

TWO HARBORS INVESTMENT CORP.

Form 10-Q

May 09, 2018

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: March 31, 2018

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.)

575 Lexington Avenue, Suite 2930 10022  
New York, New York

(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  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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

Emerging growth company

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the 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 May 8, 2018 there were 175,433,334 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 (unaudited)

(in thousands, except share data)

|   | March 31,<br>2018   | December 31,<br>2017 |
|---|---------------------|----------------------|
| <b>ASSETS</b>   |                     |                      |
| Available-for-sale securities, at fair value  | \$21,059,377        | \$21,220,819         |
| Mortgage servicing rights, at fair value  | 1,301,023           | 1,086,717            |
| Residential mortgage loans held-for-sale, at fair value   | 29,428              | 30,414               |
| Cash and cash equivalents   | 388,450             | 419,159              |
| Restricted cash   | 712,791             | 635,836              |
| Accrued interest receivable   | 67,370              | 68,309               |
| Due from counterparties   | 85,319              | 842,303              |
| Derivative assets, at fair value  | 274,048             | 309,918              |
| Other assets  | 159,359             | 175,838              |
| <b>Total Assets</b>   | <b>\$24,077,165</b> | <b>\$24,789,313</b>  |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                     |                      |
| <b>Liabilities</b>  |                     |                      |
| Repurchase agreements   | \$19,148,679        | \$19,451,207         |
| Federal Home Loan Bank advances   | 865,024             | 1,215,024            |
| Revolving credit facilities   | 20,000              | 20,000               |
| Convertible senior notes  | 283,054             | 282,827              |
| Derivative liabilities, at fair value   | 46,074              | 31,903               |
| Due to counterparties   | 39,809              | 88,898               |
| Dividends payable   | 96,201              | 12,552               |
| Accrued interest payable  | 85,405              | 87,698               |
| Other liabilities   | 25,234              | 27,780               |
| <b>Total Liabilities</b>  | <b>20,609,480</b>   | <b>21,217,889</b>    |
| <b>Stockholders' Equity</b>   |                     |                      |
| Preferred stock, par value \$0.01 per share; 50,000,000 shares authorized:  |                     |                      |
| 8.125% Series A cumulative redeemable: 5,750,000 and 5,750,000 shares issued and outstanding, respectively (\$143,750 liquidation preference)       | 138,872             | 138,872              |
| 7.625% Series B cumulative redeemable: 11,500,000 and 11,500,000 shares issued and outstanding, respectively (\$287,500 liquidation preference)     | 278,094             | 278,094              |
| 7.25% Series C cumulative redeemable: 11,800,000 and 11,800,000 shares issued and outstanding, respectively (\$295,000 liquidation preference)      | 285,584             | 285,571              |
| Common stock, par value \$0.01 per share; 450,000,000 shares authorized and 175,434,778 and 174,496,587 shares issued and outstanding, respectively | 1,754               | 1,745                |
| Additional paid-in capital  | 3,674,411           | 3,672,003            |
| Accumulated other comprehensive (loss) income   | (46                 | ) 334,813            |
| Cumulative earnings   | 2,711,495           | 2,386,604            |
| Cumulative distributions to stockholders  | (3,622,479          | ) (3,526,278 )       |
| <b>Total Stockholders' Equity</b>   | <b>3,467,685</b>    | <b>3,571,424</b>     |
| <b>Total Liabilities and Stockholders' Equity</b>   | <b>\$24,077,165</b> | <b>\$24,789,313</b>  |
| 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 (LOSS) INCOME (unaudited)  
 (in thousands, except share data)

|   | Three Months Ended |             |
|---|--------------------|-------------|
|   | March 31,          |             |
|   | 2018               | 2017        |
| Interest income:  |                    |             |
| Available-for-sale securities   | \$ 190,716         | \$ 135,327  |
| Residential mortgage loans held-for-investment in securitization trusts | —                  | 31,628      |
| Residential mortgage loans held-for-sale                                | 307                | 398         |
| Other   | 2,996              | 1,801       |
| Total interest income   | 194,019            | 169,154     |
| Interest expense:   |                    |             |
| Repurchase agreements   | 86,580             | 32,256      |
| Collateralized borrowings in securitization trusts                      | —                  | 25,386      |
| Federal Home Loan Bank advances   | 4,458              | 8,793       |
| Revolving credit facilities   | 804                | 429         |
| Convertible senior notes  | 4,718              | 3,821       |
| Total interest expense  | 96,560             | 70,685      |
| Net interest income   | 97,459             | 98,469      |
| Other-than-temporary impairments:                                       |                    |             |
| Total other-than-temporary impairment losses                            | (94                | ) —         |
| Other income (loss):  |                    |             |
| Loss on investment securities   | (20,671            | ) (52,352 ) |
| Servicing income  | 71,190             | 39,773      |
| Gain (loss) on servicing asset  | 71,807             | (14,565 )   |
| Gain on interest rate swap and swaption agreements                      | 150,545            | 9,927       |
| Gain (loss) on other derivative instruments                             | 8,053              | (27,864 )   |
| Other income  | 1,058              | 9,496       |
| Total other income (loss)   | 281,982            | (35,585 )   |
| Expenses:   |                    |             |
| Management fees   | 11,708             | 9,808       |
| Servicing expenses  | 14,554             | 5,298       |
| Other operating expenses  | 14,492             | 13,764      |
| Total expenses  | 40,754             | 28,870      |
| Income from continuing operations before income taxes                   | 338,593            | 34,014      |
| Provision for (benefit from) income taxes                               | 3,784              | (24,517 )   |
| Net income from continuing operations                                   | 334,809            | 58,531      |
| Income from discontinued operations, net of tax                         | —                  | 13,454      |
| Net income  | 334,809            | 71,985      |
| Dividends on preferred stock  | 13,747             | —           |
| Net income attributable to common stockholders                          | \$ 321,062         | \$ 71,985   |

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 (LOSS) INCOME (unaudited),  
 continued  
 (in thousands, except share data)

|   | Three Months Ended<br>March 31, |            |
|---|---------------------------------|------------|
|   | 2018                            | 2017       |
| Basic earnings per weighted average common share:               |                                 |            |
| Continuing operations   | \$1.83                          | \$ 0.33    |
| Discontinued operations   | —                               | 0.08       |
| Net income  | \$1.83                          | \$ 0.41    |
| Diluted earnings per weighted average common share:             |                                 |            |
| Continuing operations   | \$1.69                          | \$ 0.33    |
| Discontinued operations   | —                               | 0.08       |
| Net income  | \$1.69                          | \$ 0.41    |
| Dividends declared per common share                             | \$0.47                          | \$ 0.50    |
| Weighted average number of shares of common stock:              |                                 |            |
| Basic   | 175,145,964                     | 74,281,965 |
| Diluted   | 192,818,531                     | 74,281,965 |
| Comprehensive (loss) income:                                    |                                 |            |
| Net income  | \$334,809                       | \$ 71,985  |
| Other comprehensive (loss) income, net of tax:                  |                                 |            |
| Unrealized (loss) gain on available-for-sale securities         | (344,777 )                      | 73,762     |
| Other comprehensive (loss) income                               | (344,777 )                      | 73,762     |
| Comprehensive (loss) income                                     | (9,968 )                        | 145,747    |
| Dividends on preferred stock                                    | 13,747                          | —          |
| Comprehensive (loss) income attributable to common stockholders | \$(23,715 )                     | \$ 145,747 |

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 (unaudited)  
(in thousands, except share data)

|  | Series A<br>Preferred<br>Stock | Series B<br>Preferred<br>Stock | Series C<br>Preferred<br>Stock | Common<br>Stock<br>Par<br>Value | Additional<br>Paid-in<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Cumulative<br>Earnings | Cumulative<br>Distributions<br>to<br>Stockholders | Total<br>Stockholders'<br>Equity |
|--|--------------------------------|--------------------------------|--------------------------------|---------------------------------|----------------------------------|---|------------------------|---|----------------------------------|
| Balance,<br>December 31,<br>2016   | \$—                            | \$—                            | \$—                            | \$1,739                         | \$3,661,711                      | \$199,227   | \$2,038,033            | \$(2,499,599)                                     | \$3,401,111                      |
| Net income   | —                              | —                              | —                              | —                               | —                                | —   | 71,985                 | —   | 71,985                           |
| Other<br>comprehensive<br>income before<br>reclassifications,<br>net of tax<br>expense of<br>\$20,591                | —                              | —                              | —                              | —                               | —                                | 64,449  | —                      | —   | 64,449                           |
| Amounts<br>reclassified from<br>accumulated<br>other<br>comprehensive<br>income, net of<br>tax expense of<br>\$6,386 | —                              | —                              | —                              | —                               | —                                | 9,313   | —                      | —   | 9,313                            |
| Other<br>comprehensive<br>income, net of<br>tax expense of<br>\$26,977   | —                              | —                              | —                              | —                               | —                                | 73,762  | —                      | —   | 73,762                           |
| Issuance of<br>preferred stock,<br>net of offering<br>costs  | 138,872                        | —                              | —                              | —                               | —                                | —   | —                      | —   | 138,872                          |
| Issuance of<br>common stock,<br>net of offering<br>costs   | —                              | —                              | —                              | —                               | 102                              | —   | —                      | —   | 102                              |
| Common<br>dividends<br>declared  | —                              | —                              | —                              | —                               | —                                | —   | —                      | (87,228)  | (87,228)                         |
| Non-cash equity<br>award<br>compensation   | —                              | —                              | —                              | 6                               | 3,951                            | —   | —                      | —   | 3,957                            |
|  | \$138,872                      | \$—                            | \$—                            | \$1,744                         | \$3,665,765                      | \$272,989   | \$2,110,018            | \$(2,586,827)                                     | \$3,602,561                      |



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Balance,  
March 31, 2017

|   |            |            |            |          |              |            |              |               |             |
|---|------------|------------|------------|----------|--------------|------------|--------------|---------------|-------------|
| Balance,<br>December 31,<br>2017  | \$ 138,872 | \$ 278,094 | \$ 285,571 | \$ 1,745 | \$ 3,672,003 | \$ 334,813 | \$ 2,386,604 | \$(3,526,278) | \$3,571,424 |
| Cumulative<br>effect of<br>adoption of new<br>accounting<br>principle   | —          | —          | —          | —        | —            | 9,918      | (9,918 )     | —             | —           |
| Adjusted<br>balance,<br>January 1, 2018   | 138,872    | 278,094    | 285,571    | 1,745    | 3,672,003    | 344,731    | 2,376,686    | (3,526,278 )  | 3,571,424   |
| Net income  | —          | —          | —          | —        | —            | —          | 334,809      | —             | 334,809     |
| Other<br>comprehensive<br>loss before<br>reclassifications,<br>net of tax benefit<br>of \$510                 | —          | —          | —          | —        | —            | (343,542 ) | —            | —             | (343,542 )  |
| Amounts<br>reclassified from<br>accumulated<br>other<br>comprehensive<br>income, net of<br>tax benefit of \$0 | —          | —          | —          | —        | —            | (1,235 )   | —            | —             | (1,235 )    |
| Other<br>comprehensive<br>loss, net of tax<br>benefit of \$510  | —          | —          | —          | —        | —            | (344,777 ) | —            | —             | (344,777 )  |
| Issuance of<br>preferred stock,<br>net of offering<br>costs   | —          | —          | 13         | —        | —            | —          | —            | —             | 13          |
| Issuance of<br>common stock,<br>net of offering<br>costs  | —          | —          | —          | —        | 76           | —          | —            | —             | 76          |
| Preferred<br>dividends<br>declared  | —          | —          | —          | —        | —            | —          | —            | (13,747 )     | (13,747 )   |
| Common<br>dividends<br>declared   | —          | —          | —          | —        | —            | —          | —            | (82,454 )     | (82,454 )   |
| Non-cash equity<br>award<br>compensation  | —          | —          | —          | 9        | 2,332        | —          | —            | —             | 2,341       |
| Balance,<br>March 31, 2018  | \$ 138,872 | \$ 278,094 | \$ 285,584 | \$ 1,754 | \$ 3,674,411 | \$(46 )    | \$ 2,711,495 | \$(3,622,479) | \$3,467,685 |

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 (unaudited)  
 (in thousands)

|   | Three Months Ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2018                            | 2017      |
| Cash Flows From Operating Activities:   |                                 |           |
| Net income from continuing operations   | \$334,809                       | \$58,531  |
| Adjustments to reconcile net income from continuing operations to net cash provided by operating activities:  |                                 |           |
| Amortization of premiums and discounts on investment securities, net  | 22,086                          | 8,502     |
| Amortization of deferred debt issuance costs on convertible senior notes                                      | 227                             | 78        |
| Other-than-temporary impairment losses  | 94                              | —         |
| Realized and unrealized losses on investment securities   | 21,301                          | 52,352    |
| (Gain) loss on servicing asset  | (71,807 )                       | 14,565    |
| Gain on residential mortgage loans held-for-sale  | (316 )                          | (1,461 )  |
| Gain on residential mortgage loans held-for-investment and collateralized borrowings in securitization trusts | —                               | (6,683 )  |
| Realized and unrealized gain on interest rate swaps and swaptions   | (146,736 )                      | (17,831 ) |
| Unrealized loss on other derivative instruments   | 41,724                          | 59,841    |
| Equity based compensation   | 2,341                           | 3,957     |
| Depreciation of fixed assets  | 184                             | 285       |
| Purchases of residential mortgage loans held-for-sale   | —                               | (437 )    |
| Proceeds from sales of residential mortgage loans held-for-sale   | —                               | 3,708     |
| Proceeds from repayment of residential mortgage loans held-for-sale   | 1,120                           | 3,995     |
| Net change in assets and liabilities:   |                                 |           |
| Decrease (increase) in accrued interest receivable  | 939                             | (12,611 ) |
| Decrease (increase) in deferred income taxes, net   | 4,508                           | (24,710 ) |
| (Increase) decrease in income taxes receivable  | (724 )                          | 86        |
| Decrease in prepaid and fixed assets  | 393                             | 306       |
| (Increase) decrease in other receivables  | (5,032 )                        | 11,343    |
| Decrease in servicing advances  | 2,871                           | 1,466     |
| (Decrease) increase in accrued interest payable   | (2,293 )                        | 11,159    |
| Increase in income taxes payable  | —                               | 30        |
| Decrease in accrued expenses and other liabilities  | (2,546 )                        | (13,501 ) |
| Net cash provided by operating activities of discontinued operations  | —                               | 9,294     |
| Net cash provided by operating activities   | \$203,143                       | \$162,264 |
| 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 (unaudited), continued  
 (in thousands)

|   | Three Months Ended<br>March 31, |               |
|---|---------------------------------|---------------|
|   | 2018                            | 2017          |
| Cash Flows From Investing Activities:   |                                 |               |
| Purchases of available-for-sale securities  | \$(2,720,032)                   | \$(6,837,176) |
| Proceeds from sales of available-for-sale securities  | 2,047,032                       | 2,414,267     |
| Principal payments on available-for-sale securities   | 447,664                         | 272,954       |
| Purchases of mortgage servicing rights, net of purchase price adjustments                                   | (142,799 )                      | (68,551 )     |
| Proceeds from sales of mortgage servicing rights  | 300                             | 250           |
| (Purchases) short sales of derivative instruments, net  | (50,500 )                       | (42,293 )     |
| Proceeds from sales and settlement (payments for termination and settlement) of derivative instruments, net | 205,553                         | 78,763        |
| Proceeds from repayment of residential mortgage loans held-for-investment in securitization trusts          | —                               | 102,545       |
| Redemptions of Federal Home Loan Bank stock   | 12,981                          | 19,760        |
| Increase (decrease) in due to counterparties, net   | 707,895                         | (74,936 )     |
| Net cash used in investing activities of discontinued operations  | —                               | (133,843 )    |
| Net cash provided by (used in) investing activities   | 508,094                         | (4,268,260 )  |
| Cash Flows From Financing Activities:   |                                 |               |
| Proceeds from repurchase agreements   | 35,053,094                      | 36,483,681    |
| Principal payments on repurchase agreements   | (35,355,622 )                   | (32,244,366 ) |
| Principal payments on collateralized borrowings in securitization trusts                                    | —                               | (101,562 )    |
| Principal payments on Federal Home Loan Bank advances   | (350,000 )                      | (428,238 )    |
| Principal payments on revolving credit facilities   | —                               | (55,000 )     |
| Proceeds from convertible senior notes  | —                               | 282,469       |
| Proceeds from issuance of preferred stock, net of offering costs  | 13                              | 138,872       |
| Proceeds from issuance of common stock, net of offering costs   | 76                              | 102           |
| Dividends paid on preferred stock   | (11,949 )                       | —             |
| Dividends paid on common stock  | (603 )                          | (83,437 )     |
| Net cash provided by financing activities of discontinued operations  | —                               | 85,054        |
| Net cash (used in) provided by financing activities   | (664,991 )                      | 4,077,575     |
| Net increase (decrease) in cash, cash equivalents and restricted cash                                       | 46,246                          | (28,421 )     |
| Cash, cash equivalents and restricted cash of continuing operations at beginning of period                  | 1,054,995                       | 758,916       |
| Cash, cash equivalents and restricted cash of discontinued operations at beginning of period                | —                               | 56,279        |
| Cash, cash equivalents and restricted cash at beginning of period   | 1,054,995                       | 815,195       |
| Cash, cash equivalents and restricted cash at end of period   | \$1,101,241                     | \$786,774     |
| 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 (unaudited), continued  
 (in thousands)

|  | Three Months<br>Ended<br>March 31, |          |
|--|------------------------------------|----------|
|  | 2018                               | 2017     |
| Supplemental Disclosure of Cash Flow Information:  |                                    |          |
| Cash paid for interest   | \$98,854                           | \$38,237 |
| Cash paid for taxes  | \$—                                | \$81     |
| Noncash Activities:  |                                    |          |
| Transfers of residential mortgage loans held-for-sale to other receivables for foreclosed government-guaranteed loans                | \$182                              | \$1,626  |
| Transfer of fair value of mortgage servicing rights to fair value of Ginnie Mae residential mortgage loans held-for-sale upon buyout | \$—                                | \$9      |
| Additions to mortgage servicing rights due to sale of residential mortgage loans held-for-sale                                       | \$—                                | \$20     |
| Cumulative-effect adjustment for adoption of new accounting principle  | \$9,918                            | \$—      |
| Dividends declared but not paid at end of period   | \$96,201                           | \$87,228 |
| Reconciliation of residential mortgage loans held-for-sale:  |                                    |          |
| Residential mortgage loans held-for-sale at beginning of period  | \$30,414                           | \$40,146 |
| Purchases of residential mortgage loans held-for-sale  | —                                  | 437      |
| Transfers to other receivables for foreclosed government-guaranteed loans  | (182 )                             | (1,626 ) |
| Transfer of fair value of mortgage servicing rights to fair value of Ginnie Mae residential mortgage loans held-for-sale upon buyout | —                                  | (9 )     |
| Proceeds from sales of residential mortgage loans held-for-sale  | —                                  | (3,708 ) |
| Proceeds from repayment of residential mortgage loans held-for-sale  | (1,120 )                           | (3,995 ) |
| Realized and unrealized gains on residential mortgage loans held-for-sale  | 316                                | 1,441    |
| Residential mortgage loans held-for-sale at end of period  | \$29,428                           | \$32,686 |
| 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 investing in, financing and managing Agency residential mortgage-backed securities, or Agency RMBS, non-Agency securities, mortgage servicing rights, or MSR, and other financial assets. The Company's Chief Investment Officer manages the investment portfolio as a whole and resources are allocated and financial performance is assessed on a consolidated basis. 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. 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.

On June 28, 2017, the Company completed the contribution of its portfolio of commercial real estate assets to Granite Point Mortgage Trust Inc., or Granite Point, a newly formed Maryland corporation intended to qualify as a REIT, externally managed and advised by Pine River, and focused on directly originating, investing in and managing senior commercial mortgage loans and other debt and debt-like commercial real estate investments. The Company contributed its equity interests in its wholly owned subsidiary, TH Commercial Holdings LLC, to Granite Point and, in exchange for its contribution, received approximately 33.1 million shares of common stock of Granite Point, which represented approximately 76.5% of the outstanding stock of Granite Point upon completion of the initial public offering, or IPO, of its common stock on June 28, 2017. On November 1, 2017, the Company distributed, on a pro rata basis, the 33.1 million shares of Granite Point common stock that it acquired in connection with the contribution to stockholders holding shares of Two Harbors common stock outstanding as of the close of business on October 20, 2017.

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 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 per share amounts, common shares outstanding and restricted shares for all prior periods presented have been adjusted on a retroactive basis to reflect the Company's one-for-two reverse stock split effected on November 1, 2017 (refer to Note 17 - Stockholders' Equity for additional information). 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, 2017. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at March 31, 2018 and results of operations for all periods presented have been made. The results of operations for the three months ended March 31, 2018 should not be construed as indicative of the results to be expected for future periods or the full year.

Due to its controlling ownership interest in Granite Point through November 1, 2017, the Company consolidated Granite Point on its financial statements. Effective November 1, 2017 (the date the 33.1 million shares of Granite Point common stock were distributed to the Company's common stockholders), the Company no longer has a controlling interest in Granite Point and, therefore, has deconsolidated Granite Point and its subsidiaries from its financial statements and reclassified all of Granite Point's current and prior period assets, liabilities and results of operations to discontinued operations.

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TWO HARBORS INVESTMENT CORP.

Notes to the Consolidated Financial Statements (unaudited)

The Company retains debt securities and excess servicing rights purchased from securitization trusts sponsored by either third parties or the Company's subsidiaries. The securitization trusts are considered variable interest entities, or VIEs, for financial reporting purposes and, thus, are reviewed for consolidation under the applicable consolidation guidance. Whenever the Company has both the power to direct the activities of a trust 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 trust. During the majority of 2017, the Company retained the most subordinate security in each of the securitization trusts, which gave the Company the power to direct the activities of the trusts that most significantly impact the trusts' performance and the obligation to absorb losses or the right to receive benefits of the securitization trusts that could be significant. As a result, the Company consolidated all of the securitization trusts on its condensed consolidated balance sheet. During the fourth quarter of 2017, the Company sold all of the retained subordinated securities thereby removing the Company's power to direct the activities of the trusts and the obligation to absorb losses or the right to receive benefits of the securitization trusts. As a result, the securitization trusts are no longer consolidated on the Company's condensed consolidated balance sheet and the remaining retained securities are included withing non-Agency available-for-sale, or AFS, securities.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make a number of significant estimates. These 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 as of the date of the 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.

Significant Accounting Policies

Included in Note 2 to the Consolidated Financial Statements of the Company's 2017 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, 2018.

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 by 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. 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. Additionally, the Company's centrally cleared interest rate swaps require that the Company posts an "initial margin" amount determined by the clearing exchange, which is generally intended to be set at a level sufficient to protect the exchange from the interest rate swap's maximum estimated single-day price movement. The Company also exchanges "variation margin" based upon daily changes in fair value, as measured by the exchange.

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. As a result of amendments to rules governing certain central clearing activities, the exchange of variation margin is considered a settlement of the interest rate swap, as opposed to pledged collateral. Accordingly, beginning in the first quarter of 2018 and in subsequent periods, the Company accounts for the receipt or payment of variation margin as a direct reduction to the carrying value of the interest rate swap asset or liability. The receipt or payment of initial margin will continue to be accounted for separate from the interest rate swap asset or liability. As



of December 31, 2017, variation margin pledged or received was netted on a counterparty basis and classified within restricted cash, due from counterparties, or due to counterparties on the Company's condensed consolidated balance sheets.

The Company presents repurchase agreements subject to master netting arrangements or similar agreements on a gross basis and derivative assets and liabilities (other than centrally cleared interest rate swaps) 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 (other than variation margin on centrally cleared interest rate swaps) on a net basis, based on counterparty, in its condensed consolidated balance sheets. However, the Company does not offset repurchase agreements or derivative assets and liabilities (other than centrally cleared interest rate swaps) with the associated cash collateral on its condensed consolidated balance sheets.

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## TWO HARBORS INVESTMENT CORP.

Notes to the 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, 2018 and December 31, 2017:

March 31, 2018

| (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 Consolidated Balance Sheets <sup>(1)</sup> |                                    |            |
|------------------------|--|---|--|--|------------------------------------|------------|
|                        |  |   |  | Financial Instruments  | Cash Collateral (Received) Pledged | Net Amount |
| <b>Assets</b>          |  |   |  |  |                                    |            |
| Derivative assets      | \$446,109  | \$ (172,061 )   | \$274,048  | \$(46,074 )  | \$                                 | —\$227,974 |
| Total Assets           | \$446,109  | \$ (172,061 )   | \$274,048  | \$(46,074 )  | \$                                 | —\$227,974 |
| <b>Liabilities</b>     |  |   |  |  |                                    |            |
| Repurchase agreements  | \$(19,148,679)                                   | \$ —  | \$(19,148,679)   | \$19,148,679   | \$                                 | —\$—       |
| Derivative liabilities | (218,135 )                                       | 172,061   | (46,074 )  | 46,074   | —                                  | —          |
| Total Liabilities      | \$(19,366,814)                                   | \$ 172,061  | \$(19,194,753)   | \$19,194,753   | \$                                 | —\$—       |

December 31, 2017

| (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 Consolidated Balance Sheets <sup>(1)</sup> |                                    |            |
|------------------------|--|---|--|--|------------------------------------|------------|
|                        |  |   |  | Financial Instruments  | Cash Collateral (Received) Pledged | Net Amount |
| <b>Assets</b>          |  |   |  |  |                                    |            |
| Derivative assets      | \$340,576  | \$ (30,658 )  | \$309,918  | \$(31,903 )  | \$                                 | —\$278,015 |
| Total Assets           | \$340,576  | \$ (30,658 )  | \$309,918  | \$(31,903 )  | \$                                 | —\$278,015 |
| <b>Liabilities</b>     |  |   |  |  |                                    |            |
| Repurchase agreements  | \$(19,451,207)                                   | \$ —  | \$(19,451,207)   | \$19,451,207   | \$                                 | —\$—       |
| Derivative liabilities | (62,561 )  | 30,658  | (31,903 )  | 31,903   | —                                  | —          |
| Total Liabilities      | \$(19,513,768)                                   | \$ 30,658   | \$(19,483,110)   | \$19,483,110   | \$                                 | —\$—       |

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 (1) 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 Consolidated Financial Statements (unaudited)

Recently Issued and/or Adopted Accounting Standards

Revenue from Contracts with Customers

In May 2014, the Financial Accounting Standards Board, or 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. As a result of the issuance of ASU No. 2015-14 in August 2015 deferring the effective date of ASU No. 2014-09 by one year, the ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2017, with early adoption prohibited. The Company has evaluated the new guidance and determined that interest income, gains and losses on financial instruments and income from servicing residential mortgage loans are outside the scope of ASC 606, Revenues from Contracts with Customers, or ASC 606. For income from servicing residential mortgage loans, the Company considered that the FASB Transition Resource Group members generally agreed that an entity should look to ASC 860, Transfers and Servicing, to determine the appropriate accounting for these fees and ASC 606 contains a scope exception for contracts that fall under ASC 860. As a result, the adoption of this ASU did not have a material impact on the Company's financial condition, results of operations or financial statement disclosures.

Lease Classification and Accounting

In February 2016, the FASB issued ASU No. 2016-02, which requires lessees to recognize on their balance sheets both a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2018, with early adoption permitted. The Company has determined this ASU will not have a material impact on the Company's financial condition, results of operations or financial statement disclosures.

Measurement of Credit Losses on Financial Instruments

In June 2016, the FASB issued ASU No. 2016-13, which changes the impairment model for most financial assets and certain other instruments. Allowances for credit losses on AFS debt securities will be recognized, rather than direct reductions in the amortized cost of the investments. The new model also requires the estimation of lifetime expected credit losses and corresponding recognition of allowance for losses on trade and other receivables, held-to-maturity debt securities, loans, and other instruments held at amortized cost. 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, 2019, with early adoption permitted for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2018. The Company is evaluating the adoption of this ASU to determine the impact it may have on its condensed consolidated financial statements, which at the date of adoption, is expected to increase the allowance for credit losses with a resulting negative adjustment to retained earnings, with offsetting impacts to accumulated other comprehensive income.

Clarifying the Definition of a Business

In January 2017, the FASB issued ASU No. 2017-01, which changes the definition of a business to assist entities with evaluating when a set of transferred assets and activities is a business. The ASU requires an entity to evaluate if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets; if so, the set of transferred assets and activities is not a business. The guidance also requires a business to include at least one substantive process and narrows the definition of outputs by more closely aligning it with how outputs are described in ASC 606. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2017, with early adoption permitted. The Company's adoption of this ASU did not have a material impact on the Company's financial condition, results of operations or financial statement disclosures, but will impact how the Company accounts for any future transfers of sets of assets and activities.

Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income

In February 2018, the FASB issued ASU No. 2018-02, which permits entities to reclassify tax effects stranded in accumulated other comprehensive income as a result of the Tax Cuts and Jobs Act, or TCJA, to retained earnings and requires entities to disclose whether or not they elected to reclassify the tax effects related to the TCJA as well as their policy for releasing income tax effects from accumulated other comprehensive income. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2018, with early adoption permitted. Early adoption of this ASU was elected and applied by recording a cumulative-effect adjustment of \$9.9 million to retained earnings, with the offsetting impact to accumulated other comprehensive income as of January 1, 2018.

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## TWO HARBORS INVESTMENT CORP.

Notes to the Consolidated Financial Statements (unaudited)

## Note 3. Discontinued Operations

On June 28, 2017, the Company contributed its equity interests in its wholly owned subsidiary, TH Commercial Holdings LLC, to Granite Point and, in exchange for its contribution, received approximately 33.1 million shares of common stock of Granite Point, representing approximately 76.5% of the outstanding stock of Granite Point upon completion of the IPO of its common stock on June 28, 2017. On November 1, 2017, the Company distributed, on a pro rata basis, the 33.1 million shares of Granite Point common stock that it acquired in connection with the contribution to stockholders holding shares of Two Harbors common stock outstanding as of the close of business on October 20, 2017. Due to the Company's controlling ownership interest in Granite Point through November 1, 2017, its results of operations and financial condition through such date reflect Granite Point's commercial strategy, which includes as target assets first mortgages, mezzanine loans, B-notes and preferred equity. As of November 1, 2017, the Company no longer has a controlling interest in Granite Point and, therefore, has deconsolidated Granite Point and its subsidiaries from its financial statements and reclassified all of Granite Point's current and prior period assets, liabilities and results of operations to discontinued operations. In accordance with ASC 845, Nonmonetary Transactions, the pro rata distribution of a consolidated subsidiary is recognized at carrying amount within stockholders' equity. As a result, no gain or loss was recognized on the distribution.

Summarized financial information for the discontinued operations are presented below.

|  | November<br>1,<br>2017 |
|--|------------------------|
| (in thousands)                               |                        |
| Assets:                                      |                        |
| Commercial real estate assets                | \$2,233,080            |
| Available-for-sale securities, at fair value | 12,814                 |
| Cash and cash equivalents                    | 84,183                 |
| Restricted cash                              | 2,838                  |
| Accrued interest receivable                  | 6,588                  |
| Other assets                                 | 22,774                 |
| Total Assets                                 | \$2,362,277            |
| Liabilities:                                 |                        |
| Repurchase agreements                        | \$1,516,294            |
| Dividends payable                            | 48                     |
| Other liabilities                            | 10,337                 |
| Total Liabilities                            | \$1,526,679            |

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## TWO HARBORS INVESTMENT CORP.

Notes to the Consolidated Financial Statements (unaudited)

|   | Three<br>Months<br>Ended<br>March 31,<br>2018 |
|---|---|
| (in thousands)  |   |
| Interest income:  |   |
| Commercial real estate assets   | \$-23,570                                     |
| Available-for-sale securities   | —246  |
| Other   | —2  |
| Total interest income   | —23,818                                       |
| Interest expense  | —6,106  |
| Net interest income   | —17,712                                       |
| Expenses:   |   |
| Management fees   | —1,662  |
| Servicing expenses  | —322  |
| Other operating expenses  | —2,273  |
| Total expenses  | —4,257  |
| Income from discontinued operations before income taxes                 | —13,455                                       |
| Provision for income taxes  | —1  |
| Income from discontinued operations attributable to common stockholders | \$-13,454                                     |

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

The Company holds AFS investment securities which are carried at fair value on the condensed consolidated balance sheets. The following table presents the Company's AFS investment securities by collateral type as of March 31, 2018 and December 31, 2017:

| (in thousands)                           | March 31,<br>2018 | December 31,<br>2017 |
|--|-------------------|----------------------|
| Agency                                   |                   |                      |
| Federal National Mortgage Association    | \$ 14,074,434     | \$ 13,920,721        |
| Federal Home Loan Mortgage Corporation   | 3,287,343         | 3,616,967            |
| Government National Mortgage Association | 680,387           | 701,037              |
| Non-Agency                               | 3,017,213         | 2,982,094            |
| Total available-for-sale securities      | \$ 21,059,377     | \$ 21,220,819        |

At March 31, 2018 and December 31, 2017, the Company pledged AFS securities with a carrying value of \$20.9 billion and \$21.0 billion, respectively, as collateral for repurchase agreements and advances from the Federal Home Loan Bank of Des Moines, or the FHLB. See Note 13 - Repurchase Agreements and Note 14 - Federal Home Loan Bank of Des Moines Advances.

At March 31, 2018 and December 31, 2017, the Company did not have any securities purchased from and financed with the same counterparty that did not meet the conditions of ASC 860, to be considered linked transactions and, therefore, classified as derivatives.

The Company is not required to consolidate VIEs for which it has concluded it does not have both the power to direct the activities of the VIEs 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's investments in these unconsolidated VIEs include all non-Agency securities, which are classified within available-for-sale securities, at fair value on the condensed consolidated balance sheets. As of March 31, 2018 and December 31, 2017, the carrying

value, which also represents the maximum exposure to loss, of all non-Agency securities in unconsolidated VIEs was \$3.0 billion and \$3.0 billion, respectively.



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## TWO HARBORS INVESTMENT CORP.

## Notes to the 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 March 31, 2018 and December 31, 2017:

March 31, 2018

| (in thousands)                          | Principal/<br>Current<br>Face | Un-amortized<br>Premium | Accretible<br>Purchase<br>Discount | Credit<br>Reserve<br>Purchase<br>Discount | Amortized<br>Cost | Unrealized<br>Gain | Unrealized<br>Loss | Carrying<br>Value |
|---|-------------------------------|-------------------------|------------------------------------|---|-------------------|--------------------|--------------------|-------------------|
| Agency<br>Principal and<br>interest     | \$ 17,266,330                 | \$ 1,059,269            | \$(24,501 )                        | \$—                                       | \$ 18,301,098     | \$ 14,803          | \$(468,055 )       | \$ 17,847,846     |
| Interest-only                           | 3,115,095                     | 224,298                 | —                                  | —   | 224,298           | 14,374             | (44,354 )          | 194,318           |
| Total Agency                            | 20,381,425                    | 1,283,567               | (24,501 )                          | —   | 18,525,396        | 29,177             | (512,409 )         | 18,042,164        |
| Non-Agency<br>Principal and<br>interest | 3,807,719                     | 2,781                   | (657,248 )                         | (712,017 )                                | 2,441,235         | 505,434            | (3,757 )           | 2,942,912         |
| Interest-only                           | 5,495,775                     | 73,619                  | —                                  | —   | 73,619            | 3,938              | (3,256 )           | 74,301            |
| Total<br>Non-Agency                     | 9,303,494                     | 76,400                  | (657,248 )                         | (712,017 )                                | 2,514,854         | 509,372            | (7,013 )           | 3,017,213         |
| Total                                   | \$ 29,684,919                 | \$ 1,359,967            | \$(681,749 )                       | \$(712,017 )                              | \$ 21,040,250     | \$ 538,549         | \$(519,422 )       | \$ 21,059,377     |

December 31, 2017

| (in thousands)                          | Principal/<br>Current<br>Face | Un-amortized<br>Premium | Accretible<br>Purchase<br>Discount | Credit<br>Reserve<br>Purchase<br>Discount | Amortized<br>Cost | Unrealized<br>Gain | Unrealized<br>Loss | Carrying<br>Value |
|---|-------------------------------|-------------------------|------------------------------------|---|-------------------|--------------------|--------------------|-------------------|
| Agency<br>Principal and<br>interest     | \$ 17,081,849                 | \$ 1,079,246            | \$(24,638 )                        | \$—                                       | \$ 18,136,457     | \$ 42,149          | \$(134,969 )       | \$ 18,043,637     |
| Interest-only                           | 2,941,772                     | 223,289                 | —                                  | —   | 223,289           | 10,955             | (39,156 )          | 195,088           |
| Total Agency                            | 20,023,621                    | 1,302,535               | (24,638 )                          | —   | 18,359,746        | 53,104             | (174,125 )         | 18,238,725        |
| Non-Agency<br>Principal and<br>interest | 3,758,134                     | 2,757                   | (676,033 )                         | (653,613 )                                | 2,431,245         | 488,931            | (3,166 )           | 2,917,010         |
| Interest-only                           | 5,614,925                     | 65,667                  | —                                  | —   | 65,667            | 2,163              | (2,746 )           | 65,084            |
| Total<br>Non-Agency                     | 9,373,059                     | 68,424                  | (676,033 )                         | (653,613 )                                | 2,496,912         | 491,094            | (5,912 )           | 2,982,094         |
| Total                                   | \$ 29,396,680                 | \$ 1,370,959            | \$(700,671 )                       | \$(653,613 )                              | \$ 20,856,658     | \$ 544,198         | \$(180,037 )       | \$ 21,220,819     |

The following tables present the carrying value of the Company's AFS securities by rate type as of March 31, 2018 and December 31, 2017:

March 31, 2018

| (in thousands)  | Agency        | Non-Agency   | Total         |
|-----------------|---------------|--------------|---------------|
| Adjustable Rate | \$ 21,523     | \$ 2,695,195 | \$ 2,716,718  |
| Fixed Rate      | 18,020,641    | 322,018      | 18,342,659    |
| Total           | \$ 18,042,164 | \$ 3,017,213 | \$ 21,059,377 |



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## TWO HARBORS INVESTMENT CORP.

Notes to the Consolidated Financial Statements (unaudited)

|                 | December 31, 2017 |              |               |
|-----------------|-------------------|--------------|---------------|
| (in thousands)  | Agency            | Non-Agency   | Total         |
| Adjustable Rate | \$23,220          | \$ 2,622,710 | \$ 2,645,930  |
| Fixed Rate      | 18,215,505        | 359,384      | 18,574,889    |
| Total           | \$ 18,238,725     | \$ 2,982,094 | \$ 21,220,819 |

The following table presents the Company's AFS securities according to their estimated weighted average life classifications as of March 31, 2018:

|                    | March 31, 2018 |              |               |
|--------------------|----------------|--------------|---------------|
| (in thousands)     | Agency         | Non-Agency   | Total         |
| ≤ 1 year           | \$9,912        | \$ 58,342    | \$ 68,254     |
| > 1 and ≤ 3 years  | 35,720         | 107,516      | 143,236       |
| > 3 and ≤ 5 years  | 289,226        | 445,016      | 734,242       |
| > 5 and ≤ 10 years | 14,137,540     | 1,819,124    | 15,956,664    |
| > 10 years         | 3,569,766      | 587,215      | 4,156,981     |
| Total              | \$ 18,042,164  | \$ 3,017,213 | \$ 21,059,377 |

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 the Company does not expect to collect the entire discount 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 three months ended March 31, 2018 and 2017 of the net unamortized discount/premium and designated credit reserves on non-Agency AFS securities.

| (in thousands)   | Three Months Ended March 31,<br>2018 |                              |               | 2017           |                              |               |
|--|--------------------------------------|------------------------------|---------------|----------------|------------------------------|---------------|
|  | Designated                           | Net                          | Total         | Designated     | Net                          | Total         |
|  | Credit Reserve                       | Unamortized Discount/Premium |               | Credit Reserve | Unamortized Discount/Premium |               |
| Beginning balance at January 1                                   | \$(653,613)                          | \$ (607,609 )                | \$(1,261,222) | \$(367,437)    | \$ (623,440 )                | \$(990,877 )  |
| Acquisitions   | (73,882 )                            | (3,733 )                     | (77,615 )     | (88,719 )      | (71,471 )                    | (160,190 )    |
| Accretion of net discount  | —                                    | 22,154                       | 22,154        | —              | 22,183                       | 22,183        |
| Realized credit losses   | 5,482                                | —                            | 5,482         | 4,546          | —                            | 4,546         |
| Reclassification adjustment for other-than-temporary impairments | (94 )                                | —                            | (94 )         | —              | —                            | —             |
| Transfers from (to)  | 10,090                               | (10,090 )                    | —             | 8,754          | (8,754 )                     | —             |
| Sales, calls, other  | —                                    | 18,430                       | 18,430        | —              | 21,089                       | 21,089        |
| Ending balance at March 31                                       | \$(712,017)                          | \$ (580,848 )                | \$(1,292,865) | \$(442,856)    | \$ (660,393 )                | \$(1,103,249) |

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Consolidated Financial Statements (unaudited)

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, 2018 and December 31, 2017. At March 31, 2018, the Company held 1,443 AFS securities, of which 503 were in an unrealized loss position for less than twelve consecutive months and 227 were in an unrealized loss position for more than twelve consecutive months. At December 31, 2017, the Company held 1,435 AFS securities, of which 253 were in an unrealized loss position for less than twelve consecutive months and 234 were in an unrealized loss position for more than twelve consecutive months. Of the \$15.1 billion and \$12.2 billion of AFS securities in an unrealized loss position for less than twelve consecutive months as of March 31, 2018 and December 31, 2017, \$14.9 billion, or 98.5%, and \$12.0 billion, or 98.5%, respectively, were Agency AFS securities, whose principal and interest are guaranteed by the GSEs.

| (in thousands)    | Unrealized Loss Position for |                               | Unrealized Loss Position for |                               | Total                   |                               |
|-------------------|------------------------------|-------------------------------|------------------------------|-------------------------------|-------------------------|-------------------------------|
|                   | Less than 12 Months          |                               | 12 Months or More            |                               |                         |                               |
|                   | Estimated<br>Fair Value      | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value      | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value | Gross<br>Unrealized<br>Losses |
| March 31, 2018    | \$15,120,927                 | \$(347,280)                   | \$2,355,005                  | \$(172,142)                   | \$17,475,932            | \$(519,422)                   |
| December 31, 2017 | \$12,198,870                 | \$(65,313)                    | \$2,464,544                  | \$(114,724)                   | \$14,663,414            | \$(180,037)                   |

**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 either other comprehensive (loss) income, net of tax, or loss on investment securities, depending on the accounting treatment. 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.

During the three months ended March 31, 2018, the Company recorded \$0.1 million in other-than-temporary credit impairments on one non-Agency security where its future expected cash flows were less than its amortized cost. The Company did not record any other-than-temporary credit impairments during the three months ended March 31, 2017. As of March 31, 2018, impaired securities with a carrying value of \$116.8 million had actual weighted average cumulative losses of 5.7%, weighted average three-month prepayment speed of 5.4%, weighted average 60+ day delinquency of 22.0% of the pool balance, and weighted average FICO score of 658. At March 31, 2018, 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.

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The following table presents the changes in OTTI included in earnings for the three months ended March 31, 2018 and 2017:

| (in thousands)  | Three Months Ended |           |
|---|--------------------|-----------|
|   | March 31, 2018     | 2017      |
| Cumulative credit loss at beginning of period   | \$(6,395)          | \$(5,606) |
| Additions:  |                    |           |
| Other-than-temporary impairments not previously recognized  | —                  | —         |
| Increases related to other-than-temporary impairments on securities with previously recognized other-than-temporary impairments | (94 )              | —         |
| Reductions:   |                    |           |
| Decreases related to other-than-temporary impairments on securities paid down   | —                  | —         |
| Decreases related to other-than-temporary impairments on securities sold  | —                  | —         |
| Cumulative credit loss at end of period   | \$(6,489)          | \$(5,606) |

Cumulative credit losses related to OTTI may be reduced for securities sold as well as for securities that mature, are paid 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 loss on investment securities in the Company's condensed consolidated statements of comprehensive (loss) income. For the three months ended March 31, 2018 and 2017, the Company sold AFS securities for \$2.0 billion and \$2.4 billion with an amortized cost of \$2.1 billion and \$2.5 billion for net realized losses of \$19.6 million and \$50.4 million, respectively.

The following table presents the gross realized gains and losses on sales of AFS securities for the three months ended March 31, 2018 and 2017:

| (in thousands)                      | Three Months Ended |            |
|-------------------------------------|--------------------|------------|
|                                     | March 31, 2018     | 2017       |
| Gross realized gains                | \$8,195            | \$8,731    |
| Gross realized losses               | (27,758 )          | (59,134 )  |
| Total realized losses on sales, net | \$(19,563)         | \$(50,403) |

## Note 5. Servicing Activities

## Mortgage Servicing Rights, at Fair Value

One of the Company's wholly owned subsidiaries has approvals from Fannie Mae and Freddie Mac to own 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 appropriately licensed subservicers to handle substantially all servicing functions in the name of the subservicer for the loans underlying the Company's MSR.

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The following table summarizes activity related to MSR for the three months ended March 31, 2018 and 2017.

| (in thousands)   | Three Months Ended |           |
|--|--------------------|-----------|
|  | March 31,          |           |
|  | 2018               | 2017      |
| Balance at beginning of period   | \$1,086,717        | \$693,815 |
| Additions from purchases of mortgage servicing rights                  | 146,899            | 76,956    |
| Additions from sales of residential mortgage loans                     | —                  | 20        |
| Changes in fair value due to:  |                    |           |
| Changes in valuation inputs or assumptions used in the valuation model | 100,709            | 3,182     |
| Other changes in fair value <sup>(1)</sup>                             | (29,202 )          | (17,997 ) |
| Other changes <sup>(2)</sup>   | (4,100 )           | (8,396 )  |
| Balance at end of period   | \$1,301,023        | \$747,580 |

(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.

At March 31, 2018 and December 31, 2017, the Company pledged MSR with a carrying value of \$826.5 million and \$584.2 million, respectively, as collateral for repurchase agreements and revolving credit facilities. See Note 13 - Repurchase Agreements and Note 15 - Revolving Credit Facilities.

As of March 31, 2018 and December 31, 2017, 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:

| (dollars in thousands)                     | March 31,  |              | December 31, |      |
|--|------------|--------------|--------------|------|
|  | 2018       | 2017         | 2018         | 2017 |
| Weighted average prepayment speed:         | 8.1        | % 9.8        | %            | %    |
| Impact on fair value of 10% adverse change | \$(38,597) | \$ (40,100 ) |              |      |
| Impact on fair value of 20% adverse change | \$(75,373) | \$ (77,483 ) |              |      |
| Weighted average delinquency:              | 1.8        | % 1.7        | %            | %    |
| Impact on fair value of 10% adverse change | \$(5,161 ) | \$ (4,274 )  |              |      |
| Impact on fair value of 20% adverse change | \$(10,712) | \$ (8,875 )  |              |      |
| Weighted average discount rate:            | 10.4       | % 9.9        | %            | %    |
| Impact on fair value of 10% adverse change | \$(44,278) | \$ (35,137 ) |              |      |
| Impact on fair value of 20% adverse change | \$(85,824) | \$ (68,246 ) |              |      |

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.

**Risk Mitigation Activities**

The primary risk associated with 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 its Agency RMBS portfolio.



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## TWO HARBORS INVESTMENT CORP.

Notes to the Consolidated Financial Statements (unaudited)

## Mortgage Servicing Income

The following table presents the components of servicing income recorded on the Company's condensed consolidated statements of comprehensive (loss) income for the three months ended March 31, 2018 and 2017:

| (in thousands)                 | Three Months Ended |                |
|--------------------------------|--------------------|----------------|
|                                | March 31, 2018     | March 31, 2017 |
| Servicing fee income           | \$66,449           | \$38,500       |
| Ancillary and other fee income | 322                | 140            |
| Float income                   | 4,419              | 1,133          |
| Total                          | \$71,190           | \$39,773       |

## 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 \$28.2 million and \$31.1 million and were included in other assets on the condensed consolidated balance sheets as of March 31, 2018 and December 31, 2017, respectively.

## Serviced Mortgage Assets

The Company's total serviced mortgage assets consist of loans underlying MSR, residential mortgage loans held in previous on-balance sheet securitization trusts for which the Company is the named servicing administrator and loans owned and classified as residential mortgage loans held-for-sale. 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, 2018 and December 31, 2017:

| (dollars in thousands)                              | March 31, 2018  |                          | December 31, 2017 |                          |
|---|-----------------|--------------------------|-------------------|--------------------------|
|   | Number of Loans | Unpaid Principal Balance | Number of Loans   | Unpaid Principal Balance |
| Mortgage servicing rights                           | 500,338         | \$111,703,234            | 454,028           | \$101,344,054            |
| Residential mortgage loans in securitization trusts | 3,791           | 2,562,653                | 3,845             | 2,618,016                |
| Residential mortgage loans held-for-sale            | 225             | 36,016                   | 236               | 37,632                   |
| Other assets  | 22              | 2,238                    | 24                | 2,590                    |
| Total serviced mortgage assets                      | 504,376         | \$114,304,141            | 458,133           | \$104,002,292            |

## 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, 2018 and December 31, 2017:

| (in thousands)           | March 31, 2018 | December 31, 2017 |
|--------------------------|----------------|-------------------|
| Unpaid principal balance | \$36,016       | \$37,632          |
| Fair value adjustment    | (6,588)        | (7,218)           |
| Carrying value           | \$29,428       | \$30,414          |





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## Note 7. Cash, Cash Equivalents and Restricted Cash

Cash and cash equivalents include cash held in bank accounts and cash held in money market funds on an overnight basis.

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, 2018 and December 31, 2017:

| (in thousands)   | March 31,<br>2018 | December 31,<br>2017 |
|--|-------------------|----------------------|
| Restricted cash balances held by trading counterparties:                               |                   |                      |
| For securities and loan trading activity   | \$ 27,050         | \$ 27,050            |
| For derivatives trading activity   | 228,941           | 191,421              |
| As restricted collateral for repurchase agreements and Federal Home Loan Bank advances | 456,453           | 417,018              |
| Total restricted cash balances held by trading counterparties                          | 712,444           | 635,489              |
| Restricted cash balance pursuant to letter of credit on office lease                   | 347               | 347                  |
| Total  | \$ 712,791        | \$ 635,836           |

The following table provides a reconciliation of cash, cash equivalents, and restricted cash reported on the Company's condensed consolidated balance sheets as of March 31, 2018 and December 31, 2017 that sum to the total of the same such amounts shown in the statements of cash flows:

| (in thousands)                                   | March 31,<br>2018 | December 31,<br>2017 |
|--|-------------------|----------------------|
| Cash and cash equivalents                        | \$ 388,450        | \$ 419,159           |
| Restricted cash                                  | 712,791           | 635,836              |
| Total cash, cash equivalents and restricted cash | \$ 1,101,241      | \$ 1,054,995         |

## Note 8. Accrued Interest Receivable

The following table presents the Company's accrued interest receivable by collateral type as of March 31, 2018 and December 31, 2017:

| (in thousands)                           | March 31,<br>2018 | December 31,<br>2017 |
|--|-------------------|----------------------|
| Available-for-sale securities:           |                   |                      |
| Agency                                   |                   |                      |
| Federal National Mortgage Association    | \$ 46,490         | \$ 46,517            |
| Federal Home Loan Mortgage Corporation   | 11,401            | 12,255               |
| Government National Mortgage Association | 4,687             | 4,635                |
| Non-Agency                               | 4,641             | 4,740                |
| Total available-for-sale securities      | 67,219            | 68,147               |
| Residential mortgage loans held-for-sale | 151               | 162                  |
| Total                                    | \$ 67,370         | \$ 68,309            |

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## TWO HARBORS INVESTMENT CORP.

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## Note 9. 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 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, principally market risk and cash flow volatility associated with interest rate risk (including associated prepayment risk). Specifically, the Company enters into derivative and non-derivative instruments to economically hedge interest rate risk or "duration mismatch (or gap)" by adjusting the duration of its floating-rate borrowings into fixed-rate borrowings to more closely match the duration of its assets. This particularly applies to floating-rate borrowing agreements with maturities or interest rate resets of less than six months. Typically, the interest receivable terms (i.e., LIBOR) of certain derivatives match the terms of the underlying debt, resulting in an effective conversion of the rate of the related borrowing agreement from floating to fixed. The objective is to manage the cash flows associated with current and anticipated interest payments on borrowings, as well as the ability to roll or refinance borrowings at the desired amount by adjusting the duration.

To help manage the adverse impact of interest rate changes on the value of the Company's portfolio as well as its cash flows, the Company may, at times, enter into various forward contracts, including short securities, Agency to-be-announced securities, or TBAs, options, futures, swaps, caps 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 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 MSR and Agency interest-only securities (see discussion below).

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 these risks. The discussion includes both derivative and non-derivative instruments used as part of these risk management activities. Any of the Company's derivative and non-derivative instruments may be entered into in conjunction with one another in order to mitigate risks. As a result, the following discussions of each type of instrument should be read as a collective representation of the Company's risk mitigation efforts and should not be considered independent of one another. While the Company uses derivative and non-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, 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 are designated or qualifying as hedge instruments. Due to the volatility of the credit markets and difficulty in effectively matching pricing or cash flows, the Company has not designated any current derivatives as hedging instruments.

The following tables present the gross fair value and notional amounts of the Company's derivative financial instruments treated as trading derivatives as of March 31, 2018 and December 31, 2017.

| (in thousands)                   | March 31, 2018    |            |                        |           |
|----------------------------------|-------------------|------------|------------------------|-----------|
|                                  | Derivative Assets |            | Derivative Liabilities |           |
|                                  | Fair Value        | Notional   | Fair Value             | Notional  |
| Inverse interest-only securities | \$82,388          | \$558,942  | \$—                    | \$—       |
| Interest rate swap agreements    | 175,525           | 18,932,825 | —                      | 4,666,000 |
| Swaptions, net                   | 7,146             | 2,115,000  | (18,977)               | 4,060,000 |
| TBA's                            | 8,117             | 3,565,000  | (19,964)               | 3,120,000 |

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|                                    |           |              |            |              |
|------------------------------------|-----------|--------------|------------|--------------|
| Put and call options for TBAs, net | 872       | 785,000      | (6,957     | ) 845,000    |
| Markit IOS total return swaps      | —         | —            | (176       | ) 61,521     |
| Total                              | \$274,048 | \$25,956,767 | \$(46,074) | \$12,752,521 |

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| (in thousands)                   | December 31, 2017 |              |                        |             |
|----------------------------------|-------------------|--------------|------------------------|-------------|
|                                  | Derivative Assets |              | Derivative Liabilities |             |
|                                  | Fair Value        | Notional     | Fair Value             | Notional    |
| Inverse interest-only securities | \$91,827          | \$588,246    | \$—                    | \$—         |
| Interest rate swap agreements    | 206,773           | 21,516,125   | (29,867 )              | 6,966,000   |
| Swaptions, net                   | 10,405            | 2,666,000    | —                      | —           |
| TBAs                             | 913               | 733,000      | (1,930 )               | 1,306,000   |
| Markit IOS total return swaps    | —                 | —            | (106 )                 | 63,507      |
| Total                            | \$309,918         | \$25,503,371 | \$(31,903)             | \$8,335,507 |

## Comprehensive (Loss) Income Statement Presentation

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

| Derivative Instruments                    | Location of Gain (Loss) Recognized in Income on Derivatives | Amount of Gain (Loss) Recognized in Income on Derivatives |            |
|---|---|---|------------|
|   |   | Three Months Ended March 31, 2018                         | 2017       |
| (in thousands)                            |   |   |            |
| Interest rate risk management             |   |   |            |
| TBAs                                      | Gain (loss) on other derivative instruments                 | \$(22,666 )   | \$(13,459) |
| Put and call options for TBAs             | Gain (loss) on other derivative instruments                 | 32,235  | (11,240 )  |
| Interest rate swap agreements - Payers    | Gain on interest rate swap and swaption agreements          | 243,105   | 27,728     |
| Interest rate swap agreements - Receivers | Gain on interest rate swap and swaption agreements          | (153,815 )  | 2,566      |
| Swaptions                                 | Gain on interest rate swap and swaption agreements          | 61,255  | (20,367 )  |
| Markit IOS total return swaps             | Gain (loss) on other derivative instruments                 | 893   | 103        |
| Non-risk management                       |   |   |            |
| Inverse interest-only securities          | Gain (loss) on other derivative instruments                 | (2,409 )  | (3,268 )   |
| Total                                     |   | \$158,598   | \$(17,937) |

For the three months ended March 31, 2018 and 2017, the Company recognized \$3.8 million of income and \$7.9 million of expenses, respectively, 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 and receiving either LIBOR interest or a fixed interest rate on an average \$27.8 billion and \$18.7 billion notional, respectively.

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The following tables present information with respect to the volume of activity in the Company's derivative instruments during the three months ended March 31, 2018 and 2017:

| (in thousands)                     | Three Months Ended March 31, 2018   |              |   |                               |                         |  |
|------------------------------------|-------------------------------------|--------------|---|-------------------------------|-------------------------|--|
|                                    | Beginning of Period Notional Amount | Additions    | Settlement, Termination, Expiration or Exercise | End of Period Notional Amount | Average Notional Amount | Realized Gain (Loss), net <sup>(1)</sup> |
| Inverse interest-only securities   | \$588,246                           | \$—          | \$(29,304 )                                     | \$558,942                     | \$574,693               | \$—                                      |
| Interest rate swap agreements      | 28,482,125                          | 17,608,880   | (22,492,180 )                                   | 23,598,825                    | 27,751,461              | 39,706                                   |
| Swaptions, net                     | 2,666,000                           | (1,215,000 ) | (7,626,000 )                                    | (6,175,000 )                  | (1,907,211 )            | 52,773                                   |
| TBAs, net                          | (573,000 )                          | 11,231,000   | (10,213,000 )                                   | 445,000                       | 777,078                 | (11,836 )                                |
| Put and call options for TBAs, net | —                                   | 6,070,000    | (6,130,000 )                                    | (60,000 )                     | (639,089 )              | 58,204                                   |
| Markit IOS total return swaps      | 63,507                              | —            | (1,986 )  | 61,521                        | 62,148                  | —  |
| Total                              | \$31,226,878                        | \$33,694,880 | \$(46,492,470)                                  | \$18,429,288                  | \$26,619,080            | \$138,847                                |
| (in thousands)                     | Three Months Ended March 31, 2017   |              |   |                               |                         |  |
|                                    | Beginning of Period Notional Amount | Additions    | Settlement, Termination, Expiration or Exercise | End of Period Notional Amount | Average Notional Amount | Realized Gain (Loss), net <sup>(1)</sup> |
| Inverse interest-only securities   | \$740,844                           | \$—          | \$(42,018 )                                     | \$698,826                     | \$720,886               | \$—                                      |
| Interest rate swap agreements      | 20,371,063                          | 9,052,823    | (11,171,446 )                                   | 18,252,440                    | 18,707,666              | 51,146                                   |
| Swaptions, net                     | 225,000                             | (3,880,000 ) | (225,000 )                                      | (3,880,000 )                  | (1,495,500 )            | 14,885                                   |
| TBAs, net                          | (1,489,000 )                        | (3,086,000 ) | 3,582,000                                       | (993,000 )                    | (1,161,433 )            | (11,406 )                                |
| Put and call options for TBAs, net | (1,136,000 )                        | 1,270,000    | 1,636,000                                       | 1,770,000                     | (285,533 )              | 38,770                                   |
| Markit IOS total return swaps      | 90,593                              | —            | (3,324 )  | 87,269                        | 88,161                  | —  |
| Total                              | \$18,802,500                        | \$3,356,823  | \$(6,223,788)                                   | \$15,935,535                  | \$16,574,247            | \$93,395                                 |

(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. Realized gains and losses and derivative fair value adjustments are reflected within the realized and unrealized gain on interest rate swaps and swaptions and unrealized loss on other derivative instruments line items 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 (purchases) short sales of other derivative instruments, proceeds from sales (payments for termination) 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.

**Interest Rate Sensitive Assets/Liabilities**

The Company's Agency RMBS portfolio is 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. To mitigate the impact of this risk on the Company's fixed-rate Agency pool portfolio, the Company maintains a portfolio of fixed-rate interest-only securities and MSR, which increase in value when interest rates increase. As of March 31, 2018 and December 31, 2017, the Company had \$136.7 million and \$117.8 million, respectively, of interest-only securities, and \$1.3 billion and \$1.1 billion, respectively, of MSR in place to economically hedge its Agency RMBS.

Interest-only securities are included in AFS securities, at fair value, in the condensed consolidated balance sheets.

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The Company monitors its borrowings under repurchase agreements, FHLB advances and revolving credit facilities, which are generally floating-rate debt, in relation to the rate profile of its portfolio. In connection with its risk management activities, the Company enters into a variety of derivative and non-derivative instruments to economically hedge interest rate risk or “duration mismatch (or gap)” by adjusting the duration of its floating-rate borrowings into fixed-rate borrowings to more closely match the duration of its assets. 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 certain derivatives match the terms of the underlying debt, resulting in an effective conversion of the rate of the related borrowing agreement from floating to fixed. The objective is to manage the cash flows associated with current and anticipated interest payments on borrowings, as well as the ability to roll or refinance borrowings at the desired amount by adjusting the duration. To help manage the adverse impact of interest rate changes on the value of the Company’s portfolio as well as its cash flows, 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 interest rate risk management strategy, the Company has entered into TBAs, put and call options for TBAs, interest rate swap and swaption agreements and Markit IOS total return swaps.

TBAs. At times, the Company may use TBAs as a means of deploying capital until targeted investments are available or to take advantage of temporary displacements, funding advantages or valuation differentials in the marketplace. Additionally, the Company may use TBAs independently, or in conjunction with other derivative and non-derivative instruments, in order to mitigate risks. 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.

The Company may hold both long and short notional TBA positions, which are disclosed 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 March 31, 2018 and December 31, 2017:

| March 31, 2018     |                                |                           |                             |                                   |                        |
|--------------------|--------------------------------|---------------------------|-----------------------------|-----------------------------------|------------------------|
| (in thousands)     | Notional Amount <sup>(1)</sup> | Cost Basis <sup>(2)</sup> | Market Value <sup>(3)</sup> | Net Carrying Value <sup>(4)</sup> |                        |
|                    |                                |                           |                             | Derivative Assets                 | Derivative Liabilities |
| Purchase contracts | \$3,565,000                    | \$3,721,166               | \$3,729,282                 | \$8,117                           | \$—                    |
| Sale contracts     | (3,120,000)                    | (3,107,593)               | (3,127,556)                 | —                                 | (19,964)               |
| TBAs, net          | \$445,000                      | \$613,573                 | \$601,726                   | \$8,117                           | \$(19,964)             |
| December 31, 2017  |                                |                           |                             |                                   |                        |
| (in thousands)     | Notional Amount <sup>(1)</sup> | Cost Basis <sup>(2)</sup> | Market Value <sup>(3)</sup> | Net Carrying Value <sup>(4)</sup> |                        |
|                    |                                |                           |                             | Derivative Assets                 | Derivative Liabilities |
| Purchase contracts | \$733,000                      | \$769,446                 | \$770,359                   | \$913                             | \$—                    |
| Sale contracts     | (1,306,000)                    | (1,316,368)               | (1,318,297)                 | —                                 | (1,930)                |
| TBAs, net          | \$(573,000)                    | \$(546,922)               | \$(547,938)                 | \$913                             | \$(1,930)              |

(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.

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Put and Call Options for TBAs. The Company may use put and call options for TBAs independently, or in conjunction with other derivative and non-derivative instruments, in order to mitigate risks. As of March 31, 2018, the Company had purchased put and call options for TBAs with a notional amount of \$7.6 billion and short sold put and call options for TBAs with a notional amount of \$7.6 billion. The put and call options had a fair market value of \$0.9 million included in derivative assets, at fair value, and \$7.0 million included in derivative liabilities, at fair value, on the condensed consolidated balance sheet as of March 31, 2018. The Company did not hold any put and call options for TBAs as of December 31, 2017.

Interest Rate Swap Agreements. The Company may use interest rate swaps independently, or in conjunction with other derivative and non-derivative instruments, in order to mitigate risks. As of March 31, 2018 and December 31, 2017, the Company held the following interest rate swaps that were utilized as economic hedges of interest rate exposure (or duration) whereby the Company receives interest at a three-month LIBOR rate:  
(notional in thousands)

March 31, 2018

| Swaps Maturities    | Notional Amount <sup>(1)</sup> | Weighted Average Fixed Pay Rate <sup>(2)</sup> | Weighted Average Receive Rate <sup>(2)</sup> | Weighted Average Maturity (Years) <sup>(2)</sup> |
|---------------------|--------------------------------|--|--|--|
| 2018                | \$2,020,000                    | 1.289 %  | 1.885 %                                      | 0.60   |
| 2019                | 4,336,897                      | 1.769 %  | 1.802 %                                      | 1.54   |
| 2020                | 2,890,000                      | 1.785 %  | 1.952 %                                      | 2.56   |
| 2021                | 2,417,000                      | 1.788 %  | 2.198 %                                      | 3.67   |
| 2022 and Thereafter | 5,758,928                      | 2.200 %  | 1.936 %                                      | 7.88   |
| Total               | \$17,422,825                   | 1.831 %  | 1.936 %                                      | 3.65   |

(notional in thousands)

December 31, 2017

| Swaps Maturities    | Notional Amount <sup>(1)</sup> | Weighted Average Fixed Pay Rate <sup>(2)</sup> | Weighted Average Receive Rate <sup>(2)</sup> | Weighted Average Maturity (Years) <sup>(2)</sup> |
|---------------------|--------------------------------|--|--|--|
| 2018                | \$4,320,000                    | 1.155 %  | 1.508 %                                      | 0.50   |
| 2019                | 5,448,135                      | 1.767 %  | 1.386 %                                      | 1.79   |
| 2020                | 5,490,000                      | 1.945 %  | 1.509 %                                      | 2.87   |
| 2021                | 2,417,000                      | 1.788 %  | 1.628 %                                      | 3.92   |
| 2022 and Thereafter | 5,245,000                      | 1.764 %  | 1.516 %                                      | 6.44   |
| Total               | \$22,920,135                   | 1.694 %  | 1.493 %                                      | 3.01   |

(1) Notional amount includes \$1.4 billion and \$0.6 billion in forward starting interest rate swaps as of March 31, 2018 and December 31, 2017, respectively.

(2) Weighted averages exclude forward starting interest rate swaps. As of March 31, 2018 and December 31, 2017, the weighted average fixed pay rate on forward starting interest rate swaps was 2.5% and 2.1%, respectively.

Additionally, as of March 31, 2018 and December 31, 2017, the Company held the following interest rate swaps in order to mitigate mortgage interest rate exposure (or duration) risk whereby the Company pays interest at a three-month LIBOR rate:

(notional in thousands)

March 31, 2018

| Swaps Maturities    | Notional<br>Amounts | Weighted            |                                     | Weighted Average Maturity (Years) |
|---------------------|---------------------|---------------------|-------------------------------------|-----------------------------------|
|                     |                     | Average<br>Pay Rate | Average<br>Fixed<br>Receive<br>Rate |                                   |
| 2020                | \$450,000           | 1.984 %             | 1.763 %                             | 2.05                              |
| 2021                | 1,415,000           | 2.096 %             | 1.774 %                             | 2.84                              |
| 2022 and Thereafter | 4,311,000           | 2.389 %             | 1.985 %                             | 7.81                              |
| Total               | \$6,176,000         | 2.292 %             | 1.921 %                             | 6.25                              |

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(notional in thousands)

December 31, 2017

| Swaps Maturities    | Notional Amounts | Weighted Average |                    | Weighted Average Maturity (Years) |
|---------------------|------------------|------------------|--------------------|-----------------------------------|
|                     |                  | Pay Rate         | Fixed Receive Rate |                                   |
| 2020                | \$200,000        | 1.391 %          | 1.642 %            | 2.60                              |
| 2021                | 500,000          | 1.357 %          | 1.327 %            | 3.05                              |
| 2022 and Thereafter | 4,861,990        | 1.475 %          | 2.325 %            | 8.34                              |
| Total               | \$5,561,990      | 1.462 %          | 2.211 %            | 7.66                              |

Interest Rate Swaptions. The Company may use 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) independently, or in conjunction with other derivative and non-derivative instruments, in order to mitigate risks. As of March 31, 2018 and December 31, 2017, the Company had the following outstanding interest rate swaptions that were utilized as macro-economic hedges:

March 31, 2018

| Swaption            | Option Expiration | Underlying Swap |            |                              |                 |                  |                      |                      |
|---------------------|-------------------|-----------------|------------|------------------------------|-----------------|------------------|----------------------|----------------------|
|                     |                   | Cost Basis      | Fair Value | Average Months to Expiration | Notional Amount | Average Pay Rate | Average Receive Rate | Average Term (Years) |
| Purchase contracts: |                   |                 |            |                              |                 |                  |                      |                      |
| Payer               | < 6 Months        | \$8,461         | \$10,754   | 3.66                         | \$4,095,000     | 2.98 %           | 3M Libor             | 5.0                  |
| Sale contracts:     |                   |                 |            |                              |                 |                  |                      |                      |
| Payer               | ≥ 6 Months        | \$(6,808)       | \$(6,783)  | 11.19                        | \$(280,000)     | 2.99 %           | 3M Libor             | 10.0                 |
| Receiver            | < 6 Months        | \$(23,580)      | \$(9,301)  | 2.48                         | \$(9,710,000)   | 3M Libor         | 2.32 %               | 5.0                  |
| Receiver            | ≥ 6 Months        | \$(6,962)       | \$(6,501)  | 11.21                        | \$(280,000)     | 3M Libor         | 2.99 %               | 10.0                 |

December 31, 2017

| Swaption            | Option Expiration | Underlying Swap |            |                              |                 |                        |                      |                      |
|---------------------|-------------------|-----------------|------------|------------------------------|-----------------|------------------------|----------------------|----------------------|
|                     |                   | Cost            | Fair Value | Average Months to Expiration | Notional Amount | Average Fixed Pay Rate | Average Receive Rate | Average Term (Years) |
| Purchase contracts: |                   |                 |            |                              |                 |                        |                      |                      |
| Payer               | < 6 Months        | \$21,380        | \$17,736   | 4.03                         | \$7,200,000     | 2.27 %                 | 3M Libor             | 3.8                  |
| Receiver            | < 6 Months        | \$4,660         | \$2,982    | 3.72                         | \$2,300,000     | 3M Libor               | 2.10 %               | 10.0                 |

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Sale contracts:

|          |               |            |            |      |               |             |             |      |
|----------|---------------|------------|------------|------|---------------|-------------|-------------|------|
| Payer    | < 6<br>Months | \$(7,950 ) | \$(5,619 ) | 4.66 | \$(1,693,000) | 2.70 %      | 3M<br>Libor | 10.0 |
| Receiver | < 6<br>Months | \$(16,260) | \$(4,694 ) | 5.17 | \$(5,141,000) | 3M<br>Libor | 1.89 %      | 5.6  |

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Markit IOS Total Return Swaps. The Company may use 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) independently, or in conjunction with other derivative and non-derivative instruments, in order to mitigate risks. The Company enters into total return swaps to help mitigate the potential impact of larger increases or decreases in interest rates on the performance of our 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 March 31, 2018 and December 31, 2017:

(notional and dollars in thousands)

March 31, 2018

| Maturity Date    | Current Notional Amount | Fair Value | Cost Basis | Unrealized Gain (Loss) |
|------------------|-------------------------|------------|------------|------------------------|
| January 12, 2043 | \$(23,608)              | \$(63 )    | \$ 201     | \$ (264 )              |
| January 12, 2044 | (37,913 )               | (113 )     | 366        | (479 )                 |
| Total            | \$(61,521)              | \$(176)    | \$ 567     | \$ (743 )              |

(notional and dollars in thousands)

December 31, 2017

| Maturity Date    | Current Notional Amount | Fair Value | Cost Basis | Unrealized Gain (Loss) |
|------------------|-------------------------|------------|------------|------------------------|
| January 12, 2043 | \$(24,362)              | \$(24 )    | \$ 201     | \$ (225 )              |
| January 12, 2044 | (39,145 )               | (82 )      | 366        | (448 )                 |
| Total            | \$(63,507)              | \$(106)    | \$ 567     | \$ (673 )              |

**Credit Risk**

The Company’s exposure to credit losses on its Agency RMBS portfolio is limited due to implicit or explicit backing from 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.

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 securities and residential mortgage loans.

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 March 31, 2018, the fair value of derivative financial instruments as an asset and liability position was \$274.0 million and \$46.1 million, respectively.



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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 to spread its credit risk exposure across multiple counterparties in order to reduce its 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 the 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. The Company's centrally cleared interest rate swaps require that the Company posts an "initial margin" amount determined by the clearing exchange, which is generally intended to be set at a level sufficient to protect the exchange from the interest rate swap's maximum estimated single-day price movement. The Company also exchanges "variation margin" based upon daily changes in fair value, as measured by the exchange. As a result of amendments to rules governing certain central clearing activities, the exchange of variation margin is considered a settlement of the interest rate swap, as opposed to pledged collateral. Accordingly, beginning in the first quarter of 2018 and in subsequent periods, the Company accounts for the receipt or payment of variation margin as a direct reduction to the carrying value of the interest rate swap asset or liability. As of December 31, 2017, variation margin pledged or received was netted on a counterparty basis and classified within restricted cash, due from counterparties, or due to counterparties on the Company's condensed consolidated balance sheets.

## 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 inverse interest-only Agency RMBS. Inverse Interest-Only Securities. As of March 31, 2018 and December 31, 2017, inverse interest-only securities with a carrying value of \$82.4 million and \$91.8 million, including accrued interest receivable of \$0.8 million and \$0.9 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 March 31, 2018 and December 31, 2017:

| (in thousands)          | March 31,<br>2018 | December 31,<br>2017 |
|-------------------------|-------------------|----------------------|
| Face Value              | \$558,942         | \$ 588,246           |
| Amortized Cost          | \$82,250          | \$ 86,734            |
| Gross unrealized gains  | 4,092             | 6,843                |
| Gross unrealized losses | (4,714 )          | (2,602 )             |
| Market Value            | \$81,628          | \$ 90,975            |



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## Note 10. Other Assets

Other assets as of March 31, 2018 and December 31, 2017 are summarized in the following table:

| (in thousands)                          | March 31, December 31, |            |
|---|------------------------|------------|
|   | 2018                   | 2017       |
| Property and equipment at cost          | \$6,837                | \$ 6,776   |
| Accumulated depreciation <sup>(1)</sup> | (5,748 )               | (5,550 )   |
| Net property and equipment              | 1,089                  | 1,226      |
| Equity securities, at fair value        | 27,423                 | 29,413     |
| Prepaid expenses                        | 1,315                  | 1,755      |
| Income taxes receivable                 | 854                    | 130        |
| Deferred tax assets, net <sup>(2)</sup> | 21,958                 | 25,956     |
| Servicing advances                      | 28,179                 | 31,050     |
| Federal Home Loan Bank stock            | 40,845                 | 53,826     |
| Equity investments                      | 3,000                  | 3,000      |
| Other receivables                       | 34,696                 | 29,482     |
| Total other assets                      | \$159,359              | \$ 175,838 |

(1) Depreciation expense for the three months ended March 31, 2018 and 2017 was \$0.2 million and \$0.3 million, respectively.

(2) Net of valuation allowance of \$2.3 million and \$2.7 million, respectively.

## Note 11. Other Liabilities

Other liabilities as of March 31, 2018 and December 31, 2017 are summarized in the following table:

| (in thousands)          | March 31, December 31, |           |
|-------------------------|------------------------|-----------|
|                         | 2018                   | 2017      |
| Accrued expenses        | \$ 21,693              | \$ 24,737 |
| Other                   | 3,541                  | 3,043     |
| Total other liabilities | \$ 25,234              | \$ 27,780 |

## Note 12. Fair Value

## Fair Value Measurements

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 Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets  
2 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.

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Unobservable inputs are supported by little or no market activity. The unobservable inputs represent the Level assumptions that market participants would use to price the assets and liabilities, including risk. Generally, Level 3 assets and liabilities are valued using pricing models, discounted cash flow methodologies, or similar techniques that require significant judgment or estimation.

The 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.

**Available-for-sale securities.** The Company holds a portfolio of AFS securities that are carried at fair value in the condensed consolidated balance sheets and primarily comprised of Agency RMBS and non-Agency securities. The Company determines the fair value of its 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 securities, 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 principally to 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 99.3% and 0.7% of its AFS securities as Level 2 and Level 3 fair value assets, respectively, at March 31, 2018. AFS securities account for 92.8% of all assets reported at fair value at March 31, 2018.

**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 March 31, 2018.

**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 1.6% and 98.4% of its residential mortgage loans held-for-sale as Level 2 and Level 3 fair value assets, respectively, at March 31, 2018.

**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 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 Markit IOS total returns swaps reported at fair value as Level 2 at March 31, 2018.

The Company may also enter 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 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 March 31, 2018. The Company reported 100% of its TBAs as Level 1 as of March 31, 2018. The Company did not hold any short U.S. Treasuries at March 31, 2018.

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.

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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.

Equity securities. The Company's equity securities are carried at fair value and reported in other assets on the condensed consolidated balance sheets. Changes in fair value are recorded as a component of loss on investment securities in the condensed consolidated statements of comprehensive (loss) income. The Company determines fair value of its equity securities based on the closing market price of the securities at period end.

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<br>March 31, 2018 |                     |                    |                     |
|--|---|---------------------|--------------------|---------------------|
|  | Level 1   | Level 2             | Level 3            | Total               |
| <b>Assets</b>                            |   |                     |                    |                     |
| Available-for-sale securities            | \$—   | \$20,905,953        | \$153,424          | \$21,059,377        |
| Mortgage servicing rights                | —   | —                   | 1,301,023          | 1,301,023           |
| Residential mortgage loans held-for-sale | —   | 470                 | 28,958             | 29,428              |
| Derivative assets                        | 8,117   | 265,931             | —                  | 274,048             |
| Equity securities                        | 27,423  | —                   | —                  | 27,423              |
| <b>Total assets</b>                      | <b>\$35,540</b>                                     | <b>\$21,172,354</b> | <b>\$1,483,405</b> | <b>\$22,691,299</b> |
| <b>Liabilities</b>                       |   |                     |                    |                     |
| Derivative liabilities                   | \$19,964  | \$26,110            | \$—                | \$46,074            |
| <b>Total liabilities</b>                 | <b>\$19,964</b>                                     | <b>\$26,110</b>     | <b>\$—</b>         | <b>\$46,074</b>     |

| (in thousands)                           | Recurring Fair Value Measurements<br>December 31, 2017 |                     |                    |                     |
|--|--|---------------------|--------------------|---------------------|
|  | Level 1  | Level 2             | Level 3            | Total               |
| <b>Assets</b>                            |  |                     |                    |                     |
| Available-for-sale securities            | \$—  | \$21,067,678        | \$153,141          | \$21,220,819        |
| Mortgage servicing rights                | —  | —                   | 1,086,717          | 1,086,717           |
| Residential mortgage loans held-for-sale | —  | 474                 | 29,940             | 30,414              |
| Derivative assets                        | 913  | 309,005             | —                  | 309,918             |
| Equity securities                        | 29,413   | —                   | —                  | 29,413              |
| <b>Total assets</b>                      | <b>\$30,326</b>  | <b>\$21,377,157</b> | <b>\$1,269,798</b> | <b>\$22,677,281</b> |
| <b>Liabilities</b>                       |  |                     |                    |                     |
| Derivative liabilities                   | 1,930  | 29,973              | —                  | 31,903              |
| <b>Total liabilities</b>                 | <b>\$1,930</b>   | <b>\$29,973</b>     | <b>\$—</b>         | <b>\$31,903</b>     |

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TWO HARBORS INVESTMENT CORP.

Notes to the Consolidated Financial Statements (unaudited)

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 March 31, 2018, 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 and swaption agreements, put and call options for TBAs and U.S. Treasuries, constant maturity swaps, 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 Consolidated Financial Statements (unaudited)

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

| (in thousands)  | Three Months Ended<br>March 31, 2018 |   |   |
|---|--------------------------------------|---|---|
|   | Available-For-Sale<br>Securities     | Mortgage<br>For-Sale<br>Servicing<br>Rights | Residential<br>Mortgage<br>Loans<br>Held-For-Sale |
| Beginning of period level 3 fair value  | \$ 153,141                           | \$ 1,086,717                                | \$ 29,940   |
| Gains (losses) included in net income:  |                                      |   |   |
| Realized gains (losses)   | —                                    | (28,902 )                                   | (168 )  |
| Unrealized gains (losses)   | —                                    | 100,709                                     | (1) 486 (3)                                       |
| Total gains (losses) included in net income   | —                                    | 71,807                                      | 318   |
| Other comprehensive (loss) income   | 283                                  | —   | —   |
| Purchases   | —                                    | 146,899                                     | —   |
| Sales   | —                                    | (300 )                                      | —   |
| Settlements   | —                                    | (4,100 )                                    | (1,300 )  |
| Gross transfers into level 3  | —                                    | —   | —   |
| Gross transfers out of level 3  | —                                    | —   | —   |
| End of period level 3 fair value  | \$ 153,424                           | \$ 1,301,023                                | \$ 28,958   |
| Change in unrealized gains or losses for the period included in earnings for assets held at the end of the reporting period | \$ 283                               | \$ 100,131                                  | (2) \$ 512 (4)                                    |

(1) The change in unrealized gains or losses on MSR was recorded in gain (loss) on servicing asset on the condensed consolidated statements of comprehensive (loss) income.

(2) 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 (loss) income.

(3) The change in unrealized gains or losses on residential mortgage loans held-for-sale was recorded in other income on the condensed consolidated statements of comprehensive (loss) income.

(4) 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 other income on the condensed consolidated statements of comprehensive (loss) income.

The Company did not incur transfers between Level 1, Level 2 or Level 3 during the three months ended March 31, 2018 and 2017. 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 broker quotes in the fair value measurement of its Level 3 available-for-sale securities. The significant unobservable inputs used by the broker 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.

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 providers in the fair value measurement of the Company's MSR classified as Level 3 fair value assets at March 31, 2018:

March 31, 2018

| Valuation Technique  | Unobservable Input <sup>(1)</sup> | Range     | Weighted Average |
|----------------------|-----------------------------------|-----------|------------------|
| Discounted cash flow | Constant prepayment speed         | 7.1-9.2 % | 8.1%             |

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|               |           |       |
|---------------|-----------|-------|
| Delinquency   | 1.5-2.2 % | 1.8%  |
| Discount rate | 9.0-11.9% | 10.4% |



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## TWO HARBORS INVESTMENT CORP.

## Notes to the Consolidated Financial Statements (unaudited)

December 31, 2017

| Valuation Technique  | Unobservable Input <sup>(1)</sup> | Range     | Weighted Average |
|----------------------|-----------------------------------|-----------|------------------|
| Discounted cash flow | Constant prepayment speed         | 8.2-11.2% | 9.8%             |
|                      | Delinquency                       | 1.3-2.0%  | 1.7%             |
|                      | Discount rate                     | 8.3-11.2% | 9.9%             |

(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.

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.

**Fair Value Option for Financial Assets and Financial Liabilities**

On July 1, 2015, the Company elected the fair value option for Agency interest-only securities acquired on or after such date. The fair value option was elected to simplify the reporting of changes in fair value. Agency interest-only securities are carried within AFS securities on the condensed consolidated balance sheets. The Company's policy is to separately record interest income, net of premium amortization or including discount accretion, on these fair value elected securities. Fair value adjustments are reported in loss on investment securities on the condensed consolidated statements of comprehensive (loss) income.

The Company elected the fair value option for its previously held residential mortgage loans held-for-investment in securitization trusts and the collateralized borrowings in securitization trusts. The fair value option was elected to better reflect the economics of the Company's retained interests. The Company's policy was to separately record interest income on the fair value elected loans and interest expense on the fair value elected borrowings. Upfront fees and costs were not deferred or capitalized. Fair value adjustments were reported in other income on the condensed consolidated statements of comprehensive (loss) income. During the fourth quarter of 2017, the Company sold all of these retained subordinated securities thereby causing the deconsolidation of the securitization trusts from the Company's consolidated balance sheet. The remaining retained securities are included within non-Agency AFS securities.

The Company has elected the fair value option for its residential mortgage loans held-for-sale. 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 other income on the condensed consolidated statements of comprehensive (loss) income.

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## TWO HARBORS INVESTMENT CORP.

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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 (loss) income for each fair value option-elected item.

| (in thousands)  | Three Months Ended March 31, 2018 |                               |                |                              | Change in fair value due to credit risk |
|---|-----------------------------------|-------------------------------|----------------|------------------------------|---|
|   | Interest income (expense)         | Loss on investment securities | Other income   | Total included in net income |   |
| <b>Assets</b>   |                                   |                               |                |                              |   |
| Available-for-sale securities   | \$(1,989)                         | \$ 6,358                      | \$ —           | \$ 4,369                     | N/A                                     |
| Residential mortgage loans held-for-investment in securitization trusts | — <sup>(1)</sup>                  | —                             | —              | —                            | \$— <sup>(2)</sup>                      |
| Residential mortgage loans held-for-sale                                | 307 <sup>(1)</sup>                | —                             | 316            | 623                          | \$37 <sup>(3)</sup>                     |
| <b>Liabilities</b>  |                                   |                               |                |                              |   |
| Collateralized borrowings in securitization trusts                      | —                                 | —                             | —              | —                            | — <sup>(2)</sup>                        |
| <b>Total</b>  | <b>\$(1,682)</b>                  | <b>\$ 6,358</b>               | <b>\$ 316</b>  | <b>\$ 4,992</b>              | <b>\$37</b>                             |
| <b>Three Months Ended March 31, 2017</b>                                |                                   |                               |                |                              |   |
| (in thousands)  | Interest income (expense)         | Loss on investment securities | Other income   | Total included in net income | Change in fair value due to credit risk |
| <b>Assets</b>   |                                   |                               |                |                              |   |
| Available-for-sale securities   | \$(1,704)                         | \$ 2,002                      | \$—            | \$298                        | N/A                                     |
| Residential mortgage loans held-for-investment in securitization trusts | 31,628 <sup>(1)</sup>             | —                             | 13,039         | 44,667                       | \$— <sup>(2)</sup>                      |
| Residential mortgage loans held-for-sale                                | 398 <sup>(1)</sup>                | —                             | 1,461          | 1,859                        | 411 <sup>(3)</sup>                      |
| <b>Liabilities</b>  |                                   |                               |                |                              |   |
| Collateralized borrowings in securitization trusts                      | (25,386)                          | —                             | (6,355)        | (31,741)                     | — <sup>(2)</sup>                        |
| <b>Total</b>  | <b>\$4,936</b>                    | <b>\$ 2,002</b>               | <b>\$8,145</b> | <b>\$15,083</b>              | <b>\$411</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 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.

(3) 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.

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

|                |                      |
|----------------|----------------------|
| March 31, 2018 | December 31,<br>2017 |
|----------------|----------------------|

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| (in thousands)                           | Unpaid Fair<br>Principal Value<br>Balance <sup>(1)</sup> |          | Unpaid Fair<br>Principal Value<br>Balance <sup>(1)</sup> |          |
|--|--|----------|--|----------|
| Residential mortgage loans held-for-sale |  |          |  |          |
| Total loans                              | \$36,016   | \$29,428 | \$37,632   | \$30,414 |
| Nonaccrual loans                         | \$12,764   | \$10,578 | \$13,511   | \$10,963 |
| Loans 90+ days past due                  | \$10,518   | \$8,572  | \$12,136   | \$9,857  |

<sup>(1)</sup>Excludes accrued interest receivable.

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## TWO HARBORS INVESTMENT CORP.

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## 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.

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, MSR, residential mortgage loans held-for-sale, derivative assets and liabilities and equity securities 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 Note 12.

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, FHLB advances and revolving credit facilities that mature in less than one year generally approximates fair value due to the short maturities. As of March 31, 2018, the Company held \$250.0 million of repurchase agreements and \$865.0 million of FHLB advances that are considered long-term. The Company's long-term repurchase agreements and 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.

Convertible senior notes are carried at their unpaid principal balance, net of any unamortized deferred issuance costs.

The Company estimates the fair value of its convertible senior notes using the market transaction price nearest to March 31, 2018. The Company categorizes the fair value measurement of these assets 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 March 31, 2018 and December 31, 2017.

| (in thousands)                           | March 31, 2018 |              | December 31, 2017 |              |
|--|----------------|--------------|-------------------|--------------|
|  | Carrying Value | Fair Value   | Carrying Value    | Fair Value   |
| <b>Assets</b>                            |                |              |                   |              |
| Available-for-sale securities            | \$21,059,377   | \$21,059,377 | \$21,220,819      | \$21,220,819 |
| Mortgage servicing rights                | \$1,301,023    | \$1,301,023  | \$1,086,717       | \$1,086,717  |
| Residential mortgage loans held-for-sale | \$29,428       | \$29,428     | \$30,414          | \$30,414     |
| Cash and cash equivalents                | \$388,450      | \$388,450    | \$419,159         | \$419,159    |
| Restricted cash                          | \$712,791      | \$712,791    | \$635,836         | \$635,836    |
| Derivative assets                        | \$274,048      | \$274,048    | \$309,918         | \$309,918    |
| Equity securities                        | \$27,423       | \$27,423     | \$29,413          | \$29,413     |
| Federal Home Loan Bank stock             | \$40,845       | \$40,845     | \$53,826          | \$53,826     |
| Equity investments                       | \$3,000        | \$3,000      | \$3,000           | \$3,000      |
| <b>Liabilities</b>                       |                |              |                   |              |
| Repurchase agreements                    | \$19,148,679   | \$19,148,679 | \$19,451,207      | \$19,451,207 |
| Federal Home Loan Bank advances          | \$865,024      | \$865,024    | \$1,215,024       | \$1,215,024  |
| Revolving credit facilities              | \$20,000       | \$20,000     | \$20,000          | \$20,000     |

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|                          |           |           |           |           |
|--------------------------|-----------|-----------|-----------|-----------|
| Convertible senior notes | \$283,054 | \$297,922 | \$282,827 | \$306,351 |
| Derivative liabilities   | \$46,074  | \$46,074  | \$31,903  | \$31,903  |

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## TWO HARBORS INVESTMENT CORP.

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## Note 13. Repurchase Agreements

As of March 31, 2018 and December 31, 2017, the Company had outstanding \$19.1 billion and \$19.5 billion, respectively, of repurchase agreements. Excluding the effect of the Company's interest rate swaps, the repurchase agreements had a weighted average borrowing rate of 1.96% and 1.69% and weighted average remaining maturities of 97 and 83 days as of March 31, 2018 and December 31, 2017, respectively.

At March 31, 2018 and December 31, 2017, the repurchase agreement balances were as follows:

| (in thousands) | March 31,<br>2018 | December 31,<br>2017 |
|----------------|-------------------|----------------------|
| Short-term     | \$18,898,679      | \$19,338,707         |
| Long-term      | 250,000           | 112,500              |
| Total          | \$19,148,679      | \$19,451,207         |

At March 31, 2018 and December 31, 2017, the repurchase agreements had the following characteristics and remaining maturities:

| (in thousands)                  | March 31, 2018<br>Collateral Type    |                          |                       |                                 |        | Total Amount<br>Outstanding |
|---------------------------------|--------------------------------------|--------------------------|-----------------------|---------------------------------|--------|-----------------------------|
|                                 | Agency<br>RMBS                       | Non-Agency<br>Securities | Agency<br>Derivatives | Mortgage<br>Servicing<br>Rights |        |                             |
| Within 30 days                  | \$3,320,225                          | \$687,287                | \$19,720              | \$—                             |        | \$4,027,232                 |
| 30 to 59 days                   | 3,471,788                            | 413,786                  | 15,754                | —                               |        | 3,901,328                   |
| 60 to 89 days                   | 2,808,509                            | 293,799                  | —                     | —                               |        | 3,102,308                   |
| 90 to 119 days                  | 1,925,898                            | 185,900                  | —                     | —                               |        | 2,111,798                   |
| 120 to 364 days                 | 5,280,124                            | 450,239                  | 25,650                | —                               |        | 5,756,013                   |
| One year and over               | —                                    | —                        | —                     | 250,000                         |        | 250,000                     |
| Total                           | \$16,806,544                         | \$2,031,011              | \$61,124              | \$250,000                       |        | \$19,148,679                |
| Weighted average borrowing rate | 1.78                                 | % 3.20                   | % 2.63                | % 3.94                          | % 1.96 | %                           |
| (in thousands)                  | December 31, 2017<br>Collateral Type |                          |                       |                                 |        | Total Amount<br>Outstanding |
|                                 | Agency<br>RMBS                       | Non-Agency<br>Securities | Agency<br>Derivatives | Mortgage<br>Servicing<br>Rights |        |                             |
| Within 30 days                  | \$3,634,541                          | \$613,500                | \$21,423              | \$—                             |        | \$4,269,464                 |
| 30 to 59 days                   | 3,522,256                            | 261,835                  | 47,020                | —                               |        | 3,831,111                   |
| 60 to 89 days                   | 3,165,834                            | 290,628                  | 2,478                 | —                               |        | 3,458,940                   |
| 90 to 119 days                  | 2,119,490                            | 332,614                  | 322                   | —                               |        | 2,452,426                   |
| 120 to 364 days                 | 4,883,432                            | 443,334                  | —                     | —                               |        | 5,326,766                   |
| One year and over               | —                                    | —                        | —                     | 112,500                         |        | 112,500                     |
| Total                           | \$17,325,553                         | \$1,941,911              | \$71,243              | \$112,500                       |        | \$19,451,207                |
| Weighted average borrowing rate | 1.53                                 | % 2.98                   | % 2.15                | % 3.78                          | % 1.69 | %                           |

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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)                               | March 31,<br>2018 | December 31,<br>2017 |
|--|-------------------|----------------------|
| Available-for-sale securities, at fair value | \$19,955,664      | \$19,780,175         |
| Mortgage servicing rights, at fair value     | 688,078           | 424,740              |
| Cash and cash equivalents                    | —                 | 15,000               |
| Restricted cash                              | 456,453           | 417,018              |
| Due from counterparties                      | 81,860            | 773,422              |
| Derivative assets, at fair value             | 81,563            | 90,895               |
| Total  | \$21,263,618      | \$21,501,250         |

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.

The following table summarizes certain characteristics of the Company's repurchase agreements and counterparty concentration at March 31, 2018 and December 31, 2017:

| (dollars in thousands)                  | March 31, 2018     |  |                   |                                   | December 31, 2017  |  |                   |                                   |
|---|--------------------|--|-------------------|-----------------------------------|--------------------|--|-------------------|-----------------------------------|
|   | 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 |
| Barclays Capital Inc.                   | \$2,296,533        | \$268,001                                | 8 %               | 120                               | \$1,958,741        | \$275,128                                | 8 %               | 93                                |
| All other counterparties <sup>(2)</sup> | 16,852,146         | 1,473,488                                | 42 %              | 94                                | 17,492,466         | 1,467,995                                | 41 %              | 82                                |
| Total                                   | \$19,148,679       | \$1,741,489                              |                   |                                   | \$19,451,207       | \$1,743,123                              |                   |                                   |

Represents the net carrying value of the assets 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,

(1) including accrued interest. Payables due to broker counterparties for unsettled securities purchases are not included in the amounts presented above. The Company did not have any such payables at March 31, 2018 or December 31, 2017.

(2) Represents amounts outstanding with 27 and 26 counterparties at March 31, 2018 and December 31, 2017, 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 14. 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 of 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 March 31, 2018 and December 31, 2017, TH Insurance had \$0.9 billion and \$1.2 billion in outstanding secured advances with a weighted average borrowing rate of 2.13% and 1.79%, respectively. As of March 31, 2018 and December 31, 2017, TH Insurance had an additional \$2.7 billion and \$2.2 billion of available uncommitted capacity for borrowings, respectively, insofar as TH Insurance holds adequate total

assets to support a new advance. 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, Agency RMBS and certain non-Agency securities with a rating of A and above.



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## TWO HARBORS INVESTMENT CORP.

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On January 11, 2016, the Federal Housing Finance Agency, or FHFA, released a final rule regarding membership in the Federal Home Loan Bank system. Among other effects, the final rule excludes captive insurers from membership eligibility, including the Company's subsidiary member, TH Insurance. Since TH Insurance was admitted as a member in 2013, it is eligible for a membership grace period that runs through February 19, 2021, during which new advances or renewals that mature beyond the grace period will be prohibited; however, any existing advances that mature beyond this grace period will be permitted to remain in place subject to their terms insofar as the Company maintains good standing with the FHLB. If any new advances or renewals occur, TH Insurance's outstanding advances will be limited to 40% of its total assets.

At March 31, 2018 and December 31, 2017, FHLB advances had the following remaining maturities:

| (in thousands)     | March 31, December 31, |              |
|--------------------|------------------------|--------------|
|                    | 2018                   | 2017         |
| ≤ 1 year           | \$—                    | \$—          |
| > 1 and ≤ 3 years  | 815,024                | 815,024      |
| > 3 and ≤ 5 years  | —                      | —            |
| > 5 and ≤ 10 years | —                      | —            |
| > 10 years         | 50,000                 | 400,000      |
| Total              | \$ 865,024             | \$ 1,215,024 |

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)                               | March 31, December 31, |              |
|--|------------------------|--------------|
|  | 2018                   | 2017         |
| Available-for-sale securities, at fair value | \$903,047              | \$ 1,210,715 |
| Due from counterparties                      | —                      | 62,959       |
| Total  | \$903,047              | \$ 1,273,674 |

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 March 31, 2018 and December 31, 2017, the Company had stock in the FHLB totaling \$40.8 million and \$53.8 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 March 31, 2018 and December 31, 2017, the Company had not recognized an impairment charge related to its FHLB stock.

## Note 15. Revolving Credit Facilities

To finance MSR, the Company has entered into revolving credit facilities collateralized by the value of the MSR pledged. As of March 31, 2018 and December 31, 2017, the Company had outstanding short-term borrowings under revolving credit facilities of \$20.0 million and \$20.0 million with a weighted average borrowing rate of 5.67% and 5.14% and weighted average remaining maturities of 261 and 351 days, respectively.

Although the transactions under revolving credit facilities represent committed borrowings from the time of funding until maturity, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets below a designated threshold would require the Company to provide additional collateral or

pay down the facility. As of March 31, 2018 and December 31, 2017, MSR with a carrying value of \$138.4 million and \$159.5 million, respectively, was pledged as collateral for the Company's future payment obligations under its revolving credit facilities. The Company does not anticipate any defaults by its revolving credit facility counterparties, although there can be no assurance that any such default or defaults will not occur.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Consolidated Financial Statements (unaudited)

## Note 16. Convertible Senior Notes

On January 19, 2017, the Company closed an underwritten public offering of \$287.5 million aggregate principal amount of convertible senior notes due 2022. The net proceeds from the offering were approximately \$282.2 million after deducting underwriting discounts and estimated offering expenses payable by the Company. The notes are unsecured, pay interest semiannually at a rate of 6.25% per annum and are convertible at the option of the holder into shares of the Company's common stock. The notes will mature in January 2022, unless earlier converted or repurchased in accordance with their terms. The Company does not have the right to redeem the notes prior to maturity, but may be required to repurchase the notes from holders under certain circumstances. As of both March 31, 2018 and December 31, 2017, the notes had a conversion rate of 61.4698 shares of common stock per \$1,000 principal amount of the notes. The outstanding amount due on the convertible senior notes as of March 31, 2018 and December 31, 2017 was \$283.1 million and \$282.8 million, respectively, net of deferred issuance costs.

## Note 17. Stockholders' Equity

## Preferred Stock

On March 14, 2017, the Company issued 5,000,000 shares of 8.125% Series A Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock, par value \$0.01 per share, in a public offering at a price of \$25.00 per share. On March 21, 2017, an additional 750,000 shares were sold by the Company to the underwriters of the offering pursuant to an overallotment option. Holders of the preferred stock are entitled to receive, when and as declared, a dividend at a fixed rate of 8.125% per annum of the \$25.00 liquidation preference. On and after April 27, 2027, dividends will accumulate and be payable at a floating rate of three-month LIBOR plus a spread of 5.66% per annum of the \$25.00 liquidation preference. The preferred stock ranks senior to the Company's common stock and on parity with the Company's 7.625% Series B Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock and 7.25% Series C Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock with respect to the payment of dividends and the distribution of assets upon the voluntary or involuntary liquidation, dissolution or winding up of the Company. Under certain circumstances upon a change of control, the preferred stock is convertible into shares of the Company's common stock. The preferred stock will not be redeemable before April 27, 2027, except under certain limited circumstances. On or after April 27, 2027, the Company may, at its option, redeem, in whole or in part, at any time or from time to time, the preferred stock at a redemption price of \$25.00 per share, plus any accumulated and unpaid dividends thereon (whether or not authorized or declared) up to, but excluding, the redemption date. The net proceeds from the offering were approximately \$138.9 million, after deducting underwriting discounts and estimated offering expenses payable by the Company.

On July 19, 2017, the Company issued 11,500,000 shares of 7.625% Series B Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock, par value \$0.01 per share, in a public offering at a price of \$25.00 per share, which included 1,500,000 shares sold to the underwriters of the offering pursuant to an overallotment option. Holders of the preferred stock are entitled to receive, when and as declared, a dividend at a fixed rate of 7.625% per annum of the \$25.00 liquidation preference. On and after July 27, 2027, dividends will accumulate and be payable at a floating rate of three-month LIBOR plus a spread of 5.352% per annum of the \$25.00 liquidation preference. The preferred stock ranks senior to the Company's common stock and on parity with the Company's 8.125% Series A Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock and 7.25% Series C Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock with respect to the payment of dividends and the distribution of assets upon the voluntary or involuntary liquidation, dissolution or winding up of the Company. Under certain circumstances upon a change of control, the preferred stock is convertible into shares of the Company's common stock. The preferred stock will not be redeemable before July 27, 2027, except under certain limited circumstances. On or after July 27, 2027, the Company may, at its option, redeem, in whole or in part, at any time or from time to time, the preferred stock at a redemption price of \$25.00 per share, plus any accumulated and unpaid dividends thereon (whether or not authorized or declared) up to, but excluding, the redemption date. The net proceeds from the offering were approximately \$278.1

million, after deducting underwriting discounts and estimated offering expenses payable by the Company.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Consolidated Financial Statements (unaudited)

On November 27, 2017, the Company issued 11,000,000 shares of 7.25% Series C Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock, par value \$0.01 per share, in a public offering at a price of \$25.00 per share. On December 1, 2017, an additional 800,000 shares were sold by the Company to the underwriters of the offering pursuant to an overallotment option. Holders of the preferred stock are entitled to receive, when and as declared, a dividend at a fixed rate of 7.25% per annum of the \$25.00 liquidation preference. On and after January 27, 2025, dividends will accumulate and be payable at a floating rate of three-month LIBOR plus a spread of 5.011% per annum of the \$25.00 liquidation preference. The preferred stock ranks senior to the Company's common stock and on parity with the Company's 8.125% Series A Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock and 7.625% Series B Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock with respect to the payment of dividends and the distribution of assets upon the voluntary or involuntary liquidation, dissolution or winding up of the Company. Under certain circumstances upon a change of control, the preferred stock is convertible into shares of the Company's common stock. The preferred stock will not be redeemable before January 27, 2025, except under certain limited circumstances. On or after January 27, 2025, the Company may, at its option, redeem, in whole or in part, at any time or from time to time, the preferred stock at a redemption price of \$25.00 per share, plus any accumulated and unpaid dividends thereon (whether or not authorized or declared) up to, but excluding, the redemption date. The net proceeds from the offering were approximately \$285.6 million, after deducting underwriting discounts and estimated offering expenses payable by the Company.

## Distributions to Preferred Stockholders

The following table presents cash dividends declared by the Company on its preferred stock since their issuances:

| Declaration Date          | Record Date      | Payment Date     | Cash<br>Dividend<br>Per<br>Preferred<br>Share |
|---------------------------|------------------|------------------|---|
| Series A Preferred Stock: |                  |                  |   |
| March 20, 2018            | April 12, 2018   | April 27, 2018   | \$0.50781                                     |
| December 14, 2017         | January 12, 2018 | January 29, 2018 | \$0.50781                                     |
| September 14, 2017        | October 12, 2017 | October 27, 2017 | \$0.50781                                     |
| June 15, 2017             | July 12, 2017    | July 27, 2017    | \$0.75043                                     |
| Series B Preferred Stock: |                  |                  |   |
| March 20, 2018            | April 12, 2018   | April 27, 2018   | \$0.47656                                     |
| December 14, 2017         | January 12, 2018 | January 29, 2018 | \$0.47656                                     |
| September 14, 2017        | October 12, 2017 | October 27, 2017 | \$0.51892                                     |
| Series C Preferred Stock: |                  |                  |   |
| March 20, 2018            | April 12, 2018   | April 27, 2018   | \$0.45313                                     |
| December 14, 2017         | January 12, 2018 | January 29, 2018 | \$0.30208                                     |

## Common Stock

## Reverse Stock Split

On September 14, 2017, the Company's board of directors approved a one-for-two reverse stock split of its outstanding shares of common stock. The reverse stock split was effected on November 1, 2017 at 5:01 p.m. Eastern Time, following the special dividend of Granite Point common stock. At the effective time, every two issued and outstanding shares of the Company's common stock were converted into one share of common stock. No fractional shares were issued in connection with the reverse stock split; instead, each stockholder holding fractional shares was entitled to receive, in lieu of such fractional shares, cash in an amount determined on the basis of the volume weighted average price of the Company's common stock on the NYSE on November 1, 2017. In connection with the reverse stock split,

the number of authorized shares of the Company's common stock was also reduced on a one-for-two basis, from 900 million to 450 million. The par value of each share of common stock remained unchanged. All per share amounts, common shares outstanding and restricted shares for all periods presented have been adjusted on a retroactive basis to reflect the reverse stock split.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Consolidated Financial Statements (unaudited)

As of March 31, 2018, the Company had 175,434,778 shares of common stock outstanding. The following table presents a reconciliation of the common shares outstanding for the three months ended March 31, 2018 and 2017:

|  | Number of<br>common<br>shares |
|--|-------------------------------|
| Common shares outstanding, December 31, 2016 | 173,826,163                   |
| Issuance of common stock                     | 5,633                         |
| Issuance of restricted stock <sup>(1)</sup>  | 624,711                       |
| Common shares outstanding, March 31, 2017    | 174,456,507                   |
| Common shares outstanding, December 31, 2017 | 174,496,587                   |
| Issuance of common stock                     | 4,921                         |
| Issuance of restricted stock <sup>(1)</sup>  | 933,270                       |
| Common shares outstanding, March 31, 2018    | 175,434,778                   |

<sup>(1)</sup> Represents shares of restricted stock granted under the Second Restated 2009 Equity Incentive Plan, net of forfeitures, of which 1,739,397 restricted shares remained subject to vesting requirements at March 31, 2018.

## Distributions to Common Stockholders

The following table presents cash dividends declared by the Company on its common stock from December 31, 2016 through March 31, 2018:

| Declaration Date   | Record Date        | Payment Date      | Cash<br>Dividend<br>Per<br>Common<br>Share |
|--------------------|--------------------|-------------------|--|
| March 20, 2018     | April 2, 2018      | April 27, 2018    | \$ 0.47                                    |
| December 14, 2017  | December 26, 2017  | December 29, 2017 | \$ 0.47                                    |
| September 14, 2017 | September 29, 2017 | October 27, 2017  | \$ 0.52                                    |
| June 15, 2017      | June 30, 2017      | July 27, 2017     | \$ 0.52                                    |
| March 14, 2017     | March 31, 2017     | April 27, 2017    | \$ 0.50                                    |

On September 14, 2017, the Company's board of directors declared a special dividend pursuant to which the 33.1 million shares of Granite Point common stock acquired by the Company in exchange for the contribution of its equity interests in TH Commercial Holdings LLC to Granite Point on June 28, 2017 would be distributed, on a pro rata basis, to the holders of Two Harbors common stock outstanding at the close of business on October 20, 2017. The Granite Point common stock was distributed on November 1, 2017. Due to its controlling ownership interest in Granite Point through November 1, 2017, the Company consolidated Granite Point on its financial statements. Effective November 1, 2017 (the date the 33.1 million shares of Granite Point common stock were distributed to the Company's common stockholders), the Company no longer has a controlling interest in Granite Point and, therefore, has deconsolidated Granite Point and its subsidiaries from its financial statements and reclassified all of Granite Point's current and prior period assets, liabilities and results of operations to discontinued operations.

## 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 limitations detailed in the plan prospectus. The plan allows for the issuance of up to an aggregate of 3,750,000 shares of the Company's common stock. As of March 31, 2018, 204,062 shares have been issued under the plan for total proceeds of approximately \$4.0 million, of which 4,921 and 5,633 shares were issued for total proceeds of \$0.1 million and \$0.1 million during the three months ended March 31, 2018 and 2017, respectively.



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## TWO HARBORS INVESTMENT CORP.

## Notes to the Consolidated Financial Statements (unaudited)

## Share Repurchase Program

The Company's share repurchase program allows for the repurchase of up to an aggregate of 37,500,000 shares of the Company's common stock. 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 are 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, subject to SEC rules, purchases may be commenced or suspended at any time without prior notice. The share repurchase program does not have an expiration date. As of March 31, 2018, a total of 12,067,500 shares had been repurchased by the Company under the program for an aggregate cost of \$200.4 million. No shares were repurchased during the three months ended March 31, 2018 and 2017.

## At-the-Market Offering

The Company has entered into an equity distribution agreement under which the Company may sell up to an aggregate of 10,000,000 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. As of March 31, 2018, 3,792,935 shares of common stock have been sold under the equity distribution agreement for total accumulated net proceeds of approximately \$77.6 million. No shares were sold during the three months ended March 31, 2018 and 2017.

## Accumulated Other Comprehensive (Loss) Income

Accumulated other comprehensive (loss) income at March 31, 2018 and December 31, 2017 was as follows:

| (in thousands)                                | March 31,<br>2018 | December 31,<br>2017 |
|---|-------------------|----------------------|
| Available-for-sale securities                 |                   |                      |
| Unrealized gains                              | \$475,023         | \$ 475,694           |
| Unrealized losses                             | (475,069 )        | (140,881 )           |
| Accumulated other comprehensive (loss) income | \$(46 )           | \$ 334,813           |

## Reclassifications out of Accumulated Other Comprehensive (Loss) Income

The Company reclassifies unrealized gains and losses on AFS securities in accumulated other comprehensive income to net income upon the recognition of any other-than-temporary impairments and realized gains and losses on sales, net of income tax effects, as individual securities are impaired or sold. The following table summarizes reclassifications out of accumulated other comprehensive income for the three months ended March 31, 2018 and 2017:

| (in thousands)  | Affected Line Item in the Condensed Consolidated<br>Statements of Comprehensive (Loss) Income | Amount<br>Reclassified out<br>of Accumulated<br>Other<br>Comprehensive<br>(Loss) Income<br>Three Months<br>Ended<br>March 31,<br>2018 | 2017  |
|---|---|---|-------|
| Other-than-temporary impairments on<br>AFS securities | Total other-than-temporary impairment losses  | \$94  | \$—   |
|   | Loss on investment securities   | (1,329 )  | 9,313 |

Realized (gains) losses on sales of certain  
AFS securities, net of tax  
Total

\$(1,235) \$9,313

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TWO HARBORS INVESTMENT CORP.

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Noncontrolling Interest

On June 28, 2017, the Company contributed its equity interests in its wholly owned subsidiary, TH Commercial Holdings LLC, to Granite Point and, in exchange for its contribution, received approximately 33.1 million shares of common stock of Granite Point, representing approximately 76.5% of the outstanding stock of Granite Point upon completion of the IPO of its common stock on June 28, 2017. Granite Point issued 10,000,000 shares of its common stock in the IPO at a price of \$19.50 per share, for gross proceeds of \$195.0 million. Net proceeds were approximately \$181.9 million, net of issuance costs of approximately \$13.1 million.

Due to its controlling ownership interest in Granite Point through November 1, 2017 (the date the 33.1 million shares of Granite Point common stock were distributed to the Company's common stockholders), the Company consolidated Granite Point on its financial statements and reflected noncontrolling interest for the portion of equity and comprehensive income not attributable to the Company. During the period from June 28, 2017 through November 1, 2017, in accordance with ASC 810, Consolidation, the carrying amount of noncontrolling interest was adjusted to reflect (i) changes in its ownership interest in Granite Point as a result of purchases of Granite Point common stock and (ii) the portion of comprehensive income and dividends declared by Granite Point that are not attributable to the Company, with the offset to equity. Effective November 1, 2017, the Company no longer has a controlling interest in Granite Point and, therefore, has deconsolidated Granite Point and its subsidiaries, including any noncontrolling interest, from its financial statements and reclassified all of Granite Point's current and prior period assets, liabilities and results of operations to discontinued operations.

Note 18. Equity Incentive Plan

The Company's Second Restated 2009 Equity Incentive Plan, or the Plan, provides incentive compensation to attract and retain qualified directors, officers, advisors, consultants and other personnel, including PRCM Advisers and affiliates and employees of PRCM Advisers and its affiliates, and any joint venture affiliates of the Company. The Plan is administered by the compensation committee of the Company's board of directors. The compensation committee has the full authority to administer and interpret the Plan, to authorize the granting of awards, to determine the eligibility of directors, officers, advisors, consultants and other personnel, including PRCM Advisers and affiliates and personnel of PRCM Advisers and its affiliates, and any joint venture affiliates of the Company, to receive an award, to determine the number of shares of common stock to be covered by each award (subject to the individual participant limitations provided in the Plan), to determine the terms, provisions and conditions of each award (which may not be inconsistent with the terms of the Plan), to prescribe the form of instruments evidencing awards and to take any other actions and make all other determinations that it deems necessary or appropriate in connection with the Plan or the administration or interpretation thereof. In connection with this authority, the compensation committee may, among other things, establish performance goals that must be met in order for awards to be granted or to vest, or for the restrictions on any such awards to lapse.

The Company's Plan provides for grants of restricted common stock, phantom shares, dividend equivalent rights and other equity-based awards, subject to a ceiling of 6,500,000 shares available for issuance under the Plan. The Plan allows for the Company's board of directors to expand the types of awards available under the Plan to include long-term incentive plan units in the future. If an award granted under the Plan expires or terminates, the shares subject to any portion of the award that expires or terminates without having been exercised or paid, as the case may be, will again become available for the issuance of additional awards. Unless earlier terminated by the Company's board of directors, no new award may be granted under the Plan after the tenth anniversary of the date that such Plan was initially approved by the Company's board of directors. No award may be granted under the Plan to any person who, assuming payment of all awards held by such person, would own or be deemed to own more than 9.8% of the outstanding shares of the Company's common stock.

All per share amounts, common shares outstanding and restricted shares for all periods presented reflect the Company's one-for-two reverse stock split effected on November 1, 2017 (refer to Note 17 - Stockholders' Equity for

additional information).

During the three months ended March 31, 2018 and 2017, the Company granted 941,371 and 637,286 shares of restricted common stock, respectively, to key employees of PRCM Advisers pursuant to the terms of the Plan and the associated award agreements. The estimated fair value of these awards was \$15.12 and \$17.48 per share on grant date, based on the adjusted 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 March 31, 2018 was \$15.37 per share based on the adjusted 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.

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## TWO HARBORS INVESTMENT CORP.

## Notes to the Consolidated Financial Statements (unaudited)

The following table summarizes the activity related to restricted common stock for the three months ended March 31, 2018 and 2017:

|                                    | Three Months Ended March 31, |  |            |  |
|------------------------------------|------------------------------|--|------------|--|
|                                    | 2018                         | 2017   |            |  |
|                                    | Shares                       | Weighted<br>Average<br>Grant<br>Date Fair<br>Market<br>Value | Shares     | Weighted<br>Average<br>Grant<br>Date Fair<br>Market<br>Value |
| Outstanding at Beginning of Period | 1,284,010                    | \$ 17.15   | 1,319,712  | \$ 17.10   |
| Granted                            | 941,371                      | 15.12  | 637,286    | 17.48  |
| Vested                             | (477,883 )                   | (16.16 )   | (471,088 ) | (16.83 )   |
| Forfeited                          | (8,101 )                     | (15.61 )   | (12,574 )  | (18.57 )   |
| Outstanding at End of Period       | 1,739,397                    | \$ 16.33   | 1,473,336  | \$ 17.34   |

For the three months ended March 31, 2018 and 2017, the Company recognized compensation related to restricted common stock granted pursuant to the Plan of \$2.3 million and \$4.0 million, respectively.

## Note 19. Income Taxes

The TCJA significantly revises the U.S. corporate income tax laws by, among other things, lowering the federal income tax rate applicable to corporations from 35% to 21% and repealing the corporate alternative minimum tax. The Company has not completed its determination of the accounting implications of the TCJA on its tax accruals.

However, the Company reasonably estimated the effects of the TCJA and recognized a tax provision of \$17.5 million in its financial statements as of December 31, 2017. This amount represents the remeasurement of federal net deferred tax assets resulting from the permanent reduction in the U.S. statutory corporate tax rate from 35% to 21%. The TCJA requires complex computations to be performed that were not previously required in U.S. tax law, significant judgments to be made in interpretation of the provisions of the TCJA and significant estimates in calculations, and the preparation and analysis of information not previously relevant or regularly produced. The U.S. Treasury, the IRS, and other standard-setting bodies could interpret or issue guidance on how provisions of the TCJA will be applied or otherwise administered that is different from the Company's interpretation. As the Company completes its analysis of the TCJA, collects and prepares necessary data, and interprets any additional guidance, it may make adjustments to the provisional amounts. Those adjustments may materially impact the Company's provision for income taxes in the period in which the adjustments are made.

For the three months ended March 31, 2018 and 2017, 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 months ended March 31, 2018, the Company's TRSs recognized a provision for income taxes of \$3.8 million, which was primarily due to gains recognized on MSR, offset by net losses incurred on derivative instruments held in the Company's TRSs. During the three months ended March 31, 2017, the Company's TRSs recognized a benefit from income taxes of \$24.5 million, which was primarily due to realized losses on sales of AFS securities and

net losses incurred on derivative instruments held in the Company's TRSs. As of March 31, 2018 and December 31, 2017, a \$2.3 million and a \$2.7 million valuation allowance was recorded, respectively, because the Company determined that it is more likely than not that the associated deferred tax asset will not be realized.

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. Additionally, there were no amounts accrued for penalties or interest as of or during the periods presented in these consolidated financial statements.

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## TWO HARBORS INVESTMENT CORP.

Notes to the Consolidated Financial Statements (unaudited)

## Note 20. Earnings Per Share

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted earnings per share for the three months ended March 31, 2018 and 2017. All per share amounts, common shares outstanding and restricted shares for all periods presented reflect the Company's one-for-two reverse stock split effected on November 1, 2017 (refer to Note 17 - Stockholders' Equity for additional information).

| (in thousands, except share data)                                 | Three Months Ended |             |
|---|--------------------|-------------|
|   | March 31,          |             |
|   | 2018               | 2017        |
| Numerator:  |                    |             |
| Net income from continuing operations                             | \$ 334,809         | \$ 58,531   |
| Income from discontinued operations, net of tax                   | —                  | 13,454      |
| Net income  | 334,809            | 71,985      |
| Dividends on preferred stock                                      | 13,747             | —           |
| Net income attributable to common stockholders - basic            | 321,062            | 71,985      |
| Interest expense attributable to convertible notes <sup>(1)</sup> | 4,701              | —           |
| Net income attributable to common stockholders - diluted          | \$ 325,763         | \$ 71,985   |
| Denominator:  |                    |             |
| Weighted average common shares outstanding                        | 173,552,675        | 172,826,530 |
| Weighted average restricted stock shares                          | 1,593,289          | 1,455,435   |
| Basic weighted average shares outstanding                         | 175,145,964        | 174,281,965 |
| Effect of dilutive shares issued in an assumed conversion         | 17,672,567         | —           |
| Diluted weighted average shares outstanding                       | 192,818,531        | 174,281,965 |
| Basic Earnings Per Share:   |                    |             |
| Continuing operations   | \$ 1.83            | \$ 0.33     |
| Discontinued operations   | —                  | 0.08        |
| Net income  | \$ 1.83            | \$ 0.41     |
| Diluted Earnings Per Share:                                       |                    |             |
| Continuing operations   | \$ 1.69            | \$ 0.33     |
| Discontinued operations   | —                  | 0.08        |
| Net income  | \$ 1.69            | \$ 0.41     |

(1) Includes a nondiscretionary adjustment for the assumed change in the management fee calculation.

For the three months ended March 31, 2017, excluded from the calculation of diluted earnings per share is the effect of adding back \$3.8 million of interest expense, net of a nondiscretionary adjustment for the assumed change in the management fee calculation, and 11,500,000 weighted average common share equivalents, respectively, related to the assumed conversion of the Company's convertible senior notes, as their inclusion would be antidilutive.

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TWO HARBORS INVESTMENT CORP.

Notes to the Consolidated Financial Statements (unaudited)

Note 21. Related Party Transactions

The following summary provides disclosure of the material transactions with affiliates of the Company.

In accordance with its management agreement with PRCM Advisers, the Company incurred \$11.7 million and \$9.8 million as a management fee to PRCM Advisers for the three months ended March 31, 2018 and 2017, respectively, which represents approximately 1.5% of stockholders' equity on an annualized basis as defined by the management agreement. For purposes of calculating the management fee, stockholders' equity is adjusted to exclude the consolidated stockholders' equity of Granite Point and its subsidiaries previously included in the Company's condensed consolidated balance sheet and any common stock repurchases, as well as any unrealized gains, losses or other items that do not affect realized net income, among other adjustments, in accordance with the management agreement. In addition, the Company reimbursed PRCM Advisers for direct and allocated costs incurred by PRCM Advisers on behalf of the Company. These direct and allocated costs totaled approximately \$6.8 million and \$4.2 million for the three months ended March 31, 2018 and 2017, respectively.

The Company has direct relationships with the majority of its third-party vendors. The Company will continue to have certain costs allocated to it by PRCM Advisers for compensation, data services, technology and certain office lease payments, but most direct expenses with third-party vendors are paid directly by the Company.

The Company recognized \$2.3 million and \$4.0 million of compensation during the three months ended March 31, 2018 and 2017, respectively, related to restricted common stock issued to employees of PRCM Advisers and the Company's independent directors pursuant to the Plan. See Note 18 - Equity Incentive Plan for additional information. During the year ended December 31, 2017, the Company purchased 1,658,008 shares of Granite Point common stock in the open market for a cost of \$30.0 million. These equity securities are carried at fair value and reported in other assets on the condensed consolidated balance sheets. As of March 31, 2018 and December 31, 2017, the carrying value of the equity securities was \$27.4 million and \$29.4 million, which included \$2.6 million and \$0.6 million in unrealized losses, respectively.

Note 22. Subsequent Events

On April 26, 2018, the Company announced that it had entered into a definitive merger agreement under which the Company would acquire CYS Investments, Inc., or CYS, a Maryland corporation investing in primarily Agency RMBS and treated as a REIT for U.S. federal income tax purposes. In connection with the merger, CYS stockholders will exchange their shares of CYS common stock for newly issued shares of Two Harbors common stock as well as aggregate cash consideration of \$15.0 million. The number of Two Harbors shares issued will be based on an exchange ratio to be determined by dividing 96.75% of CYS' adjusted book value per share by 94.20% of the Company's adjusted book value per share. The actual exchange ratio for the merger will be publicly announced at least five business days prior to the required stockholder votes on the merger. The completion of the merger is subject to the satisfaction of certain customary conditions, and is subject to the approval of the stockholders of both the Company and CYS. The companies expect the transaction to close in the third quarter of 2018.

In connection with the merger, the Management Agreement dated as of October 28, 2009, as amended, among the Company, Two Harbors Operating Company LLC and PRCM Advisers was amended to (i) reduce PRCM Advisers' base management fee with respect to the additional equity under management resulting from the merger to 0.75% from the effective time through the first anniversary of the effective time and (ii) for the fiscal quarter in which closing of the merger occurs, to make a one-time downward adjustment of Pine River's management fees payable by Two Harbors for such quarter by \$15.0 million to offset the cash consideration payable to stockholders of CYS, plus an additional downward adjustment of up to \$3.3 million for certain transaction-related expenses.

Events subsequent to March 31, 2018, were evaluated through the date these financial statements were issued and no additional events were identified requiring further disclosure in these condensed consolidated financial statements.





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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with the consolidated financial statements and accompanying notes included elsewhere in this Quarterly Report on Form 10-Q as well as our Annual Report on Form 10-K for the year ended December 31, 2017.

General

We are a Maryland corporation focused on investing in, financing and managing Agency residential mortgage-backed securities, or Agency RMBS, non-Agency securities, mortgage servicing rights, or MSR, and other financial assets, which we collectively refer to as our target assets. We operate as a real estate investment trust, or REIT, as defined under the Internal Revenue Code of 1986, as amended, or the Code. We are externally managed by PRCM Advisers LLC, or PRCM Advisers, which is a wholly owned subsidiary of Pine River Capital Management L.P., or Pine River. Our objective is to provide attractive risk-adjusted total return to our stockholders over the long term, primarily through dividends and secondarily through capital appreciation. We selectively acquire and manage an investment portfolio of our target assets, which is constructed to generate attractive returns through market cycles. We focus on asset selection and implement a relative value investment approach across various sectors within the mortgage market. Our target assets include the following:

Agency RMBS (which includes inverse interest-only Agency securities classified as "Agency Derivatives" for purposes of U.S. generally accepted accounting principles, or U.S. GAAP), meaning RMBS whose principal and interest payments are guaranteed by the Government National Mortgage Association (or Ginnie Mae), the Federal National Mortgage Association (or Fannie Mae), or the Federal Home Loan Mortgage Corporation (or Freddie Mac), or collectively, the government sponsored entities, or GSEs;

Non-Agency securities, meaning securities that are not issued or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac;

MSR; and

Other financial assets comprising approximately 5% to 10% of the portfolio.

We generally view our target assets in two strategies that are based on our core competencies of understanding and managing prepayment and credit risk. Our rates strategy includes assets that are sensitive to changes in interest rates and prepayment speeds, specifically Agency RMBS and MSR. Our credit strategy includes assets with inherent credit risk, including non-Agency securities. Other assets include financial and mortgage-related assets other than the target assets in our rates and credit strategies, including residential mortgage loans and certain non-hedging transactions that may produce non-qualifying income for purposes of the REIT gross income tests.

As opportunities in the residential mortgage marketplace change, we continue to evolve our business model. From a capital allocation perspective, we expect to continue to increase our allocation towards MSR over time and allocate capital towards Agency RMBS based on opportunities in the marketplace, the cost of financing and the cost of hedging interest rate, prepayment, credit and other portfolio risks. Within our non-Agency securities portfolio, we have a substantial emphasis on "legacy" securities, which include securities issued prior to 2009. We have also allocated capital towards "new issue" non-Agency securities, which we believe have enabled us to find attractive returns and further diversify our non-Agency securities portfolio. In addition, we continue to hold certain securities from our previously consolidated securitization trusts.

Within our MSR business, we purchase the right to control the servicing of mortgage loans from high-quality originators. We do not directly service the mortgage loans on our consolidated balance sheet, nor the mortgage loans underlying the MSR we acquire; rather, we contract with appropriately licensed third-party subservicers to handle substantially all servicing functions in the name of the subservicer.

On June 28, 2017, we completed the contribution of our portfolio of commercial real estate assets to Granite Point Mortgage Trust Inc., or Granite Point, a newly formed Maryland corporation intended to qualify as a REIT and focused on directly originating, investing in and managing senior commercial mortgage loans and other debt and debt-like commercial real estate investments. We contributed our equity interests in our wholly owned subsidiary, TH

Commercial Holdings LLC, to Granite Point and, in exchange for our contribution, received approximately 33.1 million shares of common stock of Granite Point, representing approximately 76.5% of the outstanding stock of Granite Point upon completion of the initial public offering, or IPO, of its common stock on June 28, 2017.

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On November 1, 2017, we distributed, on a pro rata basis, the 33.1 million shares of Granite Point common stock that we acquired in connection with the contribution to the holders of our common stock outstanding as of the close of business on October 20, 2017. Due to our controlling ownership interest in Granite Point through November 1, 2017, our results of operations and financial condition through such date reflect Granite Point's commercial strategy, which includes as target assets first mortgages, mezzanine loans, B-notes and preferred equity. As of November 1, 2017, we no longer have a controlling interest in Granite Point and, therefore, have deconsolidated Granite Point and its subsidiaries from our financial statements and reclassified all of Granite Point's current and prior period assets, liabilities and results of operations to discontinued operations.

On April 26, 2018, we announced that we had entered into a definitive merger agreement under which we would acquire CYS Investments, Inc., or CYS, a Maryland corporation investing in primarily Agency RMBS and treated as a REIT for U.S. federal income tax purposes. In connection with the merger, CYS stockholders will exchange their shares of CYS common stock for newly issued shares of Two Harbors common stock as well as aggregate cash consideration of \$15.0 million. The number of Two Harbors shares issued will be based on an exchange ratio to be determined by dividing 96.75% of CYS' adjusted book value per share by 94.20% of our adjusted book value per share. The actual exchange ratio for the merger will be publicly announced at least five business days prior to the required stockholder votes on the merger. The completion of the merger is subject to the satisfaction of certain customary conditions, and is subject to the approval of stockholders of both Two Harbors and CYS. We expect the transaction to close in the third quarter of 2018.

We believe our investment model allows management to allocate capital across various sectors within the mortgage market, with a focus on asset selection and the implementation of a relative value investment approach. Our capital allocation decisions factor in the opportunities in the marketplace, the cost of financing and the cost of hedging interest rate, prepayment, credit and other portfolio risks. As a result, capital allocation reflects management's flexible approach to investing in the marketplace. The following table provides our capital allocation in each of our investment strategies as of March 31, 2018 and the four immediately preceding period ends:

|                                    | As of             |                      |                       |                  |                   |
|------------------------------------|-------------------|----------------------|-----------------------|------------------|-------------------|
|                                    | March 31,<br>2018 | December 31,<br>2017 | September 30,<br>2017 | June 30,<br>2017 | March 31,<br>2017 |
| Rates strategy                     | 69%               | 68%                  | 55%                   | 54%              | 58%               |
| Credit strategy                    | 31%               | 32%                  | 29%                   | 28%              | 27%               |
| Commercial strategy <sup>(1)</sup> | —%                | —%                   | 16%                   | 18%              | 15%               |

<sup>(1)</sup> Represents capital allocated to our controlling interest in Granite Point's commercial strategy, included in discontinued operations.

As our capital allocation shifts, our annualized yields and cost of financing shift. As previously discussed, our investment decisions are not driven solely by annualized yields, but rather a multitude of macroeconomic drivers, including market environments and their respective impacts (e.g., uncertainty of prepayment speeds, extension risk and credit events).

For the three months ended March 31, 2018, our net yield realized on the portfolio was lower than recent periods due to an increase in our cost of financing as a result of increases in LIBOR and correlated borrowing rates offered by counterparties, offset by increases in yields on MSR as a result of portfolio growth. The following table provides the average annualized yield on our assets, including Agency RMBS, non-Agency securities, MSR, residential mortgage loans held-for-investment, net of collateralized borrowings, in securitization trusts, and residential mortgage loans held-for-sale for the three months ended March 31, 2018, and the four immediately preceding quarters:

| Three Months Ended |                      |                       |                  |                   |
|--------------------|----------------------|-----------------------|------------------|-------------------|
| March 31,<br>2018  | December 31,<br>2017 | September 30,<br>2017 | June 30,<br>2017 | March 31,<br>2017 |

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|   |       |       |       |       |       |
|---|-------|-------|-------|-------|-------|
| Average annualized portfolio yield <sup>(1)</sup> | 3.77% | 3.69% | 3.66% | 3.75% | 3.78% |
| Cost of financing <sup>(2)</sup>                  | 1.84% | 1.72% | 1.68% | 1.52% | 1.46% |
| Net portfolio yield                               | 1.93% | 1.97% | 1.98% | 2.23% | 2.32% |

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(1) Average annualized yield incorporates future prepayment, credit loss and other assumptions, all of which are estimates and subject to change.

(2) Cost of financing includes swap interest rate spread.

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We seek to deploy moderate leverage as part of our investment strategy. We generally finance our Agency RMBS and non-Agency securities through short- and long-term borrowings structured as repurchase agreements and advances from the Federal Home Loan Bank of Des Moines, or the FHLB. We also finance our MSR through repurchase agreements and revolving credit facilities. In addition, in January 2017, we closed an underwritten public offering of \$287.5 million aggregate principal amount of convertible senior notes due 2022. The notes are unsecured, pay interest semiannually at a rate of 6.25% per annum and are convertible at the option of the holder into shares of our common stock. The notes will mature in January 2022, unless earlier converted or repurchased in accordance with their terms. We do not have the right to redeem the notes prior to maturity, but may be required to repurchase the notes from holders under certain circumstances. The net proceeds from the offering were approximately \$282.2 million after deducting underwriting discounts and estimated offering expenses. The majority of these proceeds were used to help fund our MSR assets, which previously had largely been funded with cash. As of March 31, 2018, the notes had a conversion rate of 61.4698 shares of common stock per \$1,000 principal amount of the notes.

Our Agency RMBS, given their liquidity and high credit quality, are eligible for higher levels of leverage, while non-Agency securities and MSR, with less liquidity and/or more exposure to credit risk, utilize lower levels of leverage. As a result, our debt-to-equity ratio is determined by our portfolio mix as well as many additional factors, including the liquidity of our portfolio, the sustainability and price of our financing, diversification of our counterparties and their available capacity to finance our assets, and anticipated regulatory developments. Over the past several quarters, we have generally maintained a debt-to-equity ratio range of 4.0 to 6.0 times to finance our securities portfolio, MSR and commercial real estate assets (included in assets of discontinued operations), on a fully deployed capital basis. Our debt-to-equity ratio is directly correlated to the composition of our portfolio; specifically, the higher percentage of Agency RMBS we hold, the higher our debt-to-equity ratio is, while the higher percentage of non-Agency securities and MSR we hold, the lower our debt-to-equity ratio is. We may alter the percentage allocation of our portfolio among our target assets depending on the relative value of the assets that are available to purchase from time to time, including at times when we are deploying proceeds from offerings we conduct. As we allocate capital toward Agency RMBS and deploy financing on MSR, our debt-to-equity ratio may increase beyond 6.0 times in the future. See the section titled “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Financial Condition - Repurchase Agreements” for further discussion.

We recognize that investing in our target assets is competitive and we compete with other entities for attractive investment opportunities. We rely on our management team and our dedicated team of investment professionals provided by our external manager to identify investment opportunities. We believe that our significant focus in the residential market, the extensive mortgage market expertise of our investment team, our strong analytics and our disciplined relative value investment approach give us a competitive advantage versus our peers.

We have elected to be treated as a REIT for U.S. federal income tax purposes. To qualify as a REIT we are required to meet certain investment and operating tests and annual distribution requirements. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute all of our net taxable income to stockholders, do not participate in prohibited transactions and maintain our intended qualification as a REIT.

However, certain activities that we may perform may cause us to earn income which will not be qualifying income for REIT purposes. We have designated certain of our subsidiaries as taxable REIT subsidiaries, or TRSs, as defined in the Code, to engage in such activities. We also operate our business in a manner that will permit us to maintain our exemption from registration under the Investment Company Act of 1940, as amended, or the 1940 Act. While we do not currently originate or service residential mortgage loans, certain of our subsidiaries have obtained the requisite licenses and approvals to purchase and sell residential mortgage loans in the secondary market and to own and manage MSR.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains, or incorporates by reference, not only historical information, but also forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the

Securities Act, and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act, and that are subject to the safe harbors created by such sections. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as “anticipate,” “estimate,” “will,” “should,” “expect,” “target,” “believe,” “intend,” “plan,” “goals,” “future,” “likely,” “may” and similar expressions or their negative forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the year ended December 31, 2017, under the caption “Risk Factors.” Other risks, uncertainties and factors that could cause actual results to differ materially from those projected are described below and may be described from time to time in reports we file with the Securities and Exchange Commission, or SEC, including our Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update or revise any such forward-looking statements, whether as a result of new information, future events, or otherwise.

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Important factors, among others, that may affect our actual results include:

- changes in interest rates and the market value of our target assets;
- changes in prepayment rates of mortgages underlying our target assets;
- the occurrence, extent and timing of credit losses within our portfolio;
  - our exposure to adjustable-rate and negative amortization mortgage loans underlying our target assets;
- the state of the credit markets and other general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers;
- the concentration of the credit risks to which we are exposed;
- legislative and regulatory actions affecting our business;
- the availability and cost of our target assets;
- the availability and cost of financing for our target assets, including repurchase agreement financing, lines of credit, revolving credit facilities and financing through the FHLB;
- declines in home prices;
  - increases in payment delinquencies and defaults on the mortgages comprising and underlying our target assets;
- changes in liquidity in the market for real estate securities, the re-pricing of credit risk in the capital markets,
- inaccurate ratings of securities by rating agencies, rating agency downgrades of securities, and increases in the supply of real estate securities available-for-sale;
- changes in the values of securities we own and the impact of adjustments reflecting those changes on our condensed consolidated statements of comprehensive (loss) income and balance sheets, including our stockholders' equity;
- our ability to generate cash flow from our target assets;
- our ability to effectively execute and realize the benefits of strategic transactions and initiatives we have pursued or may in the future pursue;
- our entry into an agreement and plan of merger to acquire CYS, our ability and the ability of CYS to satisfy the closing conditions required to complete the transaction and our ability to realize the anticipated benefits of the transaction;
- changes in the competitive landscape within our industry, including changes that may affect our ability to attract and retain personnel;
- our exposure to legal and regulatory claims, penalties or enforcement activities, including those arising from our ownership and management of MSR and prior securitization transactions;
- our exposure to counterparties involved in our MSR business and prior securitization transactions and our ability to enforce representations and warranties made by them;
- our ability to acquire MSR and successfully operate our seller-servicer subsidiary and oversee the activities of our subservicers;
- our ability to successfully diversify our business into new asset classes, and manage the new risks to which they may expose us;
- our ability to manage various operational and regulatory risks associated with our business;
- interruptions in or impairments to our communications and information technology systems;
- our ability to maintain appropriate internal controls over financial reporting;
- our ability to establish, adjust and maintain appropriate hedges for the risks in our portfolio;
- our ability to maintain our REIT qualification for U.S. federal income tax purposes; and
- limitations imposed on our business due to our REIT status and our status as exempt from registration under the 1940 Act.

This Quarterly Report on Form 10-Q may contain statistics and other data that, in some cases, have been obtained or compiled from information made available by mortgage loan servicers and other third-party service providers.





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### Factors Affecting our Operating Results

Our net interest income includes income from our securities portfolio, including the amortization of purchase premiums and accretion of purchase discounts, and income from our residential mortgage loans. Net interest income, as well as our servicing income, net of subservicing expenses, will fluctuate primarily as a result of changes in market interest rates, our financing costs and prepayment speeds on our assets. Interest rates, financing costs and prepayment rates vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty. Our operating results will also be affected by default rates and credit losses with respect to the mortgage loans underlying our non-Agency securities and in our residential mortgage loan portfolio.

### Fair Value Measurement

A significant portion of our assets and liabilities are reported at fair value and, therefore, our condensed consolidated balance sheets and statements of comprehensive (loss) income are significantly affected by fluctuations in market prices. At March 31, 2018, approximately 94.2% of our total assets, or \$22.7 billion, consisted of financial instruments recorded at fair value. See Note 12 - Fair Value to the condensed consolidated financial statements, included in this Annual Report on Form 10-K, for descriptions of 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. Although we execute various hedging strategies to mitigate our exposure to changes in fair value, we cannot fully eliminate our exposure to volatility caused by fluctuations in market prices. Although markets for asset-backed securities, including RMBS, have modestly stabilized since the severe dislocations experienced as a result of the 2008 Financial Crisis, these markets continue to experience volatility and, as a result, our assets and liabilities will be subject to valuation adjustment as well as changes in the inputs we use to measure fair value. Any temporary change in the fair value of our available-for-sale, or AFS, securities, excluding Agency interest-only mortgage-backed securities, is recorded as a component of accumulated other comprehensive (loss) income and does not impact our earnings. Our reported earnings for U.S. GAAP purposes, or GAAP net income, is affected, however, by fluctuations in market prices on the remainder of our financial assets and liabilities recorded at fair value, including interest rate swap and swaption agreements and certain other derivative instruments (i.e., TBAs, put and call options for TBAs, Markit IOS total return swaps and inverse interest-only securities), which are accounted for as derivative trading instruments under U.S. GAAP, Agency interest-only mortgage-backed securities, MSR, residential mortgage loans held-for-sale and equity securities.

We have numerous internal controls in place to help ensure the appropriateness of fair value measurements. Significant fair value measures are subject to detailed analytics and management review and approval. Our entire investment portfolio reported at fair value is priced by third-party brokers and/or by independent pricing providers. We generally receive three or more broker and vendor quotes on pass-through Agency RMBS, and generally receive multiple broker or vendor quotes on all other securities, including interest-only Agency RMBS, inverse interest-only Agency RMBS, and non-Agency securities. We also currently receive three vendor quotes for the MSR in our investment portfolio. For Agency RMBS, the third-party pricing providers and brokers use pricing models that commonly incorporate such factors as coupons, primary and secondary mortgage rates, rate reset period, issuer, prepayment speeds, credit enhancements and expected life of the security. For non-Agency securities, the third-party pricing providers and brokers utilize both observable and unobservable inputs such as pool specific characteristics (i.e., loan age, loan size, credit quality of borrowers, vintage, servicer quality), floating rate indices, prepayment and default assumptions, and recent trading of the same or similar securities. For MSR and residential mortgage loans, vendors use pricing models that generally incorporate observable inputs such as principal balance, note rate, geographical location, loan-to-value (LTV) ratios, FICO, appraised value and other loan characteristics, along with observed market yields, securitization economics and trading levels. Additionally for MSR, pricing providers will customarily incorporate loan servicing cost, servicing fee, ancillary income, and earnings rate on escrow as observable inputs. Unobservable or model-driven inputs include forecast cumulative defaults, default curve, forecast loss severity and

forecast voluntary prepayment.

We evaluate the prices we receive from both brokers and independent pricing providers by comparing those prices to actual purchase and sale transactions, our internally modeled prices calculated based on market observable rates and credit spreads, and to each other both in current and prior periods. We review and may challenge broker quotes and valuations from third-party pricing providers to ensure that such quotes and valuations are indicative of fair value as a result of this analysis. We then estimate the fair value of each security based upon the median of the final broker quotes received, and we estimate the fair value of MSR based upon the average of prices received from independent providers, subject to internally-established hierarchy and override procedures.

We utilize “bid side” pricing for our Agency RMBS and non-Agency securities and, as a result, certain assets, especially the most recent purchases, may realize a markdown due to the “bid-offer” spread. To the extent that this occurs, any economic effect of this would be reflected in accumulated other comprehensive income.

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Considerable judgment is used in forming conclusions and estimating inputs to our Level 3 fair value measurements. Level 3 inputs such as interest rate movements, prepayments speeds, credit losses and discount rates are inherently difficult to estimate. Changes to these inputs can have a significant effect on fair value measurements. Accordingly, there is no assurance that our estimates of fair value are indicative of the amounts that would be realized on the ultimate sale or exchange of these assets. The Company classified 6.2% of its total assets as Level 3 fair value assets at March 31, 2018.

**Market Conditions and Outlook**

The key macroeconomic factors that impact our business are U.S. residential property prices, national employment rates and the interest rate environment. Home prices increased modestly during the first quarter of 2018 and are expected to gradually appreciate over the next several years. Employment market conditions remain solid as jobless claims, unemployment and payroll data are showing stability, although new job creation has yet to generate meaningful wage growth. Other than LTV ratios and cash reserves, we believe employment is the most powerful determinant of homeowners' ongoing likelihood to pay their mortgages. Home price performance and employment are particularly important to our non-Agency portfolio.

The Federal Reserve has continued to modestly raise the federal funds target rate, noting a roughly balanced outlook. At the same time, due in part to the absence of meaningful inflation, longer term rates in the U.S. have not been increasing as quickly as short term rates, thus leading to a flattening of the interest rate curve. The Trump administration continues to focus on several issues that could impact interest rates, the U.S. economy and U.S. businesses, including but not limited to deregulation, fiscal spending measures and trade. While there is much uncertainty regarding the timing and specifics of many policy changes, any such actions could affect our business. While interest rates have increased, they are still at historically low levels, and the Federal Reserve has reiterated it will take a measured and conservative approach to future interest rate decisions. While the Federal Reserve has begun to reduce its mortgage-backed securities holdings in the near term, the plan continues to focus on a gradual approach which reduces reinvestment of principal and interest but with a capped amount that increases over time. We believe our blended Agency and non-Agency securities portfolio and our investing expertise, as well as our operational capabilities to invest in MSR, will allow us to better navigate the dynamic mortgage market while future regulatory and policy activities take shape. Having a diversified portfolio allows us to mitigate a variety of risks, including interest rate and RMBS spread volatility.

We expect that the majority of our assets will remain in whole-pool Agency RMBS in light of the long-term attractiveness of the asset class and in order to continue to satisfy the requirements of our exemption from registration under the 1940 Act. Interest-only Agency securities and MSR also provide a complementary investment and risk-management strategy to our principal and interest Agency RMBS. Risk-adjusted returns in our Agency RMBS portfolio may decline if we are required to pay higher purchase premiums due to lower interest rates or additional liquidity in the market. Additionally, the Federal Reserve's prior quantitative easing programs and reinvestment of its mortgage-backed security principal repayments and other policy changes may impact the returns of our Agency RMBS portfolio.

The following table provides the carrying value of our securities portfolio by product type:

| (dollars in thousands) | March 31,<br>2018 |        | December 31,<br>2017 |        |
|------------------------|-------------------|--------|----------------------|--------|
| Agency                 |                   |        |                      |        |
| Fixed Rate             | \$18,020,641      | 85.2 % | \$18,215,505         | 85.5 % |
| Hybrid ARM             | 21,523            | 0.1 %  | 23,220               | 0.1 %  |
| Total Agency           | 18,042,164        | 85.3 % | 18,238,725           | 85.6 % |
| Agency Derivatives     | 81,628            | 0.4 %  | 90,975               | 0.4 %  |
| Non-Agency             |                   |        |                      |        |
| Senior                 | 2,026,035         | 9.6 %  | 1,956,145            | 9.2 %  |

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|                          |              |       |              |       |
|--------------------------|--------------|-------|--------------|-------|
| Mezzanine                | 916,877      | 4.3 % | 960,865      | 4.5 % |
| Interest-only securities | 74,301       | 0.4 % | 65,084       | 0.3 % |
| Total Non-Agency         | 3,017,213    | 14.3% | 2,982,094    | 14.0% |
| Total                    | \$21,141,005 |       | \$21,311,794 |       |

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## Prepayment speeds and volatility due to interest rates

Our Agency RMBS portfolio is subject to inherent prepayment risk. We seek to offset a portion of our Agency pool exposure to prepayment speeds through our MSR and interest-only Agency RMBS portfolios. Generally, a decline in interest rates that leads to rising prepayment speeds will cause the market value of our interest-only securities and MSR to deteriorate, and our fixed coupon Agency pools to increase. The inverse relationship occurs when interest rates increase and prepayments slow. As previously discussed, despite the Federal Reserve raising rates throughout 2017 and in early 2018, the low interest rate environment is expected to persist in the near term. However, changes in home price performance, key employment metrics and government programs, among other macroeconomic factors, could cause prepayment speeds to increase on many RMBS, which could lead to less attractive reinvestment opportunities. Nonetheless, we believe our portfolio management approach, including our asset selection process, positions us to respond to a variety of market scenarios, including an overall faster prepayment environment. The following table provides the three-month weighted average constant prepayment rate, or CPR, on our Agency RMBS for the three months ended March 31, 2018, and the four immediately preceding quarters:

| Agency RMBS          | Three Months Ended |                   |                    |               |                |
|----------------------|--------------------|-------------------|--------------------|---------------|----------------|
|                      | March 31, 2018     | December 31, 2017 | September 30, 2017 | June 30, 2017 | March 31, 2017 |
| Weighted Average CPR | 7.0%               | 7.6 %             | 8.0 %              | 8.0 %         | 5.6 %          |

Although we are unable to predict the movement in interest rates in the remainder of 2018 and beyond, our diversified portfolio management strategy is intended to generate attractive yields with a low level of sensitivity to changes in the yield curve, prepayments and interest rate cycles.

Our Agency RMBS are collateralized by pools of fixed-rate mortgage loans and hybrid adjustable-rate mortgage loans, or hybrid ARMs, which are mortgage loans that have interest rates that are fixed for an initial period and adjustable thereafter. Our Agency portfolio also includes securities with implicit or explicit prepayment protection, including lower loan balances (securities collateralized by loans of less than \$175,000 in initial principal balance), higher LTVs (securities collateralized by loans with LTVs greater than or equal to 80%), certain geographic concentrations and lower FICO scores. Our overall allocation of Agency RMBS and holdings of pools with specific characteristics are viewed in the context of our aggregate rates strategy, including MSR and related derivative hedging instruments. Additionally, the selection of securities with certain attributes is driven by the perceived relative value of the securities, which factors in the opportunities in the marketplace, the cost of financing and the cost of hedging interest rate, prepayment, credit and other portfolio risks. As a result, Agency RMBS capital allocation reflects management's flexible approach to investing in the marketplace.

The following tables provide the carrying value of our Agency RMBS portfolio by underlying mortgage loan rate type:

| (dollars in thousands) | March 31, 2018                |                   |                             |                              |                                       |                   |  |  |  |  |
|------------------------|-------------------------------|-------------------|-----------------------------|------------------------------|---------------------------------------|-------------------|--|--|--|--|
|                        | Principal/<br>Current<br>Face | Carrying<br>Value | % of<br>Agency<br>Portfolio | %<br>Prepayment<br>Protected | Weighted<br>Average<br>Coupon<br>Rate | Amortized<br>Cost | Weighted<br>Average<br>Loan<br>Age<br>(months) |  |  |  |
| Agency RMBS AFS:       |                               |                   |                             |                              |                                       |                   |  |  |  |  |
| 30-Year Fixed          |                               |                   |                             |                              |                                       |                   |  |  |  |  |
| 3.0-3.5%               | \$3,982,815                   | \$4,004,080       | 22.1 %                      | 96.7 %                       | 3.5 %                                 | \$4,168,059       | 15   |  |  |  |
| 4.0-4.5%               | 12,645,638                    | 13,172,823        | 72.7 %                      | 100.0 %                      | 4.2 %                                 | 13,469,381        | 18   |  |  |  |
| ≥ 5%                   | 377,994                       | 415,450           | 2.3 %                       | 100.0 %                      | 5.5 %                                 | 406,900           | 105  |  |  |  |
|                        | 17,006,447                    | 17,592,353        | 97.1 %                      | 99.2 %                       | 4.1 %                                 | 18,044,340        | 20   |  |  |  |
| 15-Year & Other Fixed  | 239,654                       | 233,970           | 1.3 %                       | 0.5 %                        | 4.9 %                                 | 235,436           | 156  |  |  |  |

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|                    |              |              |       |   |      |   |     |   |              |     |
|--------------------|--------------|--------------|-------|---|------|---|-----|---|--------------|-----|
| Hybrid ARM         | 20,229       | 21,523       | 0.1   | % | —    | % | 5.0 | % | 21,322       | 169 |
| Interest-only      | 3,115,095    | 194,318      | 1.1   | % | —    | % | 2.1 | % | 224,298      | 81  |
| Agency Derivatives | 558,942      | 81,628       | 0.4   | % | —    | % | 4.6 | % | 82,250       | 166 |
| Total Agency RMBS  | \$20,940,367 | \$18,123,792 | 100.0 | % | 96.3 | % |     |   | \$18,607,646 |     |

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December 31, 2017

| (dollars in thousands) | Principal/<br>Current<br>Face | Carrying<br>Value | % of<br>Agency<br>Portfolio | %<br>Prepayment<br>Protected | Weighted<br>Average<br>Coupon<br>Rate | Amortized<br>Cost | Weighted<br>Average<br>Loan<br>Age<br>(months) |
|------------------------|-------------------------------|-------------------|-----------------------------|------------------------------|---------------------------------------|-------------------|--|
| Agency RMBS AFS:       |                               |                   |                             |                              |                                       |                   |  |
| 30-Year Fixed          |                               |                   |                             |                              |                                       |                   |  |
| 3.0-3.5%               | \$4,370,847                   | \$4,509,743       | 24.6                        | % 95.9                       | % 3.5                                 | \$4,569,946       | 13   |
| 4.0-4.5%               | 11,990,911                    | 12,764,960        | 69.7                        | % 99.1                       | % 4.2                                 | 12,812,335        | 17   |
| ≥ 5%                   | 453,054                       | 500,880           | 2.7                         | % 100.0                      | % 5.4                                 | 489,312           | 90   |
|                        | 16,814,812                    | 17,775,583        | 97.0                        | % 98.3                       | % 4.1                                 | 17,871,593        | 18   |
| 15-Year & Other Fixed  |                               |                   |                             |                              |                                       |                   |  |
| Hybrid ARM             | 245,383                       | 244,834           | 1.3                         | % 0.6                        | % 4.9                                 | 242,033           | 153  |
| Interest-only          | 21,654                        | 23,220            | 0.1                         | % —                          | % 5.0                                 | 22,831            | 166  |
| Agency Derivatives     | 2,941,772                     | 195,088           | 1.1                         | % —                          | % 2.2                                 | 223,289           | 77   |
| Total Agency RMBS      | \$20,611,867                  | \$18,329,700      | 100.0                       | % 95.4                       | %                                     | \$18,446,480      |  |

Our non-Agency securities yields are expected to increase if prepayment rates on such assets exceed our prepayment assumptions. To the extent that prepayment speeds increase due to macroeconomic factors, we expect to benefit from the ability to recognize the income from the heavily discounted prices that principally arose from credit or payment default expectations.

The following tables provide net unamortized discount/premium information on our non-Agency securities portfolio:

March 31, 2018

| (in thousands)                    | Principal/<br>Current<br>Face | Un-amortized<br>Premium | Accretable<br>Purchase<br>Discount | Credit<br>Reserve<br>Purchase<br>Discount | Amortized<br>Cost |
|-----------------------------------|-------------------------------|-------------------------|------------------------------------|---|-------------------|
| Principal and interest securities |                               |                         |                                    |   |                   |
| Senior                            | \$2,675,944                   | \$ 2,315                | \$(428,398)                        | \$(595,919)                               | \$1,653,942       |
| Mezzanine                         | 1,131,775                     | 466                     | (228,850)                          | (116,098)                                 | 787,293           |
| Total P&I securities              | 3,807,719                     | 2,781                   | (657,248)                          | (712,017)                                 | 2,441,235         |
| Interest-only                     | 5,495,775                     | 73,619                  | —                                  | —   | 73,619            |
| Total Non-Agency                  | \$9,303,494                   | \$ 76,400               | \$(657,248)                        | \$(712,017)                               | \$2,514,854       |

December 31, 2017

| (in thousands)                    | Principal/<br>Current<br>Face | Un-amortized<br>Premium | Accretable<br>Purchase<br>Discount | Credit<br>Reserve<br>Purchase<br>Discount | Amortized<br>Cost |
|-----------------------------------|-------------------------------|-------------------------|------------------------------------|---|-------------------|
| Principal and interest securities |                               |                         |                                    |   |                   |
| Senior                            | \$2,552,972                   | \$ 2,435                | \$(424,580)                        | \$(534,160)                               | \$1,596,667       |
| Mezzanine                         | 1,205,162                     | 322                     | (251,453)                          | (119,453)                                 | 834,578           |
| Total P&I securities              | 3,758,134                     | 2,757                   | (676,033)                          | (653,613)                                 | 2,431,245         |
| Interest-only                     | 5,614,925                     | 65,667                  | —                                  | —   | 65,667            |
| Total Non-Agency                  | \$9,373,059                   | \$ 68,424               | \$(676,033)                        | \$(653,613)                               | \$2,496,912       |

Credit losses



Although our Agency portfolio is supported by U.S. government agency and federally chartered corporation guarantees of payment of principal and interest, we are exposed to credit risk in our non-Agency securities and residential mortgage loans.

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The credit support built into non-Agency securities deal structures is designed to provide a level of protection from potential credit losses for more senior tranches. We evaluate credit risk on our non-Agency investments through a comprehensive asset selection process, which is predominantly focused on quantifying and pricing credit risk, including extensive initial modeling and scenario analysis. In addition, the discounted purchase prices paid for our non-Agency securities provide additional insulation from credit losses in the event we receive less than 100% of par on such assets. At purchase, we estimate the portion of the discount we do not expect to recover and factor that into our expected yield and accretion methodology. We may also record an other-than-temporary impairment, or OTTI, for a portion of our investment in a security to the extent we believe that the amortized cost exceeds the present value of expected future cash flows. We review our non-Agency securities on an ongoing basis using quantitative and qualitative analysis of the risk-adjusted returns on such investments and through on-going asset surveillance. Nevertheless, unanticipated credit losses could occur, adversely impacting our operating results.

We evaluate and review credit risk on our residential mortgage loans on an ongoing basis using quantitative and qualitative analysis and through on-going asset surveillance.

Counterparty exposure and leverage ratio

We monitor counterparty exposure in our broker, banking and lending counterparties on a daily basis. We believe our broker and banking counterparties are well-capitalized organizations and we attempt to manage our cash balances across these organizations to reduce our exposure to a single counterparty.

As of March 31, 2018, we had entered into repurchase agreements with 34 counterparties, 28 of which had outstanding balances at March 31, 2018. In addition, we held long-term secured advances from the FHLB, short-term borrowings under revolving credit facilities and long-term unsecured convertible senior notes. As of March 31, 2018, the debt-to-equity ratio funding our AFS securities, MSR and Agency Derivatives, which includes unsecured borrowings under convertible senior notes, was 5.9:1.0.

As of March 31, 2018, we held \$388.4 million in cash and cash equivalents, approximately \$1.6 million of unpledged Agency securities and derivatives and \$199.1 million of unpledged non-Agency securities. As a result, we had an overall estimated unused borrowing capacity on our unpledged securities of approximately \$140.7 million. As of March 31, 2018, we held approximately \$474.5 million of unpledged MSR and had an overall estimated unused borrowing capacity on MSR financing facilities of \$220.0 million. We also held approximately \$29.4 million of unpledged residential mortgage loans held-for-sale, for which we had no unused borrowing capacity. Generally, unused borrowing capacity may be the result of our election not to utilize certain financing, as well as delays in the timing in which funding is provided or the inability to meet lenders' eligibility requirements for specific types of asset classes. If borrowing rates and collateral requirements change in the near term, we believe we are subject to less earnings volatility than if we carried higher leverage.

We also monitor exposure to our MSR and mortgage loan counterparties. In connection with our previous securitization transactions, we were required to make certain representations and warranties to the investors in the RMBS we issued. We may also be required to make representations and warranties to investors in the loans underlying the MSR we own; however, some of our MSR were purchased on a bifurcated basis, meaning the representation and warranty obligations remain with the seller. If the representations and warranties we make prove to be inaccurate, we may be obligated to repurchase certain mortgage loans, which may impact the profitability of our portfolio. Although we obtain similar representations and warranties from the counterparty from which we acquired the relevant asset, if those representations and warranties do not directly mirror those we make to the investor, or if we are unable to enforce the representations and warranties against the counterparty for a variety of reasons, including the financial condition or insolvency of the counterparty, we may not be able to seek indemnification from our counterparties for any losses attributable to the breach.

Summary of Results of Operations and Financial Condition

On September 14, 2017, our board of directors approved a one-for-two reverse stock split of our outstanding shares of common stock. The reverse stock split was effected on November 1, 2017 at 5:01 p.m. Eastern Time, following the

special dividend of Granite Point common stock. At the effective time, every two issued and outstanding shares of our common stock were converted into one share of common stock. No fractional shares were issued in connection with the reverse stock split; instead, each stockholder holding fractional shares was entitled to receive, in lieu of such fractional shares, cash in an amount determined on the basis of the volume weighted average price of our common stock on the NYSE on November 1, 2017. In connection with the reverse stock split, the number of authorized shares of our common stock was also reduced on a one-for-two basis, from 900 million to 450 million. The par value of each share of common stock remained unchanged. All per share amounts, common shares outstanding and restricted shares for all periods presented have been adjusted on a retroactive basis to reflect the reverse stock split.

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Our GAAP net income attributable to common stockholders was \$321.1 million (\$1.69 per diluted weighted average share) for the three months ended March 31, 2018, as compared to GAAP net income attributable to common stockholders of \$72.0 million (\$0.41 per diluted weighted average share) for the three months ended March 31, 2017. With our accounting treatment for AFS securities, unrealized fluctuations in the market values of AFS securities, excluding Agency interest-only securities, do not impact our GAAP net income or taxable income but are recognized on our condensed consolidated balance sheets as a change in stockholders' equity under "accumulated other comprehensive (loss) income." As a result of this fair value accounting through stockholders' equity, we expect our net income to have less significant fluctuations and result in less U.S. GAAP to taxable income timing differences, than if the portfolio were accounted for as trading instruments. For the three months ended March 31, 2018, net unrealized losses on AFS securities recognized as other comprehensive loss, net of tax, were \$344.8 million. This, combined with GAAP net income attributable to common stockholders of \$321.1 million, resulted in comprehensive loss attributable to common stockholders of \$23.7 million for the three months ended March 31, 2018. For the three months ended March 31, 2017, net unrealized gains on AFS securities recognized as other comprehensive income, net of tax, were \$73.8 million. This, combined with GAAP net income attributable to common stockholders of \$72.0 million, resulted in comprehensive income attributable to common stockholders of \$145.7 million for the three months ended March 31, 2017.

Our book value per common share for U.S. GAAP purposes was \$15.63 at March 31, 2018, a decrease from \$16.31 book value per common share at December 31, 2017. During this three month period, we declared common dividends of \$82.5 million and recognized comprehensive loss attributable to common stockholders of \$23.7 million, which drove the overall decrease in book value.

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The following tables present the components of our comprehensive (loss) income for the three months ended March 31, 2018 and 2017:

| (in thousands, except share data)                                       | Three Months Ended<br>March 31, |             |
|---|---------------------------------|-------------|
| Income Statement Data:  | 2018                            | 2017        |
| Interest income:  |                                 |             |
| Available-for-sale securities   | \$190,716                       | \$135,327   |
| Residential mortgage loans held-for-investment in securitization trusts | —                               | 31,628      |
| Residential mortgage loans held-for-sale                                | 307                             | 398         |
| Other   | 2,996                           | 1,801       |
| Total interest income   | 194,019                         | 169,154     |
| Interest expense:   |                                 |             |
| Repurchase agreements   | 86,580                          | 32,256      |
| Collateralized borrowings in securitization trusts                      | —                               | 25,386      |
| Federal Home Loan Bank advances   | 4,458                           | 8,793       |
| Revolving credit facilities   | 804                             | 429         |
| Convertible senior notes  | 4,718                           | 3,821       |
| Total interest expense  | 96,560                          | 70,685      |
| Net interest income   | 97,459                          | 98,469      |
| Other-than-temporary impairment losses                                  | (94                             | ) —         |
| Other income (loss):  |                                 |             |
| Loss on investment securities   | (20,671                         | ) (52,352 ) |
| Servicing income  | 71,190                          | 39,773      |
| Gain (loss) on servicing asset  | 71,807                          | (14,565 )   |
| Gain on interest rate swap and swaption agreements                      | 150,545                         | 9,927       |
| Gain (loss) on other derivative instruments                             | 8,053                           | (27,864 )   |
| Other income  | 1,058                           | 9,496       |
| Total other income (loss)   | 281,982                         | (35,585 )   |
| Expenses:   |                                 |             |
| Management fees   | 11,708                          | 9,808       |
| Servicing expenses  | 14,554                          | 5,298       |
| Other operating expenses  | 14,492                          | 13,764      |
| Total expenses  | 40,754                          | 28,870      |
| Income from continuing operations before income taxes                   | 338,593                         | 34,014      |
| Provision for (benefit from) income taxes                               | 3,784                           | (24,517 )   |
| Net income from continuing operations                                   | 334,809                         | 58,531      |
| Income from discontinued operations, net of tax                         | —                               | 13,454      |
| Net income  | 334,809                         | 71,985      |
| Dividends on preferred stock  | 13,747                          | —           |
| Net income attributable to common stockholders                          | \$321,062                       | \$71,985    |

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| (in thousands)  | Three Months Ended |              |
|---|--------------------|--------------|
| Income Statement Data:  | March 31,          |              |
|   | 2018               | 2017         |
| Basic earnings per weighted average share:                      |                    |              |
| Continuing operations   | \$ 1.83            | \$ 0.33      |
| Discontinued operations   | —                  | 0.08         |
| Net income  | \$ 1.83            | \$ 0.41      |
| Diluted earnings per weighted average share:                    |                    |              |
| Continuing operations   | \$ 1.69            | \$ 0.33      |
| Discontinued operations   | —                  | 0.08         |
| Net income  | \$ 1.69            | \$ 0.41      |
| Dividends declared per common share                             | \$0.47             | \$ 0.50      |
| Weighted average number of shares of common stock:              |                    |              |
| Basic   | 175,145,964        | 174,281,965  |
| Diluted   | 192,818,531        | 174,281,965  |
| Comprehensive (loss) income:                                    |                    |              |
| Net income  | \$334,809          | \$ 71,985    |
| Other comprehensive (loss) income, net of tax:                  |                    |              |
| Unrealized (loss) gain on available-for-sale securities         | (344,777 )         | 73,762       |
| Other comprehensive (loss) income                               | (344,777 )         | 73,762       |
| Comprehensive (loss) income                                     | (9,968 )           | 145,747      |
| Dividends on preferred stock                                    | 13,747             | —            |
| Comprehensive (loss) income attributable to common stockholders | \$(23,715 )        | \$ 145,747   |
| (in thousands)  | March 31,          | December 31, |
| Balance Sheet Data:   | 2018               | 2017         |
|   | (unaudited)        |              |
| Available-for-sale securities                                   | \$21,059,377       | \$21,220,819 |
| Mortgage servicing rights                                       | \$1,301,023        | \$1,086,717  |
| Total assets  | \$24,077,165       | \$24,789,313 |
| Repurchase agreements   | \$19,148,679       | \$19,451,207 |
| Federal Home Loan Bank advances                                 | \$865,024          | \$1,215,024  |
| Total stockholders' equity                                      | \$3,467,685        | \$3,571,424  |

## Results of Operations

The following analysis focuses on financial results during the three months ended March 31, 2018 and 2017.

## Interest Income

Interest income increased from \$169.2 million for the three months ended March 31, 2017 to \$194.0 million for the same period in 2018 due to the growth of our AFS securities portfolio, offset by sales of retained interests from our on-balance sheet securitizations resulting in the deconsolidation of all securitization trusts in the fourth quarter of 2017.

## Interest Expense

Interest expense increased from \$70.7 million for the three months ended March 31, 2017 to \$96.6 million for the same period in 2018 due to increased financing on AFS securities and MSR due to portfolio growth, an increase in the proportion of total borrowings financed through repurchase agreements (relative to FHLB advances) and increases in the borrowing rates offered by counterparties, offset by sales of retained interests from our on-balance sheet securitizations resulting in the deconsolidation of all securitization trusts in the fourth quarter of 2017.



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## Net Interest Income

The following table presents the components of interest income and average annualized net asset yield earned by asset type, the components of interest expense and average annualized cost of funds on borrowings incurred by liability and/or collateral type, and net interest income and average annualized net interest rate spread for the three months ended March 31, 2018 and 2017:

| (dollars in thousands)   | Three Months Ended March 31, 2018 |                            |                                      | Three Months Ended March 31, 2017 |                            |                                      |
|--|-----------------------------------|----------------------------|--------------------------------------|-----------------------------------|----------------------------|--------------------------------------|
|  | Average<br>Balance <sup>(1)</sup> | Interest<br>Income/Expense | Net<br>Yield/Cost<br>of Funds<br>(2) | Average<br>Balance <sup>(1)</sup> | Interest<br>Income/Expense | Net<br>Yield/Cost<br>of Funds<br>(2) |
| <b>Interest-earning assets</b>   |                                   |                            |                                      |                                   |                            |                                      |
| Agency available-for-sale securities   | \$ 18,335,230                     | \$ 140,729                 | 3.1 %                                | \$ 13,129,586                     | \$ 98,898                  | 3.0 %                                |
| Non-Agency available-for-sale securities   | 2,506,443                         | 49,987                     | 8.0 %                                | 1,620,804                         | 36,429                     | 9.0 %                                |
| <b>Residential mortgage loans</b>  |                                   |                            |                                      |                                   |                            |                                      |
| held-for-investment in securitization trusts   | —                                 | —                          | — %                                  | 3,248,979                         | 31,628                     | 3.9 %                                |
| Residential mortgage loans held-for-sale   | 32,099                            | 307                        | 3.8 %                                | 39,882                            | 398                        | 4.0 %                                |
| Other  |                                   | 2,996                      |                                      |                                   | 1,801                      |                                      |
| Total interest income/net asset yield  | \$ 20,873,772                     | \$ 194,019                 | 3.7 %                                | \$ 18,039,251                     | \$ 169,154                 | 3.8 %                                |
| <b>Interest-bearing liabilities</b>  |                                   |                            |                                      |                                   |                            |                                      |
| Repurchase agreements, FHLB advances, revolving credit facilities and borrowings in securitization trusts collateralized by: |                                   |                            |                                      |                                   |                            |                                      |
| Agency available-for-sale securities   | \$ 17,605,519                     | \$ 72,984                  | 1.7 %                                | \$ 12,439,130                     | \$ 29,883                  | 1.0 %                                |
| Non-Agency available-for-sale securities   | 2,020,125                         | 15,597                     | 3.1 %                                | 1,234,918                         | 8,501                      | 2.8 %                                |
| <b>Residential mortgage loans</b>  |                                   |                            |                                      |                                   |                            |                                      |
| held-for-investment in securitization trusts   | —                                 | —                          | — %                                  | 3,180,996                         | 26,278                     | 3.3 %                                |
| Agency derivatives <sup>(3)</sup>  | 65,345                            | 395                        | 2.4 %                                | 92,613                            | 423                        | 1.8 %                                |
| Mortgage servicing rights <sup>(4)</sup>   | 220,333                           | 2,866                      | 5.2 %                                | 28,444                            | 429                        | 6.0 %                                |
| <b>Other unassignable:</b>   |                                   |                            |                                      |                                   |                            |                                      |
| Convertible senior notes   | 282,982                           | 4,718                      | 6.7 %                                | 241,469                           | 3,821                      | 6.3 %                                |
| Other  |                                   | —                          |                                      |                                   | 1,350                      |                                      |
| Total interest expense/cost of funds   | \$ 20,194,304                     | \$ 96,560                  | 1.9 %                                | \$ 17,217,570                     | \$ 70,685                  | 1.6 %                                |
| Net interest income/spread <sup>(5)</sup>  |                                   | \$ 97,459                  | 1.8 %                                |                                   | \$ 98,469                  | 2.2 %                                |

Average asset balance represents average amortized cost on AFS securities and Agency Derivatives and average (1) unpaid principal balance, adjusted for purchase price changes, on residential mortgage loans held-for-investment in securitization trusts and residential mortgage loans held-for-sale.

Cost of funds does not include the accrual and settlement of interest associated with interest rate swaps. In accordance with U.S. GAAP, those costs are included in gain on interest rate swap and swaption agreements in the condensed consolidated statements of comprehensive (loss) income. For the three months ended March 31, 2018, (2) our total average cost of funds on the assets assigned as collateral for borrowings shown in the table above, including interest spread expense associated with interest rate swaps, was 1.9%, compared to 1.8% for the same period in 2017.

(3) Yields on Agency Derivatives not shown as interest income is included in gain (loss) on other derivative instruments in the condensed consolidated statements of comprehensive (loss) income.



(4) Yields on mortgage servicing rights not shown as these assets do not earn interest.

Net interest spread does not include the accrual and settlement of interest associated with interest rate swaps. In accordance with U.S. GAAP, those costs are included in gain on interest rate swap and swaption agreements in the

(5) condensed consolidated statements of comprehensive (loss) income. For the three months ended March 31, 2018, our total average net interest rate spread on the assets and liabilities shown in the table above, including interest spread expense associated with interest rate swaps, was 1.8%, compared to 2.0% for the same period in 2017.

The increase in yields on Agency AFS securities for the three months ended March 31, 2018, as compared to the same period in 2017, was predominantly driven by purchases of pools with higher yields and sales of pools with lower yields. The increase in cost of funds associated with the financing of Agency AFS securities for the three months ended March 31, 2018, as compared to the same period in 2017, was the result of an increase in the proportion of total borrowings financed through repurchase agreements (relative to longer term FHLB advances, which have lower interest rates) and increases in the borrowing rates offered by repurchase agreement counterparties.

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The decrease in yields on non-Agency securities for the three months ended March 31, 2018, as compared to the same period in 2017, was predominantly driven by purchases of non-Agency securities at lower yields than our existing portfolio. The increase in cost of funds associated with the financing of non-Agency AFS securities for the three months ended March 31, 2018, as compared to the same period in 2017, was the result of increases in the borrowing rates offered by counterparties.

During the fourth quarter of 2017, we sold all of the subordinated securities retained from our previous securitization transactions thereby causing the deconsolidation of the securitization trusts and the associated residential mortgage loans held-for-investment and collateralized borrowings from our consolidated balance sheet.

The decrease in yields on residential mortgage loans held-for-sale for the three months ended March 31, 2018, as compared to the same period in 2017, was due to an increase in delinquencies on credit sensitive and Ginnie Mae buyout residential mortgage loans. We did not have any financing of residential mortgage loans held-for-sale in place for the three months ended March 31, 2018 and 2017.

The increase in cost of funds associated with the financing of Agency Derivatives for the three months ended March 31, 2018, as compared to the same period in 2017, was the result of increases in the borrowing rates offered by counterparties.

The decrease in cost of funds associated with the financing of MSR for the three months ended March 31, 2018, as compared to the same period in 2017, was the result of an increase in the proportion of total borrowings financed through repurchase agreements (relative to revolving credit facilities, which have higher interest rates).

Our convertible senior notes were issued in January 2017, are unsecured and pay interest semiannually at a rate of 6.25% per annum. The increase cost of funds associated with our convertible senior notes for the three months ended March 31, 2018, as compared to the same period in 2017, was the result of higher amortization of deferred debt issuance costs.

The following table presents the components of the yield earned by investment type on our AFS securities portfolio as a percentage of our average amortized cost of securities for the three months ended March 31, 2018 and 2017:

|   | Three Months Ended March 31, 2018 |            |        | Three Months Ended March 31, 2017 |            |        |
|---|-----------------------------------|------------|--------|-----------------------------------|------------|--------|
|   | Agency<br>(1)                     | Non-Agency | Total  | Agency<br>(1)                     | Non-Agency | Total  |
| Gross yield/stated coupon                     | 4.0 %                             | 4.4 %      | 4.1 %  | 3.9 %                             | 3.5 %      | 3.9 %  |
| Net (premium amortization) discount accretion | (0.9)%                            | 3.6 %      | (0.4)% | (0.9)%                            | 5.5 %      | (0.2)% |
| Net yield (2)                                 | 3.1 %                             | 8.0 %      | 3.7 %  | 3.0 %                             | 9.0 %      | 3.7 %  |

(1) Excludes Agency Derivatives. For the three months ended March 31, 2018, the average annualized net yield on total Agency RMBS, including Agency Derivatives, was 3.1%, compared to 3.1% for the same period in 2017.

(2) These yields have not been adjusted for cost of delay and cost to carry purchase premiums.

#### Other-Than-Temporary Impairments

We review each of our securities on a quarterly basis to determine if an OTTI charge is necessary. During the three months ended March 31, 2018, we recorded \$0.1 million in other-than-temporary credit impairments on one non-Agency security where its future expected cash flows were less than its amortized cost. We did not record any other-than-temporary credit impairments during the three months ended March 31, 2017. For further information about evaluating AFS securities for OTTI, refer to Note 4 - Available-for-Sale Securities, at Fair Value of the notes to the condensed consolidated financial statements.

#### Loss on Investment Securities

During the three months ended March 31, 2018 and 2017, we sold AFS securities for \$2.0 billion and \$2.4 billion with an amortized cost of \$2.1 billion and \$2.5 billion, for net realized losses of \$19.6 million and \$50.4 million, respectively. We do not expect to sell assets on a frequent basis, but may sell assets to reallocate capital into new

assets that we believe have higher risk-adjusted returns.

For the three months ended March 31, 2018 and 2017, Agency interest-only mortgage-backed securities experienced a change in unrealized gains of \$0.3 million and losses of \$1.9 million, respectively. The increase in change in unrealized gains (decrease in losses) for the three months ended March 31, 2018, as compared to the same period in 2017, was predominantly driven by lower prepayment expectations on Agency interest-only mortgage-backed securities.

For the three months ended March 31, 2018, we recognized \$0.6 million in dividend income on equity securities and experienced a change in unrealized losses of \$2.0 million due to declines in the market price of the securities. We did not hold any equity securities during the three months ended March 31, 2017.

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## Servicing Income

For the three months ended March 31, 2018 and 2017, we recognized total servicing income from our MSR portfolio of \$71.2 million and \$39.8 million, respectively. These amounts include servicing fee income of \$66.5 million and \$38.5 million, ancillary and other fee income of \$0.3 million and \$0.2 million, and float income of \$4.4 million and \$1.1 million, respectively. The increase in servicing income for the three months ended March 31, 2018, as compared to the same period in 2017, was the result of an increase in the size of our MSR portfolio.

## Gain (Loss) on Servicing Asset

For the three months ended March 31, 2018 and 2017, gain on servicing asset of \$71.8 million and loss on servicing asset \$14.6 million, respectively, includes a decrease in fair value of MSR due to realization of cash flows (runoff) of \$29.2 million and \$18.0 million, respectively, offset by an increase in fair value of MSR due to changes in valuation inputs or assumptions of \$100.7 million and \$3.2 million, respectively. Additionally, we recognized gains on sales of MSR of \$0.3 million and \$0.3 million for the three months ended March 31, 2018 and 2017, respectively. The increase in gain (decrease in loss) on servicing asset for the three months ended March 31, 2018, as compared to the same period in 2017, was predominantly driven by a decrease in prepayment speed assumptions, offset by higher portfolio runoff during the three months ended March 31, 2018 due to an increase in the size of our MSR portfolio.

## Gain on Interest Rate Swap and Swaption Agreements

For the three months ended March 31, 2018 and 2017, we recognized \$3.8 million of income and \$7.9 million of expenses, respectively, for the accrual and/or settlement of the net interest expense associated with our interest rate swaps. The income/expenses result from paying either a fixed interest rate or LIBOR interest and receiving either LIBOR interest or a fixed interest rate on an average \$27.8 billion and \$18.7 billion notional, respectively, held to economically hedge/mitigate portfolio interest rate exposure (or duration) risk.

During the three months ended March 31, 2018 and 2017, we terminated, had agreements mature or had options expire on 63 and 32 interest rate swap and swaption positions of \$39.9 billion and \$18.9 billion notional, respectively. Upon settlement of the early terminations and option expirations, we paid \$6.9 million and \$7.2 million in full settlement of our net interest spread asset/liability and recognized \$92.5 million and \$66.0 million in realized gains on the swaps and swaptions for the three months ended March 31, 2018 and 2017, respectively, including early termination penalties. We elected to terminate certain swaps and swaptions during these periods to align with our investment portfolio.

Also included in our financial results for the three months ended March 31, 2018 and 2017, was the recognition of a change in unrealized valuation gains of \$54.3 million and a change in unrealized valuation losses of \$48.2 million, respectively, on our interest rate swap and swaption agreements that were accounted for as trading instruments. The change in fair value of interest rate swaps was a result of changes to LIBOR, the swap curve and corresponding counterparty borrowing rates during the three months ended March 31, 2018 and 2017. Since these swaps and swaptions are used for purposes of hedging our interest rate exposure, their unrealized valuation gains and losses are generally offset by unrealized losses and gains in our Agency RMBS AFS portfolio, which are recorded either directly to stockholders' equity through other comprehensive (loss) income, net of tax, or to loss on investment securities, in the case of Agency interest-only securities.

The following table provides the net interest spread and gains and losses associated with our interest rate swap and swaption positions:

|   | Three Months<br>Ended<br>March 31, |           |
|---|------------------------------------|-----------|
| (in thousands)  | 2018                               | 2017      |
| Net interest spread   | \$3,809                            | \$(7,904) |
| Early termination, agreement maturation and option expiration gains                           | 92,479                             | 66,031    |
| Change in unrealized gain (loss) on interest rate swap and swaption agreements, at fair value | 54,257                             | (48,200)  |
| Gain on interest rate swap and swaption agreements  | \$150,545                          | \$9,927   |



Table of Contents**Gain (Loss) on Other Derivative Instruments**

Included in our financial results for the three months ended March 31, 2018 and 2017, was the recognition of \$8.1 million of gains and \$27.9 million of losses, respectively, on other derivative instruments we hold for purposes of both hedging and non-hedging activities, principally TBAs, put and call options for TBAs, Markit IOS total return swaps and inverse interest-only securities. Included within these results for the three months ended March 31, 2018 and 2017, was the recognition of \$2.5 million and \$3.8 million of interest income, net of accretion on inverse interest-only securities on an average amortized cost basis of \$84.9 million and \$105.2 million, respectively. The remainder represented realized and unrealized net gains (losses) on other derivative instruments. As these derivative instruments are considered trading instruments, our financial results include both realized and unrealized gains (losses) associated with these instruments.

**Other Income**

For the three months ended March 31, 2018 and 2017, we recorded other income of \$1.1 million and \$9.5 million, which includes \$0.3 million and \$1.5 million of gains on residential mortgage loans held-for-sale and \$0.8 million and \$1.4 million of dividend income on our FHLB stock, respectively. Also included in other income for the three months ended March 31, 2017 was \$13.0 million in gains on residential mortgage loans held-for-investment in securitization trusts and \$6.4 million in losses on collateralized borrowings in securitization trusts. The decrease in other income for the three months ended March 31, 2018, as compared to the same period in 2017, was predominantly driven by sales of retained interests from our on-balance sheet securitizations resulting in the deconsolidation of all securitization trusts in the fourth quarter of 2017.

**Management Fees**

We incurred management fees of \$11.7 million and \$9.8 million for the three months ended March 31, 2018 and 2017, respectively, which are payable to PRCM Advisers, our external manager, under our management agreement. The management fee is calculated based on our stockholders' equity with certain adjustments outlined in the management agreement.

**Servicing Expenses**

For the three months ended March 31, 2018 and 2017, we recognized \$14.6 million and \$5.3 million, respectively, in servicing expenses generally related to the subservicing of MSR and residential mortgage loans. The increase in servicing expenses during the three months ended March 31, 2018, as compared to the same period in 2017, was the result of an increase in the size of our MSR portfolio as well as the release of MSR representation and warranty reserves during the three months ended March 31, 2017 due to a refinement of the reserve method.

**Other Operating Expenses**

For the three months ended March 31, 2018 and 2017, we recognized \$14.5 million and \$13.8 million of other operating expenses, which represents an annualized expense ratio of 1.6% and 1.6% of average stockholders' equity, respectively. Included in other operating expenses are direct and allocated costs incurred by PRCM Advisers on our behalf and reimbursed by us. For the three months ended March 31, 2018 and 2017, these direct and allocated costs totaled approximately \$6.8 million and \$4.2 million, respectively. Included in these reimbursed costs was compensation paid to employees of Pine River serving as our principal financial officer and general counsel of \$1.1 million and \$1.1 million for the three months ended March 31, 2018 and 2017, respectively. The allocation of compensation paid to employees of Pine River serving as our principal financial officer and general counsel is based on time spent overseeing our company's activities in accordance with the management agreement; we do not reimburse PRCM Advisers for any expenses related to the compensation of our chief executive officer or chief investment officer. Equity based compensation expense for the three months ended March 31, 2018 and 2017 also includes the amortization of the restricted stock awarded to our executive officers in conjunction with the Company's Second Restated 2009 Equity Incentive Plan, or the Plan (see discussion in Note 18 - Equity Incentive Plan), including our chief executive officer, chief investment officer, principal financial officer and general counsel of \$1.3 million and \$2.2 million for the three months ended March 31, 2018 and 2017, respectively. The decrease in amortization of restricted stock was due to the decline in our share price following the special dividend of Granite Point common

stock in the fourth quarter of 2017 and resulting fair value of the unvested restricted shares.

We have direct relationships with the majority of our third-party vendors. We will continue to have certain costs allocated to us by PRCM Advisers for compensation, data services, technology and certain office lease payments, but most of our expenses with third-party vendors are paid directly by us.

#### Income Taxes

During the three months ended March 31, 2018, our TRSs recognized a provision for income taxes of \$3.8 million, which was primarily due to gains recognized on MSR, offset by net losses incurred on derivative instruments held in the TRSs. During the three months ended March 31, 2017, our TRSs recognized a benefit from income taxes of \$24.5 million, which was primarily due to realized losses on sales of AFS securities and net losses incurred on derivative instruments held in the TRSs. As of March 31, 2018 and December 31, 2017, a \$2.3 million and a \$2.7 million valuation allowance was recorded, respectively, because we determined that it is more likely than not that the associated deferred tax asset will not be realized. We currently intend to distribute 100% of our REIT taxable income and comply with all requirements to continue to qualify as a REIT.

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The recently passed TCJA significantly revises the U.S. corporate income tax laws by, among other things, lowering the federal income tax rate applicable to corporations from 35% to 21% and repealing the corporate alternative minimum tax. We have not completed our determination of the accounting implications of the TCJA on our tax accruals. However, we reasonably estimated the effects of the TCJA and recognized a tax provision of \$17.5 million in our financial statements as of December 31, 2017. This amount represents the remeasurement of federal net deferred tax assets resulting from the permanent reduction in the U.S. statutory corporate tax rate from 35% to 21%. The TCJA requires complex computations to be performed that were not previously required in U.S. tax law, significant judgments to be made in interpretation of the provisions of the TCJA and significant estimates in calculations, and the preparation and analysis of information not previously relevant or regularly produced. The U.S. Treasury, the IRS, and other standard-setting bodies could interpret or issue guidance on how provisions of the TCJA will be applied or otherwise administered that is different from our interpretation. As we complete our analysis of the TCJA, collect and prepare necessary data, and interpret any additional guidance, we may make adjustments to the provisional amounts. Those adjustments may materially impact our provision for income taxes in the period in which the adjustments are made.

Discontinued Operations

On June 28, 2017, we completed the contribution of our portfolio of commercial real estate assets to Granite Point. We contributed our equity interests in our wholly owned subsidiary, TH Commercial Holdings LLC, to Granite Point and, in exchange for our contribution, received approximately 33.1 million shares of common stock of Granite Point, representing approximately 76.5% of the outstanding stock of Granite Point upon completion of the initial public offering, or IPO, of its common stock on June 28, 2017.

On November 1, 2017, we distributed, on a pro rata basis, the 33.1 million shares of Granite Point common stock that we acquired in connection with the contribution to the holders of our common stock outstanding as of the close of business on October 20, 2017. Due to our controlling ownership interest in Granite Point through November 1, 2017, our results of operations and financial condition through such date reflect Granite Point's commercial strategy, which includes as target assets first mortgages, mezzanine loans, B-notes and preferred equity. As of November 1, 2017, we no longer have a controlling interest in Granite Point and, therefore, have deconsolidated Granite Point and its subsidiaries from our financial statements and reclassified all of Granite Point's current and prior period assets, liabilities and results of operations to discontinued operations.

For the three months ended March 31, 2017, we recognized \$13.5 million in income from discontinued operations, net of tax, related to Granite Point.

Financial Condition

Available-for-Sale Securities, at Fair Value

Agency RMBS

Our Agency RMBS AFS portfolio is comprised of adjustable rate and fixed rate mortgage-backed securities backed by single-family and multi-family mortgage loans. All of our principal and interest ("P&I") Agency RMBS AFS were Fannie Mae or Freddie Mac mortgage pass-through certificates or collateralized mortgage obligations that carry an implied rating of "AAA," or Ginnie Mae mortgage pass-through certificates, which are backed by the guarantee of the U.S. government. The majority of these securities consist of whole pools in which we own all of the investment interests in the securities.



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The tables below summarize certain characteristics of our Agency RMBS AFS at March 31, 2018:

March 31, 2018

| (dollars in thousands, except purchase price) | Principal/Current Face | Net (Discount) Premium | Amortized Cost | Unrealized Gain | Unrealized Loss | Carrying Value | Weighted Average Coupon Rate | Weighted Average Purchase Price |
|---|------------------------|------------------------|----------------|-----------------|-----------------|----------------|------------------------------|---------------------------------|
| Principal and interest securities             |                        |                        |                |                 |                 |                |                              |                                 |
| Fixed   | \$17,246,102           | \$1,033,674            | \$18,279,776   | \$14,485        | \$(467,938)     | \$17,826,323   | 4.08 %                       | \$106.41                        |
| Hybrid ARM                                    | 20,228                 | 1,094                  | 21,322         | 318             | (117 )          | 21,523         | 4.95 %                       | \$107.97                        |
| Total P&I securities                          | 17,266,330             | 1,034,768              | 18,301,098     | 14,803          | (468,055 )      | 17,847,846     | 4.08 %                       | \$106.41                        |
| Interest-only securities                      |                        |                        |                |                 |                 |                |                              |                                 |
| Fixed   | 570,874                | 56,662                 | 56,662         | 6,524           | (808 )          | 62,378         | 3.30 %                       | \$16.04                         |
| Fixed Other <sup>(1)</sup>                    | 2,544,221              | 167,636                | 167,636        | 7,850           | (43,546 )       | 131,940        | 1.57 %                       | \$8.87                          |
| Total   | \$20,381,425           | \$1,259,066            | \$18,525,396   | \$29,177        | \$(512,409)     | \$18,042,164   |                              |                                 |

Fixed Other represents weighted-average coupon interest-only securities that are not generally used for our interest-rate risk management purposes. These securities pay variable coupon interest based on the weighted average of the fixed rates of the underlying loans of the security, less the weighted average rates of the applicable issued principal and interest securities.

Our three-month average constant prepayment rate, or CPR, experienced by Agency RMBS AFS owned by us as of March 31, 2018, on an annualized basis, was 7.0%.

The following table summarizes the carrying value of our floating or adjustable rate Agency RMBS AFS portfolio by the number of months until the next reset at March 31, 2018:

| (in thousands) | March 31, 2018 |
|----------------|----------------|
| 0-12 months    | \$21,295       |
| 13-36 months   | 228            |
| Total          | \$21,523       |

#### Non-Agency Securities

Our non-Agency securities portfolio is comprised of senior and mezzanine tranches of mortgage-backed and asset-backed securities. The following tables provide investment information on our non-Agency securities as of March 31, 2018:

March 31, 2018

| (in thousands)                    | Principal/Current Face | Unamortized Premium | Accretible Purchase Discount | Credit Reserve Purchase Discount | Amortized Cost | Unrealized Gain | Unrealized Loss | Carrying Value |
|-----------------------------------|------------------------|---------------------|------------------------------|----------------------------------|----------------|-----------------|-----------------|----------------|
| Principal and interest securities |                        |                     |                              |                                  |                |                 |                 |                |
| Senior                            | \$2,675,944            | \$2,315             | \$(428,398)                  | \$(595,919)                      | \$1,653,942    | \$373,954       | \$(1,861)       | \$2,026,035    |
| Mezzanine                         | 1,131,775              | 466                 | (228,850)                    | (116,098)                        | 787,293        | 131,480         | (1,896)         | 916,877        |
| Total P&I                         | 3,807,719              | 2,781               | (657,248)                    | (712,017)                        | 2,441,235      | 505,434         | (3,757)         | 2,942,912      |
|                                   | 5,495,775              | 73,619              | —                            | —                                | 73,619         | 3,938           | (3,256)         | 74,301         |

Interest-only  
securities

|       |             |           |             |             |             |           |            |             |
|-------|-------------|-----------|-------------|-------------|-------------|-----------|------------|-------------|
| Total | \$9,303,494 | \$ 76,400 | \$(657,248) | \$(712,017) | \$2,514,854 | \$509,372 | \$(7,013 ) | \$3,017,213 |
|-------|-------------|-----------|-------------|-------------|-------------|-----------|------------|-------------|

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The majority of our non-Agency securities were rated at March 31, 2018. Note that credit ratings are based on the par value of the non-Agency securities, whereas the distressed non-Agency securities in our portfolio were acquired at heavily discounted prices. The following table summarizes the credit ratings of our non-Agency securities portfolio, based on the Bloomberg Index Rating, a composite of each of the four major credit rating agencies (i.e., DBRS Ltd., Moody's Investors Services, Inc., Standard & Poor's Corporation and Fitch, Inc.), as of March 31, 2018:

|           | March 31,<br>2018 |   |
|-----------|-------------------|---|
| AAA       | 0.9               | % |
| AA        | —                 | % |
| A         | —                 | % |
| BBB       | 3.4               | % |
| BB        | 0.3               | % |
| B         | 4.4               | % |
| Below B   | 71.4              | % |
| Not rated | 19.6              | % |
| Total     | 100.0             | % |

Within our non-Agency securities portfolio, we have a substantial emphasis on “legacy” securities, which include securities issued up to and including 2009, many of which are subprime. We believe these deeply discounted securities can add relative value as the economy and housing markets continue to improve, as there remains upside optionality to lower delinquencies, higher recoveries and faster prepayments. We also hold “new issue” non-Agency securities (issued after 2009), which include commercial mortgage-backed securities, term notes backed by MSR-related collateral, certain securities from our previously consolidated securitization trusts and other newly issued non-Agency securities. We believe these “new issue” securities have enabled us to find attractive returns and further diversify our non-Agency securities portfolio.

The following table provides the carrying value of our “legacy” and “new issue” non-Agency securities at March 31, 2018:

|   | March 31,<br>2018 |                                       |
|---|-------------------|---------------------------------------|
| (dollars in thousands)                                | Carrying<br>Value | % of Total<br>Non-Agency<br>Portfolio |
| “Legacy” non-Agency principal and interest securities | \$2,637,881       | 87.4 %                                |
| “Legacy” non-Agency interest-only securities          | 13,188            | 0.5 %                                 |
| “New issue” non-Agency securities                     | 366,144           | 12.1 %                                |
| Total   | \$3,017,213       | 100.0 %                               |

Due to acquisitions of “legacy” non-Agency securities, our designated credit reserve as a percentage of total discount increased from March 31, 2017 to March 31, 2018 (as disclosed in Note 4 - Available-for-Sale Securities, at Fair Value of the notes to the condensed consolidated financial statements). From March 31, 2017 to March 31, 2018, our designated credit reserve as a percentage of total discount increased from 40.0% to 52.0%.

A subprime bond may generally be considered higher risk; however, if purchased at a discount that reflects a high expectation of credit losses, it could be viewed as less risky than a prime bond, which is subject to unanticipated credit loss performance. Accordingly, we believe our risk profile in owning a heavily discounted subprime bond with known delinquencies affords us the ability to assume a higher percentage of expected credit loss with comparable risk-adjusted returns to a less discounted prime bond with a lower percentage of expected credit loss.



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The following tables present certain information by investment type and their respective underlying loan characteristics for our “legacy” senior and mezzanine non-Agency securities, excluding our non-Agency interest-only portfolio, at March 31, 2018:

|   | March 31, 2018 |           |             |   |
|---|----------------|-----------|-------------|---|
| “Legacy” Non-Agency P&I Securities        | Senior         | Mezzanine | Total       |   |
| Carrying Value (in thousands)             | \$1,859,995    | \$777,886 | \$2,637,881 |   |
| % of Total                                | 70.5           | % 29.5    | % 100.0     | % |
| Average Purchase Price <sup>(1)</sup>     | \$56.99        | \$65.53   | \$59.51     |   |
| Average Coupon                            | 2.9            | % 2.5     | % 2.8       | % |
| Average Fixed Coupon                      | 5.9            | % 5.2     | % 5.8       | % |
| Average Floating Coupon                   | 2.6            | % 2.5     | % 2.6       | % |
| Average Hybrid Coupon                     | 2.1            | % —       | % 2.1       | % |
| Collateral Attributes                     |                |           |             |   |
| Average Loan Age (months)                 | 140            | 148       | 142         |   |
| Average Loan Size (in thousands)          | \$373          | \$360     | \$369       |   |
| Average Original Loan-to-Value            | 69.0           | % 68.0    | % 68.7      | % |
| Average Original FICO <sup>(2)</sup>      | 628            | 574       | 612         |   |
| Current Performance                       |                |           |             |   |
| 60+ day delinquencies                     | 22.4           | % 19.6    | % 21.6      | % |
| Average Credit Enhancement <sup>(3)</sup> | 7.6            | % 16.6    | % 10.2      | % |
| 3-Month CPR <sup>(4)</sup>                | 5.3            | % 6.4     | % 5.7       | % |

Average purchase price utilized carrying value for weighting purposes. If current face were utilized for weighting (1) purposes, the average purchase price for senior, mezzanine, and total “legacy” non-Agency securities, excluding our non-Agency interest-only portfolio, would be \$54.69, \$63.00 and \$57.00, respectively, at March 31, 2018.

(2) FICO represents a mortgage industry accepted credit score of a borrower, which was developed by Fair Isaac Corporation.

(3) Average credit enhancement remaining on our “legacy” non-Agency securities portfolio, which is the average amount of protection available to absorb future credit losses due to defaults on the underlying collateral.

Three-month CPR is reflective of the prepayment speed on the underlying securitization; however, it does not (4) necessarily indicate the proceeds received on our investment tranche. Proceeds received for each security are dependent on the position of the individual security within the structure of each deal.

|                        | March 31, 2018                     |             |                |                |                |            |
|------------------------|------------------------------------|-------------|----------------|----------------|----------------|------------|
|                        | “Legacy” Non-Agency P&I Securities |             |                |                |                |            |
| (dollars in thousands) | Senior                             |             | Mezzanine      |                | Total          |            |
| Collateral Type        | Carrying Value                     | % of Senior | Carrying Value | % of Mezzanine | Carrying Value | % of Total |
| Prime                  | \$20,189                           | 1.1 %       | \$13,826       | 1.8 %          | \$34,015       | 1.3 %      |
| Alt-A                  | 152,236                            | 8.2 %       | 92,971         | 11.9 %         | 245,207        | 9.3 %      |
| POA                    | 95,177                             | 5.1 %       | 148,451        | 19.1 %         | 243,628        | 9.2 %      |
| Subprime               | 1,592,393                          | 85.6 %      | 522,638        | 67.2 %         | 2,115,031      | 80.2 %     |
| Total                  | \$1,859,995                        | 100.0 %     | \$777,886      | 100.0 %        | \$2,637,881    | 100.0 %    |

|                        | March 31, 2018                     |           |       |
|------------------------|------------------------------------|-----------|-------|
|                        | “Legacy” Non-Agency P&I Securities |           |       |
| (dollars in thousands) | Senior                             | Mezzanine | Total |
| Coupon Type            |                                    |           |       |

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|                    | Carrying Value | % of Senior | Carrying Value | % of Mezzanine | Carrying Value | % of Total |
|--------------------|----------------|-------------|----------------|----------------|----------------|------------|
| Fixed Rate         | \$145,249      | 7.8 %       | \$20,140       | 2.6 %          | \$165,389      | 6.3 %      |
| Hybrid or Floating | 1,714,746      | 92.2 %      | 757,746        | 97.4 %         | 2,472,492      | 93.7 %     |
| Total              | \$1,859,995    | 100.0 %     | \$777,886      | 100.0 %        | \$2,637,881    | 100.0 %    |

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| March 31, 2018                     |                |             |                |                |                |            |
|------------------------------------|----------------|-------------|----------------|----------------|----------------|------------|
| “Legacy” Non-Agency P&I Securities |                |             |                |                |                |            |
| (dollars in thousands)             | Senior         |             | Mezzanine      |                | Total          |            |
| Origination Year                   | Carrying Value | % of Senior | Carrying Value | % of Mezzanine | Carrying Value | % of Total |
| 2006 and Thereafter                | \$ 1,655,901   | 89.0 %      | \$ 294,784     | 37.9 %         | \$ 1,950,685   | 73.9 %     |
| 2002-2005                          | 198,942        | 10.7 %      | 481,584        | 61.9 %         | 680,526        | 25.8 %     |
| Pre-2002                           | 5,152          | 0.3 %       | 1,518          | 0.2 %          | 6,670          | 0.3 %      |
| Total                              | \$ 1,859,995   | 100.0 %     | \$ 777,886     | 100.0 %        | \$ 2,637,881   | 100.0 %    |

## Mortgage Servicing Rights, at Fair Value

One of our wholly owned subsidiaries has approvals from Fannie Mae and Freddie Mac to own and manage MSR, which represent the right to control the servicing of mortgage loans. We do not directly service mortgage loans, and instead contract with appropriately licensed subservicers to handle substantially all servicing functions in the name of the subservicer for the loans underlying our MSR. As of March 31, 2018, our MSR had a fair market value of \$1.3 billion.

As of March 31, 2018, our MSR portfolio included MSR on 500,338 loans with an unpaid principal balance of approximately \$111.7 billion. The following table summarizes certain characteristics of the loans underlying our MSR at March 31, 2018:

|   | March 31,<br>2018 |   |
|---|-------------------|---|
| Unpaid principal balance (in thousands) | \$ 111,703,234    |   |
| Number of loans                         | 500,338           |   |
| Average Coupon                          | 4.0               | % |
| Average Loan Age (months)               | 27                |   |
| Average Loan Size (in thousands)        | \$223             |   |
| Average Original Loan-to-Value          | 73.9              | % |
| Average Original FICO                   | 752               |   |
| 60+ day delinquencies                   | 0.5               | % |
| 3-Month CPR                             | 8.5               | % |

## Discontinued Operations

On June 28, 2017, we contributed our equity interests in our wholly owned subsidiary, TH Commercial Holdings LLC, to Granite Point and, in exchange for the contribution, received approximately 33.1 million shares of common stock of Granite Point, representing approximately 76.5% of the outstanding stock of Granite Point upon completion of the IPO of its common stock on June 28, 2017. On November 1, 2017, we distributed, on a pro rata basis, the 33.1 million shares of Granite Point common stock that we acquired in connection with the contribution to stockholders holding shares of Two Harbors common stock outstanding as of the close of business on October 20, 2017. Due to our controlling ownership interest in Granite Point through November 1, 2017, our results of operations and financial condition through such date reflect Granite Point’s commercial strategy, which includes as target assets first mortgages, mezzanine loans, B-notes and preferred equity. As of November 1, 2017, we no longer have a controlling interest in Granite Point and, therefore, have deconsolidated Granite Point and its subsidiaries from our financial statements and reclassified all of Granite Point’s current and prior period assets, liabilities and results of operations to discontinued operations

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Summarized financial information for the discontinued operations are presented below.

|  |             |
|--|-------------|
|  | November    |
| (in thousands)                               | 1,          |
|  | 2017        |
| Assets:                                      |             |
| Available-for-sale securities, at fair value | \$12,814    |
| Commercial real estate assets                | 2,233,080   |
| Cash and cash equivalents                    | 84,183      |
| Restricted cash                              | 2,838       |
| Accrued interest receivable                  | 6,588       |
| Other assets                                 | 22,774      |
| Total Assets                                 | \$2,362,277 |
| Liabilities:                                 |             |
| Repurchase agreements                        | \$1,516,294 |
| Dividends payable                            | 48          |
| Other liabilities                            | 10,337      |
| Total Liabilities                            | \$1,526,679 |

## Financing

Our borrowings consist primarily of repurchase agreements, FHLB advances and revolving credit facilities collateralized by our pledge of AFS securities, derivative instruments, MSR and certain cash balances. Substantially all of our Agency RMBS are currently pledged as collateral, and the majority of our non-Agency securities have been pledged, either through repurchase agreements or FHLB advances. Additionally, on January 19, 2017, we closed an underwritten public offering of \$287.5 million aggregate principal amount of 6.25% convertible senior notes due 2022. The net proceeds from the offering were approximately \$282.2 million after deducting underwriting discounts and estimated offering expenses. The majority of these proceeds were used to help fund our MSR assets, which previously had largely been funded with cash.

At March 31, 2018, borrowings under repurchase agreements, FHLB advances, revolving credit facilities and convertible senior notes had the following characteristics:

|                           |                |           |   |            |   |
|---------------------------|----------------|-----------|---|------------|---|
| (dollars in thousands)    | March 31, 2018 |           |   |            |   |
|                           | Amount         | Weighted  |   | Weighted   |   |
| Collateral Type           | Outstanding    | Average   |   | Average    |   |
|                           |                | Borrowing |   | Haircut on |   |
|                           |                | Rate      |   | Collateral |   |
|                           |                |           |   | Value      |   |
| Agency RMBS               | \$17,669,978   | 1.80      | % | 4.7        | % |
| Non-Agency securities     | 2,032,601      | 3.20      | % | 26.0       | % |
| Agency Derivatives        | 61,124         | 2.63      | % | 26.5       | % |
| Mortgage servicing rights | 270,000        | 4.07      | % | 50.0       | % |
| Other <sup>(1)</sup>      | 283,054        | 6.25      | % | NA         |   |
| Total                     | \$20,316,757   | 2.03      | % | 7.5        | % |

<sup>(1)</sup> Includes unsecured convertible senior notes paying interest semiannually at a rate of 6.25% per annum on the aggregate principal amount of \$287.5 million.

As of March 31, 2018, we had outstanding \$19.1 billion of repurchase agreements, and the term to maturity ranged from two days to over 20 months. Repurchase agreements had a weighted average borrowing rate of 1.96% and



weighted average remaining maturities of 97 days as of March 31, 2018.

As of March 31, 2018, we had outstanding \$865.0 million of FHLB advances with a weighted average term to maturity of 25 months, ranging from approximately 13 months to over 16 years. The weighted average cost of funds for our advances was 2.13% at March 31, 2018.

As of March 31, 2018, we had outstanding \$20.0 million of short-term borrowings under revolving credit facilities with a weighted average borrowing rate of 5.67% and weighted average remaining maturities of 261 days.

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As of March 31, 2018, the outstanding amount due on convertible senior notes was \$283.1 million, net of deferred issuance costs. These notes are unsecured, pay interest semiannually at a rate of 6.25% per annum and mature in January 2022.

As of March 31, 2018, the debt-to-equity ratio funding our AFS securities, MSR and Agency Derivatives, which includes unsecured borrowings under convertible senior notes, was 5.9:1.0. We believe our debt-to-equity ratio provides unused borrowing capacity and, thus, improves our liquidity and the strength of our balance sheet.

The following table provides the quarterly average balances, the quarter-end balances, and the maximum balances at any month-end within that quarterly period, of borrowings under repurchase agreements, FHLB advances, revolving credit facilities and convertible senior notes for the three months ended March 31, 2018, and the four immediately preceding quarters:

| (dollars in thousands)                        | Quarterly<br>Average <sup>(1)</sup> | End of<br>Period<br>Balance <sup>(1)</sup> | Maximum<br>Balance of<br>Any<br>Month-End<br><sup>(1)</sup> | End of<br>Period Total<br>Borrowings<br>to Equity<br>Ratio |
|---|-------------------------------------|--|---|--|
| For the Three Months Ended March 31, 2018     | \$20,194,305                        | \$20,316,757                               | \$20,466,930  | 5.9:1.0  |
| For the Three Months Ended December 31, 2017  | \$19,270,237                        | \$20,969,058                               | \$20,969,058  | 5.9:1.0  |
| For the Three Months Ended September 30, 2017 | \$17,959,764                        | \$19,143,433                               | \$19,143,433  | 5.0:1.0 <sup>(2)</sup>                                     |
| For the Three Months Ended June 30, 2017      | \$15,957,154                        | \$16,237,809                               | \$16,968,760  | 4.5:1.0 <sup>(2)</sup>                                     |
| For the Three Months Ended March 31, 2017     | \$14,187,786                        | \$16,973,524                               | \$16,973,524  | 4.9:1.0 <sup>(2)</sup>                                     |

<sup>(1)</sup> Includes borrowings under repurchase agreements, FHLB advances, revolving credit facilities and convertible senior notes and excludes collateralized borrowings in securitization trusts.

<sup>(2)</sup> Includes total borrowings of discontinued operations.

## Equity

The tables below provide details of our changes in stockholders' equity from December 31, 2017 to March 31, 2018 as well as a reconciliation of comprehensive loss and GAAP net income to non-GAAP measures.

| (dollars in millions, except per share amounts)  | Book<br>Value | Common<br>Shares<br>Outstanding | Common<br>Book<br>Value<br>Per<br>Share |
|--|---------------|---------------------------------|---|
| Common stockholders' equity at December 31, 2017   | \$2,845.1     | 174.5                           | \$ 16.31                                |
| Core Earnings, net of tax expense of \$1.1 million <sup>1</sup>                              | 94.1          |                                 |   |
| Dividends on preferred stock   | (13.7 )       |                                 |   |
| Core Earnings attributable to common stockholders <sup>1</sup>                               | 80.4          |                                 |   |
| Dollar roll income   | 3.4           |                                 |   |
| Core Earnings attributable to common stockholders, including dollar roll income <sup>1</sup> | 83.8          |                                 |   |
| Realized and unrealized gains and losses, net of tax expense of \$2.7 million                | 237.3         |                                 |   |
| Other comprehensive loss, net of tax   | (344.8 )      |                                 |   |
| Dividend declaration   | (82.5 )       |                                 |   |
| Other  | 2.4           | 0.9                             |   |
| Issuance of common stock, net of offering costs  | 0.1           | —                               |   |
| Common stockholders' equity at March 31, 2018  | \$2,741.4     | 175.4                           | \$ 15.63                                |
| Total preferred stock liquidation preference   | 726.3         |                                 |   |
| Total equity at March 31, 2018   | \$3,467.7     |                                 |   |



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| (in millions)  | Three<br>Months<br>Ended<br>March 31,<br>2018 |
|--|---|
| Comprehensive loss attributable to common stockholders                                       | \$ (23.7 )                                    |
| Adjustment for other comprehensive loss attributable to common stockholders:                 |   |
| Unrealized losses on available-for-sale securities   | 344.8   |
| Net income attributable to common stockholders   | 321.1   |
| Adjustments for non-Core Earnings:   |   |
| Realized loss on investment securities and residential mortgage loans held-for-sale          | 19.7  |
| Unrealized loss on investment securities and residential mortgage loans held-for-sale        | 1.3   |
| Other-than-temporary impairment loss   | 0.1   |
| Realized gain on termination or expiration of interest rate swaps and swaptions              | (92.5 )                                       |
| Unrealized gain on interest rate swaps and swaptions   | (54.3 )                                       |
| Loss on other derivative instruments   | (5.6 )  |
| Realized and unrealized gains on mortgage servicing rights                                   | (114.7 )                                      |
| Change in servicing reserves   | 0.3   |
| Non-cash equity compensation expense   | 2.3   |
| Net provision for income taxes on non-Core Earnings  | 2.7   |
| Core Earnings attributable to common stockholders <sup>1</sup>                               | 80.4  |
| Dollar roll income   | 3.4   |
| Core Earnings attributable to common stockholders, including dollar roll income <sup>1</sup> | \$ 83.8                                       |

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Core Earnings is a non-U.S. GAAP measure that we define as comprehensive (loss) income attributable to common stockholders, excluding “realized and unrealized gains and losses” (impairment losses, realized and unrealized gains and losses on the aggregate portfolio, reserve expense for representation and warranty obligations on MSR and non-cash compensation expense related to restricted common stock). As defined, Core Earnings (1) includes interest income or expense and premium income or loss on derivative instruments and servicing income, net of estimated amortization on MSR. Dollar roll income is the economic equivalent to holding and financing Agency RMBS using short-term repurchase agreements. We believe the presentation of Core Earnings, including dollar roll income, provides investors greater transparency into our period-over-period financial performance and facilitates comparisons to peer REITs.

### Liquidity and Capital Resources

Our liquidity and capital resources are managed and forecast on a daily basis. We believe this ensures that we have sufficient liquidity to absorb market events that could negatively impact collateral valuations and result in margin calls, and that we have the flexibility to manage our portfolio to take advantage of market opportunities.

Our principal sources of cash consist of borrowings under repurchase agreements, FHLB advances, revolving credit facilities, payments of principal and interest we receive on our target assets, cash generated from our operating results, and proceeds from capital market transactions. We typically use cash to repay principal and interest on our repurchase agreements, FHLB advances and revolving credit facilities, to purchase our target assets, to make dividend payments on our capital stock, and to fund our operations.

To the extent that we raise additional equity capital through capital market transactions, we anticipate using cash proceeds from such transactions to purchase additional Agency RMBS, non-Agency securities, MSR and other target assets and for other general corporate purposes.

As of March 31, 2018, we held \$388.4 million in cash and cash equivalents available to support our operations; \$22.7 billion of AFS securities, MSR, residential mortgage loans held-for-sale and derivative assets held at fair value; and \$20.3 billion of outstanding debt in the form of repurchase agreements, FHLB advances, borrowings under revolving credit facilities and convertible senior notes. During the three months ended March 31, 2018, the debt-to-equity ratio funding our AFS securities, MSR and Agency Derivatives, which includes unsecured borrowings under convertible senior notes remained constant at 5.9:1.0.

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As of March 31, 2018, we held approximately \$1.6 million of unpledged Agency securities and derivatives and \$199.1 million of unpledged non-Agency securities. As a result, we had an overall estimated unused borrowing capacity on unpledged securities of approximately \$140.7 million. As of March 31, 2018, we held approximately \$474.5 million of unpledged MSR and had an overall estimated unused borrowing capacity on MSR financing facilities of \$220.0 million. We also held approximately \$29.4 million of unpledged residential mortgage loans held-for-sale, for which we had no unused borrowing capacity. Generally, unused borrowing capacity may be the result of our election not to utilize certain financing, as well as delays in the timing in which funding is provided or the inability to meet lenders' eligibility requirements for specific types of asset classes. On a daily basis, we monitor and forecast our available, or excess, liquidity. Additionally, we frequently perform shock analyses against various market events to monitor the adequacy of our excess liquidity. If borrowing rates and/or collateral requirements change in the near term, we believe we are subject to less earnings volatility than a more leveraged organization.

During the three months ended March 31, 2018, we did not experience any restrictions to our funding sources, although balance sheet capacity of counterparties have tightened due to compliance with the Basel III regulatory capital reform rules as well as management of perceived risk in the volatile interest rate environment. We expect ongoing sources of financing to be primarily repurchase agreements, FHLB advances, revolving credit facilities, convertible notes and similar financing arrangements. We plan to finance our assets with a moderate amount of leverage, the level of which may vary based upon the particular characteristics of our portfolio and market conditions. As of March 31, 2018, we had master repurchase agreements in place with 34 counterparties (lenders), the majority of which are U.S. domiciled financial institutions, and we continue to evaluate additional counterparties to manage and reduce counterparty risk. Under our repurchase agreements, we are required to pledge additional assets as collateral to our lenders when the estimated fair value of the existing pledged collateral under such agreements declines and such lenders, through a margin call, demand additional collateral. Lenders generally make margin calls because of a perceived decline in the value of our assets collateralizing the repurchase agreements. This may occur following the monthly principal reduction of assets due to scheduled amortization and prepayments on the underlying mortgages, or may be caused by changes in market interest rates, a perceived decline in the market value of the investments and other market factors. To cover a margin call, we may pledge additional assets or cash. At maturity, any cash on deposit as collateral is generally applied against the repurchase agreement balance, thereby reducing the amount borrowed. Should the value of our assets suddenly decrease, significant margin calls on our repurchase agreements could result, causing an adverse change in our liquidity position.

The following table summarizes our repurchase agreements and counterparty geographical concentration at March 31, 2018 and December 31, 2017:

|                       | March 31, 2018     |  |                    | December 31, 2017  |  |                    |
|-----------------------|--------------------|--|--------------------|--------------------|--|--------------------|
|                       | Amount Outstanding | Net Counterparty Exposure <sup>(1)</sup> | Percent of Funding | Amount Outstanding | Net Counterparty Exposure <sup>(1)</sup> | Percent of Funding |
| North America         | \$ 10,469,217      | \$ 992,368                               | 57.0 %             | \$ 10,746,447      | \$ 993,279                               | 57.0 %             |
| Europe <sup>(2)</sup> | 6,147,604          | 621,886                                  | 35.7 %             | 6,109,169          | 615,150                                  | 35.3 %             |
| Asia <sup>(2)</sup>   | 2,531,858          | 127,235                                  | 7.3 %              | 2,595,591          | 134,694                                  | 7.7 %              |
| Total                 | \$ 19,148,679      | \$ 1,741,489                             | 100.0 %            | \$ 19,451,207      | \$ 1,743,123                             | 100.0 %            |

Represents the net carrying value of the assets 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,

(1) including accrued interest. Payables due to broker counterparties for unsettled securities purchases are not included in the amounts presented above. The Company did not have any such payables at March 31, 2018 or December 31, 2017.

(2) Exposure to European and Asian domiciled banks and their U.S. subsidiaries.



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In addition to our master repurchase agreements to fund our Agency and non-Agency securities, we have one repurchase facility and two revolving credit facilities that provide short- and long-term financing for our MSR portfolio. An overview of the facilities is presented in the table below:

(dollars in thousands)

March 31, 2018

| Expiration Date <sup>(1)</sup> | Committed          | Amount Outstanding | Unused Capacity | Total Capacity | Eligible Collateral                      |
|--------------------------------|--------------------|--------------------|-----------------|----------------|--|
| December 1, 2019               | Yes <sup>(2)</sup> | \$ 250,000         | \$ 150,000      | \$ 400,000     | Mortgage servicing rights <sup>(3)</sup> |
| September 1, 2018              | No                 | \$ —               | \$ 50,000       | \$ 50,000      | Mortgage servicing rights                |
| December 17, 2018              | No                 | \$ 20,000          | \$ 20,000       | \$ 40,000      | Mortgage servicing rights                |

(1) The facilities are set to mature on the stated expiration date, unless extended pursuant to their terms.

(2) Commitment fee charged on unused capacity.

(3) This repurchase facility is secured by MSR notes, which are collateralized by our MSR.

Our wholly owned subsidiary, TH Insurance, is a member of 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 March 31, 2018, TH Insurance had \$865.0 million in outstanding secured advances with a weighted average borrowing rate of 2.13%, and an additional \$2.7 billion of available uncommitted capacity for borrowings insofar as TH Insurance holds adequate total assets to support a new advance. 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 our 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, Agency RMBS and certain non-Agency securities with a rating of A and above.

In January 2016, the FHFA released a final rule regarding membership in the Federal Home Loan Bank system. Among other effects, the final rule excludes captive insurers from membership eligibility, including our subsidiary member, TH Insurance. Since TH Insurance was admitted as a member in 2013, it is eligible for a membership grace period that runs through February 19, 2021, during which new advances or renewals that mature beyond the grace period will be prohibited; however, any existing advances that mature beyond this grace period will be permitted to remain in place subject to their terms insofar as we maintain good standing with the FHLB. If any new advances or renewals occur, TH Insurance's outstanding advances will be limited to 40% of its total assets.

We are subject to a variety of financial covenants under our lending agreements. The following represent the most restrictive financial covenants across the agreements as of March 31, 2018:

• Total indebtedness to net worth must be less than the specified threshold ratio in the repurchase agreement. As of March 31, 2018, our debt to net worth, as defined, was 5.9:1.0 while our threshold ratio, as defined, was 6.8:1.0.

• Liquidity must be greater than \$100.0 million. As of March 31, 2018, our liquidity, as defined, was \$1.3 billion.

• Net worth must be greater than \$1.75 billion. As of March 31, 2018, our net worth, as defined, was \$3.5 billion.

• Interest coverage must not be less than 2.0:1.0. As of March 31, 2018, our interest coverage ratio, as defined, was 2.3:1.0.

We are also subject to additional financial covenants in connection with various other agreements we enter into in the normal course of our business. We intend to continue to operate in a manner which complies with all of our financial covenants.



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The following table summarizes assets at carrying values that were pledged or restricted as collateral for the future payment obligations of repurchase agreements, FHLB advances and revolving credit facilities at March 31, 2018 and December 31, 2017:

| (in thousands)                               | March 31,<br>2018 | December 31,<br>2017 |
|--|-------------------|----------------------|
| Available-for-sale securities, at fair value | \$20,858,711      | \$ 20,990,890        |
| Mortgage servicing rights, at fair value     | 826,514           | 584,247              |
| Cash and cash equivalents                    | —                 | 15,000               |
| Restricted cash                              | 456,453           | 417,018              |
| Due from counterparties                      | 81,860            | 836,381              |
| Derivative assets, at fair value             | 81,563            | 90,895               |
| Total  | \$22,305,101      | \$ 22,934,431        |

Although we generally intend to hold our target assets as long-term investments, we may sell certain of our assets in order to manage our interest rate risk and liquidity needs, to meet other operating objectives and to adapt to market conditions. Our Agency RMBS and non-Agency securities are generally actively traded and thus, in most circumstances, readily liquid. However, certain of our assets, including MSR and residential mortgage loans, are subject to longer trade timelines, and, as a result, market conditions could significantly and adversely affect the liquidity of our assets. Any illiquidity of our assets may make it difficult for us to sell such assets if the need or desire arises. Our ability to quickly sell certain assets, such as MSR and residential mortgage loans, may be limited by delays encountered while obtaining certain regulatory approvals required for such dispositions and may be further limited by delays due to the time period needed for negotiating transaction documents, conducting diligence, and complying with regulatory requirements regarding the transfer of such assets before settlement may occur. Consequently, even if we identify a buyer for our MSR and residential mortgage loans, there is no assurance that we would be able to quickly sell such assets if the need or desire arises.

In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we previously recorded our assets. Assets that are illiquid are more difficult to finance, and to the extent that we use leverage to finance assets that become illiquid, we may lose that leverage or have it reduced. Assets tend to become less liquid during times of financial stress, which is often the time that liquidity is most needed. As a result, our ability to sell assets or vary our portfolio in response to changes in economic and other conditions may be limited by liquidity constraints, which could adversely affect our results of operations and financial condition. We cannot predict the timing and impact of future sales of our assets, if any. Because many of our assets are financed with repurchase agreements, FHLB advances and revolving credit facilities, a significant portion of the proceeds from sales of our assets (if any), prepayments and scheduled amortization are used to repay balances under these financing sources.

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The following table provides the maturities of our repurchase agreements, FHLB advances, revolving credit facilities and convertible senior notes as of March 31, 2018 and December 31, 2017:

| (in thousands)      | March 31,<br>2018 | December 31,<br>2017 |
|---------------------|-------------------|----------------------|
| Within 30 days      | \$4,027,232       | \$4,269,464          |
| 30 to 59 days       | 3,901,328         | 3,831,111            |
| 60 to 89 days       | 3,102,308         | 3,458,940            |
| 90 to 119 days      | 2,111,798         | 2,452,426            |
| 120 to 364 days     | 5,776,013         | 5,346,766            |
| One to three years  | 1,065,024         | 927,524              |
| Three to five years | 283,054           | 282,827              |
| Five to ten years   | —                 | —                    |
| Ten years and over  | 50,000            | 400,000              |
| Total               | \$20,316,757      | \$20,969,058         |

For the three months ended March 31, 2018, our restricted and unrestricted cash balance increased approximately \$46.2 million to \$1.1 billion at March 31, 2018. The cash movements can be summarized by the following:

- Cash flows from operating activities. For the three months ended March 31, 2018, operating activities increased our cash balances by approximately \$203.1 million, primarily driven by our financial results for the quarter.

- Cash flows from investing activities. For the three months ended March 31, 2018, investing activities increased our cash balances by approximately \$508.1 million, primarily driven by a decrease in due from counterparties, net as a result of the settlement of AFS securities sold during the fourth quarter of 2017, offset by net purchases of AFS securities and MSR.

- Cash flows from financing activities. For the three months ended March 31, 2018, financing activities decreased our cash balance by approximately \$665.0 million, primarily driven by repayment of repurchase agreements as a result of the settlement of AFS securities sold during the fourth quarter of 2017 as well as repayment of a portion of our outstanding FHLB advances.

**Inflation**

Substantially all of our assets and liabilities are financial in nature. As a result, changes in interest rates and other factors impact our performance far more than does inflation. Our financial statements are prepared in accordance with U.S. GAAP and dividends are based upon net ordinary income and capital gains as calculated for tax purposes; in each case, our results of operations and reported assets, liabilities and equity are measured with reference to historical cost or fair value without considering inflation.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We seek to manage our risks related to the credit quality of our assets, interest rates, liquidity, prepayment speeds and market value while providing an opportunity to stockholders to realize attractive risk-adjusted total return through ownership of our capital stock. Although we do not seek to avoid risk completely, we believe that risk can be quantified from historical experience and we seek to manage our risk levels in order to earn sufficient compensation to justify the risks we undertake and to maintain capital levels consistent with taking such risks.

To reduce the risks to our portfolio, we employ portfolio-wide and asset-specific risk measurement and management processes in our daily operations. Risk management tools include software and services licensed or purchased from third parties as well as proprietary and third-party analytical tools and models. There can be no guarantee that these tools and methods will protect us from market risks.

**Interest Rate Risk**

Interest rates are highly sensitive to many factors, including fiscal and monetary policies and domestic and international economic and political considerations, as well as other factors beyond our control. We are subject to interest rate risk in connection with our assets and related financing obligations. Subject to maintaining our qualification as a REIT, we engage in a variety of interest rate management techniques that seek to mitigate the influence of interest rate changes on the values of our assets.

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We may enter into a variety of derivative and non-derivative instruments to economically hedge interest rate risk or “duration mismatch (or gap)” by adjusting the duration of our floating-rate borrowings into fixed-rate borrowings to more closely match the duration of our assets. 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 certain derivatives match the terms of the underlying debt, resulting in an effective conversion of the rate of the related borrowing agreement from floating to fixed. The objective is to manage the cash flows associated with current and anticipated interest payments on borrowings, as well as the ability to roll or refinance borrowings at the desired amount by adjusting the duration. To help manage the adverse impact of interest rate changes on the value of our portfolio as well as our cash flows, we 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 interest rate risk management strategy, the Company has entered into TBAs, put and call options for TBAs, interest rate swap and swaption agreements and Markit IOS total return swaps. In addition, because MSR are negative duration assets, they provide a natural hedge to interest rate exposure on our Agency RMBS portfolio. In hedging interest rate risk, we seek to reduce the risk of losses on the value of our investments that may result from changes in interest rates in the broader markets, improve risk-adjusted returns and, where possible, obtain a favorable spread between the yield on our assets and the cost of our financing.

Income of a REIT arising from “clearly identified” hedging transactions that are entered into to manage the risk of interest rate or price changes with respect to borrowings, including gain from the disposition of such hedging transactions, to the extent the hedging transactions hedge indebtedness incurred, or to be incurred, by the REIT to acquire or carry real estate assets, will not be treated as gross income for purposes of either the 75% or the 95% gross income tests. In general, for a hedging transaction to be “clearly identified,” (i) it must be identified as a hedging transaction before the end of the day on which it is acquired, originated, or entered into; and (ii) the items of risks being hedged must be identified “substantially contemporaneously” with entering into the hedging transaction (generally not more than 35 days after entering into the hedging transaction). We intend to structure any hedging transactions in a manner that does not jeopardize our qualification as a REIT, although this determination depends on an analysis of the facts and circumstances concerning each hedging transaction. We also implement part of our hedging strategy through our TRSs, which are subject to U.S. federal, state and, if applicable, local income tax.

We intend to treat our TBAs as qualifying assets for purposes of the 75% asset test, to the extent set forth in an opinion from Sidley Austin LLP substantially to the effect that, for purposes of the 75% asset test, our ownership of a TBA should be treated as ownership of the underlying Agency RMBS, and to treat income and gains from our TBAs as qualifying income for purposes of the 75% gross income test, to the extent set forth in an opinion from Sidley Austin LLP substantially to the effect that, for purposes of the 75% gross income test, any gain recognized by us in connection with the settlement of our TBAs should be treated as gain from the sale or disposition of the underlying Agency RMBS.

**Interest Rate Effect on Net Interest Income**

Our operating results depend in large part on differences between the income earned on our assets and our cost of borrowing and hedging activities. The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate Agency RMBS and non-Agency securities and residential mortgage loans held-for-sale will remain static. Moreover, interest rates may rise at a faster pace than the yields earned on our leveraged adjustable-rate and hybrid securities and adjustable-rate residential mortgage loans held-for-sale. Both of these factors could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our target assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

Our hedging techniques are partly based on assumed levels of prepayments of our target assets. If prepayments are slower or faster than assumed, the life of the investment will be longer or shorter, which could reduce the effectiveness of any hedging strategies we may use and may cause losses on such transactions. Hedging strategies involving the use of derivative securities are highly complex and may produce volatile returns.

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We acquire adjustable-rate and hybrid Agency RMBS and non-Agency securities. These are assets in which some of the underlying mortgages are typically subject to periodic and lifetime interest rate caps and floors, which may limit the amount by which the security's interest yield may change during any given period. However, our borrowing costs pursuant to our financing agreements are not subject to similar restrictions. Therefore, in a period of increasing interest rates, interest rate costs on our borrowings could increase without limitation, while the interest-rate yields on our adjustable-rate and hybrid securities could effectively be limited by caps. This issue will be magnified to the extent we acquire adjustable-rate and hybrid securities that are not based on mortgages that are fully indexed. In addition, adjustable-rate and hybrid securities may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. If this happens, we could receive less cash income on such assets than we would need to pay for interest costs on our related borrowings. These factors could lower our net interest income or cause a net loss during periods of rising interest rates, which would harm our financial condition, cash flows and results of operations.

Our adjustable-rate residential mortgage loans held-for-sale are typically subject to periodic and lifetime interest rate caps and floors, which may limit the amount by which the loan's interest yield may change during any given period. Therefore, in a period of increasing interest rates, the interest-rate yields on our adjustable-rate residential mortgage loans held-for-sale could effectively be limited by caps.

**Interest Rate Mismatch Risk**

We fund the majority of our adjustable-rate and hybrid Agency RMBS and non-Agency securities and adjustable-rate commercial real estate assets with borrowings that are based on LIBOR, while the interest rates on these assets may be indexed to other index rates, such as the one-year Constant Maturity Treasury index, or CMT, the Monthly Treasury Average index, or MTA, or the 11<sup>th</sup> District Cost of Funds Index, or COFI. Accordingly, any increase in LIBOR relative to these indices may result in an increase in our borrowing costs that is not matched by a corresponding increase in the interest earnings on these assets. Any such interest rate index mismatch could adversely affect our profitability, which may negatively impact distributions to our stockholders. To mitigate interest rate mismatches, we utilize the hedging strategies discussed above.

The following table provides the indices of our variable rate Agency RMBS, non-Agency securities and residential mortgage loans held-for-sale of March 31, 2018 and December 31, 2017, respectively, based on carrying value (dollars in thousands).

| Index Type           | March 31, 2018 |                       |             | Index % | December 31, 2017 |                       |             | Index % |
|----------------------|----------------|-----------------------|-------------|---------|-------------------|-----------------------|-------------|---------|
|                      | Floating       | Hybrid <sup>(1)</sup> | Total       |         | Floating          | Hybrid <sup>(1)</sup> | Total       |         |
| CMT                  | \$11,331       | \$17,041              | \$28,372    | 1 %     | \$11,832          | \$18,497              | \$30,329    | 1 %     |
| LIBOR                | 2,642,532      | 12,195                | 2,654,727   | 93 %    | 2,563,850         | 13,284                | 2,577,134   | 92 %    |
| Other <sup>(2)</sup> | 51,151         | 131,810               | 182,961     | 6 %     | 48,894            | 142,502               | 191,396     | 7 %     |
| Total                | \$2,705,014    | \$161,046             | \$2,866,060 | 100 %   | \$2,624,576       | \$174,283             | \$2,798,859 | 100 %   |

(1) "Hybrid" amounts reflect those assets with greater than twelve months to reset.

(2) "Other" includes COFI, MTA and other indices.

The following analyses of risks are based on our experience, estimates, models and assumptions. They rely on models which utilize estimates of fair value and interest rate sensitivity. Actual economic conditions or implementation of decisions may produce results that differ significantly from the estimates and assumptions used in our models. We perform interest rate sensitivity analyses on various measures of our financial results and condition by examining how our assets, financing, and hedges will perform in various interest rate "shock" scenarios. Two of these measures are presented here in more detail. The first is annualized net interest income over the next 12 months, including float income from custodial accounts associated with our MSR; the second is change in portfolio value, including the value of our derivative assets and liabilities. All changes in value are measured as the change from the March 31, 2018

financial position. All projected changes in annualized net interest income are measured as the change from the projected annualized net interest income based off current performance returns.

Computation of the cash flows for the rate-sensitive assets underpinning change in annualized net interest income are based on assumptions related to, among other things, prepayment speeds, yield on future acquisitions, slope of the yield curve, and size of the portfolio. (The assumption for prepayment speeds for Agency RMBS, non-Agency securities, and MSR, for example, is that they do not change in response to changes in interest rates.) Assumptions for the interest rate sensitive liabilities relate to, among other things, collateral requirements as a percentage of borrowings and amount/term of borrowing. These assumptions may not hold in practice; realized net interest income results may therefore be significantly different from the net interest income produced in scenario analyses. We also note that the uncertainty associated with the estimate of a change in net interest income is directly related to the size of interest rate move considered.

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Computation of results for portfolio value involves a two-step process. The first is the use of models to project how the value of interest rate sensitive instruments will change in the scenarios considered. We use both recognized industry models and proprietary models to make these projections. The second, and equally important, step is the improvement of the model projections based on application of our experience in assessing how current market and macroeconomic conditions will affect the prices of various interest rate sensitive instruments. Judgment is best applied to localized (less than 25 bps) interest rate moves. The more an instantaneous interest rate move exceeds 25 bps, the greater the likelihood that accompanying market events are significant enough to warrant reconsideration of interest rate sensitivities. As with net interest income, the uncertainty associated with the estimate of change in portfolio value is therefore directly related to the size of interest rate move considered.

The following interest rate sensitivity table displays the potential impact of instantaneous, parallel changes in interest rates of +/- 25 and +/- 50 bps on annualized net interest income and portfolio value, based on our interest sensitive financial instruments at March 31, 2018. The preceding discussion shows that the results for the 25 bps move scenarios are the best representation of our interest rate exposure, followed by those for the 50 bps move scenarios. This hierarchy reflects our localized approach to managing interest rate risk: monitoring rates and rebalancing our hedges on a day to day basis, where rate moves only rarely exceed 25 bps in either direction.

| (dollars in thousands)                    | Changes in Interest Rates |             |             |             |
|---|---------------------------|-------------|-------------|-------------|
|   | -50 bps                   | -25 bps     | +25 bps     | +50 bps     |
| Change in annualized net interest income: | \$10,966                  | \$5,465     | \$(5,473 )  | \$(10,950 ) |
| % change in net interest income           | 3.2                       | % 1.6       | % (1.6 )    | % (3.2 )%   |
| Change in value of financial position:    |                           |             |             |             |
| Available-for-sale securities             | \$459,710                 | \$229,070   | \$(247,612) | \$(531,601) |
| As a % of equity                          | 13.3                      | % 6.6       | % (7.1 )    | % (15.3 )%  |
| Mortgage servicing rights                 | \$(134,635)               | \$(62,757 ) | \$54,438    | \$102,745   |
| As a % of equity                          | (3.9 )%                   | (1.8 )%     | 1.6 %       | 3.0 %       |
| Residential mortgage loans held-for-sale  | \$150                     | \$42        | \$(76 )     | \$(286 )    |
| As a % of equity                          | —                         | % —         | % —         | % —         |
| Derivatives, net                          | \$(322,437)               | \$(140,480) | \$155,492   | \$365,918   |
| As a % of equity                          | (9.3 )%                   | (4.1 )%     | 4.5 %       | 10.5 %      |
| Repurchase agreements                     | \$(23,737 )               | \$(11,868 ) | \$11,869    | \$23,737    |
| As a % of equity                          | (0.7 )%                   | (0.3 )%     | 0.3 %       | 0.7 %       |
| Federal Home Loan Bank advances           | \$(180 )                  | \$(90 )     | \$90        | \$180       |
| As a % of equity                          | —                         | % —         | % —         | % —         |
| Revolving credit facilities               | \$(8 )                    | \$(4 )      | \$4         | \$8         |
| As a % of equity                          | —                         | % —         | % —         | % —         |
| Convertible senior notes                  | \$(4,312 )                | \$(2,145 )  | \$2,123     | \$4,224     |
| As a % of equity                          | (0.1 )%                   | (0.1 )%     | —           | 0.1 %       |
| Total Net Assets                          | \$(25,449 )               | \$11,768    | \$(23,672 ) | \$(35,075 ) |
| As a % of total assets                    | (0.1 )%                   | —           | % (0.1 )%   | (0.1 )%     |
| As a % of equity                          | (0.7 )%                   | 0.3 %       | (0.7 )%     | (1.0 )%     |

Certain assumptions have been made in connection with the calculation of the information set forth in the foregoing interest rate sensitivity table and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at March 31, 2018. As discussed, the analysis utilizes assumptions and estimates based on our experience and judgment. Furthermore, future purchases and sales of assets could materially change our interest rate risk profile.

The information set forth in the interest rate sensitivity table above and all related disclosures constitutes forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange



Act. While this table reflects the estimated impact of interest rate changes on the static portfolio, we actively manage our portfolio and continuously make adjustments to the size and composition of our asset and hedge portfolio. Actual results could differ significantly from those estimated in the foregoing interest rate sensitivity table.

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### Prepayment Risk

Prepayment risk is the risk that principal will be repaid at a different rate than anticipated. As we receive prepayments of principal on our Agency RMBS and non-Agency securities, premiums paid on such assets will be amortized against interest income. In general, an increase in prepayment rates will accelerate the amortization of purchase premiums, thereby reducing the interest income earned on the assets. Conversely, discounts on such assets are accreted into interest income. In general, an increase in prepayment rates will accelerate the accretion of purchase discounts, thereby increasing the interest income earned on the assets.

We believe that we will be able to reinvest proceeds from scheduled principal payments and prepayments at acceptable yields; however, no assurances can be given that, should significant prepayments occur, market conditions would be such that acceptable investments could be identified and the proceeds timely reinvested.

MSR are also subject to prepayment risk in that, generally, an increase in prepayment rates would result in a decline in value of the MSR.

### Market Risk

**Market Value Risk.** Our AFS securities are reflected at their estimated fair value, with the difference between amortized cost and estimated fair value for all AFS securities except Agency interest-only securities reflected in accumulated other comprehensive income. The estimated fair value of these securities fluctuates primarily due to changes in interest rates, market valuation of credit risks, and other factors. Generally, in a rising interest rate environment, we would expect the fair value of these securities to decrease; conversely, in a decreasing interest rate environment, we would expect the fair value of these securities to increase. As market volatility increases or liquidity decreases, the fair value of our assets may be adversely impacted.

Our MSR are reflected at their estimated fair value. The estimated fair value fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, we would expect prepayments to decrease, resulting in an increase in the fair value of our MSR. Conversely, in a decreasing interest rate environment, we would expect prepayments to increase, resulting in a decline in fair value.

Our residential mortgage loans are reflected at their estimated fair value. The estimated fair value fluctuates primarily due to changes in interest rates, market valuation of credit risks and other factors. Generally in a rising rate environment, we would expect the fair value of these loans to decrease; conversely, in a decreasing rate environment, we would expect the fair value of these loans to increase. However, the fair value of the CSL and Ginnie Mae buyout residential mortgage loans included in residential mortgage loans held-for-sale is generally less sensitive to interest rate changes.

**Real estate risk.** Residential property values are subject to volatility and may be affected adversely by a number of factors, including national, regional and local economic conditions; local real estate conditions (such as an oversupply of housing); changes or continued weakness in specific industry segments; construction quality, age and design; demographic factors; retroactive changes to building or similar codes; and natural disasters and other catastrophes. Decreases in property values reduce the value of the collateral for residential mortgage loans and the potential proceeds available to borrowers to repay the loans, which could cause us to suffer losses on our non-Agency securities and residential mortgage loans.

### Liquidity Risk

Our liquidity risk is principally associated with our financing of long-maturity assets with shorter-term borrowings in the form of repurchase agreements, FHLB advances and borrowings under revolving credit facilities. Although the interest rate adjustments of these assets and liabilities fall within the guidelines established by our operating policies, maturities are not required to be, nor are they, matched.

Should the value of our assets pledged as collateral suddenly decrease, lender margin calls could increase, causing an adverse change in our liquidity position. Moreover, the portfolio construction of MSR, which generally have negative duration, combined with levered RMBS, which generally have positive duration, may in certain market scenarios lead to variation margin calls, which could negatively impact our excess cash position. Additionally, if the FHLB or one or more of our repurchase agreement or revolving credit facility counterparties chose not to provide ongoing funding, our

ability to finance would decline or exist at possibly less advantageous terms. As such, we cannot assure that we will always be able to roll over our repurchase agreements, FHLB advances and revolving credit facilities. See Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources” in this Annual Report on Form 10-K for further information about our liquidity and capital resource management.

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Credit Risk

We believe that our investment strategy will generally keep our risk of credit losses low to moderate. However, we retain the risk of potential credit losses on all of the loans underlying our non-Agency securities and on our residential mortgage loans. With respect to our non-Agency securities that are senior in the credit structure, credit support contained in deal structures provide a level of protection from losses. We seek to manage the remaining credit risk through our pre-acquisition due diligence process, which includes comprehensive underwriting, and by factoring assumed credit losses into the purchase prices we pay for non-Agency securities and residential mortgage assets. In addition, with respect to any particular target asset, we evaluate relative valuation, supply and demand trends, shape of yield curves, prepayment rates, delinquency and default rates, recovery of various sectors and vintage of collateral. At times, we enter into credit default swaps or other derivative instruments in an attempt to manage our credit risk. Nevertheless, unanticipated credit losses could adversely affect our operating results.

Item 4. Controls and Procedures

A review and evaluation was performed by our management, including our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, of the effectiveness of our disclosure controls and procedures (as such term is defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that review and evaluation, the CEO and CFO have concluded that our current disclosure controls and procedures, as designed and implemented, were effective. Although our CEO and CFO have determined our disclosure controls and procedures were effective at the end of the period covered by this Quarterly Report on Form 10-Q, a control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that it will detect or uncover failures within the Company to disclose material information otherwise required to be set forth in the reports we submit under the Exchange Act.

There was no change in our internal control over financial reporting that occurred during the quarter ended March 31, 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time we may be involved in various legal claims and/or administrative proceedings that arise in the ordinary course of our business. As of the date of this filing, we are not party to any litigation or legal proceedings or, to the best of our knowledge, any threatened litigation or legal proceedings, which, in our opinion, individually or in the aggregate, would have a material adverse effect on our results of operations or financial condition.

Item 1A. Risk Factors

Except as set forth below, there have been no material changes to the risk factors set forth under the heading “Item 1A. Risk Factors” of our Annual Report on Form 10-K for the year ended December 31, 2017, or the Form 10-K. The materialization of any risks and uncertainties identified in our Forward-Looking Statements contained in this Quarterly Report on Form 10-Q, together with those previously disclosed in the Form 10-K, or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations, and cash flows.

See Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Forward-Looking Statements” in this Quarterly Report on Form 10-Q.

**Risks Related to the Acquisition of CYS Investments, Inc.**

Completion of the proposed acquisition of CYS Investments, Inc. remains subject to conditions that we cannot control.

Our proposed acquisition of CYS Investments, Inc., or CYS, is subject to various closing conditions, including the receipt of certain approvals from our stockholders and the stockholders of CYS in relation to the merger and the related transactions contemplated in connection therewith. There are no assurances that all of the conditions necessary to consummate the acquisition of CYS will be satisfied or that the conditions will be satisfied within the anticipated time frame.

Failure to consummate the proposed acquisition of CYS could negatively impact the share price of our common stock and our future business and financial results.

If the proposed acquisition of CYS is not consummated, our business may be adversely affected and, without realizing any of the potential benefits of having consummated the acquisition of CYS, we will be subject to a number of risks, including the following:

• we will be required to pay certain costs and expenses relating to the proposed acquisition of CYS; and matters relating to the proposed acquisition of CYS (including integration planning) may require substantial commitments of time and resources, which could otherwise have been devoted to other opportunities that may have been beneficial to us.

If the proposed acquisition of CYS is not consummated, these risks may materialize and may adversely affect the our business, financial results and share price.

**Risks Related to Our Business Following the Acquisition of CYS**

We may fail to realize all of the expected benefits of the proposed acquisition of CYS or those benefits may take longer to realize than expected.

The full benefits of the proposed acquisition of CYS may not be realized as expected or may not be achieved within the anticipated time frame, or at all. Failure to achieve the anticipated benefits of the acquisition of CYS could adversely affect our results of operations or cash flows, cause dilution to our earnings per share or book value per share and/or negatively impact the share price of our common stock.

In addition, we will be required to devote significant attention and resources prior to closing to prepare for the post-closing operation of the combined company. After the closing, we will be required to devote significant attention and resources to successfully integrate the CYS portfolio and operations into our existing structure. This integration process may disrupt our business and, if ineffective, would limit the anticipated benefits of the acquisition of CYS and could adversely affect our results of operations or cash flows, cause dilution to our earnings per share or book value

per share, decrease or delay the expected accretive effect of the acquisition of CYS, and/or negatively impact the share price of our common stock.

We will incur direct and indirect costs as a result of the proposed acquisition of CYS.

We will incur substantial expenses in connection with and as a result of completing the acquisition of CYS and, following closing of the proposed acquisition, we expect to incur additional expenses in connection with combining the businesses of the two companies. Factors beyond our control could affect the total amount or timing of these expenses, many of which, by their nature, are difficult to estimate accurately.

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Risks Related to CYS' Business

You should read and consider risk factors specific to CYS' business that will also affect the combined company after the acquisition of CYS. These risks are described in Part I, Item 1A of CYS' Annual Report on Form 10-K for the fiscal year ended December 31, 2017, and in other documents filed with the SEC.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) None.

(b) None.

(c) The Company's share repurchase program allows for the repurchase of up to an aggregate of 37,500,000 shares of the Company's common stock. 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 Exchange Act or by any combination of such methods. The manner, price, number and timing of share repurchases are 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, subject to SEC rules, purchases may be commenced or suspended at any time without prior notice. The share repurchase program does not have an expiration date. As of March 31, 2018, we had repurchased 12,067,500 shares under the program for a total cost of \$200.4 million. We did not repurchase shares during the three months ended March 31, 2018.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits

(a) Exhibits

Exhibits - The exhibits listed on the accompanying Index of Exhibits are filed or incorporated by reference as a part of this report. Such Index is incorporated herein by reference.

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| Exhibit Number | Exhibit Index  |
|----------------|--|
| 2.1            | <u>Agreement and Plan of Merger, by and among Two Harbors Investment Corp., Eiger Merger Subsidiary LLC and CYS Investments, Inc., dated as of April 25, 2018 (incorporated by reference to Exhibit 2.1 to the Registrant’s Current Report on Form 8-K filed with the SEC on April 26, 2018).</u>  |
| 3.1            | <u>Articles of Amendment and Restatement of Two Harbors Investment Corp. (incorporated by reference to Exhibit 99.1 to Annex B filed with Amendment No. 4).</u>  |
| 3.2            | <u>Articles of Amendment to the Articles of Amendment and Restatement of Two Harbors Investment Corp. (incorporated by reference to Exhibit 99.1 to the Registrant’s Current Report on Form 8-K filed with the SEC on December 19, 2012).</u>  |
| 3.3            | <u>Articles of Amendment to the Articles of Amendment and Restatement of Two Harbors Investment Corp., effective as of 5:01 PM Eastern Time on November 1, 2017 (incorporated by reference to Exhibit 3.1 to the Registrant’s Current Report on Form 8-K filed with the SEC on November 2, 2017).</u>  |
| 3.4            | <u>Articles of Amendment to the Articles of Amendment and Restatement of Two Harbors Investment Corp., effective as of 5:02 PM Eastern Time on November 1, 2017 (incorporated by reference to Exhibit 3.2 to the Registrant’s Current Report on Form 8-K filed with the SEC on November 2, 2017).</u>  |
| 3.5            | <u>Articles Supplementary to the Articles of Amendment to the Articles of Amendment and Restatement of Two Harbors Investment Corp. designating the shares of 8.125% Series A Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock, \$0.01 par value per share (incorporated by reference to Exhibit 3.3 of the Registrant’s Form 8-A filed with the SEC on March 13, 2017).</u>   |
| 3.6            | <u>Articles Supplementary to the Articles of Amendment to the Articles of Amendment and Restatement of Two Harbors Investment Corp. designating the shares of 7.625% Series B Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock, \$0.01 par value per share (incorporated by reference to Exhibit 3.4 of the Registrant’s Form 8-A filed with the SEC on July 17, 2017).</u>  |
| 3.7            | <u>Articles Supplementary to the Articles of Amendment to the Articles of Amendment and Restatement of Two Harbors Investment Corp. designating the shares of 7.25% Series C Fixed-to-Floating Rate Cumulative Redeemable Preferred Stock, \$0.01 par value per share (incorporated by reference to Exhibit 3.7 of the Registrant’s Form 8-A filed with the SEC on November 22, 2017).</u>   |
| 3.8            | <u>Amended and Restated Bylaws of Two Harbors Investment Corp. (incorporated by reference to Exhibit 3.4 to the Registrant’s Current Report on Form 8-K filed with the SEC on April 6, 2017).</u>  |
| 10.1           | <u>Fourth Amendment to Management Agreement, dated April 25, 2018 (incorporated by reference to Exhibit 10.1 to the Registrant’s Form 8-K filed with the SEC on April 26, 2018).</u>   |
| 31.1           | <u>Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (filed herewith)</u>  |
| 31.2           | <u>Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (filed herewith)</u>  |
| 32.1           | <u>Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (filed herewith)</u>  |
| 32.2           | <u>Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (filed herewith)</u>  |
| 101            | Financial statements from the Quarterly Report on Form 10-Q of Two Harbors Investment Corp. for the three months ended March 31, 2018, filed with the SEC on May 9, 2018, formatted in XBRL: (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Comprehensive (Loss) Income, (iii) the Condensed Consolidated Statements of Stockholders’ Equity, (iv) the Condensed Consolidated Statements of Cash Flows, and (v) the Notes to the Condensed Consolidated Financial Statements. (filed herewith) |



\*Management or compensatory agreement

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

TWO HARBORS INVESTMENT CORP.

Dated: May 9, 2018 By: /s/ Thomas E. Siering

Thomas E. Siering

Chief Executive Officer, President and Director

(Principal Executive Officer)

Dated: May 9, 2018 By: /s/ Brad Farrell

Brad Farrell

Chief Financial Officer and Treasurer

(Principal Financial Officer)

Dated: May 9, 2018 By: /s/ Mary Risky

Mary Risky

Chief Accounting Officer

(Principal Accounting Officer)