TWO HARBORS INVESTMENT CORP.
Form 10-Q
May 07, 2015

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: March 31, 2015

Commission File Number 001-34506

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

Maryland (State or Other Jurisdiction of Incorporation or Organization)	27-0312904 (I.R.S. Employer Identification No.)
590 Madison Avenue, 36th Floor New York, New York	10022
(Address of Principal Executive Offices)	(Zip Code)

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
As of May 7, 2015 there were 366,576,359 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)

	March 31, 2015	December 31, 2014
ASSETS	(unaudited)	
Available-for-sale securities, at fair value	$14,342,845	$14,341,102
Trading securities, at fair value	2,010,000	1,997,656
Residential mortgage loans held-for-sale, at fair value	568,582	535,712
Residential mortgage loans held-for-investment in securitization trusts, at fair value	2,170,206	1,744,746
Commercial real estate loans held-for-investment	45,556	—
Mortgage servicing rights, at fair value	410,229	452,006
Cash and cash equivalents	1,020,338	1,005,792
Restricted cash	441,158	336,771
Accrued interest receivable	62,516	65,529
Due from counterparties	30,723	35,625
Derivative assets, at fair value	362,646	380,791
Other assets	213,256	188,579
Total Assets (1)	$21,678,055	$21,084,309
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Repurchase agreements	$13,094,878	$12,932,463
Collateralized borrowings in securitization trusts, at fair value	1,400,571	1,209,663
Federal Home Loan Bank advances	2,625,000	2,500,000
Derivative liabilities, at fair value	155,149	90,233
Due to counterparties	186,352	124,206
Dividends payable	95,307	95,263
Other liabilities	59,303	64,439
Total liabilities (1)	17,616,560	17,016,267
Stockholders' Equity		
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 366,566,133 and 366,395,920 shares issued and outstanding, respectively	3,666	3,664
Additional paid-in capital	3,813,914	3,811,027
Accumulated other comprehensive income	849,858	855,789
Cumulative earnings	1,287,338	1,195,536
Cumulative distributions to stockholders	(1,893,281)	(1,797,974)
Total stockholders' equity	4,061,495	4,068,042
Total Liabilities and Stockholders' Equity	$21,678,055	$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 March 31, 2015 and December 31, 2014, assets of the VIEs totaled $2,227,499 and $1,754,943, and liabilities of the VIEs totaled $1,411,375 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 March 31,	
	2015	2014
	(unaudited)	
Interest income:		
Available-for-sale securities	$135,525	$123,913
Trading securities	4,695	1,926
Residential mortgage loans held-for-sale	4,271	4,586
Residential mortgage loans held-for-investment in securitization trusts	18,237	7,893
Commercial real estate loans held-for-investment	44	—
Cash and cash equivalents	197	217
Total interest income	162,969	138,535
Interest expense:		
Repurchase agreements	20,565	20,572
Collateralized borrowings in securitization trusts	10,708	5,353
Federal Home Loan Bank advances	2,230	153
Total interest expense	33,503	26,078
Net interest income	129,466	112,457
Other-than-temporary impairments:		
Total other-than-temporary impairment losses	(127)	(212)
Non-credit portion of loss recognized in other comprehensive (loss) income	—	—
Net other-than-temporary credit impairment losses	(127)	(212)
Other income:		
Gain (loss) on investment securities	129,457	(38,655)
Loss on interest rate swap and swaption agreements	(126,443)	(105,528)
Gain on other derivative instruments	2,967	5,801
Gain (loss) on residential mortgage loans held-for-sale	9,092	(3,181)
Servicing income	32,087	30,441
Loss on servicing asset	(52,403)	(32,760)
Other (loss) income	(1,857)	460
Total other loss	(7,100)	(143,422)
Expenses:		
Management fees	12,721	12,111
Securitization deal costs	2,611	—
Servicing expenses	6,716	5,225
Other operating expenses	16,055	14,534
Total expenses	38,103	31,870
Income (loss) before income taxes	84,136	(63,047)
Benefit from income taxes	(10,657)	(33,902)
Net income (loss)	$94,793	$(29,145)
Basic and diluted earnings (loss) per weighted average common share	$0.26	$(0.08)
Dividends declared per common share	$0.26	$0.26
Basic and diluted weighted average number of shares of common stock outstanding	366,507,657	365,611,890

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 March 31,	
	2015	2014
	(unaudited)	
Comprehensive income:		
Net income (loss)	$94,793	$(29,145)
Other comprehensive (loss) income:		
Unrealized (loss) gain on available-for-sale securities, net	(5,931)	181,735
Other comprehensive (loss) income	(5,931)	181,735
Comprehensive income	$88,862	$152,590

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 loss	—	—	—	—	(29,145)	—	(29,145)
Other comprehensive income before reclassifications	—	—	—	138,343	—	—	138,343
Amounts reclassified from accumulated other comprehensive income	—	—	—	43,392	—	—	43,392
Net other comprehensive income	—	—	—	181,735	—	—	181,735
Issuance of common stock, net of offering costs	10,780	—	110	—	—	—	110
Common dividends declared	—	—	—	—	—	(95,172)	(95,172)
Non-cash equity award compensation	1,100,097	11	6,470	—	—	—	6,481
Balance, March 31, 2014	366,046,045	$3,660	$3,801,952	$ 626,470	$999,252	$(1,512,330)	$3,919,004
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	—	—	—	—	94,793	—	94,793
Other comprehensive income before reclassifications	—	—	—	93,877	—	—	93,877
Amounts reclassified from accumulated other comprehensive income	—	—	—	(99,808)	—	—	(99,808)
Net other comprehensive loss	—	—	—	(5,931)	—	—	(5,931)
	19,412	—	200	—	—	—	200

Issuance of common stock, net of offering costs							
Common dividends declared	—	—	—	—	—	(95,307)	(95,307)
Non-cash equity award compensation	150,801	2	2,687	—	—	—	2,689
Balance, March 31, 2015	366,566,133	$3,666	$3,813,914	$ 849,858	$1,287,338	$(1,893,281)	$4,061,495

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)

	Three Months Ended March 31,	
	2015	2014
Cash Flows From Operating Activities:	(unaudited)	
Net income (loss)	$94,793	$(29,145)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Amortization of premiums and discounts on investment securities, net	7,554	(26)
Other-than-temporary impairment losses	127	212
Realized and unrealized (gains) losses on investment securities, net	(129,457)	38,655
(Gain) loss on residential mortgage loans held-for-sale	(9,092)	3,181
Loss (gain) on residential mortgage loans held-for-investment and collateralized borrowings in securitization trusts	2,919	(313)
Loss on servicing asset	52,403	32,760
(Gain) loss on termination and option expiration of interest rate swaps and swaptions	(11,775)	1,240
Unrealized loss on interest rate swaps and swaptions	110,693	90,452
Unrealized (gain) loss on other derivative instruments	(4,425)	1,162
Equity based compensation	2,689	6,481
Depreciation of fixed assets	319	207
Amortization of intangible assets	—	400
Purchases of residential mortgage loans held-for-sale	(662,064)	(28,867)
Proceeds from sales of residential mortgage loans held-for-sale	23,831	402,298
Proceeds from repayment of residential mortgage loans held-for-sale	24,947	7,334
Net change in assets and liabilities:		
Decrease in accrued interest receivable	3,013	3,579
Increase in deferred income taxes, net	(11,537)	(41,799)
Increase in income taxes receivable	(293)	(321)
Decrease/(increase) in prepaid and fixed assets	25	(400)
Decrease/(increase) in other receivables	396	(10,516)
Increase in servicing advances	(3,347)	(5,416)
Decrease in accrued interest payable	(5,353)	(4,208)
(Decrease)/increase in income taxes payable	(1,342)	7,084
Increase in accrued expenses and other liabilities	1,560	3,795
Net cash (used in) provided by operating activities	$(513,416)	$477,829

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)

	Three Months Ended March 31,	
	2015	2014
Cash Flows From Investing Activities:	(unaudited)	
Purchases of available-for-sale securities	$(1,084,742)	$(1,274,784)
Proceeds from sales of available-for-sale securities	900,107	814,872
Principal payments on available-for-sale securities	286,393	224,982
Short sales and purchases of other derivative instruments	(34,834)	(12,902)
Proceeds from sales of other derivative instruments, net	23,428	26,416
Purchases of trading securities	—	(98,219)
Proceeds from sales of trading securities	—	98,582
Proceeds from repayment of residential mortgage loans held-for-investment in securitization trusts	160,853	13,280
Purchases of commercial real estate loans held-for-investment	(45,556)	—
Purchases of mortgage servicing rights, net of purchase price adjustments	(10,399)	4,979
Purchases of Federal Home Loan Bank stock	(10,240)	(18,579)
Purchases of equity investments	—	(3,000)
Increase/(decrease) in due to counterparties, net	67,048	(172,830)
(Increase)/decrease in restricted cash	(104,387)	181,445
Net cash provided by (used in) investing activities	147,671	(215,758)
Cash Flows From Financing Activities:		
Proceeds from repurchase agreements	14,782,724	70,826,091
Principal payments on repurchase agreements	(14,620,309)	(71,055,364)
Proceeds from issuance of collateralized borrowings in securitization trusts	310,173	33,483
Principal payments on collateralized borrowings in securitization trusts	(122,232)	(15,923)
Proceeds from Federal Home Loan Bank advances	125,000	464,476
Proceeds from issuance of common stock, net of offering costs	200	110
Dividends paid on common stock	(95,263)	—
Net cash provided by financing activities	380,293	252,873
Net increase in cash and cash equivalents	14,546	514,944
Cash and cash equivalents at beginning of period	1,005,792	1,025,487
Cash and cash equivalents at end of period	$1,020,338	$1,540,431

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)

	Three Months Ended March 31,	
	2015	2014
Supplemental Disclosure of Cash Flow Information:	(unaudited)	
Cash paid for interest	$28,623	$30,286
Cash paid for taxes	$2,511	$1,134
Noncash Investing and Financing Activities:		
Transfers of residential mortgage loans held-for-sale to residential mortgage loans held-for-investment in securitization trusts	$589,255	$—
Additions to mortgage servicing rights due to sale of residential mortgage loans held-for-sale	$227	$—
Cumulative effect of adoption of new accounting principle	$(2,991)	$—
Cash dividends declared but not paid at end of period	$95,307	$95,172
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	662,064	28,867
Transfers to residential mortgage loans held-for-investment in securitization trusts	(589,255)	—
Proceeds from sales of residential mortgage loans held-for-sale	(23,831)	(402,298)
Proceeds from repayment of residential mortgage loans held-for-sale	(24,947)	(7,334)
Realized and unrealized gains (losses) on residential mortgage loans held-for-sale	8,839	(2,795)
Residential mortgage loans held-for-sale at end of period	$568,582	$161,021

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 March 31, 2015 and results of operations for all periods presented have been made. The results of operations for the three months ended March 31, 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 three months ended March 31, 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 March 31, 2015 and December 31, 2014:

	March 31, 2015					
				Gross Amounts Not Offset with Financial Assets (Liabilities) in the Condensed Consolidated Balance Sheets [(1)]		
(in thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts of Assets (Liabilities) Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets						
Derivative assets	$455,084	$(92,438)	$362,646	$(155,149)	$—	$207,497
Total Assets	$455,084	$(92,438)	$362,646	$(155,149)	$—	$207,497
Liabilities						
Repurchase agreements	$(13,094,878)	$—	$(13,094,878)	$13,094,878	$—	$—
Derivative liabilities	(247,587)	92,438	(155,149)	155,149	—	—
Total Liabilities	$(13,342,465)	$92,438	$(13,250,027)	$13,250,027	$—	$—

	December 31, 2014					
				Gross Amounts Not Offset with Financial Assets (Liabilities) in the Condensed Consolidated Balance Sheets [(1)]		
(in thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts of Assets (Liabilities) Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets						
Derivative assets	$443,490	$(62,699)	$380,791	$(90,233)	$—	$290,558
Total Assets	$443,490	$(62,699)	$380,791	$(90,233)	$—	$290,558
Liabilities						
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	$—	$—

(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
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 was 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 ASU 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. 2015-2, 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.

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 financial statements during subsequent reporting periods.

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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)	March 31, 2015	December 31, 2014
Residential mortgage loans held-for-investment in securitization trusts	$2,170,206	$1,744,746
Commercial real estate loans held-for-investment	45,556	—
Accrued interest receivable	11,737	10,197
Total Assets	$2,227,499	$1,754,943
Collateralized borrowings in securitization trusts	$1,400,571	$1,209,663
Accrued interest payable	4,152	3,678
Other liabilities	6,652	6,480
Total Liabilities	$1,411,375	$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 March 31, 2015 and December 31, 2014:

(in thousands)	March 31, 2015	December 31, 2014
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	$2,641,286	$2,418,546
Federal National Mortgage Association	6,802,084	6,768,875
Government National Mortgage Association	2,083,548	2,104,896
Non-Agency	2,815,927	3,048,785
Total mortgage-backed securities	$14,342,845	$14,341,102

At both March 31, 2015 and December 31, 2014, the Company pledged AFS securities with a carrying value of $14.2 billion 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 March 31, 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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The following tables present the amortized cost and carrying value (which approximates fair value) of AFS securities by collateral type as of March 31, 2015 and December 31, 2014:

	March 31, 2015		
(in thousands)	Agency	Non-Agency	Total
Face Value	$13,492,873	$3,858,345	$17,351,218
Unamortized premium	701,133	—	701,133
Unamortized discount			
Designated credit reserve	—	(747,384)	(747,384)
Net, unamortized	(2,939,997)	(871,983)	(3,811,980)
Amortized Cost	11,254,009	2,238,978	13,492,987
Gross unrealized gains	299,826	578,482	878,308
Gross unrealized losses	(26,917)	(1,533)	(28,450)
Carrying Value	$11,526,918	$2,815,927	$14,342,845

	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 March 31, 2015 and December 31, 2014:

	March 31, 2015		
(in thousands)	Agency	Non-Agency	Total
Adjustable Rate	$124,939	$2,340,052	$2,464,991
Fixed Rate	11,401,979	475,875	11,877,854
Total	$11,526,918	$2,815,927	$14,342,845

	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

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

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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 three months ended March 31, 2015 and 2014, of the unamortized net discount and designated credit reserves on non-Agency AFS securities.

	Three Months Ended March 31,					
	2015			2014		
(in thousands)	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	1,183	(935)	248	(16,678)	(18,254)	(34,932)
Accretion of net discount	—	27,465	27,465	—	31,831	31,831
Realized credit losses	3,727	—	3,727	3,868	—	3,868
Reclassification adjustment for other-than-temporary impairments	1,789	—	1,789	(212)	—	(212)
Transfers from (to)	41,092	(41,092)	—	22,639	(22,639)	—
Sales, calls, other	132,430	109,947	242,377	28,034	16,819	44,853
Ending balance at March 31	$(747,384)	$(871,983)	$(1,619,367)	$(1,196,798)	$(1,063,802)	$(2,260,600)

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 March 31, 2015 and December 31, 2014. At March 31, 2015, the Company held 1,506 AFS securities, of which 116 were in an unrealized loss position for less than twelve consecutive months and 171 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.

	Unrealized Loss Position for					
	Less than 12 Months		12 Months or More		Total	
(in thousands)	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
March 31, 2015	$1,075,418	$(6,006)	$1,276,019	$(22,444)	$2,351,437	$(28,450)
December 31, 2014	$413,102	$(3,146)	$1,323,688	$(32,885)	$1,736,790	$(36,031)

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 a $0.1 million other-than-temporary credit impairment during the three months ended March 31, 2015 on one non-Agency RMBS where the future expected cash flows for the security were less than its amortized cost. As of March 31, 2015, impaired securities with a carrying value of $144.8 million had actual weighted average cumulative losses of 10.1%, weighted average three-month prepayment speed of 4.6%, weighted average 60+ day delinquency of 28.8% of the pool

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balance, and weighted average FICO score of 664. At March 31, 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 three months ended March 31, 2014, the Company recorded a $0.2 million other-than-temporary credit impairment on a total of three non-Agency RMBS where the future expected cash flows for the security were less than its amortized cost.
The following table presents the changes in OTTI included in earnings for three months ended March 31, 2015 and 2014:

	Three Months Ended March 31,	
(in thousands)	2015	2014
Cumulative credit loss at beginning of period	$(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	(127)	(121)
Reductions:		
Decreases related to other-than-temporary impairments on securities paid down	—	464
Decreases related to other-than-temporary impairments on securities sold	1,916	—
Cumulative credit loss at end of period	$(6,452)	$(9,215)

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 months ended March 31, 2015 and 2014, the Company sold AFS securities for $900.1 million and $814.9 million with an amortized cost of $782.6 million and $853.7 million, for net realized gains of $117.5 million and losses of $38.8 million, respectively.
The following table presents the gross realized gains and losses on sales of AFS securities for the three months ended March 31, 2015 and 2014:

	Three Months Ended March 31,	
(in thousands)	2015	2014
Gross realized gains	$117,688	$7,209
Gross realized losses	(220)	(45,997)
Total realized gains (losses) on sales, net	$117,468	$(38,788)

Note 5. Trading Securities, at Fair Value
The Company holds U.S. Treasuries in a TRS and classifies these securities as trading instruments due to short-term investment objectives. As of both March 31, 2015 and December 31, 2014, the Company held U.S. Treasuries with an amortized cost of $2.0 billion and a fair value of $2.0 billion classified as trading securities. Included within trading securities were unrealized gains of $13.4 million and $1.4 million as of March 31, 2015 and December 31, 2014, respectively.
For the three months ended March 31, 2014, the Company sold trading securities for $98.6 million with an amortized cost of $98.2 million, resulting in realized gains of $0.4 million on the sale of these securities. The Company did not

sell any trading securities during the three months ended March 31, 2015.
For the three months ended March 31, 2015 and 2014, trading securities experienced change in unrealized gains of $12.0 million and losses of $0.2 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.

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At both March 31, 2015 and 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 March 31, 2015 and December 31, 2014:

(in thousands)	March 31, 2015	December 31, 2014
Unpaid principal balance	$569,553	$534,101
Fair value adjustment	(971)	1,611
Carrying value	$568,582	$535,712

At March 31, 2015 and December 31, 2014, the Company pledged residential mortgage loans with a carrying value of $415.9 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.

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 sheet, 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 March 31, 2015 and December 31, 2014:

(in thousands)	March 31, 2015	December 31, 2014
Unpaid principal balance	$2,112,775	$1,699,748
Fair value adjustment	57,431	44,998
Carrying value	$2,170,206	$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 March 31, 2015 and December 31, 2014:

(in thousands)	March 31, 2015	December 31, 2014
Unpaid principal balance	$45,900	$—
Unamortized discount	(344)	—
Carrying value	$45,556	$—

As of March 31, 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

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March 31, 2015, the Company had not recorded any allowances for losses as it was 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.

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 months ended March 31, 2015 and 2014.

	Three Months Ended March 31,			
(in thousands)	2015		2014	
Balance at beginning of period	$452,006		$514,402	
Additions from purchases of servicing rights	4,324		1,280	
Additions from sales of residential mortgage loans	227		—	
Changes in fair value due to:				
Changes in valuation inputs or assumptions used in the valuation model	(43,089	)	(20,250	)
Other changes in fair value (1)	(9,314	)	(12,510	)
Other changes (2)	6,075		(6,259	)
Balance at end of period	$410,229		$476,663	

(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 March 31, 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)	March 31, 2015		December 31, 2014	
Weighted average prepayment speed:	13.1	%	11.9	%
Impact on fair value of 10% adverse change	$(18,050	)	$(14,012	)
Impact on fair value of 20% adverse change	$(34,459	)	$(31,640	)
Weighted average delinquency:	4.6	%	5.6	%
Impact on fair value of 10% adverse change	$(2,461	)	$(3,616	)
Impact on fair value of 20% adverse change	$(4,513	)	$(6,780	)
Weighted average discount rate:	9.9	%	9.5	%
Impact on fair value of 10% adverse change	$(14,358	)	$(16,272	)
Impact on fair value of 20% adverse change	$(27,896	)	$(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

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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.

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 months ended March 31, 2015 and 2014:

	Three Months Ended March 31,	
(in thousands)	2015	2014
Servicing fee income	$31,237	$29,871
Ancillary fee income	564	463
Float income	286	107
Total	$32,087	$30,441

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 sheet as of March 31, 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 March 31, 2015 and December 31, 2014:

(dollars in thousands)	March 31, 2015		December 31, 2014	
	Number of Loans	Unpaid Principal Balance	Number of Loans	Unpaid Principal Balance
Residential mortgage loans held-for-sale	1,210	$569,553	1,008	$534,101
Residential mortgage loans held-for-investment in securitization trusts	465	341,824	487	358,458
Mortgage servicing rights (1)	220,033	43,974,908	224,073	44,949,061
Total serviced mortgage assets	221,708	$44,886,285	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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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 March 31, 2015 and December 31, 2014:

(in thousands)	March 31, 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	333,602	211,989
As restricted collateral for repurchase agreements and Federal Home Loan Bank advances	89,959	112,435
Total restricted cash balances held by trading counterparties	440,811	336,424
Restricted cash balance pursuant to letter of credit on office lease	347	347
Total	$441,158	$336,771

Note 11. Accrued Interest Receivable
The following table presents the Company's accrued interest receivable by collateral type:

(in thousands)	March 31, 2015	December 31, 2014
Accrued Interest Receivable:		
U.S. Treasuries	$3,674	$8,084
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	9,210	8,734
Federal National Mortgage Association	22,315	22,392
Government National Mortgage Association	10,137	10,290
Non-Agency	3,765	3,835
Total mortgage-backed securities	45,427	45,251
Residential mortgage loans held-for-sale	1,678	1,997
Residential mortgage loans held-for-investment in securitization trusts	11,693	10,197
Commercial real estate loans held-for-investment	44	—
Total	$62,516	$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, put and call options for TBAs, 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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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 sheet 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 March 31, 2015 and December 31, 2014.

(in thousands)	March 31, 2015			
	Derivative Assets		Derivative Liabilities	
Trading instruments	Fair Value	Notional	Fair Value	Notional
Inverse interest-only securities	$189,875	$1,106,210	$—	$—
Interest rate swap agreements	49,485	9,614,000	(126,063)	10,315,000
Credit default swaps	—	—	(1,460)	125,000
Swaptions, net	108,348	11,600,000	(3,840)	1,360,000
TBAs	—	—	(17,930)	2,496,000
Put and call options for TBAs, net	—	—	(5,776)	2,500,000
Constant maturity swaps	1,236	3,000,000	—	—
Markit IOS total return swaps	12,299	877,529	—	—
Forward purchase commitments	1,403	598,009	(80)	109,295
Total	$362,646	$26,795,748	$(155,149)	$16,905,295

(in thousands)	December 31, 2014			
	Derivative Assets		Derivative Liabilities	
Trading instruments	Fair Value	Notional	Fair Value	Notional
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

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.

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TWO HARBORS INVESTMENT CORP.
Notes to the Condensed Consolidated Financial Statements (unaudited)

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 March 31,	
		2015	2014
Interest rate risk management			
TBAs [1]	Gain (loss) on other derivative instruments	$(27,958)	$(17,903)
Put and call options for TBAs [1]	Gain (loss) on other derivative instruments	2,535	(1,705)
Constant maturity swaps [1]	Gain (loss) on other derivative instruments	6,090	11,531
Short U.S. Treasuries [1]	Gain (loss) on other derivative instruments	—	—
Interest rate swap agreements - Receivers [1]	Gain (loss) on interest rate swap and swaption agreements	42,326	40,979
Interest rate swap agreements - Payers [1]	Gain (loss) on interest rate swap and swaption agreements	(52,559)	(13,420)
Swaptions [1]	Gain (loss) on interest rate swap and swaption agreements	(18,506)	(112,558)
Markit IOS total return swaps [1]	Gain (loss) on other derivative instruments	3,132	(1,725)
Interest rate swap agreements - Payers [2]	Gain (loss) on interest rate swap and swaption agreements	(97,704)	(20,529)
Credit risk management			
Credit default swaps - Receive protection [3]	Gain (loss) on other derivative instruments	(93)	1,981
Non-risk management			
TBAs	Gain (loss) on other derivative instruments	—	(4,701)
Inverse interest-only securities	Gain (loss) on other derivative instruments	19,261	18,323
Forward purchase commitments	(Loss) gain on residential mortgage loans held-for-sale	970	(417)
Total		$(122,506)	$(100,144)

(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.

For the three months ended March 31, 2015 and 2014, the Company recognized $27.5 million and $13.8 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 $18.2 billion and $19.2 billion notional, respectively, and receiving either LIBOR interest or a fixed interest rate.

TWO HARBORS INVESTMENT CORP.
Notes to the Condensed Consolidated Financial Statements (unaudited)

The following table presents information with respect to the volume of activity in the Company's derivative instruments during the three months ended March 31, 2015 and 2014:
(in thousands)

Three Months Ended March 31,	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net (1)
2015						
Inverse interest-only securities	$1,168,226	$—	$(62,016)	$1,106,210	$1,138,468	$—
Interest rate swap agreements	18,584,000	5,620,000	(4,275,000)	19,929,000	18,238,389	(1,070)
Credit default swaps	125,000	—	—	125,000	125,000	—
Swaptions, net	12,410,000	5,550,000	(5,000,000)	12,960,000	12,851,667	12,845
TBAs, net	(1,325,000)	(6,933,000)	5,762,000	(2,496,000)	2,121,700	(17,364)
Put and call options for TBAs, net	2,000,000	250,000	(4,750,000)	(2,500,000)	8,333	(3,047)
Constant maturity swaps	14,000,000	6,000,000	(17,000,000)	3,000,000	6,988,889	6,384
Markit IOS total return swaps	598,459	676,633	(397,563)	877,529	875,346	4,202
Forward purchase commitments	554,838	1,128,634	(976,168)	707,304	648,343	943
Total	$48,115,523	$12,292,267	$(26,698,747)	$33,709,043	$42,996,135	$2,893
2014						
Inverse interest-only securities	$1,525,845	$—	$(113,471)	$1,412,374	$1,470,667	$193
Interest rate swap agreements	19,619,000	2,944,148	(900,000)	21,663,148	19,156,878	(22)
Credit default swaps	427,073	—	(302,073)	125,000	179,418	(13,705)
Swaptions, net	5,130,000	3,900,000	470,000	9,500,000	8,979,111	(1,219)
TBAs, net	603,000	(892,000)				