MORGAN STANLEY
Form 424B2
July 31, 2018

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities Offered	*Maximum Aggregate Offering Price*	*Amount of Registration Fee*
Contingent Income Auto Callable Securities due 2021-	$11,948,620	$1,487.60

July 2018

Pricing Supplement No. 816

Registration Statement Nos. 333-221595; 333-221595-01

Dated July 27, 2018

Filed pursuant to Rule 424(b)(2)

Morgan Stanley Finance LLC

Structured Investments

Opportunities in U.S. Equities

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Fully and Unconditionally Guaranteed by Morgan Stanley

Principal at Risk Securities

Contingent Income Auto-Callable Securities do not guarantee the payment of interest or the repayment of principal. Instead, the securities offer the opportunity for investors to earn a contingent quarterly coupon at an annual rate of 8.85%, but only with respect to each determination date on which the determination closing price of the underlying stock is greater than or equal to 75% of the initial share price, which we refer to as the downside threshold price. In addition, if the determination closing price of the underlying stock is greater than or equal to the initial share price on any determination date, the securities will be automatically redeemed for an amount per security equal to the stated principal amount and the contingent quarterly coupon. However, if the securities are not automatically redeemed prior to maturity, the payment at maturity due on the securities will be as follows: (i) if the final share price is greater than or equal to the downside threshold price, the stated principal amount and the contingent quarterly coupon with respect to the final determination date, or (ii) if the final share price is less than the downside threshold price, investors will be exposed to the decline in the underlying stock on a 1-to-1 basis and will receive a payment at maturity that is less than 75% of the principal amount of the securities and could be zero. Moreover, if on any determination date the determination closing price of the underlying stock is less than the downside threshold price, you will not receive any contingent quarterly coupon for that quarterly period. As a result, investors must be willing to accept the risk of not receiving any contingent quarterly coupons and also the risk of receiving a payment at maturity that is significantly less than the stated principal amount of the securities and could be zero. **Accordingly, investors could lose their entire initial investment in the securities.** The securities are for investors who are willing to risk their principal and seek an opportunity to earn interest at a potentially above-market rate in exchange for the risk of receiving few or no contingent quarterly coupons over the 3-year term of the securities. Investors will not participate in any appreciation of the underlying stock. The securities are unsecured obligations of Morgan Stanley Finance LLC ("MSFL") and are fully and unconditionally guaranteed by Morgan Stanley. The securities are issued as part of MSFL's Series A Global Medium-Term Notes program.

All payments are subject to our credit risk. If we default on our obligations, you could lose some or all of your investment. These securities are not secured obligations and you will not have any security interest in, or otherwise have any access to, any underlying reference asset or assets.

FINAL Terms

Issuer:	Morgan Stanley Finance LLC
Guarantor:	Morgan Stanley
Underlying stock:	Facebook, Inc. common stock
Aggregate principal amount:	$11,948,620
Stated principal amount:	$10 per security
Issue price:	$10 per security
Pricing date:	July 27, 2018
Original issue date:	August 1, 2018 (3 business days after the pricing date)
Maturity date:	July 30, 2021
Early redemption:	If, on any of the first eleven determination dates, the determination closing price of the underlying stock is greater than or equal to the initial share price, the securities will be automatically redeemed for an early redemption payment on the third business day following the related determination date. No further payments will be made on the securities once they have been redeemed.
Early redemption payment:	The early redemption payment will be an amount equal to (i) the stated principal amount *plus* (ii) the contingent quarterly coupon with respect to the related determination date.
Determination closing price:	The closing price of the underlying stock on any determination date other than the final determination date *times* the adjustment factor on such determination date.
Contingent quarterly coupon:	· If, on any determination date, the determination closing price or the final share price, as applicable, is

	greater than or equal to the downside threshold price, we will pay a contingent quarterly coupon at an annual rate of 8.85% (corresponding to approximately $0.22125 per quarter per security) on the related contingent payment date. · If, on any determination date, the determination closing price or the final share price, as applicable, is less than the downside threshold price, no contingent quarterly coupon will be paid with respect to that determination date.
Determination dates:	October 29, 2018, January 28, 2019, April 29, 2019, July 29, 2019, October 28, 2019, January 27, 2020, April 27, 2020, July 27, 2020, October 27, 2020, January 27, 2021, April 27, 2021 and July 27, 2021, subject to postponement for non-trading days and certain market disruption events. We also refer to July 27, 2021 as the final determination date.
Contingent payment dates:	With respect to each determination date other than the final determination date, the third business day after the related determination date. The payment of the contingent quarterly coupon, if any, with respect to the final determination date will be made on the maturity date.
Payment at maturity:	· If the final share price is **greater than or equal to** the downside threshold price: (i) the stated principal amount *plus* (ii) the contingent quarterly coupon with respect to the final determination date · If the final share price is **less than** the downside threshold price: (i) the stated principal amount *multiplied by* (ii) the share performance factor
Share performance factor:	Final share price divided by the initial share price
Adjustment factor:	

	1.0, subject to adjustment in the event of certain corporate events affecting the underlying stock
Downside threshold price:	$131.168, which is equal to approximately 75% of the initial share price
Initial share price:	$174.89, which is equal to the closing price of the underlying stock on the pricing date
Final share price:	The closing price of the underlying stock on the final determination date *times* the adjustment factor on such date
CUSIP:	61768R427
ISIN:	US61768R4276
Listing:	The securities will not be listed on any securities exchange.
Agent:	Morgan Stanley & Co. LLC ("MS & Co."), an affiliate of MSFL and a wholly owned subsidiary of Morgan Stanley. See "Supplemental information regarding plan of distribution; conflicts of interest."
Estimated value on the pricing date:	$9.619 per security. See "Investment Summary" beginning on page 2.

Commissions and issue price:	Price to public	Agent's commissions and fees	Proceeds to us(3)
Per security	$10	$0.20(1)	
		$0.05(2)	$9.75
Total	$11,948,620	$298,715.50	$11,649,904.50

(1) Selected dealers, including Morgan Stanley Wealth Management (an affiliate of the agent), and their financial advisors will collectively receive from the agent, MS & Co., a fixed sales commission of $0.20 for each security they sell. See "Supplemental information regarding plan of distribution; conflicts of interest." For additional information, see "Plan of Distribution (Conflicts of Interest)" in the accompanying product supplement.

(2) Reflects a structuring fee payable to Morgan Stanley Wealth Management by the agent or its affiliates of $0.05 for each security.

(3) See "Use of proceeds and hedging" on page 17.

The securities involve risks not associated with an investment in ordinary debt securities. See "Risk Factors" beginning on page 7.

The Securities and Exchange Commission and state securities regulators have not approved or disapproved these securities, or determined if this document or the accompanying product supplement and prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The securities are not deposits or savings accounts and are not insured by the Federal Deposit Insurance Corporation or any other governmental agency or instrumentality, nor are they obligations of, or guaranteed by, a bank.

You should read this document together with the related product supplement and prospectus, each of which can be accessed via the hyperlinks below. Please also see "Additional Information About the Securities" at the end of this document.

As used in this document, "we," "us" and "our" refer to Morgan Stanley or MSFL, or Morgan Stanley and MSFL collectively, as the context requires.

Product Supplement for Auto-Callable Securities dated November 16, 2017 **Prospectus dated November 16, 2017**

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

Investment Summary

Contingent Income Auto-Callable Securities

Principal at Risk Securities

The Contingent Income Auto-Callable Securities due July 30, 2021 Based on the Performance of the Common Stock of Facebook, Inc., which we refer to as the securities, provide an opportunity for investors to earn a contingent quarterly coupon at an annual rate of 8.85% with respect to each quarterly determination date on which the determination closing price or the final share price, as applicable, is greater than or equal to 75% of the initial share price, which we refer to as the downside threshold price. It is possible that the closing price of the underlying stock could remain below the downside threshold price for extended periods of time or even throughout the term of the securities so that you may receive few or no contingent quarterly coupons. If the determination closing price is greater than or equal to the initial share price on any of the first eleven determination dates, the securities will be automatically redeemed for an early redemption payment equal to the stated principal amount *plus* the contingent quarterly coupon with respect to the related determination date. If the securities have not previously been redeemed and the final share price is greater than or equal to the downside threshold price, the payment at maturity will also be the sum of the stated principal amount and the contingent quarterly coupon with respect to the related determination date. However, if the securities have not previously been redeemed and the final share price is less than the downside threshold price, investors will be exposed to the decline in the closing price of the underlying stock, as compared to the initial share price, on a 1-to-1 basis. In this case, the payment at maturity will be less than 75% of the stated principal amount of the securities and could be zero. Investors in the securities must be willing to accept the risk of losing their entire principal and also the risk of not receiving any contingent quarterly coupon. In addition, investors will not participate in any appreciation of the underlying stock.

The original issue price of each security is $10. This price includes costs associated with issuing, selling, structuring and hedging the securities, which are borne by you, and, consequently, the estimated value of the securities on the pricing date is less than $10. We estimate that the value of each security on the pricing date is $9.619.

What goes into the estimated value on the pricing date?

In valuing the securities on the pricing date, we take into account that the securities comprise both a debt component and a performance-based component linked to the underlying stock. The estimated value of the securities is determined using our own pricing and valuation models, market inputs and assumptions relating to the underlying stock, instruments based on the underlying stock, volatility and other factors including current and expected interest rates, as well as an interest rate related to our secondary market credit spread, which is the implied interest rate at which our conventional fixed rate debt trades in the secondary market.

What determines the economic terms of the securities?

In determining the economic terms of the securities, including the contingent quarterly coupon rate and the downside threshold price, we use an internal funding rate, which is likely to be lower than our secondary market credit spreads and therefore advantageous to us. If the issuing, selling, structuring and hedging costs borne by you were lower or if the internal funding rate were higher, one or more of the economic terms of the securities would be more favorable to you.

What is the relationship between the estimated value on the pricing date and the secondary market price of the securities?

The price at which MS & Co. purchases the securities in the secondary market, absent changes in market conditions, including those related to the underlying stock, may vary from, and be lower than, the estimated value on the pricing date, because the secondary market price takes into account our secondary market credit spread as well as the bid-offer spread that MS & Co. would charge in a secondary market transaction of this type and other factors. However, because the costs associated with issuing, selling, structuring and hedging the securities are not fully deducted upon issuance, for a period of up to 6 months following the issue date, to the extent that MS & Co. may buy or sell the securities in the secondary market, absent changes in market conditions, including those related to the underlying stock, and to our secondary market credit spreads, it would do so based on values higher than the estimated value. We expect that those higher values will also be reflected in your brokerage account statements.

MS & Co. may, but is not obligated to, make a market in the securities, and, if it once chooses to make a market, may cease doing so at any time.

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

Key Investment Rationale

The securities offer investors an opportunity to earn a contingent quarterly coupon at an annual rate of 8.85% with respect to each determination date on which the determination closing price or the final share price, as applicable, is greater than or equal to 75% of the initial share price, which we refer to as the downside threshold price. The securities may be redeemed prior to maturity for the stated principal amount per security *plus* the applicable contingent quarterly coupon, and the payment at maturity will vary depending on the final share price, as follows:

	On any of the first eleven determination dates, the determination closing price is *greater than or equal to* the initial share price.
Scenario 1	§ The securities will be automatically redeemed for (i) the stated principal amount plus (ii) the contingent quarterly coupon with respect to the related determination date.
	§ Investors will not participate in any appreciation of the underlying stock from the initial share price.
	The securities are not automatically redeemed prior to maturity, and the final share price is *greater than or equal to* the downside threshold price.
Scenario 2	§ The payment due at maturity will be (i) the stated principal amount plus (ii) the contingent quarterly coupon with respect to the final determination date.
	§ Investors will not participate in any appreciation of the underlying stock from the initial share price.

Scenario 3	**The securities are not automatically redeemed prior to maturity, and the final share price is *less than* the downside threshold price.**

§ The payment due at maturity will be equal to (i) the stated principal amount multiplied by (ii) the share performance factor. **Investors will lose a significant portion, and may lose all, of their principal in this scenario.**

July 2018 Page 3

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

How the Securities Work

The following diagrams illustrate the potential outcomes for the securities depending on (1) the determination closing price and (2) the final share price.

Diagram #1: First Eleven Determination Dates

Diagram #2: Payment at Maturity if No Automatic Early Redemption Occurs

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

Hypothetical Examples

The below examples are based on the following terms:

Hypothetical Initial Share Price:	$210.00
Hypothetical Downside Threshold Price:	$157.50, which is 75% of the hypothetical initial share price
Hypothetical Adjustment Factor:	1.0
Contingent Quarterly Coupon:	8.85% per annum (corresponding to approximately $0.22125 per quarter per security)[1]
Stated Principal Amount:	$10 per security

1 The actual contingent quarterly coupon will be an amount determined by the calculation agent based on the number of days in the applicable payment period, calculated on a 30/360 day count basis. The hypothetical contingent quarterly coupon of $0.22125 is used in these examples for ease of analysis.

In Examples 1 and 2, the closing price of the underlying stock fluctuates over the term of the securities and the determination closing price of the underlying stock is greater than or equal to the hypothetical initial share price of $210.00 on one of the first eleven determination dates. Because the determination closing price is greater than or equal to the initial share price on one of the first eleven determination dates, the securities are automatically redeemed following the relevant determination date. In Examples 3 and 4, the determination closing price on the first eleven determination dates is less than the initial share price, and, consequently, the securities are not automatically redeemed prior to, and remain outstanding until, maturity.

	Example 1			Example 2		
Determination Dates	Hypothetical Determination Closing Price	Contingent Quarterly Coupon	Early Redemption Amount*	Hypothetical Determination Closing Price	Contingent Quarterly Coupon	Early Redemption Amount
#1	$150.30	$0	N/A	$195.25	$0.22125	N/A
#2	$210.00	—*	$10.22125	$133.90	$0	N/A
#3	N/A	N/A	N/A	$199.70	$0.22125	N/A
#4	N/A	N/A	N/A	$136.60	$0	N/A
#5	N/A	N/A	N/A	$157.75	$0.22125	N/A

#6	N/A	N/A	N/A	$191.25	$0.22125	N/A
#7	N/A	N/A	N/A	$113.65	$0	N/A
#8	N/A	N/A	N/A	$175.50	$0.22125	N/A
#9	N/A	N/A	N/A	$184.55	$0.22125	N/A
#10	N/A	N/A	N/A	$252.00	—*	$10.22125
#11	N/A	N/A	N/A	N/A	N/A	N/A
Final Determination Date	N/A	N/A	N/A	N/A	N/A	N/A

* The Early Redemption Amount includes the unpaid contingent quarterly coupon with respect to the determination date on which the determination closing price is greater than or equal to the initial share price and the securities are redeemed as a result.

§ In **Example 1**, the securities are automatically redeemed following the second determination date, as the determination closing price on the second determination date is equal to the initial share price. You receive the early redemption payment, calculated as follows:

stated principal amount + contingent quarterly coupon = $10.00 + $0.22125 = $10.22125

In this example, the early redemption feature limits the term of your investment to approximately 6 months, and you may not be able to reinvest at comparable terms or returns. If the securities are redeemed early, you will stop receiving contingent coupons.

§ In **Example 2**, the securities are automatically redeemed following the tenth determination date, as the determination closing price on the tenth determination date is greater than the initial share price. As the determination closing prices on the first, third, fifth, sixth, eighth, ninth and tenth determination dates are greater than or equal to the downside threshold price, you receive the contingent

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

coupon of $0.22125 with respect to each such determination date. Following the tenth determination date, you receive an early redemption amount of $10.22125, which includes the contingent quarterly coupon with respect to the tenth determination date.

In this example, the early redemption feature limits the term of your investment to approximately 30 months, and you may not be able to reinvest at comparable terms or returns. If the securities are redeemed early, you will stop receiving contingent coupons. Further, although the underlying stock has appreciated by 20% from its initial share price as of the tenth determination date, you receive only $10.22125 per security and do not benefit from such appreciation.

Determination Dates	Example 3 Hypothetical Determination Closing Price / Final Share Price	Contingent Quarterly Coupon	Early Redemption Amount*	Example 4 Hypothetical Determination Closing Price / Final Share Price	Contingent Quarterly Coupon	Early Redemption Amount
#1	$150.30	$0	N/A	$111.25	$0	N/A
#2	$133.90	$0	N/A	$136.70	$0	N/A
#3	$136.60	$0	N/A	$105.25	$0	N/A
#4	$117.75	$0	N/A	$113.65	$0	N/A
#5	$144.00	$0	N/A	$111.05	$0	N/A
#6	$99.60	$0	N/A	$122.05	$0	N/A
#7	$133.40	$0	N/A	$111.30	$0	N/A
#8	$128.70	$0	N/A	$152.65	$0	N/A
#9	$128.85	$0	N/A	$133.25	$0	N/A
#10	$143.25	$0	N/A	$112.25	$0	N/A
#11	$129.75	$0	N/A	$105.30	$0	N/A
Final Determination Date	$126.00	$0	N/A	$178.50	—*	N/A
Payment at Maturity	**$6.00**			**$10.22125**		

*The final contingent quarterly coupon, if any, will be paid at maturity.

Examples 3 and 4 illustrate the payment at maturity per security based on the final share price.

§ In **Example 3**, the closing price of the underlying stock remains below the downside threshold price on every determination date. As a result, you do not receive any contingent coupons during the term of the securities and, at maturity, you are fully exposed to the decline in the closing price of the underlying stock. As the final share price is less than the downside threshold price, investors will receive a payment at maturity equal to the stated principal amount multiplied by the share performance factor, calculated as follows:

stated principal amount x share performance factor = $10.00 x ($126.00 / $210.00) = $6.00

In this example, the payment at maturity is significantly less than the stated principal amount.

§ In **Example 4**, the closing price of the underlying stock decreases to a final share price of $178.50. Although the final share price is less than the initial share price, because the final share price is still not less than the downside threshold price, you receive the stated principal amount plus a contingent quarterly coupon with respect to the final determination date. Your payment at maturity is calculated as follows:

$10.00 + $0.22125 = $10.22125

In this example, although the final share price represents a 15% decline from the initial share price, you receive the stated principal amount per security plus the final contingent quarterly coupon, equal to a total payment of $10.22125 per security at maturity, because the final share price is not less than the downside threshold price.

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

Risk Factors

The following is a non-exhaustive list of certain key risk factors for investors in the securities. For further discussion of these and other risks, you should read the section entitled "Risk Factors" in the accompanying product supplement and prospectus. You should also consult your investment, legal, tax, accounting and other advisers in connection with your investment in the securities.

§ **The securities do not guarantee the return of any principal.** The terms of the securities differ from those of ordinary debt securities in that the securities do not guarantee the payment of regular interest or the return of any of the principal amount at maturity. Instead, if the securities have not been automatically redeemed prior to maturity and if the final share price is less than the downside threshold price, you will be exposed to the decline in the closing price of the underlying stock, as compared to the initial share price, on a 1-to-1 basis and you will receive a payment that will be less than 75% of the stated principal amount and could be zero.

§ **You will not receive any contingent quarterly coupon for any quarterly period where the determination closing price is less than the downside threshold price.** A contingent quarterly coupon will be paid with respect to a quarterly period only if the determination closing price is greater than or equal to the downside threshold price. If the determination closing price remains below the downside threshold price on each determination date over the term of the securities, you will not receive any contingent quarterly coupons.

§ **The contingent quarterly coupon, if any, is based solely on the determination closing price or the final share price, as applicable.** Whether the contingent quarterly coupon will be paid with respect to a determination date will be based on the determination closing price or the final share price, as applicable. As a result, you will not know whether you will receive the contingent quarterly coupon until the related determination date. Moreover, because the contingent quarterly coupon is based solely on the determination closing price on a specific determination date or the final share price, as applicable, if such determination closing price or final share price is less than the downside threshold price, you will not receive any contingent quarterly coupon with respect to such determination date, even if the closing price of the underlying stock was higher on other days during the term of the securities.

§ **Investors will not participate in any appreciation in the price of the underlying stock.** Investors will not participate in any appreciation in the price of the underlying stock from the initial share price, and the return on the securities will be limited to the contingent quarterly coupon, if any, that is paid with respect to each determination date on which the determination closing price or the final share price, as applicable, is greater than or equal to the downside threshold price. It is possible that the closing price of the underlying stock could be below the downside threshold price on most or all of the determination dates so that you will receive few or no contingent quarterly coupons. If you do not earn sufficient contingent quarterly coupons over the term of the securities, the overall return on the securities may be less than the amount that would be paid on a conventional debt security of ours of comparable maturity.

§ **The automatic early redemption feature may limit the term of your investment to approximately three months. If the securities are redeemed early, you may not be able to reinvest at comparable terms or returns.** The term of your investment in the securities may be limited to as short as approximately three months by the automatic early redemption feature of the securities. If the securities are redeemed prior to maturity, you will receive no more contingent quarterly coupons and may be forced to invest in a lower interest rate environment and may not be able to reinvest at comparable terms or returns.

§ **The market price will be influenced by many unpredictable factors.** Several factors will influence the value of the securities in the secondary market and the price at which MS & Co. may be willing to purchase or sell the securities in the secondary market. Although we expect that generally the closing price of the underlying stock on any day will affect the value of the securities more than any other single factor, other factors that may influence the value of the securities include:

o the trading price and volatility (frequency and magnitude of changes in value) of the underlying stock,

o whether the determination closing price has been below the downside threshold price on any determination date,

o dividend rates on the underlying stock,

o interest and yield rates in the market,

o time remaining until the securities mature,

o geopolitical conditions and economic, financial, political, regulatory or judicial events that affect the underlying stock and which may affect the final share price of the underlying stock,

o the occurrence of certain events affecting the underlying stock that may or may not require an adjustment to the adjustment factor, and

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

- o any actual or anticipated changes in our credit ratings or credit spreads.

The price of the underlying stock may be, and has recently been, volatile, and we can give you no assurance that the volatility will lessen. See "Facebook, Inc. Overview" below. You may receive less, and possibly significantly less, than the stated principal amount per security if you try to sell your securities prior to maturity.

§ **The securities are subject to our credit risk, and any actual or anticipated changes to our credit ratings or credit spreads may adversely affect the market value of the securities.** You are dependent on our ability to pay all amounts due on the securities on each contingent payment date, upon automatic redemption or at maturity, and therefore you are subject to our credit risk. If we default on our obligations under the securities, your investment would be at risk and you could lose some or all of your investment. As a result, the market value of the securities prior to maturity will be affected by changes in the market's view of our creditworthiness. Any actual or anticipated decline in our credit ratings or increase in the credit spreads charged by the market for taking our credit risk is likely to adversely affect the market value of the securities.

§ **As a finance subsidiary, MSFL has no independent operations and will have no independent assets.** As a finance subsidiary, MSFL has no independent operations beyond the issuance and administration of its securities and will have no independent assets available for distributions to holders of MSFL securities if they make claims in respect of such securities in a bankruptcy, resolution or similar proceeding. Accordingly, any recoveries by such holders will be limited to those available under the related guarantee by Morgan Stanley and that guarantee will rank *pari passu* with all other unsecured, unsubordinated obligations of Morgan Stanley. Holders will have recourse only to a single claim against Morgan Stanley and its assets under the guarantee. Holders of securities issued by MSFL should accordingly assume that in any such proceedings they would not have any priority over and should be treated *pari passu* with the claims of other unsecured, unsubordinated creditors of Morgan Stanley, including holders of Morgan Stanley-issued securities.

§ **Investing in the securities is not equivalent to investing in the common stock of Facebook, Inc.** Investors in the securities will not have voting rights or rights to receive dividends or other distributions or any other rights with respect to the underlying stock.

§ **No affiliation with Facebook, Inc.** Facebook, Inc. is not an affiliate of ours, is not involved with this offering in any way, and has no obligation to consider your interests in taking any corporate actions that might affect the value of the securities. We have not made any due diligence inquiry with respect to Facebook, Inc. in connection with this offering.

§ **We may engage in business with or involving Facebook, Inc. without regard to your interests.** We or our affiliates may presently or from time to time engage in business with Facebook, Inc. without regard to your interests and thus may acquire non-public information about Facebook, Inc. Neither we nor any of our affiliates undertakes to disclose any such information to you. In addition, we or our affiliates from time to time have published and in the future may publish research reports with respect to Facebook, Inc., which may or may not recommend that investors buy or hold the underlying stock.

§ **The antidilution adjustments the calculation agent is required to make do not cover every corporate event that could affect the underlying stock.** MS & Co., as calculation agent, will adjust the adjustment factor for certain corporate events affecting the underlying stock, such as stock splits and stock dividends, and certain other corporate actions involving the issuer of the underlying stock, such as mergers. However, the calculation agent will not make an adjustment for every corporate event that can affect the underlying stock. For example, the calculation agent is not required to make any adjustments if the issuer of the underlying stock or anyone else makes a partial tender or partial exchange offer for the underlying stock, nor will adjustments be made following the final determination date. If an event occurs that does not require the calculation agent to adjust the adjustment factor, the market price of the securities may be materially and adversely affected.

§ **The securities will not be listed on any securities exchange and secondary trading may be limited.** The securities will not be listed on any securities exchange. Therefore, there may be little or no secondary market for the securities. MS & Co. may, but is not obligated to, make a market in the securities and, if it once chooses to make a market, may cease doing so at any time. When it does make a market, it will generally do so for transactions of routine secondary market size at prices based on its estimate of the current value of the securities, taking into account its bid/offer spread, our credit spreads, market volatility, the notional size of the proposed sale, the cost of unwinding any related hedging positions, the time remaining to maturity and the likelihood that it will be able to resell the securities. Even if there is a secondary market, it may not provide enough liquidity to allow you to trade or sell the securities easily. Since other broker-dealers may not participate significantly in the secondary market for the securities, the price at which you may be able to trade your securities is likely to depend on the price, if any, at which MS & Co. is willing to transact. If, at any time, MS & Co. were to cease making a market in the securities, it is likely that there would be no secondary market for the securities. Accordingly, you should be willing to hold your securities to maturity.

§ **The rate we are willing to pay for securities of this type, maturity and issuance size is likely to be lower than the rate implied by our secondary market credit spreads and advantageous to us. Both the lower rate and the inclusion of costs associated with issuing, selling, structuring and hedging the securities in the original issue price reduce the economic terms of the securities, cause the estimated value of the securities to be less than the original issue price and will**

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

adversely affect secondary market prices. Assuming no change in market conditions or any other relevant factors, the prices, if any, at which dealers, including MS & Co., may be willing to purchase the securities in secondary market transactions will likely be significantly lower than the original issue price, because secondary market prices will exclude the issuing, selling, structuring and hedging-related costs that are included in the original issue price and borne by you and because the secondary market prices will reflect our secondary market credit spreads and the bid-offer spread that any dealer would charge in a secondary market transaction of this type as well as other factors.

The inclusion of the costs of issuing, selling, structuring and hedging the securities in the original issue price and the lower rate we are willing to pay as issuer make the economic terms of the securities less favorable to you than they otherwise would be.

However, because the costs associated with issuing, selling, structuring and hedging the securities are not fully deducted upon issuance, for a period of up to 6 months following the issue date, to the extent that MS & Co. may buy or sell the securities in the secondary market, absent changes in market conditions, including those related to the underlying stock, and to our secondary market credit spreads, it would do so based on values higher than the estimated value, and we expect that those higher values will also be reflected in your brokerage account statements.

§ **The estimated value of the securities is determined by reference to our pricing and valuation models, which may differ from those of other dealers and is not a maximum or minimum secondary market price.** These pricing and valuation models are proprietary and rely in part on subjective views of certain market inputs and certain assumptions about future events, which may prove to be incorrect. As a result, because there is no market-standard way to value these types of securities, our models may yield a higher estimated value of the securities than those generated by others, including other dealers in the market, if they attempted to value the securities. In addition, the estimated value on the pricing date does not represent a minimum or maximum price at which dealers, including MS & Co., would be willing to purchase your securities in the secondary market (if any exists) at any time. The value of your securities at any time after the date of this document will vary based on many factors that cannot be predicted with accuracy, including our creditworthiness and changes in market conditions. See also "The market price will be influenced by many unpredictable factors" above.

§ **Hedging and trading activity by our affiliates could potentially adversely affect the value of the securities.** One or more of our affiliates and/or third-party dealers have carried out, and will continue to carry out, hedging activities related to the securities (and to other instruments linked to the underlying stock), including trading in the underlying stock. As a result, these entities may be unwinding or adjusting hedge positions during the term of the securities, and the hedging strategy may involve greater and more frequent dynamic adjustments to the hedge as the final determination date approaches. Some of our affiliates also trade the underlying stock and other financial instruments related to the underlying stock on a regular basis as part of their general broker-dealer and other businesses. Any of these hedging or trading activities on or prior to the pricing date could have increased the initial share price, and, as a result, could have increased the downside threshold price, which is the price at or above which the underlying stock must close on each determination date in order for you to earn a contingent quarterly coupon, and, if the securities are not called prior to maturity, in order for you to avoid being exposed to the negative price performance of the underlying stock at maturity. Additionally, such hedging or trading activities during the term of the securities could potentially affect the price of the underlying stock on the determination dates, and, accordingly, whether the securities are automatically called prior to maturity, and, if the securities are not called prior to maturity, the payout to you at maturity, if any.

§ **The calculation agent, which is a subsidiary of Morgan Stanley and an affiliate of MSFL, will make determinations with respect to the securities.** As calculation agent, MS & Co. has determined the initial share price and the downside threshold price, and will determine the final share price, whether the contingent quarterly coupon will be paid on each contingent payment date, whether the securities will be redeemed following any determination date, whether a market disruption event has occurred, whether to make any adjustments to the adjustment factor and the payment that you will receive upon an automatic early redemption or at maturity, if any. Moreover, certain determinations made by MS & Co., in its capacity as calculation agent, may require it to exercise discretion and make subjective judgments, such as with respect to the occurrence or nonoccurrence of market disruption events and certain adjustments to the adjustment factor. These potentially subjective determinations may affect the payout to you upon an automatic early redemption or at maturity, if any. For further information regarding these types of determinations, see “Description of Auto-Callable Securities—Auto-Callable Securities Linked to Underlying Shares” and “—Calculation Agent and Calculations” in the accompanying product supplement. In addition, MS & Co. has determined the estimated value of the securities on the pricing date.

§ **The U.S. federal income tax consequences of an investment in the securities are uncertain.** There is no direct legal authority as to the proper treatment of the securities for U.S. federal income tax purposes, and, therefore, significant aspects of the tax treatment of the securities are uncertain.

Please read the discussion under “Additional Provisions—Tax considerations” in this document concerning the U.S. federal income tax consequences of an investment in the securities. We intend to treat a security for U.S. federal income tax purposes as a single financial contract that provides for a coupon that will be treated as gross income to you at the time received or accrued, in accordance with your regular method of tax accounting. Under this treatment, the ordinary income treatment of the

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

coupon payments, in conjunction with the capital loss treatment of any loss recognized upon the sale, exchange or settlement of the securities, could result in adverse tax consequences to holders of the securities because the deductibility of capital losses is subject to limitations. We do not plan to request a ruling from the Internal Revenue Service (the "IRS") regarding the tax treatment of the securities, and the IRS or a court may not agree with the tax treatment described herein. If the IRS were successful in asserting an alternative treatment for the securities, the timing and character of income or loss on the securities might differ significantly from the tax treatment described herein. For example, under one possible treatment, the IRS could seek to recharacterize the securities as debt instruments. In that event, U.S. Holders (as defined below) would be required to accrue into income original issue discount on the securities every year at a "comparable yield" determined at the time of issuance (as adjusted based on the difference, if any, between the actual and the projected amount of any contingent payments on the securities) and recognize all income and gain in respect of the securities as ordinary income. The risk that financial instruments providing for buffers, triggers or similar downside protection features, such as the securities, would be recharacterized as debt is greater than the risk of recharacterization for comparable financial instruments that do not have such features.

Non-U.S. Holders (as defined below) should note that we currently intend to withhold on any coupon paid to Non-U.S. Holders generally at a rate of 30%, or at a reduced rate specified by an applicable income tax treaty under an "other income" or similar provision, and will not be required to pay any additional amounts with respect to amounts withheld.

In 2007, the U.S. Treasury Department and the IRS released a notice requesting comments on the U.S. federal income tax treatment of "prepaid forward contracts" and similar instruments. While it is not clear whether the securities would be viewed as similar to the prepaid forward contracts described in the notice, it is possible that any Treasury regulations or other guidance promulgated after consideration of these issues could materially and adversely affect the tax consequences of an investment in the securities, possibly with retroactive effect. The notice focuses on a number of issues, the most relevant of which for holders of the securities are the character and timing of income or loss and the degree, if any, to which income realized by non-U.S. investors should be subject to withholding tax. Both U.S. and Non-U.S. Holders should consult their tax advisers regarding the U.S. federal income tax consequences of an investment in the securities, including possible alternative treatments, the issues presented by this notice and any tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction.

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

Facebook, Inc. Overview

Facebook, Inc. operates a social networking website that allows people to communicate with their family, friends and coworkers. The underlying stock is registered under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Information provided to or filed with the Securities and Exchange Commission by Facebook, Inc. pursuant to the Exchange Act can be located by reference to the Securities and Exchange Commission file number 001-35551 through the Securities and Exchange Commission's website at .www.sec.gov. In addition, information regarding Facebook, Inc. may be obtained from other sources including, but not limited to, press releases, newspaper articles and other publicly disseminated documents. **Neither the issuer nor the agent makes any representation that such publicly available documents or any other publicly available information regarding the issuer of the underlying stock is accurate or complete.**

Information as of market close on July 27, 2018:

Bloomberg Ticker Symbol:	FB
Exchange:	Nasdaq
Current Stock Price:	$174.89
52 Weeks Ago:	$170.44
52 Week High (on 7/25/2018):	$217.50
52 Week Low (on 3/27/2018):	$152.22
Current Dividend Yield:	N/A

The following table sets forth the published high and low closing prices of, as well as dividends on, the underlying stock for each quarter from January 1, 2015 through July 27, 2018. The closing price of the underlying stock on July 27, 2018 was $174.89. The associated graph shows the closing prices of the underlying stock for each day from January 1, 2013 through July 27, 2018. We obtained the information in the table and graph below from Bloomberg Financial Markets, without independent verification. The historical performance of the underlying stock should not be taken as an indication of its future performance, and no assurance can be given as to the price of the underlying stock at any time, including on the determination dates.

Common Stock of Facebook, Inc. (CUSIP 30303M102)	High ($)	Low ($)	Dividends ($)
2015			
First Quarter	85.31	74.05	-
Second Quarter	88.86	77.46	-
Third Quarter	98.39	82.09	-
Fourth Quarter	109.01	90.95	-
2016			
First Quarter	116.14	94.16	-
Second Quarter	120.50	108.76	-
Third Quarter	131.05	114.00	-
Fourth Quarter	133.28	115.05	-
2017			
First Quarter	142.65	116.86	-
Second Quarter	155.07	139.39	-
Third Quarter	173.51	148.43	-
Fourth Quarter	183.03	168.42	-
2018			
First Quarter	193.09	152.22	-
Second Quarter	202.00	155.10	-
Third Quarter (through July 27, 2018)	217.50	174.89	-

We make no representation as to the amount of dividends, if any, that Facebook, Inc. may pay in the future. In any event, as an investor in the Contingent Income Auto-Callable Securities, you will not be entitled to receive dividends, if any, that may be payable on the common stock of Facebook, Inc.

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

Common Stock of Facebook, Inc. – Daily Closing Prices

January 1, 2013 to July 27, 2018

*The red solid line indicates the downside threshold price of $131.168, which is approximately 75% of the initial share price.

This document relates only to the securities referenced hereby and does not relate to the underlying stock or other securities of Facebook, Inc. We have derived all disclosures contained in this document regarding Facebook, Inc. stock from the publicly available documents described above. In connection with the offering of the securities, neither we nor the agent has participated in the preparation of such documents or made any due diligence inquiry with respect to Facebook, Inc. Neither we nor the agent makes any representation that such publicly available documents or any other publicly available information regarding Facebook, Inc. is accurate or complete. Furthermore, we cannot give any assurance that all events occurring prior to the date hereof (including events that would affect the accuracy or completeness of the publicly available documents described above) that would affect the trading price of the underlying stock (and therefore the price of the underlying stock at the time we priced the securities) have been publicly disclosed. Subsequent disclosure of any such events or the disclosure of or failure to disclose material future events concerning Facebook, Inc. could affect the value received with respect to the securities and therefore the value of the securities.

Neither the issuer nor any of its affiliates makes any representation to you as to the performance of the underlying stock.

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

Additional Information About the Securities

Please read this information in conjunction with the summary terms on the front cover of this document.

Additional Provisions:	
Interest period:	Quarterly
Day count convention:	30/360
Record date:	The record date for each contingent payment date shall be the date one business day prior to such scheduled contingent payment date; provided, however, that any contingent quarterly coupon payable at maturity or upon redemption shall be payable to the person to whom the payment at maturity or early redemption payment, as the case may be, shall be payable.
Underlying stock:	The accompanying product supplement refers to the underlying stock as the "underlying shares."
Underlying stock issuer:	Facebook, Inc. The accompanying product supplement refers to the underlying stock issuer as the "underlying company."
Downside threshold price:	The accompanying product supplement refers to the downside threshold price as the "trigger level."
Postponement of maturity date:	If the scheduled final determination date is not a trading day or if a market disruption event occurs on that day so that the final determination date is postponed and falls less than two business days prior to the scheduled maturity date, the maturity date of the securities will be postponed to the second business day following that final determination date as postponed.
Postponement of contingent payment dates:	If a contingent payment date (including the maturity date) is postponed as a result of the postponement of the relevant determination date, no adjustment shall be made to any contingent quarterly coupon paid on that postponed date.
Antidilution adjustments:	*The following replaces in its entirety the portion of the section entitled "Antidilution Adjustments" in the accompanying product supplement for auto-callable securities from the start of paragraph 5 to the end of such section.*

5. If (i) there occurs any reclassification or change of the underlying stock, including, without limitation, as a result of the issuance of any tracking stock by the underlying stock issuer, (ii) the underlying stock issuer or any surviving entity or subsequent surviving entity of the underlying stock issuer (the "successor corporation") has been subject to a merger, combination or consolidation and is not the surviving entity, (iii) any statutory exchange of securities of the underlying stock issuer or any successor corporation with another corporation occurs (other than pursuant to clause (ii) above), (iv) the underlying stock issuer is liquidated, (v) the underlying stock issuer issues to all of its shareholders equity securities of an issuer other than the underlying stock issuer (other than in a transaction described in clause (ii), (iii) or (iv) above) (a "spin-off event") or (vi) a tender or exchange offer or going-private transaction is consummated for all the outstanding shares of the underlying stock (any such event in clauses (i) through (vi), a "reorganization event"), the method of determining whether an early redemption has occurred and the amount payable upon an early redemption date or at maturity for each security will be as follows:

· Upon any determination date following the effective date of a reorganization event and prior to the final determination date: If the exchange property value (as defined below) is greater than or equal to the initial share price, the securities will be automatically redeemed for an early redemption payment.

· Upon the final determination date, if the securities have not previously been automatically redeemed: You will receive for each security that you hold a payment at maturity equal to:

Ø If the exchange property value on the final determination date is greater than or equal to the downside threshold price: *(i) the stated principal amount plus (ii) the contingent quarterly coupon with respect to the final determination date*

Ø If the exchange property value on the final determination date is less than the downside threshold price: *(i) the stated principal amount multiplied by (ii) the share performance factor. For purposes of calculating the share performance factor, the "final share price" will be deemed to equal the exchange property value on the final determination date.*

Following the effective date of a reorganization event, the contingent quarterly coupon will be payable for each determination date on which the exchange property value is greater than or equal to the downside threshold price.

In the event exchange property consists of securities, those securities will, in turn, be subject to the antidilution adjustments set forth in paragraphs 1 through 5.

For purposes of determining whether or not the exchange property value is less than the initial share price or less than the downside threshold price, “exchange property value” means (x) for any cash received in any reorganization event, the value, as determined by the Calculation Agent, as of the date of receipt, of such cash received for one share of the underlying stock, as adjusted by the adjustment factor at the time of such reorganization event, (y) for any property other than cash or securities received in any such reorganization event, the market value, as determined by the Calculation Agent in its sole discretion, as of the date of receipt, of such exchange property received for one share of the underlying stock, as adjusted by the adjustment factor at the time of such reorganization event and (z) for any security received in any such reorganization event, an amount equal to the closing price, as of the day on which the exchange property value is determined, per share of such security multiplied by the quantity of such security received for each share of the underlying stock, as adjusted by the adjustment factor at the time of such reorganization event.

For purposes of paragraph 5 above, in the case of a consummated tender or exchange offer or going-private transaction involving consideration of particular types, exchange property shall be deemed to include the amount of cash or other property delivered by the offeror in the tender or exchange offer (in an amount determined on the basis of the rate of exchange in such tender or exchange offer or going-private transaction). In the event of a tender or exchange offer or a going-private transaction with respect to exchange property in which an offeree may elect to receive cash or other property, exchange property shall be deemed to include the kind and amount of cash and other property received by offerees who elect to receive cash.

Following the occurrence of any reorganization event referred to in paragraph 5 above, all references in this offering document and in the related product supplement with respect to the securities to “the underlying stock” shall be deemed to refer to the exchange property and references to a “share” or “shares” of the underlying stock shall be deemed to refer to the applicable unit or units of such exchange property, unless the context otherwise requires.

No adjustment to the adjustment factor will be required unless such adjustment would require a change of at least 0.1% in the adjustment factor then in effect. The adjustment factor resulting from any of the adjustments specified above will be rounded to the nearest one hundred-thousandth, with five one-millionths rounded upward. Adjustments to the adjustment factor will be made up to the close of business on the final determination date.

No adjustments to the adjustment factor or method of calculating the adjustment factor will be required other than those specified above. The adjustments specified above do not cover all events that could affect the determination closing price or the final share price of the underlying stock, including, without limitation, a partial tender or exchange offer for the underlying stock.

The Calculation Agent shall be solely responsible for the determination and calculation of any adjustments to the adjustment factor or method of calculating the adjustment factor and of any related determinations and calculations with respect to any distributions of stock, other securities or other property or assets (including cash) in connection with any corporate event described in paragraphs 1 through 5 above, and its determinations and calculations with respect thereto shall be conclusive in the absence of manifest error.

The Calculation Agent will provide information as to any adjustments to the adjustment factor or to the method of calculating the amount payable at maturity of the securities made pursuant to paragraph 5 above upon written request by any investor in the securities.

Listing:	The securities will not be listed on any securities exchange.
Minimum ticketing size:	$1,000 / 100 securities
Trustee:	The Bank of New York Mellon
Calculation agent:	MS & Co.
Tax considerations:	**Prospective investors should note that the discussion under the section called "United States Federal Taxation" in the accompanying product supplement does not apply to the securities issued under this document and is superseded by the following discussion.**

The following is a general discussion of the material U.S. federal income tax consequences and certain estate tax consequences of the ownership and disposition of the securities. This discussion applies only to investors in the securities who:

· purchase the securities in the original offering; and

· hold the securities as capital assets within the meaning of Section 1221 of the Internal Revenue Code of 1986, as amended (the "Code").

This discussion does not describe all of the tax consequences that may be relevant to a holder in light of the holder’s particular circumstances or to holders subject to special rules, such as:

· certain financial institutions;

· insurance companies;

· certain dealers and traders in securities or commodities;

· investors holding the securities as part of a "straddle," wash sale, conversion transaction, integrated transaction or constructive sale transaction;

· U.S. Holders (as defined below) whose functional currency is not the U.S. dollar;

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

- partnerships or other entities classified as partnerships for U.S. federal income tax purposes;

- regulated investment companies;

- real estate investment trusts; or

- tax-exempt entities, including "individual retirement accounts" or "Roth IRAs" as defined in Section 408 or 408A of the Code, respectively.

If an entity that is classified as a partnership for U.S. federal income tax purposes holds the securities, the U.S. federal income tax treatment of a partner will generally depend on the status of the partner and the activities of the partnership. If you are a partnership holding the securities or a partner in such a partnership, you should consult your tax adviser as to the particular U.S. federal tax consequences of holding and disposing of the securities to you.

As the law applicable to the U.S. federal income taxation of instruments such as the securities is technical and complex, the discussion below necessarily represents only a general summary. The effect of any applicable state, local or non-U.S. tax laws is not discussed, nor are any alternative minimum tax consequences or consequences resulting from the Medicare tax on investment income. Moreover, the discussion below does not address the consequences to taxpayers subject to special tax accounting rules under Section 451(b) of the Code.

This discussion is based on the Code, administrative pronouncements, judicial decisions and final, temporary and proposed Treasury regulations, all as of the date hereof, changes to any of which subsequent to the date hereof may affect the tax consequences described herein. Persons considering the purchase of the securities should consult their tax advisers with regard to the application of the U.S. federal income tax laws to their particular situations as well as any tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction.

General

Due to the absence of statutory, judicial or administrative authorities that directly address the treatment of the securities or instruments that are similar to the securities for U.S. federal income tax purposes, no assurance can be given that the IRS or a court will agree with the tax treatment described herein. We intend to treat a security for U.S. federal income tax purposes as a single financial contract that provides for a coupon that will be treated as gross income to you at the time received or accrued in accordance with your regular method of tax accounting. In the opinion of our counsel, Davis Polk & Wardwell LLP, this treatment of the securities is reasonable under current law; however, our counsel has advised us that it is unable to conclude affirmatively that this treatment is more likely than not to be upheld, and that alternative treatments are possible.

You should consult your tax adviser regarding all aspects of the U.S. federal tax consequences of an investment in the securities (including possible alternative treatments of the securities). Unless otherwise stated, the following discussion is based on the treatment of each security as described in the previous paragraph.

Tax Consequences to U.S. Holders

This section applies to you only if you are a U.S. Holder. As used herein, the term "U.S. Holder" means a beneficial owner of a security that is, for U.S. federal income tax purposes:

· a citizen or individual resident of the United States;

· a corporation, or other entity taxable as a corporation, created or organized in or under the laws of the United States, any state thereof or the District of Columbia; or

· an estate or trust the income of which is subject to U.S. federal income taxation regardless of its source.

Tax Treatment of the Securities

Assuming the treatment of the securities as set forth above is respected, the following U.S. federal income tax consequences should result.

Tax Basis. A U.S. Holder's tax basis in the securities should equal the amount paid by the U.S. Holder to acquire the securities.

Tax Treatment of Coupon Payments. Any coupon payment on the securities should be taxable as ordinary income to a U.S. Holder at the time received or accrued, in accordance with the U.S. Holder's regular method of accounting for U.S. federal income tax purposes.

Sale, Exchange or Settlement of the Securities. Upon a sale, exchange or settlement of the securities, a U.S. Holder should recognize gain or loss equal to the difference between the amount realized on the sale, exchange or settlement and the U.S. Holder's tax basis in the securities sold, exchanged or settled. For this purpose, the amount realized does not include any coupon paid at settlement and may not include sale proceeds attributable to an accrued coupon, which may be treated as a coupon payment. Any such gain or loss recognized should be long-term capital gain or loss if the U.S. Holder has held the securities for more than one year at the time of the sale, exchange or settlement, and should be short-term capital gain or loss otherwise. The ordinary income treatment of the coupon payments, in conjunction with the capital loss treatment of any loss recognized upon the sale, exchange or settlement of the securities, could result in adverse tax consequences to holders of the securities because the deductibility of capital losses is subject to limitations.

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

Possible Alternative Tax Treatments of an Investment in the Securities

Due to the absence of authorities that directly address the proper tax treatment of the securities, no assurance can be given that the IRS will accept, or that a court will uphold, the treatment described above. In particular, the IRS could seek to analyze the U.S. federal income tax consequences of owning the securities under Treasury regulations governing contingent payment debt instruments (the "Contingent Debt Regulations"). If the IRS were successful in asserting that the Contingent Debt Regulations applied to the securities, the timing and character of income thereon would be significantly affected. Among other things, a U.S. Holder would be required to accrue into income original issue discount on the securities every year at a "comparable yield" determined at the time of their issuance, adjusted upward or downward to reflect the difference, if any, between the actual and the projected amount of any contingent payments on the securities. Furthermore, any gain realized by a U.S. Holder at maturity or upon a sale, exchange or other disposition of the securities would be treated as ordinary income, and any loss realized would be treated as ordinary loss to the extent of the U.S. Holder's prior accruals of original issue discount and as capital loss thereafter. The risk that financial instruments providing for buffers, triggers or similar downside protection features, such as the securities, would be recharacterized as debt is greater than the risk of recharacterization for comparable financial instruments that do not have such features.

Other alternative federal income tax treatments of the securities are possible, which, if applied, could significantly affect the timing and character of the income or loss with respect to the securities. In 2007, the U.S. Treasury Department and the IRS released a notice requesting comments on the U.S. federal income tax treatment of "prepaid forward contracts" and similar instruments. The notice focuses on whether to require holders of "prepaid forward contracts" and similar instruments to accrue income over the term of their investment. It also asks for comments on a number of related topics, including the character of income or loss with respect to these instruments; whether short-term instruments should be subject to any such accrual regime; the relevance of factors such as the exchange–traded status of the instruments and the nature of the underlying property to which the instruments are linked; whether these instruments are or should be subject to the "constructive ownership" rule, which very generally can operate to recharacterize certain long-term capital gain as ordinary income and impose an interest charge; and appropriate transition rules and effective dates. While it is not clear whether instruments such as the securities would be viewed as similar to the prepaid forward contracts described in the notice, any Treasury regulations or other guidance promulgated after consideration of these issues could materially and adversely affect the tax consequences of an investment in the securities, possibly with retroactive effect. U.S. Holders should consult their tax advisers regarding the U.S. federal income tax consequences of an investment in the securities, including possible alternative treatments and the issues presented by this notice.

Backup Withholding and Information Reporting

Backup withholding may apply in respect of payments on the securities and the payment of proceeds from a sale, exchange or other disposition of the securities, unless a U.S. Holder provides proof of an applicable exemption or a correct taxpayer identification number and otherwise complies with applicable requirements of the backup withholding rules. The amounts withheld under the backup withholding rules are not an additional tax and may be refunded, or credited against the U.S. Holder's U.S. federal income tax liability, provided that the required information is timely furnished to the IRS. In addition, information returns will be filed with the IRS in connection with payments on the securities and the payment of proceeds from a sale, exchange or other disposition of the securities, unless the U.S. Holder provides proof of an applicable exemption from the information reporting rules.

Tax Consequences to Non-U.S. Holders

This section applies to you only if you are a Non-U.S. Holder. As used herein, the term "Non-U.S. Holder" means a beneficial owner of a security that is for U.S. federal income tax purposes:

· an individual who is classified as a nonresident alien;

· a foreign corporation; or

· a foreign estate or trust.

The term "Non-U.S. Holder" does not include any of the following holders:

· a holder who is an individual present in the United States for 183 days or more in the taxable year of disposition and who is not otherwise a resident of the United States for U.S. federal income tax purposes;

· certain former citizens or residents of the United States; or

· a holder for whom income or gain in respect of the securities is effectively connected with the conduct of a trade or business in the United States.

Such holders should consult their tax advisers regarding the U.S. federal income tax consequences of an investment in the securities.

Although significant aspects of the tax treatment of each security are uncertain, we intend to withhold on any coupon paid to a Non-U.S. Holder generally at a rate of 30% or at a reduced rate specified by an applicable income tax treaty under an "other income" or similar provision. We will not be required to pay any additional amounts with respect to amounts withheld. In order to claim an exemption from, or a reduction in, the 30% withholding tax, a Non-U.S. Holder of the securities must comply with certification requirements to establish that it is not a U.S. person and is eligible for such an exemption or reduction under an applicable tax treaty. If you are a Non-U.S. Holder, you should consult your tax adviser regarding the tax treatment of the securities, including the possibility of obtaining a refund of any withholding tax and the certification requirement described above.

Section 871(m) Withholding Tax on Dividend Equivalents

Section 871(m) of the Code and Treasury regulations promulgated thereunder (“Section 871(m)”) generally impose a 30% (or a lower applicable treaty rate) withholding tax on dividend equivalents paid or deemed paid to Non-U.S. Holders with respect to certain financial instruments linked to U.S. equities or indices that include U.S. equities (each, an “Underlying Security”). Subject to certain exceptions, Section 871(m) generally applies to securities that substantially replicate the economic performance of one or more Underlying Securities, as determined based on tests set forth in the applicable Treasury regulations (a “Specified Security”). However, pursuant to an IRS notice, Section 871(m) will not apply to securities issued before January 1, 2019 that do not have a delta of one with respect to any Underlying Security. Based on our determination that the securities do not have a delta of one with respect to any Underlying Security, our counsel is of the opinion that the securities should not be Specified Securities and, therefore, should not be subject to Section 871(m).

Our determination is not binding on the IRS, and the IRS may disagree with this determination. Section 871(m) is complex and its application may depend on your particular circumstances, including whether you enter into other transactions with respect to an Underlying Security. If Section 871(m) withholding is required, we will not be required to pay any additional amounts with respect to the amounts so withheld. You should consult your tax adviser regarding the potential application of Section 871(m) to the securities.

U.S. Federal Estate Tax

Individual Non-U.S. Holders and entities the property of which is potentially includible in such an individual’s gross estate for U.S. federal estate tax purposes (for example, a trust funded by such an individual and with respect to which the individual has retained certain interests or powers) should note that, absent an applicable treaty exemption, the securities may be treated as U.S.-situs property subject to U.S. federal estate tax. Prospective investors that are non-U.S. individuals, or are entities of the type described above, should consult their tax advisers regarding the U.S. federal estate tax consequences of an investment in the securities.

Backup Withholding and Information Reporting

Information returns will be filed with the IRS in connection with any coupon payment and may be filed with the IRS in connection with the payment at maturity on the securities and the payment of proceeds from a sale, exchange or other disposition. A Non-U.S. Holder may be subject to backup withholding in respect of amounts paid to the Non-U.S. Holder, unless such Non-U.S. Holder complies with certification procedures to establish that it is not a U.S. person for U.S. federal income tax purposes or otherwise establishes an exemption. The amount of any backup withholding from a payment to a Non-U.S. Holder will be allowed as a credit against the Non-U.S. Holder's U.S. federal income tax liability and may entitle the Non-U.S. Holder to a refund, provided that the required information is timely furnished to the IRS.

FATCA

Legislation commonly referred to as "FATCA" generally imposes a withholding tax of 30% on payments to certain non-U.S. entities (including financial intermediaries) with respect to certain financial instruments, unless various U.S. information reporting and due diligence requirements have been satisfied. An intergovernmental agreement between the United States and the non-U.S. entity's jurisdiction may modify these requirements. FATCA generally applies to certain financial instruments that are treated as paying U.S.-source interest or other U.S.-source "fixed or determinable annual or periodical" income ("FDAP income"). Withholding (if applicable) applies to payments of U.S.-source FDAP income and, for dispositions after December 31, 2018, to payments of gross proceeds of the disposition (including upon retirement) of certain financial instruments treated as providing for U.S.-source interest or dividends. While the treatment of the securities is unclear, you should assume that any coupon payment with respect to the securities will be subject to the FATCA rules. It is also possible in light of this uncertainty that an applicable withholding agent will treat gross proceeds of a disposition (including upon retirement) of the securities after 2018 as being subject to the FATCA rules. If withholding applies to the securities, we will not be required to pay any additional amounts with respect to amounts withheld. Both U.S. and Non-U.S. Holders should consult their tax advisers regarding the potential application of FATCA to the securities.

The discussion in the preceding paragraphs, insofar as it purports to describe provisions of U.S. federal income tax laws or legal conclusions with respect thereto, constitutes the full opinion of Davis Polk & Wardwell LLP regarding the material U.S. federal tax consequences of an

investment in the securities.

The proceeds from the sale of the securities will be used by us for general corporate purposes. We will receive, in aggregate, $10 per security issued, because, when we enter into hedging transactions in order to meet our obligations under the securities, our hedging counterparty will reimburse the cost of the agent's commissions. The costs of the securities borne by you and described beginning on page 2 above comprise the agent's commissions and the cost of issuing, structuring and hedging the securities.

Use of proceeds and hedging: On or prior to the pricing date, we hedged our anticipated exposure in connection with the securities by entering into hedging transactions with our affiliates and/or third party dealers. We expect our hedging counterparties to have taken positions in the underlying stock and in futures and/or options contracts on the underlying stock. Such purchase activity could have increased the initial share price, and, as a result, could have increased the downside threshold price, which is the price at or above which the underlying stock must close on each determination date in order for you to earn a contingent quarterly coupon, and, if the securities are not redeemed prior to maturity, in order for you to avoid being exposed to the negative price performance of the underlying

	stock at maturity. In addition, through our affiliates, we are likely to modify our hedge position throughout the term of the securities, including on the determination dates, by purchasing and selling the underlying stock, options contracts relating to the underlying stock or any other available securities or instruments that we may wish to use in connection with such hedging activities, including by purchasing or selling any such securities or instruments on one or more determination dates. As a result, these entities may be unwinding or adjusting hedge positions during the term of the securities, and the hedging strategy may involve greater and more frequent dynamic adjustments to the hedge as the final determination date approaches. We cannot give any assurance that our hedging activities will not affect the value of the underlying stock, and, therefore, adversely affect the value of the securities or the payment you will receive at maturity, if any. For further information on our use of proceeds and hedging, see "Use of Proceeds and Hedging" in the accompanying product supplement for auto-callable securities.
Benefit plan investor considerations:	Each fiduciary of a pension, profit-sharing or other employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") (a "Plan"), should consider the fiduciary standards of ERISA in the context of the Plan's particular circumstances before authorizing an investment in the securities. Accordingly, among other factors, the fiduciary should consider whether the investment would satisfy the prudence and diversification requirements of ERISA and would be consistent with the documents and instruments governing the Plan.
	In addition, we and certain of our affiliates, including MS & Co., may each be considered a "party in interest" within the meaning of ERISA, or a "disqualified person" within the meaning of the Internal Revenue Code of 1986, as amended (the "Code"), with respect to many Plans, as well as many individual retirement accounts and Keogh plans (such accounts and plans, together with other plans, accounts and arrangements subject to Section 4975 of the Code, also "Plans"). ERISA Section 406 and Code Section 4975 generally prohibit transactions between Plans and parties in interest or disqualified persons. Prohibited transactions within the meaning of ERISA or the Code would likely arise, for example, if the securities are acquired by or with the assets of a Plan with respect to which MS & Co. or any of its affiliates is a service provider or other party in interest, unless the securities are acquired pursuant to an exemption from the "prohibited transaction" rules. A violation of these "prohibited transaction" rules could result in an excise tax or other liabilities under ERISA and/or Section 4975 of the Code for those persons, unless exemptive relief is available under an applicable statutory or administrative exemption.

The U.S. Department of Labor has issued five prohibited transaction class exemptions (“PTCEs”) that may provide exemptive relief for direct or indirect prohibited transactions resulting from the purchase or holding of the securities. Those class exemptions are PTCE 96-23 (for certain transactions determined by in-house asset managers), PTCE 95-60 (for certain transactions involving insurance company general accounts), PTCE 91-38 (for certain transactions involving bank collective investment funds), PTCE 90-1 (for certain transactions involving insurance company separate accounts) and PTCE 84-14 (for certain transactions determined by independent qualified professional asset managers). In addition, ERISA Section 408(b)(17) and Code Section 4975(d)(20) provide an exemption for the purchase and sale of securities and the related lending transactions, provided that neither the issuer of the securities nor any of its affiliates has or exercises any discretionary authority or control or renders any investment advice with respect to the assets of the Plan involved in the transaction and provided further that the Plan pays no more, and receives no less, than “adequate consideration” in connection with the transaction (the so-called “service provider” exemption). There can be no assurance that any of these class or statutory exemptions will be available with respect to transactions involving the securities.

Because we may be considered a party in interest with respect to many Plans, the securities may not be purchased, held or disposed of by any Plan, any entity whose underlying assets include “plan assets” by reason of any Plan’s investment in the entity (a “Plan Asset Entity”) or any person investing “plan assets” of any Plan, unless such purchase, holding or disposition is eligible for exemptive relief, including relief available under PTCEs 96-23, 95-60, 91-38, 90-1, 84-14 or the service provider exemption or such purchase, holding or disposition is otherwise not prohibited. Any purchaser, including any fiduciary purchasing on behalf of a Plan, transferee or holder of the securities will be deemed to have represented, in its corporate and its fiduciary capacity, by its purchase and holding of the securities that either (a) it is not a Plan or a Plan Asset Entity and is not purchasing such securities on behalf of or with “plan assets” of any Plan or with any assets of a governmental, non-U.S. or church plan that is subject to any federal, state, local or non-U.S. law that is substantially similar to the provisions of Section 406 of ERISA or Section 4975 of the Code (“Similar Law”) or (b) its purchase, holding and disposition of these securities will not constitute or result in a non-exempt prohibited transaction under Section 406 of ERISA or Section 4975 of the Code or violate any Similar Law.

Due to the complexity of these rules and the penalties that may be imposed upon persons involved in non-exempt prohibited transactions, it is particularly important that fiduciaries or other persons considering purchasing the securities on behalf of or with “plan assets” of any Plan consult with their counsel regarding the availability of exemptive relief.

The securities are contractual financial instruments. The financial exposure provided by the securities is not a substitute or proxy for, and is not intended as a substitute or proxy for, individualized investment management or advice for the benefit of any purchaser or holder of the securities. The securities have not been designed and will not be administered in a manner intended to reflect the individualized needs and objectives of any purchaser or holder of the securities.

Each purchaser or holder of any securities acknowledges and agrees that:

(i) the purchaser or holder or its fiduciary has made and shall make all investment decisions for the purchaser or holder and the purchaser or holder has not relied and shall not rely in any way upon us or our affiliates to

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

act as a fiduciary or adviser of the purchaser or holder with respect to (A) the design and terms of the securities, (B) the purchaser or holder's investment in the securities, or (C) the exercise of or failure to exercise any rights we have under or with respect to the securities;

(ii) we and our affiliates have acted and will act solely for our own account in connection with (A) all transactions relating to the securities and (B) all hedging transactions in connection with our obligations under the securities;

(iii) any and all assets and positions relating to hedging transactions by us or our affiliates are assets and positions of those entities and are not assets and positions held for the benefit of the purchaser or holder;

(iv) our interests are adverse to the interests of the purchaser or holder; and

(v) neither we nor any of our affiliates is a fiduciary or adviser of the purchaser or holder in connection with any such assets, positions or transactions, and any information that we or any of our affiliates may provide is not intended to be impartial investment advice.

Each purchaser and holder of the securities has exclusive responsibility for ensuring that its purchase, holding and disposition of the securities do not violate the prohibited transaction rules of ERISA or the Code or any Similar Law. The sale of any securities to any Plan or plan subject to Similar Law is in no respect a representation by us or any of our affiliates or representatives that such an investment meets all relevant legal requirements with respect to investments by plans generally or any particular plan, or that such an investment is appropriate for plans generally or any particular plan. In this regard, neither this discussion nor anything provided in this document is or is intended to be investment advice directed at any potential Plan purchaser or at Plan purchasers generally and such purchasers of these securities should consult and rely on their own counsel and advisers as to whether an investment in these securities is suitable.

However, individual retirement accounts, individual retirement annuities and Keogh plans, as well as employee benefit plans that permit participants to direct the investment of their accounts, will not be permitted to purchase or hold the securities if the account, plan or annuity is for the benefit of an employee of Morgan Stanley or Morgan Stanley Wealth Management or a family member and the employee receives any compensation (such as, for example, an addition to bonus) based on the purchase of the securities by the account, plan or annuity.

Additional considerations:

Client accounts over which Morgan Stanley, Morgan Stanley Wealth Management or any of their respective subsidiaries have investment discretion are not permitted to purchase the securities, either directly or indirectly.

The agent may distribute the securities through Morgan Stanley Smith Barney LLC (“Morgan Stanley Wealth Management”), as selected dealer, or other dealers, which may include Morgan Stanley & Co. International plc (“MSIP”) and Bank Morgan Stanley AG. Morgan Stanley Wealth Management, MSIP and Bank Morgan Stanley AG are affiliates of ours. Selected dealers, including Morgan Stanley Wealth Management, and their financial advisors will collectively receive from the agent, Morgan Stanley & Co. LLC, a fixed sales commission of $0.20 for each security they sell. In addition, Morgan Stanley Wealth Management will receive a structuring fee of $0.05 for each security.

Supplemental information regarding plan of distribution; conflicts of interest:

MS & Co. is an affiliate of MSFL and a wholly owned subsidiary of Morgan Stanley, and it and other affiliates of ours expect to make a profit by selling, structuring and, when applicable, hedging the securities.

MS & Co. will conduct this offering in compliance with the requirements of FINRA Rule 5121 of the Financial Industry Regulatory Authority, Inc., which is commonly referred to as FINRA, regarding a FINRA member firm’s distribution of the securities of an affiliate and related conflicts of interest. MS & Co. or any of our other affiliates may not make sales in this offering to any discretionary account. See “Plan of Distribution (Conflicts of Interest)” and “Use of Proceeds and Hedging” in the accompanying product supplement for auto-callable securities.

Validity of the securities:

In the opinion of Davis Polk & Wardwell LLP, as special counsel to MSFL and Morgan Stanley, when the securities offered by this pricing supplement have been executed and issued by MSFL, authenticated by the trustee pursuant to the MSFL Senior Debt Indenture (as defined in the accompanying prospectus) and delivered against payment as contemplated herein, such securities will be valid and binding obligations of MSFL and the related guarantee will be a valid and binding obligation of Morgan Stanley, enforceable in accordance with their terms, subject to applicable bankruptcy, insolvency and similar laws affecting creditors’ rights generally, concepts of reasonableness and equitable principles of general applicability (including, without limitation, concepts of good faith, fair dealing and the lack of bad faith), provided that such counsel expresses no opinion as to (i) the effect of fraudulent conveyance, fraudulent transfer or similar provision of applicable law on the conclusions expressed above and (ii) any provision of the MSFL Senior Debt Indenture that purports to avoid the effect of fraudulent conveyance, fraudulent transfer or similar provision of applicable law by limiting the amount of Morgan Stanley's obligation under the related guarantee. This opinion is given as of the date hereof and is limited to the laws of the State of New York, the General Corporation Law of the State of Delaware and the Delaware Limited Liability Company Act. In addition, this opinion is subject to customary assumptions about the trustee's authorization, execution and delivery of the MSFL Senior Debt Indenture and its authentication of the securities and the validity, binding nature and enforceability of the MSFL Senior Debt Indenture with respect to the trustee, all as stated in the letter of such counsel dated November 16, 2017, which is Exhibit 5-a to the Registration Statement on Form S-3 filed by Morgan Stanley on November 16, 2017.

Contact:	Morgan Stanley Wealth Management clients may contact their local Morgan Stanley branch office or our principal executive offices at 1585 Broadway, New York, New York 10036 (telephone number (866) 477-4776). All other clients may contact their local brokerage representative. Third-party distributors may contact Morgan

Morgan Stanley Finance LLC

Contingent Income Auto-Callable Securities due July 30, 2021

Based on the Performance of the Common Stock of Facebook, Inc.

Principal at Risk Securities

	Stanley Structured Investment Sales at (800) 233-1087. Morgan Stanley and MSFL have filed a registration statement (including a prospectus, as supplemented by the product supplement for auto-callable securities) with the Securities and Exchange Commission, or SEC, for the offering to which this communication relates. You should read the prospectus in that registration statement, the product supplement for auto-callable securities and any other documents relating to this offering that Morgan Stanley and MSFL have filed with the SEC for more complete information about Morgan Stanley, MSFL and this offering. You may get these documents without cost by visiting EDGAR on the SEC web site at.www.sec.gov. Alternatively, Morgan Stanley, MSFL, any underwriter or any dealer participating in the offering will arrange to send you the product supplement for auto-callable securities and prospectus if you so request by calling toll-free 1-(800)-584-6837.
Where you can find more information:	You may access these documents on the SEC web site at.www.sec.gov as follows: **<u>Product Supplement for Auto-Callable Securities dated November 16, 2017</u>** **<u>Prospectus dated November 16, 2017</u>** Terms used but not defined in this document are defined in the product supplement for auto-callable securities or in the prospectus.

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(11,887
)

640,000

TBAs

—

—

(5,187
)

1,434,000

Put and call options for TBAs, net

—

—

(105
)

—

Constant maturity swaps

—

—

—

—

Markit IOS total return swaps

725

855,872

(134
)

132,537

Forward purchase commitments

107

135,181

(2,596
)

491,479

Total

$
347,322

$
26,416,319

$
(22,475
)

$
4,723,016

(in thousands)	December 31, 2014			
	Derivative Assets		Derivative Liabilities	
Trading instruments	Fair Value	Notional	Fair Value	Notional
Inverse interest-only securities	$188,592	$1,168,226	$—	$—
Interest rate swap agreements	55,471	9,569,000	(65,392)	9,015,000
Credit default swaps	—	—	(1,672)	125,000
Swaptions, net	121,591	9,550,000	(4,999)	2,860,000
TBAs	10,350	875,000	(17,687)	2,200,000
Put and call options for TBAs, net	90	2,000,000	—	—
Constant maturity swaps	2,013	12,000,000	(483)	2,000,000
Markit IOS total return swaps	1,387	598,459	—	—
Forward purchase commitments	1,297	554,838	—	—
Total	$380,791	$36,315,523	$(90,233)	$16,200,000

21

Table of Contents

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

Comprehensive Income Statement Presentation
The Company has not applied hedge accounting to its current derivative portfolio held to mitigate the interest rate risk and credit risk associated with its portfolio. As a result, the Company is subject to volatility in its earnings due to movement in the unrealized gains and losses associated with its interest rate swaps and its other derivative instruments.
The following table summarizes the location and amount of gains and losses on derivative instruments reported in the condensed consolidated statements of comprehensive income on the Company's derivative trading instruments:
(in thousands)

Trading Instruments	Location of Gain (Loss) Recognized in Income on Derivatives	Amount of Gain (Loss) Recognized in Income on Derivatives			
		Three Months Ended June 30,		Six Months Ended June 30,	
		2015	2014	2015	2014
Interest rate risk management					
TBAs [1]	Loss on other derivative instruments	$5,262	$(29,877)	$(22,696)	$(47,780)
Short U.S. Treasuries [1]	Loss on other derivative instruments	125	(8)	125	(8)
Put and call options for TBAs [1]	Loss on other derivative instruments	5,671	(4,614)	8,206	(6,319)
Put and call options for U.S. Treasuries [1]	Loss on other derivative instruments	(837)	—	(837)	—
Constant maturity swaps [1]	Loss on other derivative instruments	74	(6,103)	6,164	5,428
Interest rate swap agreements - Receivers [1]	Gain (loss) on interest rate swap and swaption agreements	(42,470)	65,963	(144)	106,942
Interest rate swap agreements - Payers [1]	Gain (loss) on interest rate swap and swaption agreements	20,713	(46,341)	(31,846)	(59,761)
Swaptions [1]	Gain (loss) on interest rate swap and swaption agreements	19,752	(57,250)	1,246	(169,808)
Markit IOS total return swaps [1]	Loss on other derivative instruments	(20,658)	353	(17,526)	(1,372)
Interest rate swap agreements - Payers [2]	Gain (loss) on interest rate swap and swaption agreements	46,957	(78,391)	(50,747)	(98,920)
Credit risk management					
Credit default swaps - Receive protection [3]	Loss on other derivative instruments	(30)	(5)	(123)	1,976
Non-risk management					
TBAs	Loss on other derivative instruments	—	—	—	(4,701)
Inverse interest-only securities	Loss on other derivative instruments	4,909	16,052	24,170	34,375
Forward purchase commitments	(Loss) gain on residential mortgage loans held-for-sale	(5,130)	4,163	(4,160)	3,746
Total		$34,338	$(136,058)	$(88,168)	$(236,202)

(1) Includes derivative instruments held to mitigate interest rate risk associated with the Company's investment portfolio.

(2) Includes derivative instruments held to mitigate interest rate risk associated with the Company's repurchase agreements and FHLB advances.

(3) Includes derivative instruments held to mitigate credit risk associated with the Company's non-Agency RMBS and residential mortgage loans held-for-sale.

Table of Contents

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

For the three and six months ended June 30, 2015, the Company recognized $26.1 million and $53.7 million, respectively, of expenses for the accrual and/or settlement of the net interest expense associated with its interest rate swaps. The expenses result from paying either a fixed interest rate or LIBOR interest on an average $16.7 billion and $17.5 billion notional, respectively, and receiving either LIBOR interest or a fixed interest rate. For the three and six months ended June 30, 2014, the Company recognized $18.9 million and $32.7 million, respectively, of expenses for the accrual and/or settlement of the net interest expense associated with its interest rate swaps. The expenses result from paying either a fixed interest rate or LIBOR interest on an average $23.5 billion and $21.3 billion notional, respectively, and receiving either LIBOR interest or a fixed interest rate.
The following tables present information with respect to the volume of activity in the Company's derivative instruments during the three and six months ended June 30, 2015 and 2014:

	Three Months Ended June 30, 2015					
(in thousands)	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net (1)
Inverse interest-only securities	$1,106,210	$12,563	$(69,030)	$1,049,743	$1,086,760	$64
Interest rate swap agreements	19,929,000	11,493,227	(15,196,704)	16,225,523	16,681,983	(66,799)
Credit default swaps	125,000	—	—	125,000	125,000	—
Swaptions, net	12,960,000	1,500,000	(5,050,000)	9,410,000	10,292,418	(8,053)
TBAs, net	(2,496,000)	(3,929,000)	5,401,000	(1,024,000)	(1,362,451)	(7,482)
Short U.S. Treasuries	—	(50,000)	50,000	—	—	125
Put and call options for TBAs, net	(2,500,000)	—	2,500,000	—	(722,527)	10,843
Put and call options for U.S. Treasuries, net	—	500,000	(500,000)	—	2,747	(837)
Constant maturity swaps	3,000,000	—	(3,000,000)	—	384,615	1,310
Markit IOS total return swaps	877,529	747,910	(637,030)	988,409	1,201,515	(13,130)
Forward purchase commitments	707,304	978,297	(1,058,941)	626,660	679,266	(1,318)
Total	$33,709,043	$11,252,997	$(17,560,705)	$27,401,335	$28,369,326	$(85,277)

	Three Months Ended June 30, 2014					
(in thousands)	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net (1)
Inverse interest-only securities	$1,412,374	$—	$(88,724)	$1,323,650	$1,372,535	$—
Interest rate swap agreements	21,663,148	8,465,000	(6,500,000)	23,628,148	23,467,489	(2,983)
Credit default swaps	125,000	—	—	125,000	125,000	—
Swaptions, net	9,500,000	3,250,000	(1,300,000)	11,450,000	10,412,088	(2,178)
TBAs, net	(1,022,000)	(2,032,000)	2,682,000	(372,000)	660,308	(26,530)
Short U.S. Treasuries	—	(125,000)	125,000	—	1,374	2

Put and call options for TBAs, net	1,500,000	—	(1,500,000)	—	901,099	(5,332)
Constant maturity swaps	10,000,000	4,000,000	(8,000,000)	6,000,000	5,571,429	(1,460)
Markit IOS total return swaps	243,987	339,869	(7,378)	576,478	393,910	—
Forward purchase commitments	153,637	872,756	(378,452)	647,941	367,940	332
Total	$43,576,146	$14,770,625	$(14,967,554)	$43,379,217	$43,273,172	$(38,149)

23

Table of Contents

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

	Six Months Ended June 30, 2015					
(in thousands)	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net (1)
Inverse interest-only securities	$1,168,226	$12,563	$(131,046)	$1,049,743	$1,112,471	$64
Interest rate swap agreements	18,584,000	17,113,227	(19,471,704)	16,225,523	17,455,887	(67,869)
Credit default swaps	125,000	—	—	125,000	125,000	—
Swaptions, net	12,410,000	7,050,000	(10,050,000)	9,410,000	11,564,972	4,793
TBAs, net	(1,325,000)	(10,862,000)	11,163,000	(1,024,000)	(1,739,978)	(24,846)
Short U.S. Treasuries	—	(50,000)	50,000	—	—	125
Put and call options for TBAs, net	2,000,000	250,000	(2,250,000)	—	(359,116)	7,796
Put and call options for U.S. Treasuries, net	—	500,000	(500,000)	—	1,381	(837)
Constant maturity swaps	14,000,000	6,000,000	(20,000,000)	—	4,552,486	7,694
Markit IOS total return swaps	598,459	1,424,543	(1,034,593)	988,409	1,039,332	(8,928)
Forward purchase commitments	554,838	2,106,931	(2,035,109)	626,660	663,890	(374)
Total	$48,115,523	$23,545,264	$(44,259,452)	$27,401,335	$34,416,325	$(82,382)

	Six Months Ended June 30, 2014					
(in thousands)	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net (1)
Inverse interest-only securities	$1,525,845	$—	$(202,195)	$1,323,650	$1,421,330	$193
Interest rate swap agreements	19,619,000	11,409,148	(7,400,000)	23,628,148	21,324,091	(3,005)
Credit default swaps	427,073	—	(302,073)	125,000	152,059	(13,705)
Swaptions, net	5,130,000	7,150,000	(830,000)	11,450,000	9,699,558	(3,396)
TBAs, net	603,000	(2,924,000)	1,949,000	(372,000)	593,746	(14,677)
Short U.S. Treasuries	—	(125,000)	125,000	—	691	2
Put and call options for TBAs, net	—	1,500,000	(1,500,000)	—	580,110	(5,332)
Constant maturity swaps	10,000,000	12,000,000	(16,000,000)	6,000,000	7,773,481	2,427
Markit IOS total return swaps	49,629	536,881	(10,032)	576,478	274,573	—
Forward purchase commitments	12,063	1,058,706	(422,828)	647,941	204,336	302
Total	$37,366,610	$30,605,735	$(24,593,128)	$43,379,217	$42,023,975	$(37,191)

(1) Excludes net interest paid or received in full settlement of the net interest spread liability.

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

Table of Contents

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

Interest Rate Sensitive Assets/Liabilities
The Company's RMBS investment securities and MSR 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 and an increase in the value of the Company's MSR. To mitigate the impact of this risk, the Company maintains a portfolio of fixed-rate interest-only securities, which increase in value when interest rates increase, as well as TBA positions, short U.S. Treasuries, put and call options for TBAs and U.S. Treasuries, constant maturity swaps, interest rate swap and swaption agreements and Markit IOS total return swaps to further mitigate its exposure to higher interest rates, decreased prepayment speeds and widening mortgage spreads.
As of June 30, 2015 and December 31, 2014, the Company had outstanding fair value of $49.3 million and $55.7 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 is exposed to interest rate risk on residential mortgage loans from the time it commits to purchase a mortgage loan until it acquires the loan from the originator and subsequently sells the loan to a third party. Changes in interest rates impact the market price for the mortgage loans. For example, as market interest rates decline, the value of residential mortgage loans held-for-sale increases, and vice versa. To mitigate the impact of this risk, the Company may enter into derivative contracts to hedge the interest rate risk related to its commitments to purchase residential mortgage loans and residential mortgage loans held-for-sale, such as interest rate swaps, swaptions, TBA positions, short U.S. Treasuries, put and call options for TBAs and U.S. Treasuries and constant maturity swaps.
TBAs. At times, the Company may use TBAs for risk management purposes or as a means of deploying capital until targeted investments are available and to take advantage of temporary displacements in the marketplace. TBAs are forward contracts for the purchase (long notional positions) or sale (short notional positions) of Agency RMBS. The issuer, coupon and stated maturity of the Agency RMBS are predetermined as well as the trade price, face amount and future settle date (published each month by the Securities Industry and Financial Markets Association). However, the specific Agency RMBS to be delivered upon settlement is not known at the time of the TBA transaction. As a result, and because physical delivery of the Agency RMBS upon settlement cannot be assured, the Company accounts for TBAs as derivative instruments.
As of June 30, 2015, $0.2 billion of the Company's long notional TBA positions and $1.2 billion of the Company's short notional TBA positions were held in order to economically hedge portfolio risk. As of December 31, 2014, $0.9 billion of the Company's long notional TBA positions and $2.2 billion of the Company's short notional TBA positions were held in order to economically hedge portfolio risk. The Company discloses these positions on a gross basis according to the unrealized gain or loss position of each TBA contract regardless of long or short notional position.
The following tables present the notional amount, cost basis, market value and carrying value (which approximates fair value) of the Company's TBA positions as of June 30, 2015 and December 31, 2014:

	As of June 30, 2015				
				Net Carrying Value (4)	
(in thousands)	Notional Amount (1)	Cost Basis (2)	Market Value (3)	Derivative Assets	Derivative Liabilities
Purchase contracts	$205,000	$219,441	$219,369	$—	$(72)
Sale contracts	(1,229,000)	(1,284,198)	(1,289,313)	—	(5,115)
TBAs, net	$(1,024,000)	$(1,064,757)	$(1,069,944)	$—	$(5,187)

Table of Contents

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

	As of December 31, 2014				
				Net Carrying Value [4]	
(in thousands)	Notional Amount [1]	Cost Basis [2]	Market Value [3]	Derivative Assets	Derivative Liabilities
Purchase contracts	$875,000	$862,868	$873,218	$10,350	$—
Sale contracts	(2,200,000)	(2,294,813)	(2,312,500)	—	(17,687)
TBAs, net	$(1,325,000)	$(1,431,945)	$(1,439,282)	$10,350	$(17,687)

(1) Notional amount represents the face amount of the underlying Agency RMBS.
(2) Cost basis represents the forward price to be paid (received) for the underlying Agency RMBS.
(3) Market value represents the current market value of the TBA (or of the underlying Agency RMBS) as of period-end.
(4) Net carrying value represents the difference between the market value of the TBA as of period-end and its cost basis, and is reported in derivative assets / (liabilities), at fair value, in the condensed consolidated balance sheets.

Put and Call Options for TBAs. As of June 30, 2015, the Company had purchased put options for TBAs with a notional amount of $250.0 million and paid upfront premiums of approximately $0.9 million. The Company had also short sold call options for TBAs with a notional amount of $250.0 million and received upfront premiums of approximately $0.9 million as of June 30, 2015. Each of the options will expire in August 2015. The put and call options had a net fair market value of $0.1 million included in derivative liabilities, at fair value, in the condensed consolidated balance sheet as of June 30, 2015. As of December 31, 2014, the Company had purchased put options for TBAs with a notional amount of $2.0 billion and paid upfront premiums of approximately $0.6 million. The put options had a net fair market value of $0.1 million included in derivative assets, at fair value, in the condensed consolidated balance sheet as of December 31, 2014.

Constant Maturity Swaps. The Company has also entered into constant maturity swaps between the 10-year interest rate swap curve and the yield to maturity on a 30-year Fannie Mae TBA to economically hedge mortgage spread widening risk. The Company had the following constant maturity swap agreements in place at December 31, 2014:

(notional and dollars in thousands)
December 31, 2014

Determination Date	Average Strike Swap Rate	Notional Amount	Fair Value	Upfront Premium Paid	Unrealized Gain (Loss)
January 2015	0.538%	$7,000,000	$1,502	$—	$1,502
February 2015	0.572%	2,000,000	(13)	—	(13)
March 2015	0.552%	5,000,000	41	—	41
Total	0.548%	$14,000,000	$1,530	$—	$1,530

The Company did not have any constant maturity swap agreements in place at June 30, 2015.

Interest Rate Swap Agreements. As of June 30, 2015 and December 31, 2014, the Company held the following interest rate swaps in order to mitigate mortgage interest rate exposure (or duration) risk associated with the Company's investment portfolio whereby the Company receives interest at a three-month LIBOR rate:

(notional in thousands)
June 30, 2015

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate	Average Receive Rate	Average Maturity (Years)
2018	$2,040,000	1.563%	0.282%	3.44

2020 and Thereafter	1,210,000	2.164	%	0.281	%	5.58
Total	$3,250,000	1.787	%	0.282	%	4.24

26

Table of Contents

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

(notional in thousands)
December 31, 2014

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2017	$2,000,000	1.070	%	0.229	%	2.54
2018	2,040,000	1.563	%	0.238	%	3.94
2019 and Thereafter	900,000	2.378	%	0.255	%	6.24
Total	$4,940,000	1.512	%	0.237	%	3.80

Additionally, as of June 30, 2015 and December 31, 2014, the Company held the following interest rate swaps in order to mitigate mortgage interest rate exposure (or duration) risk associated with the Company's investment portfolio whereby the Company pays interest at a three-month LIBOR rate:
(notional in thousands)
June 30, 2015

Swaps Maturities	Notional Amounts	Average Pay Rate		Average Fixed Receive Rate		Average Maturity (Years)
2018	$575,000	0.281	%	1.440	%	3.39
2020 and Thereafter	1,889,000	0.283	%	2.588	%	8.10
Total	$2,464,000	0.282	%	2.320	%	7.00

(notional in thousands)
December 31, 2014

Swaps Maturities	Notional Amounts	Average Pay Rate		Average Fixed Receive Rate		Average Maturity (Years)
2018	$575,000	0.231	%	1.440	%	3.89
2019 and Thereafter	1,579,000	0.239	%	2.794	%	9.19
Total	$2,154,000	0.237	%	2.433	%	7.77

The Company monitors its borrowings under repurchase agreements and FHLB advances, which are generally floating rate debt, in relation to the rate profile of its investment securities. When it is cost effective to do so, the Company may enter into interest rate swap arrangements to align the interest rate composition of its borrowings under repurchase agreements and FHLB advances with that of its investment securities and debt portfolios. This particularly applies to borrowing agreements with maturities or interest rate resets of less than six months. Typically, the interest receivable terms (i.e., LIBOR) of the interest rate swaps match the terms of the underlying debt, resulting in an effective conversion of the rate of the related repurchase agreement or FHLB advance from floating to fixed.

Table of Contents

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

As of June 30, 2015 and December 31, 2014, the Company had the following outstanding interest rate swaps that were utilized as economic hedges of interest rate exposure (or duration) associated with the Company's short-term repurchase agreements and FHLB advances:

(notional in thousands)
June 30, 2015

Swaps Maturities	Notional Amount	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2016	$4,200,000	0.583	%	0.282	%	1.10
2017	2,375,000	0.864	%	0.281	%	2.09
2018	800,000	1.165	%	0.280	%	2.65
2019	350,000	1.730	%	0.278	%	3.94
2020 and Thereafter	2,786,523	1.944	%	0.279	%	7.62
Total	$10,511,523	1.090	%	0.281	%	3.26

(notional in thousands)
December 31, 2014

Swaps Maturities	Notional Amount	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2016	$4,100,000	0.667	%	0.249	%	1.65
2017	5,285,000	1.063	%	0.248	%	2.55
2018	625,000	0.945	%	0.233	%	3.08
2019 and Thereafter	1,480,000	2.408	%	0.235	%	7.70
Total	$11,490,000	1.089	%	0.246	%	2.92

Table of Contents

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

Interest Rate Swaptions. As of June 30, 2015 and December 31, 2014, the Company had the following outstanding interest rate swaptions (agreements to enter into interest rate swaps in the future for which the Company would either pay or receive a fixed rate) that were utilized as macro-economic hedges:

	June 30, 2015							
(notional and dollars in thousands)	Option				Underlying Swap			
Swaption	Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Pay Rate	Average Receive Rate	Average Term (Years)
Purchase contracts:								
Payer	< 6 Months	$17,963	$14,444	4.36	$5,600,000	2.75 %	3M Libor	6.3
Payer	≥ 6 Months	259,328	134,633	50.71	9,210,000	4.01 %	3M Libor	6.9
Total Payer		$277,291	$149,077	46.40	$14,810,000	3.53 %	3M Libor	6.7
Receiver	< 6 Months	$13,538	$298	1.04	$2,000,000	3M Libor	1.33 %	5.0
Total Receiver		$13,538	$298	1.04	$2,000,000	3M Libor	1.33 %	5.0
Sale contracts:								
Payer	≥ 6 Months	$(81,248)	$(20,660)	24.02	$(800,000)	3.44 %	3M Libor	10.0
Total Payer		$(81,248)	$(20,660)	24.02	$(800,000)	3.44 %	3M Libor	10.0
Receiver	< 6 Months	$(28,980)	$(19,895)	4.29	$(6,600,000)	3M Libor	1.64 %	6.1
Total Receiver		$(28,980)	$(19,895)	4.29	$(6,600,000)	3M Libor	1.64 %	6.1

	December 31, 2014							
(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)
Purchase contracts:								
Payer	≥ 6 Months	$255,358	$130,120	56.62	$8,210,000	4.12 %	3M Libor	7.4
Total Payer		$255,358	$130,120	56.62	$8,210,000	4.12 %	3M Libor	7.4
Receiver	< 6 Months	$10,715	$6,462	3.38	$5,000,000	3M Libor	1.35 %	5.0
Total Receiver		$10,715	$6,462	3.38	$5,000,000	3M Libor	1.35 %	5.0
Sale contracts:								
Payer	≥ 6 Months	$(81,248)	$(19,990)	30.02	$(800,000)	3.44 %	3M Libor	10.0
Total Payer		$(81,248)	$(19,990)	30.02	$(800,000)	3.44 %	3M Libor	10.0

Table of Contents

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

Markit IOS Total Return Swaps. The Company also enters into total return swaps (agreements whereby the Company receives or makes payments based on the total return of an underlying instrument or index, such as the Markit IOS Index, in exchange for fixed or floating rate interest payments) to help mitigate the potential impact of larger increases or decreases in interest rates on the performance of our investment portfolio (referred to as "convexity risk"). Total return swaps based on the Markit IOS Index are intended to synthetically replicate the performance of interest-only securities. The Company had the following total return swap agreements in place at June 30, 2015 and December 31, 2014:

(notional and dollars in thousands)
June 30, 2015

Maturity Date	Current Notional Amount	Fair Value	Upfront Payable	Unrealized Gain (Loss)
January 12, 2043	$(390,645)	$641	$(866)	$(225)
January 12, 2044	(597,764)	(50)	(7,799)	(7,849)
Total	$(988,409)	$591	$(8,665)	$(8,074)

(notional and dollars in thousands)
December 31, 2014

Maturity Date	Current Notional Amount	Fair Value	Upfront Payable	Unrealized Gain (Loss)
January 12, 2043	$(411,281)	$763	$(1,457)	$(694)
January 12, 2044	(187,178)	624	(275)	349
Total	$(598,459)	$1,387	$(1,732)	$(345)

Credit Risk

The Company's exposure to credit losses on its U.S. Treasuries and Agency portfolio of investment securities is limited due to implicit or explicit backing from the U.S. Department of the Treasury or the GSEs. The payment of principal and interest on the Freddie Mac and Fannie Mae mortgage-backed securities are guaranteed by those respective agencies, and the payment of principal and interest on the Ginnie Mae mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

Credit Default Swaps. For non-Agency investment securities and residential mortgage loans, the Company may enter into credit default swaps to hedge credit risk. In future periods, the Company could enhance its credit risk protection, enter into further paired derivative positions, including both long and short credit default swaps, and/or seek opportunistic trades in the event of a market disruption (see discussion under "Non-Risk Management Activities" below). The Company also has processes and controls in place to monitor, analyze, manage and mitigate its credit risk with respect to non-Agency RMBS and residential mortgage loans.

As of June 30, 2015 and December 31, 2014, the Company held credit default swaps whereby the Company received 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.

Table of Contents

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

The following tables present credit default swaps whereby the Company is receiving protection held as of June 30, 2015 and December 31, 2014:

(notional and dollars in thousands)
June 30, 2015

Protection	Maturity Date	Average Implied Credit Spread	Current Notional Amount	Fair Value	Upfront (Payable) Receivable	Unrealized Gain (Loss)
Receive	June 20, 2016	105.50	$(100,000)	$(901)	$(260)	$(1,161)
	December 20, 2016	496.00	(25,000)	(263)	(4,062)	(4,325)
	Total	183.60	$(125,000)	$(1,164)	$(4,322)	$(5,486)

(notional and dollars in thousands)
December 31, 2014

Protection	Maturity Date	Average Implied Credit Spread	Current Notional Amount	Fair Value	Upfront (Payable) Receivable	Unrealized Gain (Loss)
Receive	June 20, 2016	105.50	$(100,000)	$(1,350)	$(260)	$(1,610)
	December 20, 2016	496.00	(25,000)	(322)	(4,062)	(4,384)
	Total	183.60	$(125,000)	$(1,672)	$(4,322)	$(5,994)

Derivative financial instruments contain an element of credit risk if counterparties are unable to meet the terms of the agreements. Credit risk associated with derivative financial instruments is measured as the net replacement cost should the counterparties that owe the Company under such contracts completely fail to perform under the terms of these contracts, assuming there are no recoveries of underlying collateral, as measured by the market value of the derivative financial instruments. As of June 30, 2015, the fair value of derivative financial instruments as an asset and liability position was $347.3 million and $22.5 million, respectively.

The Company attempts to mitigate its credit risk exposure on derivative financial instruments by limiting its counterparties to banks and financial institutions that meet established credit guidelines. The Company also seeks spread its credit risk exposure across multiple 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 or clearing agency, in the case of centrally cleared interest rate swaps, upon occurrence of certain events. To further mitigate the risk of counterparty default, the Company maintains collateral agreements with certain of its counterparties and clearing agencies, which require both parties to maintain cash deposits in the event the fair values of the derivative financial instruments exceed established thresholds. As of June 30, 2015, the Company has received cash deposits from counterparties of $75.9 million and placed cash deposits of $211.4 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 Company’s condensed consolidated balance sheet.

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 forward purchase commitments, TBAs and inverse interest-only RMBS.

Table of Contents

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

Commitments to Purchase Residential 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 Company's condensed consolidated balance sheets as assets or liabilities and measured at fair value. Subsequent changes in fair value are recorded on the Company's condensed consolidated balance sheets as adjustments to the carrying value of these assets or liabilities with a corresponding adjustment recognized in current period earnings. As of June 30, 2015 and December 31, 2014, the Company had outstanding commitments to purchase $626.7 million and $554.8 million of mortgage loans, subject to fallout if the loans do not close, with a fair value asset of $0.1 million and a fair value liability of $2.6 million at June 30, 2015 and a fair value asset of $1.3 million at December 31, 2014, respectively.
Inverse Interest-Only Securities. As of June 30, 2015 and December 31, 2014, inverse interest-only securities with a carrying value of $178.8 million and $188.6 million, including accrued interest receivable of $1.9 million and $2.2 million, respectively, are accounted for as derivative financial instruments in the condensed consolidated financial statements. The following table presents the amortized cost and carrying value (which approximates fair value) of inverse interest-only securities as of June 30, 2015 and December 31, 2014:

(in thousands)	June 30, 2015	December 31, 2014
Face Value	$1,049,743	$1,168,226
Unamortized premium	—	—
Unamortized discount		
Designated credit reserve	—	—
Net, unamortized	(891,752)	(991,715)
Amortized Cost	157,991	176,511
Gross unrealized gains	21,068	14,162
Gross unrealized losses	(2,156)	(4,269)
Carrying Value	$176,903	$186,404

Note 13. Other Assets
Other assets as of June 30, 2015 and December 31, 2014 are summarized in the following table:

(in thousands)	June 30, 2015	December 31, 2014
Property and equipment at cost	$5,492	$4,849
Accumulated depreciation (1)	(2,593)	(1,941)
Net property and equipment	2,899	2,908
Prepaid expenses	1,375	1,790
Income taxes receivable	7,175	—
Deferred tax assets, net	52,240	40,847
Servicing advances	30,828	27,490
Federal Home Loan Bank stock	125,250	100,010
Equity investments	3,000	3,000
Other receivables	13,793	12,534
Total other assets	$236,560	$188,579

(1) Depreciation expense for the three and six months ended June 30, 2015 was $0.3 million and $0.7 million, respectively.

Table of Contents

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

Note 14. Other Liabilities
Other liabilities as of June 30, 2015 and December 31, 2014 are summarized in the following table:

(in thousands)	June 30, 2015	December 31, 2014
Accrued expenses	$30,724	$29,819
Accrued interest payable	18,984	23,772
Income taxes payable	39	1,375
Other	10,821	9,473
Total other liabilities	$60,568	$64,439

Note 15. Fair Value
Fair Value Measurements
ASC 820, Fair Value Measurements and Disclosures, or ASC 820, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices available in active markets (i.e., observable inputs) and the lowest priority to data lacking transparency (i.e., unobservable inputs). Additionally, ASC 820 requires an entity to consider all aspects of nonperformance risk, including the entity’s own credit standing, when measuring fair value of a liability.
ASC 820 establishes a three-level hierarchy to be used when measuring and disclosing fair value. An instrument’s categorization within the fair value hierarchy is based on the lowest level of significant input to its valuation. Following is a description of the three levels:

Level 1	Inputs are quoted prices in active markets for identical assets or liabilities as of the measurement date under current market conditions. Additionally, the entity must have the ability to access the active market and the quoted prices cannot be adjusted by the entity.
Level 2	Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets for identical or similar assets or liabilities; or inputs that are observable or can be corroborated by observable market data by correlation or other means for substantially the full-term of the assets or liabilities.
Level 3	Unobservable inputs are supported by little or no market activity. The unobservable inputs represent the assumptions that market participants would use to price the assets and liabilities, including risk. Generally, Level 3 assets and liabilities are valued using pricing models, discounted cash flow methodologies, or similar techniques that require significant judgment or estimation.

Following are descriptions of the valuation methodologies used to measure material assets and liabilities at fair value and details of the valuation models, key inputs to those models and significant assumptions utilized.

Investment securities. The Company holds a portfolio of AFS and trading securities that are carried at fair value in the condensed consolidated balance sheets. AFS securities are primarily comprised of Agency and non-Agency RMBS while the Company's U.S. Treasuries are classified as trading securities. The Company determines the fair value of its U.S. Treasuries and Agency RMBS based upon prices obtained from third-party pricing providers or broker quotes received using bid price, which are deemed indicative of market activity. The third-party pricing providers and brokers use pricing models that generally incorporate such factors as coupons, primary and secondary mortgage rates, rate reset period, issuer, prepayment speeds, credit enhancements and expected life of the security. In determining the fair value of its non-Agency RMBS, management judgment may be used to arrive at fair value that considers prices obtained from third-party pricing providers, broker quotes received and other applicable market data. If observable market prices are not available or insufficient to determine fair value due to principally illiquidity in the marketplace, then fair value is based upon internally developed models that are primarily based on observable market-based inputs but also include unobservable market data inputs (including prepayment speeds, delinquency levels, and credit losses). The Company did not hold any U.S. Treasuries at June 30, 2015. The Company classified 100% of its RMBS AFS securities reported at fair value as Level 2 at June 30, 2015. AFS securities account for 76.5% of all assets reported at fair value at June 30, 2015.

Residential mortgage loans held-for-sale. The Company holds residential mortgage loans held-for-sale that are carried at fair value in the condensed consolidated balance sheets as a result of a fair value option election. The Company determines fair value of its residential mortgage loans based on prices obtained from third-party pricing providers and other applicable market data. If observable market prices are not available or insufficient to determine fair value due principally to illiquidity in the marketplace, then fair value is based upon cash flow models that are primarily based on observable market-based inputs but also include unobservable market data inputs (including prepayment speeds, delinquency levels and credit losses). The Company classified 91.2% and 8.8% of its residential mortgage loans held-for-sale as Level 2 and Level 3 fair value assets, respectively, at June 30, 2015.

Residential mortgage loans held-for-investment in securitization trusts. The Company recognizes on its condensed consolidated balance sheets residential mortgage loans held-for-investment in securitization trusts that are carried at fair value as a result of a fair value option election. An entity is allowed to measure both the financial assets and financial liabilities of a qualifying CFE it consolidates using the fair value of either the CFE's financial assets or financial liabilities, whichever is more observable. As the Company's securitization trusts are considered qualifying CFEs, the Company determines the fair value of these residential mortgage loans based on the fair value of its collateralized borrowings in securitization trusts and its retained interests from the Company's on-balance sheet securitizations (eliminated in consolidation in accordance with U.S. GAAP), as the fair value of these instruments is more observable. The Company classified 100% of its residential mortgage loans held-for-investment in securitization trusts as Level 2 fair value assets at June 30, 2015.

Mortgage servicing rights. The Company holds a portfolio of MSR that are carried at fair value on the condensed consolidated balance sheets. The Company determines fair value of its MSR based on prices obtained from third-party pricing providers. Although MSR transactions are observable in the marketplace, the valuation is based upon cash flow models that include unobservable market data inputs (including prepayment speeds, delinquency levels and discount rates). As a result, the Company classified 100% of its MSR as Level 3 fair value assets at June 30, 2015.

Derivative instruments. The Company may enter into a variety of derivative financial instruments as part of its hedging strategies. The Company principally executes over-the-counter, or OTC, derivative contracts, such as interest rate swaps, swaptions, put and call options for TBAs and U.S. Treasuries, credit default swaps, constant maturity swaps and Markit IOS total return swaps. The Company utilizes third-party pricing providers to value its financial derivative instruments. The Company classified 100% of the interest rate swaps, swaptions, put and call options for TBAs and U.S. Treasuries, credit default swaps, constant maturity swaps and total returns swaps reported at fair value as Level 2 at June 30, 2015.

The Company also enters into certain other derivative financial instruments, such as TBAs, short U.S. Treasuries and inverse interest-only securities. These instruments are similar in form to the Company's AFS and trading securities and the Company utilizes a pricing service to value TBAs and broker quotes to value short U.S. Treasuries and inverse interest-only securities. The Company classified 100% of its inverse interest-only securities at fair value as Level 2 at June 30, 2015. The Company reported 100% of its TBAs as Level 1 as of June 30, 2015. The Company did not hold any short U.S. Treasuries at June 30, 2015.

Table of Contents

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

The Company may also enter into forward purchase commitments on residential mortgage loans whereby the Company commits to purchasing the loans at a particular interest rate. The fair value of these derivatives is determined based on prices currently offered in the marketplace for new commitments. Fallout assumptions if the borrower elects not to close the loan are applied to the pricing. As of June 30, 2015, the Company had outstanding commitments to purchase $626.7 million of mortgage loans, subject to fallout if the loans do not close, with a fair value asset of $0.1 million and a fair value liability of $2.6 million. The Company classified 100% of the forward purchase commitments reported at fair value as Level 2 at June 30, 2015.

The Company's risk management committee governs trading activity relating to derivative instruments. The Company's policy is to minimize credit exposure related to financial derivatives used for hedging by limiting the hedge counterparties to major banks, financial institutions, exchanges, and private investors who meet established capital and credit guidelines as well as by limiting the amount of exposure to any individual counterparty.

The Company has netting arrangements in place with all derivative counterparties pursuant to standard documentation developed by ISDA, or central clearing exchange agreements, in the case of centrally cleared interest rate swaps. Additionally, both the Company and the counterparty or clearing agency are required to post cash collateral based upon the net underlying market value of the Company's open positions with the counterparty. Posting of cash collateral typically occurs daily, subject to certain dollar thresholds. Due to the existence of netting arrangements, as well as frequent cash collateral posting at low posting thresholds, credit exposure to the Company and/or to the counterparty or clearing agency is considered materially mitigated. Based on the Company's assessment, there is no requirement for any additional adjustment to derivative valuations specifically for credit.

Collateralized borrowings in securitization trusts. The Company recognizes on its condensed consolidated balance sheets collateralized borrowings that are carried at fair value as a result of a fair value option election. In determining the fair value of its collateralized borrowings, management judgment may be used to arrive at fair value that considers prices obtained from third-party pricing providers, broker quotes received and other applicable market data. If observable market prices are not available or insufficient to determine fair value due to principally illiquidity in the marketplace, then fair value is based upon internally developed models that are primarily based on observable market-based inputs but also include unobservable market data inputs (including prepayment speeds, delinquency levels, and credit losses). The Company classified 100% of its collateralized borrowings in securitization trusts as Level 2 fair value liabilities at June 30, 2015.

The following tables display the Company's assets and liabilities measured at fair value on a recurring basis. The Company often economically hedges the fair value change of its assets or liabilities with derivatives and other financial instruments. The tables below display the hedges separately from the hedged items, and therefore do not directly display the impact of the Company's risk management activities.

	Recurring Fair Value Measurements At June 30, 2015			
(in thousands)	Level 1	Level 2	Level 3	Total
Assets				
Available-for-sale securities	$—	$12,807,658	$—	$12,807,658
Residential mortgage loans held-for-sale	—	633,578	61,500	695,078
Residential mortgage loans held-for-investment in securitization trusts	—	2,449,199	—	2,449,199
Mortgage servicing rights	—	—	437,576	437,576
Derivative assets	—	347,322	—	347,322
Total assets	$—	$16,237,757	$499,076	$16,736,833
Liabilities				
Collateralized borrowings in securitization trusts	$—	$1,714,735	$—	$1,714,735
Derivative liabilities	5,187	17,288	—	22,475

Total liabilities	$5,187	$1,732,023	$—	$1,737,210

35

Table of Contents

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

	Recurring Fair Value Measurements At December 31, 2014			
(in thousands)	Level 1	Level 2	Level 3	Total
Assets				
Available-for-sale securities	$—	$14,341,102	$—	$14,341,102
Trading securities	1,997,656	—	—	1,997,656
Residential mortgage loans held-for-sale	—	500,159	35,553	535,712
Residential mortgage loans held-for-investment in securitization trusts	—	1,744,746	—	1,744,746
Mortgage servicing rights	—	—	452,006	452,006
Derivative assets	10,350	370,441	—	380,791
Total assets	$2,008,006	$16,956,448	$487,559	$19,452,013
Liabilities				
Collateralized borrowings in securitization trusts	$—	$1,209,663	$—	$1,209,663
Derivative liabilities	17,687	72,546	—	90,233
Total liabilities	$17,687	$1,282,209	$—	$1,299,896

The Company may be required to measure certain assets or liabilities at fair value from time to time. These periodic fair value measures typically result from application of certain impairment measures under U.S. GAAP. These items would constitute nonrecurring fair value measures under ASC 820. As of June 30, 2015, the Company did not have any assets or liabilities measured at fair value on a nonrecurring basis in the periods presented.

The valuation of Level 3 instruments requires significant judgment by the third-party pricing providers and/or management. The third-party pricing providers and/or management rely on inputs such as market price quotations from market makers (either market or indicative levels), original transaction price, recent transactions in the same or similar instruments, and changes in financial ratios or cash flows to determine fair value. Level 3 instruments may also be discounted to reflect illiquidity and/or non-transferability, with the amount of such discount estimated by the third-party pricing provider in the absence of market information. Assumptions used by the third-party pricing provider due to lack of observable inputs may significantly impact the resulting fair value and therefore the Company’s condensed consolidated financial statements. The Company’s valuation committee reviews all valuations that are based on pricing information received from a third-party pricing provider. As part of this review, prices are compared against other pricing or input data points in the marketplace, along with internal valuation expertise, to ensure the pricing is reasonable. In addition, the Company performs back-testing of pricing information to validate price information and identify any pricing trends of a third-party price provider.

In determining fair value, third-party pricing providers use various valuation approaches, including market and income approaches. Inputs that are used in determining fair value of an instrument may include pricing information, credit data, volatility statistics, and other factors. In addition, inputs can be either observable or unobservable.

The availability of observable inputs can vary by instrument and is affected by a wide variety of factors, including the type of instrument, whether the instrument is new and not yet established in the marketplace and other characteristics particular to the instrument. The third-party pricing provider uses prices and inputs that are current as of the measurement date, including during periods of market dislocations. In periods of market dislocation, the availability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified to or from various levels within the fair value hierarchy.

Securities for which market quotations are readily available are valued at the bid price (in the case of long positions) or the ask price (in the case of short positions) at the close of trading on the date as of which value is determined. Exchange-traded securities for which no bid or ask price is available are valued at the last traded price. OTC derivative contracts, including interest rate swaps, swaptions, credit default swaps and Markit IOS total return swaps, are valued by the Company using observable inputs, specifically quotations received from third-party pricing providers, and are therefore classified within Level 2.

Table of Contents

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

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

	Level 3 Recurring Fair Value Measurements			
	Three Months Ended June 30, 2015		Six Months Ended June 30, 2015	
(in thousands)	Residential Mortgage Loans Held-For-Sale	Mortgage Servicing Rights	Residential Mortgage Loans Held-For-Sale	Mortgage Servicing Rights
Beginning of period level 3 fair value	$70,149	$410,229	$35,553	$452,006
Gains (losses) included in net income (loss):				
Realized gains (losses)	10,491	(7,805)	15,612	(17,119)
Unrealized gains (losses)	30 (1)	25,440 (3)	777 (1)	(17,649) (3)
Total net gains (losses) included in net income (loss)	10,521	17,635	16,389	(34,768)
Other comprehensive income	—	—	—	—
Purchases	61,054	4,799	131,720	9,350
Sales	(51,981)	—	(75,890)	—
Settlements	(28,243)	4,913	(46,272)	10,988
Gross transfers into level 3	—	—	—	—
Gross transfers out of level 3	—	—	—	—
End of period level 3 fair value	$61,500	$437,576	$61,500	$437,576
Change in unrealized gains or losses for the period included in earnings for assets held at the end of the reporting period	$370 (2)	$25,440 (4)	$352 (2)	$(17,649) (4)

(1) For the three and six months ended June 30, 2015, the change in unrealized gains or losses on residential mortgage loans held-for-sale was recorded in (loss) gain on residential mortgage loans held-for-sale on the condensed consolidated statements of comprehensive income.

(2) For the three and six months ended June 30, 2015, the change in unrealized gains or losses on residential mortgage loans held-for-sale that were held at the end of the reporting period was recorded in (loss) gain on residential mortgage loans held-for-sale on the condensed consolidated statements of comprehensive income.

(3) For the three and six months ended June 30, 2015, the change in unrealized gains or losses on MSR was recorded in gain (loss) on servicing asset on the condensed consolidated statements of comprehensive income.

(4) For the three and six months ended June 30, 2015, the change in unrealized gains or losses on MSR that were held at the end of the reporting period was recorded in gain (loss) on servicing asset on the condensed consolidated statements of comprehensive income.

The Company did not incur transfers between Level 1, Level 2 or Level 3 during the six months ended June 30, 2015. Transfers between Levels are deemed to take place on the first day of the reporting period in which the transfer has taken place.
The Company used a third-party pricing provider in the fair value measurement of its Level 3 residential mortgage loans held-for-sale. The significant unobservable inputs used by the third-party pricing provider included expected

default, severity and discount rate. Significant increases (decreases) in any of the inputs in isolation may result in significantly lower (higher) fair value measurement.

37

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

The Company also used a third-party pricing provider in the fair value measurement of its Level 3 MSR. The table below presents information about the significant unobservable inputs used by the third-party pricing provider in the fair value measurement of the Company's MSR classified as Level 3 fair value assets at June 30, 2015:

As of June 30, 2015

Valuation Technique	Unobservable Input [1]	Range	Weighted Average
Discounted cash flow	Constant prepayment speed	9.5 - 12.8 %	11.2%
	Delinquency	4.3 - 4.9 %	4.6%
	Discount rate	8.1 - 10.7 %	9.4%

(1) Significant increases (decreases) in any of the inputs in isolation may result in significantly lower (higher) fair value measurement. A change in the assumption used for discount rates may be accompanied by a directionally similar change in the assumption used for the probability of delinquency and a directionally opposite change in the assumption used for prepayment rates.

Fair Value Option for Financial Assets and Financial Liabilities

The Company elected the fair value option for the residential mortgage loans it has acquired. The fair value option was elected to mitigate earnings volatility by better matching the accounting for the assets with the related hedges. The mortgage loans are carried within residential mortgage loans held-for-sale on the condensed consolidated balance sheets. The Company's policy is to separately record interest income on these fair value elected loans. Upfront fees and costs related to the fair value elected loans are not deferred or capitalized. Fair value adjustments are reported in (loss) gain on residential mortgage loans held-for-sale on the condensed consolidated statements of comprehensive income. The fair value option is irrevocable once the loan is acquired.

The Company also elected the fair value option for both the residential mortgage loans held-for-investment in securitization trusts and the collateralized borrowings in securitization trusts carried on the condensed consolidated balance sheets. The fair value option was elected to better reflect the economics of the Company's retained interests. The Company's policy is to separately record interest income on the fair value elected loans and interest expense on the fair value elected borrowings. Upfront fees and costs are not deferred or capitalized. Fair value adjustments are reported in other (loss) income on the condensed consolidated statements of comprehensive income.

The following tables summarize the fair value option elections and information regarding the line items and amounts recognized in the condensed consolidated statements of comprehensive income for each fair value option-elected item.

	Three Months Ended June 30, 2015				
(in thousands)	Interest income (expense)	(Loss) gain on residential mortgage loans held-for-sale	Other (loss) income	Total included in net income	Change in fair value due to credit risk
Assets					
Residential mortgage loans held-for-sale	$7,518 [1]	$(3,019)	$—	$4,499	$272 [2]
Residential mortgage loans held-for-investment in securitization trusts	21,830 [1]	—	(49,143)	(27,313)	— [3]
Liabilities					
Collateralized borrowings in securitization trusts	(13,131)	—	31,536	18,405	— [3]
Total	$16,217	$(3,019)	$(17,607)	$(4,409)	$272

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

	Three Months Ended June 30, 2014							
(in thousands)	Interest income (expense)		(Loss) gain on residential mortgage loans held-for-sale	Other (loss) income		Total included in net income	Change in fair value due to credit risk	
Assets								
Residential mortgage loans held-for-sale	$2,699	(1)	$7,638	$—		$10,337	$1,036	(2)
Residential mortgage loans held-for-investment in securitization trusts	7,761	(1)	—	36,631		44,392	—	(3)
Liabilities								
Collateralized borrowings in securitization trusts	(5,592	)	—	(15,802	)	(21,394	) —	(3)
Total	$4,868		$7,638	$20,829		$33,335	$1,036	

	Six Months Ended June 30, 2015							
(in thousands)	Interest income (expense)		(Loss) gain on residential mortgage loans held-for-sale	Other (loss) income		Total included in net income	Change in fair value due to credit risk	
Assets								
Residential mortgage loans held-for-sale	$11,789	(1)	$6,047	$—		$17,836	$30	(2)
Residential mortgage loans held-for-investment in securitization trusts	40,067	(1)	—	(49,094	)	(9,027	) —	(3)
Liabilities								
Collateralized borrowings in securitization trusts	(23,839	)	—	28,569		4,730	—	(3)
Total	$28,017		$6,047	$(20,525	)	$13,539	$30	

Table of Contents

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

	Six Months Ended June 30, 2014				
(in thousands)	Interest income (expense)	(Loss) gain on residential mortgage loans held-for-sale	Other (loss) income	Total included in net income	Change in fair value due to credit risk
Assets					
Residential mortgage loans held-for-sale	$7,285 (1)	$4,874	$—	$12,159	$1,069 (2)
Residential mortgage loans held-for-investment in securitization trusts	15,654 (1)	—	38,606	54,260	— (3)
Liabilities					
Collateralized borrowings in securitization trusts	(10,945)	—	(17,463)	(28,408)	— (3)
Total	$11,994	$4,874	$21,143	$38,011	$1,069

(1) Interest income on residential mortgage loans held-for-sale and residential mortgage loans held-for-investment in securitization trusts is measured by multiplying the unpaid principal balance on the loans by the coupon rate and the number of days of interest due.
(2) The change in fair value due to credit risk on residential mortgage loans held-for-sale was quantified by holding yield constant in the cash flow model in order to isolate credit risk component.
(3) The change in fair value on residential mortgage loans held-for-investment in securitization trusts and collateralized borrowings in securitization trusts was due entirely to changes in market interest rates.

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

	June 30, 2015		December 31, 2014	
(in thousands)	Unpaid Principal Balance	Fair Value (1)	Unpaid Principal Balance	Fair Value (1)
Residential mortgage loans held-for-sale				
Total loans	$703,966	$695,078	$534,101	$535,712
Nonaccrual loans	$48,379	$42,212	$26,405	$20,574
Loans 90+ days past due	$45,547	$39,525	$25,263	$19,675
Residential mortgage loans held-for-investment in securitization trusts				
Total loans	$2,431,573	$2,449,199	$1,699,748	$1,744,746
Nonaccrual loans	$862	$865	$—	$—
Loans 90+ days past due	$—	$—	$—	$—
Collateralized borrowings in securitization trusts				
Total borrowings	$1,743,289	$1,714,735	$1,218,589	$1,209,663

(1) Excludes accrued interest receivable.

Fair Value of Financial Instruments

In accordance with ASC 820, the Company is required to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the condensed consolidated balance sheets, for which fair value can be estimated.

Table of Contents

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

The following describes the Company’s methods for estimating the fair value for financial instruments. Descriptions are not provided for those items that have zero balances as of the current balance sheet date.

- AFS securities, trading securities, residential mortgage loans held-for-sale, residential mortgage loans held-for-investment in securitization trusts, MSR, derivative assets and liabilities, and collateralized borrowings in securitization trusts are recurring fair value measurements; carrying value equals fair value. See discussion of valuation methods and assumptions within the Fair Value Measurements section of this footnote.
- Commercial real estate loans held-for-investment are carried at cost, net of any unamortized premiums or discounts, unless deemed impaired. Because the Company has not yet recorded any allowances for losses and the rate and terms of the one newly-issued senior mezzanine commercial real estate loan held are similar to those observed in the market, carrying value, or amortized cost, approximates fair value. The Company categorizes the fair value measurement of these assets as Level 2.
- Cash and cash equivalents and restricted cash have a carrying value which approximates fair value because of the short maturities of these instruments. The Company categorizes the fair value measurement of these assets as Level 1.
- As a condition to membership in the FHLB, the Company is required to purchase and hold a certain amount of FHLB stock, which is considered a non-marketable, long-term investment, and is carried at cost. Because this stock can only be redeemed or sold at its par value, and only to the FHLB, carrying value, or cost, approximates fair value. The Company categorizes the fair value measurement of these assets as Level 3.
- Equity investments include cost method investments for which fair value is not estimated. Carrying value, or cost, approximates fair value. The Company categorizes the fair value measurement of these assets as Level 3.
- The carrying value of repurchase agreements and FHLB advances that mature in less than one year generally approximates fair value due to the short maturities. The Company holds $3.0 billion of FHLB advances that are considered long-term. The Company’s long-term FHLB advances have floating rates based on an index plus a spread and, for members of the FHLB, the credit spread is typically consistent with those demanded in the market. Accordingly, the interest rates on these borrowings are at market and thus carrying value approximates fair value. The Company categorizes the fair value measurement of these liabilities as Level 2.

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at June 30, 2015 and December 31, 2014.

	June 30, 2015		December 31, 2014	
(in thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Available-for-sale securities	$12,807,658	$12,807,658	$14,341,102	$14,341,102
Trading securities	$—	$—	$1,997,656	$1,997,656
Residential mortgage loans held-for-sale	$695,078	$695,078	$535,712	$535,712
Residential mortgage loans held-for-investment in securitization trusts	$2,449,199	$2,449,199	$1,744,746	$1,744,746
Commercial real estate loans held-for-investment	$45,605	$45,605	$—	$—
Mortgage servicing rights	$437,576	$437,576	$452,006	$452,006
Cash and cash equivalents	$933,579	$933,579	$1,005,792	$1,005,792
Restricted cash	$410,903	$410,903	$336,771	$336,771
Derivative assets	$347,322	$347,322	$380,791	$380,791
Federal Home Loan Bank stock	$125,250	$125,250	$100,010	$100,010
Equity investments	$3,000	$3,000	$3,000	$3,000
Liabilities				
Repurchase agreements	$9,422,803	$9,422,803	$12,932,463	$12,932,463
Collateralized borrowings in securitization trusts	$1,714,735	$1,714,735	$1,209,663	$1,209,663
Federal Home Loan Bank advances	$3,000,000	$3,000,000	$2,500,000	$2,500,000

Derivative liabilities	$22,475	$22,475	$90,233	$90,233

41

Table of Contents

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

Note 16. Repurchase Agreements

As of June 30, 2015, the Company had outstanding $9.4 billion of repurchase agreements. Excluding the effect of the Company's interest rate swaps, the repurchase agreements had a weighted average borrowing rate of 0.75% and weighted average remaining maturities of 69 days as of June 30, 2015. As of December 31, 2014, the Company had outstanding $12.9 billion of repurchase agreements, including repurchase agreements funding the Company's U.S. Treasuries of $2.0 billion. Excluding the debt associated with the Company's U.S. Treasuries and the effect of the Company's interest rate swaps, the repurchase agreements had a weighted average borrowing rate of 0.72% and weighted average remaining maturities of 64 days as of December 31, 2014. As of December 31, 2014, the debt associated with the Company's U.S. Treasuries had a weighted average borrowing rate of 0.23%. The Company did not have any repurchase agreements collateralized by U.S. Treasuries as of June 30, 2015.

At June 30, 2015 and December 31, 2014, the repurchase agreement balances were as follows:

(in thousands)	June 30, 2015	December 31, 2014
Short-term	$9,422,803	$12,839,242
Long-term	—	93,221
Total	$9,422,803	$12,932,463

At June 30, 2015 and December 31, 2014, the repurchase agreements had the following characteristics and remaining maturities:

	June 30, 2015 Collateral Type					
(in thousands)	Agency RMBS	Non-Agency RMBS [1]	Agency Derivatives	Residential Mortgage Loans Held-for-Sale	Commercial Real Estate Loans Held-for-Investment	Total Amount Outstanding
Within 30 days	$1,912,119	$471,133	$47,770	$—	$ 22,950	$2,453,972
30 to 59 days	3,077,003	461,904	85,097	—	—	3,624,004
60 to 89 days	484,627	230,613	—	—	—	715,240
90 to 119 days	471,052	64,420	—	—	—	535,472
120 to 364 days	1,376,499	708,162	—	9,454	—	2,094,115
Total	$7,321,300	$1,936,232	$132,867	$9,454	$ 22,950	$9,422,803
Weighted average borrowing rate	0.45 %	1.85 %	1.03 %	2.63 %	1.84 %	0.75 %

Table of Contents

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

(in thousands)	December 31, 2014 Collateral Type U.S Treasuries	Agency RMBS	Non-Agency RMBS [1]	Agency Derivatives	Residential Mortgage Loans Held-for-Sale	Total Amount Outstanding
Within 30 days	$998,750	$2,305,726	$630,118	$44,723	$—	$3,979,317
30 to 59 days	—	3,568,049	945,032	82,344	—	4,595,425
60 to 89 days	—	631,992	260,228	11,066	—	903,286
90 to 119 days	—	317,155	117,395	—	—	434,550
120 to 364 days	—	1,635,650	278,401	—	15,113	1,929,164
Open maturity [2]	997,500	—	—	—	—	997,500
One year and over	—	—	93,221	—	—	93,221
Total	$1,996,250	$8,458,572	$2,324,395	$138,133	$15,113	$12,932,463
Weighted average borrowing rate	0.23 %	0.42 %	1.79 %	0.99 %	3.03 %	0.64 %

(1) Includes repurchase agreements collateralized by retained interests from the Company's on-balance sheet securitizations, which are eliminated in consolidation in accordance with U.S. GAAP.

(2) Includes repurchase agreements collateralized by U.S. Treasuries with an open maturity period (i.e., rolling 1-day maturity) renewable at the discretion of either party to the agreements.

The following table summarizes assets at carrying values that are pledged or restricted as collateral for the future payment obligations of repurchase agreements:

(in thousands)	June 30, 2015	December 31, 2014
Available-for-sale securities, at fair value	$10,284,534	$11,874,783
Trading securities, at fair value	—	1,997,656
Residential mortgage loans held-for-sale, at fair value	10,545	19,123
Commercial real estate loans held-for-investment	45,605	—
Net economic interests in consolidated securitization trusts [1]	113,824	363,564
Cash and cash equivalents	15,000	14,117
Restricted cash	182,709	112,435
Due from counterparties	24,252	32,495
Derivative assets, at fair value	176,017	185,067
Total	$10,852,486	$14,599,240

(1) Includes the retained interests from the Company's on-balance sheet securitizations, which are eliminated in consolidation in accordance with U.S. GAAP.

Although the transactions under repurchase agreements represent committed borrowings until maturity, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral or fund margin calls.

Table of Contents

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

The following table summarizes certain characteristics of the Company's repurchase agreements and counterparty concentration at June 30, 2015 and December 31, 2014:

	June 30, 2015				December 31, 2014			
(dollars in thousands)	Amount Outstanding	Net Counterparty Exposure [1]	Percent of Equity	Weighted Average Days to Maturity	Amount Outstanding	Net Counterparty Exposure [1]	Percent of Equity	Weighted Average Days to Maturity
Royal Bank of Canada	$1,161,333	$316,965	8 %	119.6	$1,373,549	$401,194	10 %	83.8
Barclays Capital Inc.	789,908	265,129	7 %	59.5	1,346,085	365,879	9 %	50.5
All other counterparties [2] [3]	7,471,562	843,313	21 %	61.5	9,215,329	907,066	22 %	57.7
Total	$9,422,803	$1,425,407			$11,934,963	$1,674,139		

(1) Represents the net carrying value of the securities, residential mortgage loans held-for-sale and commercial real estate loans held-for-investment sold under agreements to repurchase, including accrued interest plus any cash or assets on deposit to secure the repurchase obligation, less the amount of the repurchase liability, including accrued interest. Payables due to broker counterparties for unsettled securities purchases are not included in the amounts presented above. However, at both June 30, 2015 and December 31, 2014, the Company did not have any such payables.

(2) Excludes $997.5 million of repurchase agreements collateralized by U.S. Treasuries with a rolling 1-day maturity as of December 31, 2014.

(3) Represents amounts outstanding with 21 and 23 counterparties at June 30, 2015 and December 31, 2014, respectively.

The Company does not anticipate any defaults by its repurchase agreement counterparties. There can be no assurance, however, that any such default or defaults will not occur.

Note 17. Collateralized Borrowings in Securitization Trusts, at Fair Value

The Company purchases subordinated debt and excess servicing rights from securitization trusts sponsored by either third parties or the Company's subsidiaries. The debt associated with the underlying residential mortgage loans held by the trusts, which are consolidated on the Company's condensed consolidated balance sheets, is classified as collateralized borrowings in securitization trusts and carried at fair value as a result of a fair value option election. See Note 3 - Variable Interest Entities for additional information regarding consolidation of the securitization trusts. As of June 30, 2015 and December 31, 2014, collateralized borrowings in securitization trusts had a carrying value of $1.7 billion and $1.2 billion with a weighted average interest rate of 3.6% for both period ends. The stated maturity dates for all collateralized borrowings were more than five years from both June 30, 2015 and December 31, 2014.

Note 18. Federal Home Loan Bank of Des Moines Advances

The Company's wholly owned subsidiary, TH Insurance Holdings Company LLC, or TH Insurance, is a member in the FHLB. As a member of the FHLB, TH Insurance has access to a variety of products and services offered by the FHLB, including secured advances. As of June 30, 2015 and December 31, 2014, TH Insurance had $3.0 billion and $2.5 billion in outstanding secured advances with a weighted average borrowing rate of 0.35% and 0.34%, respectively, and had an additional $1.0 billion of available uncommitted capacity for borrowings as of June 30, 2015. As of December 31, 2014, TH Insurance had no additional uncommitted capacity to borrow. To the extent TH Insurance has uncommitted capacity, it may be adjusted at the sole discretion of the FHLB.

The ability to borrow from the FHLB is subject to the Company's continued creditworthiness, pledging of sufficient eligible collateral to secure advances, and compliance with certain agreements with the FHLB. Each advance requires approval by the FHLB and is secured by collateral in accordance with the FHLB's credit and collateral guidelines, as may be revised from time to time by the FHLB. Eligible collateral may include conventional 1-4 family residential mortgage loans, commercial real estate loans, Agency RMBS and certain non-Agency RMBS with a rating of A and above.

Table of Contents

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

At June 30, 2015 and December 31, 2014, FHLB advances had the following remaining maturities:

(in thousands)	June 30, 2015	December 31, 2014
≤ 1 year	$—	$33,738
> 1 and ≤ 3 years	651,238	651,238
> 3 and ≤ 5 years	815,024	815,024
> 5 and ≤ 10 years	—	—
> 10 years	1,533,738	1,000,000
Total	$3,000,000	$2,500,000

The following table summarizes assets at carrying values that are pledged or restricted as collateral for the future payment obligations of FHLB advances:

(in thousands)	June 30, 2015	December 31, 2014
Available-for-sale securities, at fair value	$2,268,550	$2,284,532
Residential mortgage loans held-for-sale, at fair value	551,257	397,656
Net economic interests in consolidated securitization trusts (1)	491,270	80,732
Total	$3,311,077	$2,762,920

(1) Includes the retained interests from the Company’s on-balance sheet securitizations, which are eliminated in consolidation in accordance with U.S. GAAP.

The FHLB retains the right to mark the underlying collateral for FHLB advances to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral. In addition, as a condition to membership in the FHLB, the Company is required to purchase and hold a certain amount of FHLB stock, which is based, in part, upon the outstanding principal balance of advances from the FHLB. At June 30, 2015 and December 31, 2014, the Company had stock in the FHLB totaling $125.3 million and $103.0 million, respectively, which is included in other assets on the condensed consolidated balance sheets. FHLB stock is considered a non-marketable, long-term investment, is carried at cost and is subject to recoverability testing under applicable accounting standards. This stock can only be redeemed or sold at its par value, and only to the FHLB. Accordingly, when evaluating FHLB stock for impairment, the Company considers the ultimate recoverability of the par value rather than recognizing temporary declines in value. As of June 30, 2015 and December 31, 2014, the Company had not recognized an impairment charge related to its FHLB stock.

Note 19. Stockholders’ Equity
Distributions to Stockholders
The following table presents cash dividends declared by the Company on its common stock during the three months ended June 30, 2015, and the four immediately preceding quarters:

Declaration Date	Record Date	Payment Date	Cash Dividend Per Share
June 17, 2015	June 30, 2015	July 21, 2015	$0.26
March 18, 2015	March 31, 2015	April 21, 2015	$0.26
December 16, 2014	December 30, 2014	January 20, 2015	$0.26
September 16, 2014	September 30, 2014	October 21, 2014	$0.26
June 17, 2014	July 2, 2014	July 22, 2014	$0.26

Table of Contents

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

Accumulated Other Comprehensive Income
Accumulated other comprehensive income at June 30, 2015 and December 31, 2014 was as follows:

(in thousands)	June 30, 2015	December 31, 2014
Available-for-sale securities, at fair value		
Unrealized gains	$711,813	$891,820
Unrealized losses	(80,781)	(36,031)
Accumulated other comprehensive income	$631,032	$855,789

Reclassifications out of Accumulated Other Comprehensive Income
The following table summarizes reclassifications out of accumulated other comprehensive income for the three and six months ended June 30, 2015 and 2014:

(in thousands)	Affected Line Item in the Condensed Consolidated Statements of Comprehensive Income	Amount Reclassified out of Accumulated Other Comprehensive Income			
		Three Months Ended June 30,		Six Months Ended June 30,	
		2015	2014	2015	2014
Other-than-temporary-impairments on AFS securities	Total other-than-temporary impairment losses	$170	$—	$297	$212
Realized (gains) losses on sales of AFS securities	Gain (loss) on investment securities	(75,135)	(20,952)	(175,071)	22,228
		$(74,965)	$(20,952)	$(174,774)	$22,440

Dividend Reinvestment and Direct Stock Purchase Plan
The Company sponsors a dividend reinvestment and direct stock purchase plan through which stockholders may purchase additional shares of the Company’s common stock by reinvesting some or all of the cash dividends received on shares of the Company’s common stock. Stockholders may also make optional cash purchases of shares of the Company’s common stock subject to certain limitation detailed in the plan prospectus. An aggregate of 7.5 million shares of the Company’s common stock were originally reserved for issuance under the plan. As of June 30, 2015, 249,650 shares have been issued under the plan for total proceeds of approximately $2.6 million, of which 16,772 and 36,184 shares were issued for total proceeds of $178,436 and $378,700 during the three and six months ended June 30, 2015, respectively. During the three and six months ended June 30, 2014, 12,694 and 23,474 shares were issued under the plan for total proceeds for $130,652 and $240,792, respectively.
Share Repurchase Program
On October 5, 2011, the Company’s board of directors authorized a share repurchase program, which allows the Company to repurchase up to 10,000,000 shares of its common stock. On November 14, 2012, the board of directors authorized an increase in the share repurchase program of 15,000,000, for a total of 25,000,000 shares. Shares may be repurchased from time to time through privately negotiated transactions or open market transactions, pursuant to a trading plan in accordance with Rules 10b5-1 and 10b-18 under the Securities Exchange Act of 1934, as amended, or the Exchange Act, or by any combination of such methods. The manner, price, number and timing of share repurchases will be subject to a variety of factors, including market conditions and applicable SEC rules. The share repurchase program does not require the purchase of any minimum number of shares, and purchases may be commenced or suspended at any time without prior notice. As of June 30, 2015, 2,450,700 shares had been repurchased by the Company under the program for a total cost of $23.9 million; however, no shares were repurchased

during the three and six months ended June 30, 2015 and 2014.

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

At-the-Market Offering
On May 25, 2012, the Company entered into an equity distribution agreement under which the Company may sell up to an aggregate of 20,000,000 shares of its common stock from time to time in any method permitted by law deemed to be an “at the market” offering as defined in Rule 415 under the Securities Act of 1933, as amended, or the Securities Act. On May 22, 2015, the Company entered into an amendment to the equity distribution agreement providing that any subsequent offers or sales of the Company’s common stock under the equity distribution agreement shall be made pursuant to a new prospectus supplement, which was filed on the same date. As of June 30, 2015, 7,585,869 shares of common stock have been sold under the equity distribution agreement for total accumulated net proceeds of approximately $77.6 million; however, no shares were sold during the three and six months ended June 30, 2015 and 2014.

Note 20. Equity Incentive Plan
On May 14, 2015, the Company’s stockholders approved the Company’s Second Restated 2009 Equity Incentive Plan, which replaced the previous Restated 2009 Equity Incentive Plan, both of which are referred to collectively as the Plan. This stockholder approval effectuated, among other changes, an increase in the number of shares of common stock available for issuance under the Plan by 10,000,000 shares.
On May 20, 2014 and May 14, 2015, the Company granted 52,180 and 35,521 shares of common stock, respectively, to its independent directors pursuant to the Plan. The estimated fair value of these awards was $10.31 and $10.53 per share on grant date, based on the closing price of the Company’s common stock on the NYSE on such date. The grants vested immediately.
Additionally, on February 5, 2014, February 12, 2015 and May 14, 2015, the Company granted 1,103,162, 206,275 and 909,299 shares of restricted common stock, respectively, to key employees of PRCM Advisers pursuant to the Plan. The estimated fair value of these awards was $9.79, $10.30 and $10.53 per share on grant date, based on the closing market price of the Company’s common stock on the NYSE on such date. However, as the cost of these awards is measured at fair value at each reporting date based on the price of the Company’s stock as of period end in accordance with ASC 505, Equity, or ASC 505, the fair value of these awards as of June 30, 2015 was $9.74 per share based on the closing market price of the Company’s common stock on the NYSE on such date. The shares underlying the grants vest in three equal annual installments commencing on the first anniversary of the grant date, as long as such grantee complies with the terms and conditions of his or her applicable restricted stock award agreement.
The following table summarizes the activity related to restricted common stock for the six months ended June 30, 2015 and 2014:

	Six Months Ended June 30,			
	2015		2014	
(in thousands)	Shares	Weighted Average Grant Date Fair Market Value	Shares	Weighted Average Grant Date Fair Market Value
Outstanding at Beginning of Period	2,002,406	$10.32	1,024,459	$11.22
Granted	1,151,095	10.49	1,155,342	9.81
Vested	(711,124)	(10.45)	(395,986)	(11.10)
Forfeited	(55,474)	(10.19)	(3,065)	(9.79)
Outstanding at End of Period	2,386,903	$10.36	1,780,750	$10.34

For the three and six months ended June 30, 2015, the Company recognized compensation costs related to restricted common stock of $2.9 million and $5.6 million, respectively. For the three and six months ended June 30, 2014, the Company recognized compensation costs related to restricted common stock of $3.7 million and $6.8 million, respectively.

Table of Contents

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

Note 21. Income Taxes
For the three and six months ended June 30, 2015 and 2014, the Company qualified to be taxed as a REIT under the Code for U.S. federal income tax purposes. As long as the Company qualifies as a REIT, the Company generally will not be subject to U.S. federal income taxes on its taxable income to the extent it annually distributes its net taxable income to stockholders, and does not engage in prohibited transactions. The Company intends to distribute 100% of its REIT taxable income and comply with all requirements to continue to qualify as a REIT. The majority of states also recognize the Company’s REIT status. The Company’s TRSs file separate tax returns and are fully taxed as standalone U.S. C-corporations. It is assumed that the Company will retain its REIT status and will incur no REIT level taxation as it intends to comply with the REIT regulations and annual distribution requirements.
During the three and six months ended June 30, 2015, the Company’s TRSs recognized a benefit from income taxes of $7.0 million and $17.6 million, respectively, which was primarily due to losses incurred on derivative instruments held in the Company’s TRSs. During the three and six months ended June 30, 2014, the Company’s TRSs recognized a benefit from income taxes of $23.3 million and $57.2 million, respectively, which was primarily due to losses incurred on derivative instruments held in the Company’s TRSs.
Based on the Company’s evaluation, it has been concluded that there are no significant uncertain tax positions requiring recognition in the Company’s condensed consolidated financial statements of a contingent tax liability for uncertain tax positions.

Note 22. Earnings Per Share
The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted earnings per share, or EPS, for the three and six months ended June 30, 2015 and 2014:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands, except share data)	2015	2014	2015	2014
Numerator:				
Net income	$221,501	$39,657	$316,294	$10,512
Denominator:				
Weighted average common shares outstanding	364,919,352	364,078,669	364,775,066	363,996,652
Weighted average restricted stock shares	2,154,779	1,999,455	2,017,393	1,849,643
Basic and diluted weighted average shares outstanding	367,074,131	366,078,124	366,792,459	365,846,295
Basic and Diluted Earnings Per Share:	$0.60	$0.11	$0.86	$0.03

Note 23. Related Party Transactions
The following summary provides disclosure of the material transactions with affiliates of the Company.
In accordance with the Management Agreement with PRCM Advisers, the Company incurred $12.7 million and $25.4 million as a management fee to PRCM Advisers for the three and six months ended June 30, 2015, respectively, and $12.2 million and $24.3 million as a management fee to PRCM Advisers for the three and six months ended June 30, 2014, respectively, which represents approximately 1.5% of stockholders’ equity on an annualized basis as defined by the Management Agreement. For purposes of calculating the management fee, stockholders’ equity is adjusted to exclude any common stock repurchases as well as any unrealized gains, losses or other items that do not affect realized net income (loss), among other adjustments, in accordance with the Management Agreement. In addition, the Company reimbursed PRCM Advisers for direct and allocated costs incurred by PRCM Advisers on behalf of the Company. These direct and allocated costs totaled approximately $5.4 million and $10.1 million for the three and six months ended June 30, 2015, respectively, and $3.9 million and $7.2 million for the three and six months ended June 30, 2014, respectively.

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

The Company recognized $2.9 million and $5.6 million of compensation expense during the three and six months ended June 30, 2015, respectively, related to restricted common stock. The Company recognized $3.7 million and $6.8 million of compensation expense during the three and six months ended June 30, 2014, respectively, related to restricted common stock. See Note 20 - Equity Incentive Plan for additional information.

Note 24. Subsequent Events

Events subsequent to June 30, 2015, were evaluated through the date these financial statements were issued and no additional events were identified requiring further disclosure in these Condensed Consolidated Financial Statements.

Table of Contents

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

The following discussion and analysis should be read in conjunction with our unaudited condensed consolidated financial statements and accompanying notes included elsewhere in this Quarterly Report on Form 10-Q as well as our Annual Report on Form 10-K for the year ended December 31, 2014.

General

We are a Maryland corporation focused on investing in, financing and managing residential mortgage-backed securities, or RMBS, residential mortgage loans, mortgage servicing rights, or MSR, commercial real estate and other financial assets, which we collectively refer to as our target assets. We operate as a real estate investment trust, or REIT, as defined under the Internal Revenue Code of 1986, as amended, or the Code.

We are externally managed by PRCM Advisers LLC, or PRCM Advisers, which is a wholly owned subsidiary of Pine River Capital Management L.P., or Pine River, a global multi-strategy asset management firm providing comprehensive portfolio management, transparency and liquidity to institutional and high net worth investors.

Our objective is to provide attractive risk-adjusted total return to our stockholders over the long term, primarily through dividends and secondarily through capital appreciation. We selectively acquire and manage an investment portfolio of our target assets, which is constructed to generate attractive returns through market cycles. We focus on asset selection and implement a relative value investment approach across various sectors within the mortgage market. Our target assets include the following:

- Agency RMBS (which includes inverse interest-only Agency securities classified as "Agency Derivatives" for purposes of U.S. generally accepted accounting principles, or U.S. GAAP), meaning RMBS whose principal and interest payments are guaranteed by the Government National Mortgage Association (or Ginnie Mae), the Federal National Mortgage Association (or Fannie Mae), or the Federal Home Loan Mortgage Corporation (or Freddie Mac);
- Non-Agency RMBS, meaning RMBS that are not issued or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac;
- Residential mortgage loans;
- MSR;
- Commercial real estate assets; and
- Other financial assets comprising approximately 5% to 10% of the portfolio.

We generally view our target assets in three strategies that rely on our core competencies of managing prepayment and credit risk. Our rates strategy includes assets that are sensitive to changes in interest rates and prepayment speeds, specifically Agency RMBS and MSR. Our credit strategy includes assets with inherent credit risk including non-Agency RMBS, residential mortgage loans and net economic interests in securitizations on prime nonconforming residential mortgage loans. Additionally, in the fourth quarter of 2014, we announced our intended expansion into the commercial real estate market, planning an initial allocation of approximately $500 million of equity capital. Our commercial strategy will include first mortgage loans, mezzanine loans, b-notes and preferred equity. As of June 30, 2015, we had invested $45.6 million in one senior mezzanine commercial real estate loan.

During the three months ended June 30, 2015, we maintained our hybrid Agency and non-Agency RMBS investment model and continued to develop our operational businesses in support of other mortgage-related investments, which stem from the changing opportunities in the residential mortgage marketplace, including residential mortgage loans and MSR. Within our non-Agency RMBS portfolio, we have historically had a substantial emphasis on "legacy" bonds, which include bonds issued prior to 2009. Throughout the past year, however, we have sold a number of these bonds that we believe had reached maximum value, many of which were replaced with "new issue" non-Agency RMBS. We believe these "new issue" bonds, which include some GSE credit risk transfer bonds, have enabled us to find attractive returns and further diversify our non-Agency RMBS portfolio.

Within our mortgage loan conduit and securitization business, we acquire prime nonconforming residential mortgage loans from select mortgage loan originators and secondary market institutions with the intent to securitize the loans through the issuance of non-Agency mortgage-backed securities. Our intention is to retain the related subordinated securities, representing the credit risk piece associated with these deals. We also hold a small legacy portfolio of credit sensitive residential mortgage loans, or CSL, which are loans that are currently performing, but where the borrower has previously experienced payment delinquencies and is more likely to be underwater (i.e., the amount owed on a mortgage loan exceeds the current market value of the home). As a result, there is a higher probability of default on CSL than on newly originated residential mortgage loans. We do not originate loans or provide direct financing to lenders; rather, through our mortgage loan conduit we contract with originators to acquire loans they originate that meet our purchase criteria.

Table of Contents

Within our MSR business, we purchase the right to control the servicing of mortgage loans from high-quality originators. Additionally, as owner of MSR on loans from securitizations guaranteed by Ginnie Mae, we are obligated to purchase these loans from time to time in order to complete modifications on the mortgage loans or to convey foreclosed properties to the U.S. Department of Housing and Urban Development, or HUD. We held a small portfolio of these Ginnie Mae buyout residential mortgage loans as of June 30, 2015, which, in the majority of instances, will undergo successful loan modifications, return to performing loans and be redelivered to future Ginnie Mae pools or be immediately conveyed to HUD. We do not directly service the mortgage loans we acquire, nor the mortgage loans underlying the MSR we acquire; rather, we contract with fully licensed third-party subservicers to handle substantially all servicing functions.

We believe our investment model allows management to allocate capital across various sectors within the mortgage market, with a focus on asset selection and the implementation of a relative value investment approach. Capital allocation decisions factor in the opportunities in the marketplace, cost of financing and cost of hedging interest rate, prepayment, credit and other portfolio risks. As a result, capital allocation reflects management's opportunistic approach to investing in the marketplace. The following table provides our capital allocation among the target assets in each of our investment strategies as of June 30, 2015 and the four immediately preceding period ends:

	As of				
	June 30, 2015	March 31, 2015	December 31, 2014	September 30, 2014	June 30, 2014
Rates strategy					
Agency RMBS	44%	45%	44%	44%	45%
Mortgage servicing rights	11%	10%	12%	12%	13%
Credit strategy					
Non-Agency RMBS	33%	34%	34%	36%	36%
Mortgage loan conduit/securitization	12%	11%	10%	8%	6%
Commercial strategy	< 1%	< 1%	—%	—%	—%

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

For the three months ended June 30, 2015, our net yield realized on the portfolio was lower than previous periods. Yields and net interest spreads on Agency and non-Agency RMBS, residential mortgage loans held-for-sale and MSR are generally lower than what we have historically realized in our portfolio, while yields and spreads on net economic interests in securitization have remained consistent. Our cost of financing increased as a result of higher swap spread. The following table provides the average annualized yield on our target assets, including Agency and non-Agency RMBS, residential mortgage loans held-for-sale, residential mortgage loans held-for-investment, net of collateralized borrowings, in securitization trusts, commercial real estate loans held-for-investment and MSR for the three months ended June 30, 2015, and the four immediately preceding quarters:

	Three Months Ended				
	June 30, 2015	March 31, 2015	December 31, 2014	September 30, 2014	June 30, 2014
Average annualized portfolio yield [(1)]	4.16%	4.40%	4.46%	4.46%	4.64%
Cost of financing [(2)]	1.37%	1.33%	1.55%	1.47%	1.26%
Net portfolio yield	2.79%	3.07%	2.91%	2.99%	3.38%

(1) Average annualized yield incorporates future prepayment, credit loss and other assumptions, all of which are estimates and subject to change.
(2) Cost of financing includes swap interest rate spread.

51

Table of Contents

We seek to deploy moderate leverage as part of our investment strategy. We generally finance our RMBS assets through short- and long-term borrowings structured as repurchase agreements and through short- and long-term advances from the Federal Home Loan Bank of Des Moines, or the FHLB. Our Agency RMBS, given their liquidity and high credit quality, are eligible for higher levels of leverage, while non-Agency RMBS, with less liquidity and exposure to credit risk, utilize lower levels of leverage. We may also finance our U.S. Treasuries, which we hold from time to time for trading purposes, and our residential mortgage loans held-for-sale and commercial real estate loans held-for-investment. We believe the debt-to-equity ratio funding our Agency RMBS, non-Agency RMBS, residential mortgage loans held-for-sale and commercial real estate loans held-for-investment is the most meaningful leverage measure as U.S. Treasuries are viewed to be highly liquid in nature and collateralized borrowings on residential mortgage loans held-for-investment in securitization trusts represents term financing with no stated maturity. As a result, our debt-to-equity ratio is determined by our RMBS portfolio mix as well as many additional factors, including the liquidity of our portfolio, the sustainability and price of our financing, diversification of our counterparties and their available capacity to finance our RMBS assets, and anticipated regulatory developments. Over the past several quarters, we have generally maintained a debt-to-equity ratio range of 3.0 to 5.0 times to finance our RMBS portfolio, residential mortgage loans held-for-sale and commercial real estate loans held-for-investment, on a fully deployed capital basis. Our debt-to-equity ratio is directly correlated to the make-up of our RMBS portfolio; specifically, the higher percentage of Agency RMBS we hold, the higher our debt-to-equity ratio is, and vice versa. We may alter the percentage allocation of our RMBS portfolio between Agency and non-Agency RMBS depending on the relative value of the assets that are available to purchase from time to time, including at times when we are deploying proceeds from common stock offerings we conduct. The debt-to-equity ratio range has been driven by our relatively stable asset allocation between Agency and non-Agency RMBS, as disclosed above. See the section titled “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Financial Condition - Repurchase Agreements” for further discussion.

We recognize that investing in our target assets is competitive and that we compete with other entities for attractive investment opportunities. We rely on our management team and our dedicated team of investment professionals provided by our external manager to identify investment opportunities. In addition, we have benefited and expect to continue to benefit from our external manager’s analytical and portfolio management expertise and infrastructure. We believe that our significant focus in the mortgage market, the extensive mortgage market expertise of our investment team, our strong analytics and our disciplined relative value investment approach give us a competitive advantage versus our peers.

We have elected to be treated as a REIT for U.S. federal income tax purposes. To qualify as a REIT we are required to meet certain investment and operating tests and annual distribution requirements. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute all of our net taxable income to stockholders, do not participate in prohibited transactions and maintain our intended qualification as a REIT. However, certain activities that we may perform may cause us to earn income which will not be qualifying income for REIT purposes. We have designated certain of our subsidiaries as taxable REIT subsidiaries, or TRSs, as defined in the Code, to engage in such activities, and we may form additional TRSs in the future. We also operate our business in a manner that will permit us to maintain our exemption from registration under the Investment Company Act of 1940, as amended, or the 1940 Act. While we do not currently originate or service residential mortgage loans, certain of our subsidiaries have obtained the requisite licenses and approvals to purchase and sell residential mortgage loans and to hold and manage MSR.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains, or incorporates by reference, not only historical information, but also forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act, and that are subject to the safe harbors created by such sections. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as "anticipate," "estimate," "will," "should," "expect," "target," "believe," "inten "plan," "goals," "future," "likely," "may" and similar expressions or their negative forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the year ended December 31, 2014, under the caption "Risk Factors." Other risks, uncertainties and factors that could cause actual results to differ materially from those projected are described below and may be described from time to time in reports we file with the Securities and Exchange Commission, or SEC, including our Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update or revise any such forward-looking statements, whether as a result of new information, future events, or otherwise, except as required by law.

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

- changes in interest rates and the market value of our target assets;
- changes in prepayment rates of mortgages underlying our target assets;

52

- the occurrence, extent and timing of credit losses within our portfolio;
- our exposure to adjustable-rate and negative amortization mortgage loans underlying our target assets;
- the state of the credit markets and other general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers;
- the concentration of the credit risks to which we are exposed;
- legislative and regulatory actions affecting our business;
- the availability and cost of our target assets;
- the availability and cost of financing for our target assets, including repurchase agreement financing, lines of credit and financing through the FHLB;
- declines in home prices;
- increases in payment delinquencies and defaults on the mortgages comprising and underlying our target assets;
- changes in liquidity in the market for real estate securities, the re-pricing of credit risk in the capital markets, inaccurate ratings of securities by rating agencies, rating agency downgrades of securities, and increases in the supply of real estate securities available-for-sale;
- changes in the values of securities we own and the impact of adjustments reflecting those changes on our condensed consolidated statements of comprehensive income and balance sheets, including our stockholders' equity;
- our ability to generate cash flow from our target assets;
- changes in our investment, financing and hedging strategies and the new risks to which those changes may expose us;
- changes in the competitive landscape within our industry, including changes that may affect our ability to attract and retain personnel;
- our ability to build and maintain successful relationships with loan originators;
- our ability to acquire mortgage loans in connection with our mortgage loan conduit program;
- our ability to securitize the mortgage loans we acquire;
- our exposure to legal and regulatory claims, including litigation arising from our involvement in securitization transactions and investments in MSR;
- our ability to acquire MSR and successfully operate our seller-servicer subsidiary and oversee our subservicers;
- our ability to acquire commercial real estate debt and related assets, and to originate commercial loans, in connection with our commercial real estate initiative;
- the state of commercial real estate markets, including the demand for commercial loans;
- our ability to successfully diversify our business into new asset classes, and manage the new risks to which they may expose us;
- our ability to manage various operational and regulatory risks associated with our business;
- interruptions in or impairments to our communications and information technology systems;
- our ability to maintain appropriate internal controls over financial reporting;
- our ability to establish, adjust and maintain appropriate hedges for the risks in our portfolio;
- our ability to maintain our REIT qualification for U.S. federal income tax purposes; and
- limitations imposed on our business due to our REIT status and our status as exempt from registration under the 1940 Act.

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

Factors Affecting our Operating Results

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

Table of Contents

Fair Value Measurement

A significant portion of our assets and liabilities are at fair value and, therefore, our condensed consolidated balance sheets and statements of comprehensive income are significantly affected by fluctuations in market prices. At June 30, 2015, approximately 90.7% of total assets, or $16.7 billion, and approximately 12.0% of total liabilities, or $1.7 billion, consisted of financial instruments recorded at fair value. See Note 15 - Fair Value to the Condensed Consolidated Financial Statements, included in this Quarterly Report on Form 10-Q, for descriptions of valuation methodologies used to measure material assets and liabilities at fair value and details of the valuation models, key inputs to those models and significant assumptions utilized. Although we execute various hedging strategies to mitigate our exposure to changes in fair value, we cannot fully eliminate our exposure to volatility caused by fluctuations in market prices. Although markets for asset-backed securities, including RMBS, have modestly stabilized since the severe dislocations experienced as a result of the financial crisis, these markets continue to experience volatility and, as a result, our assets and liabilities will be subject to valuation adjustment as well as changes in the inputs we use to measure fair value.

Any temporary change in the fair value of our available-for-sale, or AFS, securities is recorded as a component of accumulated other comprehensive income and does not impact our earnings. Our condensed consolidated balance sheets and statements of comprehensive income are affected, however, by fluctuations in market prices on the remainder of our financial assets and liabilities recorded at fair value. For the three and six months ended June 30, 2015, our unrealized fair value gains on interest rate swap and swaption agreements, which are accounted for as derivative trading instruments under U.S. GAAP, positively affected our financial results. The change in fair value of the interest rate swaps was a result of changes to LIBOR, the swap curve and corresponding counterparty borrowing rates during the three and six months ended June 30, 2015. Our financial results for the three and six months ended June 30, 2015 were negatively affected by unrealized fair value losses on certain U.S. Treasuries classified as trading instruments due to their short-term investment objectives and residential mortgage loans held-for-sale, and positively affected by unrealized fair value gains on MSR for the three months ended June 30, 2015. Our financial results for the six months ended June 30, 2015 were negatively affected by unrealized fair value losses on MSR.

For the three and six months ended June 30, 2014, our unrealized fair value losses on interest rate swap and swaption agreements negatively affected our financial results. The change in fair value of the interest rate swaps was a result of changes to LIBOR, the swap curve and corresponding counterparty borrowing rates during the three and six months ended June 30, 2014. Our financial results for the three and six months ended June 30, 2014 were positively affected by unrealized fair value gains on certain U.S. Treasuries classified as trading instruments and residential mortgage loans held-for-sale, and negatively affected by unrealized fair value losses on MSR.

In addition, our financial results for the three and six months ended June 30, 2015 and 2014 were affected by the unrealized gains and losses of certain other derivative instruments that were accounted for as trading derivative instruments (i.e., credit default swaps, TBAs, short U.S. Treasuries, put and call options for TBAs and U.S. Treasuries, constant maturity swaps, Markit IOS total return swaps, inverse interest-only securities and forward residential mortgage loan purchase commitments).

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

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

Table of Contents

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

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

Market Conditions and Outlook

The key macroeconomic factors that impact our business are home prices and the employment and interest rate environments. Home price metrics remained steady through the second quarter of 2015. While home prices are expected to appreciate over the next several years, the pace of the recovery remains muted. Despite a modest easing in recent months, credit standards remain tight and have had the effect of limiting borrowers’ ability to refinance their mortgages notwithstanding low interest rates and government programs that promote refinancing. Employment market conditions remain solid as jobless claims, unemployment and payroll data are showing positive or stable trends, although underemployment levels remain stubbornly high. Other than LTV ratios and cash reserves, employment is the most powerful determinant of homeowners’ ongoing likelihood to pay their mortgages. Home price performance and employment are particularly important to our non-Agency portfolio.

The interest rate environment was volatile in the second quarter of 2015 as interest rates rose higher in May and June. Overall, interest rates remain at historically low levels despite stable employment statistics and other economic indicators. While the market generally expects a modest increase in rates later in 2015, the low interest rate environment is expected to persist in the near term, as the Federal Reserve has made dovish commentary suggesting it will take a measured approach to its interest rate decisions. Additionally, it appears the Federal Reserve will continue to reinvest its mortgage-backed security principal repayments for the foreseeable future.

The U.S. economy continues to navigate headwinds that include global economic lethargy, geopolitical unrest across various regions worldwide, the ongoing European debt crisis, quantitative easing by the European Central Bank, persistently high underemployment, tepid wage inflation and a fragile housing market.

Regulatory and legislative actions taken in the past few years in an effort to improve economic conditions and increase liquidity in the financial markets, as well as other actions related to the fall-out from the financial and foreclosure crises, continue to impact the market. Regulatory actions that could affect the value and availability of our target assets, either positively or negatively, include: attempts by the U.S. government to further simplify the refinancing process to allow more borrowers to refinance into lower interest rate mortgage loans; the streamlined loan modification initiative for borrowers that are 90+ days delinquent implemented by the government sponsored entities, or GSEs; the real estate owned, or REO, to-rental program supported by the GSEs; the extension of both the Home Affordable Modification Program, or HAMP, and the Home Affordable Refinance Program 2.0, or HARP 2.0, through 2016; the strict “ability-to-repay” and “qualified mortgage” regulations promulgated by the Consumer Financial Protection Bureau, or the CFPB; and the application of the risk retention requirements of Section 15G of the Exchange Act.

There are also a number of impending legislative proposals related to the eventual wind-down or phase out of the GSEs. While it remains uncertain if any proposal will ultimately become legislation, it does not appear that meaningful efforts relative to GSE reform will take place in the near future. We will continue to monitor these and other regulatory and policy activities closely.

In fall of 2014, the FHFA published a proposed rulemaking regarding membership in the Federal Home Loan Bank system. Among other effects, the rulemaking would exclude captive insurers from membership, including our subsidiary member, TH Insurance Holdings Company LLC, or TH Insurance. We have no indication of how the FHFA will proceed with the rulemaking, if at all, but we are currently a member in good standing with the FHLB and believe our mission aligns well with that of the Federal Home Loan Bank system. We continue to closely monitor matters that could impact our FHLB membership.

Also in 2014, the U.S. Department of Treasury, or the Treasury, requested comment on the development of a responsible private label securities market. We believe that private capital, through the private label securities market, is a critical component to the long-term stability of the mortgage market and, accordingly, submitted a comment letter in response to the request. The Treasury echoes our sentiment and views a diverse housing finance system with numerous capital streams as critical to promoting competition, market efficiency, and consumer choice.

Table of Contents

We believe our blended Agency and non-Agency RMBS portfolio and our investing expertise, as well as our operational business platforms, will allow us to better navigate the dynamic mortgage market while future regulatory and policy activities take shape. Having a diversified portfolio allows us to mitigate a variety of risks, including interest rate and RMBS spread volatility. As such, we have diversified into several target assets that capitalize on our prepayment and credit expertise, including MSR, prime nonconforming residential mortgage loans and commercial real estate loans.

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

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

(dollars in thousands)	June 30, 2015			December 31, 2014		
Agency						
Fixed Rate	$9,981,103	76.9	%	$11,164,032	76.8	%
Hybrid ARMs	119,710	0.9	%	128,285	0.9	%
Total Agency	10,100,813	77.8	%	11,292,317	77.7	%
Agency Derivatives	176,903	1.4	%	186,404	1.3	%
Non-Agency						
Senior	1,904,680	14.6	%	2,370,435	16.3	%
Mezzanine	795,071	6.1	%	670,421	4.6	%
Interest-only securities	7,094	0.1	%	7,929	0.1	%
Total Non-Agency	2,706,845	20.8	%	3,048,785	21.0	%
Total	$12,984,561			$14,527,506		

Prepayment speeds and volatility due to interest rates

Our Agency RMBS and MSR portfolios are subject to inherent prepayment risk. Generally, a decline in interest rates that leads to rising prepayment speeds will cause the market value of our interest-only securities and MSR to deteriorate, and our fixed coupon Agency pools to increase. The inverse relationship occurs when interest rates increase and prepayments slow. As previously discussed, while the market generally expects a modest increase in rates later in 2015, the low interest rate environment is expected to persist in the near term. However, changes in home price performance, key employment metrics and government programs, among other macroeconomic factors, could cause prepayment speeds to increase on many RMBS, which could lead to less attractive reinvestment opportunities. Nonetheless, we believe our portfolio management approach, including our security selection process, positions us to ideally respond to a variety of market scenarios, including an overall faster prepayment environment.

Although we are unable to predict the movement in interest rates in 2015 and beyond, our diversified portfolio management strategy is intended to generate attractive yields with a low level of sensitivity to changes in the yield curve, prepayments and interest rate cycles.

Our portfolio includes Agency securities, which includes bonds with explicit prepayment protection, $85,000 maximum loan balance pools (securities collateralized by loans of less than $85,000 in principal), other low loan balances (securities collateralized by loans of less than $175,000, but more than $85,000 in principal), high LTV ratios (securities collateralized by loans with greater or equal to 80% LTV predominantly comprised of Making Homeownership Affordable, or MHA, pools that consist of borrowers who have refinanced through HARP), home equity conversion mortgages (securities collateralized by reverse mortgages), low FICO scores (lower credit borrowers), and seasoned bonds reflecting less prepayment risk due to previously experienced high levels of refinancing. We believe these RMBS characteristics reduce the prepayment risk to the portfolio.

Table of Contents

The following tables provide the carrying value of our Agency RMBS portfolio by vintage and prepayment protection:

	As of June 30, 2015					
	Agency RMBS AFS		Agency	Total Agency RMBS		
(dollars in thousands)	Fixed Rate	Hybrid ARMs	Derivatives			
Other low loan balances	$3,793,833	$—	$—	$3,793,833	37	%
$85K Max Pools	1,748,879	—	—	1,748,879	17	%
Home equity conversion mortgages	1,691,235	—	—	1,691,235	16	%
2006 and subsequent vintages	945,523	27,120	—	972,643	10	%
High LTV (predominantly MHA)	458,475	—	—	458,475	4	%
Pre-pay lock-out or penalty-based	464,517	3,554	—	468,071	5	%
Seasoned (2005 and prior vintages)	205,389	89,036	125,264	419,689	4	%
2006 and subsequent vintages - discount	334,194	—	51,639	385,833	4	%
Low FICO	339,058	—	—	339,058	3	%
Total	$9,981,103	$119,710	$176,903	$10,277,716	100	%

	As of December 31, 2014					
	Agency RMBS AFS		Agency	Total Agency RMBS		
(dollars in thousands)	Fixed Rate	Hybrid ARMs	Derivatives			
Other low loan balances	$3,815,603	$—	$—	$3,815,603	33	%
$85K Max Pools	2,529,610	—	—	2,529,610	22	%
Home equity conversion mortgages	1,740,830	—	—	1,740,830	15	%
2006 and subsequent vintages	1,353,827	28,997	—	1,382,824	12	%
High LTV (predominantly MHA)	515,428	—	—	515,428	5	%
Pre-pay lock-out or penalty-based	492,333	3,670	—	496,003	4	%
Seasoned (2005 and prior vintages)	254,921	95,618	130,961	481,500	4	%
2006 and subsequent vintages - discount	347,618	—	55,443	403,061	4	%
Low FICO	113,862	—	—	113,862	1	%
Total	$11,164,032	$128,285	$186,404	$11,478,721	100	%

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

The following tables provide discount information on our non-Agency RMBS portfolio:

	As of June 30, 2015			
(in thousands)	Principal and Interest Securities		Interest-Only	Total
	Senior	Mezzanine	Securities	
Face Value	$2,511,578	$897,459	$258,158	$3,667,195
Unamortized discount				
Designated credit reserve	(597,875)	(59,751)	—	(657,626)
Unamortized net discount	(424,032)	(143,840)	(252,152)	(820,024)
Amortized Cost	$1,489,671	$693,868	$6,006	$2,189,545

Table of Contents

(in thousands)	As of December 31, 2014			
	Principal and Interest Securities		Interest-Only Securities	Total
	Senior	Mezzanine		
Face Value	$3,213,104	$794,798	$283,970	$4,291,872
Unamortized discount				
Designated credit reserve	(843,106)	(84,499)	—	(927,605)
Unamortized net discount	(531,531)	(158,465)	(277,372)	(967,368)
Amortized Cost	$1,838,467	$551,834	$6,598	$2,396,899

Credit losses

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

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

We evaluate credit risk on our residential mortgage loans through a comprehensive asset selection process, which includes pre-acquisition due diligence and underwriting. We review our residential mortgage loans on an ongoing basis using quantitative and qualitative analysis and through on-going asset surveillance.

We also evaluate credit risk on our commercial real estate loans through a comprehensive asset selection process, which includes valuing the underlying collateral property as well as the financial and operating capability of the borrower, borrowing entity or loan sponsor. We also assess the financial wherewithal of any loan guarantors, the borrower’s competency in managing and operating the properties, and the overall economic environment, real estate sector, and geographic sub-market in which the borrower operates. We evaluate each loan for impairment at least quarterly and may record an allowance to reduce the carrying value of the loan to the present value of expected future cash flows, if deemed impaired.

Counterparty exposure and leverage ratio

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

As of June 30, 2015, we had entered into repurchase agreements with 30 counterparties, 23 of which had outstanding balances at June 30, 2015, including one facility that provides short-term financing for our mortgage loan collateral with outstanding balances at June 30, 2015. In addition, we held both short- and long-term secured advances from the FHLB. As of June 30, 2015, we had a total consolidated debt-to-equity ratio of 3.6 times. As of June 30, 2015, we had $0.9 billion in cash and cash equivalents, approximately $215.4 million of unpledged Agency securities and derivatives and $158.6 million of unpledged non-Agency securities and retained interests from the Company’s on-balance sheet securitizations, which are eliminated in consolidation in accordance with U.S. GAAP. As a result, we had an overall estimated unused borrowing capacity on our unpledged RMBS and retained interests of approximately $312.1 million. We also had approximately $71.8 million of unpledged prime nonconforming residential mortgage loans, $10.9 million of unpledged CSL, and $50.6 million of unpledged Ginnie Mae buyout residential mortgage loans, and an overall estimated unused borrowing capacity on unpledged residential mortgage loans held-for-sale of approximately $64.6 million. As of June 30, 2015, we did not have any unpledged commercial real estate loans held-for-investment. If borrowing rates and collateral requirements change in the near term, we believe we are subject to less earnings volatility than if we carried higher leverage.

Table of Contents

We also monitor exposure to counterparties involved in our mortgage loan conduit and MSR businesses. In connection with securitization transactions and MSR assets, we are required to make certain representations and warranties to the investors in the RMBS we issue or the loans underlying the MSR we own. If the representations and warranties that we are required to make prove to be inaccurate, we may be obligated to repurchase certain mortgage loans, which may impact the profitability of these businesses. Although we obtain similar representations and warranties from the counterparty from which we acquired the relevant asset, if those representations and warranties do not directly mirror those we make to the investor, or if we are unable to enforce the representations and warranties against the party for a variety of reasons, including the financial condition or insolvency of the counterparty, we may not be able to seek indemnification from our counterparties for any losses attributable to the breach.

Summary of Results of Operations and Financial Condition

Our reported earnings for U.S. GAAP purposes, or GAAP net income, was $221.5 million and $316.3 million ($0.60 and $0.86 per weighted share) for the three and six months ended June 30, 2015, as compared to $39.7 million and $10.5 million ($0.11 and $0.03 per weighted share) for the three and six months ended June 30, 2014.

With our accounting treatment for AFS securities, unrealized fluctuations in the market values of securities do not impact our GAAP net income (loss) or taxable income but are recognized on our condensed consolidated balance sheets as a change in stockholders' equity under "accumulated other comprehensive income." As a result of this fair value accounting through stockholders' equity, we expect our net income (loss) to have less significant fluctuations and result in less U.S. GAAP to taxable income timing differences, than if the portfolio were accounted for as trading instruments. For the three months ended June 30, 2015 and 2014, net unrealized losses on AFS securities recognized as other comprehensive loss were $218.8 million and net unrealized gains on AFS securities recognized as other comprehensive income were $191.2 million, respectively, which resulted in comprehensive income of $2.7 million for the three months ended June 30, 2015 as compared to $230.8 million for the three months ended June 30, 2014. For the six months ended June 30, 2015 and 2014, net unrealized losses on AFS securities recognized as other comprehensive loss were $224.8 million and net unrealized gains on AFS securities recognized as other comprehensive income were $372.9 million, respectively, which resulted in comprehensive income of $91.5 million for the six months ended June 30, 2015 as compared to $383.4 million for the six months ended June 30, 2014.

On June 17, 2015, we declared a cash dividend of $0.26 per share. Our book value per common share for U.S. GAAP purposes was $10.81 at June 30, 2015, a decrease from $11.08 book value per common share at December 31, 2014. During this six month period, we recognized a decrease in accumulated other comprehensive income due to net unrealized losses on AFS securities of $224.8 million and declared cash dividends of $190.9 million, driving the overall decrease in book value.

Table of Contents

The following tables present the components of our comprehensive income for the three and six months ended June 30, 2015 and 2014:

(in thousands, except share data)	Three Months Ended		Six Months Ended	
Income Statement Data:	June 30,		June 30,	
	2015	2014	2015	2014
Interest income:	(unaudited)		(unaudited)	
Available-for-sale securities	$118,129	$127,605	$253,654	$251,518
Trading securities	3,981	1,940	8,676	3,866
Residential mortgage loans held-for-sale	7,518	2,699	11,789	7,285
Residential mortgage loans held-for-investment in securitization trusts	21,830	7,761	40,067	15,654
Commercial real estate loans held-for-investment	850	—	894	—
Cash and cash equivalents	221	144	418	361
Total interest income	152,529	140,149	315,498	278,684
Interest expense:				
Repurchase agreements	19,398	18,603	39,963	39,175
Collateralized borrowings in securitization trusts	13,131	5,592	23,839	10,945
Federal Home Loan Bank advances	2,500	755	4,730	908
Total interest expense	35,029	24,950	68,532	51,028
Net interest income	117,500	115,199	246,966	227,656
Other-than-temporary impairment losses	(170)	—	(297)	(212)
Other income:				
Gain (loss) on investment securities	69,932	37,688	199,389	(967)
Gain (loss) on interest rate swap and swaption agreements	44,952	(116,019)	(81,491)	(221,547)
Loss on other derivative instruments	(5,484)	(24,202)	(2,517)	(18,401)
(Loss) gain on residential mortgage loans held-for-sale	(6,832)	11,801	2,260	8,620
Servicing income	30,516	33,868	62,603	64,309
Gain (loss) on servicing asset	17,635	(29,571)	(34,768)	(62,331)
Other (loss) income	(16,609)	21,003	(18,466)	21,463
Total other income (loss)	134,110	(65,432)	127,010	(208,854)
Expenses:				
Management fees	12,686	12,190	25,407	24,301
Securitization deal costs	2,484	—	5,095	—
Servicing expenses	5,899	6,857	12,615	12,082
Other operating expenses	15,827	14,323	31,882	28,857
Total expenses	36,896	33,370	74,999	65,240
Income (loss) before income taxes	214,544	16,397	298,680	(46,650)
Benefit from for income taxes	(6,957)	(23,260)	(17,614)	(57,162)
Net income	$221,501	$39,657	$316,294	$10,512
Basic and diluted earnings per weighted average common share	$0.60	$0.11	$0.86	$0.03
Dividends declared per common share	$0.26	$0.26	$0.52	$0.52
Basic and diluted weighted average number of shares of common stock	367,074,131	366,078,124	366,792,459	365,846,295

60

Table of Contents

(in thousands)	Three Months Ended		Six Months Ended	
Income Statement Data:	June 30,		June 30,	
	2015	2014	2015	2014
Comprehensive income:	(unaudited)		(unaudited)	
Net income	$221,501	$39,657	$316,294	$10,512
Other comprehensive (loss) income:				
Unrealized (loss) gain on available-for-sale securities, net	(218,826)	191,160	(224,757)	372,895
Other comprehensive (loss) income	(218,826)	191,160	(224,757)	372,895
Comprehensive income	$2,675	$230,817	$91,537	$383,407

(in thousands)	June 30,	December 31,
Balance Sheet Data:	2015	2014
	(unaudited)	
Available-for-sale securities	$12,807,658	$14,341,102
Total assets	$18,447,721	$21,084,309
Repurchase agreements	$9,422,803	$12,932,463
Federal Home Loan Bank advances	$3,000,000	$2,500,000
Total stockholders' equity	$3,971,569	$4,068,042

Results of Operations

The following analysis focuses on the results generated during the three and six months ended June 30, 2015 and 2014.

Interest Income and Average Portfolio Yield

The following tables present the components of interest income and average annualized net asset yield earned by investment type on our AFS securities, trading securities, residential mortgage loans held-for-sale, residential mortgage loans held-for-investment in securitization trusts, commercial real estate loans held-for-investment and Agency Derivatives for the three and six months ended June 30, 2015 and 2014:

	Three Months Ended June 30, 2015			Six Months Ended June 30, 2015		
(dollars in thousands)	Average Balance (1)	Interest Income	Net Asset Yield	Average Balance (1)	Interest Income	Net Asset Yield
Available-for-sale securities	$12,435,182	$118,129	3.8 %	$12,926,307	$253,654	3.9 %
Trading securities	1,996,767	3,981	0.8 %	1,831,154	8,676	0.9 %
Residential mortgage loans held-for-sale	839,611	7,518	3.6 %	634,310	11,789	3.7 %
Residential mortgage loans held-for-investment in securitization trusts	2,254,686	21,830	3.9 %	2,065,134	40,067	3.9 %
Commercial real estate loans held-for-investment	45,583	850	7.5 %	24,427	894	7.3 %
	17,571,829	152,308	3.5 %	17,481,332	315,080	3.6 %
Agency derivatives (2)	160,981	6,903	17.2 %	162,943	15,088	18.5 %
Total	$17,732,810	$159,211	3.6 %	$17,644,275	$330,168	3.7 %

Table of Contents

(dollars in thousands)	Three Months Ended June 30, 2014 Average Balance [1]	Interest Income	Net Asset Yield		Six Months Ended June 30, 2014 Average Balance [1]	Interest Income	Net Asset Yield	
Available-for-sale securities	$12,160,180	$127,605	4.2	%	$12,001,266	$251,518	4.2	%
Trading securities	996,667	1,940	0.8	%	998,124	3,867	0.8	%
Residential mortgage loans held-for-sale	253,944	2,699	4.3	%	362,904	7,285	4.0	%
Residential mortgage loans held-for-investment in securitization trusts	794,771	7,761	3.9	%	801,418	15,654	3.9	%
Commercial real estate loans held-for-investment	—	—	—	%	—	—	—	%
	14,205,562	140,005	3.9	%	14,163,712	278,324	3.9	%
Agency derivatives [2]	203,831	7,928	15.6	%	208,740	14,934	14.3	%
Total	$14,409,393	$147,933	4.1	%	$14,372,452	$293,258	4.1	%

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

(2) Interest income on Agency Derivatives is included in loss on other derivative instruments on the condensed consolidated statements of comprehensive income.

Total interest income, including interest income on Agency Derivatives, has increased from $147.9 million and $293.3 million for the three and six months ended June 30, 2014 to $159.2 million and $330.2 million for the same periods in 2015, due primarily to purchases of residential mortgage loans held-for-sale and the completion of multiple securitization transactions in the latter half of 2014 and the first half of 2015, offset by decreases in yields on Agency and non-Agency RMBS.

The decrease in net yields on AFS securities for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was predominantly driven by sales of non-Agency RMBS previously purchased at higher yields that we believe had reached maximum value, which were replaced with bonds at lower yields as well as faster prepayments on Agency RMBS. The yields on trading securities for the three months ended June 30, 2015 were consistent with those for the same period in 2014. The increase in yields on trading securities for the six months ended June 30, 2015, as compared to the same period in 2014, was the result of increases in Treasury rates. The decrease in yields on residential mortgage loans held-for-sale for the three and six months ended June 30, 2015 as compared to the same period in 2014, was the result of a decline in market interest rates as well as the sale of substantially all of our CSL portfolio during the first quarter of 2014. The yields on residential mortgage loans held-for-investment in securitization trusts for the three and six months ended June 30, 2015 were consistent with those for the same periods in 2014. The increase in net yields on Agency Derivatives for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was predominantly driven by slower expectation of prepayments on these interest-only securities. The yield on commercial real estate loans held-for-investment for the three and six months ended June 30, 2015 represents interest income on one commercial real estate loan settled during the first quarter of 2015, which, as a result, is not indicative of future yields.

The following tables present the components of the net yield earned by investment type on our RMBS AFS portfolio as a percentage of our average amortized cost of securities for the three and six months ended June 30, 2015 and 2014:

	Three Months Ended June 30, 2015	Six Months Ended June 30, 2015

	Agency [1]	Non-Agency	Total	Agency [1]	Non-Agency	Total
Gross yield/stated coupon	4.5 %	3.3 %	4.3 %	4.5 %	3.2 %	4.3 %
Net (premium amortization) discount accretion	(1.6)%	4.6 %	(0.5)%	(1.4)%	4.7 %	(0.4)%
Net yield [2]	2.9 %	7.9 %	3.8 %	3.1 %	7.9 %	3.9 %

62

Table of Contents

	Three Months Ended June 30, 2014			Six Months Ended June 30, 2014		
	Agency [(1)]	Non-Agency	Total	Agency [(1)]	Non-Agency	Total
Gross yield/stated coupon	4.5 %	3.1 %	4.3 %	4.5 %	3.1 %	4.2 %
Net (premium amortization) discount accretion	(1.4)%	5.6 %	(0.1)%	(1.4)%	5.7 %	— %
Net yield [(2)]	3.1 %	8.7 %	4.2 %	3.1 %	8.8 %	4.2 %

(1) Excludes Agency Derivatives. For the three and six months ended June 30, 2015, average annualized net yield on total Agency RMBS, including Agency Derivatives, was 3.1% and 3.3%, respectively, compared to 3.4% for both of the same periods in 2014.
(2) These yields have not been adjusted for cost of delay and cost to carry purchase premiums.

The following tables provide the components of interest income and net asset yield by investment type on our RMBS AFS portfolio:

	Three Months Ended June 30, 2015			Six Months Ended June 30, 2015		
(dollars in thousands)	Agency [(1)]	Non-Agency	Total	Agency [(1)]	Non-Agency	Total
Average amortized cost	$10,242,687	$2,192,495	$12,435,182	$10,676,950	$2,249,356	$12,926,306
Coupon interest	115,257	17,829	133,086	240,982	35,541	276,523
Net (premium amortization) discount accretion	(40,251)	25,294	(14,957)	(75,628)	52,759	(22,869)
Interest income	$75,006	$43,123	$118,129	$165,354	$88,300	$253,654
Net asset yield	2.9 %	7.9 %	3.8 %	3.1 %	7.9 %	3.9 %

	Three Months Ended June 30, 2014			Six Months Ended June 30, 2014		
(dollars in thousands)	Agency [(1)]	Non-Agency	Total	Agency [(1)]	Non-Agency	Total
Average amortized cost	$9,848,383	$2,311,797	$12,160,180	$9,763,230	$2,238,036	$12,001,266
Coupon interest	111,662	17,808	129,470	218,524	34,833	253,357
Net (premium amortization) discount accretion	(34,118)	32,253	(1,865)	(65,923)	64,084	(1,839)
Interest income	$77,544	$50,061	$127,605	$152,601	$98,917	$251,518
Net asset yield	3.1 %	8.7 %	4.2 %	3.1 %	8.8 %	4.2 %

(1) Excludes Agency Derivatives. For the three and six months ended June 30, 2015, average annualized net yield on total Agency RMBS, including Agency Derivatives, was 3.1% and 3.3%, respectively, compared to 3.4% for both of the same periods in 2014.

The decrease in net yields on Agency RMBS AFS for the three months ended June 30, 2015, as compared to the same period in 2014, was predominantly driven by faster prepayments. The yields on Agency RMBS AFS for the six months ended June 30, 2015 were consistent with those for the same period in 2014. The decrease in net yields on non-Agency RMBS for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was due to the sale of bonds previously purchased at higher yields that we believe had reached maximum value, which were replaced with bonds at lower yields.

Table of Contents

Interest Expense and the Cost of Funds

The following tables present the components of interest expense and average annualized cost of funds on borrowings incurred by investment type on our AFS securities, Agency Derivatives, trading securities, residential mortgage loans held-for-sale, residential mortgage loans held-for-investment in securitization trusts and commercial real estate loans held-for-investment for the three and six months ended June 30, 2015 and 2014:

	Three Months Ended June 30, 2015			Six Months Ended June 30, 2015		
(dollars in thousands)	Average Balance (1)	Interest Expense	Cost of Funds (2)	Average Balance (1)	Interest Expense	Cost of Funds (2)
Available-for-sale securities						
Agency (3)	$9,819,649	$10,502	0.4 %	$10,227,512	$21,345	0.4 %
Non-Agency	1,850,870	8,759	1.9 %	1,894,072	17,680	1.9 %
	11,670,519	19,261	0.7 %	12,121,584	39,025	0.6 %
Agency derivatives	133,923	346	1.0 %	134,563	683	1.0 %
Trading securities	1,672,198	881	0.2 %	1,835,364	1,727	0.2 %
Residential mortgage loans held-for-sale	440,797	457	0.4 %	424,593	900	0.4 %
Residential mortgage loans held-for-investment in securitization trusts (4)	2,072,674	14,025	2.7 %	1,887,402	26,138	2.8 %
Commercial real estate loans held-for-investment	12,610	59	1.9 %	6,340	59	1.9 %
Total	$16,002,721	$35,029	0.9 %	$16,409,846	$68,532	0.8 %

	Three Months Ended June 30, 2014			Six Months Ended June 30, 2014		
(dollars in thousands)	Average Balance (1)	Interest Expense	Cost of Funds (2)	Average Balance (1)	Interest Expense	Cost of Funds (2)
Available-for-sale securities						
Agency (3)	$9,301,465	$9,383	0.4 %	$9,177,489	$19,179	0.4 %
Non-Agency	1,965,593	8,711	1.8 %	1,910,300	17,707	1.9 %
	11,267,058	18,094	0.6 %	11,087,789	36,886	0.7 %
Agency derivatives	155,961	403	1.0 %	159,125	826	1.0 %
Trading securities	943,626	228	0.1 %	972,443	388	0.1 %
Residential mortgage loans held-for-sale	104,330	633	2.4 %	143,762	1,983	2.8 %
Residential mortgage loans held-for-investment in securitization trusts (4)	630,917	5,592	3.5 %	659,296	10,945	3.3 %
Commercial real estate loans held-for-investment	—	—	— %	—	—	— %
Total	$13,101,892	$24,950	0.8 %	$13,022,415	$51,028	0.8 %

(1) Average balance represents average total repurchase agreements and FHLB advances on AFS securities, Agency Derivatives, trading securities, residential mortgage loans held-for-sale and commercial real estate loans held-for-investment, and average collateralized borrowings for residential mortgage loans held-for-investment in securitization trusts.

(2)

Cost of funds by investment type is based on the underlying investment type of the asset assigned as collateral. Cost of funds does not include the accrual and settlement of interest associated with interest rate swaps. In accordance with U.S. GAAP, those costs are included in gain (loss) on interest rate swap and swaption agreements in the condensed consolidated statements of comprehensive income. For the three and six months ended June 30, 2015, our total average cost of funds on the assets assigned as collateral for repurchase agreements, FHLB advances and collateralized borrowings shown in the table above, including interest spread expense associated with interest rate swaps, was 1.7% and 1.6%, respectively, compared to 1.4% and 1.3% for the same periods in 2014.

(3) Excludes Agency Derivatives. For the three and six months ended June 30, 2015, our average cost of funds on total Agency RMBS, including Agency Derivatives, was 0.4%, compared to 0.4% for both of the same periods in 2014.

(4) Includes repurchase agreements and FHLB advances collateralized by retained interests from our on-balance sheet securitizations, which are eliminated in consolidation in accordance with U.S. GAAP.

Table of Contents

Total interest expense has increased from $24.9 million and $51.0 million for the three and six months ended June 30, 2014 to $35.0 million and $68.5 million for the same periods in 2015, due primarily to increased interest expense on collateralized borrowings due to the completion of multiple securitization transactions in the latter half of 2014 and the first half of 2015.

The cost of funds associated with the financing of Agency RMBS AFS and Agency Derivatives for the three and six months ended June 30, 2015 and non-Agency RMBS for the six months ended June 30, 2015 were consistent with those for the same periods in 2014. However, the increase in cost of funds associated with the financing of non-Agency RMBS for the three months ended June 30, 2015, as compared to the same period in 2014, was the result of increases in the repurchase agreement borrowing rates offered by counterparties, which are generally based on a specified margin over one-month LIBOR. The increase in cost of funds associated with the financing of trading securities for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was due to an increase in U.S. Treasury borrowing rates. The decrease in cost of funds associated with the financing of residential mortgage loans held-for-sale for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was the result of a decrease in the outstanding balance under repurchase agreements and increase in the outstanding balance under FHLB advances, which provide lower financing rates. The decrease in cost of funds associated with the financing of residential mortgage loans held-for-investment in securitization trusts for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was primarily the result of an increase in the outstanding balance of FHLB advances collateralized by retained interests from our on-balance sheet securitizations. The cost of funds associated with the financing of commercial real estate loans held-for-investment for the three and six months ended June 30, 2015 represents repurchase agreement financing on one commercial real estate loan started in May 2015, which, as a result, is not indicative of future cost of funds.

Net Interest Income

The following tables present the components of net interest income and average annualized net interest rate spread earned by investment type on our AFS securities, trading securities, residential mortgage loans held-for-sale, residential mortgage loans held-for-investment in securitization trusts, commercial real estate loans held-for-investment and Agency Derivatives for the three and six months ended June 30, 2015 and 2014:

	Three Months Ended June 30, 2015			Six Months Ended June 30, 2015		
(dollars in thousands)	Net Interest Income	Net Interest Rate Spread (1)		Net Interest Income	Net Interest Rate Spread (1)	
Available-for-sale securities						
Agency (2)	$64,504	2.5	%	$144,009	2.7	%
Non-Agency	34,364	6.0	%	70,620	6.0	%
	98,868	3.1	%	214,629	3.3	%
Trading securities	3,100	0.6	%	6,949	0.7	%
Residential mortgage loans held-for-sale	7,061	3.2	%	10,889	3.3	%
Residential mortgage loans held-for-investment in securitization trusts (3)	7,805	1.2	%	13,929	1.1	%
Commercial real estate loans held-for-investment	791	5.6	%	835	12.8	%
	117,625	2.6	%	247,231	2.8	%
Agency derivatives (4)	6,557	16.2	%	14,405	17.5	%
Total	$124,182	2.7	%	$261,636	2.9	%

65

Table of Contents

(dollars in thousands)	Three Months Ended June 30, 2014 Net Interest Income	Net Interest Rate Spread [1]		Six Months Ended June 30, 2014 Net Interest Income	Net Interest Rate Spread [1]	
Available-for-sale securities						
Agency [2]	$68,161	2.7	%	$133,422	2.7	%
Non-Agency	41,350	6.9	%	81,210	6.9	%
	109,511	3.6	%	214,632	3.5	%
Trading securities	1,712	0.7	%	3,479	0.7	%
Residential mortgage loans held-for-sale	2,066	1.9	%	5,302	1.2	%
Residential mortgage loans held-for-investment in securitization trusts [3]	2,169	0.4	%	4,709	0.6	%
Commercial real estate loans held-for-investment	—	—	%	—	—	%
	115,458	3.1	%	228,122	3.1	%
Agency derivatives [4]	7,525	14.6	%	14,108	13.3	%
Total	$122,983	3.3	%	$242,230	3.3	%

(1) Net interest rate spread does not include the accrual and settlement of interest associated with interest rate swaps. In accordance with U.S. GAAP, those costs are included in gain (loss) on interest rate swap and swaption agreements in the condensed consolidated statements of comprehensive income. For the three and six months ended June 30, 2015, our total average net interest rate spread on the assets shown in the table above, including interest spread expense associated with interest rate swaps, was 1.9% and 2.1%, respectively, compared to 2.7% and 2.8% for the same periods in 2014.

(2) Excludes Agency Derivatives. For the three and six months ended June 30, 2015, our average annualized net interest rate spread on total Agency RMBS, including Agency Derivatives, was 2.7% and 2.9%, respectively, compared to 3.0% for both of the same periods in 2014.

(3) Net of interest expense on repurchase agreements and FHLB advances collateralized by retained interests from our on-balance sheet securitizations, which are eliminated in consolidation in accordance with U.S. GAAP.

(4) Interest income on Agency Derivatives is included in loss on other derivative instruments on the condensed consolidated statements of comprehensive income, while interest expense on Agency Derivatives is included in interest expense on repurchase agreements on the condensed consolidated statements of comprehensive income.

The decrease in net interest rate spread on Agency RMBS AFS for the three months ended June 30, 2015, as compared to the same period in 2014, was predominantly driven by faster prepayments. The net interest rate spread on Agency RMBS AFS for the six months ended June 30, 2015 was consistent with the spread for the same period in 2014. The decrease in net interest rate spread on non-Agency RMBS was due to the sale of bonds previously purchased at higher yields that we believe had reached maximum value, which were replaced with bonds at lower yields.

The decrease in net interest rate spread on trading securities for the three months ended June 30, 2015, as compared to the same period in 2014, was due to a slight increase in borrowing rates on U.S. Treasuries. The net interest rate spread on trading securities for the six months ended June 30, 2015 was consistent with the spread for the same period in 2014. The increase in net interest spread on our residential mortgage loans held-for-sale for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was generally driven by lower financing rates, as discussed above. The increase in net interest spread on our residential mortgage loans held-for-investment in securitization trusts for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was generally the result of the securitization transactions completed in the latter half of 2014 and the first half of 2015. The increase in net interest spread on Agency Derivatives for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was predominantly driven by slower expectation of prepayments on these interest-only securities.

The net interest rate spread on commercial real estate loans held-for-investment for the three and six months ended June 30, 2015 represents interest income on one commercial real estate loan settled during the first quarter of 2015, net of interest expense on one repurchase agreement started in May 2015, which, as a result, is not indicative of future spreads.

Table of Contents

Other-Than-Temporary Impairments

We review each of our securities on a quarterly basis to determine if an OTTI charge is necessary. For the three and six months ended June 30, 2015, we recognized $0.2 million and $0.3 million of OTTI losses. For the three months ended June 30, 2014, we did not recognize any OTTI losses, but for the six months ended June 30, 2014, we recognized $0.2 million in OTTI losses. For further information about evaluating AFS securities for other-than-temporary impairments, refer to Note 4 - Available-for-Sale Securities, at Fair Value of the notes to the condensed consolidated financial statements.

Gain (Loss) on Investment Securities

During the three and six months ended June 30, 2015, we sold AFS securities for $1.7 billion and $2.6 billion with an amortized cost of $1.6 billion and $2.4 billion, for net realized gains of $75.9 million and $193.3 million, respectively. We also sold U.S. Treasuries for $2.0 billion with an amortized cost of $2.0 billion, resulting in realized gains of $7.4 million for both the three and six months ended June 30, 2015. During the three and six months ended June 30, 2014, we sold AFS securities for $459.4 million and $1.3 billion with an amortized cost of $423.4 million and $1.3 billion, for net realized gains of $36.0 million and losses of $2.8 million, respectively. We also sold U.S. Treasuries for $44.8 million and $143.4 million with an amortized cost of $44.8 million and $143.0 million, resulting in realized losses of $7,031 and gains of $0.4 million, respectively, for the three and six months ended June 30, 2014. We do not expect to sell assets on a frequent basis, but may sell assets to reallocate capital into new assets that our management believes have higher risk-adjusted returns.

For the three and six months ended June 30, 2015, trading securities experienced a change in unrealized losses of $13.4 million and $1.4 million, respectively, compared to a change in unrealized gains of $1.7 million and $1.5 million for the same periods in 2014. The decrease in change in unrealized gains for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was driven by the sale of our U.S. Treasuries and corresponding recognition of realized gains during the three and six months ended June 30, 2015.

Gain (Loss) on Interest Rate Swap and Swaption Agreements

For the three and six months ended June 30, 2015, we recognized $26.1 million and $53.7 million, respectively, of expenses for the accrual and/or settlement of the net interest expense associated with our interest rate swaps. The expenses result from paying either a fixed interest rate or LIBOR interest on an average $16.7 billion and $17.5 billion notional for the three and six months ended June 30, 2015, respectively, to economically hedge/mitigate interest rate exposure (or duration) risk associated with our investment portfolio and our short-term repurchase agreements and FHLB advances, and receiving either LIBOR interest or a fixed interest rate. For the three and six months ended June 30, 2014, we recognized $18.9 million and $32.7 million, respectively, of expenses for the accrual and/or settlement of the net interest expense associated with our interest rate swaps. The expenses result from paying either a fixed interest rate or LIBOR interest on an average $23.5 billion and $21.3 billion notional for the three and six months ended June 30, 2014, respectively, to economically hedge/mitigate interest rate exposure (or duration) risk associated with our investment portfolio and our short-term repurchase agreements and FHLB advances, and receiving either LIBOR interest or a fixed interest rate.

During the three and six months ended June 30, 2015, we terminated, had agreements mature or had options expire on 29 and 44 interest rate swap and swaption positions of $20.2 billion and $29.5 billion notional, respectively. Upon settlement of the early terminations and option expirations, we paid $23.0 million and $27.6 million in full settlement of our net interest spread liability and recognized $74.9 million and $63.1 million in realized losses on the swaps and swaptions for the three and six months ended June 30, 2015, respectively, including early termination penalties. During the three and six months ended June 30, 2014, we terminated, had agreements mature or had options expire on 10 and 17 interest rate swap and swaption positions of $8.8 billion and $11.8 billion notional, respectively. Upon settlement of the early terminations and option expirations, we paid $3.0 million and $3.8 million in full settlement of our net interest spread liability and recognized $5.2 million and $6.4 million in realized losses on the swaps and swaptions for the three and six months ended June 30, 2014, respectively, including early termination penalties. We elected to terminate certain swaps and swaptions during these periods to align with our investment portfolio.

Also included in our financial results for the three and six months ended June 30, 2015, was the recognition of a change in unrealized valuation gains of $146.0 million and $35.3 million, respectively, on our interest rate swap and swaption agreements that were accounted for as trading instruments. For the three and six months ended June 30, 2014, we recognized changes in unrealized valuation losses of $92.0 million and $182.4 million, respectively, on our interest rate swap and swaption agreements that were accounted for as trading instruments. The change in fair value of interest rate swaps was a result of changes to LIBOR, the swap curve and corresponding counterparty borrowing rates during the six months ended June 30, 2015. Since these swaps and swaptions are used for purposes of hedging our interest rate exposure, their unrealized valuation gains and losses are generally offset by unrealized losses and gains in our Agency RMBS AFS portfolio, which are recorded directly to stockholders’ equity through other comprehensive (loss) income.

Table of Contents

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2015	2014	2015	2014
Net interest spread	$(26,147)	$(18,891)	$(53,673)	$(32,727)
Early termination, agreement maturation and option expiration gains (losses)	(74,851)	(5,161)	(63,076)	(6,401)
Change in unrealized loss on interest rate swap and swaption agreements, at fair value	145,950	(91,967)	35,258	(182,419)
Loss on interest rate swap and swaption agreements	$44,952	$(116,019)	$(81,491)	$(221,547)

Loss on Other Derivative Instruments

Included in our financial results for the three and six months ended June 30, 2015, was the recognition of $5.5 million and $2.5 million of losses, respectively, on other derivative instruments we hold for purposes of both hedging and non-hedging activities, principally credit default swaps, TBAs, short U.S. Treasuries, put and call options for TBAs and U.S. Treasuries, constant maturity swaps, Markit IOS total return swaps and inverse interest-only securities. Included within the results for the three and six months ended June 30, 2015, was the recognition of $6.9 million and $15.1 million of interest income, net of accretion on inverse interest-only securities on an average amortized cost basis of $161.0 million and $162.9 million, respectively. The remainder represented realized and unrealized net gains (losses) on other derivative instruments. As these derivative instruments are considered trading instruments, our financial results include both realized and unrealized gains (losses) associated with these instruments.

Included in our financial results for the three and six months ended June 30, 2014, was the recognition of $24.2 million and $18.4 million of losses, respectively, on other derivative instruments we hold for purposes of both hedging and non-hedging activities, principally credit default swaps, TBAs, short U.S. Treasuries, put and call options for TBAs, constant maturity swaps, Markit IOS total return swaps and inverse interest-only securities. Included within the results for the three and six months ended June 30, 2014, was the recognition of $7.9 million and $14.9 million of interest income, net of accretion on inverse interest-only securities on an average amortized cost basis of $203.8 million and $208.7 million, respectively. The remainder represented realized and unrealized net gains (losses) on other derivative instruments. Since our derivative instruments are generally used for purposes of hedging our interest rate and credit risk exposure, their unrealized valuation gains and losses are generally offset by unrealized losses and gains in our RMBS AFS and residential mortgage loan portfolios.

(Loss) Gain on Residential Mortgage Loans Held-for-Sale

For the three and six months ended June 30, 2015, we recorded losses of $6.8 million and gains of $2.3 million, respectively, on residential mortgage loans held-for-sale. Included within these results was the recognition of losses of $1.7 million and gains of $6.4 million, respectively, on residential mortgage loans held-for-sale and losses of $5.1 million and $4.2 million on commitments to purchase residential mortgage loans held-for-sale for the three and six months ended June 30, 2015, respectively. For the three and six months ended June 30, 2014, we recorded gains of $11.8 million and $8.6 million, respectively, on residential mortgage loans held-for-sale. Included within these results was the recognition of gains of $7.6 million and $4.9 million, respectively, on residential mortgage loans held-for-sale and gains of $4.2 million and $3.7 million on commitments to purchase residential mortgage loans held-for-sale for the three and six months ended June 30, 2014, respectively. The increase in losses (decrease in gains) on residential mortgage loans held-for-sale during the three and six months ended June 30, 2015, as compared to the same periods in 2014, were due in part to rising interest rates during the three and six months ended June 30, 2015 as compared to falling interest rates during the three and six months ended June 30, 2014.

Servicing Income

For the three and six months ended June 30, 2015, we recognized total servicing income of $30.5 million and $62.6 million, respectively. These amounts include servicing fee income of $29.6 million and $60.8 million, ancillary fee income of $0.6 million and $1.1 million, and float income of $0.4 million and $0.7 million, respectively. For the three and six months ended June 30, 2014, we recognized total servicing income of $33.9 million and $64.3 million, respectively. These amounts include servicing fee income of $33.1 million and $62.9 million, ancillary fee income of $0.6 million and $1.0 million, and float income of $0.2 million and $0.3 million, respectively. The decrease in servicing income for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was the result of a decline in the size of our MSR portfolio due to prepayments.

Gain (Loss) on Servicing Asset

For the three and six months ended June 30, 2015, gain on servicing asset of $17.6 million and loss on servicing asset of $34.8 million, respectively, includes a decrease in fair value of MSR due to realization of cash flows (runoff) of $7.8 million and $17.1 million, respectively, and an increase in fair value of MSR due to changes in valuation inputs or assumptions of $25.4 million and a decrease in fair value of MSR due to changes in valuation inputs or assumptions of $17.6 million, respectively. For the three and six months ended June 30, 2014, loss on servicing asset of $29.6 million and $62.3 million, respectively, includes a decrease in fair value of MSR due to realization of cash flows (runoff) of $13.9 million and $26.4 million and a decrease in fair value of MSR due to changes in valuation inputs or assumptions of $15.7 million and $35.9 million, respectively. The increase in gain (decrease in loss) on servicing asset for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was the result of decreased prepayment speeds and a slight decrease in the discount rate.

Other (Loss) Income

For the three and six months ended June 30, 2015, we recorded other loss of $16.6 million and $18.5 million, which includes $49.1 million in losses on residential mortgage loans held-for-investment in securitization trusts for both respective periods and $31.5 million and $28.6 million in gain, respectively, on collateralized borrowings in securitization trusts. Also included in other (loss) income for the three and six months ended June 30, 2015 was other mortgage loan revenue of $0.1 million and $0.3 million, respectively, and dividend income on our FHLB stock of $0.9 million and $1.7 million for the three and six months ended June 30, 2015.

For the three and six months ended June 30, 2014, we recorded other income of $21.0 million and $21.5 million, which includes $36.6 million and $38.6 million in gains, respectively, on residential mortgage loans held-for-investment in securitization trusts and $15.8 million and $17.5 million in losses, respectively, on collateralized borrowings in securitization trusts. Also included in other (loss) income for the three and six months ended June 30, 2014 was other mortgage loan revenue of $0.1 million and $0.3 million, respectively, and dividend income on our FHLB stock of $0.1 million for both the three and six months ended June 30, 2014. The decrease in other (loss) income for the three and six months ended June 30, 2015, as compared to the same periods in 2014, was due in part to rising interest rates during the three and six months ended June 30, 2015 as compared to falling interest rates during the three and six months ended June 30, 2014.

Management Fees

We incurred management fees of $12.7 million and $25.4 million for the three and six months ended June 30, 2015 and $12.2 million and $24.3 million for the three and six months ended June 30, 2014, respectively, which are payable to PRCM Advisers, our external manager, under our management agreement. The management fee is calculated based on our stockholders' equity with certain adjustments outlined in the management agreement. See further discussion of the management fee calculation in Note 23 - Related Party Transactions of the notes to the condensed consolidated financial statements.

Securitization Deal Costs

For the three and six months ended June 30, 2015, we recognized $2.5 million and $5.1 million in upfront costs related to the sponsoring of securitization trusts. Because we did not participate in any securitization deals during the six months ended June 30, 2014, we did not incur any securitization deal costs. These costs are included when evaluating the economics of a securitization; however, the election of the fair value option for the assets and liabilities held in the securitization trusts requires the expense to be recognized upfront on the condensed consolidated statements of comprehensive income. Changes in securitization deal costs are directly related to the number and size of securitization trusts sponsored by either third parties or our subsidiaries during the respective periods.

Servicing Expenses

For the three and six months ended June 30, 2015, we recognized $5.9 million and $12.6 million, respectively, in servicing expenses generally related to the subservicing of residential mortgage loans held-for-sale and MSR, compared to $6.9 million and $12.1 million in servicing expenses recognized during the three and six months ended June 30, 2014, respectively. Included in servicing expenses for the three and six months ended June 30, 2015 was a decrease in the MSR representation and warranty reserve of $0.9 million and $0.8 million, compared to $0.6 million in reserve expense for both the three and six months ended June 30, 2014. The decrease in servicing expenses during the three months ended June 30, 2015, as compared to the same period in 2014, was the result of a reduction in the MSR representation and warranty reserve. The slight increase in servicing expenses during the six months ended June 30, 2015, as compared to the same period in 2014, was due to the timing of certain servicing costs passed on to us by our subservicers.

Other Operating Expenses

For the three and six months ended June 30, 2015, we recognized $15.8 million and $31.9 million, of other operating expenses, which represents an annualized expense ratio of 1.6% of average equity for both periods, compared to $14.3 million and $28.9 million of expenses, which represents an annualized expense ratio of 1.5% of average equity, for both of the same periods in 2014. The increase of our operating expense ratio resulted primarily from an increase in expenses related to the personnel and infrastructure to support our residential mortgage loan, MSR and commercial real estate activities.

69

Table of Contents

Included in other operating expenses are direct and allocated costs incurred by PRCM Advisers on our behalf and reimbursed by us. For the three and six months ended June 30, 2015, these direct and allocated costs totaled approximately $5.4 million and $10.1 million, respectively, compared to $3.9 million and $7.2 million for the same periods in 2014. Included in these reimbursed costs was compensation paid to employees of Pine River serving as our principal financial officer and general counsel of $0.2 million and $1.3 million for the three and six months ended June 30, 2015 and $0.2 million and $1.3 million for the three and six months ended June 30, 2014, respectively. The allocation of compensation paid to employees of Pine River serving as our principal financial officer and general counsel is based on time spent overseeing our company's activities in accordance with the management agreement. Equity based compensation expense for the three and six months ended June 30, 2015 also includes the amortization of the restricted stock awarded to our executive officers in conjunction with the Company's Second Restated 2009 Equity Incentive Plan, or the Plan (see discussion in Note 20 - Equity Incentive Plan), including our chief executive officer, chief investment officer, principal financial officer and general counsel of $1.1 million and $2.6 million, compared to $1.9 million and $3.8 million for the three and six months ended June 30, 2014, respectively.
We have established an accounts payable function and direct relationships with the majority of our third-party vendors. We will continue to have certain costs allocated to us by PRCM Advisers for compensation, data services and proprietary technology, but most of our expenses with third-party vendors are paid directly by us.

Income Taxes

During the three and six months ended June 30, 2015, our TRSs recognized a benefit from income taxes of $7.0 million and $17.6 million, compared to $23.3 million and $57.2 million during the three and six months ended June 30, 2014, respectively, which for each period was primarily due to losses incurred on derivative instruments held in our TRSs. We currently intend to distribute 100% of our REIT taxable income and comply with all requirements to continue to qualify as a REIT.

Financial Condition

Available-for-Sale Securities, at Fair Value

Agency RMBS

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

The table below summarizes certain characteristics of our Agency RMBS AFS securities at June 30, 2015:

	June 30, 2015							
(dollars in thousands, except purchase price)	Principal/Current Face	Net (Discount) Premium	Amortized Cost	Unrealized Gain	Unrealized Loss	Carrying Value	Weighted Average Coupon Rate	Weighted Average Purchase Price
Principal and interest securities:								
Fixed	$9,051,042	$577,131	$9,628,173	$165,513	$(63,794)	$9,729,892	4.32 %	$108.01
Hybrid/ARM	111,399	5,009	116,408	3,638	(336)	119,710	3.51 %	$106.05
Total P&I Securities	9,162,441	582,140	9,744,581	169,151	(64,130)	9,849,602	4.31 %	$107.98
Interest-only securities								
Fixed	326,102	(290,672)	35,430	7,018	(265)	42,183	4.32 %	$15.23

Fixed Other [1]	2,734,036	(2,526,966)	207,070	13,353	(11,395)	209,028	1.64 %	$9.25
Total	$12,222,579	$(2,235,498)	$9,987,081	$189,522	$(75,790)	$10,100,813		

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

Our three-month average constant prepayment rate, or CPR, experienced by Agency RMBS AFS owned by us as of June 30, 2015, on an annualized basis, was 8.9%.

70

Table of Contents

The following table summarizes the number of months until the next re-set for our floating or adjustable rate Agency RMBS AFS mortgage portfolio at June 30, 2015:

(in thousands)	June 30, 2015
0-12 months	$118,366
13-36 months	1,344
Total	$119,710

Non-Agency RMBS

Our non-Agency RMBS portfolio is comprised of senior and mezzanine tranches of mortgage-backed securities, and excludes the retained interests from our on-balance sheet securitizations, as they are eliminated in consolidation in accordance with U.S. GAAP. The following table provides investment information on our non-Agency RMBS as of June 30, 2015:

	As of June 30, 2015						
(in thousands)	Principal/current face	Accretable purchase discount	Credit reserve purchase discount	Amortized cost	Unrealized gain	Unrealized loss	Carrying value
Principal and interest securities:							
Senior	$2,511,578	$(424,032)	$(597,875)	$1,489,671	$415,729	$(720)	$1,904,680
Mezzanine	897,459	(143,840)	(59,751)	693,868	105,474	(4,271)	795,071
Total P&I Securities	3,409,037	(567,872)	(657,626)	2,183,539	521,203	(4,991)	2,699,751
Interest-only securities	258,158	(252,152)	—	6,006	1,088	—	7,094
Total	$3,667,195	$(820,024)	$(657,626)	$2,189,545	$522,291	$(4,991)	$2,706,845

The majority of our non-Agency RMBS were rated at June 30, 2015. Note that credit ratings are based on the par value of the non-Agency RMBS, whereas the distressed non-Agency RMBS assets in our portfolio were acquired at a heavily discounted price. The following table summarizes the credit ratings of our non-Agency RMBS portfolio, based on the Bloomberg Index Rating, a composite of each of the four major credit rating agencies (i.e., DBRS Ltd., Moody's Investors Services, Inc., Standard & Poor's Corporation and Fitch, Inc.), as of June 30, 2015:

	June 30, 2015
AAA	6.6 %
AA	— %
A	1.0 %
BBB	0.3 %
BB	0.8 %
B	5.1 %
Below B	68.5 %
Not rated	17.7 %
Total	100.0 %

Table of Contents

The size of our non-Agency RMBS portfolio has decreased slightly since June 30, 2014. Our allocation of non-Agency RMBS to prime securities has increased from 10.9% at June 30, 2014 to 11.6% at June 30, 2015. Conversely, our allocation of non-Agency RMBS to subprime securities has decreased from 78.3% at June 30, 2014 to 65.2% at June 30, 2015. As a result, our designated credit reserve as a percentage of total discount and total face value has also decreased (as disclosed in Note 4 - Available-for-Sale Securities, at Fair Value of the notes to the condensed consolidated financial statements). When focused on principal and interest securities, from June 30, 2014 to June 30, 2015, our designated credit reserve as a percentage of total discount decreased from 60.6% to 53.7% and our designated credit reserve as a percentage of total face value decreased from 25.4% to 17.9%. As our allocation of non-Agency RMBS to subprime securities has decreased over the period from June 30, 2014 to June 30, 2015, we believe these comparable portfolio metrics are reflective of our investment profile, regardless of portfolio size.

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

Within our non-Agency RMBS portfolio, we have historically had a substantial emphasis on “legacy” bonds, which include bonds issued prior to 2009, many subprime. We believe these deeply discounted bonds can add relative value as the economy and housing markets continue to improve. There remains upside optionality to lower delinquencies, higher recoveries and faster prepays. Throughout the past year, however, we have sold a number of these bonds that we believe had reached maximum value, many of which were replaced with “new issue” non-Agency RMBS. We believe these “new issue” bonds, which include some GSE credit risk transfer bonds, have enabled us to find attractive returns and further diversify our non-Agency RMBS portfolio. Our allocation of non-Agency RMBS to “legacy” bonds has decreased from 92.4% at June 30, 2014 to 86.7% at June 30, 2015. Conversely, our allocation of non-Agency RMBS to “new issue” bonds has increased from 7.6% at June 30, 2014 to 13.3% at June 30, 2015.

The following tables present certain information by investment type and, if applicable, their respective underlying loan characteristics for our senior and mezzanine non-Agency RMBS, excluding our non-Agency interest-only portfolio, at June 30, 2015:

	At June 30, 2015					
Non-Agency Principal and Interest (P&I) RMBS	Senior Bonds		Mezzanine Bonds		Total P&I Bonds	
Carrying Value (in thousands)	$1,904,680		$795,071		$2,699,751	
% of Non-Agency Portfolio	70.6	%	29.4	%	100.0	%
Average Purchase Price [(1)]	$57.24		$76.78		$62.99	
Average Coupon	2.7	%	2.7	%	2.7	%
Average Fixed Coupon	4.2	%	5.5	%	4.3	%
Average Floating Coupon	2.1	%	2.6	%	2.3	%
Average Hybrid Coupon	5.2	%	—	%	5.2	%
Collateral Attributes						
Avg Loan Age (months)	98		78		92	
Avg Loan Size (in thousands)	$385		$294		$361	
Avg Original Loan-to-Value	71.1	%	73.0	%	71.6	%
Avg Original FICO [(2)]	647		692		659	
Current Performance						
60+ day delinquencies	26.4	%	14.3	%	23.1	%
Average Credit Enhancement [(3)]	8.9	%	14.7	%	10.4	%
3-Month CPR [(4)]	4.3	%	10.5	%	6.0	%

(1)

Average purchase price utilized carrying value for weighting purposes. If current face were utilized for weighting purposes, the average purchase price for senior, mezzanine, and total non-Agency RMBS, excluding our non-Agency interest-only portfolio, would be $53.12, $73.75, and $58.55, respectively, at June 30, 2015.

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

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

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

Table of Contents

	June 30, 2015					
(dollars in thousands)	Senior Bonds		Mezzanine Bonds		Total Bonds	
Collateral Type	Carrying Value	% of Senior Bonds	Carrying Value	% of Mezzanine Bonds	Carrying Value	% of Non-Agency Portfolio
Prime	$269,026	14.1 %	$43,428	5.5 %	$312,454	11.6 %
Alt-A	64,129	3.4 %	23,251	2.9 %	87,380	3.2 %
POA	152,132	8.0 %	29,609	3.7 %	181,741	6.7 %
Subprime	1,419,393	74.5 %	339,967	42.8 %	1,759,360	65.2 %
Other	—	— %	358,816	45.1 %	358,816	13.3 %
	$1,904,680	100.0 %	$795,071	100.0 %	$2,699,751	100.0 %

	June 30, 2015					
(dollars in thousands)	Senior Bonds		Mezzanine Bonds		Total Bonds	
Coupon Type	Carrying Value	% of Senior Bonds	Carrying Value	% of Mezzanine Bonds	Carrying Value	% of Non-Agency Portfolio
Fixed Rate	$451,719	23.7 %	$23,617	3.0 %	$475,336	17.6 %
Hybrid or Floating	1,452,961	76.3 %	771,454	97.0 %	2,224,415	82.4 %
	$1,904,680	100.0 %	$795,071	100.0 %	$2,699,751	100.0 %

	June 30, 2015					
(dollars in thousands)	Senior Bonds		Mezzanine Bonds		Total Bonds	
Origination Year	Carrying Value	% of Senior Bonds	Carrying Value	% of Mezzanine Bonds	Carrying Value	% of Non-Agency Portfolio
2006+	$1,631,980	85.7 %	$448,895	56.4 %	$2,080,875	77.0 %
2002-2005	268,666	14.1 %	345,649	43.5 %	614,315	22.8 %
Pre-2002	4,034	0.2 %	527	0.1 %	4,561	0.2 %
	$1,904,680	100.0 %	$795,071	100.0 %	$2,699,751	100.0 %

Residential Mortgage Loans Held-for-Sale, at Fair Value

We acquire prime nonconforming residential mortgage loans from select mortgage loan originators and secondary market institutions. As of June 30, 2015, we held prime nonconforming residential mortgage loans with a carrying value of $633.6 million and had outstanding commitments to purchase $626.7 million of residential mortgage loans, subject to fallout if the loans do not close. Our intention is to securitize these loans and/or exit through a whole loan sale.

In 2013, we acquired a portfolio of CSL, which are loans that are currently performing, but where the borrower has previously experienced payment delinquencies and is more likely to be underwater (i.e., the amount owed on a mortgage loan exceeds the current market value of the home). As a result, there is a higher probability of default than on newly originated residential mortgage loans. We subsequently sold substantially all of our CSL portfolio during the first quarter of 2014. As of June 30, 2015, we had CSL with a carrying value of $10.9 million remaining.

Additionally, as owner of MSR on loans from securitizations guaranteed by Ginnie Mae, we are obligated to purchase these loans from time to time in order to complete modifications on the mortgage loans or to convey foreclosed properties to HUD. As of June 30, 2015, we held Ginnie Mae buyout residential mortgage loans with a carrying value of $50.6 million, which, in the majority of instances, will undergo successful loan modifications, return to performing loans and be redelivered to future Ginnie Mae pools or be immediately conveyed to HUD.

73

Table of Contents

The following table presents our residential mortgage loans held-for-sale portfolio by loan type as of June 30, 2015:

	June 30, 2015			
(in thousands)	Unpaid Principal Balance	Fair Value - Purchase Price	Fair Value - Unrealized	Carrying Value
Prime nonconforming residential mortgage loans	$630,435	$10,660	$(7,517)	$633,578
Credit sensitive residential mortgage loans	19,294	(5,707)	(2,737)	10,850
Ginnie Mae buyout residential mortgage loans	54,237	(3,918)	331	50,650
Residential mortgage loans held-for-sale	$703,966	$1,035	$(9,923)	$695,078

Residential Mortgage Loans Held-for-Investment in Securitization Trusts, at Fair Value

We purchase subordinated debt and excess servicing rights from securitization trusts sponsored by either third parties or our subsidiaries. The underlying residential mortgage loans held by the trusts, which are consolidated on our condensed consolidated balance sheets, are classified as residential mortgage loans held-for-investment in securitization trusts and carried at fair value as a result of a fair value option election. See Note 3 - Variable Interest Entities to the Condensed Consolidated Financial Statements for additional information regarding consolidation of the securitization trusts. As of June 30, 2015, residential mortgage loans held-for-investment in securitization trusts had a carrying value of $2.4 billion.

Commercial Real Estate Loans Held-for-Investment

We are the sole certificate holder of a trust entity that holds a commercial real estate loan. The underlying loan held by the trust, which is consolidated on our condensed consolidated balance sheet, is classified as commercial real estate loans held-for-investment and carried at cost, net of any unamortized premiums or discounts, unless deemed impaired. See Note 3 - Variable Interest Entities for additional information regarding consolidation of the trust. As of June 30, 2015, our commercial real estate loans held-for-investment were comprised of one newly-issued senior mezzanine loan with a two-year interest-only term and carrying value of $45.6 million.

Mortgage Servicing Rights, at Fair Value

One of our wholly owned subsidiaries has approvals from Fannie Mae, Freddie Mac and Ginnie Mae to hold and manage MSR, which represent the right to control the servicing of mortgage loans. We do not directly service mortgage loans, and instead contract with fully licensed subservicers to handle substantially all servicing functions for the loans underlying our MSR. As of June 30, 2015 our MSR had a fair market value of $437.6 million.

As of June 30, 2015, our MSR portfolio included MSR on 214,745 loans with an unpaid principal balance of approximately $42.8 billion. The following table summarizes certain characteristics of the loans underlying our MSR at June 30, 2015:

	At June 30, 2015			
	Government FHA [1]	Government VA/USDA [1]	Conventional [2]	Total
Unpaid principal balance (in thousands)	$8,187,381	$2,789,337	$31,834,576	$42,811,294
Number of loans	56,429	14,901	143,415	214,745
Average Coupon	4.4%	3.9%	3.8%	3.9%
Avg Loan Age (months)	51	39	31	35
Avg Loan Size (in thousands)	$145	$187	$222	$199
Avg Original Loan-to-Value	92.3%	96.1%	67.6%	74.2%
Avg Original FICO	699	719	764	749
60+ day delinquencies	5.0%	2.6%	0.3%	1.4%
3-Month CPR	19.4%	17.2%	13.3%	14.8%

(1) Includes loans issued by Ginnie Mae.
(2) Includes loans issued by Fannie Mae, Freddie Mac or private investors.

Table of Contents

Repurchase Agreements and Federal Home Loan Bank of Des Moines Advances

Our borrowings consist primarily of repurchase agreements and FHLB advances collateralized by our pledge of AFS securities, derivative instruments, residential mortgage loans, commercial real estate loans and certain cash balances. Substantially all of our Agency RMBS AFS are currently pledged as collateral, and the majority of our non-Agency RMBS have been pledged, either through repurchase agreements or FHLB advances. As of June 30, 2015, our total consolidated debt-to-equity ratio was 3.6:1.0. The debt-to-equity ratio funding our RMBS AFS, residential mortgage loans held-for-sale, commercial real estate loans held-for-investment and Agency Derivatives only was 3.1:1.0. We believe our debt-to-equity ratio provides unused borrowing capacity and, thus, improves our liquidity and the strength of our balance sheet.

At June 30, 2015, repurchase agreements and FHLB advances had the following characteristics:

(dollars in thousands)	June 30, 2015				
Collateral Type	Amount Outstanding	Weighted Average Borrowing Rate		Weighted Average Haircut on Collateral Value	
Agency RMBS	$9,438,364	0.43	%	6.0	%
Non-Agency RMBS [1]	2,386,050	1.56	%	25.9	%
Agency Derivatives	132,867	1.03	%	26.5	%
Residential mortgage loans held-for-sale	442,572	0.40	%	21.9	%
Commercial real estate loans held-for-investment	22,950	1.84	%	50.0	%
Total	$12,422,803	0.66	%	10.7	%

(1) Includes repurchase agreements and FHLB advances collateralized by retained interests from the Company's on-balance sheet securitizations which are eliminated in consolidation in accordance with U.S. GAAP.

As of June 30, 2015, we had outstanding $9.4 billion of repurchase agreements, and the term to maturity ranged from one day to over 11 months. Repurchase agreements had a weighted average borrowing rate of 0.8% and weighted average remaining maturities of 69 days as of June 30, 2015.

As of June 30, 2015, we had outstanding $3.0 billion of FHLB advances. As of June 30, 2015, the weighted average term to maturity of our FHLB advances was 137 months, ranging from approximately 18 months to over 19 years. The weighted average cost of funds for our advances was 0.35% at June 30, 2015.

The following table provides the quarterly average balances, the quarter-end balances, and the maximum balances at any month-end within that quarterly period, of repurchase agreements and FHLB advances (total borrowings) for the three months ended June 30, 2015, and the four immediately preceding quarters:

(dollars in thousands)	Quarterly Average [1]	End of Period Balance [1]	Maximum Balance of Any Month-End [1]	Total Borrowings to Equity Ratio	
For the Three Months Ended June 30, 2015	$12,809,115	$12,422,803	$12,763,673	3.1	:1.0
For the Three Months Ended March 31, 2015	$13,598,611	$13,718,628	$13,843,240	3.4	:1.0
For the Three Months Ended December 31, 2014	$12,726,721	$13,436,213	$13,436,213	3.3	:1.0
For the Three Months Ended September 30, 2014	$11,626,507	$11,788,628	$11,788,628	2.9	:1.0
For the Three Months Ended June 30, 2014	$11,527,349	$11,891,187	$11,891,187	2.9	:1.0

(1) Includes repurchase agreements and FHLB advances collateralized by RMBS AFS, residential mortgage loans held-for-sale, commercial real estate loans held-for-investment and Agency Derivatives and excludes repurchase

agreements collateralized by U.S. Treasuries and collateralized borrowings in securitization trusts.

Table of Contents

Collateralized Borrowings in Securitization Trusts, at Fair Value

We purchase subordinated debt and excess servicing rights from securitization trusts sponsored by either third parties or our subsidiaries. The underlying debt held by the trusts, which are consolidated on our condensed consolidated balance sheets, is classified as collateralized borrowings in securitization trusts and carried at fair value as a result of a fair value option election. See Note 3 - Variable Interest Entities to the Condensed Consolidated Financial Statements for additional information regarding consolidation of the securitization trusts. As of June 30, 2015, collateralized borrowings in securitization trusts had a carrying value of $1.7 billion with a weighted average interest rate of 3.6%. The stated maturity dates for all collateralized borrowings are more than five years from June 30, 2015.

Equity

As of June 30, 2015, our stockholders' equity was $4.0 billion and our book value per share was $10.81. As of March 31, 2015, our stockholders' equity was $4.1 billion and our book value per share was $11.08.

The following table provides details of our changes in stockholders' equity from March 31, 2015 to June 30, 2015:

(dollars in millions, except per share amounts)	Book Value	Common Shares Outstanding	Book Value Per Share
Stockholders' equity at March 31, 2015	$4,061.5	366.6	$11.08
GAAP net income:			
Core Earnings, net of tax expense of $0.4 million [(1)]	80.2		
Realized gains and losses, net of tax benefit of $2.5 million	4.0		
Unrealized mark-to-market gains and losses, net of tax benefit of $4.9 million	137.3		
Total GAAP net income	221.5		
Other comprehensive loss	(218.8)		
Dividend declaration	(95.5)		
Other	2.9	0.9	
Balance before capital transactions	3,971.6	367.5	
Issuance of common stock, net of offering costs	—	—	
Stockholders' equity at June 30, 2015	$3,971.6	367.5	$10.81

(1) Core Earnings is a non-U.S. GAAP measure that we define as GAAP net income, excluding impairment losses, realized and unrealized gains or losses on the aggregate portfolio, amortization of business combination intangible assets, reserve expense for representation and warranty obligations on MSR and certain upfront costs related to securitization transactions. As defined, Core Earnings includes interest income or expense and premium income or loss on derivative instruments and servicing income, net of estimated amortization on MSR. Core Earnings is provided for purposes of comparability to other peer issuers.

Equity Incentive Plan

Our Second Restated 2009 Equity Incentive Plan was approved by our stockholders on May 14, 2015. The Plan provides incentive compensation to attract and retain qualified directors, officers, advisors, consultants and other personnel, including PRCM Advisers and its affiliates. The Plan is administered by the compensation committee of our board of directors. The Plan provides for grants of common stock, restricted common stock, phantom shares, dividend equivalent rights and other equity-based awards, subject to a ceiling of 13,000,000 shares. In addition, with respect to awards intended to qualify for relief from the limitations of Section 162(m) of the Code, the maximum number of shares that may underlie awards over any three-year period to any eligible person may not exceed 1,500,000 as options and 600,000 as other grants. Section 162(m) generally disallows a federal income tax deduction for any publicly held corporation with respect to compensation exceeding $1 million (on a per employee basis) paid in any year to the corporation's chief executive officer or to any of the corporation's three other most highly compensated executive officers, other than its chief financial officer. Because we do not have any employees, management does not believe that Section 162(m) is applicable to us and, therefore, does not currently consider and has not previously considered the effects of Section 162(m) with respect to the granting of awards under the Plan. As such, certain individual restricted stock awards previously disclosed in our proxy statements and other filings with the SEC have exceeded 600,000 shares, as permitted under the Plan. See Note 20 - Equity Incentive Plan for further details regarding the Plan.

Table of Contents

Liquidity and Capital Resources

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

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

To the extent that we raise additional equity capital through capital market transactions, we anticipate using cash proceeds from such transactions to purchase additional RMBS, residential mortgage loans, MSR, commercial real estate debt and related assets and other target assets and for other general corporate purposes.

As of June 30, 2015, we held $0.9 billion in cash and cash equivalents available to support our operations, $16.7 billion of AFS securities, residential mortgage loans held-for-sale, residential mortgage loans held-for-investment in securitization trusts, commercial real estate loans held-for-investment, MSR and derivative assets held at fair value, and $14.1 billion of outstanding debt in the form of repurchase agreements, FHLB advances and collateralized borrowings in securitization trusts. During the three months ended June 30, 2015, our total consolidated debt-to-equity ratio decreased from 4.2:1.0 to 3.6:1.0 (excludes payables due to broker counterparties for unsettled securities purchases; however, at June 30, 2015, we did not have any such payables). The debt-to-equity ratio funding our RMBS AFS, residential mortgage loans held-for-sale, commercial real estate loans held-for-investment and Agency Derivatives only also decreased from 3.4:1.0 to 3.1:1.0 due to the repayment of repurchase agreements as a result of sales of AFS securities of $1.6 billion during the three months ended June 30, 2015. We believe the debt-to-equity ratio funding our RMBS AFS, residential mortgage loans held-for-sale, commercial real estate loans held-for-investment and Agency Derivatives is the most meaningful debt-to-equity measure as U.S. Treasuries are viewed to be highly liquid in nature and collateralized borrowings on residential mortgage loans held-for-investment in securitization trusts represents term financing with no stated maturity.

As of June 30, 2015, we had approximately $215.4 million of unpledged Agency RMBS AFS and Agency Derivatives and $158.6 million of unpledged non-Agency securities and retained interests from our on-balance sheet securitizations, which are eliminated in consolidation in accordance with U.S. GAAP. As a result, we had an overall estimated unused borrowing capacity on unpledged RMBS and retained interests of approximately $312.1 million. We also had approximately $71.8 million of unpledged prime nonconforming residential mortgage loans, $10.9 million of unpledged CSL, $50.6 million of unpledged Ginnie Mae buyout residential mortgage loans and an overall estimated unused borrowing capacity on unpledged residential mortgage loans held-for-sale of approximately $64.6 million. As of June 30, 2015, we did not have any unpledged commercial real estate loans held-for-investment. On a daily basis, we monitor and forecast our available, or excess, liquidity. Additionally, we frequently perform shock analyses against various market events to monitor the adequacy of our excess liquidity. If borrowing rates and/or collateral requirements change in the near term, we believe we are subject to less earnings volatility than a more leveraged organization.

During the six months ended June 30, 2015, we did not experience any restrictions to our funding sources and have generally experienced an increase in available financing in the RMBS marketplace, including FHLB advances with maturities greater than one year. We expect ongoing sources of financing to be primarily repurchase agreements, FHLB advances and similar financing arrangements. We plan to finance our assets with a moderate amount of leverage, the level of which may vary based upon the particular characteristics of our portfolio and market conditions.

As of June 30, 2015, we have master repurchase agreements in place with 30 counterparties (lenders), the majority of which are U.S. domiciled financial institutions, and we continue to evaluate further counterparties to manage and reduce counterparty risk. Under our repurchase agreements, we are required to pledge additional assets as collateral to our lenders when the estimated fair value of the existing pledged collateral under such agreements declines and such lenders, through a margin call, demand additional collateral. Lenders generally make margin calls because of a perceived decline in the value of our assets collateralizing the repurchase agreements. This may occur following the monthly principal reduction of assets due to scheduled amortization and prepayments on the underlying mortgages, or may be caused by changes in market interest rates, a perceived decline in the market value of the investments and other market factors. To cover a margin call, we may pledge additional securities or cash. At maturity, any cash on deposit as collateral is generally applied against the repurchase agreement balance, thereby reducing the amount borrowed. Should the value of our assets suddenly decrease, significant margin calls on our repurchase agreements could result, causing an adverse change in our liquidity position.

Table of Contents

The following table summarizes our repurchase agreements and counterparty geographical concentration at June 30, 2015 and December 31, 2014:

(dollars in thousands)	June 30, 2015			December 31, 2014		
	Amount Outstanding	Net Counterparty Exposure(1)	Percent of Funding	Amount Outstanding	Net Counterparty Exposure(1)	Percent of Funding
North America	$5,804,879	$919,409	64.5 %	$8,331,244	$974,519	57.9 %
Europe (2)	2,229,597	420,232	29.5 %	2,950,991	604,711	35.9 %
Asia (2)	1,388,327	85,766	6.0 %	1,650,228	103,571	6.2 %
Total	$9,422,803	$1,425,407	100.0 %	$12,932,463	$1,682,801	100.0 %

(1) Represents the net carrying value of the securities, residential mortgage loans held-for-sale and commercial real estate loans held-for-investment sold under agreements to repurchase, including accrued interest plus any cash or assets on deposit to secure the repurchase obligation, less the amount of the repurchase liability, including accrued interest. Payables due to broker counterparties for unsettled securities purchases are not included in the amounts presented above. However, at both June 30, 2015 and December 31, 2014, we did not have any such payables.

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

In addition to our master repurchase agreements to fund our RMBS and commercial real estate loans held-for-investment, we have two facilities that provide short-term financing for our mortgage loan collateral during our aggregation period. An overview of the facilities is presented in the table below:

(dollars in thousands)

As of June 30, 2015

Expiration Date		Committed	Amount Outstanding	Unused Capacity	Total Capacity	Eligible Collateral
May 10, 2016	(1)	No	$—	$50,000	$50,000	Prime nonconforming residential mortgage loans
May 19, 2016	(1)	No	$9,454	$190,546	$200,000	Prime nonconforming residential mortgage loans Credit sensitive residential mortgage loans

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

Our wholly owned subsidiary, TH Insurance, is a member in the FHLB. As a member of the FHLB, TH Insurance has access to a variety of products and services offered by the FHLB, including secured advances. As of June 30, 2015, TH Insurance had $3.0 billion in outstanding secured advances with a weighted average borrowing rate of 0.35%, and had an additional $1.0 billion of available uncommitted capacity for borrowings. To the extent TH Insurance has uncommitted capacity, it may be adjusted at the sole discretion of the FHLB.

The ability to borrow from the FHLB is subject to our continued creditworthiness, pledging of sufficient eligible collateral to secure advances, and compliance with certain agreements with the FHLB. Each advance requires approval by the FHLB and is secured by collateral in accordance with the FHLB's credit and collateral guidelines, as may be revised from time to time by the FHLB. Eligible collateral may include conventional 1-4 family residential mortgage loans, commercial real estate loans, Agency RMBS and certain non-Agency RMBS with a rating of A and above.

In fall of 2014, the FHFA published a proposed rulemaking regarding membership in the Federal Home Loan Bank system. Among other effects, the rulemaking would exclude captive insurers from membership, including our subsidiary member, TH Insurance. We have no indication of what, if anything, will come of the proposal, but we are currently a member in good standing with the FHLB and believe our mission aligns well with that of the Federal Home Loan Bank system. We continue to closely monitor matters that could impact our FHLB membership.

Table of Contents

We are subject to a variety of financial covenants under our lending agreements. The following represent the most restrictive financial covenants across the agreements as of June 30, 2015:

(a) As of the last business day of each calendar quarter, total indebtedness to net worth must be less than the specified threshold ratio in the repurchase agreement. As of June 30, 2015, our debt to net worth, as defined, was 3.6:1.0 while our threshold ratio, as defined, was 5.4:1.0.

(b) As of the last business day of each calendar quarter, liquidity must be greater than $100 million and the aggregate amount of unrestricted cash or cash equivalents must be greater than $35 million. As of June 30, 2015, our liquidity, as defined, was $1.5 billion and our total unrestricted cash and cash equivalents, as defined, was $0.9 billion.

(c) As of the last business day of each calendar quarter, net worth must be greater than $1.75 billion. As of June 30, 2015, our net worth, as defined, was $4.0 billion.

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

The following table summarizes assets at carrying values that are pledged or restricted as collateral for the future payment obligations of repurchase agreements and FHLB advances.

(in thousands)	June 30, 2015	December 31, 2014
Available-for-sale securities, at fair value	$12,553,084	$14,159,315
Trading securities, at fair value	—	1,997,656
Residential mortgage loans held-for-sale, at fair value	561,802	416,779
Commercial real estate loans held-for-investment	45,605	—
Net economic interests in consolidated securitization trusts (1)	605,094	367,468
Cash and cash equivalents	15,000	14,117
Restricted cash	182,709	112,435
Due from counterparties	24,252	38,200
Derivative assets, at fair value	176,017	185,067
Total	$14,163,563	$17,291,037

(1) Includes the retained interests from the Company's on-balance sheet securitizations, which are eliminated in consolidation in accordance with U.S. GAAP.

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

In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we previously recorded our assets. Assets that are illiquid are more difficult to finance, and to the extent that we use leverage to finance assets that become illiquid, we may lose that leverage or have it reduced. Assets tend to become less liquid during times of financial stress, which is often the time that liquidity is most needed.

As a result, our ability to sell assets or vary our portfolio in response to changes in economic and other conditions may be limited by liquidity constraints, which could adversely affect our results of operations and financial condition.
We cannot predict the timing and impact of future sales of our assets, if any. Because many of our assets are financed with repurchase agreements and FHLB advances, and may be financed with credit facilities (including term loans and revolving facilities), a significant portion of the proceeds from sales of our assets (if any), prepayments and scheduled amortization are used to repay balances under these financing sources.

Table of Contents

The following table provides the maturities of our repurchase agreements and FHLB advances as of June 30, 2015 and December 31, 2014:

(in thousands)	June 30, 2015	December 31, 2014
Within 30 days	$2,453,972	$4,013,055
30 to 59 days	3,624,004	4,595,425
60 to 89 days	715,240	903,286
90 to 119 days	535,472	434,550
120 to 364 days (1)	2,094,115	1,929,164
One to three years	651,238	744,459
Three to five years	815,024	815,024
Five to ten years	—	—
Ten years and over	1,533,738	1,000,000
Open maturity (2)	—	997,500
Total	$12,422,803	$15,432,463

(1) As of June 30, 2015, 120 to 364 days includes the amounts outstanding under the uncommitted mortgage loan warehouse facilities.

(2) Repurchase agreements collateralized by U.S. Treasuries include an open maturity period (i.e., rolling 1-day maturity) renewable at the discretion of either party to the agreements.

For the three months ended June 30, 2015, our unrestricted cash balance decreased approximately $86.8 million to $933.6 million at June 30, 2015. The cash movements can be summarized by the following:

- Cash flows from operating activities. For the three months ended June 30, 2015, operating activities decreased our cash balances by approximately $541.5 million, primarily driven by purchases of residential mortgage loans held-for-sale.
- Cash flows from investing activities. For the three months ended June 30, 2015, investing activities increased our cash balances by approximately $3.5 billion, primarily driven by sales of AFS and trading securities.
- Cash flows from financing activities. For the three months ended June 30, 2015, financing activities decreased our cash balance by approximately $3.0 billion, primarily driven by repayment of repurchase agreements due to sales of AFS and trading securities.

Inflation

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

To reduce the risks to our portfolio, we employ portfolio-wide and asset-specific risk measurement and management processes in our daily operations. PRCM Advisers and its affiliates’ risk management tools include software and services licensed or purchased from third parties and proprietary software and analytical methods developed by Pine River. There can be no guarantee that these tools will protect us from market risks.

Table of Contents

Interest Rate Risk

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

We may utilize U.S. Treasuries as well as derivative financial instruments, which during the six months ended June 30, 2015 were limited to interest rate swaps, swaptions, TBAs, short U.S. Treasuries, put and call options for TBAs and U.S. Treasuries, constant maturity swaps, Markit IOS total return swaps and, to a certain extent, inverse interest-only securities, to hedge the interest rate risk associated with our portfolio. In addition, because MSR are negative duration assets, they provide a natural hedge to interest rate exposure on our RMBS portfolio. We seek to hedge interest rate risk with respect to both the fixed income nature of our assets and the financing of our portfolio. In hedging interest rates with respect to our fixed income assets, we seek to reduce the risk of losses on the value of our investments that may result from changes in interest rates in the broader markets. In utilizing interest rate hedges with respect to our financing, we seek to improve risk-adjusted returns and, where possible, to obtain a favorable spread between the yield on our assets and the cost of our financing. We implement part of our hedging strategy through our TRSs, which are subject to U.S. federal, state and, if applicable, local income tax.

Interest Rate Effect on Net Interest Income

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

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

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

We also acquire adjustable-rate residential mortgage loans held-for-sale. These assets are typically subject to periodic and lifetime interest rate caps and floors, which may limit the amount by which the loan’s interest yield may change during any given period. However, our borrowing costs pursuant to our financing agreements are not subject to similar restrictions. Therefore, in a period of increasing interest rates, interest rate costs on our borrowings could increase without limitation, while the interest-rate yields on our adjustable-rate residential mortgage loans held-for-sale could effectively be limited by caps.

Interest Rate Mismatch Risk

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

Table of Contents

The following table provides the indices of our variable rate RMBS AFS, residential mortgage loans held-for-sale and commercial real estate loans held-for-investment of June 30, 2015 and December 31, 2014, respectively, based on carrying value (dollars in thousands).

	As of June 30, 2015					As of December 31, 2014				
Index Type	Floating	Hybrid (1)	Total	Index %		Floating	Hybrid (1)	Total	Index %	
CMT	$1,284	$107,653	$108,937	4	%	$1,121	$115,619	$116,740	4	%
LIBOR	2,339,410	37,997	2,377,407	90	%	2,762,807	42,530	2,805,337	93	%
Other (2)	146,424	18,116	164,540	6	%	68,244	19,228	87,472	3	%
Total	$2,487,118	$163,766	$2,650,884	100	%	$2,832,172	$177,377	$3,009,549	100	%

(1) "Hybrid" amounts reflect those assets with greater than twelve months to reset.
(2) "Other" includes COFI, MTA and other indices.

Our analysis of risks is based on PRCM Advisers' and its affiliates' experience, estimates, models and assumptions. These analyses rely on models which utilize estimates of fair value and interest rate sensitivity. Actual economic conditions or implementation of decisions by PRCM Advisers may produce results that differ significantly from the estimates and assumptions used in our models.

Table of Contents

We use a variety of recognized industry models, as well as proprietary models, to perform sensitivity analyses which are derived from primary assumptions for prepayment rates, discount rates and credit losses. The primary assumption used in this model is implied market volatility of interest rates. The information presented in the following interest rate sensitivity table projects the potential impact of sudden parallel changes in interest rates on our financial results and financial condition over the next 12 months, based on our interest sensitive financial instruments at June 30, 2015.
All changes in value are measured as the change from the June 30, 2015 financial position. All projected changes in annualized net interest income are measured as the change from the projected annualized net interest income based off current performance returns.

	Changes in Interest Rates			
(dollars in thousands)	-100 bps	-50 bps	+50 bps	+100 bps
Change in value of financial position:				
Available-for-sale securities	$397,077	$198,123	$(286,344)	$(588,081)
As a % of June 30, 2015 equity	10.0 %	5.0 %	(7.2)%	(14.8)%
Residential mortgage loans held-for-sale	$32,361	$17,626	$(21,284)	$(43,044)
As a % of June 30, 2015 equity	0.8 %	0.4 %	(0.5)%	(1.1)%
Residential mortgage loans held-for-investment in securitization trusts	$122,908	$67,481	$(81,058)	$(162,528)
As a % of June 30, 2015 equity	3.1 %	1.7 %	(2.0)%	(4.1)%
Commercial real estate loans held-for-investment	$—	$—	$—	$—
As a % of June 30, 2015 equity	— %	— %	— %	— %
Mortgage servicing rights	$(90,959)	$(25,696)	$17,927	$29,792
As a % of June 30, 2015 equity	(2.3)%	(0.7)%	0.5 %	0.8 %
Derivatives, net	$(519,943)	$(234,219)	$275,777	$595,434
As a % of June 30, 2015 equity	(13.1)%	(5.9)%	6.9 %	15.0 %
Repurchase Agreements	$(4,892)	$(4,892)	$8,519	$17,038
As a % of June 30, 2015 equity	(0.1)%	(0.1)%	0.2 %	0.4 %
Collateralized borrowings in securitization trusts	$(97,025)	$(53,284)	$59,626	$119,682
As a % of June 30, 2015 equity	(2.5)%	(1.3)%	1.5 %	3.0 %
Federal Home Loan Bank advances	$(820)	$(820)	$1,442	$2,883
As a % of June 30, 2015 equity	— %	— %	— %	0.1 %
Total Net Assets	$(161,293)	$(35,681)	$(25,395)	$(28,824)
As a % of June 30, 2015 total assets	(0.9)%	(0.2)%	(0.1)%	(0.2)%
As a % of June 30, 2015 equity	(4.1)%	(0.9)%	(0.6)%	(0.7)%
	-100 bps	-50 bps	+50 bps	+100 bps
Change in annualized net interest income:	$(10,276)	$(9,650)	$8,889	$17,777
% change in net interest income	(2.6)%	(2.4)%	2.2 %	4.5 %

The interest rate sensitivity table quantifies the potential changes in net interest income and portfolio value, which includes the value of swaps and our other derivatives, should interest rates immediately change. The interest rate sensitivity table presents the estimated impact of interest rates instantaneously rising 50 and 100 basis points, and falling 50 and 100 basis points. The cash flows associated with the portfolio for each rate change are calculated based on assumptions, including prepayment speeds, yield on future acquisitions, slope of the yield curve, and size of the portfolio. Assumptions made on the interest rate sensitive liabilities include anticipated interest rates, collateral requirements as a percentage of borrowings and amount and term of borrowing.
Certain assumptions have been made in connection with the calculation of the information set forth in the foregoing interest rate sensitivity table and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at June 30,

2015. The analysis utilizes assumptions and estimates based on management's judgment and experience. Furthermore, while we generally expect to retain such assets and the associated interest rate risk to maturity, future purchases and sales of assets could materially change our interest rate risk profile.

Table of Contents

The change in annualized net interest income does not include any benefit or detriment from faster or slower prepayment rates on our Agency premium RMBS, non-Agency discount RMBS, and instruments that represent the interest payments (but not the principal) on a pool of mortgages, or interest-only securities. We anticipate that faster prepayment speeds in lower interest rate scenarios will generate lower realized yields on Agency and non-Agency premium and interest-only securities and higher realized yields on Agency and non-Agency discount RMBS. Similarly, we anticipate that slower prepayment speeds in higher interest rate scenarios will generate higher realized yields on Agency premium and interest-only bonds and lower realized yields on non-Agency discount RMBS. Although we have sought to construct the portfolio to limit the effect of changes in prepayment speeds, there can be no assurance this will actually occur, and the realized yield of the portfolio may be significantly different than we anticipate in changing interest rate scenarios.

Given the low interest rate environment at June 30, 2015, we applied a floor of 0% for all anticipated interest rates included in our assumptions. Because of this floor, we anticipate that any hypothetical interest rate shock decrease would have a limited positive impact on our funding costs; however, because prepayment speeds are unaffected by this floor, we expect that any increase in our prepayment speeds (occurring as a result of any interest rate decrease or otherwise) could result in an acceleration of our premium amortization on Agency and interest-only securities purchased at a premium, and accretion of discount on our non-Agency RMBS purchased at a discount. As a result, because this floor limits the positive impact of any interest rate decrease on our funding costs, hypothetical interest rate decreases could cause the fair value of our financial instruments and our net interest income to decline.

The information set forth in the interest rate sensitivity table above and all related disclosures constitutes forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. Actual results could differ significantly from those estimated in the foregoing interest rate sensitivity table.

Prepayment Risk

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

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

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

Market Risk

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

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

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

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

Table of Contents

Liquidity Risk

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

Should the value of our assets pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. Additionally, if the FHLB or one or more of our repurchase agreement counterparties chose not to provide ongoing funding, our ability to finance would decline or exist at possibly less advantageous terms. As such, we cannot assure that we will always be able to roll over our repurchase agreements and FHLB advances. See Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources” in this Quarterly Report on Form 10-Q for further information about our liquidity and capital resource management.

Credit Risk

We believe that our investment strategy will generally keep our risk of credit losses low to moderate. However, we retain the risk of potential credit losses on all of the loans underlying our non-Agency RMBS and on our residential mortgage and commercial real estate loans. With respect to our non-Agency RMBS that are senior in the credit structure, credit support contained in RMBS deal structures provide a level of protection from losses. We seek to manage the remaining credit risk through our pre-acquisition due diligence process, which includes comprehensive underwriting, and by factoring assumed credit losses into the purchase prices we pay for non-Agency RMBS and residential mortgage and commercial real estate loans. In addition, with respect to any particular target asset, we evaluate relative valuation, supply and demand trends, shape of yield curves, prepayment rates, delinquency and default rates, recovery of various sectors and vintage of collateral. We further mitigate credit risk in our residential mortgage and commercial real estate loan portfolios through (1) selecting servicers whose specialties are well matched against the underlying attributes of the borrowers contained in the loan pools, and (2) an actively managed internal servicer oversight and surveillance program. At times, we enter into credit default swaps or other derivative instruments in an attempt to manage our credit risk. Nevertheless, unanticipated credit losses could adversely affect our operating results.

Item 4. Controls and Procedures

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

There was no change in our internal control over financial reporting that occurred during the quarter ended June 30, 2015 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

Except as set forth below, there have been no material changes to the risk factors set forth under the heading "Item 1A. Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2014, or the Form 10-K. The materialization of any risks and uncertainties identified in our Forward-Looking Statements contained in this Quarterly Report on Form 10-Q, together with those previously disclosed in the Form 10-K or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations, and cash flows. See Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations - Forward-Looking Statements" in this Quarterly Report on Form 10-Q.

Risks Related to Our Business and Operations

The commercial real estate debt and related assets in which the Company invests are subject to delinquency, foreclosure and loss, which may adversely impact the Company's business, results of operations and financial condition.

The Company has initiated its previously announced expansion into the commercial real estate market, with target assets including first mortgage loans, mezzanine loans, B-notes and preferred equity. Such investments may be subject to risks of delinquency, foreclosure and loss that are greater than similar risks associated with loans made on the security of residential properties. The ability of a borrower to repay a loan secured by an income-producing property typically is dependent primarily upon the successful operation of the property, as opposed to the borrower's independent income or assets. If the net operating income of the property is reduced, the borrower's ability to repay the loan may be impaired. The net operating income of an income-producing property can be affected by numerous factors, including:

- tenant mix;
- success of tenant businesses;
- property management decisions, including decisions on capital improvements;
- property location and condition;
- competition from similar properties;
- changes in national, regional or local economic conditions;
- changes in regional or local real estate values;
- changes in regional or local rental or occupancy rates;
- changes in interest rates and in the state of the debt and equity capital markets, including the availability of debt financing for commercial real estate;
- changes in governmental rules, regulations and fiscal policies, including real estate taxes, environmental legislation and zoning laws;
- environmental contamination; and
- acts of God, terrorism, social unrest and civil disturbances, which may result in property damage, decrease the availability of or increase the cost of insurance or otherwise result in uninsured losses.

In the event any of the properties or entities underlying or collateralizing the Company's commercial real estate loans or investments is adversely impacted by any of the foregoing events or occurrences, the value of, and return on, such investments could be reduced, which in turn would adversely affect the Company's results of operations and financial condition.

Table of Contents

The lack of liquidity in certain commercial real estate investments may materially and adversely affect the Company.
The illiquidity of certain commercial real estate investments may make it difficult for the Company to sell such investments if the need or desire arises. Investments such as commercial mortgages, B-notes, mezzanine and other loans (including participations) and preferred equity, in particular, are relatively illiquid due to their short life, their potential unsuitability for securitization and the greater difficulty of recovery in the event of a borrower's default. Moreover, certain of the Company's investments will not be registered under the relevant securities laws, resulting in prohibitions against their transfer, sale, pledge or their disposition except in transactions that are exempt from registration requirements or are otherwise in accordance with such laws. If the Company desires or is required to liquidate all or a portion of its portfolio, it may have difficulty selling these investments in a timely manner or be forced to sell them for an amount less than it would otherwise have been able to realize, or both.
Risks Related to Our Assets
Most commercial mortgage loans are nonrecourse loans and the assets securing these loans may not be sufficient to protect the Company from a partial or complete loss if a borrower defaults on a loan, which could materially and adversely affect the Company.
Except for customary nonrecourse carve-outs for certain "bad acts" and environmental liability, most commercial mortgage loans are nonrecourse obligations of the borrower, meaning that there is no recourse against the assets of the borrower other than the underlying collateral. In the event of any default under a commercial mortgage loan, the Company will bear the risk of loss to the extent of any deficiency between the value of the collateral and the principal of and accrued interest on the mortgage loan, which could materially and adversely affect the Company. Even if a commercial mortgage loan is recourse to the borrower (or if a nonrecourse carve-out to the borrower applies), in most cases, the borrower's assets are limited primarily to its interest in the related mortgaged property. Further, although a commercial mortgage loan may provide for limited recourse to a principal or affiliate of a borrower, there is no assurance that any recovery from such principal or affiliate will be made or that such principal's or affiliate's assets would be sufficient to pay any otherwise recoverable claim. In the event of the bankruptcy of a borrower, the loan to such borrower will be deemed to be secured only to the extent of the value of the underlying collateral at the time of bankruptcy (as determined by the bankruptcy court), and the lien securing the loan will be subject to the avoidance powers of the bankruptcy trustee or debtor-in-possession to the extent the lien is unenforceable under state law.
The Company may be subject to additional risks associated with commercial mortgage loan participations.
Some of the Company's commercial mortgage loans may be held in the form of participation interests or co-lender arrangements in which the Company shares the loan rights, obligations and benefits with other lenders. With respect to such participation interests, the Company may require the consent of these parties to exercise its rights under such loans, including rights with respect to amendment of loan documentation, enforcement proceedings upon a default and the institution of, and control over, foreclosure proceedings. In circumstances where the Company holds a minority interest, it may be become bound to actions of the majority to which it otherwise would object. The Company may be adversely affected by this lack of control with respect to these interests.
B-notes may be subject to additional risks related to the privately negotiated structure and terms of the transaction, which may result in losses to the Company.
The Company may originate or acquire B-notes, which are mortgage loans that are typically secured by a first mortgage on a single commercial property or group of related properties, but subordinated to an A-note secured by the same first mortgage on the same collateral. As a result, if a borrower defaults, there may not be sufficient funds remaining for B-notes holders after payment to the A-note holders. Because each transaction is privately negotiated, B-notes can vary in their structural characteristics and risks. For example, the rights of holders of B-notes to control the process following a borrower default may vary from transaction to transaction. Further, B-notes typically are secured by a single property and accordingly reflect the risks associated with significant concentration. Losses related to the Company's B-notes would adversely affect its financial condition and results of operations.
Mezzanine loan assets involve greater risks of loss than senior loans secured by income-producing properties.

The Company may originate or acquire mezzanine loans, which are subordinated loans secured by a pledge of the ownership interests of the entity that owns the interest in the entity owning the property. These types of assets involve a higher degree of risk than long-term senior mortgage lending secured by income producing real property, because the loan may become unsecured as a result of foreclosure by the senior lender. In the event of a bankruptcy of the entity providing the pledge of its ownership interests as security, the Company may not have full recourse to the assets of such entity, or the assets of the entity may not be sufficient to satisfy the Company's mezzanine loan. If a borrower on any debt that is senior to the Company's mezzanine loan, or in the event of a borrower bankruptcy, the Company's mezzanine loan will be satisfied only after the senior debt. As a result, the Company may not be able to recover all, or possibly any, of its initial expenditure. In addition, mezzanine loans have higher loan-to-value ratios than conventional mortgage loans, resulting in less equity in the property and increasing the risk of loss of principal. Losses related to the Company's mezzanine loans would adversely affect its financial condition and results of operations.

Table of Contents

Investments in preferred equity involve a greater risk of loss than traditional debt financing.

The Company may invest in real estate preferred equity, which involves a higher degree of risk than first mortgage loans due to a variety of factors, including the risk that, similar to mezzanine loans, such investments are subordinate to first mortgage loans and are not collateralized by property underlying the investment. Unlike mezzanine loans, preferred equity investments generally do not have a pledge of the ownership interests of the entity that owns the interest in the entity owning the property. Although as a holder of preferred equity the Company may protect its position with covenants that limit the activities of the entity in which the Company holds an interest and protect its equity by obtaining an exclusive right to control the underlying property after an event of default, should such a default occur, the Company would only be able to proceed against the entity in which it holds an interest, and not the property owned by such entity and underlying the investment. Further, similar to mezzanine loans, preferred equity investments do not ordinarily afford the holder with the full range of traditional creditor protections. As a result, the Company may not be able to recover all of its investment.

Investments in nonconforming and non-investment grade rated commercial real estate loans or securities involve increased risk of loss.

Certain commercial real estate investments may not conform to conventional loan standards applied by traditional lenders and either will not be rated or will be rated as non-investment grade by the rating agencies. The non-investment grade ratings for these assets typically result from the overall leverage of the loans, the lack of a strong operating history for the properties underlying the loans, the borrowers' credit history, the underlying properties' cash flow or other factors. As a result, these investments should be expected to have a higher risk of default and loss than investment grade rated assets. Losses related to the Company's non-investment grade loans or securities would adversely affect its financial condition and results of operations.

Tax Risks

The failure of a mezzanine loan to qualify as a real estate asset could adversely affect the Company's ability to continue to qualify as a REIT.

In Revenue Procedure 2003-65, the IRS provided a safe harbor pursuant to which a mezzanine loan, if it meets each of the requirements contained in the Revenue Procedure, will be treated by the IRS as a real estate asset for purposes of the REIT asset tests, and interest derived from the mezzanine loan will be treated as qualifying mortgage interest for purposes of the REIT 75% gross income test. Although the Revenue Procedure provides a safe harbor on which taxpayers may rely, it does not prescribe rules of substantive tax law. The Company expects to treat certain mezzanine loans that may not meet all of the requirements for reliance on this safe harbor as real estate assets giving rise to qualifying mortgage interest for purposes of the REIT asset and income requirements, or otherwise not adversely affecting the Company's qualification as a REIT. There can be no assurance that the IRS will not challenge the tax treatment of these mezzanine loans, and if such a challenge were sustained, the Company could in certain circumstances be required to pay a penalty tax or fail to qualify as a REIT.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits
(a) Exhibits
Exhibits - The exhibits listed on the accompanying Index of Exhibits are filed or incorporated by reference as a part of this report. Such Index is incorporated herein by reference.

Table of Contents

SIGNATURES

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

			TWO HARBORS INVESTMENT CORP.
Dated:	August 5, 2015	By:	/s/ Thomas E. Siering
			Thomas E. Siering
			Chief Executive Officer, President and Director (Principal Executive Officer)
Dated:	August 5, 2015	By:	/s/ Brad Farrell
			Brad Farrell
			Chief Financial Officer and Treasurer (Principal Accounting and Financial Officer)

Table of Contents

Exhibit Number	Exhibit Index
3.1	Articles of Amendment and Restatement of Two Harbors Investment Corp. (incorporated by reference to Exhibit 99.1 to Annex B filed with Pre-effective Amendment No. 4 to the Company's Registration Statement on Form S-4 (File No. 333-160199), filed with the SEC on October 8, 2009).
3.2	Articles of Amendment to the Articles of Amendment and Restatement of Two Harbors Investment Corp. (incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K, filed with the SEC on December 19, 2012).
3.3	Amended and Restated Bylaws of Two Harbors Investment Corp. (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K, filed with the SEC on December 19, 2013).
10.1*	Second Restated 2009 Equity Incentive Plan (incorporated by reference to Appendix A to the Registrant's Definitive Proxy Statement filed with the SEC on March 26, 2015).
10.2*	Form of Restricted Stock Agreement under the Second Restated 2009 Equity Incentive Plan. (filed herewith)
31.1	Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (filed herewith)
31.2	Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (filed herewith)
32.1	Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (filed herewith)
32.2	Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (filed herewith)
101	Financial statements from the Quarterly Report on Form 10-Q of Two Harbors Investment Corp. for the quarter ended June 30, 2015, filed with the SEC on August 5, 2015, formatted in XBRL: (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Comprehensive Income, (iii) the Condensed Consolidated Statements of Stockholders' Equity, (iv) the Condensed Consolidated Statements of Cash Flows, and (v) the Notes to the Condensed Consolidated Financial Statements. (filed herewith)

*Management or compensatory agreement