

TWO HARBORS INVESTMENT CORP.  
Form 10-Q  
August 05, 2015

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

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FORM 10-Q

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

For the Quarterly Period Ended: June 30, 2015

Commission File Number 001-34506

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TWO HARBORS INVESTMENT CORP.  
(Exact Name of Registrant as Specified in Its Charter)

Maryland 27-0312904  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)

590 Madison Avenue, 36th Floor 10022  
New York, New York (Zip Code)  
(Address of Principal Executive Offices)  
(612) 629-2500  
(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 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  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the 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.

As of August 5, 2015 there were 367,539,843 shares of outstanding common stock, par value \$.01 per share, issued and outstanding.



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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## TWO HARBORS INVESTMENT CORP.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	June 30, 2015 (unaudited)	December 31, 2014
<b>ASSETS</b>		
Available-for-sale securities, at fair value	\$12,807,658	\$14,341,102
Trading securities, at fair value	—	1,997,656
Residential mortgage loans held-for-sale, at fair value	695,078	535,712
Residential mortgage loans held-for-investment in securitization trusts, at fair value	2,449,199	1,744,746
Commercial real estate loans held-for-investment	45,605	—
Mortgage servicing rights, at fair value	437,576	452,006
Cash and cash equivalents	933,579	1,005,792
Restricted cash	410,903	336,771
Accrued interest receivable	57,011	65,529
Due from counterparties	27,230	35,625
Derivative assets, at fair value	347,322	380,791
Other assets	236,560	188,579
Total Assets <sup>(1)</sup>	\$18,447,721	\$21,084,309
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Liabilities</b>		
Repurchase agreements	\$9,422,803	\$12,932,463
Collateralized borrowings in securitization trusts, at fair value	1,714,735	1,209,663
Federal Home Loan Bank advances	3,000,000	2,500,000
Derivative liabilities, at fair value	22,475	90,233
Due to counterparties	160,014	124,206
Dividends payable	95,557	95,263
Other liabilities	60,568	64,439
Total Liabilities <sup>(1)</sup>	14,476,152	17,016,267
<b>Stockholders' Equity</b>		
Preferred stock, par value \$0.01 per share; 50,000,000 shares authorized; no shares issued and outstanding	—	—
Common stock, par value \$0.01 per share; 900,000,000 shares authorized and 367,527,725 and 366,395,920 shares issued and outstanding, respectively	3,675	3,664
Additional paid-in capital	3,816,861	3,811,027
Accumulated other comprehensive income	631,032	855,789
Cumulative earnings	1,508,839	1,195,536
Cumulative distributions to stockholders	(1,988,838)	(1,797,974)
Total Stockholders' Equity	3,971,569	4,068,042
Total Liabilities and Stockholders' Equity	\$18,447,721	\$21,084,309

(1) The condensed consolidated balance sheets include assets of consolidated variable interest entities, or VIEs, that can only be used to settle obligations of these VIEs, and liabilities of the consolidated VIEs for which creditors do not have recourse to Two Harbors Investment Corp. At June 30, 2015 and December 31, 2014, assets of the VIEs totaled \$2,508,625 and \$1,754,943, and liabilities of the VIEs totaled \$1,727,995 and \$1,219,821, respectively. See

Note 3 - Variable Interest Entities for additional information.

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

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TWO HARBORS INVESTMENT CORP.  
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(in thousands, except share data)

	Three Months Ended		Six Months Ended		
	June 30,		June 30,		
	2015	2014	2015	2014	
	(unaudited)		(unaudited)		
Interest income:					
Available-for-sale securities	\$ 118,129	\$ 127,605	\$ 253,654	\$ 251,518	
Trading securities	3,981	1,940	8,676	3,866	
Residential mortgage loans held-for-sale	7,518	2,699	11,789	7,285	
Residential mortgage loans held-for-investment in securitization trusts	21,830	7,761	40,067	15,654	
Commercial real estate loans held-for-investment	850	—	894	—	
Cash and cash equivalents	221	144	418	361	
Total interest income	152,529	140,149	315,498	278,684	
Interest expense:					
Repurchase agreements	19,398	18,603	39,963	39,175	
Collateralized borrowings in securitization trusts	13,131	5,592	23,839	10,945	
Federal Home Loan Bank advances	2,500	755	4,730	908	
Total interest expense	35,029	24,950	68,532	51,028	
Net interest income	117,500	115,199	246,966	227,656	
Other-than-temporary impairments:					
Total other-than-temporary impairment losses	(170	) —	(297	) (212	)
Non-credit portion of loss recognized in other comprehensive (loss) income	—	—	—	—	
Net other-than-temporary credit impairment losses	(170	) —	(297	) (212	)
Other income:					
Gain (loss) on investment securities	69,932	37,688	199,389	(967	)
Gain (loss) on interest rate swap and swaption agreements	44,952	(116,019	) (81,491	) (221,547	)
Loss on other derivative instruments	(5,484	) (24,202	) (2,517	) (18,401	)
(Loss) gain on residential mortgage loans held-for-sale	(6,832	) 11,801	2,260	8,620	
Servicing income	30,516	33,868	62,603	64,309	
Gain (loss) on servicing asset	17,635	(29,571	) (34,768	) (62,331	)
Other (loss) income	(16,609	) 21,003	(18,466	) 21,463	
Total other income (loss)	134,110	(65,432	) 127,010	(208,854	)
Expenses:					
Management fees	12,686	12,190	25,407	24,301	
Securitization deal costs	2,484	—	5,095	—	
Servicing expenses	5,899	6,857	12,615	12,082	
Other operating expenses	15,827	14,323	31,882	28,857	
Total expenses	36,896	33,370	74,999	65,240	
Income (loss) before income taxes	214,544	16,397	298,680	(46,650	)
Benefit from income taxes	(6,957	) (23,260	) (17,614	) (57,162	)
Net income	\$ 221,501	\$ 39,657	\$ 316,294	\$ 10,512	
Basic and diluted earnings per weighted average common share	\$ 0.60	\$ 0.11	\$ 0.86	\$ 0.03	

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Dividends declared per common share	\$0.26	\$0.26	\$0.52	\$0.52
Basic and diluted weighted average number of shares of common stock outstanding	367,074,131	366,078,124	366,792,459	365,846,295

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

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TWO HARBORS INVESTMENT CORP.  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME, continued  
 (in thousands, except share data)

	Three Months Ended		Six Months Ended	
	June 30, 2015 (unaudited)	2014	June 30, 2015 (unaudited)	2014
Comprehensive income:				
Net income	\$221,501	\$39,657	\$316,294	\$10,512
Other comprehensive (loss) income:				
Unrealized (loss) gain on available-for-sale securities, net	(218,826 )	191,160	(224,757 )	372,895
Other comprehensive (loss) income	(218,826 )	191,160	(224,757 )	372,895
Comprehensive income	\$2,675	\$230,817	\$91,537	\$383,407

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



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TWO HARBORS INVESTMENT CORP.  
 CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
 (in thousands, except share data)

	Common Stock						
	Shares	Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (unaudited)	Cumulative Earnings	Cumulative Distributions to Stockholders	Total Stockholders' Equity
Balance, December 31, 2013	364,935,168	\$3,649	\$3,795,372	\$ 444,735	\$1,028,397	\$(1,417,158)	\$ 3,854,995
Net income	—	—	—	—	10,512	—	10,512
Other comprehensive income before reclassifications	—	—	—	350,455	—	—	350,455
Amounts reclassified from accumulated other comprehensive income	—	—	—	22,440	—	—	22,440
Net other comprehensive income	—	—	—	372,895	—	—	372,895
Issuance of common stock, net of offering costs	23,474	—	240	—	—	—	240
Common dividends declared	—	—	—	—	—	(190,361 )	(190,361 )
Non-cash equity award compensation	1,152,277	12	10,212	—	—	—	10,224
Balance, June 30, 2014	366,110,919	\$3,661	\$3,805,824	\$ 817,630	\$1,038,909	\$(1,607,519)	\$ 4,058,505
Balance, December 31, 2014	366,395,920	\$3,664	\$3,811,027	\$ 855,789	\$1,195,536	\$(1,797,974)	\$ 4,068,042
Cumulative effect of adoption of new accounting principle	—	—	—	—	(2,991 )	—	(2,991 )
Adjusted balance, January 1, 2015	366,395,920	3,664	3,811,027	855,789	1,192,545	(1,797,974 )	4,065,051
Net income	—	—	—	—	316,294	—	316,294
Other comprehensive loss before reclassifications	—	—	—	(49,983 )	—	—	(49,983 )
Amounts reclassified from accumulated other comprehensive loss	—	—	—	(174,774 )	—	—	(174,774 )
Net other comprehensive loss	—	—	—	(224,757 )	—	—	(224,757 )
Issuance of common stock, net of offering	36,184	—	226	—	—	—	226

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Common dividends declared	—	—	—	—	—	(190,864 )	(190,864 )
Non-cash equity award compensation	1,095,621	11	5,608	—	—	—	5,619
Balance, June 30, 2015	367,527,725	\$3,675	\$3,816,861	\$ 631,032	\$1,508,839	\$(1,988,838)	\$ 3,971,569

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

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TWO HARBORS INVESTMENT CORP.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (in thousands)

	Six Months Ended	
	June 30,	2014
	2015	2014
	(unaudited)	
Cash Flows From Operating Activities:		
Net income	\$316,294	\$10,512
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Amortization of premiums and discounts on investment securities and commercial real estate loans held-for-investment, net	22,157	1,840
Other-than-temporary impairment losses	297	212
Realized and unrealized (gains) losses on investment securities, net	(199,389)	) 967
Gain on residential mortgage loans held-for-sale	(2,260)	) (8,620)
Loss (gain) on residential mortgage loans held-for-investment and collateralized borrowings in securitization trusts	20,525	(21,142)
Loss on servicing asset	34,768	62,331
Loss on termination and option expiration of interest rate swaps and swaptions	63,076	6,401
Unrealized (gain) loss on interest rate swaps and swaptions	(35,258)	) 182,420
Unrealized gain on other derivative instruments	(1,634)	) (51)
Equity based compensation	5,619	10,224
Depreciation of fixed assets	652	463
Amortization of intangible assets	—	533
Purchases of residential mortgage loans held-for-sale	(1,382,061)	) (261,983)
Proceeds from sales of residential mortgage loans held-for-sale	75,272	400,739
Proceeds from repayment of residential mortgage loans held-for-sale	53,452	11,160
Net change in assets and liabilities:		
Decrease in accrued interest receivable	8,518	193
Increase in deferred income taxes, net	(11,393)	) (60,310)
Increase in income taxes receivable	(7,175)	) (290)
Increase in prepaid and fixed assets	(228)	) (929)
Decrease (increase) in other receivables	6,059	(11,396)
Increase in servicing advances	(3,338)	) (8,532)
Decrease in accrued interest payable	(4,788)	) (3,756)
Decrease in income taxes payable	(1,336)	) (465)
Increase in accrued expenses and other liabilities	2,253	5,673
Net cash (used in) provided by operating activities	\$(1,039,918)	) \$316,194
The accompanying notes are an integral part of these condensed consolidated financial statements.		

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TWO HARBORS INVESTMENT CORP.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS, continued  
 (in thousands)

	Six Months Ended	
	June 30,	
	2015	2014
	(unaudited)	
Cash Flows From Investing Activities:		
Purchases of available-for-sale securities	\$(1,705,012 )	\$(2,232,865 )
Proceeds from sales of available-for-sale securities	2,572,015	1,273,923
Principal payments on available-for-sale securities	611,850	474,696
Short sales and purchases of other derivative instruments	4,825	102,423
Proceeds from sales of other derivative instruments, net	(69,085 )	(74,476 )
Purchases of trading securities	—	(143,022 )
Proceeds from sales of trading securities	2,004,375	143,378
Proceeds from repayment of residential mortgage loans held-for-investment in securitization trusts	335,346	26,330
Purchases of commercial real estate loans held-for-investment	(45,556 )	—
Purchases of mortgage servicing rights, net of purchase price adjustments	(19,522 )	(48,419 )
Purchases of Federal Home Loan Bank stock	(25,240 )	(60,000 )
Purchases of equity investments	—	(3,000 )
Increase (decrease) in due to counterparties, net	44,203	(183,167 )
(Increase) decrease in restricted cash	(74,132 )	114,682
Net cash provided by (used in) investing activities	3,634,067	(609,517 )
Cash Flows From Financing Activities:		
Proceeds from repurchase agreements	28,285,657	140,931,599
Principal payments on repurchase agreements	(31,795,316 )	(141,790,862)
Proceeds from issuance of collateralized borrowings in securitization trusts	771,271	33,483
Principal payments on collateralized borrowings in securitization trusts	(237,630 )	(128,756 )
Proceeds from Federal Home Loan Bank advances	500,000	3,793,911
Principal payments on Federal Home Loan Bank advances	—	(2,293,911 )
Proceeds from issuance of common stock, net of offering costs	226	240
Dividends paid on common stock	(190,570 )	(95,172 )
Net cash (used in) provided by financing activities	(2,666,362 )	450,532
Net (decrease) increase in cash and cash equivalents	(72,213 )	157,209
Cash and cash equivalents at beginning of period	1,005,792	1,025,487
Cash and cash equivalents at end of period	\$933,579	\$1,182,696
The accompanying notes are an integral part of these condensed consolidated financial statements.		

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TWO HARBORS INVESTMENT CORP.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS, continued  
 (in thousands)

	Six Months Ended	
	June 30,	
	2015	2014
	(unaudited)	
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	\$50,932	\$54,785
Cash paid for taxes	\$2,286	\$3,903
Noncash Investing and Financing Activities:		
Transfers of residential mortgage loans held-for-sale to residential mortgage loans held-for-investment in securitization trusts	\$ 1,091,884	\$—
Transfers of residential mortgage loans held-for-sale to other receivables for foreclosed government-guaranteed loans	\$7,318	\$—
Additions to mortgage servicing rights due to sale of residential mortgage loans held-for-sale	\$816	\$—
Cumulative-effect adjustment to equity for adoption of new accounting principle	\$(2,991	) \$—
Cash dividends declared but not paid at end of period	\$95,557	\$95,189
Reconciliation of residential mortgage loans held-for-sale:		
Residential mortgage loans held-for-sale at beginning of period	\$535,712	\$544,581
Purchases of residential mortgage loans held-for-sale	1,382,061	261,983
Transfers to residential mortgage loans held-for-investment in securitization trusts	(1,091,884	) —
Transfers to other receivables for foreclosed government-guaranteed loans	(7,318	) —
Proceeds from sales of residential mortgage loans held-for-sale	(75,272	) (400,739 )
Proceeds from repayment of residential mortgage loans held-for-sale	(53,452	) (11,160 )
Realized and unrealized gains on residential mortgage loans held-for-sale	5,231	5,176
Residential mortgage loans held-for-sale at end of period	\$695,078	\$399,841
The accompanying notes are an integral part of these condensed consolidated financial statements.		

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

Note 1. Organization and Operations

Two Harbors Investment Corp., or the Company, is a Maryland corporation focused on investing in, financing and managing residential mortgage-backed securities, or RMBS, residential mortgage loans, mortgage servicing rights, or MSR, commercial real estate and other financial assets. The Company is externally managed and advised by PRCM Advisers LLC, or PRCM Advisers, which is a subsidiary of Pine River Capital Management L.P., or Pine River, a global multi-strategy asset management firm. The Company's common stock is listed on the NYSE under the symbol "TWO".

The Company was incorporated on May 21, 2009, and commenced operations as a publicly traded company on October 28, 2009, upon completion of a merger with Capitol Acquisition Corp., or Capitol, which became a wholly owned indirect subsidiary of the Company as a result of the merger.

The Company has elected to be treated as a real estate investment trust, or REIT, as defined under the Internal Revenue Code of 1986, as amended, or the Code, for U.S. federal income tax purposes. As long as the Company continues to comply with a number of requirements under federal tax law and maintains its qualification as a REIT, the Company generally will not be subject to U.S. federal income taxes to the extent that the Company distributes its taxable income to its stockholders on an annual basis and does not engage in prohibited transactions. However, certain activities that the Company may perform may cause it to earn income which will not be qualifying income for REIT purposes. The Company has designated certain of its subsidiaries as taxable REIT subsidiaries, or TRSs, as defined in the Code, to engage in such activities, and the Company may in the future form additional TRSs.

Note 2. Basis of Presentation and Significant Accounting Policies

Consolidation and Basis of Presentation

The interim unaudited condensed consolidated financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles, or U.S. GAAP, have been condensed or omitted according to such SEC rules and regulations. However, management believes that the disclosures included in these interim condensed consolidated financial statements are adequate to make the information presented not misleading. The accompanying condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at June 30, 2015 and results of operations for all periods presented have been made. The results of operations for the three and six months ended June 30, 2015 should not be construed as indicative of the results to be expected for future periods or the full year. The condensed consolidated financial statements of the Company have been prepared on the accrual basis of accounting in accordance with U.S. GAAP. The preparation of financial statements in conformity with U.S. GAAP requires us to make a number of significant estimates and assumptions. These estimates include estimates of fair value of certain assets and liabilities, amount and timing of credit losses, prepayment rates, the period of time during which the Company anticipates an increase in the fair values of real estate securities sufficient to recover unrealized losses in those securities, and other estimates that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities as of the date of the condensed consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (e.g., valuation changes due to supply and demand, credit performance, prepayments, interest rates, or other reasons) will occur in the near term. The Company's estimates are inherently subjective in nature and actual results could differ from its estimates and the differences may be material.

The condensed consolidated financial statements of the Company include the accounts of all subsidiaries; inter-company accounts and transactions have been eliminated. Certain prior period amounts have been reclassified to conform to the current period presentation.

All trust entities in which the Company holds investments that are considered VIEs for financial reporting purposes were reviewed for consolidation under the applicable consolidation guidance. Because the Company has both the power to direct the activities of the trusts that most significantly impact the entities' performance, and the obligation to absorb losses or the right to receive benefits of the entities that could be significant, the Company consolidates the trusts.

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

Significant Accounting Policies

Included in Note 2 to the Consolidated Financial Statements of the Company's 2014 Annual Report on Form 10-K is a summary of the Company's significant accounting policies. Provided below is a summary of additional accounting policies that are significant to the Company's consolidated financial condition and results of operations for the six months ended June 30, 2015.

Commercial Real Estate Loans Held-for-Investment

The Company is the sole certificate holder of a trust entity that holds a commercial real estate loan. The trust is considered a VIE for financial reporting purposes and, thus, is reviewed for consolidation under the applicable consolidation guidance. As the Company has both the power to direct the activities of the trust that most significantly impact the entity's performance, and the obligation to absorb losses or the right to receive benefits of the entity that could be significant, the Company consolidates the trust. The underlying loan is classified as commercial real estate loans held-for-investment on the condensed consolidated balance sheets. The loan is legally isolated from the Company and has been structured to be beyond the reach of creditors of the Company. Interest income on commercial real estate loans held-for-investment is recorded on the condensed consolidated statements of comprehensive income. Commercial real estate loans held-for-investment are reported at cost, net of any unamortized premiums or discounts, unless deemed impaired. The Company evaluates each loan for impairment at least quarterly. Impairment occurs when it is deemed probable that the Company will not be able to collect all amounts due according to the contractual terms of the loan. If a loan is considered to be impaired, the Company records an allowance to reduce the carrying value of the loan to the present value of expected future cash flows.

The Company's commercial real estate loans are collateralized either by real property or by equity interests in the commercial real estate borrower. As a result, the Company regularly evaluates the extent and impact of any credit deterioration associated with the performance and/or value of the underlying collateral property, as well as the financial and operating capability of the borrower, borrowing entity or loan sponsor. The Company also evaluates the financial wherewithal of any loan guarantors as well as the borrower's competency in managing and operating the properties. In addition, the Company considers the overall economic environment, real estate sector, and geographic sub-market in which the borrower operates.

Interest income on commercial real estate loans held-for-investment is recognized at the loan coupon rate. Any premiums or discounts are amortized or accreted into interest income using the effective interest method. Loans are considered past due when they are 30 days past their contractual due date. Interest income recognition is suspended when loans are placed on nonaccrual status. Generally, commercial real estate loans are placed on nonaccrual status when delinquent for more than 60 days or when determined not to be probable of full collection. Interest accrued, but not collected, at the date loans are placed on nonaccrual is reversed and subsequently recognized only to the extent it is received in cash or until it qualifies for return to accrual status. However, where there is doubt regarding the ultimate collectability of loan principal, all cash received is applied to reduce the carrying value of such loans. Commercial real estate loans are restored to accrual status only when contractually current or the collection of future payments is reasonably assured.

Offsetting Assets and Liabilities

Certain of the Company's repurchase agreements are governed by underlying agreements that provide for a right of setoff in the event of default of either party to the agreement. The Company also has netting arrangements in place with all derivative counterparties pursuant to standard documentation developed by the International Swap and Derivatives Association, or ISDA, or central clearing exchange agreements, in the case of centrally cleared interest rate swaps. Additionally, the Company and the counterparty or clearing agency are required to post cash collateral based upon the net underlying market value of the Company's open positions with the counterparty.

Under U.S. GAAP, if the Company has a valid right of setoff, it may offset the related asset and liability and report the net amount. The Company presents repurchase agreements subject to master netting arrangements or similar agreements on a gross basis, and derivative assets and liabilities subject to such arrangements on a net basis, based on



derivative type and counterparty, in its condensed consolidated balance sheets. Separately, the Company presents cash collateral subject to such arrangements on a net basis, based on counterparty, in its condensed consolidated balance sheets. However, the Company does not offset financial assets and liabilities with the associated cash collateral on its condensed consolidated balance sheets.

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## TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

The following tables present information about the Company's assets and liabilities that are subject to master netting arrangements or similar agreements and can potentially be offset on the Company's condensed consolidated balance sheets as of June 30, 2015 and December 31, 2014:

June 30, 2015

(in thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets (Liabilities) Presented in the Consolidated Balance Sheets	Gross Amounts Not Offset with Financial Assets (Liabilities) in the Condensed Consolidated Balance Sheets <sup>(1)</sup>		Net Amount
				Financial Instruments	Cash Collateral (Received) Pledged	
<b>Assets</b>						
Derivative assets	\$414,958	\$(67,636)	) \$347,322	\$(22,475)	) \$—	\$324,847
Total Assets	\$414,958	\$(67,636)	) \$347,322	\$(22,475)	) \$—	\$324,847
<b>Liabilities</b>						
Repurchase agreements	\$(9,422,803)	) \$—	\$(9,422,803)	) \$9,422,803	\$—	\$—
Derivative liabilities	(90,111)	) 67,636	(22,475)	) 22,475	—	—
Total Liabilities	\$(9,512,914)	) \$67,636	\$(9,445,278)	) \$9,445,278	\$—	\$—

December 31, 2014

(in thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets (Liabilities) Presented in the Consolidated Balance Sheets	Gross Amounts Not Offset with Financial Assets (Liabilities) in the Condensed Consolidated Balance Sheets <sup>(1)</sup>		Net Amount
				Financial Instruments	Cash Collateral (Received) Pledged	
<b>Assets</b>						
Derivative assets	\$443,490	\$(62,699)	) \$380,791	\$(90,233)	) \$—	\$290,558
Total Assets	\$443,490	\$(62,699)	) \$380,791	\$(90,233)	) \$—	\$290,558
<b>Liabilities</b>						
Repurchase agreements	\$(12,932,463)	) \$—	\$(12,932,463)	) \$12,932,463	\$—	\$—
Derivative liabilities	(152,932)	) 62,699	(90,233)	) 90,233	—	—

Total Liabilities	\$(13,085,395)	\$62,699	\$(13,022,696 )	\$13,022,696	\$—	\$—
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(1) Amounts presented are limited in total to the net amount of assets or liabilities presented in the condensed consolidated balance sheets by instrument. Excess cash collateral or financial assets that are pledged to counterparties may exceed the financial liabilities subject to a master netting arrangement or similar agreement, or counterparties may have pledged excess cash collateral to the Company that exceed the corresponding financial assets. These excess amounts are excluded from the table above, although separately reported within restricted cash, due from counterparties, or due to counterparties in the Company's condensed consolidated balance sheets.

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

Recently Issued and/or Adopted Accounting Standards

Revenue from Contracts with Customers

In May 2014, the FASB issued ASU No. 2014-09, which is a comprehensive revenue recognition standard that supersedes virtually all existing revenue guidance under U.S. GAAP. The standard's core principle is that an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2016, with early adoption prohibited. The Company has determined this ASU will not have a material impact on the Company's financial condition or results of operations.

Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures

In June 2014, the FASB issued ASU No. 2014-11, which requires repurchase-to-maturity transactions to be accounted for as secured borrowings, eliminates the existing guidance for repurchase financings, and requires new disclosures for certain transactions accounted for as secured borrowings and sales. This ASU is effective for the first interim or annual period beginning after December 15, 2014, except for the disclosures related to transactions accounted for as secured borrowings, which are effective for periods beginning on or after March 15, 2015. Adoption of this ASU did not have any impact on the Company's financial condition or results of operations, but did impact financial statement disclosures.

Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity

In August 2014, the FASB issued ASU No. 2014-13, which updates the guidance on measuring the financial assets and financial liabilities of consolidated collateralized financing entities, or CFEs. The update allows an entity to measure both the financial assets and financial liabilities of a qualifying CFE it consolidates using the fair value of either the CFE's financial assets or financial liabilities, whichever is more observable. The ASU requires certain recurring disclosures and is effective for annual periods beginning on or after December 15, 2015, with early adoption permitted as of the beginning of an annual period. Early adoption of this ASU was applied using a modified retrospective approach by recording a cumulative-effect adjustment to equity as of January 1, 2015, which did not have a material impact on the Company's financial condition or results of operations.

Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure

In August 2014, the FASB issued ASU No. 2014-14, which requires that, upon foreclosure, a mortgage loan that is fully guaranteed under certain government programs be derecognized and a separate receivable be recognized when specific criteria are met. The ASU requires certain recurring disclosures and is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2014, with early adoption permitted. Adoption of this ASU did not have a material impact on the Company's financial condition or results of operations.

Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern

In August 2014, the FASB issued ASU No. 2014-15, which requires management to evaluate whether there are conditions and events that raise substantial doubt about the entity's ability to continue as a going concern for both annual and interim reporting periods. The update requires certain disclosures if management concludes that substantial doubt exists and plans to alleviate that doubt. The ASU is effective for annual periods ending after December 15, 2016, and for both annual and interim periods thereafter, with early adoption permitted.

Amendments to the Consolidation Analysis

In February 2015, the FASB issued ASU No. 2015-02, which changes the guidance on the consolidation of certain investment funds as well as both the variable interest model and the voting model. The ASU requires certain recurring disclosures and is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2015, with early adoption permitted. Early adoption of this ASU did not have a material impact on the Company's financial condition or results of operations.



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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

## Note 3. Variable Interest Entities

The Company purchases subordinated debt and excess servicing rights from securitization trusts sponsored by either third parties or the Company's subsidiaries. Additionally, the Company is the sole certificate holder of a trust entity that holds a commercial real estate loan. All of these trusts are considered VIEs for financial reporting purposes and, thus, were reviewed for consolidation under the applicable consolidation guidance. Because the Company has both the power to direct the activities of the trusts that most significantly impact the entities' performance, and the obligation to absorb losses or the right to receive benefits of the entities that could be significant, the Company consolidates the trusts. As the Company is required to reassess VIE consolidation guidance each quarter, new facts and circumstances may change the Company's determination. A change in the Company's determination could result in a material impact to the Company's condensed consolidated financial statements during subsequent reporting periods.

The following table presents a summary of the assets and liabilities of all consolidated trusts as reported on the condensed consolidated balance sheets:

(in thousands)	June 30, 2015	December 31, 2014
Residential mortgage loans held-for-investment in securitization trusts	\$2,449,199	\$1,744,746
Commercial real estate loans held-for-investment	45,605	—
Accrued interest receivable	13,821	10,197
Total Assets	\$2,508,625	\$1,754,943
Collateralized borrowings in securitization trusts	\$1,714,735	\$1,209,663
Accrued interest payable	5,128	3,678
Other liabilities	8,132	6,480
Total Liabilities	\$1,727,995	\$1,219,821

## Note 4. Available-for-Sale Securities, at Fair Value

The Company holds available-for-sale, or AFS, investment securities, which are carried at fair value. AFS securities exclude the retained interests from the Company's on-balance sheet securitizations, as they are eliminated in consolidation in accordance with U.S. GAAP. The following table presents the Company's AFS investment securities by collateral type as of June 30, 2015 and December 31, 2014:

(in thousands)	June 30, 2015	December 31, 2014
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	\$2,279,632	\$2,418,546
Federal National Mortgage Association	5,796,614	6,768,875
Government National Mortgage Association	2,024,567	2,104,896
Non-Agency	2,706,845	3,048,785
Total mortgage-backed securities	\$12,807,658	\$14,341,102

At June 30, 2015 and December 31, 2014, the Company pledged AFS securities with a carrying value of \$12.6 billion and \$14.2 billion, respectively, as collateral for repurchase agreements and advances from Federal Home Loan Bank of Des Moines, or the FHLB. See Note 16 - Repurchase Agreements and Note 18 - Federal Home Loan Bank of Des Moines Advances.

At June 30, 2015 and December 31, 2014, the Company did not have any securities purchased from and financed with the same counterparty that did not meet the conditions of ASC 860, Transfers and Servicing, or ASC 860, to be considered linked transactions and, therefore, classified as derivatives.



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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

The following tables present the amortized cost and carrying value (which approximates fair value) of AFS securities by collateral type as of June 30, 2015 and December 31, 2014:

	June 30, 2015		
(in thousands)	Agency	Non-Agency	Total
Face Value	\$12,222,579	\$3,667,195	\$15,889,774
Unamortized premium	612,534	—	612,534
Unamortized discount			
Designated credit reserve	—	(657,626)	(657,626)
Net, unamortized	(2,848,032)	(820,024)	(3,668,056)
Amortized Cost	9,987,081	2,189,545	12,176,626
Gross unrealized gains	189,522	522,291	711,813
Gross unrealized losses	(75,790)	(4,991)	(80,781)
Carrying Value	\$10,100,813	\$2,706,845	\$12,807,658
	December 31, 2014		
(in thousands)	Agency	Non-Agency	Total
Face Value	\$13,421,555	\$4,291,872	\$17,713,427
Unamortized premium	676,641	—	676,641
Unamortized discount			
Designated credit reserve	—	(927,605)	(927,605)
Net, unamortized	(3,009,782)	(967,368)	(3,977,150)
Amortized Cost	11,088,414	2,396,899	13,485,313
Gross unrealized gains	238,291	653,529	891,820
Gross unrealized losses	(34,388)	(1,643)	(36,031)
Carrying Value	\$11,292,317	\$3,048,785	\$14,341,102

The following tables present the carrying value of the Company's AFS investment securities by rate type as of June 30, 2015 and December 31, 2014:

	June 30, 2015		
(in thousands)	Agency	Non-Agency	Total
Adjustable Rate	\$119,710	\$2,231,509	\$2,351,219
Fixed Rate	9,981,103	475,336	10,456,439
Total	\$10,100,813	\$2,706,845	\$12,807,658
	December 31, 2014		
(in thousands)	Agency	Non-Agency	Total
Adjustable Rate	\$128,285	\$2,558,832	\$2,687,117
Fixed Rate	11,164,032	489,953	11,653,985
Total	\$11,292,317	\$3,048,785	\$14,341,102



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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

When the Company purchases a credit-sensitive AFS security at a significant discount to its face value, the Company often does not amortize into income a significant portion of this discount that the Company is entitled to earn because it does not expect to collect it due to the inherent credit risk of the security. The Company may also record an other-than-temporary impairment, or OTTI, for a portion of its investment in the security to the extent the Company believes that the amortized cost will exceed the present value of expected future cash flows. The amount of principal that the Company does not amortize into income is designated as a credit reserve on the security, with unamortized net discounts or premiums amortized into income over time to the extent realizable.

The following table presents the changes for the six months ended June 30, 2015 and 2014, of the unamortized net discount and designated credit reserves on non-Agency AFS securities.

(in thousands)	Six Months Ended June 30, 2015			2014		
	Designated Credit Reserve	Unamortized Net Discount	Total	Designated Credit Reserve	Unamortized Net Discount	Total
Beginning balance at January 1	\$ (927,605 )	\$ (967,368 )	\$ (1,894,973 )	\$ (1,234,449 )	\$ (1,071,559 )	\$ (2,306,008 )
Acquisitions	(1,284 )	(3,283 )	(4,567 )	(62,752 )	(46,581 )	(109,333 )
Accretion of net discount	—	52,759	52,759	—	64,084	64,084
Realized credit losses	8,470	—	8,470	6,607	—	6,607
Reclassification adjustment for other-than-temporary impairments	1,619	—	1,619	(212 )	—	(212 )
Transfers from (to)	58,716	(58,716 )	—	47,495	(47,495 )	—
Sales, calls, other	202,458	156,584	359,042	80,854	45,251	126,105
Ending balance at June 30	\$ (657,626 )	\$ (820,024 )	\$ (1,477,650 )	\$ (1,162,457 )	\$ (1,056,300 )	\$ (2,218,757 )

The following table presents the components comprising the carrying value of AFS securities not deemed to be other than temporarily impaired by length of time that the securities had an unrealized loss position as of June 30, 2015 and December 31, 2014. At June 30, 2015, the Company held 1,455 AFS securities, of which 198 were in an unrealized loss position for less than twelve consecutive months and 177 were in an unrealized loss position for more than twelve consecutive months. At December 31, 2014, the Company held 1,452 AFS securities, of which 57 were in an unrealized loss position for less than twelve months and 172 were in an unrealized loss position for more than twelve consecutive months.

(in thousands)	Unrealized Loss Position for					
	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
June 30, 2015	\$ 2,659,052	\$ (40,295 )	\$ 1,204,291	\$ (40,486 )	\$ 3,863,343	\$ (80,781 )
December 31, 2014	\$ 413,102	\$ (3,146 )	\$ 1,323,688	\$ (32,885 )	\$ 1,736,790	\$ (36,031 )

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

## Evaluating AFS Securities for Other-Than-Temporary Impairments

In evaluating AFS securities for OTTI, the Company determines whether there has been a significant adverse quarterly change in the cash flow expectations for a security. The Company compares the amortized cost of each security in an unrealized loss position against the present value of expected future cash flows of the security. The Company also considers whether there has been a significant adverse change in the regulatory and/or economic environment as part of this analysis. If the amortized cost of the security is greater than the present value of expected future cash flows using the original yield as the discount rate, an other-than-temporary credit impairment has occurred. If the Company does not intend to sell and will not be more likely than not required to sell the security, the credit loss is recognized in earnings and the balance of the unrealized loss is recognized in other comprehensive (loss) income. If the Company intends to sell the security or will be more likely than not required to sell the security, the full unrealized loss is recognized in earnings.

The Company recorded \$0.2 million and \$0.3 million in other-than-temporary credit impairments during the three and six months ended June 30, 2015, respectively, on one non-Agency RMBS where the future expected cash flows for each security were less than its amortized cost. As of June 30, 2015, impaired securities with a carrying value of \$141.2 million had actual weighted average cumulative losses of 10.4%, weighted average three-month prepayment speed of 4.3%, weighted average 60+ day delinquency of 27.2% of the pool balance, and weighted average FICO score of 664. At June 30, 2015, the Company did not intend to sell the securities and determined that it was not more likely than not that the Company will be required to sell the securities; therefore, only the projected credit loss was recognized in earnings. During the six months ended June 30, 2014, the Company recorded \$0.2 million in other-than-temporary credit impairments on a total of three non-Agency RMBS where the future expected cash flows for each security were less than its amortized cost.

The following table presents the changes in OTTI included in earnings for three and six months ended June 30, 2015 and 2014:

(in thousands)	Three Months Ended		Six Months Ended	
	June 30, 2015	2014	June 30, 2015	2014
Cumulative credit loss at beginning of period	\$(6,452	) \$(9,215	) \$(8,241	) \$(9,467
Additions:				
Other-than-temporary impairments not previously recognized	—	—	—	(91
Increases related to other-than-temporary impairments on securities with previously recognized other-than-temporary impairments	(170	) —	(297	) (121
Reductions:				
Decreases related to other-than-temporary impairments on securities paid down	—	—	—	464
Decreases related to other-than-temporary impairments on securities sold	—	1,154	1,916	1,154
Cumulative credit loss at end of period	\$(6,622	) \$(8,061	) \$(6,622	) \$(8,061

Cumulative credit losses related to OTTI may be reduced for securities sold as well as for securities that mature, pay down, or are prepaid such that the outstanding principal balance is reduced to zero. Additionally, increases in cash flows expected to be collected over the remaining life of the security cause a reduction in the cumulative credit loss.

## Gross Realized Gains and Losses

Gains and losses from the sale of AFS securities are recorded as realized gains (losses) within gain (loss) on investment securities in the Company's condensed consolidated statements of comprehensive income. For the three

and six months ended June 30, 2015, the Company sold AFS securities for \$1.7 billion and \$2.6 billion with an amortized cost of \$1.6 billion and \$2.4 billion for net realized gains of \$75.9 million and \$193.3 million, respectively. For the three and six months ended June 30, 2014, the Company sold AFS securities for \$459.4 million and \$1.3 billion with an amortized cost of \$423.4 million and \$1.3 billion for net realized gains of \$36.0 million and losses of \$2.8 million, respectively.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

The following table presents the gross realized gains and losses on sales of AFS securities for the three and six months ended June 30, 2015 and 2014:

(in thousands)	Three Months Ended		Six Months Ended	
	June 30, 2015	2014	June 30, 2015	2014
Gross realized gains	\$76,199	\$35,954	\$193,887	\$43,163
Gross realized losses	(336	) —	(556	) (45,997
Total realized gains (losses) on sales, net	\$75,863	\$35,954	\$193,331	\$(2,834)

## Note 5. Trading Securities, at Fair Value

At December 31, 2014 and during the three and six months ended June 30, 2015, the Company held U.S. Treasuries in a TRS and classified these securities as trading instruments due to short-term investment objectives. The following table presents the carrying value of the Company's trading securities as of June 30, 2015 and December 31, 2014:

(in thousands)	June 30, 2015	December 31, 2014
Amortized cost	\$—	\$1,996,289
Unrealized gains (losses), net	—	1,367
Carrying value	\$—	\$1,997,656

For both the three and six months ended June 30, 2015, the Company sold trading securities for \$2.0 billion with an amortized cost of \$2.0 billion, resulting in realized gains of \$7.4 million on the sale of these securities. For the three and six months ended June 30, 2014, the Company sold trading securities for \$44.8 million and \$143.4 million with an amortized cost of \$44.8 million and \$143.0 million, resulting in realized losses of \$7,031 and gains of \$0.4 million, respectively, on the sale of these securities.

For the three and six months ended June 30, 2015, trading securities experienced changes in unrealized losses of \$13.4 million and \$1.4 million, respectively. For the three and six months ended June 30, 2014, trading securities experienced changes in unrealized gains of \$1.7 million and \$1.5 million, respectively. Both realized and unrealized gains and losses are recorded as a component of gain (loss) on investment securities in the Company's condensed consolidated statements of comprehensive income.

At December 31, 2014, the Company pledged trading securities with a carrying value of \$2.0 billion as collateral for repurchase agreements. See Note 16 - Repurchase Agreements.

## Note 6. Residential Mortgage Loans Held-for-Sale, at Fair Value

Residential mortgage loans held-for-sale consists of residential mortgage loans carried at fair value as a result of a fair value option election. The following table presents the carrying value of the Company's residential mortgage loans held-for-sale as of June 30, 2015 and December 31, 2014:

(in thousands)	June 30, 2015	December 31, 2014
Unpaid principal balance	\$703,966	\$534,101
Fair value adjustment	(8,888	) 1,611
Carrying value	\$695,078	\$535,712

At June 30, 2015 and December 31, 2014, the Company pledged residential mortgage loans with a carrying value of \$561.8 million and \$416.8 million, respectively, as collateral for repurchase agreements and FHLB advances. See Note 16 - Repurchase Agreements and Note 18 - Federal Home Loan Bank of Des Moines Advances.



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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

## Note 7. Residential Mortgage Loans Held-for-Investment in Securitization Trusts, at Fair Value

The Company purchases subordinated debt and excess servicing rights from securitization trusts sponsored by either third parties or the Company's subsidiaries. The underlying residential mortgage loans held by the trusts, which are consolidated on the Company's condensed consolidated balance sheets, are classified as residential mortgage loans held-for-investment in securitization trusts and carried at fair value as a result of a fair value option election. See Note 3 - Variable Interest Entities for additional information regarding consolidation of the securitization trusts. The following table presents the carrying value of the Company's residential mortgage loans held-for-investment in securitization trusts as of June 30, 2015 and December 31, 2014:

(in thousands)	June 30, 2015	December 31, 2014
Unpaid principal balance	\$2,431,573	\$1,699,748
Fair value adjustment	17,626	44,998
Carrying value	\$2,449,199	\$1,744,746

## Note 8. Commercial Real Estate Loans Held-for-Investment

The Company is the sole certificate holder of a trust entity that holds a commercial real estate loan. The underlying loan held by the trust, which is consolidated on the Company's condensed consolidated balance sheet, is classified as commercial real estate loans held-for-investment and carried at cost, net of any unamortized premiums or discounts, unless deemed impaired. See Note 3 - Variable Interest Entities for additional information regarding consolidation of the trust.

The following table presents the carrying value of the Company's commercial real estate loans held-for-investment as of June 30, 2015 and December 31, 2014:

(in thousands)	June 30, 2015	December 31, 2014
Unpaid principal balance	\$45,900	\$—
Unamortized discount	(295	) —
Carrying value	\$45,605	\$—

As of June 30, 2015, the Company's commercial real estate loans held-for-investment were comprised of one newly-issued senior mezzanine commercial real estate loan with a two-year interest-only term. The Company evaluates each loan for impairment at least quarterly as described in Note 2 - Basis of Presentation and Significant Accounting Policies. As of June 30, 2015, the properties collateralizing the Company's one commercial real estate loan have continued to perform as originally underwritten, and as such, are considered to have very low risk. The Company has not recorded any allowances for losses as it is not deemed probable that the Company will not be able to collect all amounts due according to the contractual terms of the loan. The Company did not hold any commercial real estate loans held-for-investment as of December 31, 2014. At June 30, 2015, the Company pledged commercial real estate loans held-for-investment with a carrying value of \$45.6 million as collateral for repurchase agreements. See Note 16 - Repurchase Agreements.

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## TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

## Note 9. Servicing Activities

## Mortgage Servicing Rights, at Fair Value

One of the Company's wholly owned subsidiaries has approvals from the Federal National Mortgage Association, or Fannie Mae, the Federal Home Loan Mortgage Corporation, or Freddie Mac, and the Government National Mortgage Association, or Ginnie Mae, to hold and manage MSR, which represent the right to control the servicing of mortgage loans. The Company and its subsidiaries do not originate or directly service mortgage loans, and instead contract with fully licensed subservicers to handle substantially all servicing functions for the loans underlying the Company's MSR. The following table summarizes activity related to MSR for the three and six months ended June 30, 2015 and 2014.

(in thousands)	Three Months Ended		Six Months Ended	
	June 30, 2015	2014	June 30, 2015	2014
Balance at beginning of period	\$410,229	\$476,663	\$452,006	\$514,402
Additions from purchases of servicing rights	4,210	53,013	8,534	54,293
Additions from sales of residential mortgage loans	589	—	816	—
Changes in fair value due to:				
Changes in valuation inputs or assumptions used in the valuation model	25,440	(15,655)	(17,649)	(35,905)
Other changes in fair value <sup>(1)</sup>	(7,805)	(13,916)	(17,119)	(26,427)
Other changes <sup>(2)</sup>	4,913	385	10,988	(5,873)
Balance at end of period	\$437,576	\$500,490	\$437,576	\$500,490

(1) Other changes in fair value primarily represents changes due to the realization of expected cash flows.

(2) Other changes includes purchase price adjustments, contractual prepayment protection, and changes due to the Company's purchase of the underlying collateral.

As of June 30, 2015 and December 31, 2014, the key economic assumptions and sensitivity of the fair value of MSR to immediate 10% and 20% adverse changes in these assumptions were as follows:

(in thousands)	June 30, 2015	December 31, 2014		
Weighted average prepayment speed:	11.2	% 11.9		%
Impact on fair value of 10% adverse change	\$(17,941)	) \$(14,012)		)
Impact on fair value of 20% adverse change	\$(34,131)	) \$(31,640)		)
Weighted average delinquency:	4.6	% 5.6		%
Impact on fair value of 10% adverse change	\$(2,188)	) \$(3,616)		)
Impact on fair value of 20% adverse change	\$(4,376)	) \$(6,780)		)
Weighted average discount rate:	9.4	% 9.5		%
Impact on fair value of 10% adverse change	\$(15,753)	) \$(16,272)		)
Impact on fair value of 20% adverse change	\$(30,630)	) \$(31,640)		)

These assumptions and sensitivities are hypothetical and should be considered with caution. Changes in fair value based on 10% and 20% variations in assumptions generally cannot be extrapolated because the relationship of the change in assumptions to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of MSR is calculated without changing any other assumptions. In reality, changes in one factor may result in changes in another (e.g., increased market interest rates may result in lower prepayments and increased credit losses) that could magnify or counteract the sensitivities. Further, these sensitivities show only the change in the asset balances and do not show any expected change in the fair value of the instruments used to manage

the interest rates and prepayment risks associated with these assets.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

## Risk Mitigation Activities

The primary risk of the Company's MSR is interest rate risk and the resulting impact on prepayments. A significant decline in interest rates could lead to higher-than-expected prepayments that could reduce the value of the MSR. The Company economically hedges the impact of these risks with AFS securities and derivative financial instruments. Refer to Note 12 - Derivative Instruments and Hedging Activities for additional information regarding the derivative financial instruments used to economically hedge MSR.

## Mortgage Servicing Income

The following table presents the components of servicing income recorded on the Company's condensed consolidated statements of comprehensive income for the three and six months ended June 30, 2015 and 2014:

(in thousands)	Three Months Ended		Six Months Ended	
	June 30, 2015	2014	June 30, 2015	2014
Servicing fee income	\$29,586	\$33,079	\$60,823	\$62,950
Ancillary fee income	551	581	1,115	1,044
Float income	379	208	665	315
Total	\$30,516	\$33,868	\$62,603	\$64,309

## Mortgage Servicing Advances

In connection with the servicing of loans, the Company's subservicers make certain payments for property taxes and insurance premiums, default and property maintenance payments, as well as advances of principal and interest payments before collecting them from individual borrowers. Servicing advances, including contractual interest, are priority cash flows in the event of a loan principal reduction or foreclosure and ultimate liquidation of the real estate-owned property, thus making their collection reasonably assured. These servicing advances, which are funded by the Company, totaled \$30.8 million and \$27.5 million and were included in other assets on the condensed consolidated balance sheets as of June 30, 2015 and December 31, 2014, respectively.

## Serviced Mortgage Assets

The Company's total serviced mortgage assets consist of loans owned and classified as residential mortgage loans held-for-sale, loans held in consolidated VIEs classified as residential mortgage loans held-for-investment in securitization trusts and loans underlying MSR. The following table presents the number of loans and unpaid principal balance of the mortgage assets for which the Company manages the servicing as of June 30, 2015 and December 31, 2014:

(dollars in thousands)	June 30, 2015		December 31, 2014	
	Number of Loans	Unpaid Principal Balance	Number of Loans	Unpaid Principal Balance
Residential mortgage loans held-for-sale	1,293	\$703,966	1,008	\$534,101
Residential mortgage loans held-for-investment in securitization trusts	441	322,335	487	358,458
Mortgage servicing rights <sup>(1)</sup>	214,745	42,811,294	224,073	44,949,061
Total serviced mortgage assets	216,479	\$43,837,595	225,568	\$45,841,620

(1) Includes residential mortgage loans held-for-investment in securitization trusts for which the Company is the named servicing administrator.



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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

## Note 10. Restricted Cash

The Company is required to maintain certain cash balances with counterparties for securities and derivatives trading activity and collateral for the Company's repurchase agreements and FHLB advances in restricted accounts. The Company has also placed cash in a restricted account pursuant to a letter of credit on an office space lease.

The following table presents the Company's restricted cash balances as of June 30, 2015 and December 31, 2014:

(in thousands)	June 30, 2015	December 31, 2014
Restricted cash balances held by trading counterparties:		
For securities and loan trading activity	\$17,250	\$12,000
For derivatives trading activity	210,597	211,989
As restricted collateral for repurchase agreements and Federal Home Loan Bank advances	182,709	112,435
Total restricted cash balances held by trading counterparties	410,556	336,424
Restricted cash balance pursuant to letter of credit on office lease	347	347
Total	\$410,903	\$336,771

## Note 11. Accrued Interest Receivable

The following table presents the Company's accrued interest receivable by collateral type:

(in thousands)	June 30, 2015	December 31, 2014
Accrued Interest Receivable:		
U.S. Treasuries	\$—	\$8,084
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	8,042	8,734
Federal National Mortgage Association	19,223	22,392
Government National Mortgage Association	9,901	10,290
Non-Agency	3,576	3,835
Total mortgage-backed securities	40,742	45,251
Residential mortgage loans held-for-sale	2,448	1,997
Residential mortgage loans held-for-investment in securitization trusts	13,680	10,197
Commercial real estate loans held-for-investment	141	—
Total	\$57,011	\$65,529

## Note 12. Derivative Instruments and Hedging Activities

The Company enters into a variety of derivative and non-derivative instruments in connection with its risk management activities. The Company's primary objective for executing these derivative and non-derivative instruments is to mitigate the Company's economic exposure to future events that are outside its control. The Company's derivative financial instruments are utilized principally to manage market risk and cash flow volatility associated with interest rate risk (including associated prepayment risk) related to certain assets and liabilities. As part of its risk management activities, the Company may, at times, enter into various forward contracts, including short securities, Agency to-be-announced securities, or TBAs, options, futures, swaps, caps, credit default swaps and total return swaps. In executing on the Company's current risk management strategy, the Company has entered into interest rate swap and swaption agreements, TBAs, short U.S. Treasuries, put and call options for TBAs and U.S. Treasuries, constant maturity swaps, credit default swaps and total return swaps (based on the Markit IOS Index). The Company has also entered into a number of non-derivative instruments to manage interest rate risk, principally U.S. Treasuries

and Agency interest-only securities.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

The following summarizes the Company's significant asset and liability classes, the risk exposure for these classes, and the Company's risk management activities used to mitigate certain of these risks. The discussion includes both derivative and non-derivative instruments used as part of these risk management activities. While the Company uses non-derivative and derivative instruments to achieve the Company's risk management activities, it is possible that these instruments will not effectively mitigate all or a substantial portion of the Company's market rate risk. In addition, the Company might elect, at times, not to enter into certain hedging arrangements in order to maintain compliance with REIT requirements.

## Balance Sheet Presentation

In accordance with ASC 815, Derivatives and Hedging, as amended and interpreted, or ASC 815, the Company records derivative financial instruments on its condensed consolidated balance sheets as assets or liabilities at fair value. Changes in fair value are accounted for depending on the use of the derivative instruments and whether they qualify for hedge accounting treatment. Due to the volatility of the credit markets and difficulty in effectively matching pricing or cash flows, the Company has elected to treat all current derivative contracts as trading instruments.

The following tables present the gross fair value and notional amounts of the Company's derivative financial instruments treated as trading instruments as of June 30, 2015 and December 31, 2014.

(in thousands)

June 30, 2015

	Derivative Assets		Derivative Liabilities	
	Fair Value	Notional	Fair Value	Notional
Trading instruments				
Inverse interest-only securities	\$ 178,848	\$ 1,049,743	\$—	\$—
Interest rate swap agreements	46,935	14,325,523	(1,402	) 1,900,000
Credit default swaps	—	—	(1,164	) 125,000
Swaptions, net	120,707	10,050,000	(11,887	) 640,000
TBAs	—	—	(5,187	) 1,434,000
Put and call options for TBAs, net	—	—	(105	) —
Constant maturity swaps	—	—	—	—
Markit IOS total return swaps	725	855,872	(134	) 132,537
Forward purchase commitments	107	135,181	(2,596	) 491,479
Total	\$347,322	\$26,416,319	\$(22,475	) \$4,723,016

(in thousands)

December 31, 2014

	Derivative Assets		Derivative Liabilities	
	Fair Value	Notional	Fair Value	Notional
Trading instruments				
Inverse interest-only securities	\$ 188,592	\$ 1,168,226	\$—	\$—
Interest rate swap agreements	55,471	9,569,000	(65,392	) 9,015,000
Credit default swaps	—	—	(1,672	) 125,000
Swaptions, net	121,591	9,550,000	(4,999	) 2,860,000
TBAs	10,350	875,000	(17,687	) 2,200,000
Put and call options for TBAs, net	90	2,000,000	—	—
Constant maturity swaps	2,013	12,000,000	(483	) 2,000,000
Markit IOS total return swaps	1,387	598,459	—	—
Forward purchase commitments	1,297	554,838	—	—
Total	\$380,791	\$36,315,523	\$(90,233	) \$16,200,000

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

## Comprehensive Income Statement Presentation

The Company has not applied hedge accounting to its current derivative portfolio held to mitigate the interest rate risk and credit risk associated with its portfolio. As a result, the Company is subject to volatility in its earnings due to movement in the unrealized gains and losses associated with its interest rate swaps and its other derivative instruments.

The following table summarizes the location and amount of gains and losses on derivative instruments reported in the condensed consolidated statements of comprehensive income on the Company's derivative trading instruments: (in thousands)

Trading Instruments	Location of Gain (Loss) Recognized in Income on Derivatives	Amount of Gain (Loss) Recognized in Income on Derivatives			
		Three Months Ended June 30,		Six Months Ended June 30,	
		2015	2014	2015	2014
Interest rate risk management					
TBA <sub>s</sub> <sup>(1)</sup>	Loss on other derivative instruments	\$5,262	\$(29,877 )	\$(22,696 )	\$(47,780 )
Short U.S. Treasuries <sup>(1)</sup>	Loss on other derivative instruments	125	(8 )	125	(8 )
Put and call options for TBA <sub>s</sub> <sup>(1)</sup>	Loss on other derivative instruments	5,671	(4,614 )	8,206	(6,319 )
Put and call options for U.S. Treasuries <sup>(1)</sup>	Loss on other derivative instruments	(837 )	—	(837 )	—
Constant maturity swaps <sup>(1)</sup>	Loss on other derivative instruments	74	(6,103 )	6,164	5,428
Interest rate swap agreements - Receivers <sup>(1)</sup>	Gain (loss) on interest rate swap and swaption agreements	(42,470 )	65,963	(144 )	106,942
Interest rate swap agreements - Payers <sup>(1)</sup>	Gain (loss) on interest rate swap and swaption agreements	20,713	(46,341 )	(31,846 )	(59,761 )
Swaptions <sup>(1)</sup>	Gain (loss) on interest rate swap and swaption agreements	19,752	(57,250 )	1,246	(169,808 )
Markit IOS total return swaps <sup>(1)</sup>	Loss on other derivative instruments	(20,658 )	353	(17,526 )	(1,372 )
Interest rate swap agreements - Payers <sup>(2)</sup>	Gain (loss) on interest rate swap and swaption agreements	46,957	(78,391 )	(50,747 )	(98,920 )
Credit risk management					
Credit default swaps - Receive protection <sup>(3)</sup>	Loss on other derivative instruments	(30 )	(5 )	(123 )	1,976
Non-risk management					
TBA <sub>s</sub>	Loss on other derivative instruments	—	—	—	(4,701 )
Inverse interest-only securities	Loss on other derivative instruments	4,909	16,052	24,170	34,375
Forward purchase commitments	(Loss) gain on residential mortgage loans held-for-sale	(5,130 )	4,163	(4,160 )	3,746
Total		\$34,338	\$(136,058 )	\$(88,168 )	\$(236,202 )

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- (1) Includes derivative instruments held to mitigate interest rate risk associated with the Company's investment portfolio.
  - (2) Includes derivative instruments held to mitigate interest rate risk associated with the Company's repurchase agreements and FHLB advances.
  - (3) Includes derivative instruments held to mitigate credit risk associated with the Company's non-Agency RMBS and residential mortgage loans held-for-sale.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

For the three and six months ended June 30, 2015, the Company recognized \$26.1 million and \$53.7 million, respectively, of expenses for the accrual and/or settlement of the net interest expense associated with its interest rate swaps. The expenses result from paying either a fixed interest rate or LIBOR interest on an average \$16.7 billion and \$17.5 billion notional, respectively, and receiving either LIBOR interest or a fixed interest rate. For the three and six months ended June 30, 2014, the Company recognized \$18.9 million and \$32.7 million, respectively, of expenses for the accrual and/or settlement of the net interest expense associated with its interest rate swaps. The expenses result from paying either a fixed interest rate or LIBOR interest on an average \$23.5 billion and \$21.3 billion notional, respectively, and receiving either LIBOR interest or a fixed interest rate.

The following tables present information with respect to the volume of activity in the Company's derivative instruments during the three and six months ended June 30, 2015 and 2014:

(in thousands)	Three Months Ended June 30, 2015					
	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net (1)
Inverse interest-only securities	\$ 1,106,210	\$ 12,563	\$(69,030)	\$ 1,049,743	\$ 1,086,760	\$ 64
Interest rate swap agreements	19,929,000	11,493,227	(15,196,704)	16,225,523	16,681,983	(66,799)
Credit default swaps	125,000	—	—	125,000	125,000	—
Swaptions, net	12,960,000	1,500,000	(5,050,000)	9,410,000	10,292,418	(8,053)
TBAs, net	(2,496,000)	(3,929,000)	5,401,000	(1,024,000)	(1,362,451)	(7,482)
Short U.S. Treasuries	—	(50,000)	50,000	—	—	125
Put and call options for TBAs, net	(2,500,000)	—	2,500,000	—	(722,527)	10,843
Put and call options for U.S. Treasuries, net	—	500,000	(500,000)	—	2,747	(837)
Constant maturity swaps	3,000,000	—	(3,000,000)	—	384,615	1,310
Markit IOS total return swaps	877,529	747,910	(637,030)	988,409	1,201,515	(13,130)
Forward purchase commitments	707,304	978,297	(1,058,941)	626,660	679,266	(1,318)
Total	\$ 33,709,043	\$ 11,252,997	\$(17,560,705)	\$ 27,401,335	\$ 28,369,326	\$(85,277)
(in thousands)	Three Months Ended June 30, 2014					
	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net (1)
Inverse interest-only securities	\$ 1,412,374	\$—	\$(88,724)	\$ 1,323,650	\$ 1,372,535	\$—
Interest rate swap agreements	21,663,148	8,465,000	(6,500,000)	23,628,148	23,467,489	(2,983)
Credit default swaps	125,000	—	—	125,000	125,000	—
Swaptions, net	9,500,000	3,250,000	(1,300,000)	11,450,000	10,412,088	(2,178)
TBAs, net	(1,022,000)	(2,032,000)	2,682,000	(372,000)	660,308	(26,530)
Short U.S. Treasuries	—	(125,000)	125,000	—	1,374	2



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Put and call options for TBAs, net	1,500,000	—	(1,500,000 )	—	901,099	(5,332 )
Constant maturity swaps	10,000,000	4,000,000	(8,000,000 )	6,000,000	5,571,429	(1,460 )
Markit IOS total return swaps	243,987	339,869	(7,378 )	576,478	393,910	—
Forward purchase commitments	153,637	872,756	(378,452 )	647,941	367,940	332
Total	\$43,576,146	\$14,770,625	\$(14,967,554 )	\$43,379,217	\$43,273,172	\$(38,149 )

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## TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

(in thousands)	Six Months Ended June 30, 2015					
	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net (1)
Inverse interest-only securities	\$ 1,168,226	\$ 12,563	\$(131,046 )	\$ 1,049,743	\$ 1,112,471	\$ 64
Interest rate swap agreements	18,584,000	17,113,227	(19,471,704 )	16,225,523	17,455,887	(67,869 )
Credit default swaps	125,000	—	—	125,000	125,000	—
Swaptions, net	12,410,000	7,050,000	(10,050,000 )	9,410,000	11,564,972	4,793
TBAs, net	(1,325,000 )	(10,862,000 )	11,163,000	(1,024,000 )	(1,739,978 )	(24,846 )
Short U.S. Treasuries	—	(50,000 )	50,000	—	—	125
Put and call options for TBAs, net	2,000,000	250,000	(2,250,000 )	—	(359,116 )	7,796
Put and call options for U.S. Treasuries, net	—	500,000	(500,000 )	—	1,381	(837 )
Constant maturity swaps	14,000,000	6,000,000	(20,000,000 )	—	4,552,486	7,694
Markit IOS total return swaps	598,459	1,424,543	(1,034,593 )	988,409	1,039,332	(8,928 )
Forward purchase commitments	554,838	2,106,931	(2,035,109 )	626,660	663,890	(374 )
Total	\$ 48,115,523	\$ 23,545,264	\$(44,259,452 )	\$ 27,401,335	\$ 34,416,325	\$(82,382 )
(in thousands)	Six Months Ended June 30, 2014					
	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net (1)
Inverse interest-only securities	\$ 1,525,845	\$—	\$(202,195 )	\$ 1,323,650	\$ 1,421,330	\$ 193
Interest rate swap agreements	19,619,000	11,409,148	(7,400,000 )	23,628,148	21,324,091	(3,005 )
Credit default swaps	427,073	—	(302,073 )	125,000	152,059	(13,705 )
Swaptions, net	5,130,000	7,150,000	(830,000 )	11,450,000	9,699,558	(3,396 )
TBAs, net	603,000	(2,924,000 )	1,949,000	(372,000 )	593,746	(14,677 )
Short U.S. Treasuries	—	(125,000 )	125,000	—	691	2
Put and call options for TBAs, net	—	1,500,000	(1,500,000 )	—	580,110	(5,332 )
Constant maturity swaps	10,000,000	12,000,000	(16,000,000 )	6,000,000	7,773,481	2,427
Markit IOS total return swaps	49,629	536,881	(10,032 )	576,478	274,573	—
Forward purchase commitments	12,063	1,058,706	(422,828 )	647,941	204,336	302
Total	\$ 37,366,610	\$ 30,605,735	\$(24,593,128 )	\$ 43,379,217	\$ 42,023,975	\$(37,191 )

(1) Excludes net interest paid or received in full settlement of the net interest spread liability.

Cash flow activity related to derivative instruments is reflected within the operating activities and investing activities sections of the condensed consolidated statements of cash flows. Derivative fair value adjustments are reflected within the unrealized (gain) loss on interest rate swaps and swaptions, unrealized gain on other derivative instruments, and gain on residential mortgage loans held-for-sale line items within the operating activities section of the condensed consolidated statements of cash flows. Realized gains and losses on interest rate swap and swaption agreements are reflected within the loss on termination and option expiration of interest rate swaps and swaptions line item within the operating activities section of the condensed consolidated statements of cash flows. The remaining cash flow activity related to derivative instruments is reflected within the short sales and purchases of other derivative instruments, proceeds from sales of other derivative instruments, net and increase (decrease) in due to counterparties, net line items within the investing activities section of the condensed consolidated statements of cash flows.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

## Interest Rate Sensitive Assets/Liabilities

The Company's RMBS investment securities and MSR are generally subject to change in value when mortgage rates decline or increase, depending on the type of investment. Rising mortgage rates generally result in a slowing of refinancing activity, which slows prepayments and results in a decline in the value of the Company's fixed-rate Agency pools and an increase in the value of the Company's MSR. To mitigate the impact of this risk, the Company maintains a portfolio of fixed-rate interest-only securities, which increase in value when interest rates increase, as well as TBA positions, short U.S. Treasuries, put and call options for TBAs and U.S. Treasuries, constant maturity swaps, interest rate swap and swaption agreements and Markit IOS total return swaps to further mitigate its exposure to higher interest rates, decreased prepayment speeds and widening mortgage spreads.

As of June 30, 2015 and December 31, 2014, the Company had outstanding fair value of \$49.3 million and \$55.7 million, respectively, of interest-only securities in place to economically hedge its investment securities. These interest-only securities are included in AFS securities, at fair value, in the condensed consolidated balance sheets. The Company is exposed to interest rate risk on residential mortgage loans from the time it commits to purchase a mortgage loan until it acquires the loan from the originator and subsequently sells the loan to a third party. Changes in interest rates impact the market price for the mortgage loans. For example, as market interest rates decline, the value of residential mortgage loans held-for-sale increases, and vice versa. To mitigate the impact of this risk, the Company may enter into derivative contracts to hedge the interest rate risk related to its commitments to purchase residential mortgage loans and residential mortgage loans held-for-sale, such as interest rate swaps, swaptions, TBA positions, short U.S. Treasuries, put and call options for TBAs and U.S. Treasuries and constant maturity swaps.

TBAs. At times, the Company may use TBAs for risk management purposes or as a means of deploying capital until targeted investments are available and to take advantage of temporary displacements in the marketplace. TBAs are forward contracts for the purchase (long notional positions) or sale (short notional positions) of Agency RMBS. The issuer, coupon and stated maturity of the Agency RMBS are predetermined as well as the trade price, face amount and future settle date (published each month by the Securities Industry and Financial Markets Association). However, the specific Agency RMBS to be delivered upon settlement is not known at the time of the TBA transaction. As a result, and because physical delivery of the Agency RMBS upon settlement cannot be assured, the Company accounts for TBAs as derivative instruments.

As of June 30, 2015, \$0.2 billion of the Company's long notional TBA positions and \$1.2 billion of the Company's short notional TBA positions were held in order to economically hedge portfolio risk. As of December 31, 2014, \$0.9 billion of the Company's long notional TBA positions and \$2.2 billion of the Company's short notional TBA positions were held in order to economically hedge portfolio risk. The Company discloses these positions on a gross basis according to the unrealized gain or loss position of each TBA contract regardless of long or short notional position. The following tables present the notional amount, cost basis, market value and carrying value (which approximates fair value) of the Company's TBA positions as of June 30, 2015 and December 31, 2014:

As of June 30, 2015

(in thousands)	Notional Amount (1)	Cost Basis (2)	Market Value (3)	Net Carrying Value (4)	
				Derivative Assets	Derivative Liabilities
Purchase contracts	\$205,000	\$219,441	\$219,369	\$—	\$(72)
Sale contracts	(1,229,000)	(1,284,198)	(1,289,313)	—	(5,115)
TBAs, net	\$(1,024,000)	\$(1,064,757)	\$(1,069,944)	\$—	\$(5,187)

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## TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

(in thousands)	As of December 31, 2014			Net Carrying Value <sup>(4)</sup>	
	Notional Amount <sup>(1)</sup>	Cost Basis <sup>(2)</sup>	Market Value <sup>(3)</sup>	Derivative Assets	Derivative Liabilities
Purchase contracts	\$875,000	\$862,868	\$873,218	\$10,350	\$—
Sale contracts	(2,200,000 )	(2,294,813 )	(2,312,500 )	—	(17,687 )
TBAs, net	\$(1,325,000 )	\$(1,431,945 )	\$(1,439,282 )	\$10,350	\$(17,687 )

(1) Notional amount represents the face amount of the underlying Agency RMBS.

(2) Cost basis represents the forward price to be paid (received) for the underlying Agency RMBS.

(3) Market value represents the current market value of the TBA (or of the underlying Agency RMBS) as of period-end.

(4) Net carrying value represents the difference between the market value of the TBA as of period-end and its cost basis, and is reported in derivative assets / (liabilities), at fair value, in the condensed consolidated balance sheets.

Put and Call Options for TBAs. As of June 30, 2015, the Company had purchased put options for TBAs with a notional amount of \$250.0 million and paid upfront premiums of approximately \$0.9 million. The Company had also short sold call options for TBAs with a notional amount of \$250.0 million and received upfront premiums of approximately \$0.9 million as of June 30, 2015. Each of the options will expire in August 2015. The put and call options had a net fair market value of \$0.1 million included in derivative liabilities, at fair value, in the condensed consolidated balance sheet as of June 30, 2015. As of December 31, 2014, the Company had purchased put options for TBAs with a notional amount of \$2.0 billion and paid upfront premiums of approximately \$0.6 million. The put options had a net fair market value of \$0.1 million included in derivative assets, at fair value, in the condensed consolidated balance sheet as of December 31, 2014.

Constant Maturity Swaps. The Company has also entered into constant maturity swaps between the 10-year interest rate swap curve and the yield to maturity on a 30-year Fannie Mae TBA to economically hedge mortgage spread widening risk. The Company had the following constant maturity swap agreements in place at December 31, 2014: (notional and dollars in thousands)

December 31, 2014

Determination Date	Average Strike Swap Rate	Notional Amount	Fair Value	Upfront Premium Paid	Unrealized Gain (Loss)
January 2015	0.538	% \$7,000,000	\$1,502	\$—	\$1,502
February 2015	0.572	% 2,000,000	(13 )	—	(13 )
March 2015	0.552	% 5,000,000	41	—	41
Total	0.548	% \$14,000,000	\$1,530	\$—	\$1,530

The Company did not have any constant maturity swap agreements in place at June 30, 2015.

Interest Rate Swap Agreements. As of June 30, 2015 and December 31, 2014, the Company held the following interest rate swaps in order to mitigate mortgage interest rate exposure (or duration) risk associated with the Company's investment portfolio whereby the Company receives interest at a three-month LIBOR rate: (notional in thousands)

June 30, 2015

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate	Average Receive Rate	Average Maturity (Years)
2018	\$2,040,000	1.563	% 0.282	% 3.44

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2020 and Thereafter	1,210,000	2.164	% 0.281	% 5.58
Total	\$3,250,000	1.787	% 0.282	% 4.24

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## TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

(notional in thousands)

December 31, 2014

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate	Average Receive Rate	Average Maturity (Years)
2017	\$2,000,000	1.070	% 0.229	% 2.54
2018	2,040,000	1.563	% 0.238	% 3.94
2019 and Thereafter	900,000	2.378	% 0.255	% 6.24
Total	\$4,940,000	1.512	% 0.237	% 3.80

Additionally, as of June 30, 2015 and December 31, 2014, the Company held the following interest rate swaps in order to mitigate mortgage interest rate exposure (or duration) risk associated with the Company's investment portfolio whereby the Company pays interest at a three-month LIBOR rate:

(notional in thousands)

June 30, 2015

Swaps Maturities	Notional Amounts	Average Pay Rate	Average Fixed Receive Rate	Average Maturity (Years)
2018	\$575,000	0.281	% 1.440	% 3.39
2020 and Thereafter	1,889,000	0.283	% 2.588	% 8.10
Total	\$2,464,000	0.282	% 2.320	% 7.00

(notional in thousands)

December 31, 2014

Swaps Maturities	Notional Amounts	Average Pay Rate	Average Fixed Receive Rate	Average Maturity (Years)
2018	\$575,000	0.231	% 1.440	% 3.89
2019 and Thereafter	1,579,000	0.239	% 2.794	% 9.19
Total	\$2,154,000	0.237	% 2.433	% 7.77

The Company monitors its borrowings under repurchase agreements and FHLB advances, which are generally floating rate debt, in relation to the rate profile of its investment securities. When it is cost effective to do so, the Company may enter into interest rate swap arrangements to align the interest rate composition of its borrowings under repurchase agreements and FHLB advances with that of its investment securities and debt portfolios. This particularly applies to borrowing agreements with maturities or interest rate resets of less than six months. Typically, the interest receivable terms (i.e., LIBOR) of the interest rate swaps match the terms of the underlying debt, resulting in an effective conversion of the rate of the related repurchase agreement or FHLB advance from floating to fixed.

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## TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

As of June 30, 2015 and December 31, 2014, the Company had the following outstanding interest rate swaps that were utilized as economic hedges of interest rate exposure (or duration) associated with the Company's short-term repurchase agreements and FHLB advances:

(notional in thousands)

June 30, 2015

Swaps Maturities	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Maturity (Years)
2016	\$4,200,000	0.583	% 0.282	% 1.10
2017	2,375,000	0.864	% 0.281	% 2.09
2018	800,000	1.165	% 0.280	% 2.65
2019	350,000	1.730	% 0.278	% 3.94
2020 and Thereafter	2,786,523	1.944	% 0.279	% 7.62
Total	\$10,511,523	1.090	% 0.281	% 3.26

(notional in thousands)

December 31, 2014

Swaps Maturities	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Maturity (Years)
2016	\$4,100,000	0.667	% 0.249	% 1.65
2017	5,285,000	1.063	% 0.248	% 2.55
2018	625,000	0.945	% 0.233	% 3.08
2019 and Thereafter	1,480,000	2.408	% 0.235	% 7.70
Total	\$11,490,000	1.089	% 0.246	% 2.92



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## TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

Interest Rate Swaptions. As of June 30, 2015 and December 31, 2014, the Company had the following outstanding interest rate swaptions (agreements to enter into interest rate swaps in the future for which the Company would either pay or receive a fixed rate) that were utilized as macro-economic hedges:

June 30, 2015

Swaption	Option				Underlying Swap				
	Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Pay Rate	Average Receive Rate	Average Term (Years)	
(notional and dollars in thousands)									
Purchase contracts:									
Payer	< 6 Months	\$17,963	\$14,444	4.36	\$5,600,000	2.75	% 3M Libor	6.3	
Payer	≥ 6 Months	259,328	134,633	50.71	9,210,000	4.01	% 3M Libor	6.9	
Total Payer		\$277,291	\$149,077	46.40	\$14,810,000	3.53	% 3M Libor	6.7	
Receiver	< 6 Months	\$13,538	\$298	1.04	\$2,000,000	3M Libor	1.33	% 5.0	
Total Receiver		\$13,538	\$298	1.04	\$2,000,000	3M Libor	1.33	% 5.0	
Sale contracts:									
Payer	≥ 6 Months	\$(81,248)	\$(20,660)	24.02	\$(800,000)	3.44	% 3M Libor	10.0	
Total Payer		\$(81,248)	\$(20,660)	24.02	\$(800,000)	3.44	% 3M Libor	10.0	
Receiver	< 6 Months	\$(28,980)	\$(19,895)	4.29	\$(6,600,000)	3M Libor	1.64	% 6.1	
Total Receiver		\$(28,980)	\$(19,895)	4.29	\$(6,600,000)	3M Libor	1.64	% 6.1	

December 31, 2014

Swaption	Option				Underlying Swap				
	Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Term (Years)	
(notional and dollars in thousands)									
Purchase contracts:									
Payer	≥ 6 Months	\$255,358	\$130,120	56.62	\$8,210,000	4.12	% 3M Libor	7.4	
Total Payer		\$255,358	\$130,120	56.62	\$8,210,000	4.12	% 3M Libor	7.4	
Receiver	< 6 Months	\$10,715	\$6,462	3.38	\$5,000,000	3M Libor	1.35	% 5.0	
Total Receiver		\$10,715	\$6,462	3.38	\$5,000,000	3M Libor	1.35	% 5.0	
Sale contracts:									
Payer	≥ 6 Months	\$(81,248)	\$(19,990)	30.02	\$(800,000)	3.44	% 3M Libor	10.0	
Total Payer		\$(81,248)	\$(19,990)	30.02	\$(800,000)	3.44	% 3M Libor	10.0	



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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

Markit IOS Total Return Swaps. The Company also enters into total return swaps (agreements whereby the Company receives or makes payments based on the total return of an underlying instrument or index, such as the Markit IOS Index, in exchange for fixed or floating rate interest payments) to help mitigate the potential impact of larger increases or decreases in interest rates on the performance of our investment portfolio (referred to as “convexity risk”). Total return swaps based on the Markit IOS Index are intended to synthetically replicate the performance of interest-only securities. The Company had the following total return swap agreements in place at June 30, 2015 and December 31, 2014:

(notional and dollars in thousands)

June 30, 2015

Maturity Date	Current Notional Amount	Fair Value	Upfront Payable	Unrealized Gain (Loss)
January 12, 2043	\$ (390,645	) \$641	\$ (866	) \$(225
January 12, 2044	(597,764	) (50	) (7,799	) (7,849
Total	\$ (988,409	) \$591	\$ (8,665	) \$(8,074

(notional and dollars in thousands)

December 31, 2014

Maturity Date	Current Notional Amount	Fair Value	Upfront Payable	Unrealized Gain (Loss)
January 12, 2043	\$ (411,281	) \$763	\$ (1,457	) \$(694
January 12, 2044	(187,178	) 624	(275	) 349
Total	\$ (598,459	) \$1,387	\$ (1,732	) \$(345

**Credit Risk**

The Company’s exposure to credit losses on its U.S. Treasuries and Agency portfolio of investment securities is limited due to implicit or explicit backing from the U.S. Department of the Treasury or the GSEs. The payment of principal and interest on the Freddie Mac and Fannie Mae mortgage-backed securities are guaranteed by those respective agencies, and the payment of principal and interest on the Ginnie Mae mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

Credit Default Swaps. For non-Agency investment securities and residential mortgage loans, the Company may enter into credit default swaps to hedge credit risk. In future periods, the Company could enhance its credit risk protection, enter into further paired derivative positions, including both long and short credit default swaps, and/or seek opportunistic trades in the event of a market disruption (see discussion under “Non-Risk Management Activities” below). The Company also has processes and controls in place to monitor, analyze, manage and mitigate its credit risk with respect to non-Agency RMBS and residential mortgage loans.

As of June 30, 2015 and December 31, 2014, the Company held credit default swaps whereby the Company received credit protection for a fixed premium. The maximum payouts for these credit default swaps are limited to the current notional amounts of each swap contract. Maximum payouts for credit default swaps do not represent the expected future cash requirements, as the Company’s credit default swaps are typically liquidated or expire and are not exercised by the holder of the credit default swaps.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

The following tables present credit default swaps whereby the Company is receiving protection held as of June 30, 2015 and December 31, 2014:

(notional and dollars in thousands)

June 30, 2015

Protection	Maturity Date	Average Implied Credit Spread	Current Notional Amount	Fair Value	Upfront (Payable) Receivable	Unrealized Gain (Loss)
Receive	June 20, 2016	105.50	\$(100,000)	) \$(901	) \$(260	) \$(1,161
	December 20, 2016	496.00	(25,000)	) (263	) (4,062	) (4,325
	Total	183.60	\$(125,000)	) \$(1,164	) \$(4,322	) \$(5,486

(notional and dollars in thousands)

December 31, 2014

Protection	Maturity Date	Average Implied Credit Spread	Current Notional Amount	Fair Value	Upfront (Payable) Receivable	Unrealized Gain (Loss)
Receive	June 20, 2016	105.50	\$(100,000)	) \$(1,350	) \$(260	) \$(1,610
	December 20, 2016	496.00	(25,000)	) (322	) (4,062	) (4,384
	Total	183.60	\$(125,000)	) \$(1,672	) \$(4,322	) \$(5,994

Derivative financial instruments contain an element of credit risk if counterparties are unable to meet the terms of the agreements. Credit risk associated with derivative financial instruments is measured as the net replacement cost should the counterparties that owe the Company under such contracts completely fail to perform under the terms of these contracts, assuming there are no recoveries of underlying collateral, as measured by the market value of the derivative financial instruments. As of June 30, 2015, the fair value of derivative financial instruments as an asset and liability position was \$347.3 million and \$22.5 million, respectively.

The Company attempts to mitigate its credit risk exposure on derivative financial instruments by limiting its counterparties to banks and financial institutions that meet established credit guidelines. The Company also seeks spread its credit risk exposure across multiple counterparties in order to reduce the exposure to any single counterparty. Additionally, the Company reduces credit risk on the majority of its derivative instruments by entering into agreements that permit the closeout and netting of transactions with the same counterparty or clearing agency, in the case of centrally cleared interest rate swaps, upon occurrence of certain events. To further mitigate the risk of counterparty default, the Company maintains collateral agreements with certain of its counterparties and clearing agencies, which require both parties to maintain cash deposits in the event the fair values of the derivative financial instruments exceed established thresholds. As of June 30, 2015, the Company has received cash deposits from counterparties of \$75.9 million and placed cash deposits of \$211.4 million in accounts maintained by counterparties, of which the amounts are netted on a counterparty basis and classified within restricted cash, due from counterparties, or due to counterparties on the Company's condensed consolidated balance sheet.

#### Non-Risk Management Activities

The Company has entered into certain financial instruments that are considered derivative contracts under ASC 815 that are not for purposes of hedging. These contracts are currently limited to forward purchase commitments, TBAs and inverse interest-only RMBS.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

Commitments to Purchase Residential Mortgage Loans Held-for-Sale. Prior to a mortgage loan purchase, the Company may enter into forward purchase commitments with counterparties whereby the Company commits to purchasing the loans at a particular interest rate, provided the borrower elects to close the loan. These commitments to purchase mortgage loans have been defined as derivatives and are, therefore, recorded on the Company's condensed consolidated balance sheets as assets or liabilities and measured at fair value. Subsequent changes in fair value are recorded on the Company's condensed consolidated balance sheets as adjustments to the carrying value of these assets or liabilities with a corresponding adjustment recognized in current period earnings. As of June 30, 2015 and December 31, 2014, the Company had outstanding commitments to purchase \$626.7 million and \$554.8 million of mortgage loans, subject to fallout if the loans do not close, with a fair value asset of \$0.1 million and a fair value liability of \$2.6 million at June 30, 2015 and a fair value asset of \$1.3 million at December 31, 2014, respectively. Inverse Interest-Only Securities. As of June 30, 2015 and December 31, 2014, inverse interest-only securities with a carrying value of \$178.8 million and \$188.6 million, including accrued interest receivable of \$1.9 million and \$2.2 million, respectively, are accounted for as derivative financial instruments in the condensed consolidated financial statements. The following table presents the amortized cost and carrying value (which approximates fair value) of inverse interest-only securities as of June 30, 2015 and December 31, 2014:

(in thousands)	June 30, 2015	December 31, 2014
Face Value	\$1,049,743	\$1,168,226
Unamortized premium	—	—
Unamortized discount		
Designated credit reserve	—	—
Net, unamortized	(891,752	) (991,715
Amortized Cost	157,991	176,511
Gross unrealized gains	21,068	14,162
Gross unrealized losses	(2,156	) (4,269
Carrying Value	\$176,903	\$186,404

## Note 13. Other Assets

Other assets as of June 30, 2015 and December 31, 2014 are summarized in the following table:

(in thousands)	June 30, 2015	December 31, 2014
Property and equipment at cost	\$5,492	\$4,849
Accumulated depreciation <sup>(1)</sup>	(2,593	) (1,941
Net property and equipment	2,899	2,908
Prepaid expenses	1,375	1,790
Income taxes receivable	7,175	—
Deferred tax assets, net	52,240	40,847
Servicing advances	30,828	27,490
Federal Home Loan Bank stock	125,250	100,010
Equity investments	3,000	3,000
Other receivables	13,793	12,534
Total other assets	\$236,560	\$188,579

(1) Depreciation expense for the three and six months ended June 30, 2015 was \$0.3 million and \$0.7 million, respectively.



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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

## Note 14. Other Liabilities

Other liabilities as of June 30, 2015 and December 31, 2014 are summarized in the following table:

(in thousands)	June 30, 2015	December 31, 2014
Accrued expenses	\$30,724	\$29,819
Accrued interest payable	18,984	23,772
Income taxes payable	39	1,375
Other	10,821	9,473
Total other liabilities	\$60,568	\$64,439

## Note 15. Fair Value

## Fair Value Measurements

ASC 820, Fair Value Measurements and Disclosures, or ASC 820, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices available in active markets (i.e., observable inputs) and the lowest priority to data lacking transparency (i.e., unobservable inputs). Additionally, ASC 820 requires an entity to consider all aspects of nonperformance risk, including the entity's own credit standing, when measuring fair value of a liability.

ASC 820 establishes a three-level hierarchy to be used when measuring and disclosing fair value. An instrument's categorization within the fair value hierarchy is based on the lowest level of significant input to its valuation.

Following is a description of the three levels:

- Level 1 Inputs are quoted prices in active markets for identical assets or liabilities as of the measurement date under current market conditions. Additionally, the entity must have the ability to access the active market and the quoted prices cannot be adjusted by the entity.
- Level 2 Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets for identical or similar assets or liabilities; or inputs that are observable or can be corroborated by observable market data by correlation or other means for substantially the full-term of the assets or liabilities. Unobservable inputs are supported by little or no market activity. The unobservable inputs represent the assumptions that market participants would use to price the assets and liabilities, including risk. Generally,
- Level 3 Level 3 assets and liabilities are valued using pricing models, discounted cash flow methodologies, or similar techniques that require significant judgment or estimation.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

Following are descriptions of the valuation methodologies used to measure material assets and liabilities at fair value and details of the valuation models, key inputs to those models and significant assumptions utilized.

**Investment securities.** The Company holds a portfolio of AFS and trading securities that are carried at fair value in the condensed consolidated balance sheets. AFS securities are primarily comprised of Agency and non-Agency RMBS while the Company's U.S. Treasuries are classified as trading securities. The Company determines the fair value of its U.S. Treasuries and Agency RMBS based upon prices obtained from third-party pricing providers or broker quotes received using bid price, which are deemed indicative of market activity. The third-party pricing providers and brokers use pricing models that generally incorporate such factors as coupons, primary and secondary mortgage rates, rate reset period, issuer, prepayment speeds, credit enhancements and expected life of the security. In determining the fair value of its non-Agency RMBS, management judgment may be used to arrive at fair value that considers prices obtained from third-party pricing providers, broker quotes received and other applicable market data. If observable market prices are not available or insufficient to determine fair value due to principally illiquidity in the marketplace, then fair value is based upon internally developed models that are primarily based on observable market-based inputs but also include unobservable market data inputs (including prepayment speeds, delinquency levels, and credit losses). The Company did not hold any U.S. Treasuries at June 30, 2015. The Company classified 100% of its RMBS AFS securities reported at fair value as Level 2 at June 30, 2015. AFS securities account for 76.5% of all assets reported at fair value at June 30, 2015.

**Residential mortgage loans held-for-sale.** The Company holds residential mortgage loans held-for-sale that are carried at fair value in the condensed consolidated balance sheets as a result of a fair value option election. The Company determines fair value of its residential mortgage loans based on prices obtained from third-party pricing providers and other applicable market data. If observable market prices are not available or insufficient to determine fair value due principally to illiquidity in the marketplace, then fair value is based upon cash flow models that are primarily based on observable market-based inputs but also include unobservable market data inputs (including prepayment speeds, delinquency levels and credit losses). The Company classified 91.2% and 8.8% of its residential mortgage loans held-for-sale as Level 2 and Level 3 fair value assets, respectively, at June 30, 2015.

**Residential mortgage loans held-for-investment in securitization trusts.** The Company recognizes on its condensed consolidated balance sheets residential mortgage loans held-for-investment in securitization trusts that are carried at fair value as a result of a fair value option election. An entity is allowed to measure both the financial assets and financial liabilities of a qualifying CFE it consolidates using the fair value of either the CFE's financial assets or financial liabilities, whichever is more observable. As the Company's securitization trusts are considered qualifying CFEs, the Company determines the fair value of these residential mortgage loans based on the fair value of its collateralized borrowings in securitization trusts and its retained interests from the Company's on-balance sheet securitizations (eliminated in consolidation in accordance with U.S. GAAP), as the fair value of these instruments is more observable. The Company classified 100% of its residential mortgage loans held-for-investment in securitization trusts as Level 2 fair value assets at June 30, 2015.

**Mortgage servicing rights.** The Company holds a portfolio of MSR that are carried at fair value on the condensed consolidated balance sheets. The Company determines fair value of its MSR based on prices obtained from third-party pricing providers. Although MSR transactions are observable in the marketplace, the valuation is based upon cash flow models that include unobservable market data inputs (including prepayment speeds, delinquency levels and discount rates). As a result, the Company classified 100% of its MSR as Level 3 fair value assets at June 30, 2015.

**Derivative instruments.** The Company may enter into a variety of derivative financial instruments as part of its hedging strategies. The Company principally executes over-the-counter, or OTC, derivative contracts, such as interest rate swaps, swaptions, put and call options for TBAs and U.S. Treasuries, credit default swaps, constant maturity swaps and Markit IOS total return swaps. The Company utilizes third-party pricing providers to value its financial derivative instruments. The Company classified 100% of the interest rate swaps, swaptions, put and call options for TBAs and U.S. Treasuries, credit default swaps, constant maturity swaps and total returns swaps reported at fair value



as Level 2 at June 30, 2015.

The Company also enters into certain other derivative financial instruments, such as TBAs, short U.S. Treasuries and inverse interest-only securities. These instruments are similar in form to the Company's AFS and trading securities and the Company utilizes a pricing service to value TBAs and broker quotes to value short U.S. Treasuries and inverse interest-only securities. The Company classified 100% of its inverse interest-only securities at fair value as Level 2 at June 30, 2015. The Company reported 100% of its TBAs as Level 1 as of June 30, 2015. The Company did not hold any short U.S. Treasuries at June 30, 2015.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

The Company may also enter into forward purchase commitments on residential mortgage loans whereby the Company commits to purchasing the loans at a particular interest rate. The fair value of these derivatives is determined based on prices currently offered in the marketplace for new commitments. Fallout assumptions if the borrower elects not to close the loan are applied to the pricing. As of June 30, 2015, the Company had outstanding commitments to purchase \$626.7 million of mortgage loans, subject to fallout if the loans do not close, with a fair value asset of \$0.1 million and a fair value liability of \$2.6 million. The Company classified 100% of the forward purchase commitments reported at fair value as Level 2 at June 30, 2015.

The Company's risk management committee governs trading activity relating to derivative instruments. The Company's policy is to minimize credit exposure related to financial derivatives used for hedging by limiting the hedge counterparties to major banks, financial institutions, exchanges, and private investors who meet established capital and credit guidelines as well as by limiting the amount of exposure to any individual counterparty.

The Company has netting arrangements in place with all derivative counterparties pursuant to standard documentation developed by ISDA, or central clearing exchange agreements, in the case of centrally cleared interest rate swaps. Additionally, both the Company and the counterparty or clearing agency are required to post cash collateral based upon the net underlying market value of the Company's open positions with the counterparty. Posting of cash collateral typically occurs daily, subject to certain dollar thresholds. Due to the existence of netting arrangements, as well as frequent cash collateral posting at low posting thresholds, credit exposure to the Company and/or to the counterparty or clearing agency is considered materially mitigated. Based on the Company's assessment, there is no requirement for any additional adjustment to derivative valuations specifically for credit.

Collateralized borrowings in securitization trusts. The Company recognizes on its condensed consolidated balance sheets collateralized borrowings that are carried at fair value as a result of a fair value option election. In determining the fair value of its collateralized borrowings, management judgment may be used to arrive at fair value that considers prices obtained from third-party pricing providers, broker quotes received and other applicable market data. If observable market prices are not available or insufficient to determine fair value due to principally illiquidity in the marketplace, then fair value is based upon internally developed models that are primarily based on observable market-based inputs but also include unobservable market data inputs (including prepayment speeds, delinquency levels, and credit losses). The Company classified 100% of its collateralized borrowings in securitization trusts as Level 2 fair value liabilities at June 30, 2015.

The following tables display the Company's assets and liabilities measured at fair value on a recurring basis. The Company often economically hedges the fair value change of its assets or liabilities with derivatives and other financial instruments. The tables below display the hedges separately from the hedged items, and therefore do not directly display the impact of the Company's risk management activities.

(in thousands)	Recurring Fair Value Measurements			
	At June 30, 2015			
	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Available-for-sale securities	\$—	\$12,807,658	\$—	\$12,807,658
Residential mortgage loans held-for-sale	—	633,578	61,500	695,078
Residential mortgage loans held-for-investment in securitization trusts	—	2,449,199	—	2,449,199
Mortgage servicing rights	—	—	437,576	437,576
Derivative assets	—	347,322	—	347,322
<b>Total assets</b>	<b>\$—</b>	<b>\$16,237,757</b>	<b>\$499,076</b>	<b>\$16,736,833</b>
<b>Liabilities</b>				
Collateralized borrowings in securitization trusts	\$—	\$1,714,735	\$—	\$1,714,735
Derivative liabilities	5,187	17,288	—	22,475

Total liabilities	\$5,187	\$1,732,023	\$—	\$1,737,210
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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

(in thousands)	Recurring Fair Value Measurements At December 31, 2014			Total
	Level 1	Level 2	Level 3	
<b>Assets</b>				
Available-for-sale securities	\$—	\$14,341,102	\$—	\$14,341,102
Trading securities	1,997,656	—	—	1,997,656
Residential mortgage loans held-for-sale	—	500,159	35,553	535,712
Residential mortgage loans held-for-investment in securitization trusts	—	1,744,746	—	1,744,746
Mortgage servicing rights	—	—	452,006	452,006
Derivative assets	10,350	370,441	—	380,791
<b>Total assets</b>	<b>\$2,008,006</b>	<b>\$16,956,448</b>	<b>\$487,559</b>	<b>\$19,452,013</b>
<b>Liabilities</b>				
Collateralized borrowings in securitization trusts	\$—	\$1,209,663	\$—	\$1,209,663
Derivative liabilities	17,687	72,546	—	90,233
<b>Total liabilities</b>	<b>\$17,687</b>	<b>\$1,282,209</b>	<b>\$—</b>	<b>\$1,299,896</b>

The Company may be required to measure certain assets or liabilities at fair value from time to time. These periodic fair value measures typically result from application of certain impairment measures under U.S. GAAP. These items would constitute nonrecurring fair value measures under ASC 820. As of June 30, 2015, the Company did not have any assets or liabilities measured at fair value on a nonrecurring basis in the periods presented.

The valuation of Level 3 instruments requires significant judgment by the third-party pricing providers and/or management. The third-party pricing providers and/or management rely on inputs such as market price quotations from market makers (either market or indicative levels), original transaction price, recent transactions in the same or similar instruments, and changes in financial ratios or cash flows to determine fair value. Level 3 instruments may also be discounted to reflect illiquidity and/or non-transferability, with the amount of such discount estimated by the third-party pricing provider in the absence of market information. Assumptions used by the third-party pricing provider due to lack of observable inputs may significantly impact the resulting fair value and therefore the Company's condensed consolidated financial statements. The Company's valuation committee reviews all valuations that are based on pricing information received from a third-party pricing provider. As part of this review, prices are compared against other pricing or input data points in the marketplace, along with internal valuation expertise, to ensure the pricing is reasonable. In addition, the Company performs back-testing of pricing information to validate price information and identify any pricing trends of a third-party price provider.

In determining fair value, third-party pricing providers use various valuation approaches, including market and income approaches. Inputs that are used in determining fair value of an instrument may include pricing information, credit data, volatility statistics, and other factors. In addition, inputs can be either observable or unobservable. The availability of observable inputs can vary by instrument and is affected by a wide variety of factors, including the type of instrument, whether the instrument is new and not yet established in the marketplace and other characteristics particular to the instrument. The third-party pricing provider uses prices and inputs that are current as of the measurement date, including during periods of market dislocations. In periods of market dislocation, the availability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified to or from various levels within the fair value hierarchy.

Securities for which market quotations are readily available are valued at the bid price (in the case of long positions) or the ask price (in the case of short positions) at the close of trading on the date as of which value is determined. Exchange-traded securities for which no bid or ask price is available are valued at the last traded price. OTC derivative contracts, including interest rate swaps, swaptions, credit default swaps and Markit IOS total return swaps,

are valued by the Company using observable inputs, specifically quotations received from third-party pricing providers, and are therefore classified within Level 2.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

The following table presents the reconciliation for all of the Company's Level 3 assets measured at fair value on a recurring basis:

(in thousands)	Level 3 Recurring Fair Value Measurements			
	Three Months Ended		Six Months Ended	
	June 30, 2015		June 30, 2015	
	Residential Mortgage Loans Held-For-Sale	Mortgage Servicing Rights	Residential Mortgage Loans Held-For-Sale	Mortgage Servicing Rights
Beginning of period level 3 fair value	\$70,149	\$410,229	\$35,553	\$452,006
Gains (losses) included in net income (loss):				
Realized gains (losses)	10,491	(7,805 )	15,612	(17,119 )
Unrealized gains (losses)	30	(1) 25,440	(3) 777	(1) (17,649 ) (3)
Total net gains (losses) included in net income (loss)	10,521	17,635	16,389	(34,768 )
Other comprehensive income	—	—	—	—
Purchases	61,054	4,799	131,720	9,350
Sales	(51,981 )	—	(75,890 )	—
Settlements	(28,243 )	4,913	(46,272 )	10,988
Gross transfers into level 3	—	—	—	—
Gross transfers out of level 3	—	—	—	—
End of period level 3 fair value	\$61,500	\$437,576	\$61,500	\$437,576
Change in unrealized gains or losses for the period included in earnings for assets held at the end of the reporting period	\$370	(2) \$25,440	(4) \$352	(2) \$(17,649 ) (4)

For the three and six months ended June 30, 2015, the change in unrealized gains or losses on residential mortgage (1) loans held-for-sale was recorded in (loss) gain on residential mortgage loans held-for-sale on the condensed consolidated statements of comprehensive income.

(2) For the three and six months ended June 30, 2015, the change in unrealized gains or losses on residential mortgage loans held-for-sale that were held at the end of the reporting period was recorded in (loss) gain on residential mortgage loans held-for-sale on the condensed consolidated statements of comprehensive income.

(3) For the three and six months ended June 30, 2015, the change in unrealized gains or losses on MSR was recorded in gain (loss) on servicing asset on the condensed consolidated statements of comprehensive income.

(4) For the three and six months ended June 30, 2015, the change in unrealized gains or losses on MSR that were held at the end of the reporting period was recorded in gain (loss) on servicing asset on the condensed consolidated statements of comprehensive income.

The Company did not incur transfers between Level 1, Level 2 or Level 3 during the six months ended June 30, 2015. Transfers between Levels are deemed to take place on the first day of the reporting period in which the transfer has taken place.

The Company used a third-party pricing provider in the fair value measurement of its Level 3 residential mortgage loans held-for-sale. The significant unobservable inputs used by the third-party pricing provider included expected

default, severity and discount rate. Significant increases (decreases) in any of the inputs in isolation may result in significantly lower (higher) fair value measurement.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

The Company also used a third-party pricing provider in the fair value measurement of its Level 3 MSR. The table below presents information about the significant unobservable inputs used by the third-party pricing provider in the fair value measurement of the Company's MSR classified as Level 3 fair value assets at June 30, 2015:

As of June 30, 2015

Valuation Technique	Unobservable Input <sup>(1)</sup>	Range	Weighted Average
Discounted cash flow	Constant prepayment speed	9.5 - 12.8 %	11.2%
	Delinquency	4.3 - 4.9 %	4.6%
	Discount rate	8.1 - 10.7 %	9.4%

(1) Significant increases (decreases) in any of the inputs in isolation may result in significantly lower (higher) fair value measurement. A change in the assumption used for discount rates may be accompanied by a directionally similar change in the assumption used for the probability of delinquency and a directionally opposite change in the assumption used for prepayment rates.

## Fair Value Option for Financial Assets and Financial Liabilities

The Company elected the fair value option for the residential mortgage loans it has acquired. The fair value option was elected to mitigate earnings volatility by better matching the accounting for the assets with the related hedges. The mortgage loans are carried within residential mortgage loans held-for-sale on the condensed consolidated balance sheets. The Company's policy is to separately record interest income on these fair value elected loans. Upfront fees and costs related to the fair value elected loans are not deferred or capitalized. Fair value adjustments are reported in (loss) gain on residential mortgage loans held-for-sale on the condensed consolidated statements of comprehensive income. The fair value option is irrevocable once the loan is acquired.

The Company also elected the fair value option for both the residential mortgage loans held-for-investment in securitization trusts and the collateralized borrowings in securitization trusts carried on the condensed consolidated balance sheets. The fair value option was elected to better reflect the economics of the Company's retained interests. The Company's policy is to separately record interest income on the fair value elected loans and interest expense on the fair value elected borrowings. Upfront fees and costs are not deferred or capitalized. Fair value adjustments are reported in other (loss) income on the condensed consolidated statements of comprehensive income.

The following tables summarize the fair value option elections and information regarding the line items and amounts recognized in the condensed consolidated statements of comprehensive income for each fair value option-elected item.

(in thousands)	Three Months Ended June 30, 2015					
	Interest income (expense)	(Loss) gain on residential mortgage loans held-for-sale	Other (loss) income	Total included in net income	Change in fair value due to credit risk	
<b>Assets</b>						
Residential mortgage loans held-for-sale	\$7,518 <sup>(1)</sup>	\$(3,019)	\$—	\$4,499	\$272	<sup>(2)</sup>
Residential mortgage loans held-for-investment in securitization trusts	21,830 <sup>(1)</sup>	—	(49,143)	(27,313)	—	<sup>(3)</sup>
<b>Liabilities</b>						
Collateralized borrowings in securitization trusts	(13,131)	—	31,536	18,405	—	<sup>(3)</sup>
<b>Total</b>	<b>\$16,217</b>	<b>\$(3,019)</b>	<b>\$(17,607)</b>	<b>\$(4,409)</b>	<b>\$272</b>	





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## TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

(in thousands)	Three Months Ended June 30, 2014					Change in fair value due to credit risk
	Interest income (expense)		(Loss) gain on residential mortgage loans held-for-sale	Other (loss) income	Total included in net income	
<b>Assets</b>						
Residential mortgage loans held-for-sale	\$2,699	(1)	\$7,638	\$—	\$10,337	\$1,036 (2)
Residential mortgage loans held-for-investment in securitization trusts	7,761	(1)	—	36,631	44,392	— (3)
<b>Liabilities</b>						
Collateralized borrowings in securitization trusts	(5,592 )		—	(15,802 )	(21,394 )	— (3)
<b>Total</b>	<b>\$4,868</b>		<b>\$7,638</b>	<b>\$20,829</b>	<b>\$33,335</b>	<b>\$1,036</b>
(in thousands)	Six Months Ended June 30, 2015					Change in fair value due to credit risk
	Interest income (expense)		(Loss) gain on residential mortgage loans held-for-sale	Other (loss) income	Total included in net income	
<b>Assets</b>						
Residential mortgage loans held-for-sale	\$11,789	(1)	\$6,047	\$—	\$17,836	\$30 (2)
Residential mortgage loans held-for-investment in securitization trusts	40,067	(1)	—	(49,094 )	(9,027 )	— (3)
<b>Liabilities</b>						
Collateralized borrowings in securitization trusts	(23,839 )		—	28,569	4,730	— (3)
<b>Total</b>	<b>\$28,017</b>		<b>\$6,047</b>	<b>\$(20,525 )</b>	<b>\$13,539</b>	<b>\$30</b>

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## TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

(in thousands)	Six Months Ended June 30, 2014					Change in fair value due to credit risk
	Interest income (expense)		(Loss) gain on residential mortgage loans held-for-sale	Other (loss) income	Total included in net income	
<b>Assets</b>						
Residential mortgage loans held-for-sale	\$7,285	(1)	\$4,874	\$—	\$12,159	\$1,069 (2)
Residential mortgage loans held-for-investment in securitization trusts	15,654	(1)	—	38,606	54,260	— (3)
<b>Liabilities</b>						
Collateralized borrowings in securitization trusts	(10,945)		—	(17,463)	(28,408)	— (3)
<b>Total</b>	<b>\$11,994</b>		<b>\$4,874</b>	<b>\$21,143</b>	<b>\$38,011</b>	<b>\$1,069</b>

Interest income on residential mortgage loans held-for-sale and residential mortgage loans held-for-investment in (1) securitization trusts is measured by multiplying the unpaid principal balance on the loans by the coupon rate and the number of days of interest due.

(2) The change in fair value due to credit risk on residential mortgage loans held-for-sale was quantified by holding yield constant in the cash flow model in order to isolate credit risk component.

(3) The change in fair value on residential mortgage loans held-for-investment in securitization trusts and collateralized borrowings in securitization trusts was due entirely to changes in market interest rates.

The table below provides the fair value and the unpaid principal balance for the Company's fair value option-elected loans and collateralized borrowings.

(in thousands)	June 30, 2015		December 31, 2014	
	Unpaid Principal Balance	Fair Value (1)	Unpaid Principal Balance	Fair Value (1)
<b>Residential mortgage loans held-for-sale</b>				
Total loans	\$703,966	\$695,078	\$534,101	\$535,712
Nonaccrual loans	\$48,379	\$42,212	\$26,405	\$20,574
Loans 90+ days past due	\$45,547	\$39,525	\$25,263	\$19,675
<b>Residential mortgage loans held-for-investment in securitization trusts</b>				
Total loans	\$2,431,573	\$2,449,199	\$1,699,748	\$1,744,746
Nonaccrual loans	\$862	\$865	\$—	\$—
Loans 90+ days past due	\$—	\$—	\$—	\$—
<b>Collateralized borrowings in securitization trusts</b>				
Total borrowings	\$1,743,289	\$1,714,735	\$1,218,589	\$1,209,663

(1) Excludes accrued interest receivable.

## Fair Value of Financial Instruments

In accordance with ASC 820, the Company is required to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the condensed consolidated balance sheets, for which fair value can be estimated.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

The following describes the Company's methods for estimating the fair value for financial instruments. Descriptions are not provided for those items that have zero balances as of the current balance sheet date.

AFS securities, trading securities, residential mortgage loans held-for-sale, residential mortgage loans held-for-investment in securitization trusts, MSR, derivative assets and liabilities, and collateralized borrowings in securitization trusts are recurring fair value measurements; carrying value equals fair value. See discussion of valuation methods and assumptions within the Fair Value Measurements section of this footnote.

Commercial real estate loans held-for-investment are carried at cost, net of any unamortized premiums or discounts, unless deemed impaired. Because the Company has not yet recorded any allowances for losses and the rate and terms of the one newly-issued senior mezzanine commercial real estate loan held are similar to those observed in the market, carrying value, or amortized cost, approximates fair value. The Company categorizes the fair value measurement of these assets as Level 2.

Cash and cash equivalents and restricted cash have a carrying value which approximates fair value because of the short maturities of these instruments. The Company categorizes the fair value measurement of these assets as Level 1. As a condition to membership in the FHLB, the Company is required to purchase and hold a certain amount of FHLB stock, which is considered a non-marketable, long-term investment, and is carried at cost. Because this stock can only be redeemed or sold at its par value, and only to the FHLB, carrying value, or cost, approximates fair value. The Company categorizes the fair value measurement of these assets as Level 3.

Equity investments include cost method investments for which fair value is not estimated. Carrying value, or cost, approximates fair value. The Company categorizes the fair value measurement of these assets as Level 3.

The carrying value of repurchase agreements and FHLB advances that mature in less than one year generally approximates fair value due to the short maturities. The Company holds \$3.0 billion of FHLB advances that are considered long-term. The Company's long-term FHLB advances have floating rates based on an index plus a spread and, for members of the FHLB, the credit spread is typically consistent with those demanded in the market.

Accordingly, the interest rates on these borrowings are at market and thus carrying value approximates fair value. The Company categorizes the fair value measurement of these liabilities as Level 2.

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at June 30, 2015 and December 31, 2014.

(in thousands)	June 30, 2015		December 31, 2014	
	Carrying Value	Fair Value	Carrying Value	Fair Value
<b>Assets</b>				
Available-for-sale securities	\$12,807,658	\$12,807,658	\$14,341,102	\$14,341,102
Trading securities	\$—	\$—	\$1,997,656	\$1,997,656
Residential mortgage loans held-for-sale	\$695,078	\$695,078	\$535,712	\$535,712
Residential mortgage loans held-for-investment in securitization trusts	\$2,449,199	\$2,449,199	\$1,744,746	\$1,744,746
Commercial real estate loans held-for-investment	\$45,605	\$45,605	\$—	\$—
Mortgage servicing rights	\$437,576	\$437,576	\$452,006	\$452,006
Cash and cash equivalents	\$933,579	\$933,579	\$1,005,792	\$1,005,792
Restricted cash	\$410,903	\$410,903	\$336,771	\$336,771
Derivative assets	\$347,322	\$347,322	\$380,791	\$380,791
Federal Home Loan Bank stock	\$125,250	\$125,250	\$100,010	\$100,010
Equity investments	\$3,000	\$3,000	\$3,000	\$3,000
<b>Liabilities</b>				
Repurchase agreements	\$9,422,803	\$9,422,803	\$12,932,463	\$12,932,463
Collateralized borrowings in securitization trusts	\$1,714,735	\$1,714,735	\$1,209,663	\$1,209,663
Federal Home Loan Bank advances	\$3,000,000	\$3,000,000	\$2,500,000	\$2,500,000

Derivative liabilities	\$22,475	\$22,475	\$90,233	\$90,233
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## TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

## Note 16. Repurchase Agreements

As of June 30, 2015, the Company had outstanding \$9.4 billion of repurchase agreements. Excluding the effect of the Company's interest rate swaps, the repurchase agreements had a weighted average borrowing rate of 0.75% and weighted average remaining maturities of 69 days as of June 30, 2015. As of December 31, 2014, the Company had outstanding \$12.9 billion of repurchase agreements, including repurchase agreements funding the Company's U.S. Treasuries of \$2.0 billion. Excluding the debt associated with the Company's U.S. Treasuries and the effect of the Company's interest rate swaps, the repurchase agreements had a weighted average borrowing rate of 0.72% and weighted average remaining maturities of 64 days as of December 31, 2014. As of December 31, 2014, the debt associated with the Company's U.S. Treasuries had a weighted average borrowing rate of 0.23%. The Company did not have any repurchase agreements collateralized by U.S. Treasuries as of June 30, 2015.

At June 30, 2015 and December 31, 2014, the repurchase agreement balances were as follows:

(in thousands)	June 30, 2015	December 31, 2014
Short-term	\$9,422,803	\$12,839,242
Long-term	—	93,221
Total	\$9,422,803	\$12,932,463

At June 30, 2015 and December 31, 2014, the repurchase agreements had the following characteristics and remaining maturities:

(in thousands)	June 30, 2015						Total Amount Outstanding
	Collateral Type						
	Agency RMBS	Non-Agency RMBS <sup>(1)</sup>	Agency Derivatives	Residential Mortgage Loans Held-for-Sale	Commercial Real Estate Loans Held-for-Investment		
Within 30 days	\$1,912,119	\$471,133	\$47,770	\$—	\$ 22,950		\$2,453,972
30 to 59 days	3,077,003	461,904	85,097	—	—		3,624,004
60 to 89 days	484,627	230,613	—	—	—		715,240
90 to 119 days	471,052	64,420	—	—	—		535,472
120 to 364 days	1,376,499	708,162	—	9,454	—		2,094,115
Total	\$7,321,300	\$1,936,232	\$132,867	\$9,454	\$ 22,950		\$9,422,803
Weighted average borrowing rate	0.45	% 1.85	% 1.03	% 2.63	% 1.84	% 0.75	%

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## TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

(in thousands)	December 31, 2014						Total Amount Outstanding
	Collateral Type						
	U.S Treasuries	Agency RMBS	Non-Agency RMBS <sup>(1)</sup>	Agency Derivatives	Residential Mortgage Loans Held-for-Sale		
Within 30 days	\$998,750	\$2,305,726	\$630,118	\$44,723	\$—	\$3,979,317	
30 to 59 days	—	3,568,049	945,032	82,344	—	4,595,425	
60 to 89 days	—	631,992	260,228	11,066	—	903,286	
90 to 119 days	—	317,155	117,395	—	—	434,550	
120 to 364 days	—	1,635,650	278,401	—	15,113	1,929,164	
Open maturity <sup>(2)</sup>	997,500	—	—	—	—	997,500	
One year and over	—	—	93,221	—	—	93,221	
<b>Total</b>	<b>\$1,996,250</b>	<b>\$8,458,572</b>	<b>\$2,324,395</b>	<b>\$138,133</b>	<b>\$15,113</b>	<b>\$12,932,463</b>	
Weighted average borrowing rate	0.23	% 0.42	% 1.79	% 0.99	% 3.03	% 0.64	%

(1) Includes repurchase agreements collateralized by retained interests from the Company's on-balance sheet securitizations, which are eliminated in consolidation in accordance with U.S. GAAP.

(2) Includes repurchase agreements collateralized by U.S. Treasuries with an open maturity period (i.e., rolling 1-day maturity) renewable at the discretion of either party to the agreements.

The following table summarizes assets at carrying values that are pledged or restricted as collateral for the future payment obligations of repurchase agreements:

(in thousands)	June 30, 2015	December 31, 2014
Available-for-sale securities, at fair value	\$10,284,534	\$11,874,783
Trading securities, at fair value	—	1,997,656
Residential mortgage loans held-for-sale, at fair value	10,545	19,123
Commercial real estate loans held-for-investment	45,605	—
Net economic interests in consolidated securitization trusts <sup>(1)</sup>	113,824	363,564
Cash and cash equivalents	15,000	14,117
Restricted cash	182,709	112,435
Due from counterparties	24,252	32,495
Derivative assets, at fair value	176,017	185,067
<b>Total</b>	<b>\$10,852,486</b>	<b>\$14,599,240</b>

(1) Includes the retained interests from the Company's on-balance sheet securitizations, which are eliminated in consolidation in accordance with U.S. GAAP.

Although the transactions under repurchase agreements represent committed borrowings until maturity, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral or fund margin calls.





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## Notes to the Condensed Consolidated Financial Statements (unaudited)

The following table summarizes certain characteristics of the Company's repurchase agreements and counterparty concentration at June 30, 2015 and December 31, 2014:

(dollars in thousands)	June 30, 2015				December 31, 2014			
	Amount Outstanding	Net Counterparty Exposure <sup>(1)</sup>	Percent of Equity	Weighted Average Days to Maturity	Amount Outstanding	Net Counterparty Exposure <sup>(1)</sup>	Percent of Equity	Weighted Average Days to Maturity
Royal Bank of Canada	\$1,161,333	\$316,965	8 %	119.6	\$1,373,549	\$401,194	10 %	83.8
Barclays Capital Inc.	789,908	265,129	7 %	59.5	1,346,085	365,879	9 %	50.5
All other counterparties <sup>(2) (3)</sup>	7,471,562	843,313	21 %	61.5	9,215,329	907,066	22 %	57.7
Total	\$9,422,803	\$1,425,407			\$11,934,963	\$1,674,139		

<sup>(1)</sup> Represents the net carrying value of the securities, residential mortgage loans held-for-sale and commercial real estate loans held-for-investment sold under agreements to repurchase, including accrued interest plus any cash or assets on deposit to secure the repurchase obligation, less the amount of the repurchase liability, including accrued interest. Payables due to broker counterparties for unsettled securities purchases are not included in the amounts presented above. However, at both June 30, 2015 and December 31, 2014, the Company did not have any such payables.

<sup>(2)</sup> Excludes \$997.5 million of repurchase agreements collateralized by U.S. Treasuries with a rolling 1-day maturity as of December 31, 2014.

<sup>(3)</sup> Represents amounts outstanding with 21 and 23 counterparties at June 30, 2015 and December 31, 2014, respectively.

The Company does not anticipate any defaults by its repurchase agreement counterparties. There can be no assurance, however, that any such default or defaults will not occur.

## Note 17. Collateralized Borrowings in Securitization Trusts, at Fair Value

The Company purchases subordinated debt and excess servicing rights from securitization trusts sponsored by either third parties or the Company's subsidiaries. The debt associated with the underlying residential mortgage loans held by the trusts, which are consolidated on the Company's condensed consolidated balance sheets, is classified as collateralized borrowings in securitization trusts and carried at fair value as a result of a fair value option election. See Note 3 - Variable Interest Entities for additional information regarding consolidation of the securitization trusts. As of June 30, 2015 and December 31, 2014, collateralized borrowings in securitization trusts had a carrying value of \$1.7 billion and \$1.2 billion with a weighted average interest rate of 3.6% for both period ends. The stated maturity dates for all collateralized borrowings were more than five years from both June 30, 2015 and December 31, 2014.

## Note 18. Federal Home Loan Bank of Des Moines Advances

The Company's wholly owned subsidiary, TH Insurance Holdings Company LLC, or TH Insurance, is a member in the FHLB. As a member of the FHLB, TH Insurance has access to a variety of products and services offered by the FHLB, including secured advances. As of June 30, 2015 and December 31, 2014, TH Insurance had \$3.0 billion and \$2.5 billion in outstanding secured advances with a weighted average borrowing rate of 0.35% and 0.34%, respectively, and had an additional \$1.0 billion of available uncommitted capacity for borrowings as of June 30, 2015. As of December 31, 2014, TH Insurance had no additional uncommitted capacity to borrow. To the extent TH Insurance has uncommitted capacity, it may be adjusted at the sole discretion of the FHLB.

The ability to borrow from the FHLB is subject to the Company's continued creditworthiness, pledging of sufficient eligible collateral to secure advances, and compliance with certain agreements with the FHLB. Each advance requires approval by the FHLB and is secured by collateral in accordance with the FHLB's credit and collateral guidelines, as may be revised from time to time by the FHLB. Eligible collateral may include conventional 1-4 family residential mortgage loans, commercial real estate loans, Agency RMBS and certain non-Agency RMBS with a rating of A and above.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

At June 30, 2015 and December 31, 2014, FHLB advances had the following remaining maturities:

(in thousands)	June 30, 2015	December 31, 2014
≤ 1 year	\$—	\$33,738
> 1 and ≤ 3 years	651,238	651,238
> 3 and ≤ 5 years	815,024	815,024
> 5 and ≤ 10 years	—	—
> 10 years	1,533,738	1,000,000
Total	\$3,000,000	\$2,500,000

The following table summarizes assets at carrying values that are pledged or restricted as collateral for the future payment obligations of FHLB advances:

(in thousands)	June 30, 2015	December 31, 2014
Available-for-sale securities, at fair value	\$2,268,550	\$2,284,532
Residential mortgage loans held-for-sale, at fair value	551,257	397,656
Net economic interests in consolidated securitization trusts <sup>(1)</sup>	491,270	80,732
Total	\$3,311,077	\$2,762,920

(1) Includes the retained interests from the Company's on-balance sheet securitizations, which are eliminated in consolidation in accordance with U.S. GAAP.

The FHLB retains the right to mark the underlying collateral for FHLB advances to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral. In addition, as a condition to membership in the FHLB, the Company is required to purchase and hold a certain amount of FHLB stock, which is based, in part, upon the outstanding principal balance of advances from the FHLB. At June 30, 2015 and December 31, 2014, the Company had stock in the FHLB totaling \$125.3 million and \$103.0 million, respectively, which is included in other assets on the condensed consolidated balance sheets. FHLB stock is considered a non-marketable, long-term investment, is carried at cost and is subject to recoverability testing under applicable accounting standards. This stock can only be redeemed or sold at its par value, and only to the FHLB. Accordingly, when evaluating FHLB stock for impairment, the Company considers the ultimate recoverability of the par value rather than recognizing temporary declines in value. As of June 30, 2015 and December 31, 2014, the Company had not recognized an impairment charge related to its FHLB stock.

## Note 19. Stockholders' Equity

## Distributions to Stockholders

The following table presents cash dividends declared by the Company on its common stock during the three months ended June 30, 2015, and the four immediately preceding quarters:

Declaration Date	Record Date	Payment Date	Cash Dividend Per Share
June 17, 2015	June 30, 2015	July 21, 2015	\$0.26
March 18, 2015	March 31, 2015	April 21, 2015	\$0.26
December 16, 2014	December 30, 2014	January 20, 2015	\$0.26
September 16, 2014	September 30, 2014	October 21, 2014	\$0.26
June 17, 2014	July 2, 2014	July 22, 2014	\$0.26



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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

## Accumulated Other Comprehensive Income

Accumulated other comprehensive income at June 30, 2015 and December 31, 2014 was as follows:

(in thousands)	June 30, 2015	December 31, 2014
Available-for-sale securities, at fair value		
Unrealized gains	\$711,813	\$891,820
Unrealized losses	(80,781	) (36,031
Accumulated other comprehensive income	\$631,032	\$855,789

## Reclassifications out of Accumulated Other Comprehensive Income

The following table summarizes reclassifications out of accumulated other comprehensive income for the three and six months ended June 30, 2015 and 2014:

(in thousands)	Affected Line Item in the Condensed Consolidated Statements of Comprehensive Income	Amount Reclassified out of Accumulated Other Comprehensive Income			
		Three Months Ended June 30,		Six Months Ended June 30,	
		2015	2014	2015	2014
Other-than-temporary-impairments on AFS securities	Total other-than-temporary impairment losses	\$ 170	\$—	\$297	\$212
Realized (gains) losses on sales of AFS securities	Gain (loss) on investment securities	(75,135	) (20,952	) (175,071	) 22,228
		\$(74,965	) \$(20,952	) \$(174,774)	) \$22,440

## Dividend Reinvestment and Direct Stock Purchase Plan

The Company sponsors a dividend reinvestment and direct stock purchase plan through which stockholders may purchase additional shares of the Company's common stock by reinvesting some or all of the cash dividends received on shares of the Company's common stock. Stockholders may also make optional cash purchases of shares of the Company's common stock subject to certain limitation detailed in the plan prospectus. An aggregate of 7.5 million shares of the Company's common stock were originally reserved for issuance under the plan. As of June 30, 2015, 249,650 shares have been issued under the plan for total proceeds of approximately \$2.6 million, of which 16,772 and 36,184 shares were issued for total proceeds of \$178,436 and \$378,700 during the three and six months ended June 30, 2015, respectively. During the three and six months ended June 30, 2014, 12,694 and 23,474 shares were issued under the plan for total proceeds for \$130,652 and \$240,792, respectively.

## Share Repurchase Program

On October 5, 2011, the Company's board of directors authorized a share repurchase program, which allows the Company to repurchase up to 10,000,000 shares of its common stock. On November 14, 2012, the board of directors authorized an increase in the share repurchase program of 15,000,000, for a total of 25,000,000 shares. Shares may be repurchased from time to time through privately negotiated transactions or open market transactions, pursuant to a trading plan in accordance with Rules 10b5-1 and 10b-18 under the Securities Exchange Act of 1934, as amended, or the Exchange Act, or by any combination of such methods. The manner, price, number and timing of share repurchases will be subject to a variety of factors, including market conditions and applicable SEC rules. The share repurchase program does not require the purchase of any minimum number of shares, and purchases may be commenced or suspended at any time without prior notice. As of June 30, 2015, 2,450,700 shares had been repurchased by the Company under the program for a total cost of \$23.9 million; however, no shares were repurchased

during the three and six months ended June 30, 2015 and 2014.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

## At-the-Market Offering

On May 25, 2012, the Company entered into an equity distribution agreement under which the Company may sell up to an aggregate of 20,000,000 shares of its common stock from time to time in any method permitted by law deemed to be an “at the market” offering as defined in Rule 415 under the Securities Act of 1933, as amended, or the Securities Act. On May 22, 2015, the Company entered into an amendment to the equity distribution agreement providing that any subsequent offers or sales of the Company’s common stock under the equity distribution agreement shall be made pursuant to a new prospectus supplement, which was filed on the same date. As of June 30, 2015, 7,585,869 shares of common stock have been sold under the equity distribution agreement for total accumulated net proceeds of approximately \$77.6 million; however, no shares were sold during the three and six months ended June 30, 2015 and 2014.

## Note 20. Equity Incentive Plan

On May 14, 2015, the Company’s stockholders approved the Company’s Second Restated 2009 Equity Incentive Plan, which replaced the previous Restated 2009 Equity Incentive Plan, both of which are referred to collectively as the Plan. This stockholder approval effectuated, among other changes, an increase in the number of shares of common stock available for issuance under the Plan by 10,000,000 shares.

On May 20, 2014 and May 14, 2015, the Company granted 52,180 and 35,521 shares of common stock, respectively, to its independent directors pursuant to the Plan. The estimated fair value of these awards was \$10.31 and \$10.53 per share on grant date, based on the closing price of the Company’s common stock on the NYSE on such date. The grants vested immediately.

Additionally, on February 5, 2014, February 12, 2015 and May 14, 2015, the Company granted 1,103,162, 206,275 and 909,299 shares of restricted common stock, respectively, to key employees of PRCM Advisers pursuant to the Plan. The estimated fair value of these awards was \$9.79, \$10.30 and \$10.53 per share on grant date, based on the closing market price of the Company’s common stock on the NYSE on such date. However, as the cost of these awards is measured at fair value at each reporting date based on the price of the Company’s stock as of period end in accordance with ASC 505, Equity, or ASC 505, the fair value of these awards as of June 30, 2015 was \$9.74 per share based on the closing market price of the Company’s common stock on the NYSE on such date. The shares underlying the grants vest in three equal annual installments commencing on the first anniversary of the grant date, as long as such grantee complies with the terms and conditions of his or her applicable restricted stock award agreement. The following table summarizes the activity related to restricted common stock for the six months ended June 30, 2015 and 2014:

(in thousands)	Six Months Ended June 30, 2015		2014	
	Shares	Weighted Average Grant Date Fair Market Value	Shares	Weighted Average Grant Date Fair Market Value
Outstanding at Beginning of Period	2,002,406	\$10.32	1,024,459	\$11.22
Granted	1,151,095	10.49	1,155,342	9.81
Vested	(711,124)	(10.45)	(395,986)	(11.10)
Forfeited	(55,474)	(10.19)	(3,065)	(9.79)
Outstanding at End of Period	2,386,903	\$10.36	1,780,750	\$10.34

For the three and six months ended June 30, 2015, the Company recognized compensation costs related to restricted common stock of \$2.9 million and \$5.6 million, respectively. For the three and six months ended June 30, 2014, the Company recognized compensation costs related to restricted common stock of \$3.7 million and \$6.8 million,



respectively.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Condensed Consolidated Financial Statements (unaudited)

## Note 21. Income Taxes

For the three and six months ended June 30, 2015 and 2014, the Company qualified to be taxed as a REIT under the Code for U.S. federal income tax purposes. As long as the Company qualifies as a REIT, the Company generally will not be subject to U.S. federal income taxes on its taxable income to the extent it annually distributes its net taxable income to stockholders, and does not engage in prohibited transactions. The Company intends to distribute 100% of its REIT taxable income and comply with all requirements to continue to qualify as a REIT. The majority of states also recognize the Company's REIT status. The Company's TRSs file separate tax returns and are fully taxed as standalone U.S. C-corporations. It is assumed that the Company will retain its REIT status and will incur no REIT level taxation as it intends to comply with the REIT regulations and annual distribution requirements.

During the three and six months ended June 30, 2015, the Company's TRSs recognized a benefit from income taxes of \$7.0 million and \$17.6 million, respectively, which was primarily due to losses incurred on derivative instruments held in the Company's TRSs. During the three and six months ended June 30, 2014, the Company's TRSs recognized a benefit from income taxes of \$23.3 million and \$57.2 million, respectively, which was primarily due to losses incurred on derivative instruments held in the Company's TRSs.

Based on the Company's evaluation, it has been concluded that there are no significant uncertain tax positions requiring recognition in the Company's condensed consolidated financial statements of a contingent tax liability for uncertain tax positions.

## Note 22. Earnings Per Share

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted earnings per share, or EPS, for the three and six months ended June 30, 2015 and 2014:

(in thousands, except share data)	Three Months Ended		Six Months Ended	
	June 30, 2015	2014	June 30, 2015	2014
Numerator:				
Net income	\$221,501	\$39,657	\$316,294	\$10,512
Denominator:				
Weighted average common shares outstanding	364,919,352	364,078,669	364,775,066	363,996,652
Weighted average restricted stock shares	2,154,779	1,999,455	2,017,393	1,849,643
Basic and diluted weighted average shares outstanding	367,074,131	366,078,124		