsidiary whose stock is pledged to secure agreements to repurchase is summarized by counterparty below as of December 31, 2012:

| <b>Counterparty</b>                             | <b>Amount at risk<br/>(in<br/>thousands)</b> | <b>Weighted-average<br/>repurchase agreement<br/>maturity</b> |
|---|--|---|
| Credit Suisse First Boston Mortgage Capital LLC | \$ 8,910                                     | June 5, 2013  |

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 23 Note Payable Secured by Mortgage Loans at Fair Value**

The Company did not have a note payable secured by mortgage loans before 2011. Following is a summary of financial information relating to note payable secured by mortgage loans at fair value:

|  | <b>Year ended December 31,</b>       |             |
|--|--------------------------------------|-------------|
|  | <b>2012</b>                          | <b>2011</b> |
|  | <b>(dollar amounts in thousands)</b> |             |
| Year end:  |                                      |             |
| Balance  | \$                                   | \$ 28,617   |
| Unused amount(1)   | \$                                   | \$ 11,383   |
| Weighted-average interest rate   |                                      | 3.30%       |
| Fair value of mortgage loans at fair value and REO securing the note payable | \$                                   | \$ 49,617   |
| During the year:   |                                      |             |
| Weighted-average interest rate(2)  | 6.95%                                | 2.53%       |
| Average balance  | \$ 1,708                             | \$ 8,265    |
| Interest expense   | \$ 112                               | \$ 254      |
| Maximum daily amount outstanding   | \$ 28,617                            | \$ 33,386   |

(1) The amount the Company is able to borrow under this lending facility is tied to the fair value of unencumbered mortgage loans eligible to secure the facility.

(2) Weighted-average interest rate during the period excludes the effect of amortization of debt issuance costs of \$8,000 and \$42,000 during the years ended December 31, 2012 and 2011, respectively.

The facility underlying the *Note payable secured by mortgage loans at fair value*, matured on September 26, 2012. The Company had \$237,000 on deposit with its counterparty at December 31, 2011.

**Note 24 Borrowings under Forward Purchase Agreements**

The Company did not have borrowings under forward purchase agreements before 2011. Following is a summary of financial information relating to borrowings under forward purchase agreements:

|  | <b>Year ended December 31,</b>       |             |
|--|--------------------------------------|-------------|
|  | <b>2012</b>                          | <b>2011</b> |
|  | <b>(dollar amounts in thousands)</b> |             |
| Year end:                              |                                      |             |
| Balance                                | \$                                   | \$ 152,427  |
| Weighted-average interest rate         |                                      | 3.97%       |
| Fair value of underlying loans and REO | \$                                   | \$ 151,448  |
| During the year:                       |                                      |             |
| Weighted-average interest rate         | 4.01%                                | 4.11%       |
| Average balance                        | \$ 58,719                            | \$ 74,864   |
| Interest expense                       | \$ 2,396                             | \$ 3,116    |
| Maximum daily amount outstanding       | \$ 152,428                           | \$ 173,398  |



**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 25 Liability for Representations and Warranties**

Following is a summary of the Company's liability for representations and warranties included in *Recourse liability* in the consolidated balance sheets:

|                            | Year ended December 31, |        |      |
|----------------------------|-------------------------|--------|------|
|                            | 2012                    | 2011   | 2010 |
|                            | (in thousands)          |        |      |
| Balance, beginning of year | \$ 205                  | \$     | \$   |
| Provisions for losses      | 4,236                   | 205    |      |
| Incurred losses            |                         |        |      |
| Balance, end of year       | \$ 4,441                | \$ 205 | \$   |

Following is a summary of the repurchase activity:

|   | Year ended December 31, |      |      |
|---|-------------------------|------|------|
|   | 2012                    | 2011 | 2010 |
|   | (in thousands)          |      |      |
| During the year:  |                         |      |      |
| Unpaid balance of mortgage loans repurchased                              | \$ 290                  | \$   | \$   |
| Incurred losses on repurchased loans                                      | \$                      | \$   | \$   |
| At year end:  |                         |      |      |
| Unpaid balance of mortgage loans subject to pending claims for repurchase | \$ 1,727                | \$   | \$   |

**Note 26 Commitments and Contingencies**

From time to time, the Company may be involved in various proceedings, claims and legal actions arising in the ordinary course of business. As of December 31, 2012, the Company was not involved in any such proceedings, claims or legal actions that would have a material adverse effect on the Company.

***Mortgage Loan Commitments***

The following table summarizes the Company's outstanding contractual loan commitments:

|  | December 31,<br>2012<br>(in thousands) |
|--|--|
| Commitments to purchase mortgage loans : |  |
| Correspondent lending                    | \$ 1,694,739                           |
| Other mortgage loans                     | \$ 173,413                             |

**Note 27 Shareholders' Equity**



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On August 22, 2012, the Company issued and sold 17,250,000 common shares in an underwritten public offering and received \$357.2 million of proceeds, after the underwriting discount and estimated offering expenses and the reimbursement of certain expenses. Proceeds from the issuance of these shares were used to fund a portion of the purchase price of portfolios of residential mortgage whole loans, to fund the continued growth of the correspondent lending business, to acquire additional mortgage loans or other investments, including those under existing forward purchase agreements, and for general corporate purposes.

On May 11, 2012, the Company issued and sold 10,000,000 common shares in an underwritten public offering and received \$193.5 million of proceeds, after the underwriting discount and estimated offering

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expenses and the reimbursement of certain expenses. On May 17, 2012, the Company issued and sold an additional 287,706 common shares pursuant to the exercise of an option to purchase additional shares by the public offering's underwriters and received \$5.4 million of net proceeds after the underwriting discount and reimbursement of certain expenses. Proceeds from the issuance of these shares were used to fund a portion of the purchase price of portfolios of residential mortgage whole loans, to fund the continued growth of the correspondent lending business, to acquire additional mortgage loans or other investments, including those under existing forward purchase agreements, and for general corporate purposes.

During the year ended December 31, 2012, the Company sold common shares under a Controlled Equity Offering Sales Agreement with Cantor Fitzgerald & Co. and under an ATM Equity Offering<sup>SM</sup> Sales Agreement with Merrill Lynch, Pierce, Fenner & Smith Incorporated. Pursuant to the Controlled Equity Offering Sales Agreement and the ATM Equity Offering<sup>SM</sup> Sales Agreement, the Company sold 2,800,710 of its common shares at a weighted average price of \$18.58 per share, providing net proceeds to the Company of \$51.0 million, net of sales commissions. The sales agents received a total of approximately \$999,000, which represents an average commission of approximately 2.0% of the gross sales price.

During the year ended December 31, 2011, the Company sold a total of 558,500 of its common shares under a Controlled Equity Offering Sales Agreement with Cantor Fitzgerald & Co. at a weighted average price of \$16.86 per share, providing net proceeds to the Company of approximately \$9.2 million, net of sales commissions. The sales agent received a total of approximately \$188,000, which represents an average commission of approximately 2.0% of the gross sales price.

On February 16, 2011, the Company issued and sold 9,500,000 common shares in an underwritten public offering at a price of \$18 per share, for net proceeds of approximately \$163.8 million after the underwriting discount and estimated offering expenses and the reimbursement of certain expenses. On March 3, 2011, the Company issued and sold an additional 1,425,000 common shares at a price of \$18 per share pursuant to the exercise of an over-allotment option by the public offering's underwriters and received \$24.6 million of proceeds after the underwriting discount and reimbursement of certain expenses.

**Note 28 Net Gain on Mortgage Loans Acquired For Sale**

Net gain on mortgage loans acquired for sale is summarized below:

|  | Year ended December 31, |            |       |
|--|-------------------------|------------|-------|
|  | 2012                    | 2011       | 2010  |
|  | (in thousands)          |            |       |
| Cash gain (loss):  |                         |            |       |
| Sales proceeds   | \$ 13,918               | \$ (1,571) | \$ 78 |
| Hedging activities   | (57,040)                | (4,794)    | 20    |
|  | (43,122)                | (6,365)    | 98    |
| Non cash gain:   |                         |            |       |
| Change in fair value of commitments to purchase loans                                  | 13,707                  | 5,772      |       |
| Receipt of MSR in loan sale transactions   | 134,682                 | 6,073      |       |
| Provision for losses relating to representations and warranties provided in loan sales | (4,236)                 | (205)      | (12)  |
| Change in fair value relating to loans and hedging derivatives held at year-end:       |                         |            |       |
| Mortgage loans   | 43,691                  | 6,192      | (24)  |
| Hedging derivatives  | 2,953                   | (3,834)    | (44)  |
|  | 46,644                  | 2,358      | (68)  |
|  | \$ 147,675              | \$ 7,633   | \$ 18 |

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### PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### Note 29 Net Loan Servicing Fees

Net loan servicing fees is summarized below:

|   | Year ended December 31, |       |      |
|---|-------------------------|-------|------|
|   | 2012                    | 2011  | 2010 |
|   | (in thousands)          |       |      |
| Servicing fees(1)   | \$ 11,172               | \$ 62 | \$   |
| Effect of MSR:  |                         |       |      |
| Amortization  | (5,460)                 | (17)  |      |
| Provision for impairment of MSRs carried at lower of amortized cost or fair value | (7,547)                 |       |      |
| Change in fair value of MSRs carried at fair value                                | (852)                   | (25)  |      |
| Gains on hedging derivatives  | 2,123                   |       |      |
|   | (11,736)                | (42)  |      |
| Net loan servicing fees   | \$ (564)                | \$ 20 | \$   |

(1) Includes contractually specified servicing fees.

#### Note 30 Share-Based Compensation Plans

The Company has adopted an equity incentive plan which provides for the issuance of equity based awards, including share options, restricted shares, restricted share units, unrestricted common share awards, LTIP units (a special class of partnership interests in the Operating Partnership) and other awards based on PMT's shares that may be made by the Company directly to its officers and trustees, and the members, officers, trustees, directors and employees of PCM, PLS, or their affiliates and to PCM, PLS and other entities that provide services to PMT and the employees of such other entities. The equity incentive plan is administered by the Company's compensation committee, pursuant to authority delegated by the board of trustees, which has the authority to make awards to the eligible participants referenced above, and to determine what form the awards will take, and the terms and conditions of the awards.

The Company's equity incentive plan allows for grants of equity-based awards up to an aggregate of 8% of PMT's issued and outstanding shares on a diluted basis at the time of the award.

The shares underlying award grants will again be available for award under the equity incentive plan if:

any shares subject to an award granted under the equity incentive plan are forfeited, cancelled, exchanged or surrendered;

an award terminates or expires without a distribution of shares to the participant; or

shares are surrendered or withheld by PMT as payment of either the exercise price of an award and/or withholding taxes for an award.

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Restricted share units have been awarded to trustees and officers of the Company and to employees of PCM and PLS at no cost to the grantees. Such awards generally vest over a one- to four-year period. Each share option awarded under the equity incentive plan will have a term of no longer than ten years, and will have an exercise price that is no less than 100% of the fair value of the Company's shares on the date of grant of the award.

The Company's estimate of value included assumed grantee forfeiture rates of 15% per year for employees of PCM and its affiliates and no turnover for PMT's officers and its board of trustees.

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**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The table below summarizes restricted share unit activity and compensation expense:

|   | Year ended December 31, |              |              |
|---|-------------------------|--------------|--------------|
|   | 2012                    | 2011         | 2010         |
| Number of units:                                |                         |              |              |
| Outstanding at beginning of period              | 491,809                 | 272,984      | 374,810      |
| Granted   | 350,000                 | 340,500      | 23,600       |
| Vested  | (161,678)               | (88,711)     | (97,026)     |
| Expired or canceled                             | (14,514)                | (32,964)     | (28,400)     |
| Outstanding at year end                         | 665,617                 | 491,809      | 272,984      |
| Weighted Average Grant Date Fair Value:         |                         |              |              |
| Outstanding at beginning of period              | \$ 12.57                | \$ 6.18      | \$ 8.36      |
| Granted   | \$ 18.91                | \$ 16.52     | \$ 7.74      |
| Vested  | \$ 12.15                | \$ 9.82      | \$ 14.73     |
| Expired or canceled                             | \$ 16.82                | \$ 7.88      | \$ 7.10      |
| Outstanding at year end                         | \$ 15.92                | \$ 12.57     | \$ 6.18      |
| Compensation expense recorded during the period | \$ 6,032,000            | \$ 4,214,000 | \$ 1,812,000 |
| Period end:                                     |                         |              |              |
| Units available for future awards(1)            | 4,100,000               | 1,820,000    | 1,095,000    |
| Unamortized compensation cost                   | \$ 5,798,000            | \$ 3,355,000 | \$ 927,000   |

- (1) Based on common shares outstanding as of period end. Total units available for future awards may be adjusted in accordance with the equity incentive plan based on future issuances of PMT's shares as described above.

As of December 31, 2012, 614,360 restricted share units with a weighted average grant date fair value of \$16.81 per share unit are expected to vest over their average remaining vesting period of 2.4 years. The grant date fair values of share unit awards are based on the market value of the Company's stock at the date of grant.

**Note 31 Income Taxes**

The Company has elected to be taxed as a REIT for U.S. federal income tax purposes under Sections 856 through 860 of the Internal Revenue Code. Therefore, PMT generally will not be subject to corporate federal or state income tax to the extent that qualifying distributions are made to shareholders and the Company meets REIT requirements including certain asset, income, distribution and share ownership tests. The Company believes that it has met the distribution requirements, as it has declared dividends sufficient to distribute substantially all of its taxable income. Taxable income will generally differ from net income. The primary difference between net income and the REIT taxable income (before deduction for qualifying distributions) is the income of the TRSs and the method of determining the income or loss related to valuation of the mortgage loans owned by the qualified REIT subsidiary ( QRS ). Other differences between REIT book income and REIT taxable income are not material.

In general, cash dividends declared by the Company will be considered ordinary income to the shareholders for income tax purposes. Some portion of the dividends may be characterized as capital gain distributions or a return of capital. Approximately 83%, 95% and 100% of the distributions for 2012, 2011 and 2010, respectively, are characterized as ordinary income. Approximately 17% of the 2012 distributions are characterized as a return of capital and approximately 5% of the 2011 distributions are characterized as long term capital gain.



**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company had elected to treat two of its subsidiaries as TRSs. In the quarter ended September 30, 2012, the Company revoked the election to treat its wholly owned subsidiary that is the sole general partner of our Operating Partnership as a TRS. As a result, beginning September 1, 2012, one subsidiary, PennyMac Corp. (PMC), is treated as a TRS. Income from a TRS is only included as a component of REIT taxable income to the extent that the TRS makes dividend distributions of income to the REIT. No such dividend distributions were made in 2012, 2011 or 2010. A TRS is subject to corporate federal and state income tax. Accordingly, a provision for income taxes for PMC and, for the periods for which TRS treatment had been elected, the sole general partner of the Company's Operating Partnership is included in the consolidated statements of income.

The Company files U.S. federal and state income tax returns for both the REIT and TRSs. These returns for 2009 and forward are subject to examination by the respective tax authorities and the California returns for 2008 and forward are subject to examination. No returns are currently under examination.

The following table details the Company's income tax expense (benefit) which relates primarily to the TRSs:

|   | <b>Year ended December 31,</b> |                 |                 |
|---|--------------------------------|-----------------|-----------------|
|   | <b>2012</b>                    | <b>2011</b>     | <b>2010</b>     |
|   | <b>(in thousands)</b>          |                 |                 |
| <b>Current expense:</b>                 |                                |                 |                 |
| Federal                                 | \$ 4,760                       | \$ 6,250        | \$ 1,998        |
| State                                   | 1,686                          | 2,139           | 694             |
| <b>Total current expense</b>            | <b>6,446</b>                   | <b>8,389</b>    | <b>2,692</b>    |
| <b>Deferred expense (benefit):</b>      |                                |                 |                 |
| Federal                                 | 31,266                         | (247)           | (77)            |
| State                                   | 10,861                         | (86)            | (27)            |
| <b>Total deferred expense</b>           | <b>42,127</b>                  | <b>(333)</b>    | <b>(104)</b>    |
| <b>Valuation allowance</b>              |                                |                 | <b>(45)</b>     |
| <b>Total provision for income taxes</b> | <b>\$ 48,573</b>               | <b>\$ 8,056</b> | <b>\$ 2,543</b> |

The provision for deferred income taxes for the years ended December 31, 2012, December 31, 2011 and December 31, 2010 primarily relates to a net unrealized valuation loss on REO and to mortgage servicing rights the Company received pursuant to sales of mortgage loans with servicing rights retained as detailed below.



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## PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table is a reconciliation of the Company's provision for income taxes at statutory rates to the provision for income taxes at the Company's effective rate:

|  | 2012      |         | Year ended December 31,<br>2011  |         | 2010     |         |
|--|-----------|---------|----------------------------------|---------|----------|---------|
|  | Amount    | Rate    | Amount<br>(dollars in thousands) | Rate    | Amount   | Rate    |
| Federal income tax expense at statutory tax rate | \$ 65,387 | 35.0%   | \$ 25,373                        | 35.0%   | \$ 9,459 | 35.0%   |
| Effect of non-taxable REIT income                | (24,943)  | (13.4%) | (18,749)                         | (25.8%) | (7,272)  | (26.9%) |
| State income taxes, net of federal benefit       | 8,140     | 4.4%    | 1,335                            | 1.8%    | 434      | 1.6%    |
| Other  | (11)      | 0.0%    | 97                               | 0.1%    | (33)     | -0.1%   |
| Valuation allowance                              |           | 0.0%    |                                  | 0.0%    | (45)     | -0.2%   |
| Provision for income taxes                       | \$ 48,573 | 26.0%   | \$ 8,056                         | 11.1%   | \$ 2,543 | 9.4%    |

The Company's components of the provision for deferred income taxes are as follows:

|   | Year ended December 31, |                        |          |
|---|-------------------------|------------------------|----------|
|   | 2012                    | 2011<br>(in thousands) | 2010     |
| Real estate valuation loss                          | \$ (5,512)              | \$ (2,783)             | \$ (104) |
| Mortgage servicing rights                           | 49,420                  | 2,536                  |          |
| Other   | (1,781)                 | (86)                   |          |
| Valuation allowance                                 |                         |                        | (45)     |
| Total provision (benefit) for deferred income taxes | \$ 42,127               | \$ (333)               | \$ (149) |

The tax effects of temporary differences that gave rise to deferred income tax assets and liabilities are presented below:

|                                  | December 31, |                        |
|----------------------------------|--------------|------------------------|
|                                  | 2012         | 2011<br>(in thousands) |
| Deferred income tax assets:      |              |                        |
| REO valuation loss               | \$ 8,399     | \$ 2,886               |
| Other                            | 1,867        | 87                     |
| Gross deferred tax assets        | 10,266       | 2,973                  |
| Deferred income tax liabilities: |              |                        |
| Mortgage servicing rights        | 51,956       | 2,536                  |
| Gross deferred tax liabilities   | 51,956       | 2,536                  |

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Net deferred income tax asset (liability)

\$ (41,690)

\$ 437

The net deferred income tax liability is included in Income taxes payable in the consolidated balance sheets as of December 31, 2012 and 2011.

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**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

At December 31, 2012, December 31, 2011 and December 31, 2010, the Company had no unrecognized tax benefits and does not anticipate any increase in unrecognized tax benefits. Should the accrual of any interest or penalties relative to unrecognized tax benefits be necessary, it is the Company's policy to record such accruals in the Company's income tax accounts. No such accruals existed at December 31, 2012, December 31, 2011 or at December 31, 2010.

**Note 32 Segments and Related Information**

The Company has two business segments: investment activities and correspondent lending.

The investment activities segment represents the Company's investments in distressed mortgage loans, REO, MBS and MSRs. Management seeks to maximize the value of the mortgage loans acquired by the Company through proprietary loan modification programs, special servicing and 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. The Company also invests in mortgage related securities and other mortgage related real estate and financial assets.

The correspondent lending segment represents the Company's operations aimed at serving as an intermediary between mortgage originators, particularly mortgage lenders, and the capital markets by purchasing, pooling and reselling the loans either directly or in the form of MBS, using the operations of the Manager.

Before 2011, the Company's activities were almost exclusively within the investment activities segment. Accordingly, segment information is presented beginning with the 2011 fiscal year. Financial highlights by operating segment are summarized below:

| <b>Year ended December 31, 2012</b>          | <b>Correspondent<br/>lending</b> | <b>Investment<br/>activities<br/>(in thousands)</b> | <b>Intersegment<br/>elimination</b> | <b>Total</b> |
|--|----------------------------------|---|-------------------------------------|--------------|
| <b>Revenues:</b>                             |                                  |   |                                     |              |
| External                                     |                                  |   |                                     |              |
| Net gain on mortgage loans acquired for sale | \$ 147,675                       | \$  | \$                                  | \$ 147,675   |
| Net gain on investments                      |                                  | 103,649   |                                     | 103,649      |
| Interest income                              | 19,733                           | 52,796  | (88)                                | 72,441       |
| Other income                                 | 10,545                           | 858   |                                     | 11,403       |
|  | 177,953                          | 157,303   | (88)                                | 335,168      |
| <b>Expenses:</b>                             |                                  |   |                                     |              |
| Loan fulfillment fees                        | 62,906                           |   |                                     | 62,906       |
| Interest                                     | 11,289                           | 20,441  | (88)                                | 31,642       |
| Loan servicing expense                       | 205                              | 19,975  |                                     | 20,180       |
| Other  | 2,826                            | 30,792  |                                     | 33,618       |
|  | 77,226                           | 71,208  | (88)                                | 148,346      |
| Pre-tax net income                           | \$ 100,727                       | \$ 86,095   | \$                                  | \$ 186,822   |
| Total assets at year end                     | \$ 1,004,399                     | \$ 1,555,264  | \$                                  | \$ 2,559,663 |



**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

| <b>Year ended December 31, 2011</b>          | <b>Correspondent<br/>lending</b> | <b>Investment<br/>activities<br/>(in thousands)</b> | <b>Intersegment<br/>elimination</b> | <b>Total</b> |
|--|----------------------------------|---|-------------------------------------|--------------|
| <b>Revenues:</b>                             |                                  |   |                                     |              |
| External                                     |                                  |   |                                     |              |
| Net gain on investments                      | \$                               | \$ 82,643   | \$                                  | 82,643       |
| Interest income                              | 2,085                            | 34,063  |                                     | 36,148       |
| Net gain on mortgage loans acquired for sale | 7,633                            |   |                                     | 7,633        |
| Other income                                 | 1,017                            | 1,173   |                                     | 2,190        |
|  | 10,735                           | 117,879   |                                     | 128,614      |
| <b>Expenses:</b>                             |                                  |   |                                     |              |
| Loan fulfillment fees                        | 1,747                            |   |                                     | 1,747        |
| Interest                                     | 1,167                            | 15,779  |                                     | 16,946       |
| Loan servicing expense                       | 225                              | 15,139  |                                     | 15,364       |
| Other  | 324                              | 21,738  |                                     | 22,062       |
|  | 3,463                            | 52,656  |                                     | 56,119       |
| Pre-tax net income                           | \$ 7,272                         | \$ 65,223   | \$                                  | \$ 72,495    |
| Total assets at year end                     | \$ 237,351                       | \$ 1,148,711  | \$                                  | \$ 1,386,062 |

The accounting policies of the reportable segments are the same as those described in Note 3 *Significant Accounting Policies* except that intersegment transactions are not eliminated.

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 33 Selected Quarterly Results (Unaudited)**

Following is a presentation of selected quarterly financial data:

|  | Quarter ended                         |              |              |              |              |              |            |            |
|--|---------------------------------------|--------------|--------------|--------------|--------------|--------------|------------|------------|
|  | 2012                                  |              |              |              | 2011         |              |            |            |
|  | Dec. 31                               | Sept. 30     | June 30      | Mar. 31      | Dec. 31      | Sept. 30     | June 30    | Mar. 31    |
|  | (in thousands, except per share data) |              |              |              |              |              |            |            |
| For the quarter ended:                               |                                       |              |              |              |              |              |            |            |
| Net investment income                                | \$ 124,917                            | \$ 99,196    | \$ 64,406    | \$ 46,649    | \$ 39,123    | \$ 41,985    | \$ 30,223  | \$ 17,283  |
| Net income   | \$ 49,238                             | \$ 40,384    | \$ 29,569    | \$ 19,058    | \$ 19,649    | \$ 20,528    | \$ 16,617  | \$ 7,645   |
| Earnings per share:                                  |                                       |              |              |              |              |              |            |            |
| Basic  | \$ 0.83                               | \$ 0.81      | \$ 0.80      | \$ 0.65      | \$ 0.69      | \$ 0.76      | \$ 0.61    | \$ 0.35    |
| Diluted  | \$ 0.83                               | \$ 0.81      | \$ 0.79      | \$ 0.65      | \$ 0.69      | \$ 0.76      | \$ 0.61    | \$ 0.35    |
| Cash dividends declared per share                    | \$ 0.57                               | \$ 0.55      | \$ 0.55      | \$ 0.55      | \$ 0.50      | \$ 0.50      | \$ 0.42    | \$         |
| At period end:                                       |                                       |              |              |              |              |              |            |            |
| Short-term investments at fair value                 | \$ 39,017                             | \$ 38,322    | \$ 32,340    | \$ 63,444    | \$ 30,319    | \$ 30,743    | \$ 38,633  | \$ 53,194  |
| United States Treasury security                      |                                       |              |              |              | 50,000       |              |            |            |
| Mortgage-backed securities at fair value             |                                       |              | 167,446      | 174,604      | 72,813       | 86,702       | 82,421     | 102,195    |
| Mortgage loans at fair value(1)                      | 2,165,155                             | 1,937,541    | 1,447,254    | 927,867      | 1,057,592    | 909,030      | 676,071    | 592,445    |
| Real estate acquired in settlement of loans(2)       | 88,078                                | 86,180       | 89,918       | 104,870      | 103,549      | 69,906       | 48,872     | 31,285     |
| Mortgage servicing rights(3)                         | 126,776                               | 65,154       | 32,832       | 18,534       | 6,031        | 636          | 180        |            |
| Other assets   | 140,637                               | 201,528      | 120,955      | 88,701       | 65,758       | 58,477       | 37,298     | 61,412     |
| Total assets   | \$ 2,559,663                          | \$ 2,328,725 | \$ 1,890,745 | \$ 1,378,020 | \$ 1,386,062 | \$ 1,155,494 | \$ 883,475 | \$ 840,531 |
| Assets sold under agreements to repurchase(4)        | \$ 1,256,102                          | \$ 1,041,371 | \$ 1,007,712 | \$ 501,441   | \$ 631,313   | \$ 421,626   | \$ 340,989 | \$ 308,432 |
| Note payable secured by mortgage loans at fair value |                                       |              |              |              | 28,617       |              |            |            |
| Borrowings under forward purchase agreements         |                                       |              | 16,693       | 127,591      | 152,427      | 163,755      |            |            |
| Other liabilities                                    | 102,225                               | 103,151      | 60,667       | 153,032      | 27,688       | 39,450       | 19,562     | 15,337     |
| Total liabilities                                    | 1,358,327                             | 1,144,522    | 1,085,072    | 782,064      | 840,045      | 624,831      | 360,551    | 323,769    |
| Shareholders' equity                                 | 1,201,336                             | 1,184,203    | 805,673      | 595,956      | 546,017      | 530,663      | 522,924    | 516,762    |
| Total liabilities and shareholders' equity           | \$ 2,559,663                          | \$ 2,328,725 | \$ 1,890,745 | \$ 1,378,020 | \$ 1,386,062 | \$ 1,155,494 | \$ 883,475 | \$ 840,531 |

(1) Includes mortgage loans acquired for sale at fair value, mortgage loans at fair value and mortgage loans under forward purchase agreements at fair value.

(2) Includes real estate acquired in settlement of loans and real estate acquired in settlement of loans under forward purchase agreements.

(3) Includes mortgage servicing rights at fair value and mortgage servicing rights at lower of amortized cost or fair value.

(4) Includes securities, mortgage loans acquired for sale at fair value, mortgage loans at fair value and real estate acquired in settlement of loans.

**Table of Contents****PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 34 Supplemental Cash Flow Information**

|   | Year ended December 31, |            |           |
|---|-------------------------|------------|-----------|
|   | 2012                    | 2011       | 2010      |
|   | (in thousands)          |            |           |
| Cash paid for interest  | \$ 31,693               | \$ 16,963  | \$ 484    |
| Cash paid for income taxes  | \$ 12,700               | \$ 6,941   | \$ 3,248  |
| Non-cash investing activities:  |                         |            |           |
| Transfer of mortgage loans to REO   | \$ 112,642              | \$ 110,891 | \$ 45,951 |
| Transfer of mortgage loans acquired for sale to mortgage loans  | \$ 18                   | \$         | \$        |
| Addition of unpaid interest to mortgage loan balances in loan modifications                           | \$ 19,745               | \$ 8,657   | \$ 155    |
| Purchase of mortgage loans financed through forward purchase agreements                               | \$ 1,070                | \$ 194,286 | \$        |
| Transfer of mortgage loans under forward purchase agreements to mortgage loans, at fair value         | \$ 117,913              | \$         | \$        |
| Transfer of mortgage loans under forward purchase agreements to REO under forward purchase agreements | \$ 6,633                | \$ 23,880  | \$        |
| Receipt of MSR as proceeds from sales of loans  | \$ 134,682              | \$ 6,073   | \$        |
| Purchase of REO financed through forward purchase agreements  | \$ 249                  | \$ 964     | \$        |
| Transfer of REO under forward purchase agreements to REO  | \$ 21,819               | \$ 778     | \$        |
| Non-cash financing activities:  |                         |            |           |
| Purchase of mortgage loans financed through forward purchase agreements                               | \$ 1,070                | \$ 194,286 | \$        |
| Purchase of REO financed through forward purchase agreements  | \$ 249                  | \$ 964     | \$        |
| Declaration of cash dividends to common shareholders  | \$                      | \$         | \$ 7,070  |

**Note 35 Regulatory Net Worth Requirement**

PMC, an indirect subsidiary of the Company, is a seller-servicer for Fannie Mae. To retain its status as an approved seller-servicer, PMC is required to meet Fannie Mae's capital standards, which require PMC to maintain a minimum net worth of \$32.8 million. Management believes PMC complies with Fannie Mae's net worth requirement as of December 31, 2012.

**Note 36 Recently Issued Accounting Pronouncements**

In December 2011, the FASB issued an Accounting Standards Update, (ASU), ASU 2011-11 to the *Balance Sheet* topic of the Codification. The amendments in this ASU affect all entities that have financial instruments and derivative instruments that are either (1) offset in accordance with the *Offsetting Presentation* section of the *Balance Sheet* topic or the *Presentation* section of the *Derivatives and Hedging* topic of the Codification or (2) subject an enforceable master netting arrangement or similar agreement.

The amendments in this ASU require the Company to disclose information about offsetting and related arrangement to enable users of financial statements to understand the effect of netting to an entity's financial position.

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**PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In January 2013, the FASB issued ASU 2013-01, *Clarifying the Scope of Disclosures About Offsetting Assets and Liabilities*, which clarifies which instruments and transactions are subject to the offsetting disclosure requirements established by ASU 2011-11. The ASU clarifies that the scope applied to derivatives accounted for in accordance with the *Derivatives and Hedging* topic of the Codification, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with the *Offsetting Presentation* section of the *Balance Sheet* topic or the *Presentation* section of the *Derivatives and Hedging* topic or subject to an enforceable master netting arrangement or similar agreement.

The ASU amendment and the subsequent clarification of the amendment are effective for periods beginning on or after January 1, 2013, and must be shown for all periods shown on the balance sheet. The adoption of these ASU amendments is not expected to have a material effect on our financial condition or results of operations.

**Note 37 Subsequent Events**

Management has evaluated all events and transactions through the date the Company issued these consolidated financial statements. During this period:

On February 1, 2013, the Company entered into the following agreements with PennyMac and its subsidiaries: Amended and Restated Management Agreement (the *Management Agreement*), by and among PMT, the Operating Partnership and PCM; Amended and Restated Flow Servicing Agreement (the *Servicing Agreement*), between the Operating Partnership and PLS; Mortgage Banking and Warehouse Services Agreement (the *MBWS Agreement*), between PLS and PMC; MSR Recapture Agreement (the *MSR Recapture Agreement*), between PLS and PMC; Master Spread Acquisition and MSR Servicing Agreement (the *Spread Acquisition and MSR Servicing Agreement*), between PLS and the Operating Partnership; and Amended and Restated Underwriting Fee Reimbursement Agreement (the *Reimbursement Agreement*), by and among PMT, the Operating Partnership and PCM. The current term of each of the agreements other than the Reimbursement 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 respective agreements. The Reimbursement Agreement expires on February 1, 2019.

The Management Agreement was amended to provide for the payment to PCM of a base management fee and a performance incentive fee, both payable quarterly and in arrears. The base management fee is equal to the sum of (i) 1.5% per annum of shareholders' equity up to \$2 billion, (ii) 1.375% per annum of shareholders' equity in excess of \$2 billion and up to \$5 billion, and (iii) 1.25% per annum 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 the incentive fee, exceeds certain levels of return on equity. Net income, for purposes of determining the amount of the performance incentive fee, is defined as net income or loss computed in accordance with GAAP and adjusted for certain non cash charges.

The Servicing Agreement was amended to provide for servicing fees payable to PLS that changed from a percentage of the loan's UPB to fixed per-loan monthly amounts based on the delinquency, bankruptcy and/or foreclosure status of the serviced loan or the real estate acquired in settlement of a loan.



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**PENNYMAC MORTGAGE INVESTMENT TRUST AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The MBWS Agreement provides for a fulfillment fee paid to PLS based on the type of mortgage loan that PMT acquires. The fulfillment fee is equal to a percentage of the unpaid principal balance of such mortgage loan. The terms of the MBWS agreement are similar to the prior MBWS agreement, with the addition of potential fee rate discounts applicable to PMT's monthly purchase volume in excess of designated thresholds. The Company has also agreed to provide such services exclusively for PMT's benefit, and PLS and its affiliates are prohibited from providing such services for any other third party.

Pursuant to the terms of the MSR Recapture Agreement, if PLS refinances via its retail lending business loans for which PMT previously held the MSRs, PLS is generally required to transfer and convey to PMC, without cost to PMC, 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.

Pursuant to the Spread Acquisition and MSR Servicing Agreement, PMT may acquire from PLS the rights to receive certain excess servicing spread arising from mortgage servicing rights 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 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.

Pursuant to the Reimbursement Agreement, PCM may be entitled to reimbursement of certain payments. In connection with the initial public offering of PMT's common shares, on August 4, 2009, PCM entered into an agreement with PMT pursuant to which PMT agreed to reimburse PCM for a \$2.9 million payment that it made to the underwriters of the IPO if PMT satisfied certain performance measures over a specified period of time. Such reimbursements are contingent on earning a performance incentive fee under the Management Agreement and are subject to specified maximum payments in any 12-month period.

On February 8, 2013, the Company's board of trustees declared a cash dividend of \$0.57 per share payable on March 1, 2013 to holders of record of the Company's common shares as of February 21, 2013.

On February 14, 2013, PCM committed to acquire on the Company's behalf mortgage loans with purchase prices totaling approximately \$121.3 million. The pending transaction is subject to continuing due diligence and customary closing conditions. There can be no assurance that the committed amounts will ultimately be acquired or that the transactions will be completed at all.

All agreements to repurchase assets that matured before the date of this Report were extended or renewed.

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**SIGNATURES**

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

PENNYMAC MORTGAGE INVESTMENT TRUST

By: */s/ STANFORD L. KURLAND*  
*Stanford L. Kurland,*  
*Chairman of the Board of Trustees and*  
  
*Chief Executive Officer*  
*(Principal Executive Officer)*

Dated: February 28, 2013

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

| <b>Signatures</b>                                     | <b>Title</b>   | <b>Date</b>       |
|---|--|-------------------|
| <i>/s/ STANFORD L. KURLAND</i><br>Stanford L. Kurland | Chairman of the Board of Trustees and Chief Executive Officer<br>(Principal Executive Officer) | February 28, 2013 |
| <i>/s/ ANNE D. McCALLION</i><br>Anne D. McCallion     | Chief Financial Officer<br>(Principal Financial Officer)                                       | February 28, 2013 |
| <i>/s/ GREGORY L. HENDRY</i><br>Gregory L. Hendry     | Chief Accounting Officer<br>(Principal Accounting Officer)                                     | February 28, 2013 |
| <i>/s/ MATTHEW BOTEIN</i><br>Matthew Botein           | Trustee  | February 28, 2013 |
| <i>/s/ SCOTT W. CARNAHAN</i><br>Scott W. Carnahan     | Trustee  | February 28, 2013 |
| <i>/s/ PRESTON DUFAUCHARD</i><br>Preston DuFauchard   | Trustee  | February 28, 2013 |
| <i>/s/ RANDALL D. HADLEY</i><br>Randall D. Hadley     | Trustee  | February 28, 2013 |
| <i>/s/ CLAY A. HALVORSEN</i><br>Clay A. Halvorsen     | Trustee  | February 28, 2013 |

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|                       |         |                   |
|-----------------------|---------|-------------------|
| /s/ NANCY McALLISTER  | Trustee | February 28, 2013 |
| Nancy McAllister      |         |                   |
| /s/ DAVID A. SPECTOR  | Trustee | February 28, 2013 |
| David A. Spector      |         |                   |
| /s/ STACEY D. STEWART | Trustee | February 28, 2013 |
| Stacey D. Stewart     |         |                   |
| /s/ FRANK P. WILLEY   | Trustee | February 28, 2013 |
| Frank P. Willey       |         |                   |

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**PENNYMAC MORTGAGE INVESTMENT TRUST**

**FORM 10-K**

**December 31, 2012**

**INDEX OF EXHIBITS**

| <b>Exhibit</b> |  |
|----------------|--|
| <b>Number</b>  | <b>Exhibit Description</b>   |
| 3.1            | Declaration of Trust of PennyMac Mortgage Investment Trust, as amended and restated (incorporated by reference to Exhibit 3.1 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).  |
| 3.2            | Bylaws of PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 3.2 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).   |
| 4.1            | Specimen Common Share Certificate of PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 4.1 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).  |
| 10.1           | Registration Rights Agreement, dated as of August 4, 2009, among PennyMac Mortgage Investment Trust, Stanford L. Kurland, David A. Spector, BlackRock Holdco II, Inc., Highfields Capital Investments LLC and Private National Mortgage Acceptance Company, LLC (incorporated by reference to Exhibit 10.1 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009). |
| 10.2           | Underwriting Fee Reimbursement Agreement, dated as of August 4, 2009, among PennyMac Mortgage Investment Trust, PennyMac Operating Partnership, L.P. and PNMAC Capital Management, LLC (incorporated by reference to Exhibit 10.7 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).  |
| 10.3           | Amended and Restated Limited Partnership Agreement of PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.2 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).  |
| 10.4           | Management Agreement, dated as of August 4, 2009, among PennyMac Mortgage Investment Trust, PennyMac Operating Partnership, L.P. and PNMAC Capital Management, LLC (incorporated by reference to Exhibit 10.3 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).  |
| 10.5           | Amendment No. 1 to Management Agreement, dated March 3, 2010, among PennyMac Mortgage Investment Trust, PennyMac Operating Partnership, L.P. and PNMAC Capital Management, LLC (incorporated by reference to Exhibit 10.4 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2010).  |
| 10.6           | Amendment No. 2 to Management Agreement, dated May 16, 2012, among PennyMac Mortgage Investment Trust, PennyMac Operating Partnership, L.P. and PNMAC Capital Management, LLC (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on May 22, 2012).  |
| 10.7           | Flow Servicing Agreement, dated as of August 4, 2009, between PennyMac Operating Partnership, L.P. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.4 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).  |
| 10.8           | Amendment No. 1 to Flow Servicing Agreement, dated as of March 3, 2010, between PennyMac Operating Partnership, L.P. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.6 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2010).  |
| 10.9           | Amendment No. 2 to Flow Servicing Agreement, dated as of March 8, 2011, between PennyMac Operating Partnership, L.P. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.8 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2011).  |

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### **Exhibit**

| <b>Number</b> | <b>Exhibit Description</b>   |
|---------------|--|
| 10.10         | Amendment No. 3 to Flow Servicing Agreement, dated as of May 17, 2011, by and between PennyMac Operating Partnership, L.P. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.9 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2011).   |
| 10.11         | PennyMac Mortgage Investment Trust 2009 Equity Incentive Plan (incorporated by reference to Exhibit 10.5 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).   |
| 10.12         | Form of Restricted Share Unit Award Agreement under the PennyMac Mortgage Investment Trust 2009 Equity Incentive Plan (incorporated by reference to Exhibit 10.8 to Amendment No. 3 to the Company's Registration Statement on Form S-11, filed with the SEC on July 24, 2009).  |
| 10.13         | Master Repurchase Agreement, dated as of November 2, 2010, among PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC, and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.11 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2010).  |
| 10.14         | Amendment Number One to Master Repurchase Agreement, dated as of August 18, 2011, among PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC, and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.13 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).                       |
| 10.15         | Amendment Number Two to Master Repurchase Agreement, dated as of September 28, 2011, among PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC, and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.14 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).                    |
| 10.16         | Amendment Number Three to Master Repurchase Agreement, dated as of December 30, 2011, among PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC, and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.15 of our Annual Report on Form 10-K for the year ended December 31, 2011).                          |
| 10.17         | Amendment Number Four to Master Repurchase Agreement, dated as of December 28, 2012, among PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC, and Wells Fargo Bank, National Association.   |
| 10.18         | Guaranty Agreement, dated as of November 2, 2010, by PennyMac Mortgage Investment Trust in favor of Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.12 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2010).   |
| 10.19         | Amendment Number One to Guaranty Agreement, dated as of August 18, 2011, by PennyMac Mortgage Investment Trust in favor of Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.16 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).  |
| 10.20         | Amendment Number Two to Guaranty Agreement, dated as of September 28, 2011, by PennyMac Mortgage Investment Trust in favor of Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.17 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).   |
| 10.21         | Master Repurchase Agreement, dated as of November 2, 2010, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.13 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2010).               |
| 10.22         | Amendment Number One to Master Repurchase Agreement, dated as of May 20, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.15 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2011). |

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### **Exhibit**

| <b>Number</b> | <b>Exhibit Description</b>   |
|---------------|--|
| 10.23         | Amendment Number Two to Master Repurchase Agreement, dated as of July 14, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.20 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).     |
| 10.24         | Amendment Number Three to Master Repurchase Agreement, dated as of October 7, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.21 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011). |
| 10.25         | Amendment Number Four to Master Repurchase Agreement, dated as of November 1, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.22 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011). |
| 10.26         | Amendment Number Five to Master Repurchase Agreement, dated as of November 30, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on November 30, 2011).                   |
| 10.27         | Amendment Number Six to Master Repurchase Agreement, dated as of March 29, 2012, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.25 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2012).        |
| 10.28         | Amendment Number Seven to Master Repurchase Agreement, dated as of July 25, 2012, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on July 31, 2012).                          |
| 10.29         | Amendment Number Eight to Master Repurchase Agreement, dated as of September 26, 2012, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on October 1, 2012).                   |
| 10.30         | Amendment Number Nine to Master Repurchase Agreement, dated as of October 29, 2012, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on October 29, 2012).                     |
| 10.31         | Guaranty, dated as of November 2, 2010, by PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. and Credit Suisse First Boston Mortgage Capital, LLC (incorporated by reference to Exhibit 10.14 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2010).  |
| 10.32         | Master Repurchase Agreement, dated as of December 9, 2010, among PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC, and PennyMac Loan Services, LLC, and Citibank, N.A. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on December 15, 2010).  |
| 10.33         | Amendment Number One to Master Repurchase Agreement, dated as of February 25, 2011, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on March 3, 2011).  |
| 10.34         | Amendment Number Two to Master Repurchase Agreement, dated as of December 8, 2011, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.28 of our Annual Report on Form 10-K for the year ended December 31, 2011).                         |

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### **Exhibit**

| <b>Number</b> | <b>Exhibit Description</b>  |
|---------------|---|
| 10.35         | Amendment Number Three to Master Repurchase Agreement, dated as of February 24, 2012, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.30 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2012).  |
| 10.36         | Amendment Number Four to Master Repurchase Agreement, dated as of April 13, 2012, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.32 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012).   |
| 10.37         | Amendment Number Five to Master Repurchase Agreement, dated as of April 20, 2012, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.33 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012).   |
| 10.38         | Amendment Number Six to Master Repurchase Agreement, dated as of May 31, 2012, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on June 5, 2012).   |
| 10.39         | Amendment Number Seven to Master Repurchase Agreement, dated as of November 13, 2012, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC.   |
| 10.40         | Amendment Number Eight to Master Repurchase Agreement, dated as of December 31, 2012, by and among Citibank, N.A. and PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Loan Services, LLC.   |
| 10.41         | Guaranty Agreement, dated as of December 9, 2010, by PennyMac Mortgage Investment Trust in favor of Citibank, N.A. (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on December 15, 2010).   |
| 10.42         | Master Repurchase Agreement, dated as of June 8, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on June 14, 2011).  |
| 10.43         | Amended and Restated Master Repurchase Agreement, dated as of August 25, 2011, among Credit Suisse First Boston Mortgage Capital LLC, PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 10.28 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).             |
| 10.44         | Amendment No. 1 to Amended and Restated Master Repurchase Agreement, dated as of June 6, 2012, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Corp., PennyMac Mortgage Investment Trust Holdings I, LLC and PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 10.38 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012). |
| 10.45         | Guaranty, dated as of June 8, 2011, of PennyMac Mortgage Investment Trust in favor of Credit Suisse First Boston Mortgage Capital LLC (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on June 14, 2011).  |
| 10.46         | Master Loan and Security Agreement, dated as of September 28, 2011, by and between PCNPL Trust and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on October 4, 2011).  |
| 10.47         | Limited Guaranty Agreement, dated as of September 28, 2011, of PennyMac Mortgage Investment Trust in favor of Wells Fargo Bank, National Association (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on October 4, 2011).   |

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### **Exhibit**

| <b>Number</b> | <b>Exhibit Description</b>   |
|---------------|--|
| 10.48         | Master Repurchase Agreement, dated as of November 7, 2011, among Bank of America, N.A., PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on November 14, 2011).   |
| 10.49         | Amendment No. 1 to Master Repurchase Agreement, dated as of August 17, 2012, among Bank of America, N.A., PennyMac Corp., PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 10.45 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2012).  |
| 10.50         | Guaranty, dated as of November 7, 2011, by PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P., in favor of Bank of America, N.A. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on November 14, 2011).   |
| 10.51         | Letter Agreement, dated as of July 21, 2011, by and between PennyMac Corp. and Citigroup Global Markets Realty Corp. (incorporated by reference to Exhibit 10.32 of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2011).*  |
| 10.52         | Amendment Number One, dated as of January 6, 2012, to Letter Agreement, dated as of July 12, 2011, by and between PennyMac Corp. and Citigroup Global Markets Realty Corp. (incorporated by reference to Exhibit 10.40 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2012).*  |
| 10.53         | Amendment Number Two, dated as of February 1, 2012, to Letter Agreement, dated as of July 12, 2011, by and between PennyMac Corp. and Citigroup Global Markets Realty Corp. (incorporated by reference to Exhibit 10.41 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2012).*   |
| 10.54         | Letter Agreement, dated as of December 20, 2011, by and between PennyMac Corp. and Citigroup Global Markets Realty Corp. (incorporated by reference to Exhibit 10.38 of our Annual Report on Form 10-K filed on March 9, 2012).*   |
| 10.55         | Master Repurchase Agreement, dated as of March 29, 2012, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Mortgage Investment Trust Holdings I, LLC, PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on March 29, 2012).                               |
| 10.56         | Amendment Number One to Master Repurchase Agreement, dated as of July 25, 2012, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Mortgage Investment Trust Holdings I, LLC, PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on July 31, 2012).         |
| 10.57         | Amendment Number Two to Master Repurchase Agreement, dated as of September 26, 2012, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Mortgage Investment Trust Holdings I, LLC, PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on October 1, 2012).  |
| 10.58         | Amendment Number Three to Master Repurchase Agreement, dated as of October 29, 2012, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Mortgage Investment Trust Holdings I, LLC, PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on October 29, 2012). |
| 10.59         | Guaranty, dated as of March 29, 2012, by PennyMac Mortgage Investment Trust and PennyMac Operating Partnership, L.P. in favor of Credit Suisse First Boston Mortgage Capital, LLC (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on March 29, 2012).  |



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### **Exhibit**

| <b>Number</b> | <b>Exhibit Description</b>  |
|---------------|---|
| 10.60         | Master Repurchase Agreement, dated as of May 24, 2012, among Citibank, N.A., PennyMac Corp. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on May 30, 2012).   |
| 10.61         | Amendment Number One to Master Repurchase Agreement, dated as of October 15, 2012, among Citibank, N.A., PennyMac Corp. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on October 16, 2012).   |
| 10.62         | Amendment Number Two to Master Repurchase Agreement, dated as of November 13, 2012, among Citibank, N.A., PennyMac Corp. and PennyMac Loan Services, LLC.   |
| 10.63         | Guaranty, dated as of May 24, 2012, by PennyMac Mortgage Investment Trust in favor of Citibank, N.A. (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on May 30, 2012).  |
| 10.64         | Master Repurchase Agreement, dated as of July 2, 2012, among Barclays Bank PLC, PennyMac Corp., PennyMac Loan Services, LLC and PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on July 10, 2012).                                 |
| 10.65         | Amended and Restated Mortgage Banking Services Agreement, dated as of November 1, 2010, between PennyMac Corp. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.53 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012).                                   |
| 10.66         | Amendment No. 1 to Amended and Restated Mortgage Banking Services Agreement, dated as of July 1, 2011, between PennyMac Corp. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.54 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012).                    |
| 10.67         | Amendment No. 2 to Amended and Restated Mortgage Banking Services Agreement, dated as of February 29, 2012, between PennyMac Corp. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.55 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012).               |
| 10.68         | Amendment No. 3 to Amended and Restated Mortgage Banking Services Agreement, dated as of May 16, 2012, between PennyMac Corp. and PennyMac Loan Services, LLC (incorporated by reference to Exhibit 10.56 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012).                    |
| 10.69         | Master Repurchase Agreement, dated as of September 28, 2012, among Credit Suisse First Boston Mortgage Capital, LLC, PennyMac Operating Partnership, L.P. and PennyMac Mortgage Investment Trust (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on October 3, 2012). |
| 10.70         | Guaranty, dated as of September 28, 2012, by PennyMac Mortgage Investment Trust in favor of Credit Suisse First Boston Mortgage Capital, LLC (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on October 3, 2012).   |
| 10.71         | Master Repurchase Agreement, dated as of November 20, 2012, among PennyMac Corp., Morgan Stanley Bank, N.A. and Morgan Stanley Mortgage Capital Holdings LLC (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on November 26, 2012).                                   |
| 10.72         | Guaranty, dated as of November 20, 2012, by PennyMac Mortgage Investment Trust in favor of Morgan Stanley Bank, N.A. and Morgan Stanley Mortgage Capital Holdings LLC (incorporated by reference to Exhibit 1.2 of our Current Report on Form 8-K filed on November 26, 2012).                          |
| 21.1          | Subsidiaries of PennyMac Mortgage Investment Trust.   |
| 23.1          | Consent of Deloitte & Touche LLP.   |

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### **Exhibit**

| <b>Number</b> | <b>Exhibit Description</b>  |
|---------------|---|
| 31.1          | Certification of Stanford L. Kurland pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2          | Certification of Anne D. McCallion pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1          | Certification of Stanford L. Kurland pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 32.2          | Certification of Anne D. McCallion pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 101           | Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Balance Sheets as of December 31, 2012 and December 31, 2011, (ii) the Consolidated Statements of Income for the years ended December 31, 2012, 2011 and 2010, (iii) the Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2012, 2011 and 2010, (iv) the Consolidated Statements of Cash Flows for the years ended December 31, 2012, 2011 and 2010 and (v) the Notes to the Consolidated Financial Statements.** |

\* Certain terms have been redacted pursuant to requests for confidential treatment that were granted by the Securities and Exchange Commission.

\*\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is otherwise not subject to liability under those sections.