Two Harbors Investment Corp.
Form 10-Q
August 03, 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: June 30, 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 August 3, 2012 there were 279,354,704 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, 2012 (unaudited)	December 31, 2011
ASSETS		
Available-for-sale securities, at fair value	$10,724,149	$6,249,252
Trading securities, at fair value	999,375	1,003,301
Mortgage loans held-for-sale, at fair value	11,378	5,782
Investment in real estate, net	71,726	—
Cash and cash equivalents	496,674	360,016
Restricted cash	138,336	166,587
Accrued interest receivable	35,954	23,437
Due from counterparties	81,039	32,587
Derivative assets, at fair value	361,073	251,856
Other assets	60,998	7,566
Total Assets	$12,980,702	$8,100,384
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Repurchase agreements	$10,438,441	$6,660,148
Derivative liabilities, at fair value	82,619	49,080
Accrued interest payable	11,545	6,456
Due to counterparties	166,949	45,565
Accrued expenses	11,164	8,912
Dividends payable	87,061	56,239
Income taxes payable	266	3,898
Total liabilities	10,798,045	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 219,655,462 and 140,596,708 shares issued and outstanding, respectively	2,196	1,406
Additional paid-in capital	2,142,554	1,373,099
Receivable from issuance of common stock	(22,248)	—
Accumulated other comprehensive income (loss)	202,798	(58,716)
Cumulative earnings	233,256	157,452
Cumulative distributions to stockholders	(375,899)	(203,155)
Total stockholders' equity	2,182,657	1,270,086
Total Liabilities and Stockholders' Equity	$12,980,702	$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 June 30,		Six Months Ended June 30,	
	2012 (unaudited)	2011	2012 (unaudited)	2011
Interest income:				
Available-for-sale securities	$104,319	$39,959	$188,533	$59,494
Trading securities	1,250	805	2,300	1,077
Mortgage loans held-for-sale	126	—	195	—
Cash and cash equivalents	209	64	377	127
Total interest income	105,904	40,828	191,405	60,698
Interest expense	15,527	3,863	26,994	6,362
Net interest income	90,377	36,965	164,411	54,336
Other-than-temporary impairments:				
Total other-than temporary impairment losses	(4,476)	(294)	(8,751)	(294)
Non-credit portion of loss recognized in other comprehensive income	—	—	—	—
Net other-than-temporary credit impairment losses	(4,476)	(294)	(8,751)	(294)
Other income:				
Gain on investment securities, net	1,789	3,189	11,720	4,728
Loss on interest rate swap and swaption agreements	(61,014)	(50,808)	(77,207)	(48,869)
(Loss) gain on other derivative instruments	(7,617)	9,766	(16,507)	15,113
Other income	131	—	91	—
Total other loss	(66,711)	(37,853)	(81,903)	(29,028)
Expenses:				
Management fees	7,610	2,728	14,353	4,278
Other operating expenses	4,181	2,155	7,782	3,667
Total expenses	11,791	4,883	22,135	7,945
Income (loss) before income taxes	7,399	(6,065)	51,622	17,069
Benefit from income taxes	(16,605)	(5,081)	(24,182)	(4,324)
Net income (loss) attributable to common stockholders	$24,004	$(984)	$75,804	$21,393
Basic and diluted earnings (loss) per weighted average common share	$0.11	$(0.01)	$0.38	$0.35
Dividends declared per common share	$0.40	$0.40	$0.80	$0.80
Basic and diluted weighted average number of shares of common stock	214,810,579	77,101,606	200,833,084	61,443,978
Comprehensive income:				
Net income (loss)	$24,004	$(984)	$75,804	$21,393
Other comprehensive income:				
Unrealized gain on available-for-sale securities, net	117,604	14,514	261,514	23,629
Other comprehensive income	117,604	14,514	261,514	23,629
Comprehensive income	$141,608	$13,530	$337,318	$45,022

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

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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	Receivable from Issuance of Common Stock	Accumulated Other Comprehensive Income (Loss)	Cumulative Earnings	Cumulative Distributions to Stockholders	Total Stockholders' Equity
					(unaudited)			
Balance, January 1, 2011	40,501,212	$405	$366,974	$—	$ 22,619	$30,020	$ (37,570)	$ 382,448
Net income	—	—	—	—	—	21,393	—	21,393
Other comprehensive income	—	—	—	—	23,629	—	—	23,629
Net proceeds from issuance of common stock, net of offering costs	51,769,180	518	522,558	—	—	—	—	523,076
Common dividends declared	—	—	—	—	—	—	(53,112)	(53,112)
Non-cash equity award compensation	7,599	—	147	—	—	—	—	147
Balance, June 30, 2011	92,277,991	$923	$889,679	$—	$ 46,248	$51,413	$ (90,682)	$ 897,581
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	—	—	—	—	261,514	—	—	261,514
Net proceeds from issuance of common stock, net of offering costs	79,058,754	790	769,022	—	—	—	—	769,812
Increase in receivable from issuance of	—	—	—	(22,248)	—	—	—	(22,248)

common stock								
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

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	2011
	(unaudited)	
Cash Flows From Operating Activities:		
Net income	$75,804	$21,393
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of premiums and discounts on RMBS, net	(9,058)	4,693
Other-than-temporary impairment losses	8,751	294
Gain on investment securities, net	(11,720)	(4,728)
Loss on termination and option expiration of interest rate swaps and swaptions	18,540	227
Unrealized loss on interest rate swaps and swaptions	46,296	38,351
Unrealized gain on other derivative instruments	(4,773)	(5,893)
Unrealized gain on mortgage loans	(4)	—
Equity based compensation expense	433	147
Depreciation of real estate	32	—
Purchases of mortgage loans held-for-sale	(6,618)	—
Proceeds from repayment of mortgage loans held-for-sale	1,026	—
Net change in assets and liabilities:		
Increase in accrued interest receivable	(12,517)	(12,334)
Increase in deferred income taxes, net	(19,720)	(4,330)
Increase in current income tax receivable	(4,465)	—
(Increase)/decrease in prepaid and fixed assets	(554)	157
Increase in accrued interest payable, net	5,089	2,085
(Decrease)/increase in income taxes payable	(3,632)	5
Increase in accrued expenses	2,252	2,858
Net cash provided by operating activities	85,162	42,925
Cash Flows From Investing Activities:		
Purchases of available-for-sale securities	(4,696,861)	(3,338,528)
Proceeds from sales of available-for-sale securities	197,714	95,782
Principal payments on available-for-sale securities	295,829	116,651
Purchases of other derivative instruments	(205,440)	(165,831)
Proceeds from sales of other derivative instruments	69,699	19,572
Purchases of trading securities	(996,016)	(1,319,959)
Proceeds from sales of trading securities	1,001,904	500,133
Purchases of investments in real estate	(71,758)	—
Increase in escrow deposits	(28,693)	—
Increase (decrease) in due to counterparties, net	72,932	(19,866)
Decrease (increase) in restricted cash	28,251	(66,695)
Net cash used in investing activities	(4,332,439)	(4,178,741)

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,	
	2012	2011
	(unaudited)	
Cash Flows From Financing Activities:		
Proceeds from repurchase agreements	$23,100,723	$8,283,571
Principal payments on repurchase agreements	(19,322,430)	(4,626,172)
Proceeds from issuance of common stock, net of offering costs	769,812	523,076
Increase in receivable from issuance of common stock	(22,248)	—
Dividends paid on common stock	(141,922)	(26,650)
Net cash provided by financing activities	4,383,935	4,153,825
Net increase in cash and cash equivalents	136,658	18,009
Cash and cash equivalents at beginning of period	360,016	163,900
Cash and cash equivalents at end of period	$496,674	$181,909
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$10,438	$4,277
Cash paid for taxes	$3,635	$1
Non-Cash Financing Activity:		
Dividends declared but not paid at end of period	$87,061	$36,911
Reconciliation of mortgage loans held-for-sale:		
Mortgage loans held-for-sale at beginning of period	$5,782	$—
Purchases of mortgage loans held-for-sale	6,618	—
Proceeds from repayment of mortgage loans held-for-sale	(1,026)	—
Unrealized gain on mortgage loans	4	—
Loans held-for-sale at end of period	$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, 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 MKT 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 June 30, 2012 and results of operations for all periods presented have been made. The results of operations for the three and six months ended June 30, 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 renting the properties. Real estate is recorded at acquisition cost, allocated between land and building. In making estimates of fair values for purposes of allocating purchase price, the Company utilizes information obtained from county tax assessment records to develop regional averages. 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).

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 than 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 income 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 June 30, 2012 and December 31, 2011:

(in thousands)	June 30, 2012	December 31, 2011
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	$2,647,214	$1,609,003
Federal National Mortgage Association	4,412,010	2,414,637
Government National Mortgage Association	1,652,978	1,029,517
Non-Agency	2,011,947	1,196,095
Total mortgage-backed securities	$10,724,149	$6,249,252

At June 30, 2012 and December 31, 2011, the Company pledged investment securities with a carrying value of $10.5 billion and $6.2 billion, respectively, as collateral for repurchase agreements. See Note 12 - Repurchase Agreements.

At June 30, 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 June 30, 2012 and December 31, 2011:

	June 30, 2012		
(in thousands)	Agency	Non-Agency	Total
Face Value	$9,298,257	$4,291,928	$13,590,185
Unamortized premium	548,956	—	548,956
Unamortized discount			
Designated credit reserve	—	(1,322,098)	(1,322,098)
Net, unamortized	(1,351,394)	(944,298)	(2,295,692)
Amortized Cost	8,495,819	2,025,532	10,521,351
Gross unrealized gains	230,117	62,491	292,608
Gross unrealized losses	(13,734)	(76,076)	(89,810)
Carrying Value	$8,712,202	$2,011,947	$10,724,149

	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

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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 June 30, 2012 and December 31, 2011:

	June 30, 2012		
(in thousands)	Agency	Non-Agency	Total
Adjustable Rate	$221,568	$1,750,513	$1,972,081
Fixed Rate	8,490,634	261,434	8,752,068
Total	$8,712,202	$2,011,947	$10,724,149

	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 six months ended June 30, 2012 and 2011 of the unamortized net discount and designated credit reserves on non-Agency AFS securities.

	Six Months Ended June 30,					
	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	(553,552)	(479,435)	(1,032,987)	(249,153)	(168,684)	(417,837)
Accretion of net discount	250	62,768	63,018	—	12,409	12,409
Realized credit losses	17,908	—	17,908	1,242	—	1,242
Reclassification adjustment for other-than-temporary impairments	(8,751)	—	(8,751)	(294)	—	(294)
Transfers from (to)	—	—	—	66	(66)	—
Sales, calls, other	4,653	13,338	17,991	8,253	5,618	13,871
Ending balance at June 30	$(1,322,098)	$(944,298)	$(2,266,396)	$(385,741)	$(280,715)	$(666,456)

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 June 30, 2012 and December 31, 2011. At June 30, 2012, the Company held 1,233 AFS securities, of which 194 were in an unrealized loss position for less than twelve consecutive months and 95 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
June 30, 2012	$1,257,841	$(33,629)	$452,791	$(56,181)	$1,710,632	$(89,810)
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 $4.5 million and an $8.8 million other-than-temporary credit impairment during the three and six months ended June 30, 2012, respectively, on a total of 27 non-Agency RMBS where the future expected cash flows for each security was less than its amortized cost. As of June 30, 2012, the impaired securities had weighted average cumulative losses of 1.1%, weighted average three-month prepayment speed of 2.17, weighted average 60+ day delinquency of 36.1% of the pool balance, and weighted average FICO score of 653. At June 30, 2012, 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, 2011, the Company recorded a $0.3 million other-than-temporary credit impairment on one non-Agency RMBS where the future expected cash flows for each security was less than its amortized cost.
The following table presents the changes in OTTI included in earnings for six months ended June 30, 2012 and 2011:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2012	2011	2012	2011
Cumulative credit loss at beginning of period	$(9,377)	$—	$(5,102)	$—
Additions:				
Other-than-temporary impairments not previously recognized	(2,644)	(294)	(6,128)	(294)
Increases related to other-than-temporary impairments on securities with previously recognized other-than-temporary impairments	(1,832)	—	(2,623)	—

Reductions:				
Decreases related to other-than-temporary impairments on securities paid down	250	—	250	—
Cumulative credit loss at end of period	$(13,603)	$(294)	$(13,603)	$(294)

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Cumulative credit losses related to OTTI may be reduced for securities sold as well as 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, net in the Company's condensed consolidated statements of comprehensive income. For the three and six months ended June 30, 2012, the Company sold AFS securities for $27.6 million and $197.7 million with an amortized cost of $28.7 million and $187.7 million, for a net realized loss of $1.1 million and a net realized gain of $10.0 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, 2012 and 2011:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2012	2011	2012	2011
Gross realized gains	$560	$141	$11,663	$1,949
Gross realized losses	(1,629)	(95)	(1,629)	(265)
Total realized gains on sales, net	$(1,069)	$46	$10,034	$1,684

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 June 30, 2012 and December 31, 2011, the Company held U.S. Treasuries with an amortized cost of $1.0 billion and $1.0 billion and a fair value of $1.0 billion and $1.0 billion, respectively, classified as trading securities. The unrealized gains included within trading securities were $3.0 million and $3.1 million as of June 30, 2012 and December 31, 2011, respectively.

For the three and six months ended June 30, 2012, the Company sold trading securities for $1.0 billion with an amortized cost of $1.0 billion resulting in realized gains of $1.7 million on the sale of these securities. For the three and six months ended June 30, 2012, trading securities experienced unrealized gains of $1.2 million and unrealized losses of $0.1 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 June 30, 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 June 30, 2012 and December 31, 2011:

(in thousands)	June 30, 2012	December 31, 2011
Unpaid principal balance	$11,093	$5,655
Fair value adjustment	285	127
Carrying value	$11,378	$5,782

At June 30, 2012, the Company pledged mortgage loans with a carrying value of $4.8 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 June 30, 2012 and December 31, 2011:

(in thousands)	June 30, 2012	December 31, 2011
Land	$15,106	$—
Building	56,652	—
	71,758	—
Accumulated depreciation	(32)	—
Investment in real estate, net	$71,726	$—

Note 7. 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.

The following table presents the Company's restricted cash balances as of June 30, 2012 and December 31, 2011:

(in thousands)	June 30, 2012	December 31, 2011
Restricted cash balances held by trading counterparties:		
For securities trading activity	$9,000	$9,000
For derivatives trading activity	114,064	62,784
As restricted collateral for repurchase agreements	14,926	94,803
	137,990	166,587
Restricted cash balance pursuant to letter of credit on office lease	346	—
Total	$138,336	$166,587

Note 8. Accrued Interest Receivable

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

(in thousands)	June 30, 2012	December 31, 2011
Accrued Interest Receivable:		
U.S. Treasuries	$1,101	$1,003
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	9,089	5,844
Federal National Mortgage Association	16,049	9,770
Government National Mortgage Association	6,869	4,454
Non-Agency	2,767	2,328
Total mortgage-backed securities	34,774	22,396
Mortgage loans held-for-sale	79	38
Total	$35,954	$23,437

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Note 9. Derivative Instruments and Hedging Activities
The Company enters into a variety of derivative and non-derivative instruments in connection with its risk management activities. The 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, 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, TBA positions and credit default 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 June 30, 2012 and December 31, 2011.

(in thousands)	June 30, 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	$280,672	1,790,065	$—	—	$157,421	1,131,084	$—	—
Interest rate swap agreements	—	—	(71,793)	9,135,000	—	—	(28,790)	5,810,000
Credit default swap agreements	42,173	541,444	(10,826)	83,591	86,136	544,699	(14,638)	154,812
Swaptions	38,228	4,200,000	—	—	5,635	2,900,000	—	—
TBAs	—	—	—	—	2,664	275,000	(5,652)	850,000
Forward purchase commitment	—	32,406	—	—	—	—	—	—
Forward sale commitment	—	—	—	—	—	5,202	—	—
Total	$361,073	6,563,915	$(82,619)	9,218,591	$251,856	4,855,985	$(49,080)	6,814,812

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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, 2012.

(in thousands)	Three Months Ended June 30, 2012		Six Months Ended June 30, 2012	
Trading instruments	Derivative Assets	Derivative Liabilities	Derivative Assets	Derivative Liabilities
Inverse interest-only securities	1,727,601	—	1,529,218	—
Interest rate swap agreements	—	8,154,231	—	7,300,525
Credit default swaps	570,354	88,077	556,121	112,822
Swaptions	3,790,110	—	3,307,792	—
TBAs	324,176	945,055	267,265	854,420
Forward purchase commitment	1,480	—	601	—
Forward sale commitment	4,446	—	4,816	—

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 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 June 30,		Six Months Ended June 30,	
		2012	2011	2012	2011
Risk Management Instruments					
Interest Rate Contracts					
Investment securities - RMBS	(Loss) gain on other derivative instruments	$(22,350)	$(381)	$(24,987)	$(639)
Investment securities - U.S. Treasuries and TBA contracts	(Loss) gain on interest rate swap and swaption agreements	(5,697)	(3,401)	(7,345)	(3,811)
Mortgage loans held-for-sale	(Loss) gain on other derivative instruments	(39)	—	(26)	—
Repurchase agreements	(Loss) gain on interest rate swap and swaption agreements	(55,317)	(47,407)	(69,862)	(45,058)
Credit default swaps - Receive protection	(Loss) gain on other derivative instruments	(1,225)	273	(25,526)	273
Non-Risk Management Instruments					
Credit default swaps - Provide protection	(Loss) gain on other derivative instruments	752	(3,513)	8,972	(1,175)
Inverse interest-only securities	(Loss) gain on other derivative instruments	15,245	13,387	25,060	16,654
Total		$(68,631)	$(41,042)	$(93,714)	$(33,756)

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For the three and six months ended June 30, 2012, the Company recognized $7.7 million and $12.4 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 $8.2 billion and $7.3 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 and six months ended June 30, 2012, the Company terminated or had options expire on a total of 8 and 19 interest rate swap and swaption positions of $2.0 billion notional and $2.9 billion notional, respectively. Upon settlement of the early terminations and option expirations, the Company paid $1.0 million and $1.5 million in full settlement of its net interest spread liability and recognized $7.3 million and $18.5 million in realized losses on the swaps and swaptions, respectively, including early termination penalties.
For the three and six months ended June 30, 2012, the Company terminated a total of 6 and 10 credit default swap positions totaling $155.0 million and $240.0 million notional, respectively. Upon settlement of the early terminations, the Company received $73,700 and $63,208 in full settlement of its net interest spread receivable and recognized $1.7 million and $3.3 million in realized losses on the credit default swaps, including early termination penalties.
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 increase (decrease) in due to counterparties, net line items within the investing activities section of the condensed consolidated statements of cash flows.
Interest Rate Sensitive Assets/Liabilities
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 June 30, 2012 and December 31, 2011, the Company had outstanding fair value of $61.2 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. The Company did not hold any long or short notional TBA positions as of June 30, 2012, but held TBA positions with $275.0 million in long notional and $850.0 million in short notional as of 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 December 31, 2011, these contracts held a fair market value of $2.7 million, included in derivative assets, at fair value, and $5.7 million, included in derivative liabilities, at fair value, in the condensed consolidated balance sheet as of December 31, 2011.
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, 2012, the Company had entered into commitments to purchase mortgage loans of $32.4 million, subject to fallout if the loans do not close. No fair value was assigned to the derivative at June 30, 2012 as it was entered into at market terms at the end of the period.
The Company is exposed to interest rate risk on mortgage loans from the time it commits to purchase the mortgage loan 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 may from time to time enter into a forward sale commitment under the Forward AAA Securities

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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 December 31, 2011, one trade had been executed under the Forward Agreement with a notional of $5.2 million. 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. This trade was settled by the Company in the three months ended June 30, 2012. As of June 30, 2012, the Company had no additional trades under the Forward Agreement.

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 June 30, 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)
June 30, 2012

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2012	25,000	0.868	%	0.522	%	0.48
2013	2,275,000	0.713	%	0.500	%	1.06
2014	1,675,000	0.644	%	0.517	%	2.07
2015	2,070,000	1.039	%	0.447	%	2.87
2016 and Thereafter	2,090,000	1.053	%	0.476	%	4.28
Total	8,135,000	0.870	%	0.484	%	2.55

(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 June 30, 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)
June 30, 2012

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2015	1,000,000	0.799	%	0.476	%	2.78
Total	1,000,000					

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(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 June 30, 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			

Additionally, as of June 30, 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:
June 30, 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	$9,540	$3	3.38	1,000,000	2.95 %	3M Libor	5.4
Payer	≥ 6 Months	60,800	38,225	48.33	3,200,000	3.70 %	3M Libor	9.6
Total Payer		$70,340	$38,228	48.33	4,200,000	3.52 %	3M Libor	8.6

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	$16,147	$4	4.97	1,600,000	3.22 %	3M Libor	3.7
Payer	≥ 6 Months	13,523	5,631	12.27	1,300,000	3.19 %	3M Libor	6.5
Total Payer		$29,670	$5,635	12.26	2,900,000	3.21 %	3M Libor	4.9

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.

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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 government sponsored entities, 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, the Company enters 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.

As of June 30, 2012, the Company held credit default swaps where 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 where the Company is receiving protection held as of June 30, 2012 and December 31, 2011:

(notional and dollars in thousands)
June 30, 2012

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)	$47	$ (3,127)	$(3,080)
	12/20/2013	181.91	(105,000)	479	(3,225)	(2,746)
	6/20/2016	105.50	(100,000)	(1,051)	(260)	(1,311)
	12/20/2016	682.82	(121,000)	4,360	(13,062)	(8,702)
	6/20/2017	586.18	(99,000)	3,190	(3,563)	(373)
	5/25/2046	356.00	(71,444)	35,148	(32,558)	2,590
	Total	365.95	(541,444)	$42,173	$ (55,795)	$(13,622)

(notional and dollars in thousands)
December 31, 2011

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)	$2,422	$ (3,127)	$(705)
	12/20/2013	172.50	(105,000)	3,742	(3,225)	517
	6/20/2016	105.00	(150,000)	2,074	(355)	1,719
	12/20/2016	684.38	(125,000)	10,200	(13,062)	(2,862)
	5/25/2046	377.23	(119,699)	67,698	(57,322)	10,376
	Total	341.94	(544,699)	$86,136	$ (77,091)	$9,045

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Derivative financial instruments contain an element of credit risk if counterparties are unable to meet the terms of the agreements. Credit risk associated with derivative financial instruments is measured as the net replacement cost should the counterparties that owe the Company under contracts completely fail to perform under the terms of these contracts, assuming there are no recoveries of underlying collateral, as measured by the market value of the derivative financial instruments. As of June 30, 2012, the fair value of derivative financial instruments as an asset and liability position was $361.1 million and $82.6 million, respectively.

The Company mitigates the credit risk exposure on derivative financial instruments by limiting the counterparties to those major banks and financial institutions that meet established credit guidelines, and the Company seeks to transact with several different counterparties in order to reduce the exposure to any single counterparty. Additionally, the Company reduces credit risk on the majority of its derivative instruments by entering into agreements that permit the closeout and netting of transactions with the same counterparty upon occurrence of certain events. To further mitigate the risk of counterparty default, the Company maintains collateral agreements with certain of its counterparties. The agreements require both parties to maintain cash deposits in the event the fair values of the derivative financial instruments exceed established thresholds. As of June 30, 2012, the Company has received cash deposits from counterparties of $34.2 million and placed cash deposits of $124.1 million in accounts maintained by counterparties, of which the amounts are netted on a counterparty basis and classified within restricted cash, due from counterparties, or due to counterparties on the condensed consolidated balance sheet.

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

Non-Risk Management Activities

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

Inverse interest-only securities with a carrying value of $280.7 million, including accrued interest receivable of $3.5 million, are accounted for as derivative financial instruments in the condensed consolidated financial statements. The following table presents the amortized cost and carrying value (which approximates fair value) of inverse interest-only securities as of June 30, 2012 and December 31, 2011:

(in thousands)	June 30, 2012	December 31, 2011
Face Value	$1,790,065	$1,131,084
Unamortized premium	—	—
Unamortized discount		
Designated credit reserve	—	—
Net, unamortized	(1,520,825)	(973,066)
Amortized Cost	269,240	158,018
Gross unrealized gains	15,138	4,606
Gross unrealized losses	(7,166)	(7,385)
Carrying Value	$277,212	$155,239

As of June 30, 2012 and December 31, 2011, the Company also held credit default swaps where the Company provides credit protection for a fixed premium. The maximum payouts for these credit default swaps are limited to the current notional amounts of each swap contract. Maximum payouts for credit default swaps do not represent the expected future cash requirements, as the Company's credit default swaps are typically liquidated or expire and are not exercised by the holder of the credit default swaps.

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

The following tables present credit default swaps where the Company is providing protection held as of June 30, 2012 and December 31, 2011:
(notional and dollars in thousands)
June 30, 2012

Protection	Maturity Date	Average Implied Credit Spread	Current Notional Amount	Fair Value	Upfront (Payable)/Receivable	Unrealized Gain/(Loss)
Provide	7/25/2036	345.69	33,577	$2,186	$ (6,374)	$(4,188)
	5/25/2046	146.18	50,014	(13,012)	13,573	561
		226.32	83,591	$(10,826)	$ 7,199	$(3,627)

(notional and dollars in thousands)