

Edgar Filing: Ellington Residential Mortgage REIT - Form 10-Q

Ellington Residential Mortgage REIT  
Form 10-Q  
August 06, 2018

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

FORM 10-Q

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

For the quarterly period ended June 30, 2018

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 001-35896  
Ellington Residential Mortgage REIT  
(Exact Name of Registrant as Specified in Its Charter)

Maryland 46-0687599  
(State or Other Jurisdiction of Incorporation) (IRS Employer Identification No.)  
53 Forest Avenue  
Old Greenwich, CT 06870  
(Address of principal executive offices, zip code)  
(203) 698-1200  
(Registrant's Telephone Number, Including Area Code)

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

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

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

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer (do not check if a smaller reporting company)  Smaller Reporting Company   
Emerging Growth Company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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

Class Outstanding at August 1, 2018

Edgar Filing: Ellington Residential Mortgage REIT - Form 10-Q

Common Shares of Beneficial Interest, \$0.01 par value per share 12,690,330

---

ELLINGTON RESIDENTIAL MORTGAGE REIT

INDEX

PART I. Financial Information

Item 1. Consolidated Financial Statements (unaudited)	<u>3</u>
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	<u>33</u>
Item 3. Quantitative and Qualitative Disclosures about Market Risk	<u>50</u>
Item 4. Controls and Procedures	<u>52</u>

PART II. Other Information

Item 1. Legal Proceedings	<u>53</u>
Item 1A. Risk Factors	<u>53</u>
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	<u>53</u>
Item 6. Exhibits	<u>54</u>

---

## PART I. FINANCIAL INFORMATION

## Item 1. Consolidated Financial Statements (unaudited)

## ELLINGTON RESIDENTIAL MORTGAGE REIT

## CONSOLIDATED BALANCE SHEET

(UNAUDITED)

	June 30, 2018	December 31, 2017
(In thousands except for share amounts)		
<b>ASSETS</b>		
Cash and cash equivalents	\$41,402	\$56,117
Mortgage-backed securities, at fair value	1,580,103	1,685,998
Due from brokers	26,946	26,754
Financial derivatives—assets, at fair value	20,095	8,792
Reverse repurchase agreements	21,373	81,461
Receivable for securities sold	51,614	21,606
Interest receivable	5,988	5,784
Other assets	748	575
Total Assets	\$1,748,269	\$1,887,087
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>LIABILITIES</b>		
Repurchase agreements	\$1,537,216	\$1,597,206
Payable for securities purchased	1,387	3,830
Due to brokers	7,312	489
Financial derivatives—liabilities, at fair value	1,655	1,863
U.S. Treasury securities sold short, at fair value	16,195	81,289
Dividend payable	4,703	4,936
Accrued expenses	849	728
Management fee payable to affiliate	656	725
Interest payable	4,127	3,318
Total Liabilities	1,574,100	1,694,384
<b>SHAREHOLDERS' EQUITY</b>		
Preferred shares, par value \$0.01 per share, 100,000,000 shares authorized; (0 shares issued and outstanding, respectively)	—	—
Common shares, par value \$0.01 per share, 500,000,000 shares authorized; (12,712,050 and 13,340,217 shares issued and outstanding, respectively)	127	134
Additional paid-in-capital	233,152	240,062
Accumulated deficit	(59,110 )	(47,493 )
Total Shareholders' Equity	174,169	192,703
Total Liabilities and Shareholders' Equity	\$1,748,269	\$1,887,087

See Notes to Consolidated Financial Statements

3

ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED STATEMENT OF OPERATIONS  
(UNAUDITED)

	Three-Month Period Ended June 30,		Six-Month Period Ended June 30,	
	2018	2017	2018	2017
(In thousands except for per share amounts)				
<b>INTEREST INCOME (EXPENSE)</b>				
Interest income	\$14,081	\$10,883	\$27,506	\$23,211
Interest expense	(7,668 )	(4,020 )	(14,915 )	(7,199 )
Total net interest income	6,413	6,863	12,591	16,012
<b>EXPENSES</b>				
Management fees to affiliate	656	685	1,327	1,212
Professional fees	217	178	452	354
Compensation expense	187	216	375	375
Insurance expense <sup>(1)</sup>	74	74	148	156
Other operating expenses <sup>(1)</sup>	293	284	641	612
Total expenses	1,427	1,437	2,943	2,709
<b>OTHER INCOME (LOSS)</b>				
Net realized gains (losses) on securities	(7,114 )	(359 )	(5,188 )	(3,350 )
Net realized gains (losses) on financial derivatives	(3,702 )	(9,128 )	12,253	(7,474 )
Change in net unrealized gains (losses) on securities	(3,218 )	4,136	(30,279 )	1,789
Change in net unrealized gains (losses) on financial derivatives	10,834	1,528	11,399	(613 )
Total other income (loss)	(3,200 )	(3,823 )	(11,815 )	(9,648 )
<b>NET INCOME (LOSS)</b>	<b>\$1,786</b>	<b>\$1,603</b>	<b>\$(2,167)</b>	<b>\$3,655</b>
<b>NET INCOME (LOSS) PER COMMON SHARE:</b>				
Basic and Diluted	\$0.14	\$0.15	\$(0.17 )	\$0.37
<b>CASH DIVIDENDS PER COMMON SHARE:</b>				
Dividends declared	\$0.37	\$0.40	\$0.74	\$0.80

(1) Conformed to current period presentation.

See Notes to Consolidated Financial Statements

ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY  
(UNAUDITED)

	Common Shares	Common Shares, par value	Preferred Shares	Preferred Shares, par value	Additional Paid-in-Capital	Accumulated (Deficit) Earnings	Total
(In thousands except for share amounts)							
BALANCE, December 31, 2016	9,130,897	\$ 92	—	\$ —	\$ 180,996	\$(39,411)	\$141,677
Shares issued <sup>(1)</sup>	3,236,738	32	—	—	45,186		45,218
Offering costs					(141)		(141)
Forfeiture of common shares to satisfy tax withholding obligations	(37)	) —			—		—
Share based compensation					95		95
Dividends declared						(8,599)	(8,599)
Net income						3,655	3,655
BALANCE, June 30, 2017	12,367,598	\$ 124	—	\$ —	\$ 226,136	\$(44,355)	\$181,905
BALANCE, December 31, 2017	13,340,217	\$ 134	—	\$ —	\$ 240,062	\$(47,493)	\$192,703
Share based compensation					99		99
Repurchase of common shares	(628,167)	(7)	—	—	(7,009)		(7,016)
Dividends declared						(9,450)	(9,450)
Net loss						(2,167)	(2,167)
BALANCE, June 30, 2018	12,712,050	\$ 127	—	\$ —	\$ 233,152	\$(59,110)	\$174,169

(1) For the six-month period ended June 30, 2017 proceeds from the issuance of shares is net of an underwriters' discount of \$1.9 million.

See Notes to Consolidated Financial Statements

ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(UNAUDITED)

	Six-Month Period Ended June 30,	
	2018	2017
(In thousands)		
Cash flows provided by (used in) operating activities:		
Net income (loss)	\$(2,167)	\$ 3,655
Reconciliation of net income (loss) to net cash provided by (used in) operating activities:		
Net realized (gains) losses on securities	5,188	3,350
Change in net unrealized (gains) losses on securities	30,279	(1,789 )
Net realized (gains) losses on financial derivatives	(12,253 )	7,474
Change in net unrealized (gains) losses on financial derivatives	(11,399 )	613
Amortization of premiums and accretion of discounts (net)	7,250	4,142
Share based compensation	99	95
(Increase) decrease in assets:		
Due from brokers	(192 )	14,594
Interest receivable	(204 )	(1,333 )
Other assets	(173 )	(240 )
Increase (decrease) in liabilities:		
Due to brokers	6,823	(737 )
Accrued expenses	121	253
Interest payable	809	357
Management fees payable to affiliate	(69 )	152
Net cash provided by (used in) operating activities	24,112	30,586
Cash flows provided by (used in) investing activities:		
Purchases of securities	(611,463 )	(1,536,238 )
Proceeds from sale of securities	551,032	981,059
Principal repayments of mortgage-backed securities	87,304	73,221
Proceeds from investments sold short	635,002	423,237
Repurchase of investments sold short	(696,242 )	(426,058 )
Proceeds from disposition of financial derivatives	22,174	5,674
Purchase of financial derivatives	(10,033 )	(13,149 )
Payments made on reverse repurchase agreements	(9,536,399 )	(8,872,124 )
Proceeds from reverse repurchase agreements	9,596,486	8,873,666
Net cash provided by (used in) investing activities	37,861	(490,712 )

See Notes to Consolidated Financial Statements

ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED STATEMENT OF CASH FLOWS (CONTINUED)  
(UNAUDITED)

	Six-Month Period Ended June 30,	
	2018	2017
Cash flows provided by (used in) financing activities:		
Net proceeds from the issuance of common shares	\$—	\$ 45,218
Offering costs paid	—	(108 )
Repurchase of common shares	(7,016 )	—
Dividends paid	(9,682 )	(7,305 )
Borrowings under repurchase agreements	771,028	1,651,747
Repayments of repurchase agreements	(831,018)	(1,221,270)
Cash provided by (used in) financing activities	(76,688 )	468,282
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(14,715 )	8,156
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	56,117	33,504
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$41,402	\$ 41,660
Supplemental disclosure of cash flow information:		
Interest paid	\$14,106	\$ 6,842
Dividends payable	\$4,703	\$ 4,947

See Notes to Consolidated Financial Statements

7

---



ELLINGTON RESIDENTIAL MORTGAGE REIT  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2018

(UNAUDITED)

1. Organization and Investment Objective

Ellington Residential Mortgage REIT, or "EARN," was formed as a Maryland real estate investment trust, or "REIT," on August 2, 2012, and commenced operations on September 25, 2012. EARN conducts its business through its wholly owned subsidiaries, EARN OP GP LLC, or the "General Partner," and Ellington Residential Mortgage LP, or the "Operating Partnership," which were formed as a Delaware limited liability company and a Delaware limited partnership, respectively, on July 31, 2012 and commenced operations on September 25, 2012. The Operating Partnership conducts its business of acquiring, investing in, and managing residential mortgage- and real estate-related assets through its wholly owned subsidiaries. EARN, the General Partner, the Operating Partnership, and their consolidated subsidiaries are hereafter defined as the "Company."

Ellington Residential Mortgage Management LLC, or the "Manager," serves as the Manager of the Company pursuant to the terms of the Fifth Amended and Restated Management Agreement, or the "Management Agreement." The Manager is an affiliate of Ellington Management Group, L.L.C., or "EMG," an investment management firm that is an SEC-registered investment adviser with a 23-year history of investing in a broad spectrum of mortgage-backed securities and related derivatives, with an emphasis on the residential mortgage-backed securities, or "RMBS," market. In accordance with the terms of the Management Agreement and the Services Agreement (as described in Note 9), the Manager is responsible for administering the Company's business activities and day-to-day operations, and performs certain services, subject to oversight by the Board of Trustees. See Note 9 for further information on the Management Agreement.

The Company acquires and manages RMBS, for which the principal and interest payments are guaranteed by a U.S. government agency or a U.S. government-sponsored entity, or "Agency RMBS," and RMBS that do not carry such guarantees, or "non-Agency RMBS," such as RMBS backed by prime jumbo, Alternative A-paper, manufactured housing, and subprime residential mortgage loans. Agency RMBS include both Agency pools and Agency collateralized mortgage obligations, or "CMOs," and non-Agency RMBS primarily consist of non-Agency CMOs, both investment grade and non-investment grade. The Company may also acquire and manage mortgage servicing rights, credit risk transfer securities, residential mortgage loans, and other mortgage- and real estate-related assets. The Company may also invest in other instruments including, but not limited to, forward-settling To-Be-Announced Agency pass-through certificates, or "TBAs," interest rate swaps and swaptions, U.S. Treasury securities, Eurodollar and U.S. Treasury futures, other financial derivatives, and cash equivalents. The Company's targeted investments may range from unrated first loss securities to AAA senior securities.

The Company has elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, or "the Code," and intends to conduct its operations to be qualified and taxed as a REIT. As a REIT, the Company is required to distribute annually at least 90% of its taxable income. As long as the Company continues to qualify as a REIT, it will not be subject to U.S. federal corporate taxes on its taxable income to the extent that it distributes all of its annual taxable income to its shareholders. It is the intention of the Company to distribute at least 100% of its taxable income, after application of available tax attributes, within the time limits prescribed by the Code, which may extend into the subsequent taxable year.

2. Significant Accounting Policies

(A) Basis of Presentation: The Company's unaudited interim consolidated financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America, or "U.S. GAAP." Entities in which the Company has a controlling financial interest, through ownership of the majority of the entities' voting equity interests, or through other contractual rights that give the Company control, are consolidated by the Company. All inter-company balances and transactions have been eliminated. The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and those

differences could be material. In management's opinion, all material adjustments considered necessary for a fair statement of the Company's interim consolidated financial statements have been included and are only of a normal recurring nature. Interim results are not necessarily indicative of the results that may be expected for the entire fiscal year. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

(B) Valuation: The Company applies ASC 820-10, Fair Value Measurement ("ASC 820-10"), to its holdings of financial instruments. ASC 820-10 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation

hierarchy is based upon the observability of inputs to the valuation of an asset or liability as of the measurement date.

The three levels are defined as follows:

Level 1—inputs to the valuation methodology are observable and reflect quoted prices (unadjusted) for identical assets or liabilities in active markets. Currently, the types of financial instruments the Company generally includes in this category are exchange-traded derivatives;

Level 2—inputs to the valuation methodology other than quoted prices included in Level 1 are observable for the asset or liability, either directly or indirectly. Currently, the types of financial instruments that the Company generally includes in this category are Agency RMBS, U.S. Treasury securities, certain non-Agency RMBS, and actively traded derivatives such as TBAs, interest rate swaps, and swaptions, and;

Level 3—inputs to the valuation methodology are unobservable and significant to the fair value measurement. Currently, this category includes certain RMBS, such as certain non-Agency RMBS and certain Agency IOs, where there is less price transparency.

For certain financial instruments, the various inputs that management uses to measure fair value for such financial instrument may fall into different levels of the fair value hierarchy. In such cases, the determination of which category within the fair value hierarchy is appropriate for such financial instrument is based on the lowest level of input that is significant to the fair value measurement. ASC 820 prioritizes the various inputs that management uses to measure fair value with the highest priority to inputs that are observable and reflect quoted prices (unadjusted) for identical assets or liabilities in active markets (Level 1) and the lowest priority to inputs that are unobservable and significant to the fair value measurement (Level 3). The assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the financial instrument. The Company may use valuation techniques consistent with the market and income approaches to measure the fair value of its assets and liabilities. The market approach uses third-party valuations and information obtained from market transactions involving identical or similar assets or liabilities. The income approach uses projections of the future economic benefits of an instrument to determine its fair value, such as in the discounted cash flow methodology. The inputs or methodology used for valuing financial instruments are not necessarily an indication of the risk associated with investing in these financial instruments. The leveling of each financial instrument is reassessed at the end of each period. Transfers between levels of the fair value hierarchy are assumed to occur at the end of the reporting period.

#### Summary Valuation Techniques

For financial instruments that are traded in an "active market," the best measure of fair value is the quoted market price. However, many of the Company's financial instruments are not traded in an active market. Therefore, management generally uses third-party valuations when available. If third-party valuations are not available, management uses other valuation techniques, such as the discounted cash flow methodology. The following are summary descriptions, for the various categories of financial instruments, of the valuation methodologies management uses in determining fair value of the Company's financial instruments in such categories. Management utilizes such methodologies to assign a good faith fair value (the estimated price that, in an orderly transaction at the valuation date, would be received to sell an asset, or paid to transfer a liability, as the case may be) to each such financial instrument. Valuations for fixed-rate RMBS pass-throughs issued by a U.S. government agency or government-sponsored enterprise, or "GSE," are typically based on observable pay-up data (pay-ups are price premiums for specified categories of fixed-rate pools relative to their TBA counterparts) or models that use observable market data, such as interest rates and historical prepayment speeds, and are validated against third-party valuations. With respect to the Company's other RMBS investments and TBAs, management seeks to obtain at least one third-party valuation, and often obtains multiple valuations when available. Management has been able to obtain third-party valuations on the vast majority of these instruments and expects to continue to solicit third-party valuations in the future. Management generally values each financial instrument at the average of third-party valuations received and not rejected as described below. Third-party valuations are not binding, and while management generally does not adjust the valuations it receives, management may challenge or reject a valuation when, based on its validation criteria, management determines that such valuation is unreasonable or erroneous. Furthermore, based on its validation criteria, management may determine that the average of the third-party valuations received for a given instrument does not result in what management believes to be the fair value of such instrument, and in such circumstances

management may override this average with its own good faith valuation. The validation criteria may take into account output from management's own models, recent trading activity in the same or similar instruments, and valuations received from third parties. The use of proprietary models requires the use of a significant amount of judgment and the application of various assumptions including, but not limited to, assumptions concerning future prepayment rates and default rates.

Given their relatively high level of price transparency, Agency RMBS pass-throughs and TBAs are typically designated as Level 2 assets. Non-Agency RMBS and Agency interest only and inverse interest only RMBS are generally classified as either

Level 2 or Level 3 based on the analysis of available market data and/or third-party valuations. Furthermore, the methodology used by the third-party valuation providers is reviewed at least annually by management, so as to ascertain whether such providers are utilizing observable market data to determine the valuations that they provide. Interest rate swaps and swaptions are typically valued based on internal models that use observable market data, including applicable interest rates in effect as of the measurement date; the model-generated valuations are then typically compared to counterparty valuations for reasonableness. These financial derivatives are generally designated as Level 2 instruments.

In valuing its derivatives, the Company also considers the creditworthiness of both the Company and its counterparties, along with collateral provisions contained in each derivative agreement.

The Company's repurchase and reverse repurchase agreements are carried at cost, which approximates fair value. Repurchase agreements and reverse repurchase agreements are classified as Level 2 assets and liabilities based on the adequacy of the collateral and their short term nature.

The Company's valuation process, including the application of validation criteria, is overseen by the Manager's Valuation Committee ("Valuation Committee"). The Valuation Committee includes senior level executives from various departments within the Manager, and each quarter the Valuation Committee reviews and approves the valuations of the Company's investments. The valuation process also includes a monthly review by the Company's third party administrator. The goal of this review is to replicate various aspects of the Company's valuation process based on the Company's documented procedures.

Because of the inherent uncertainty of valuation, the estimated fair value of the Company's financial instruments may differ significantly from the values that would have been used had a ready market for the financial instruments existed, and the differences could be material to the consolidated financial statements.

(C) Accounting for Securities: Purchases and sales of investments are recorded on trade date and realized and unrealized gains and losses are calculated based on identified cost.

The Company has chosen to make a fair value election pursuant to ASC 825-10, Financial Instruments, for its securities portfolio. Electing the fair value option allows the Company to record changes in fair value in the Consolidated Statement of Operations, which, in management's view, more appropriately reflects the results of operations for a particular reporting period as all securities activities will be recorded in a similar manner. As such, securities are recorded at fair value on the Consolidated Balance Sheet and the period change in fair value is recorded in current period earnings on the Consolidated Statement of Operations as a component of Change in net unrealized gains (losses) on securities.

(D) Interest Income: Coupon interest income on investment securities is accrued based on the outstanding principal balance or notional amount and the current coupon rate on each security. The Company amortizes purchase premiums and accretes purchase discounts on its fixed-income securities. For RMBS that are deemed to be of high credit quality at the time of purchase, premiums and discounts are generally amortized/accreted into interest income over the life of such securities using the effective interest method. An effective yield retroactive to the time of purchase is periodically recomputed based on actual prepayments and changes in projected prepayment activity, and a catch-up adjustment, or "Catch-up Premium Amortization Adjustment," is made to amortization to reflect the cumulative impact of the change in effective yield. For RMBS that are deemed not to be of high credit quality at the time of purchase, interest income is recognized based on the effective interest method. For purposes of determining the effective interest rate, management estimates the future expected cash flows of its investment holdings based on assumptions including, but not limited to, assumptions for future prepayment rates, default rates, and loss severities (each of which may in turn incorporate various macro-economic assumptions, such as future housing prices). These assumptions are re-evaluated not less than quarterly. Principal write-offs are generally treated as realized losses. Changes in projected cash flows, as applied to the current amortized cost of the security, may result in a prospective change in the yield/interest income recognized on such securities.

The Company's accretion of discounts and amortization of premiums on securities for U.S. federal and other tax purposes is likely to differ from the accounting treatment under U.S. GAAP of these items as described above.

(E) Cash and Cash Equivalents: Cash and cash equivalents include cash and short term investments with original maturities of three months or less at the date of acquisition. Cash and cash equivalents typically include amounts held

in an interest bearing overnight account and amounts held in money market funds, and these balances generally exceed insured limits. The Company holds its cash at institutions that it believes to be highly creditworthy.

(F) Due from brokers/Due to brokers: Due from brokers and Due to brokers accounts on the Consolidated Balance Sheet include collateral transferred to or received from counterparties, including clearinghouses, along with receivables and payables for open and/or closed derivative positions.

(G) Financial Derivatives: The Company enters into various types of financial derivatives subject to its investment guidelines, which include restrictions associated with maintaining its qualification as a REIT. The Company's financial derivatives are predominantly subject to bilateral collateral arrangements or clearing in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Company may be required to deliver or may receive cash or securities as collateral upon entering into derivative transactions. In addition, changes in the relative value of financial derivative transactions may require the Company or the counterparty to post or receive additional collateral. In the case of cleared financial derivatives, the clearinghouse becomes the Company's counterparty and a futures commission merchant acts as intermediary between the Company and the clearinghouse with respect to all facets of the related transaction, including the posting and receipt of required collateral. Collateral received by the Company is reflected on the Consolidated Balance Sheet as "Due to Brokers." Conversely, collateral posted by the Company is reflected as "Due from Brokers" on the Consolidated Balance Sheet. The types of financial derivatives that have been utilized by the Company to date are interest rate swaps, TBAs, swaptions, and futures.

Swaps: The Company enters into interest rate swaps. Interest rate swaps are contractual agreements whereby one party pays a floating interest rate on a notional principal amount and receives a fixed-rate payment on the same notional principal, or vice versa, for a fixed period of time. The Company enters into interest rate swap contracts primarily to mitigate interest rate risk. The Company is subject to interest rate risk exposure in the normal course of pursuing its investment objectives.

Swaps change in value with movements in interest rates or total return of the reference securities. During the term of swap contracts, changes in value are recognized as unrealized gains or losses on the Consolidated Statement of Operations. When a contract is terminated, the Company realizes a gain or loss equal to the difference between the proceeds from (or cost of) the closing transaction and the Company's basis in the contract, if any. Periodic payments or receipts required by swap agreements are recorded as unrealized gains or losses when accrued and realized gains or losses when received or paid. Upfront payments paid and/or received by the Company to open swap contracts are recorded as an asset and/or liability on the Consolidated Balance Sheet and are recorded as a realized gain or loss on the termination date.

TBA Securities: The Company transacts in the forward settling TBA market. A TBA position is a forward contract for the purchase ("long position") or sale ("short position") of Agency RMBS at a predetermined price, face amount, issuer, coupon, and maturity on an agreed-upon future delivery date. For each TBA contract and delivery month, a uniform settlement date for all market participants is determined by the Securities Industry and Financial Markets Association. The specific Agency RMBS to be delivered into the contract at the settlement date are not known at the time of the transaction. The Company typically does not take delivery of TBAs, but rather enters into offsetting transactions and settles the associated receivable and payable balances with its counterparties. The Company primarily uses TBAs to mitigate interest rate risk, but from time to time it also holds net long positions in certain TBA securities as a means of acquiring exposure to Agency RMBS.

TBAs are accounted for by the Company as financial derivatives. The difference between the contract price and the fair value of the TBA position as of the reporting date is included in Change in net unrealized gains (losses) on financial derivatives in the Consolidated Statement of Operations. Upon settlement of the TBA contract, the realized gain (loss) on the TBA contract is equal to the net cash amount received (paid).

Options: The Company enters into swaption contracts. It may purchase or write put, call, straddle, or other similar options contracts. The Company enters into options contracts primarily to help mitigate interest rate risk. When the Company purchases an options contract, the option asset is initially recorded at an amount equal to the premium paid, if any, and is subsequently marked-to-market. Premiums paid for purchasing options contracts that expire unexercised are recognized on the expiration date as realized losses. If an options contract is exercised, the premium paid is subtracted from the proceeds of the sale or added to the cost of the purchase to determine whether the Company has realized a gain or loss on the related investment transaction. When the Company writes an options contract, the option liability is initially recorded at an amount equal to the premium received, if any, and is subsequently marked-to-market. Premiums received for writing options contracts that expire unexercised are recognized on the expiration date as realized gains. If an options contract is exercised, the premium received is subtracted from the cost of the purchase or added to the proceeds of the sale to determine whether the Company has realized a gain or loss on

the related investment transaction. When the Company enters into a closing transaction, the Company will realize a gain or loss depending upon whether the amount from the closing transaction is greater or less than the premiums paid or received. In general, the Company's options contracts contain forward-settling premiums. In this case, no money is exchanged upfront; instead, the agreed-upon premium is paid by the buyer upon expiration of the options contract, regardless of whether or not the options contract is exercised. Unrealized gains or (losses) resulting from the options contract being marked-to-market are included in Change in net unrealized gains (losses) on financial derivatives in the Consolidated Statement of Operations. Realized gains or (losses) are included in Realized gains (losses) on financial derivatives in the Consolidated Statement of Operations.



**Futures Contracts:** The Company enters into Eurodollar futures contracts and U.S. Treasury futures contracts. A futures contract is an exchange-traded agreement to buy or sell an asset for a set price on a future date. Initial margin deposits are made upon entering into futures contracts and can be either in the form of cash or securities. During the period the futures contract is open, changes in the value of the contract are recognized as unrealized gains or losses by marking-to-market to reflect the current market value of the contract. Unrealized gains or (losses) are included in Change in net unrealized gains (losses) on financial derivatives in the Consolidated Statement of Operations.

Variation margin payments are made or received periodically, depending upon whether unrealized losses or gains are incurred. When the contract is closed, the Company records a realized gain or loss equal to the difference between the proceeds of the closing transaction and the Company's basis in the contract. Realized gains or (losses) are included in Realized gains (losses) on financial derivatives in the Consolidated Statement of Operations.

Financial derivative assets are included in Financial derivatives—assets, at fair value on the Consolidated Balance Sheet while financial derivative liabilities are included in Financial derivatives—liabilities, at fair value on the Consolidated Balance Sheet.

**(H) Repurchase Agreements:** The Company enters into repurchase agreements with third-party broker-dealers, whereby it sells securities under agreements to repurchase at an agreed upon price and date. The Company accounts for repurchase agreements as collateralized borrowings, with the initial sale price representing the amount borrowed, and with the future repurchase price consisting of the amount borrowed plus interest, at the implied interest rate of the repurchase agreement, on the amount borrowed over the term of the repurchase agreement. The interest rate on a repurchase agreement is based on competitive market rates (or competitive market spreads, in the case of agreements with floating interest rates) at the time such agreement is entered into. When the Company enters into a repurchase agreement, the lender establishes and maintains an account containing cash and/or securities having a value not less than the repurchase price, including accrued interest, of the repurchase agreement. Repurchase agreements are carried at their contractual amounts, which approximate fair value due to their short-term nature.

**(I) Reverse Repurchase Agreements:** The Company enters into reverse repurchase agreement transactions with third-party broker-dealers, whereby it purchases securities under agreements to resell at an agreed upon price and date. The interest rate on a reverse repurchase agreement is based on competitive market rates (or competitive market spreads, in the case of agreements with floating interest rates) at the time such agreement is entered into. Reverse repurchase agreements are carried at their contractual amounts, which approximate fair value due to their short-term nature.

Repurchase and reverse repurchase agreements that are conducted with the same counterparty can be reported on a net basis if they meet the requirements of ASC 210-20, Balance Sheet Offsetting. There are currently no repurchase and reverse repurchase agreements reported on a net basis in the Company's consolidated financial statements.

**(J) Securities Sold Short:** The Company may purchase or engage in short sales of U.S. Treasury securities to mitigate the potential impact of changes in interest rates on the performance of its portfolio. When the Company sells securities short, it typically satisfies its security delivery settlement obligation by obtaining the security sold short from the same or a different counterparty. The Company generally is required to deliver cash or securities as collateral to the counterparty for the Company's obligation to return the borrowed security.

The Company has chosen to make a fair value election pursuant to ASC 825-10, Financial Instruments, for its securities sold short. Electing the fair value option allows the Company to record changes in fair value in the Consolidated Statement of Operations, which, in management's view, more appropriately reflects the results of operations for a particular reporting period as all securities activities will be recorded in a similar manner. As such, securities sold short are recorded at fair value on the Consolidated Balance Sheet and the period change in fair value is recorded in current period earnings on the Consolidated Statement of Operations as a component of Change in net unrealized gains (losses) on securities. A realized gain or loss will be recognized upon the termination of a short sale if the market price is less or greater than the proceeds originally received. Such realized gain or loss is recorded on the Company's Consolidated Statement of Operations in Net realized gains (losses) on securities.

**(K) Offering Costs/Deferred Offering Costs/Underwriters' Discounts:** Offering costs, underwriters' discounts and commissions and fees, are charged against shareholders' equity within Additional paid-in-capital. Offering costs typically include legal, accounting, and other fees associated with the cost of raising equity capital.

(L) Share Based Compensation: The Company applies the provisions of ASC 718, Compensation—Stock Compensation ("ASC 718"), with regard to its equity incentive plan. ASC 718 covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. ASC 718 requires that compensation cost relating to share-based payment transactions be recognized in the

12

---

financial statements. The cost is measured based on the fair value, at the grant date, of the equity or liability instruments issued and is amortized over the vesting period. Restricted shares issued to the Company's independent directors and partially dedicated personnel are participating securities and receive dividends prior to vesting. Fair value for such awards is based on the closing stock price on the New York Stock Exchange at the grant date. The vesting period for restricted share awards is typically one to two years. Shares issued to the Company's independent directors and partially dedicated personnel are subject to tax withholding upon vesting. The Company's independent directors and partially dedicated personnel are permitted to forfeit a portion of their vested shares to pay such withholding tax. Forfeited shares decrease the total number of shares issued and outstanding and are immediately retired upon settlement.

(M) Dividends: Dividends payable are recorded on the declaration date.

(N) Expenses: Expenses are recognized as incurred on the Consolidated Statement of Operations.

(O) Earnings Per Share: In accordance with the provisions of ASC 260, Earnings per Share, the Company calculates basic income (loss) per share by dividing net income (loss) for the period by the weighted average of the Company's common shares outstanding for that period. Diluted income (loss) per share takes into account the effect of dilutive instruments, such as share options and warrants, and uses the average share price for the period in determining the number of incremental shares that are to be added to the weighted average number of shares outstanding.

(P) Share Repurchases: Common shares that are repurchased by the Company subsequent to issuance decrease the total number of shares issued and outstanding and are immediately retired upon settlement. The cost of such share repurchases is charged against Additional paid-in-capital on the Company's Consolidated Balance Sheet.

(Q) Income Taxes: The Company has elected to be taxed as a REIT under Sections 856 to 860 of the Code. As a REIT, the Company is generally not subject to corporate-level federal and state income tax on net income it distributes to its shareholders. To qualify as a REIT, the Company must meet a number of organizational and operational requirements, including the distribution of at least 90% of its annual taxable income to shareholders. Even if the Company qualifies as a REIT, it may be subject to certain federal, state, local and foreign taxes on its income and property and to federal income and excise taxes on its undistributed taxable income. If the Company fails to qualify as a REIT, and does not qualify for certain statutory relief provisions, it will be subject to U.S. federal, state, and local income taxes and may be precluded from qualifying as a REIT for the four taxable years following the year in which the Company fails to qualify as a REIT.

The Company follows the authoritative guidance on accounting for and disclosure of uncertainty on tax positions, which requires management to determine whether a tax position of the Company is more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any related appeals or litigation processes, based on the technical merits of the position. For uncertain tax positions, the tax benefit to be recognized is measured as the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. The Company did not have any unrecognized tax benefits resulting from tax positions related to the current period or to 2017, 2016, 2015, or 2014 (its open tax years). In the normal course of business, the Company may be subject to examination by federal, state, local, and foreign jurisdictions, where applicable, for the current period, 2017, 2016, 2015, and 2014 (its open tax years). The Company may take positions with respect to certain tax issues which depend on legal interpretation of facts or applicable tax regulations. Should the relevant tax regulators successfully challenge any of such positions, the Company might be found to have a tax liability that has not been recorded in the accompanying consolidated financial statements. Also, management's conclusions regarding the authoritative guidance may be subject to review and adjustment at a later date based on changing tax laws, regulations, and interpretations thereof. There were no amounts accrued for penalties or interest as of or during the periods presented in these consolidated financial statements.

(R) Recent Accounting Pronouncements: In June 2018, the FASB issued ASU 2018-07, Compensation—Stock Compensation—Improvements to Nonemployee Share-Based Payment Accounting ("ASU 2018-07"). This amends ASC 718, Compensation—Stock Compensation, to simplify several aspects of accounting for nonemployee share-based payment transactions. ASU 2018-07 is effective for annual periods beginning after December 15, 2019 and interim periods beginning after December 15, 2020 with early adoption permitted. The adoption of ASU 2018-07 is not expected to have a material impact on the Company's consolidated financial statements.

### 3. Mortgage-Backed Securities

The following tables present details of the Company's mortgage-backed securities portfolio at June 30, 2018 and December 31, 2017, respectively. The Company's Agency RMBS include mortgage pass-through certificates and CMOs representing interests in or obligations backed by pools of residential mortgage loans issued or guaranteed by a U.S. government agency or GSE. The non-Agency RMBS portfolio is not issued or guaranteed by the Federal National Mortgage

Edgar Filing: Ellington Residential Mortgage REIT - Form 10-Q

Association, the Federal Home Loan Mortgage Corporation, or any agency of the U.S. Government and is therefore subject to greater credit risk.

By RMBS Type

June 30, 2018:

(\$ in thousands)

	Current Principal	Unamortized Premium (Discount)	Amortized Cost	Gross Unrealized			Weighted Average		
				Gains	Losses	Fair Value	Coupon	Yield	Life (Years) <sup>(1)</sup>
Agency RMBS:									
15-year fixed-rate mortgages	\$ 147,080	\$ 6,432	\$ 153,512	\$—	\$(5,013 )	\$ 148,499	3.41%	2.33%	4.58
20-year fixed-rate mortgages	8,143	624	8,767	—	(346 )	8,421	4.00%	2.54%	6.01
30-year fixed-rate mortgages	1,263,388	66,524	1,329,912	531	(35,960 )	1,294,483	4.02%	3.20%	8.20
Adjustable rate mortgages	20,124	1,397	21,521	7	(798 )	20,730	3.87%	2.64%	3.96
Reverse mortgages	71,781	6,822	78,603	79	(1,851 )	76,831	4.54%	2.90%	5.64
Interest only securities	n/a	n/a	18,583	1,343	(811 )	19,115	4.45%	8.22%	4.56
Total Agency RMBS	1,510,516	81,799	1,610,898	1,960	(44,779 )	1,568,079	4.02%	3.15%	7.42
Non-Agency RMBS	14,839	(4,561 )	10,278	1,825	(79 )	12,024	4.06%	11.37%	7.43
Total RMBS	\$ 1,525,355	\$ 77,238	\$ 1,621,176	\$ 3,785	\$(44,858)	\$ 1,580,103	4.02%	3.20%	7.42

Average lives of RMBS are generally shorter than stated contractual maturities. Average lives are affected by the (1) contractual maturities of the underlying mortgages, scheduled periodic payments of principal, and unscheduled prepayments of principal.

December 31, 2017:

(\$ in thousands)

	Current Principal	Unamortized Premium (Discount)	Amortized Cost	Gross Unrealized			Weighted Average		
				Gains	Losses	Fair Value	Coupon	Yield	Life (Years) <sup>(1)</sup>
Agency RMBS:									
15-year fixed-rate mortgages	\$ 170,998	\$ 7,553	\$ 178,551	\$ 28	\$(1,805 )	\$ 176,774	3.38%	2.31%	4.75
20-year fixed-rate mortgages	8,712	682	9,394	—	(164 )	9,230	4.00%	2.55%	6.02
30-year fixed-rate mortgages	1,303,584	76,681	1,380,265	1,929	(12,605 )	1,369,589	3.96%	3.06%	8.18
Adjustable rate mortgages	28,087	1,862	29,949	30	(421 )	29,558	3.87%	2.58%	4.70
Reverse mortgages	64,608	6,293	70,901	259	(543 )	70,617	4.53%	2.79%	6.09
Interest only securities	n/a	n/a	13,197	382	(1,374 )	12,205	4.36%	5.64%	3.28
Total Agency RMBS	1,575,989	93,071	1,682,257	2,628	(16,912 )	1,667,973	3.95%	2.98%	7.38
Non-Agency RMBS	21,995	(6,717 )	15,278	2,846	(99 )	18,025	3.58%	8.39%	7.94
Total RMBS	\$ 1,597,984	\$ 86,354	\$ 1,697,535	\$ 5,474	\$(17,011)	\$ 1,685,998	3.94%	3.03%	7.39

(1) Average lives of RMBS are generally shorter than stated contractual maturities. Average lives are affected by the contractual maturities of the underlying mortgages, scheduled periodic payments of principal, and unscheduled

prepayments of principal.

14

---

Edgar Filing: Ellington Residential Mortgage REIT - Form 10-Q

By Estimated Weighted Average Life  
As of June 30, 2018:

(\$ in thousands)	Agency RMBS			Agency Interest Only Securities			Non-Agency RMBS		
	Fair Value	Amortized Cost	Weighted Average Coupon	Fair Value	Amortized Cost	Weighted Average Coupon	Fair Value	Amortized Cost	Weighted Average Coupon
Estimated Weighted Average Life <sup>(1)</sup>									
Less than three years	\$6,230	\$ 6,322	3.81 %	\$1,303	\$ 1,676	4.47 %	\$—	—	— %
Greater than three years and less than seven years	338,238	348,766	3.94 %	17,812	16,907	4.45 %	7,406	646	4.99 %
Greater than seven years and less than eleven years	1,169,634	1,202,396	3.99 %	—	—	— %	2,115	593	3.06 %
Greater than eleven years	34,862	34,831	4.00 %	—	—	— %	2,479		