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Two Harbors Investment Corp.
Form 10-Q
August 07, 2013

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

FORM 10-Q

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

For the Quarterly Period Ended: June 30, 2013

Commission File Number 001-34506

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.)

601 Carlson Parkway, Suite 1400 55305
Minnetonka, Minnesota (Zip Code)
(Address of Principal Executive Offices)
(612) 629-2500
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of August 7, 2013 there were 365,742,864 shares of outstanding common stock, par value \$.01 per share, issued and outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TWO HARBORS INVESTMENT CORP.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	June 30, 2013 (unaudited)	December 31, 2012
ASSETS		
Available-for-sale securities, at fair value	\$14,892,315	\$13,666,954
Trading securities, at fair value	1,001,172	1,002,062
Equity securities, at fair value	—	335,638
Mortgage loans held-for-sale, at fair value	958,201	58,607
Mortgage loans held-for-investment in securitization trust, at fair value	401,347	—
Cash and cash equivalents	917,224	821,108
Restricted cash	685,965	302,322
Accrued interest receivable	54,080	42,613
Due from counterparties	17,210	39,974
Derivative assets, at fair value	699,351	462,080
Other assets	13,886	82,586
Total Assets ⁽¹⁾	\$19,640,751	\$16,813,944
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Repurchase agreements	\$14,903,155	\$12,624,510
Collateralized borrowings in securitization trust, at fair value	363,012	—
Derivative liabilities, at fair value	46,028	129,294
Accrued interest payable	17,510	19,060
Due to counterparties	340,043	412,861
Dividends payable	113,378	164,347
Other liabilities	23,502	13,295
Total liabilities ⁽¹⁾	15,806,628	13,363,367
Stockholders' Equity		
Preferred stock, par value \$0.01 per share; 50,000,000 shares authorized; no shares issued and outstanding	—	—
Common stock, par value \$0.01 per share; 900,000,000 shares authorized and 365,733,931 and 298,813,258 shares issued and outstanding, respectively	3,657	2,988
Additional paid-in capital	3,803,013	2,948,345
Accumulated other comprehensive income	265,997	696,458
Cumulative earnings	981,711	449,358
Cumulative distributions to stockholders	(1,220,255)	(646,572)
Total stockholders' equity	3,834,123	3,450,577
Total Liabilities and Stockholders' Equity	\$19,640,751	\$16,813,944

The condensed consolidated balance sheets include assets of a consolidated variable interest entity ("VIE") that can only be used to settle obligations of this VIE and liabilities of the consolidated VIE for which creditors do not have (1) recourse to the Company (Two Harbors Investment Corp.). At June 30, 2013, assets of consolidated the VIE totaled \$402,775 and liabilities of the consolidated VIE totaled \$363,819. The Company did not consolidate any VIEs as of December 31, 2012. See Note 3 - Variable Interest Entities for additional information.

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

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

	Three Months Ended		Six Months Ended	
	June 30,	June 30,	June 30,	June 30,
	2013	2012	2013	2012
	(unaudited)		(unaudited)	
Interest income:				
Available-for-sale securities	\$ 134,651	\$ 104,319	\$ 264,943	\$ 188,533
Trading securities	1,261	1,250	2,525	2,300
Mortgage loans held-for-sale	4,794	126	6,112	195
Mortgage loans held-for-investment in securitization trust	4,369	—	6,023	—
Cash and cash equivalents	250	209	557	377
Total interest income	145,325	105,904	280,160	191,405
Interest expense:				
Repurchase agreements	22,553	15,527	45,571	26,994
Collateralized borrowings in securitization trust	2,169	—	2,987	—
Total interest expense	24,722	15,527	48,558	26,994
Net interest income	120,603	90,377	231,602	164,411
Other-than-temporary impairments:				
Total other-than-temporary impairment losses	(1,426)	(4,476)	(1,662)	(8,751)
Non-credit portion of loss recognized in other comprehensive (loss) income	—	—	—	—
Net other-than-temporary credit impairment losses	(1,426)	(4,476)	(1,662)	(8,751)
Other income:				
Gain on investment securities	50,863	1,789	77,831	11,720
Gain (loss) on interest rate swap and swaption agreements	259,826	(61,014)	278,798	(77,207)
Gain (loss) on other derivative instruments	62,283	(7,577)	45,621	(16,480)
(Loss) gain on mortgage loans held-for-sale	(35,142)	10	(20,819)	(22)
Other income	1,810	—	8,099	—
Total other income (loss)	339,640	(66,792)	389,530	(81,989)
Expenses:				
Management fees	12,591	7,610	17,352	14,353
Securitization deal costs	—	—	2,028	—
Other operating expenses	9,486	3,919	16,047	7,470
Total expenses	22,077	11,529	35,427	21,823
Income from continuing operations before income taxes	436,740	7,580	584,043	51,848
Provision for (benefit from) income taxes	49,119	(16,605)	54,083	(24,183)
Net income from continuing operations	387,621	24,185	529,960	76,031
Income (loss) from discontinued operations	1,016	(181)	2,393	(227)
Net income attributable to common stockholders	\$ 388,637	\$ 24,004	\$ 532,353	\$ 75,804

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, continued
 (in thousands, except share data)

	Three Months Ended		Six Months Ended	
	June 30, 2013 (unaudited)	2012	June 30, 2013 (unaudited)	2012
Basic earnings per weighted average common share:				
Continuing operations	\$ 1.06	\$ 0.11	\$ 1.58	\$ 0.38
Discontinued operations	—	—	0.01	—
Net income	\$ 1.06	\$ 0.11	\$ 1.59	\$ 0.38
Diluted earnings per weighted average common share:				
Continuing operations	\$ 1.06	\$ 0.11	\$ 1.57	\$ 0.38
Discontinued operations	—	—	0.01	—
Net income	\$ 1.06	\$ 0.11	\$ 1.58	\$ 0.38
Dividends declared per common share	\$ 0.31	\$ 0.40	\$ 0.63	\$ 0.80
Weighted average number of shares of common stock:				
Basic	365,589,300	214,810,579	335,603,697	200,833,084
Diluted	366,057,203	214,810,579	336,677,044	200,833,084
Comprehensive (loss) income:				
Net income	\$ 388,637	\$ 24,004	\$ 532,353	\$ 75,804
Other comprehensive (loss) income:				
Unrealized (loss) gain on available-for-sale securities, net	(534,713)	117,604	(430,461)	261,514
Other comprehensive (loss) income	(534,713)	117,604	(430,461)	261,514
Comprehensive (loss) income	\$ (146,076)	\$ 141,608	\$ 101,892	\$ 337,318

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

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CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(in thousands, except share data)

	Common Stock			Receivable	Accumulated	Cumulative	Cumulative	Total
	Shares	Amount	Additional	from	Other	Earnings	Distributions	Stockholders'
			Paid-in	Issuance	Comprehensive		to	Equity
			Capital	of	Income		Stockholders	
				Common	(Loss)			
				Stock	(unaudited)			
Balance, January 1, 2012	140,596,708	\$1,406	\$1,373,099	\$—	\$(58,716)	\$157,452	\$(203,155)	\$1,270,086
Net income	—	—	—	—	—	75,804	—	75,804
Other comprehensive income before reclassifications	—	—	—	—	259,908	—	—	259,908
Amounts reclassified from accumulated other comprehensive income	—	—	—	—	1,606	—	—	1,606
Net other comprehensive income	—	—	—	—	261,514	—	—	261,514
Issuance of common stock, net of offering costs	79,058,754	790	769,022	—	—	—	—	769,812
Increase in receivable from issuance of common stock	—	—	—	(22,248)	—	—	—	(22,248)
Common dividends declared	—	—	—	—	—	—	(172,744)	(172,744)
Non-cash equity award compensation	—	—	433	—	—	—	—	433
Balance, June 30, 2012	219,655,462	\$2,196	\$2,142,554	\$(22,248)	\$202,798	\$233,256	\$(375,899)	\$2,182,657
Balance, January 1, 2013	298,813,258	\$2,988	\$2,948,345	\$—	\$696,458	\$449,358	\$(646,572)	\$3,450,577
Net income	—	—	—	—	—	532,353	—	532,353

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Other comprehensive loss before reclassifications	—	—	—	—	(368,205)	—	—	(368,205)
Amounts reclassified from accumulated other comprehensive loss	—	—	—	—	(62,256)	—	—	(62,256)
Net other comprehensive loss	—	—	—	—	(430,461)	—	—	(430,461)
Issuance of common stock, net of offering costs	57,541,664	575	762,651	—	—	—	—	763,226
Issuance of common stock in connection with exercise of warrants	9,321,705	93	101,517	—	—	—	—	101,610
Repurchase of common stock	(1,000,000)	(10)	(10,488)	—	—	—	—	(10,498)
Common dividends declared	—	—	—	—	—	—	(230,202)	(230,202)
Special dividends declared	—	—	—	—	—	—	(343,481)	(343,481)
Non-cash equity award compensation	1,057,304	11	988	—	—	—	—	999
Balance, June 30, 2013	365,733,931	\$3,657	\$3,803,013	\$—	\$265,997	\$981,711	\$(1,220,255)	\$3,834,123

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

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

	Six Months Ended	
	June 30,	2012
	2013	
	(unaudited)	
Cash Flows From Operating Activities:		
Net income	\$532,353	\$75,804
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Amortization of premiums and discounts on available-for-sale securities, net	12,406	(9,058)
Other-than-temporary impairment losses	1,662	8,751
Realized and unrealized gains on investment securities, net	(77,653)	(11,720)
Loss on mortgage loans held-for-sale	20,819	22
Gain on mortgage loans held-for-investment and collateralized borrowings in securitization trust	(7,847)	—
Unrealized loss on mortgage servicing rights	45	—
Loss on termination and option expiration of interest rate swaps and swaptions	62,675	18,540
Unrealized (gain) loss on interest rate swaps and swaptions	(374,884)	46,296
Unrealized gain on other derivative instruments	(8,131)	(4,799)
Equity based compensation expense	999	433
Depreciation of fixed assets	256	46
Depreciation of real estate	—	32
Purchases of mortgage loans held-for-sale	(954,027)	(6,618)
Proceeds from sales of mortgage loans held-for-sale	25,404	—
Proceeds from repayment of mortgage loans held-for-sale	9,649	1,026
Net change in assets and liabilities:		
Increase in accrued interest receivable	(11,467)	(12,517)
Decrease/(increase) in deferred income taxes, net	52,692	(19,720)
Decrease/(increase) in current income tax receivable	4,323	(4,465)
Increase in prepaid and fixed assets	(557)	(600)
Decrease in other receivables	28,437	—
Increase in servicing advances	(4,881)	—
(Decrease)/increase in accrued interest payable, net	(1,550)	5,089
Increase/(decrease) in income taxes payable	1,320	(3,632)
Increase in accrued expenses and other liabilities	379	2,252
Net change in assets and liabilities due to purchase of entity	3,306	—
Net cash (used in) provided by operating activities	(684,272)	85,162
The accompanying notes are an integral part of these condensed consolidated financial statements.		

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

	Six Months Ended	
	June 30,	
	2013	2012
	(unaudited)	
Cash Flows From Investing Activities:		
Purchases of available-for-sale securities	\$(3,142,095)	\$(4,696,861)
Proceeds from sales of available-for-sale securities	986,357	197,714
Principal payments on available-for-sale securities	556,549	295,829
Purchases of other derivative instruments	(49,526)	(205,440)
Proceeds from sales of other derivative instruments, net	47,890	69,699
Purchases of trading securities	—	(996,016)
Proceeds from sales of trading securities	—	1,001,904
Purchases of mortgage loans held-for-investment in securitization trust	(442,788)	—
Proceeds from repayment of mortgage loans held-for-investment in securitization trust	16,684	—
Purchases of investments in real estate	—	(71,758)
Purchase of entity	(6,404)	—
(Decrease)/increase in due to counterparties, net	(50,054)	72,932
(Increase)/decrease in restricted cash	(383,643)	28,251
Increase in escrow deposits of discontinued operations	—	(28,693)
Net cash used in investing activities	(2,467,030)	(4,332,439)
Cash Flows From Financing Activities:		
Proceeds from repurchase agreements	73,388,331	23,100,723
Principal payments on repurchase agreements	(71,109,686)	(19,322,430)
Proceeds from issuance of collateralized borrowings in securitization trust	412,216	—
Principal payments on collateralized borrowings in securitization trust	(16,600)	—
Proceeds from issuance of common stock, net of offering costs	763,226	769,812
Proceeds from exercise of warrants	101,600	—
Increase in receivable from issuance of common stock	—	(22,248)
Repurchase of common stock	(10,498)	—
Dividends paid on common stock	(281,171)	(141,922)
Net cash provided by financing activities	3,247,418	4,383,935
Net increase in cash and cash equivalents	96,116	136,658
Cash and cash equivalents at beginning of period	821,108	360,016
Cash and cash equivalents at end of period	\$917,224	\$496,674
The accompanying notes are an integral part of these condensed consolidated financial statements.		

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

	Six Months Ended	
	June 30,	
	2013	2012
	(unaudited)	
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	\$50,108	\$10,438
Cash (received) paid for taxes	\$(4,252	) \$3,635
Noncash Investing and Financing Activities:		
Distribution of Silver Bay common stock	\$343,481	\$—
Cashless exercise of warrants	\$75	\$—
Cash dividends declared but not paid at end of period	\$113,378	\$87,061
Reconciliation of mortgage loans held-for-sale:		
Mortgage loans held-for-sale at beginning of period	\$58,607	\$5,782
Purchases of mortgage loans held-for-sale	954,027	6,618
Proceeds from sales of mortgage loans held-for-sale	(25,404) —
Proceeds from repayment of mortgage loans held-for-sale	(9,649	) (1,026
Realized and unrealized (losses) gains on mortgage loans held-for-sale	(19,380	) 4
Mortgage loans held-for-sale at end of period	\$958,201	\$11,378
The accompanying notes are an integral part of these condensed consolidated financial statements.		

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

Note 1. Organization and Operations

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

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 as a result of the merger.

The Company has elected to be treated as a real estate investment trust, or REIT, for U.S. federal income tax purposes commencing with its initial taxable period ended December 31, 2009. As long as the Company continues to comply with a number of requirements under federal tax law and maintains its qualification as a REIT, the Company generally will not be subject to U.S. federal income taxes to the extent that the Company distributes its taxable income to its stockholders on an annual basis and does not engage in prohibited transactions. However, certain activities that the Company may perform may cause it to earn income which will not be qualifying income for REIT purposes. The Company has designated certain of its subsidiaries as taxable REIT subsidiaries, or TRSs, as defined in the Code, to engage in such activities, and the Company may in the future form additional TRSs.

On December 19, 2012, the Company completed the contribution of its portfolio of single-family rental properties to Silver Bay Realty Trust Corp., or Silver Bay, a newly organized Maryland corporation intended to qualify as a REIT and focused on the acquisition, renovation, leasing and management of single-family residential properties for rental income and long-term capital appreciation. The Company contributed its equity interests in its wholly owned subsidiary, Two Harbors Property Investment LLC, to Silver Bay, and in exchange for its contribution, received shares of common stock of Silver Bay. Silver Bay completed its initial public offering, or IPO, of its common stock on December 19, 2012. As the Company will not have any significant continuing involvement in Two Harbors Property Investment LLC, all of the associated operating results were removed from continuing operations and are presented separately as discontinued operations for the three and six months ended June 30, 2013 and 2012. See Note 4 - Discontinued Operations for additional information.

On April 30, 2013, one of the Company's wholly-owned subsidiaries acquired a company that has seller-servicer approvals from the Federal National Mortgage Association, or Fannie Mae, the Federal Home Loan Mortgage Corporation, or Freddie Mac, and the Government National Mortgage Association, or Ginnie Mae, to hold and manage mortgage servicing rights, or MSRs. The MSRs acquired in conjunction with the acquisition of this entity, or the MSR subsidiary, represent the right to service mortgage loans. The Company and its subsidiaries do not originate or directly service mortgage loans, and instead contract with fully licensed subservicers to handle all servicing functions for the loans underlying the Company's MSRs. See Note 13 - Other Assets for additional information.

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 GAAP, have been condensed or omitted according to such SEC rules and regulations. Management believes, however, that the disclosures included in these interim condensed consolidated financial statements are adequate to make the information presented not misleading. The accompanying condensed consolidated financial

statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at June 30, 2013 and results of operations for all periods presented have been made. The results of operations for the three and six months ended June 30, 2013 should not be construed as indicative of the results to be expected for the full year.

The condensed consolidated financial statements of the Company have been prepared on the accrual basis of accounting in accordance with GAAP. The preparation of financial statements in conformity with GAAP requires us to make a number of significant estimates and assumptions. These estimates include estimates of fair value of certain assets and liabilities, amount and timing of credit losses, prepayment rates, the period of time during which the Company anticipates an increase in the fair values of real estate securities sufficient to recover unrealized losses in those securities, and other estimates that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities as of the date of the

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

condensed consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (e.g., valuation changes due to supply and demand, credit performance, prepayments, interest rates, or other reasons) will occur in the near term. The Company's estimates are inherently subjective in nature and actual results could differ from its estimates and the differences may be material. The condensed consolidated financial statements of the Company include the accounts of all subsidiaries; inter-company accounts and transactions have been eliminated. Certain prior period amounts have been reclassified to conform to the current period presentation.

The Company's investment in the common stock of Silver Bay was reviewed for consolidation under the applicable consolidation guidance, including voting control and variable interest entities ("VIE") models. The Company concluded that it did not have voting control of Silver Bay nor was Silver Bay considered a VIE and, therefore, consolidation of Silver Bay was not required.

The legal entity used in securitization (i.e., the securitization trust), which is considered a VIE for financial reporting purposes, was also reviewed for consolidation under the applicable consolidation guidance. As the Company has both the power to direct the activities of the securitization trust that most significantly impact the entity's performance, and the obligation to absorb losses or the right to receive benefits of the entity that could be significant, the Company consolidates the trust. The accounting is consistent with a secured financing, where the loans and securitized debt are both carried on the Company's condensed consolidated balance sheets.

Significant Accounting Policies

Mortgage Servicing Rights, at Fair Value

The MSR's acquired in conjunction with the acquisition of the Company's MSR subsidiary represent the right to service mortgage loans. As of June 30, 2013, the Company and its subsidiaries do not originate or directly service mortgage loans, and instead contract with fully licensed subservicers to handle all servicing functions for the loans underlying the Company's MSR's. However, as an owner and manager of MSR's, the Company may be obligated to fund advances of principal and interest payments due to third party owners of the loans, but not yet received from the individual borrowers. These advances are reported as servicing advances within the other assets line item on the condensed consolidated balance sheets.

MSR's are reported at fair value within the other assets line item on the condensed consolidated balance sheets.

Changes in the fair value of MSR's as well as servicing fee income are reported within other income on the condensed consolidated statements of comprehensive (loss) income. The related subservicing expenses are recorded in other operating expenses on the condensed consolidated statements of comprehensive (loss) income.

See Note 13 - Other Assets for further discussion on MSR's.

Equity Incentive Plan

The Company adopted an equity incentive plan in 2009 which provides incentive compensation to attract and retain qualified directors, officers, advisors, consultants and other personnel, including PRCM Advisers LLC and its affiliates. The 2009 equity incentive plan is administered by the compensation committee of the Company's board of directors. The 2009 equity incentive plan permits the granting of restricted shares of common stock, phantom shares, dividend equivalent rights and other equity-based awards.

On May 21, 2013, the Company's stockholders approved the restated 2009 equity incentive plan, which effectuated, among other changes, an increase in the number of shares available for issuance under the restated 2009 equity incentive plan by 2,800,000 shares of common stock. Other amendments provide for the possibility of making grants of equity-based compensation to the Company's executive officers and other key employees of the Company's external manager, PRCM Advisers LLC, upon a determination by the compensation committee, and the implementation of certain best practices of equity-based compensation.

The cost of equity-based compensation awarded to employees of our manager is determined using fair value liability accounting in accordance with ASC 718, Compensation - Stock Compensation, or ASC 718, and amortized over the vesting term.

Offsetting Assets and Liabilities

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

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Under GAAP, if the Company has a valid right of setoff, it may offset the related asset and liability and report the net amount. The Company presents repurchase agreements subject to master netting arrangements or similar agreements on a gross basis, and derivative assets and liabilities subject to such arrangements on a net basis, based on derivative type and counterparty, in its condensed consolidated balance sheets. Separately, the Company presents cash collateral subject to such arrangements on a net basis, based on counterparty, in its condensed consolidated balance sheets. However, the Company does not offset financial assets and liabilities with the associated cash collateral on its condensed consolidated balance sheets.

The following tables present information about the Company's assets and liabilities that are subject to master netting arrangements or similar agreements and can potentially be offset on the Company's condensed consolidated balance sheets as of June 30, 2013 and December 31, 2012:

June 30, 2013

(in thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts of Assets (Liabilities) Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset with Financial Assets (Liabilities) in the Condensed Consolidated Balance Sheets (1)			Net Amount
				Financial Instruments	Cash Collateral (Received) Pledged		
Assets							
Derivative assets	\$723,246	\$(23,895)	) \$699,351	\$(46,028)	) \$(189,927)	)	\$463,396
Total Assets	\$723,246	\$(23,895)	) \$699,351	\$(46,028)	) \$(189,927)	)	\$463,396
Liabilities							
Repurchase agreements	\$(14,903,155)	\$—	) \$(14,903,155)	) \$14,903,155	\$—)	\$—
Derivative liabilities	(69,923)) 23,895	(46,028)) 46,028	—)	—
Total Liabilities	\$(14,973,078)	\$23,895) \$(14,949,183)) \$14,949,183	\$—)	\$—

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Notes to the Condensed Consolidated Financial Statements (unaudited)

December 31, 2012

(in thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts of Assets (Liabilities) Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset with Financial Assets (Liabilities) in the Condensed Consolidated Balance Sheets (1)		
				Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets						
Derivative assets	\$463,027	\$(947)	) \$462,080	\$(129,294)	) \$85,798	\$418,584
Total Assets	\$463,027	\$(947)	) \$462,080	\$(129,294)	) \$85,798	\$418,584
Liabilities						
Repurchase agreements	\$(12,624,510)	\$—	) \$(12,624,510)	) \$12,624,510	\$—	\$—
Derivative liabilities	(130,241)	) 947	(129,294)	) 129,294	—	—
Total Liabilities	\$(12,754,751)	\$947	) \$(12,753,804)	) \$12,753,804	\$—	\$—

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. Refer to Note 2 to the Consolidated Financial Statements in the Company's 2012 Annual Report on Form 10-K regarding additional significant accounting policies.

Recently Issued and/or Adopted Accounting Standards**Offsetting Assets and Liabilities**

In December 2011, the Financial Accounting Standards Board, or FASB, issued ASU No. 2011-11, which amends ASC 210, Balance Sheet. The amendments in this ASU enhance disclosures required by U.S. GAAP by requiring improved information about financial instruments and derivative instruments that are either (1) offset in accordance with ASC 210, Balance Sheet or ASC 815, Other Presentation Matters or (2) subject to an enforceable master netting arrangement or similar agreement. ASU 2011-11 is effective for the first interim or annual period beginning on or after January 1, 2013. In January 2013, the FASB issued ASU No. 2013-01, which limits the scope of ASU 2011-11 to certain derivatives, repurchase agreements and securities lending arrangements. ASU 2013-01 is also effective for the first interim or annual period beginning on or after January 1, 2013. Adopting both ASU 2011-11 and ASU 2013-01 did not have any impact on the Company's condensed consolidated financial condition or results of operations, but did impact financial statement disclosures.

Comprehensive Income

In February 2013, the FASB issued ASU No. 2013-02, which amends ASC 220, Comprehensive Income. The amendments are intended to make the presentation of items within Other Comprehensive Income (OCI) more

prominent. ASU 2013-02 requires reclassification adjustments between OCI and net income to be presented separately on the face of the financial statements. The new guidance does not change the requirement to present items of net income and OCI, and totals for net income, OCI and comprehensive income in a single continuous statement or two consecutive statements. ASU 2013-02 is effective for the first interim or annual period beginning on or after December 15, 2012. Adopting this ASU did not have any impact on the Company's condensed consolidated financial condition or results of operations, but did impact financial statement disclosures.

Note 3. Variable Interest Entities

During the six months ended June 30, 2013, the Company purchased subordinated debt and excess servicing rights from a securitization trust issued by a third party. The securitization trust is considered a VIE for financial reporting purposes and,

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thus, was reviewed for consolidation under the applicable consolidation guidance. Since the Company has both the power to direct the activities of the securitization trust that most significantly impact the entity's performance, and the obligation to absorb losses or the right to receive benefits of the entity that could be significant, the Company consolidates the trust. As the Company is required to reassess VIE consolidation guidance each quarter, new facts and circumstances may change the Company's determination. This could result in a material impact to the Company's financial statements during subsequent reporting periods.

The following table presents a summary of the assets and liabilities of the securitization trust:

(in thousands)	June 30, 2013	December 31, 2012
Mortgage loans held-for-investment in securitization trust	\$401,347	\$—
Accrued interest receivable	1,428	—
Total Assets	\$402,775	\$—
Collateralized borrowings in securitization trust	363,012	—
Accrued interest payable	715	—
Accrued expenses	92	—
Total Liabilities	\$363,819	\$—

Note 4. Discontinued Operations

On December 19, 2012, the Company completed the contribution of its equity interests in its wholly owned subsidiary, Two Harbors Property Investment LLC, to Silver Bay. Two Harbors Property Investment LLC previously housed the Company's portfolio of single-family rental properties. As the Company will not have any significant continuing involvement in Two Harbors Property Investment LLC, all of the associated operating results were removed from continuing operations and are presented separately as discontinued operations for the three and six months ended June 30, 2013 and 2012.

Summarized financial information for the discontinued operations are presented below.

(in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Income:				
Gain on contribution of entity	\$1,016	\$—	\$2,255	\$—
Real estate related revenues	—	83	—	87
Total income	1,016	83	2,255	87
Expenses:				
Management fees	—	—	—	—
Real estate related expenses	—	181	—	198
Other operating expenses	—	83	(138	) 116
Total expenses	—	264	(138	) 314
Income (loss) from discontinued operations	\$1,016	\$(181	) \$2,393	\$(227

In addition to the gain on contribution of entity that was recorded in 2012 in connection with the closing of the contribution, certain adjustments were agreed to be recognized in 2013. These include an installment sales gain of approximately \$4.0 million from Silver Bay, a reduction of 2013 management fees payable to PRCM Advisers of \$4.3 million, and an immaterial amount of additional working capital adjustments determined in accordance with the contribution agreement entered into with Silver Bay. Of these amounts, \$1.0 million and \$2.3 million of the installment sales gain was recorded as a gain on contribution of entity within discontinued operations for the three and six months ended June 30, 2013, and the full \$4.3 million of the reduction of 2013 management fees payable to

PRCM Advisers was recorded within management fees, on the condensed consolidated statements of comprehensive (loss) income for the six months ended June 30, 2013, respectively. The remaining \$0.1 million recorded within discontinued operations on the condensed consolidated statements of comprehensive (loss)

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income for the six months ended June 30, 2013 relates to accrual adjustments for transaction expenses related to the contribution. See Note 23 - Related Party Transactions for additional information.

Note 5. Available-for-Sale Securities, at Fair Value

The following table presents the Company's available-for-sale, or AFS, investment securities by collateral type, which were carried at their fair value as of June 30, 2013 and December 31, 2012:

(in thousands)	June 30, 2013	December 31, 2012
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	\$4,056,456	\$3,608,272
Federal National Mortgage Association	5,867,736	5,130,965
Government National Mortgage Association	2,016,636	2,272,866
Non-Agency	2,951,487	2,654,851
Total mortgage-backed securities	\$14,892,315	\$13,666,954

At June 30, 2013 and December 31, 2012, the Company pledged investment securities with a carrying value of \$14.2 billion and \$12.8 billion, respectively, as collateral for repurchase agreements. See Note 16 - Repurchase Agreements. At June 30, 2013 and December 31, 2012, the Company did not have any securities purchased from and financed with the same counterparty that did not meet the conditions of ASC 860, Transfers and Servicing, to be considered linked transactions and, therefore, classified as derivatives.

The following tables present the amortized cost and carrying value (which approximates fair value) of AFS securities by collateral type as of June 30, 2013 and December 31, 2012:

(in thousands)	June 30, 2013		
	Agency	Non-Agency	Total
Face Value	\$13,791,266	\$4,994,692	\$18,785,958
Unamortized premium	809,226	—	809,226
Unamortized discount	—	—	—
Designated credit reserve	—	(1,386,607)	(1,386,607)
Net, unamortized	(2,359,641)	(1,222,618)	(3,582,259)
Amortized Cost	12,240,851	2,385,467	14,626,318
Gross unrealized gains	101,471	577,151	678,622
Gross unrealized losses	(401,494)	(11,131)	(412,625)
Carrying Value	\$11,940,828	\$2,951,487	\$14,892,315
	December 31, 2012		
(in thousands)	Agency	Non-Agency	Total
Face Value	\$11,934,492	\$4,503,999	\$16,438,491
Unamortized premium	749,252	—	749,252
Unamortized discount	—	—	—
Designated credit reserve	—	(1,290,946)	(1,290,946)
Net, unamortized	(1,929,811)	(996,490)	(2,926,301)
Amortized Cost	10,753,933	2,216,563	12,970,496
Gross unrealized gains	276,293	448,403	724,696
Gross unrealized losses	(18,123)	(10,115)	(28,238)
Carrying Value	\$11,012,103	\$2,654,851	\$13,666,954

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The following tables present the carrying value of the Company's AFS investment securities by rate type as of June 30, 2013 and December 31, 2012:

(in thousands)	June 30, 2013		
	Agency	Non-Agency	Total
Adjustable Rate	\$170,682	\$2,543,467	\$2,714,149
Fixed Rate	11,770,146	408,020	12,178,166
Total	\$11,940,828	\$2,951,487	\$14,892,315
(in thousands)	December 31, 2012		
	Agency	Non-Agency	Total
Adjustable Rate	\$188,429	\$2,334,950	\$2,523,379
Fixed Rate	10,823,674	319,901	11,143,575
Total	\$11,012,103	\$2,654,851	\$13,666,954

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

The following table presents the changes for the six months ended June 30, 2013 and 2012, of the unamortized net discount and designated credit reserves on non-Agency AFS securities.

(in thousands)	Six Months Ended June 30, 2013			2012		
	Designated Credit Reserve	Unamortized Net Discount	Total	Designated Credit Reserve	Unamortized Net Discount	Total
Beginning balance at January 1	\$(1,290,946)	\$(996,490)	\$(2,287,436)	\$(782,606)	\$(540,969)	\$(1,323,575)
Acquisitions	(158,955)	(365,348)	(524,303)	(553,552)	(479,435)	(1,032,987)
Accretion of net discount	886	71,625	72,511	250	62,768	63,018
Realized credit losses	22,658	—	22,658	17,908	—	17,908
Reclassification adjustment for other-than-temporary impairments	(1,662)	—	(1,662)	(8,751)	—	(8,751)
Transfers from (to)	30,883	(30,883)	—	—	—	—
Sales, calls, other	10,529	98,478	109,007	4,653	13,338	17,991
Ending balance at June 30	\$(1,386,607)	\$(1,222,618)	\$(2,609,225)	\$(1,322,098)	\$(944,298)	\$(2,266,396)

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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 the securities had an unrealized loss position as of June 30, 2013 and December 31, 2012. At June 30, 2013, the Company held 1,732 AFS securities, of which 863 were in an unrealized loss position for less than twelve consecutive months and 35 were in an unrealized loss position for more than twelve consecutive months. Of the \$8.5 billion and \$2.5 billion of AFS securities in an unrealized loss position for less than twelve consecutive months as of June 30, 2013 and December 31, 2012, \$8.2 billion, or 97.5%, and \$2.4 billion, or 95.8%, respectively, were Agency AFS securities, whose principal and interest are guaranteed by government sponsored entities, or GSEs. At December 31, 2012, the Company held 1,493 AFS securities, of which 250 were in an unrealized loss position for less than twelve months and 47 were in an unrealized loss position for more than twelve consecutive months.

(in thousands)	Unrealized Loss Position for Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
June 30, 2013	\$8,461,815	\$(405,056)	\$62,024	\$(7,569)	\$8,523,839	\$(412,625)
December 31, 2012	\$2,548,995	\$(18,610)	\$52,689	\$(9,628)	\$2,601,684	\$(28,238)

Evaluating AFS Securities for Other-Than-Temporary Impairments

In order to evaluate 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 is not more likely than not required to sell the security, the credit loss is recognized in earnings and the balance of the unrealized loss is recognized in other comprehensive (loss) income. If the Company intends to sell the security or will be more likely than not required to sell the security, the full unrealized loss is recognized in earnings.

The Company recorded a \$1.4 million and a \$1.7 million other-than-temporary credit impairment during the three and six months ended June 30, 2013, respectively, on a total of four non-Agency RMBS where the future expected cash flows for each security was less than its amortized cost. As of June 30, 2013, impaired securities had weighted average cumulative losses of 10.9%, weighted average three-month prepayment speed of 6.7%, weighted average 60+ day delinquency of 35.6% of the pool balance, and weighted average FICO score of 626. At June 30, 2013, the Company did not intend to sell the securities and determined that it was not more likely than not that the Company will be required to sell the securities, therefore, only the projected credit loss was recognized in earnings. During the three and six months ended June 30, 2012, the Company recorded a \$4.5 million and an \$8.8 million other-than-temporary credit impairment on a total of 27 non-Agency RMBS where the future expected cash flows for each security was less than its amortized cost.

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The following table presents the changes in OTTI included in earnings for three and six months ended June 30, 2013 and 2012:

(in thousands)	Three Months Ended		Six Months Ended	
	June 30,	2012	June 30,	2012
Cumulative credit loss at beginning of period	2013	2012	2013	2012
	\$(15,142	) \$(9,377	) \$(15,561	) \$(5,102
Additions:				
Other-than-temporary impairments not previously recognized	—	(2,644	) —	(6,128
Increases related to other-than-temporary impairments on securities with previously recognized other-than-temporary impairments	(1,426	) (1,832	) (1,662	) (2,623
Reductions:				
Decreases related to other-than-temporary impairments on securities paid down	231	250	231	250
Decreases related to other-than-temporary impairments on securities sold	1,291	—	1,946	—
Cumulative credit loss at end of period	\$(15,046	) \$(13,603	) \$(15,046	) \$(13,603

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

Gross Realized Gains and Losses

Gains and losses from the sale of AFS securities are recorded as realized gains (losses) within gain on investment securities in the Company's condensed consolidated statements of comprehensive (loss) income. For the three and six months ended June 30, 2013, the Company sold AFS securities for \$189.7 million and \$986.4 million with an amortized cost of \$137.3 million and \$915.0 million, for net realized gains of \$52.4 million and \$71.4 million, respectively.

The following table presents the gross realized gains and losses on sales of AFS securities for the three and six months ended June 30, 2013 and 2012:

(in thousands)	Three Months Ended		Six Months Ended	
	June 30,	2012	June 30,	2012
Gross realized gains	2013	2012	2013	2012
	\$52,439	\$560	\$75,665	\$11,663
Gross realized losses	(1	) (1,629	) (4,297	) (1,629
Total realized gains on sales, net	\$52,438	\$(1,069	) \$71,368	\$10,034

Note 6. Trading Securities, at Fair Value

The Company holds U.S. Treasuries in a taxable REIT subsidiary and classifies these securities as trading instruments due to short-term investment objectives. As of June 30, 2013 and December 31, 2012, the Company held U.S. Treasuries with an amortized cost of \$1.0 billion and a fair value of \$1.0 billion for both periods classified as trading securities. The unrealized gains included within trading securities were \$3.5 million and \$5.0 million as of June 30, 2013 and December 31, 2012, respectively.

The Company did not sell any trading securities during the three and six months ended June 30, 2013. For both the three and six months ended June 30, 2013, trading securities experienced change in unrealized losses of \$1.6 million. Unrealized gains and losses are recorded as a component of gains on investment securities in the Company's

condensed consolidated statements of comprehensive (loss) income.

At June 30, 2013, the Company pledged trading securities with a carrying value of \$1.0 billion as collateral for repurchase agreements. See Note 16 - Repurchase Agreements.

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Note 7. Equity Securities, at Fair Value

At December 31, 2012, equity securities consisted of shares of Silver Bay common stock carried at fair value as a result of a fair value option election. In exchange for the contribution of the Company's equity interests in its wholly owned subsidiary, Two Harbors Property Investment LLC, to Silver Bay on December 19, 2012, the Company received 17,824,647 shares of common stock, or 47.7%, of Silver Bay at the initial public offering price of \$18.50. The initial carrying value of the Company's equity securities was \$329.8 million and the carrying value as of December 31, 2012 was \$335.6 million, which included \$5.9 million in unrealized gains.

On March 18, 2013, the Company declared a special dividend pursuant to which the 17,824,647 shares of Silver Bay common stock would be distributed, on a pro rata basis, to Two Harbors stockholders of record at the close of business on April 2, 2013. The dividend was payable on or about April 24, 2013. As a result, the Company recognized \$13.7 million of realized gains on distribution as well as \$13.7 million and \$5.9 million of change in unrealized losses within gain on investment securities on the condensed consolidated statements of comprehensive (loss) income for the three and six months ended June 30, 2013, respectively. As the shares were distributed to Two Harbors stockholders during the six months ended June 30, 2013, equity securities are no longer recognized on the condensed consolidated balance sheet as of June 30, 2013.

Note 8. Mortgage Loans Held-for-Sale, at Fair Value

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 mortgage loans held-for-sale as of June 30, 2013 and December 31, 2012:

(in thousands)	June 30, 2013	December 31, 2012
Unpaid principal balance	\$1,101,389	\$56,976
Fair value adjustment	(143,188	) 1,631
Carrying value	\$958,201	\$58,607

At June 30, 2013 and December 31, 2012, the Company pledged mortgage loans with a carrying value of \$475.0 million and \$52.5 million, respectively, as collateral for repurchase agreements. See Note 16 - Repurchase Agreements.

Note 9. Mortgage Loans Held-for-Investment in Securitization Trust, at Fair Value

During the six months ended June 30, 2013, the Company purchased subordinated debt and excess servicing rights from a securitization trust issued by a third party. The underlying residential mortgage loans held by the trust, which are consolidated on the Company's condensed consolidated balance sheet, are classified as mortgage loans held-for-investment in securitization trust and carried at fair value as a result of a fair value option election. See Note 3 - Variable Interest Entities for additional information regarding consolidation of the securitization trust. The following table presents the carrying value of the Company's mortgage loans held-for-investment in securitization trust as of June 30, 2013 and December 31, 2012:

(in thousands)	June 30, 2013	December 31, 2012
Unpaid principal balance	\$405,519	\$—
Fair value adjustment	(4,172) —
Carrying value	\$401,347	\$—

Note 10. Restricted Cash

The Company is required to maintain certain cash balances with counterparties for broker activity and collateral for the Company's repurchase agreements in non-interest bearing accounts. The Company has also placed cash in a restricted account pursuant to a letter of credit on an office space lease.

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The following table presents the Company's restricted cash balances as of June 30, 2013 and December 31, 2012:

(in thousands)	June 30, 2013	December 31, 2012
Restricted cash balances held by trading counterparties:		
For securities trading activity	\$9,000	\$9,000
For derivatives trading activity	80,140	208,669
As restricted collateral for repurchase agreements	596,479	84,307
	685,619	301,976
Restricted cash balance pursuant to letter of credit on office lease	346	346
Total	\$685,965	\$302,322

Note 11. Accrued Interest Receivable

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

(in thousands)	June 30, 2013	December 31, 2012
Accrued Interest Receivable:		
U.S. Treasuries	\$1,101	\$1,119
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	13,660	11,888
Federal National Mortgage Association	19,732	17,101
Government National Mortgage Association	8,880	8,962
Non-Agency	3,926	3,296
Total mortgage-backed securities	46,198	41,247
Mortgage loans held-for-sale	5,353	247
Mortgage loans held-for-investment in securitization trust	1,428	—
Total	\$54,080	\$42,613

Note 12. Derivative Instruments and Hedging Activities

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

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

compliance with REIT requirements.

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Balance Sheet Presentation

The following tables present the gross fair value and notional amounts of the Company's derivative financial instruments treated as trading instruments as of June 30, 2013 and December 31, 2012.

(in thousands)	June 30, 2013		Derivative Liabilities	
	Fair Value	Notional	Fair Value	Notional
Trading instruments				
Inverse interest-only securities	\$245,195	\$1,798,972	\$—	\$—
Interest rate swap agreements	142,317	18,485,000	—	—
Credit default swap agreements	—	—	(8,198	) 1,630,404
Swaptions	225,810	6,250,000	—	—
TBAs	61,156	2,813,000	(22,568	) 2,892,000
Put and call options for TBAs	24,873	210,000	—	—
Constant maturity swaps	—	—	(14,058	) 19,000,000
Forward purchase commitment	—	—	(1,204	) 29,229
Total	\$699,351	\$29,556,972	\$(46,028	) \$23,551,633
(in thousands)	December 31, 2012		Derivative Liabilities	
	Fair Value	Notional	Fair Value	Notional
Trading instruments				
Inverse interest-only securities	\$304,975	\$1,909,351	\$—	\$—
Interest rate swap agreements	—	—	(129,055	) 14,070,000
Credit default swap agreements	52,906	438,440	—	—
Swaptions	102,048	4,950,000	—	—
TBAs	1,917	2,414,000	(239	) 139,000
Forward purchase commitment	234	56,865	—	—
Total	\$462,080	\$9,768,656	\$(129,294	) \$14,209,000

The following table provides the average outstanding notional amounts of the Company's derivative financial instruments treated as trading instruments for the three and six months ended June 30, 2013.

(in thousands)	Three Months Ended June 30, 2013		Six Months Ended June 30, 2013	
	Derivative Assets	Derivative Liabilities	Derivative Assets	Derivative Liabilities
Trading instruments				
Inverse interest-only securities	\$1,895,789	\$—	\$1,908,919	\$—
Interest rate swap agreements	17,655,220	—	16,267,624	—
Credit default swaps	—	764,914	—	602,283
Swaptions	5,748,352	—	5,646,133	—
TBAs	1,959,495	1,234,769	1,588,630	783,227
Put and call options for TBAs	130,901	—	65,812	—
Constant maturity swaps	—	5,532,967	—	2,781,768
Short treasuries	—	26,703	—	13,425
Forward purchase commitment	—	297,207	—	174,920

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

Comprehensive Income Statement Presentation

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

The following table summarizes the location and amount of gains and losses on derivative instruments reported in the condensed consolidated statements of comprehensive (loss) income on its derivative instruments:

(in thousands)

Trading Instruments	Location of Gain/(Loss) Recognized in Income on Derivatives	Amount of Gain/(Loss) Recognized in Income on Derivatives			
		Three Months Ended June 30,		Six Months Ended June 30,	
		2013	2012	2013	2012
Risk Management Instruments					
Interest Rate Contracts					
Investment securities - RMBS	Gain (loss) on other derivative instruments	\$ 116,709	\$(22,350)	\$ 104,057	\$(24,987)
Investment securities - U.S. Treasuries and TBA contracts	Gain (loss) on interest rate swap and swaption agreements	409	(5,697)	320	(7,345)
Mortgage loans held-for-sale	(Loss) gain on mortgage loans held-for-sale	(20,302)	(39)	(20,015)	(26)
Repurchase agreements	Gain (loss) on interest rate swap and swaption agreements	259,417	(55,317)	278,478	(69,862)
Credit default swaps - Receive protection	Gain (loss) on other derivative instruments	(4,220)	(1,225)	(9,862)	(25,526)
Non-Risk Management Instruments					
Credit default swaps - Provide protection	Gain (loss) on other derivative instruments	—	752	—	8,972
Inverse interest-only securities	Gain (loss) on other derivative instruments	(40,149)	15,245	(38,920)	25,060
Other TBA positions	Gain (loss) on other derivative instruments	(10,057)	—	(9,654)	—
Total		\$ 301,807	\$(68,631)	\$ 304,404	\$(93,714)

For the three and six months ended June 30, 2013, the Company recognized \$19.4 million and \$33.4 million, respectively, of expenses for the accrual and/or settlement of the net interest expense associated with its interest rate swaps. The expenses result from generally paying a fixed interest rate on an average \$17.7 billion and \$16.3 billion notional, respectively, to economically hedge a portion of the Company's interest rate risk on its short-term repurchase agreements, funding costs, and macro-financing risk and generally receiving LIBOR interest.

For the three and six months ended June 30, 2013, the Company terminated, had agreements mature or had options expire on a total of three and 72 interest rate swap and swaption positions of \$300.0 million and \$8.5 billion notional, respectively. Upon settlement of the early terminations, contractual maturities and option expirations, the Company paid \$17.2 million in full settlement of its net interest spread liability and recognized \$4.0 million and \$62.7 million in realized losses on the swaps and swaptions, respectively, including early termination penalties.

For the three and six months ended June 30, 2013, the Company terminated a total of five credit default swap positions of \$115.0 million notional. Upon settlement of the early terminations, the Company paid \$2,035 in full

settlement of its net interest spread liability and recognized \$12.4 million in realized losses on the credit default swaps, including early terminations penalties.

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

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

Available-for-sale Securities - The Company's RMBS investment securities are generally subject to change in value when mortgage rates decline or increase, depending on the type of investment. Rising mortgage rates generally result in a slowing of refinancing activity, which slows prepayments and results in a decline in the value of the Company's fixed-rate Agency pools. To mitigate the impact of this risk, the Company maintains a portfolio of financial instruments, primarily fixed-rate interest-only securities, which increase in value when interest rates increase. In addition, the Company has initiated TBA positions, put and call options for TBAs, and constant maturity swaps to further mitigate its exposure to higher interest rates, decreased prepayment speeds and widening mortgage spreads. The objective is to reduce the risk of losses to the portfolio caused by interest rate changes and changes in prepayment speeds.

As of June 30, 2013 and December 31, 2012, the Company had outstanding fair value of \$95.0 million and \$77.3 million, respectively, of interest-only securities in place to economically hedge its investment securities. These interest-only securities are included in AFS securities, at fair value, in the condensed consolidated balance sheets. In addition, the Company held TBA positions with \$1.5 billion and \$1.8 billion in long notional as of June 30, 2013 and December 31, 2012, respectively, and an additional \$4.2 billion and \$800.0 million in short notional as of June 30, 2013 and December 31, 2012, respectively. At June 30, 2013, \$92.0 million of the Company's long notional TBA positions and \$4.2 billion of the Company's short notional TBA positions were held as a means to mitigate exposure to higher interest rates and wider mortgage spreads, while the remaining \$1.4 billion long notional TBA positions were held for non-risk management purposes (see "Non-Risk Management Activities" section). The Company discloses these on a gross basis according to the unrealized gain or loss position of each TBA contract regardless of long or short notional position. These contracts had a fair market value of \$61.2 million and \$1.9 million, included in derivative assets, at fair value, and \$22.6 million and \$0.2 million, included in derivative liabilities, at fair value, in the condensed consolidated balance sheet as of June 30, 2013 and December 31, 2012, respectively.

As of June 30, 2013, the Company had purchased put and call options for TBAs with a total notional amount of \$1.3 billion and sold put and call options for TBAs with a total notional amount of \$1.5 billion. The Company paid upfront premiums of approximately \$10.0 million for the options purchased and received upfront premiums of approximately \$8.3 million for the options sold. Each of the options will expire by September 2013. The put and call options had a net fair market value of \$24.9 million, included in derivative assets, at fair value, in the condensed consolidated balance sheet as of June 30, 2013. The Company did not hold any put or call options for TBAs as of December 31, 2012.

The Company has also entered into constant maturity swaps between the 10-year interest rate swap curve and the yield to maturity on a 30-year Fannie Mae TBA to economically hedge mortgage spread widening. The Company had the following constant maturity swaps agreements in place at June 30, 2013:

(notional and dollars in thousands)

June 30, 2013

Notional Amount Fair Value

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Determination Date	Average Strike Swap Rate				Upfront Premium Paid	Unrealized Gain/(Loss)	
August 2013	0.837	%	\$8,000,000	\$(3,497	) \$—	\$(3,497)
September 2013	0.981	%	5,000,000	(6,527	) —	(6,527)
November 2013	0.900	%	1,000,000	(670	) —	(670)
December 2013	0.890	%	5,000,000	(3,364	) —	(3,364)
Total	0.892	%	\$19,000,000	\$(14,058	) \$—	\$(14,058)

The Company did not hold any constant maturity swaps as of December 31, 2012.

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

Commitments to Purchase and/or Sell Mortgage Loans Held-for-Sale - Prior to a mortgage loan purchase, the Company may enter into forward purchase commitments with counterparties whereby the Company commits to purchasing the loans at a particular interest rate, provided the borrower elects to close the loan. These commitments to purchase mortgage loans have been defined as derivatives and are, therefore, recorded on the balance sheet as assets or liabilities and measured at fair value. Subsequent changes in fair value are recorded on the balance sheet as adjustments to the carrying value of these assets or liabilities with a corresponding adjustment recognized in current period earnings. As of June 30, 2013 and December 31, 2012, the Company had entered into commitments to purchase \$29.2 million and \$56.9 million of mortgage loans, respectively, subject to fallout if the loans do not close, with a fair value of \$1.2 million included in derivative liabilities on the condensed consolidated balance sheet at June 30, 2013 and \$0.2 million included in derivative assets on the condensed consolidated balance sheet at December 31, 2012.

The Company is exposed to interest rate risk on mortgage loans from the time it commits to purchase the mortgage loan until it acquires the loan from the originator and subsequently sells the loan to a third party. Changes in interest rates impact the market price for the mortgage loans. For example, as market interest rates decline, the value of mortgage loans held-for-sale increases, and vice versa. To mitigate the impact of this risk, the Company may from time to time enter into a forward sale commitment under the Forward AAA Securities Agreement, or the Forward Agreement, with Barclays Bank PLC, or Barclays, pursuant to which Barclays would purchase certain securities issued in connection with a potential securitization transaction involving mortgage loans subject to the Forward Agreement. As of June 30, 2013, the Company had did not have any trades under the Forward Agreement. The Company may also enter into other derivative contracts to hedge the interest rate risk related to the commitments to purchase mortgage loans, such as interest rate swaps, swaptions or TBAs.

Repurchase Agreements - The Company monitors its repurchase agreements, which are generally floating rate debt, in relation to the rate profile of its investment securities. When it is cost effective to do so, the Company may enter into interest rate swap arrangements to align the interest rate composition of its investment securities and debt portfolios, specifically repurchase agreements with maturities of less than 6 months. Typically, the interest receivable terms (i.e., LIBOR) of the interest rate swaps match the terms of the underlying debt, resulting in an effective conversion of the rate of the related repurchase agreement from floating to fixed.

As of June 30, 2013 and December 31, 2012, the Company had the following outstanding interest rate swaps that were utilized as economic hedges of interest rate exposure (or duration) associated with the Company's short-term repurchase agreements:

(notional in thousands)

June 30, 2013

Swaps Maturities	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Maturity (Years)
2013	\$500,000	0.523	% 0.274	% 0.15
2014	900,000	0.316	% 0.277	% 0.54
2015	4,000,000	0.386	% 0.278	% 1.53
2016	2,650,000	0.579	% 0.276	% 2.67
2017 and Thereafter	9,435,000	0.999	% 0.277	% 4.58
Total	\$17,485,000	0.746	% 0.277	% 3.26

(notional in thousands)

December 31, 2012

Swaps Maturities	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Maturity (Years)
2013	\$2,275,000	0.713	% 0.315	% 0.56
2014	1,675,000	0.644	% 0.311	% 1.57

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2015	2,770,000	0.908	% 0.313	% 2.43
2016	1,940,000	0.874	% 0.323	% 3.46
2017 and Thereafter	3,910,000	0.960	% 0.313	% 4.72
Total	\$12,570,000	0.850	% 0.315	% 2.85

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

The Company has also entered into interest rate swaps in combination with U.S. Treasuries to economically hedge funding cost risk. As of June 30, 2013 and December 31, 2012, the Company held \$1.0 billion in fair value of U.S. Treasuries classified as trading securities and the following outstanding interest rate swaps:

(notional in thousands)

June 30, 2013

Swaps Maturities	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Maturity (Years)
2015	\$1,000,000	0.799	% 0.280	% 1.78
Total	\$1,000,000			

(notional in thousands)

December 31, 2012

Swaps Maturities	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Maturity (Years)
2015	\$1,000,000	0.799	% 0.350	% 2.28
Total	\$1,000,000			

As of December 31, 2012, the Company had the following outstanding interest rate swaps that were entered into in combination with TBA contracts to economically hedge mortgage interest rate exposure (or duration):

(notional in thousands)

December 31, 2012

Swaps Maturities	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Maturity (Years)
2014	\$500,000	0.399	% 0.356	% 1.78
Total	\$500,000			

The Company did not hold any interest rate swaps entered into in combination with TBA contracts to economically hedge mortgage interest rate exposure (or duration) at June 30, 2013.

As of June 30, 2013 and December 31, 2012, the Company had the following outstanding interest rate swaptions (agreements to enter into interest rate swaps in the future for which the Company would pay a fixed rate) that were utilized as macro-economic hedges:

June 30, 2013

(notional and dollars in thousands)

Swaption	Option	Underlying Swap						
		Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Term (Years)
Payer	< 6 Months	\$28,213	\$4,639	2.15	\$2,750,000	3.13	% 3M Libor	8.2
Payer	≥ 6 Months	133,710	221,171	49.35	3,500,000	3.94	% 3M Libor	10.0
Total Payer		\$161,923	\$225,810	46.65	\$6,250,000	3.58	% 3M Libor	9.2

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

December 31, 2012

(notional and
dollars in
thousands)

Swaption	Option		Underlying Swap					
	Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Term (Years)
Payer	< 6 Months	\$3,983	\$30	5.38	\$300,000	4.00	% 3M Libor	10.0
Payer	≥ 6 Months	129,925	102,018	53.38	4,650,000	3.74	% 3M Libor	9.7
Total Payer		\$133,908	\$102,048	53.38	\$4,950,000	3.75	% 3M Libor	9.8

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

Foreign Currency Risk

In compliance with the Company's REIT requirements, the Company does not have exposure to foreign denominated assets or liabilities. As such, the Company is not subject to foreign currency risk.

Credit Risk

The Company's exposure to credit losses on its U.S. Treasuries and Agency portfolio of investment securities is limited because these securities are issued by the U.S. Department of the Treasury or 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 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 "Non-Risk Management Activities" section). The Company also has processes and controls in place to monitor, analyze, manage and mitigate its credit risk with respect to non-Agency RMBS and mortgage loans.

As of June 30, 2013, the Company held credit default swaps whereby the Company receives credit protection for a fixed premium. The maximum payouts for these credit default swaps are limited to the current notional amounts of each swap contract. Maximum payouts for credit default swaps do not represent the expected future cash requirements, as the Company's credit default swaps are typically liquidated or expire and are not exercised by the holder of the credit default swaps.

The following tables present credit default swaps whereby the Company is receiving protection held as of June 30, 2013 and December 31, 2012:

(notional and dollars in thousands)

June 30, 2013

Protection	Maturity Date	Average Implied Credit Spread	Current Notional Amount	Fair Value	Upfront (Payable)/Receivable	Unrealized Gain/(Loss)
Receive	9/20/2013	460.00	\$(45,000)	\$(91)	\$(3,127)	\$(3,218)
	12/20/2013	181.91	(105,000)	(116)	(3,225)	(3,341)
	6/20/2016	105.50	(100,000)	(1,722)	(260)	(1,982)
	12/20/2016	496.00	(25,000)	245	(4,062)	(3,817)
	6/20/2018	247.35	(1,300,000)	(22,858)	21,277	(1,581)
	5/25/2046	356.00	(55,404)	16,344	(25,758)	(9,414)

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Total 247.81 \$(1,630,404) \$(8,198) \$