Two Harbors Investment Corp.
Form 10-Q
May 04, 2012

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: March 31, 2012

Commission File Number 001-34506

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

Maryland (State or Other Jurisdiction of Incorporation or Organization)	27-0312904 (I.R.S. Employer Identification No.)
601 Carlson Parkway, Suite 150 Minnetonka, Minnesota	55305
(Address of Principal Executive Offices)	(Zip Code)

(612) 629-2500
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
As of May 4, 2012 there were 214,217,304 shares of outstanding common stock, par value $.01 per share, issued and outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	March 31, 2012 (unaudited)	December 31, 2011
ASSETS		
Available-for-sale securities, at fair value	$9,171,511	$6,249,252
Trading securities, at fair value	1,002,090	1,003,301
Mortgage loans held-for-sale, at fair value	5,711	5,782
Investment in real estate, net	6,107	—
Cash and cash equivalents	545,688	360,016
Restricted cash	154,283	166,587
Accrued interest receivable	30,801	23,437
Due from counterparties	50,738	32,587
Derivative assets, at fair value	340,715	251,856
Other assets	23,338	7,566
Total Assets	$11,330,982	$8,100,384
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Repurchase agreements	$8,693,756	$6,660,148
Derivative liabilities, at fair value	47,475	49,080
Accrued interest payable	9,314	6,456
Due to counterparties	413,086	45,565
Accrued expenses	9,495	8,912
Dividends payable	85,683	56,239
Income taxes payable	—	3,898
Total liabilities	9,258,809	6,830,298
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; 450,000,000 shares authorized and 214,207,346 and 140,596,708 shares issued and outstanding, respectively	2,142	1,406
Additional paid-in capital	2,064,423	1,373,099
Accumulated other comprehensive income (loss)	85,194	(58,716)
Cumulative earnings	209,252	157,452
Cumulative distributions to stockholders	(288,838)	(203,155)
Total stockholders' equity	2,072,173	1,270,086
Total Liabilities and Stockholders' Equity	$11,330,982	$8,100,384

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

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

	Three Months Ended March 31,	
	2012	2011
	(unaudited)	
Interest income:		
Available-for-sale securities	$84,214	$19,535
Trading securities	1,050	272
Mortgage loans held-for-sale	69	—
Cash and cash equivalents	168	63
Total interest income	85,501	19,870
Interest expense	11,467	2,499
Net interest income	74,034	17,371
Other-than-temporary impairments:		
Total other-than temporary impairment losses	(4,275)	—
Non-credit portion of loss recognized in other comprehensive income	—	—
Net other-than-temporary credit impairment losses	(4,275)	—
Other income:		
Gain on investment securities, net	9,931	1,539
(Loss) gain on interest rate swap and swaption agreements	(16,193)	1,939
(Loss) gain on other derivative instruments	(8,890)	5,347
Other loss	(40)	—
Total other (loss) income	(15,192)	8,825
Expenses:		
Management fees	6,743	1,550
Other operating expenses	3,601	1,512
Total expenses	10,344	3,062
Income before income taxes	44,223	23,134
(Benefit from) provision for income taxes	(7,577)	757
Net income attributable to common stockholders	$51,800	$22,377
Basic and diluted earnings per weighted average common share	$0.28	$0.49
Dividends declared per common share	$0.40	$0.40
Basic and diluted weighted average number of shares of common stock	186,855,589	45,612,376
Comprehensive income:		
Net income	$51,800	$22,377
Other comprehensive income:		
Unrealized gain on available-for-sale securities, net	143,910	9,115
Other comprehensive income	143,910	9,115
Comprehensive income	$195,710	$31,492

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

TWO HARBORS INVESTMENT CORP.
CONDENDSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
AND COMPREHENSIVE INCOME
(in thousands, except share data)

	Common Stock						
	Shares	Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss) (unaudited)	Cumulative Earnings	Cumulative Distributions to Stockholders	Total Stockholders' Equity
Balance, January 1, 2011	40,501,212	$405	$366,974	$ 22,619	$ 30,020	$ (37,570)	$ 382,448
Net income	—	—	—	—	22,377	—	22,377
Other comprehensive income	—	—	—	9,115	—	—	9,115
Net proceeds from issuance of common stock, net of offering costs	28,750,545	288	287,478	—	—	—	287,766
Common dividends declared	—	—	—	—	—	(16,200)	(16,200)
Non-cash equity award compensation	—	—	62	—	—	—	62
Balance, March 31, 2011	69,251,757	$693	$654,514	$ 31,734	$ 52,397	$ (53,770)	$ 685,568
Balance, January 1, 2012	140,596,708	$1,406	$1,373,099	$ (58,716)	$ 157,452	$ (203,155)	$ 1,270,086
Net income	—	—	—	—	51,800	—	51,800
Other comprehensive income	—	—	—	143,910	—	—	143,910
Net proceeds from issuance of common stock, net of offering costs	73,610,638	736	691,264	—	—	—	692,000
Common dividends declared	—	—	—	—	—	(85,683)	(85,683)
Non-cash equity award compensation	—	—	60	—	—	—	60
Balance, March 31, 2012	214,207,346	$2,142	$2,064,423	$ 85,194	$ 209,252	$ (288,838)	$ 2,072,173

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

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

	Three Months Ended March 31,	
	2012	2011
	(unaudited)	
Cash Flows From Operating Activities:		
Net income	$51,800	$22,377
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of premiums and discounts on RMBS, net	(5,925)	2,467
Other-than-temporary impairment losses	4,275	—
Gain on investment securities, net	(9,931)	(1,539)
Loss (gain) on termination and option expiration of interest rate swaps and swaptions	11,265	(1,253)
Unrealized loss (gain) on interest rate swaps and swaptions	212	(3,838)
Unrealized loss (gain) on other derivative instruments	8,026	(1,971)
Unrealized loss on mortgage loans	45	—
Equity based compensation expense	60	62
Depreciation of real estate	1	—
Proceeds from repayment of mortgage loans held-for-sale	26	—
Net change in assets and liabilities:		
Increase in accrued interest receivable	(7,364)	(5,627)
Decrease in deferred income taxes, net	638	482
Increase in current tax receivable	(7,952)	—
Decrease in prepaid and fixed assets	38	204
Increase in escrow deposits	(8,496)	—
Increase in accrued interest payable, net	2,858	520
(Decrease)/increase in income taxes payable	(3,898)	275
Increase in accrued expenses	583	934
Net cash provided by operating activities	36,261	13,093
Cash Flows From Investing Activities:		
Purchases of available-for-sale securities	(3,065,659)	(1,636,366)
Proceeds from sales of available-for-sale securities	170,102	71,405
Principal payments on available-for-sale securities	130,002	44,659
Purchases of other derivative instruments	(124,323)	(70,302)
Proceeds from sales of other derivative instruments	14,354	11,342
Purchases of trading securities	—	(299,337)
Proceeds from sales of trading securities	—	199,500
Purchases of investments in real estate	(6,108)	—
Increase in due to counterparties, net	349,370	97,269
Decrease (increase) in restricted cash	12,304	(16,443)
Net cash used in investing activities	(2,519,958)	(1,598,273)

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

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

	Three Months Ended March 31,	
	2012	2011
	(unaudited)	
Cash Flows From Financing Activities:		
Proceeds from repurchase agreements	$10,564,948	$3,131,249
Principal payments on repurchase agreements	(8,531,340)	(1,685,022)
Proceeds from issuance of common stock, net of offering costs	692,000	287,766
Dividends paid on common stock	(56,239)	(10,450)
Net cash provided by financing activities	2,669,369	1,723,543
Net increase in cash and cash equivalents	185,672	138,363
Cash and cash equivalents at beginning of period	360,016	163,900
Cash and cash equivalents at end of period	$545,688	$302,263
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$8,609	$1,980
Cash paid for taxes	$3,635	$1
Non-Cash Financing Activity:		
Dividends declared but not paid at end of period	$85,683	$16,200
Reconciliation of mortgage loans held-for-sale:		
Mortgage loans held-for-sale at beginning of period	$5,782	$—
Proceeds from repayment of mortgage loans held-for-sale	(26)	—
Unrealized loss on mortgage loans	(45)	—
Loans held-for-sale at end of period	$5,711	$—

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, residential real properties, 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 Amex under the symbols “TWO” and “TWO.WS,” respectively.

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 is qualification as a REIT, the Company generally will not be subject to U.S. federal income taxes to the extent that the Company distributes its taxable income to its stockholders on an annual basis and does not engage in prohibited transactions. However, certain activities that the Company may perform may cause it to earn income which will not be qualifying income for REIT purposes. The Company has designated certain of its subsidiaries as taxable REIT subsidiaries, or TRSs, as defined in the Code, to engage in such activities, and the Company may in the future form additional TRSs.

Note 2. Basis of Presentation and Significant Accounting Policies

Consolidation and Basis of Presentation

The interim unaudited condensed consolidated financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles, or 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, 2011. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at March 31, 2012 and results of operations for all periods presented have been made. The results of operations for the three months ended March 31, 2012 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 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.

Significant Accounting Policies

Investment in Real Estate, Net

Beginning in early 2012, the Company began investing in single family residential properties with the intention of holding and renting the properties. Real estate is recorded at acquisition cost, allocated between land and building. Building depreciation is computed on the straight-line basis over the estimated useful lives of the assets. The Company generally uses a 27.5-year estimated life with no salvage value. For properties purchased subject to an existing lease, the assets are recorded at fair value, allocated to land, building and the existing lease. Any difference between fair value and cost is recorded in the income statement. The lease value is amortized over the expected benefit period (i.e., the lease term).

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

The Company evaluates its long-lived assets for impairment periodically or whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. If an impairment indicator exists, the Company compares the expected future undiscounted cash flows against the carrying amount of an asset. If the sum of the estimated undiscounted cash flows is less that the carrying amount of the asset, the Company would record an impairment loss for the difference between the estimated fair value and the carrying amount of the asset.

The lease periods are generally short term in nature (one year or less) and reflect market rental rates. Gross rental income and expenses applicable to rental income are reported in the statement of comprehensive income in other loss and other operating expenses, respectively. Expenditures for ordinary maintenance and repairs are expensed to operations as incurred and expenditures for significant renovations that improve the asset and extend the useful life of the asset are capitalized and depreciated over their estimated useful life.

Refer to Note 2 to the Consolidated Financial Statements in the Company's 2011 Annual Report on Form 10-K regarding additional significant accounting policies.

Recently Issued and/or Adopted Accounting Standards

Comprehensive Income

In June 2011, the Financial Accounting Standards Board, or FASB, issued ASU No. 2011-05, which amends ASC 820, Comprehensive Income. The amendments are intended to make the presentation of items within Other Comprehensive Income (OCI) more prominent. ASU 2011-05 eliminates the option to present components of OCI in the statement of changes in stockholders' equity and requires companies to present all non-owner changes in stockholders' equity either as a single continuous statement of comprehensive income or as two separate but consecutive statements. In addition, reclassification adjustments between OCI and net income must be presented separately on the face of the financial statements. The new guidance does not change the components of OCI or the calculation of earnings per share. ASU 2011-05 is effective for the first interim or annual period beginning on or after December 15, 2011. Adopting this ASU did not have a material impact on the Company's condensed consolidated financial condition or results of operations. On December 23, 2011, the FASB issued ASU 2011-12, which defers those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments. This was done to allow the FASB time to re-deliberate whether to present on the face of the financial statements the effects of reclassification out of accumulated OCI on the components of net income and comprehensive income for all periods presented. No other requirements under ASU 2011-05 are affected by this update.

Fair Value

In May 2011, the FASB issued ASU No. 2011-04, which amends ASC 820, Fair Value Measurements. The amendments in this ASU clarify the requirements for measuring fair value and disclosing information about fair value. It is intended to improve the comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with GAAP and International Financial Reporting Standards, or IFRS. The ASU is effective for the first interim or annual period beginning on or after December 15, 2011. Adopting this ASU did not have a material impact on the Company's condensed consolidated financial condition or results of operations.

Offsetting Assets and Liabilities

In December 2011, the 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. We anticipate that adopting this ASU will not have a material impact on the Company's condensed consolidated financial condition or results of operations.

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

Note 3. 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 March 31, 2012 and December 31, 2011:

(in thousands)	March 31, 2012	December 31, 2011
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	$2,034,926	$1,609,003
Federal National Mortgage Association	3,801,065	2,414,637
Government National Mortgage Association	1,391,615	1,029,517
Non-Agency	1,943,905	1,196,095
Total mortgage-backed securities	$9,171,511	$6,249,252

At March 31, 2012 and December 31, 2011, the Company pledged investment securities with a carrying value of $8.6 billion and $6.2 billion, respectively, as collateral for repurchase agreements. See Note 12 - Repurchase Agreements.
At March 31, 2012 and December 31, 2011, 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 March 31, 2012 and December 31, 2011:

	March 31, 2012		
(in thousands)	Agency	Non-Agency	Total
Face Value	$7,722,200	$4,233,247	$11,955,447
Unamortized premium	458,949	—	458,949
Unamortized discount			
Designated credit reserve	—	(1,304,753)	(1,304,753)
Net, unamortized	(1,074,953)	(948,373)	(2,023,326)
Amortized Cost	7,106,196	1,980,121	9,086,317
Gross unrealized gains	142,484	48,976	191,460
Gross unrealized losses	(21,074)	(85,192)	(106,266)
Carrying Value	$7,227,606	$1,943,905	$9,171,511

	December 31, 2011		
(in thousands)	Agency	Non-Agency	Total
Face Value	$5,692,754	$2,667,929	$8,360,683
Unamortized premium	279,640	—	279,640
Unamortized discount			
Designated credit reserve	—	(782,606)	(782,606)
Net, unamortized	(1,008,780)	(540,969)	(1,549,749)
Amortized Cost	4,963,614	1,344,354	6,307,968
Gross unrealized gains	108,864	11,881	120,745
Gross unrealized losses	(19,321)	(160,140)	(179,461)
Carrying Value	$5,053,157	$1,196,095	$6,249,252

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

The following tables present the carrying value of the Company's AFS investment securities by rate type as of March 31, 2012 and December 31, 2011:

	March 31, 2012		
(in thousands)	Agency	Non-Agency	Total
Adjustable Rate	$227,164	$1,683,540	$1,910,704
Fixed Rate	7,000,442	260,365	7,260,807
Total	$7,227,606	$1,943,905	$9,171,511

	December 31, 2011		
(in thousands)	Agency	Non-Agency	Total
Adjustable Rate	$231,678	$995,014	$1,226,692
Fixed Rate	4,821,479	201,081	5,022,560
Total	$5,053,157	$1,196,095	$6,249,252

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 an off balance sheet 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, 2012 and 2011 of the unamortized net discount and designated credit reserves on non-Agency AFS securities.

	Three Months Ended March 31,					
	2012			2011		
(in thousands)	Designated Credit Reserve	Unamortized Net Discount	Total	Designated Credit Reserve	Unamortized Net Discount	Total
Beginning balance at January 1	$(782,606)	$(540,969)	$(1,323,575)	$(145,855)	$(129,992)	$(275,847)
Acquisitions	(521,424)	(437,331)	(958,755)	(96,343)	(38,763)	(135,106)
Accretion of net discount	—	28,897	28,897	—	5,376	5,376
Realized credit losses	3,309	—	3,309	771	—	771
Reclassification adjustment for other-than-temporary impairments	(4,275)	—	(4,275)	—	—	—
Transfers from (to)	—	—	—	(123)	123	—
Sales, calls, other	243	1,030	1,273	8,085	5,145	13,230
Ending balance at March 31	$(1,304,753)	$(948,373)	$(2,253,126)	$(233,465)	$(158,111)	$(391,576)

TWO HARBORS INVESTMENT CORP.
Notes to the Condensed 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 the securities had an unrealized loss position as of March 31, 2012 and December 31, 2011. At March 31, 2012, the Company held 1,074 AFS securities, of which 315 were in an unrealized loss position for less than twelve consecutive months and 41 were in an unrealized loss position for more than twelve consecutive months. At December 31, 2011, the Company held 854 AFS securities, of which 264 were in an unrealized loss position for less than twelve months and 20 were in an unrealized loss position for more than twelve consecutive months.

	Unrealized Loss Position for Less than 12 Months		12 Months or More		Total	
(in thousands)	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
March 31, 2012	$2,893,328	$(89,623)	$172,780	$(16,643)	$3,066,108	$(106,266)
December 31, 2011	$1,277,120	$(175,348)	$15,608	$(4,113)	$1,292,728	$(179,461)

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 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 $4.3 million other-than-temporary credit impairment during three months ended March 31, 2012 on a total of fifteen non-Agency RMBS where the future expected cash flows for each security was less than its amortized cost. As of March 31, 2012, the impaired securities had weighted average cumulative losses of 2.5%, weighted average three-month prepayment speed of 2.31, weighted average 60+ day delinquency of 37.5% of the pool balance, and weighted average FICO score of 650. At March 31, 2012 the Company did not intend to sell the securities and it is 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. The Company did not record an other-than-temporary credit impairment during the three months ended March 31, 2011.

The following table presents the OTTI included in earnings for three months ended March 31, 2012 and 2011:

	Three Months Ended March 31,	
(in thousands)	2012	2011
Cumulative credit loss at beginning of period	$(5,102)	$—
Additions:		
Other-than-temporary impairments not previously recognized	(3,483)	—
Increases related to other-than-temporary impairments on securities with previously recognized other-than-temporary impairments	(792)	—
Cumulative credit loss at end of period	$(9,377)	$—

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, net in the Company's condensed consolidated statements of comprehensive income. For the three months ended March 31, 2012, the Company sold AFS securities for $170.1 million with an amortized cost of $159.0 million, for a net

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

realized gain of $11.1 million. For the three months ended March 31, 2011, the Company sold AFS securities for $71.4 million with an amortized cost of $69.8 million, for a net realized gain of $1.6 million.
The following table presents the gross realized gains and losses on sales of AFS securities for the three months ended March 31, 2012 and 2011:

	Three Months Ended March 31,	
(in thousands)	2012	2011
Gross realized gains	$11,103	$1,808
Gross realized losses	—	(170)
Total realized gains on sales, net	$11,103	$1,638

Note 4. Trading Securities, at Fair Value
The Company holds U.S. Treasuries in its taxable REIT subsidiary and classifies these securities as trading instruments due to its short-term investment objectives. As of March 31, 2012 and December 31, 2011, 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 $1.9 million and $3.1 million as of March 31, 2012 and December 31, 2011, respectively.
For the three months ended March 31, 2012, the Company did not sell any trading securities. For the three months ended March 31, 2011, the Company sold trading securities for $199.5 million with an amortized cost of $200.0 million, resulting in realized losses of $0.5 million on the sale of these investment securities. For the three months ended March 31, 2012 and March 31, 2011, trading securities experienced unrealized losses of $1.2 million and unrealized gains of $0.4 million, respectively. Both realized and unrealized gains and losses are recorded as a component of gains on investment securities, net in the Company's condensed consolidated statements of comprehensive income.
At March 31, 2012, the Company pledged trading securities with a carrying value of $1.0 billion as collateral for repurchase agreements. See Note 12 - Repurchase Agreements.

Note 5. 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 March 31, 2012 and December 31, 2011:

(in thousands)	March 31, 2012	December 31, 2011
Unpaid principal balance	$5,629	$5,655
Fair value adjustment	82	127
Carrying value	$5,711	$5,782

At March 31, 2012, the Company pledged mortgage loans with a carrying value of $5.7 million as collateral for repurchase agreements. See Note 12 - Repurchase Agreements.

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Note 6. Investment in Real Estate, Net
Investments in real estate consists of single family residential properties purchased by the Company with the intention to hold and rent the properties. The following table presents the carrying value of the Company's investment in real estate as of March 31, 2012 and December 31, 2011:

(in thousands)	March 31, 2012	December 31, 2011
Land	$1,191	$—
Building	4,917	—
	6,108	—
Accumulated depreciation	(1)	—
Carrying value	$6,107	$—

Note 7. Restricted Cash
As of March 31, 2012 and December 31, 2011, 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 following table presents the Company's restricted cash balances:

(in thousands)	March 31, 2012	December 31, 2011
Restricted cash balances held by:		
Broker counterparties for securities trading activity	$9,000	$9,000
Broker counterparties for derivatives trading activity	99,103	62,784
Repurchase counterparties as restricted collateral	46,180	94,803
Total	$154,283	$166,587

Note 8. Accrued Interest Receivable
The following table presents the Company's accrued interest receivable by collateral type:

(in thousands)	March 31, 2012	December 31, 2011
Accrued Interest Receivable:		
U.S. Treasuries	$1,155	$1,003
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	7,203	5,844
Federal National Mortgage Association	13,830	9,770
Government National Mortgage Association	5,725	4,454
Non-Agency	2,854	2,328
Total mortgage-backed securities	29,612	22,396
Mortgage loans held-for-sale	34	38
Total	$30,801	$23,437

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 Company's primary objective for executing these derivatives 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 and caps. In executing on the Company's current risk management strategy, the Company has entered into interest rate swap and swaption agreements, TBA positions and credit default

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swaps. 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.
Balance Sheet Presentation
The following table presents the gross fair value and notional amounts of the Company's derivative financial instruments treated as trading instruments as of March 31, 2012 and December 31, 2011.

(in thousands)	March 31, 2012				December 31, 2011			
	Derivative Assets		Derivative Liabilities		Derivative Assets		Derivative Liabilities	
Trading instruments	Fair Value	Notional	Fair Value	Notional	Fair Value	Notional	Fair Value	Notional
Inverse interest-only securities	$246,066	1,666,707	$—	—	$157,421	1,131,084	$—	—
Interest rate swap agreements	—	—	(34,540)	7,035,000	—	—	(28,790)	5,810,000
Credit default swap agreements	62,924	541,426	(9,802)	111,450	86,136	544,699	(14,638)	154,812
Swaptions	30,214	4,300,000	—	—	5,635	2,900,000	—	—
TBAs	1,484	500,000	(3,133)	2,000,000	2,664	275,000	(5,652)	850,000
Forward sale commitment	27	5,178	—	—	—	5,202	—	—
Total	$340,715	7,013,311	$(47,475)	9,146,450	$251,856	4,855,985	$(49,080)	6,814,812

The following table provides the average outstanding notional amounts of the Company's derivative financial instruments treated as trading instruments for the three months ended March 31, 2012.

(in thousands)	Three Months Ended March 31, 2012	
Trading instruments	Derivative Assets	Derivative Liabilities
Inverse interest-only securities	1,330,835	—
Interest rate swap agreements	—	6,366,593
Credit default swaps	541,888	137,567
Swaptions	3,573,077	—
TBAs	207,418	754,396
Forward sale commitment	5,186	—

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.

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The following table summarizes the location and amount of gains and losses on derivative instruments reported in the condensed consolidated statement of comprehensive 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 March 31,	
		2012	2011
Risk Management Instruments			
Interest Rate Contracts			
Investment securities - RMBS	(Loss) gain on other derivative instruments	$(2,637)	$(258)
Investment securities - U.S. Treasuries and TBA contracts	(Loss) gain on interest rate swap and swaption agreements	(1,648)	(410)
Mortgage loans held-for-sale	(Loss) gain on other derivative instruments	13	—
Repurchase agreements	(Loss) gain on interest rate swap and swaption agreements	(14,545)	2,349
Credit default swaps - Receive protection	(Loss) gain on other derivative instruments	(24,301)	—
Non-Risk Management Instruments			
Credit default swaps - Provide protection	(Loss) gain on other derivative instruments	8,220	2,338
Inverse interest-only securities	(Loss) gain on other derivative instruments	9,815	3,267
Total		$(25,083)	$7,286

For the three months ended March 31, 2012 and 2011, the Company recognized $4.7 million and $3.2 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 $6.4 billion and $1.3 billion notional, respectively, to 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 months ended March 31, 2012 and 2011, the Company terminated or had options expire on a total of 11 and 4 interest rate swap and swaption positions of $0.9 billion notional and $0.4 billion notional, respectively. Upon settlement of the early terminations and option expirations, the Company paid $0.5 million and $0.4 million in 2012 and 2011, respectively, in full settlement of its net interest spread liability and recognized $11.3 million in realized losses and and $1.3 million in realized gains on the swaps and swaptions in 2012 and 2011, respectively, including early termination penalties.
For the three months ended March 31, 2012, the Company terminated a total of 4 credit default swap positions totaling $85.0 million notional. Upon settlement of the early terminations, the Company received $10,492 in full settlement of its net interest spread receivable and recognized $1.6 million in realized losses on the credit default swaps, including early termination penalties. The Company did not terminate any credit default swap positions during the three months ended March 31, 2011.
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 loss (gain) on interest rate swaps and swaptions and unrealized loss (gain) on other derivative instruments line items and 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 (decrease) increase in due to counterparties, net line items within the investing activities section of the condensed consolidated statements of cash flows.

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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 to further mitigate its exposure to increased prepayment speeds. The objective is to reduce the risk of losses to the portfolio caused by interest rate changes and changes in prepayment speeds.
As of March 31, 2012 and December 31, 2011, the Company had outstanding fair value of $60.6 million and $48.4 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 $500.0 million and $275.0 million in long notional and $2.0 billion and $850.0 million in short notional as of March 31, 2012 and December 31, 2011, respectively. 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. As of March 31, 2012 and December 31, 2011, these contracts held a fair market value of $1.5 million and $2.7 million, included in derivative assets, at fair value, and $3.1 million and $5.7 million, included in derivative liabilities, at fair value, in the condensed consolidated balance sheets as of March 31, 2012 and December 31, 2011, respectively.
Mortgage Loans Held-for-Sale - The Company is exposed to interest rate risk on mortgage loans from the time of purchase until the mortgage loan is sold. 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 entered into a Forward AAA Securities Agreement, or the Forward Agreement, with Barclays Bank PLC, or Barclays, under which Barclays would purchase certain securities issued in connection with a potential securitization transaction involving mortgage loans subject to the Forward Agreement. As of March 31, 2012 and December 31, 2011, one trade has been executed under the Forward Agreement with a notional of $5.2 million for both period ends and a fair value of $26,701 as of March 31, 2012. No fair value was assigned to the derivative at December 31, 2011 as it was entered into at market terms at the end of the year.
Repurchase Agreements - The Company monitors its repurchase agreements, which are generally floating rate debt, in relationship 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 March 31, 2012 and December 31, 2011, the Company had the following outstanding interest rate swaps that were utilized as economic hedges of interest rate risk associated with the Company's short-term repurchase agreements:
(notional in thousands)
March 31, 2012

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2012	25,000	0.868	%	0.563	%	0.73
2013	2,275,000	0.713	%	0.513	%	1.31
2014	1,675,000	0.644	%	0.553	%	2.32
2015	1,670,000	1.136	%	0.504	%	3.09
2016 and Thereafter	390,000	1.342	%	0.498	%	4.46

Total	6,035,000	0.852 %	0.521 %	2.28

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(notional in thousands)
December 31, 2011

Swaps Maturities	Notional Amount	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2012	25,000	0.868	%	0.315	%	0.98
2013	2,025,000	0.737	%	0.368	%	1.55
2014	1,275,000	0.670	%	0.380	%	2.72
2015	820,000	1.575	%	0.329	%	3.52
2016	240,000	2.156	%	0.316	%	4.32
Total	4,385,000	0.952	%	0.361	%	2.41

The Company has also entered into interest rate swaps in combination with U.S. Treasuries to economically hedge funding cost risk. As of March 31, 2012 and December 31, 2011, 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)
March 31, 2012

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2013	1,000,000	0.644	%	0.515	%	1.26
Total	1,000,000					

(notional in thousands)
December 31, 2011

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2013	1,250,000	0.620	%	0.339	%	1.54
Total	1,250,000					

As of March 31, 2012, all of the Company's interest rate swap contracts receive interest at a 1-month or 3-month LIBOR rate. As of December 31, 2011, all of the Company's interest rate swap contracts received interest at a 1-month or 3-month LIBOR rate, except the following interest rate swap entered in combination with TBA contracts to economically hedge mortgage basis widening where the Company paid interest at a 3-month LIBOR rate:

(notional in thousands)
December 31, 2011

Swaps Maturities	Notional Amounts	Average Pay Rate		Average Fixed Receive Rate		Average Maturity (Years)
2016	175,000	0.420	%	1.772	%	4.58
Total	175,000					

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Additionally, as of March 31, 2012 and December 31, 2011, 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:

March 31, 2012 (notional and dollars in thousands)	Option				Underlying Swap			
Swaption	Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Term (Years)
Payer	< 6 Months	$13,653	$452	5.84	1,800,000	3.06 %	3M Libor	4.0
Payer	≥ 6 Months	30,965	29,762	16.40	2,500,000	3.73 %	3M Libor	9.3
Total Payer		$44,618	$30,214	15.89	4,300,000	3.45 %	3M Libor	7.1

December 31, 2011 (notional and dollars in thousands)	Option				Underlying Swap			
Swaption	Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Term (Years)
Payer	< 6 Months							