TWO HARBORS INVESTMENT CORP.
Form 10-Q
November 05, 2014

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: September 30, 2014

Commission File Number 001-34506

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

| | |
|---|---|
| Maryland<br>(State or Other Jurisdiction of<br>Incorporation or Organization) | 27-0312904<br>(I.R.S. Employer<br>Identification No.) |
| 590 Madison Avenue, 36th Floor<br>New York, New York<br>(Address of Principal Executive Offices) | 10022<br>(Zip Code) |

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
As of November 5, 2014 there were 366,117,954 shares of outstanding common stock, par value $.01 per share, issued and outstanding.

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

| | September 30, 2014 (unaudited) | December 31, 2013 |
|---|---|---|
| ASSETS | | |
| Available-for-sale securities, at fair value | $12,697,908 | $12,256,727 |
| Trading securities, at fair value | 1,993,124 | 1,000,180 |
| Mortgage loans held-for-sale, at fair value | 445,065 | 544,581 |
| Mortgage loans held-for-investment in securitization trusts, at fair value | 1,428,890 | 792,390 |
| Mortgage servicing rights, at fair value | 498,466 | 514,402 |
| Cash and cash equivalents | 1,225,281 | 1,025,487 |
| Restricted cash | 310,421 | 401,647 |
| Accrued interest receivable | 52,605 | 50,303 |
| Due from counterparties | 23,341 | 25,087 |
| Derivative assets, at fair value | 353,893 | 549,859 |
| Other assets | 125,831 | 13,199 |
| Total Assets [(1)] | $19,154,825 | $17,173,862 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities | | |
| Repurchase agreements | $12,274,878 | $12,250,450 |
| Collateralized borrowings in securitization trusts, at fair value | 938,506 | 639,731 |
| Federal Home Loan Bank advances | 1,500,000 | — |
| Derivative liabilities, at fair value | 4,221 | 22,081 |
| Accrued interest payable | 14,924 | 20,277 |
| Due to counterparties | 167,444 | 318,848 |
| Dividends payable | 95,205 | — |
| Other liabilities | 41,548 | 67,480 |
| Total liabilities [(1)] | 15,036,726 | 13,318,867 |
| Stockholders' Equity | | |
| Preferred stock, par value $0.01 per share; 50,000,000 shares authorized; no shares issued and outstanding | — | — |
| Common stock, par value $0.01 per share; 900,000,000 shares authorized and 366,107,149 and 364,935,168 shares issued and outstanding, respectively | 3,661 | 3,649 |
| Additional paid-in capital | 3,808,015 | 3,795,372 |
| Accumulated other comprehensive income | 776,648 | 444,735 |
| Cumulative earnings | 1,232,499 | 1,028,397 |
| Cumulative distributions to stockholders | (1,702,724) | (1,417,158) |
| Total stockholders' equity | 4,118,099 | 3,854,995 |
| Total Liabilities and Stockholders' Equity | $19,154,825 | $17,173,862 |

(1) The condensed consolidated balance sheets include assets of consolidated variable interest entities, or VIEs, that can only be used to settle obligations of these VIEs, and liabilities of the consolidated VIEs for which creditors do not have recourse to Two Harbors Investment Corp., or the Company. At September 30, 2014 and December 31, 2013, assets of the VIEs totaled $1,436,027 and $796,896, and liabilities of the VIEs

totaled $945,002 and $644,051, respectively. See Note 3 - Variable Interest Entities for additional information.

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

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (unaudited) | | (unaudited) | |
| Interest income: | | | | |
| Available-for-sale securities | $123,056 | $121,303 | $374,574 | $386,246 |
| Trading securities | 4,308 | 1,509 | 8,174 | 4,034 |
| Mortgage loans held-for-sale | 5,268 | 9,297 | 12,553 | 15,409 |
| Mortgage loans held-for-investment in securitization trusts | 9,526 | 5,649 | 25,180 | 11,672 |
| Cash and cash equivalents | 145 | 216 | 506 | 773 |
| Total interest income | 142,303 | 137,974 | 420,987 | 418,134 |
| Interest expense: | | | | |
| Repurchase agreements | 17,509 | 21,802 | 56,684 | 67,373 |
| Collateralized borrowings in securitization trusts | 5,678 | 3,125 | 16,623 | 6,112 |
| Federal Home Loan Bank advances | 1,531 | — | 2,439 | — |
| Total interest expense | 24,718 | 24,927 | 75,746 | 73,485 |
| Net interest income | 117,585 | 113,047 | 345,241 | 344,649 |
| Other-than-temporary impairments: | | | | |
| Total other-than-temporary impairment losses | — | — | (212) | (1,662) |
| Non-credit portion of loss recognized in other comprehensive (loss) income | — | — | — | — |
| Net other-than-temporary credit impairment losses | — | — | (212) | (1,662) |
| Other income: | | | | |
| Gain (loss) on investment securities | 59,471 | (230,111) | 58,504 | (152,280) |
| Gain (loss) on interest rate swap and swaption agreements | 28,519 | (55,410) | (193,028) | 223,388 |
| Gain (loss) on other derivative instruments | 6,056 | 20,434 | (12,345) | 66,055 |
| (Loss) gain on mortgage loans held-for-sale | (2,387) | (4,443) | 6,233 | (25,262) |
| Servicing income | 32,264 | 989 | 96,573 | 1,234 |
| (Loss) gain on servicing asset | (10,711) | 861 | (73,042) | 816 |
| Other (loss) income | (1,515) | 8,938 | 19,948 | 16,837 |
| Total other income (loss) | 111,697 | (258,742) | (97,157) | 130,788 |
| Expenses: | | | | |
| Management fees | 12,258 | 12,036 | 36,559 | 29,388 |
| Securitization deal costs | 3,355 | 2,125 | 3,355 | 4,153 |
| Servicing expenses | 12,513 | 862 | 24,595 | 1,200 |
| Other operating expenses | 12,424 | 9,155 | 41,281 | 24,864 |
| Total expenses | 40,550 | 24,178 | 105,790 | 59,605 |
| Income (loss) from continuing operations before income taxes | 188,732 | (169,873) | 142,082 | 414,170 |
| (Benefit from) provision for income taxes | (4,858) | 23,726 | (62,020) | 77,809 |
| Net income (loss) from continuing operations | 193,590 | (193,599) | 204,102 | 336,361 |
| Income from discontinued operations | — | 871 | — | 3,264 |

| | | | | |
|---|---|---|---|---|
| Net income (loss) | $193,590 | $(192,728 ) | $204,102 | $339,625 |

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

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (unaudited) | | (unaudited) | |
| Basic earnings (loss) per weighted average common share: | | | | |
| Continuing operations | $0.53 | $(0.53) | $0.56 | $0.97 |
| Discontinued operations | — | — | — | 0.01 |
| Net income (loss) | $0.53 | $(0.53) | $0.56 | $0.98 |
| Diluted earnings (loss) per weighted average common share: | | | | |
| Continuing operations | $0.53 | $(0.53) | $0.56 | $0.97 |
| Discontinued operations | — | — | — | 0.01 |
| Net income (loss) | $0.53 | $(0.53) | $0.56 | $0.98 |
| Dividends declared per common share | $0.26 | $0.28 | $0.78 | $0.91 |
| Weighted average number of shares of common stock: | | | | |
| Basic | 366,118,866 | 365,057,767 | 365,938,150 | 345,529,611 |
| Diluted | 366,118,866 | 365,166,992 | 365,938,150 | 346,370,358 |
| Comprehensive income: | | | | |
| Net income (loss) | $193,590 | $(192,728) | $204,102 | $339,625 |
| Other comprehensive (loss) income: | | | | |
| Unrealized (loss) gain on available-for-sale securities, net | (40,982) | 246,777 | 331,913 | (183,684) |
| Other comprehensive (loss) income | (40,982) | 246,777 | 331,913 | (183,684) |
| Comprehensive income | $152,608 | $54,049 | $536,015 | $155,941 |

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

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands, except share data)

| | Common Stock | | | | | | |
|---|---|---|---|---|---|---|---|
| | Shares | Amount | Additional Paid-in Capital | Accumulated Other Comprehensive Income (unaudited) | Cumulative Earnings | Cumulative Distributions to Stockholders | Total Stockholders' Equity |
| Balance, December 31, 2012 | 298,813,258 | $2,988 | $2,948,345 | $ 696,458 | $449,358 | $(646,572 ) | $ 3,450,577 |
| Net income | — | — | — | — | 339,625 | — | 339,625 |
| Other comprehensive loss before reclassifications | — | — | — | (308,435 ) | — | — | (308,435 ) |
| Amounts reclassified from accumulated other comprehensive loss | — | — | — | 124,751 | — | — | 124,751 |
| Net other comprehensive loss | — | — | — | (183,684 ) | — | — | (183,684 ) |
| Issuance of common stock, net of offering costs | 57,553,749 | 576 | 762,808 | — | — | — | 763,384 |
| Issuance of common stock in connection with exercise of warrants | 9,391,406 | 94 | 102,182 | — | — | — | 102,276 |
| Repurchase of common stock | (2,450,700 ) | (25 ) | (23,869 ) | — | — | — | (23,894 ) |
| Common dividends declared | — | — | — | — | — | (332,224 ) | (332,224 ) |
| Special dividends declared | — | — | — | — | — | (343,481 ) | (343,481 ) |
| Non-cash equity award compensation | 1,057,304 | 11 | 463 | — | — | — | 474 |
| Balance, September 30, 2013 | 364,365,017 | $3,644 | $3,789,929 | $ 512,774 | $788,983 | $(1,322,277) | $ 3,773,053 |
| | | | | | | | |
| Balance, December 31, 2013 | 364,935,168 | $3,649 | $3,795,372 | $ 444,735 | $1,028,397 | $(1,417,158) | $ 3,854,995 |
| Net income | — | — | — | — | 204,102 | — | 204,102 |
| Other comprehensive income before reclassifications | — | — | — | 364,026 | — | — | 364,026 |
| Amounts reclassified from accumulated other comprehensive income | — | — | — | (32,113 ) | — | — | (32,113 ) |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Net other comprehensive income | — | — | — | 331,913 | — | — | 331,913 |
| Issuance of common stock, net of offering costs | 38,742 | — | 399 | — | — | — | 399 |
| Common dividends declared | — | — | — | — | — | (285,566 ) | (285,566 ) |
| Non-cash equity award compensation | 1,133,239 | 12 | 12,244 | — | — | — | 12,256 |
| Balance, September 30, 2014 | 366,107,149 | $3,661 | $3,808,015 | $ 776,648 | $1,232,499 | $(1,702,724) | $4,118,099 |

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

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

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2014 | 2013 |
| Cash Flows From Operating Activities: | (unaudited) | |
| Net income | $204,102 | $339,625 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Amortization of premiums and discounts on investment securities, net | 7,415 | 16,511 |
| Other-than-temporary impairment losses | 212 | 1,662 |
| Realized and unrealized (gains) losses on investment securities, net | (58,504) | 152,458 |
| (Gain) loss on mortgage loans held-for-sale | (6,233) | 25,262 |
| Gain on mortgage loans held-for-investment and collateralized borrowings in securitization trusts | (18,940) | (16,621) |
| Loss (gain) on servicing asset | 73,042 | (816) |
| Loss on termination and option expiration of interest rate swaps and swaptions | 51,712 | 21,904 |
| Unrealized loss (gain) on interest rate swaps and swaptions | 81,805 | (293,783) |
| Unrealized (gain) loss on other derivative instruments | (5,625) | 79,553 |
| Equity based compensation | 12,256 | 474 |
| Depreciation of fixed assets | 768 | 424 |
| Amortization of intangible assets | 533 | — |
| Purchases of mortgage loans held-for-sale | (991,990) | (989,665) |
| Proceeds from sales of mortgage loans held-for-sale | 415,889 | 25,404 |
| Proceeds from repayment of mortgage loans held-for-sale | 25,164 | 24,256 |
| Net change in assets and liabilities: | | |
| Increase in accrued interest receivable | (2,302) | (6,241) |
| (Increase)/decrease in deferred income taxes, net | (65,496) | 75,384 |
| Decrease in income taxes receivable | — | 4,323 |
| Increase in prepaid and fixed assets | (1,481) | (602) |
| (Increase)/decrease in other receivables | (10,885) | 29,687 |
| Increase in servicing advances | (12,485) | (5,368) |
| Increase in Federal Home Loan Bank stock | (60,000) | — |
| Increase in equity investments | (3,000) | — |
| Decrease in accrued interest payable | (5,353) | (3,278) |
| (Decrease)/increase in income taxes payable | (430) | 2,356 |
| Increase in accrued expenses and other liabilities | 13,912 | 9,274 |
| Net change in assets and liabilities due to purchase of entity | — | 3,306 |
| Net cash used in operating activities | $(355,914) | $(504,511) |

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

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

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2014 | 2013 |
| Cash Flows From Investing Activities: | (unaudited) | |
| Purchases of available-for-sale securities | $(4,017,640) | $(4,288,995) |
| Proceeds from sales of available-for-sale securities | 3,176,234 | 4,056,691 |
| Principal payments on available-for-sale securities | 783,308 | 860,984 |
| Short sales and purchases of other derivative instruments | 590 | (72,158) |
| Proceeds from sales of other derivative instruments, net | 49,729 | 126,347 |
| Purchases of trading securities | (2,138,647) | (995,625) |
| Proceeds from sales of trading securities | 1,145,410 | 1,000,946 |
| Purchases of beneficial interests in securitization trusts | — | (30,550) |
| Proceeds from repayment of mortgage loans held-for-investment in securitization trusts | 51,763 | 28,568 |
| Purchases of mortgage servicing rights, net of purchase price adjustments | (57,106) | (13,390) |
| Purchase of entity | — | (6,404) |
| Decrease in due to counterparties, net | (149,658) | (135,162) |
| Decrease/(increase) in restricted cash | 91,226 | (376,006) |
| Net cash (used in) provided by investing activities | (1,064,791) | 155,246 |
| Cash Flows From Financing Activities: | | |
| Proceeds from repurchase agreements | 200,827,955 | 145,909,686 |
| Principal payments on repurchase agreements | (200,803,527) | (146,382,131) |
| Proceeds from issuance of collateralized borrowings in securitization trusts | 693,717 | 307,119 |
| Principal payments on collateralized borrowings in securitization trusts | (407,684) | (30,574) |
| Proceeds from Federal Home Loan Bank advances | 3,796,411 | — |
| Principal payments on Federal Home Loan Bank advances | (2,296,411) | — |
| Proceeds from issuance of common stock, net of offering costs | 399 | 763,384 |
| Proceeds from exercise of warrants | — | 102,276 |
| Repurchase of common stock | — | (23,894) |
| Dividends paid on common stock | (190,361) | (394,549) |
| Net cash provided by financing activities | 1,620,499 | 251,317 |
| Net increase (decrease) in cash and cash equivalents | 199,794 | (97,948) |
| Cash and cash equivalents at beginning of period | 1,025,487 | 821,108 |
| Cash and cash equivalents at end of period | $1,225,281 | $723,160 |

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

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

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2014 | 2013 |
| Supplemental Disclosure of Cash Flow Information: | (unaudited) | |
| Cash paid for interest | $81,100 | $76,762 |
| Cash paid (received) for taxes | $3,905 | $(4,254) |
| Noncash Investing and Financing Activities: | | |
| Transfers of mortgage loans held-for-sale to mortgage loans held-for-investment in securitization trusts | $656,581 | $413,848 |
| Consolidation of mortgage loans held-for-investment in securitization trusts | $— | $442,767 |
| Consolidation of collateralized borrowings in securitization trusts | $— | $412,217 |
| Cashless exercise of warrants | $— | $75 |
| Distribution of Silver Bay common stock | $— | $343,481 |
| Cash dividends declared but not paid at end of period | $95,205 | $102,022 |
| Reconciliation of mortgage loans held-for-sale: | | |
| Mortgage loans held-for-sale at beginning of period | $544,581 | $58,607 |
| Purchases of mortgage loans held-for-sale | 991,990 | 989,665 |
| Transfers to mortgage loans held-for-investment in securitization trusts | (656,581) | (413,848) |
| Proceeds from sales of mortgage loans held-for-sale | (415,889) | (25,404) |
| Proceeds from repayment of mortgage loans held-for-sale | (25,164) | (24,256) |
| Realized and unrealized gains (losses) on mortgage loans held-for-sale | 6,128 | (25,027) |
| Mortgage loans held-for-sale at end of period | $445,065 | $559,737 |

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

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

Note 1. Organization and Operations

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

The Company was incorporated on May 21, 2009 and commenced operations as a publicly traded company on October 28, 2009, upon completion of a merger with Capitol Acquisition Corp., or Capitol, which became a wholly owned indirect subsidiary as a result of the merger.

The Company has elected to be treated as a real estate investment trust, or REIT, as defined under the Internal Revenue Code of 1986, as amended, or the Code, for U.S. federal income tax purposes commencing with its initial taxable period ended December 31, 2009. As long as the Company continues to comply with a number of requirements under federal tax law and maintains its qualification as a REIT, the Company generally will not be subject to U.S. federal income taxes to the extent that the Company distributes its taxable income to its stockholders on an annual basis and does not engage in prohibited transactions. However, certain activities that the Company may perform may cause it to earn income which will not be qualifying income for REIT purposes. The Company has designated certain of its subsidiaries as taxable REIT subsidiaries, or TRSs, as defined in the Code, to engage in such activities, and the Company may in the future form additional TRSs.

On December 19, 2012, the Company completed the contribution of its portfolio of single-family rental properties to Silver Bay Realty Trust Corp., or Silver Bay, a newly organized Maryland corporation intended to qualify as a REIT and focused on the acquisition, renovation, leasing and management of single-family residential properties for rental income and long-term capital appreciation. The Company contributed its equity interests in its wholly owned subsidiary, Two Harbors Property Investment LLC, to Silver Bay, and in exchange for its contribution, received shares of common stock of Silver Bay. Silver Bay completed its initial public offering, or IPO, of its common stock on December 19, 2012. Because the Company will not have any significant continuing involvement in Two Harbors Property Investment LLC, all of the associated operating results were removed from continuing operations and are presented separately as discontinued operations for the three and nine months ended September 30, 2014 and 2013. See Note 4 - Discontinued Operations for additional information.

On April 30, 2013, one of the Company's wholly owned subsidiaries acquired a company that has approvals from the Federal National Mortgage Association, or Fannie Mae, the Federal Home Loan Mortgage Corporation, or Freddie Mac, and the Government National Mortgage Association, or Ginnie Mae, to hold and manage MSR. The MSR acquired in conjunction with the acquisition of this entity and those subsequently purchased represent the right to service mortgage loans. The Company and its subsidiaries do not originate or directly service mortgage loans, and instead contract with fully licensed subservicers to handle all servicing functions for the loans underlying the Company's MSR. See Note 9 - Servicing Activities for additional information.

Note 2. Basis of Presentation and Significant Accounting Policies

Consolidation and Basis of Presentation

The interim unaudited condensed consolidated financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles, or U.S. GAAP, have been condensed or omitted according to such SEC rules and regulations. However, management believes that the disclosures included in these interim condensed consolidated financial statements are adequate to make the information presented not misleading. The accompanying condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at September 30, 2014 and results of operations for all periods presented have been made. The results of operations for the three and nine months ended September 30, 2014 should not be construed as indicative of the results to be expected for future periods or the full year.

The condensed consolidated financial statements of the Company have been prepared on the accrual basis of accounting in accordance with U.S. GAAP. The preparation of financial statements in conformity with U.S. GAAP requires us to make a number of significant estimates and assumptions. These estimates include estimates of fair value of certain assets and liabilities, amount and timing of credit losses, prepayment rates, the period of time during which the Company anticipates an increase in the fair values of real estate securities sufficient to recover unrealized losses in those securities, and other estimates that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities as of the date of the condensed consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (e.g., valuation changes due to supply and demand, credit performance, prepayments, interest rates, or other reasons) will occur in the near term. The Company's estimates are inherently subjective in nature and actual results could differ from its estimates and the differences may be material.

The condensed consolidated financial statements of the Company include the accounts of all subsidiaries; inter-company accounts and transactions have been eliminated. Certain prior period amounts have been reclassified to conform to the current period presentation.

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

### Significant Accounting Policies

Included in Note 2 to the Consolidated Financial Statements of the Company's 2013 Annual Report on Form 10-K is a summary of the Company's significant accounting policies. Provided below is a summary of additional accounting policies that are significant to the Company's consolidated financial condition and results of operations for the nine months ended September 30, 2014.

### Federal Home Loan Bank Advances

In December 2013, the Company's wholly owned subsidiary, TH Insurance Holdings Company LLC, or TH Insurance Holdings, was accepted for membership in the Federal Home Loan Bank of Des Moines, or the FHLB. As a member of the FHLB, TH Insurance Holdings has access to a variety of products and services offered by the FHLB, including secured advances.

As of September 30, 2014, the Company had FHLB advances with both short-term and long-term maturities. The advances generally bear interest rates of one- or three-month LIBOR. FHLB advances are treated as secured financing transactions and are carried at their contractual amounts.

### Offsetting Assets and Liabilities

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

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

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TWO HARBORS INVESTMENT CORP.
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The following tables present information about the Company's assets and liabilities that are subject to master netting arrangements or similar agreements and can potentially be offset on the Company's condensed consolidated balance sheets as of September 30, 2014 and December 31, 2013:

September 30, 2014

| (in thousands) | Gross Amounts of Recognized Assets (Liabilities) | Gross Amounts Offset in the Condensed Consolidated Balance Sheets | Net Amounts of Assets (Liabilities) Presented in the Condensed Consolidated Balance Sheets | Gross Amounts Not Offset with Financial Assets (Liabilities) in the Condensed Consolidated Balance Sheets [1] Financial Instruments | Cash Collateral (Received) Pledged | Net Amount |
|---|---|---|---|---|---|---|
| Assets | | | | | | |
| Derivative assets | $370,906 | $(17,013) | $353,893 | $(4,221) | $— | $349,672 |
| Total Assets | $370,906 | $(17,013) | $353,893 | $(4,221) | $— | $349,672 |
| Liabilities | | | | | | |
| Repurchase agreements | $(12,274,878) | $— | $(12,274,878) | $12,274,878 | $— | $— |
| Federal Home Loan Bank advances | (1,500,000) | — | (1,500,000) | 1,500,000 | — | — |
| Derivative liabilities | (21,234) | 17,013 | (4,221) | 4,221 | — | — |
| Total Liabilities | $(13,796,112) | $17,013 | $(13,779,099) | $13,779,099 | $— | $— |

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| December 31, 2013 | | | | | | |
|---|---|---|---|---|---|---|
| | | | | Gross Amounts Not Offset with Financial Assets (Liabilities) in the Condensed Consolidated Balance Sheets [1] | | |
| (in thousands) | Gross Amounts of Recognized Assets (Liabilities) | Gross Amounts Offset in the Condensed Consolidated Balance Sheets | Net Amounts of Assets (Liabilities) Presented in the Condensed Consolidated Balance Sheets | Financial Instruments | Cash Collateral (Received) Pledged | Net Amount |
| Assets | | | | | | |
| Derivative assets | $572,050 | $(22,191) | $549,859 | $(22,081) | $— | $527,778 |
| Total Assets | $572,050 | $(22,191) | $549,859 | $(22,081) | $— | $527,778 |
| Liabilities | | | | | | |
| Repurchase agreements | $(12,250,450) | $— | $(12,250,450) | $12,250,450 | $— | $— |
| Derivative liabilities | (44,272) | 22,191 | (22,081) | 22,081 | — | — |
| Total Liabilities | $(12,294,722) | $22,191 | $(12,272,531) | $12,272,531 | $— | $— |

(1) Amounts presented are limited in total to the net amount of assets or liabilities presented in the condensed consolidated balance sheets by instrument. Excess cash collateral or financial assets that are pledged to counterparties may exceed the financial liabilities subject to a master netting arrangement or similar agreement, or counterparties may have pledged excess cash collateral to the Company that exceed the corresponding financial assets. These excess amounts are excluded from the table above, although separately reported within restricted cash, due from counterparties, or due to counterparties in the Company's condensed consolidated balance sheets.

Recently Issued and/or Adopted Accounting Standards

Presentation of an Unrecognized Tax Benefit

In July 2013, the FASB issued ASU No. 2013-11, which requires an entity to present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss, or NOL, carryforward, or similar tax loss or tax credit carryforward, rather than as a liability when (1) the uncertain tax position would reduce the NOL or other carryforward under the tax law of the applicable jurisdiction and (2) the entity intends to use the deferred tax asset for that purpose. The ASU does not require any new recurring disclosures. It is effective prospectively for fiscal years, and interim periods within those years, beginning on or after December 15, 2013, with early adoption permitted. Adopting this ASU did not have any impact on the Company's condensed consolidated financial condition or results of operations.

Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity

In August 2014, the FASB issued ASU No. 2014-13, which updates the guidance on measuring the financial assets and financial liabilities of consolidated collateralized financing entities, or CFEs. The update will allow an entity 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. The ASU will require certain recurring disclosures and is effective for annual periods beginning on or after December 15, 2015, with early adoption permitted as of the beginning of an annual period. The Company is evaluating the adoption of this ASU.

Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure

In August 2014, the FASB issued ASU No. 2014-14, which requires that, upon foreclosure, a mortgage loan that is fully guaranteed under certain government programs be derecognized and a separate receivable be recognized when specific criteria are met. The ASU will require certain recurring disclosures and is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2014, with early adoption permitted. The Company is evaluating the adoption of this ASU.

Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern

In August 2014, the FASB issued ASU No. 2014-15, which requires management to evaluate whether there are conditions and events that raise substantial doubt about the entity’s ability to continue as a going concern for both annual and interim

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reporting periods. The ASU will require certain disclosures if it concludes that substantial doubt exists and plans to alleviate that doubt. It is effective for annual periods ending after December 15, 2016, and for both annual and interim periods thereafter, with early adoption permitted. The Company does not expect this ASU to have any impact on the Company's condensed consolidated financial condition or results of operations.

Note 3. Variable Interest Entities
The Company purchases subordinated debt and excess servicing rights from securitization trusts sponsored by either third parties or the Company's subsidiaries. These securitization trusts are considered VIEs for financial reporting purposes and, thus, were reviewed for consolidation under the applicable consolidation guidance. Because the Company has both the power to direct the activities of the securitization trusts that most significantly impact the entities' performance, and the obligation to absorb losses or the right to receive benefits of the entities that could be significant, the Company consolidates the trusts. As the Company is required to reassess VIE consolidation guidance each quarter, new facts and circumstances may change the Company's determination. A change in the Company's determination could result in a material impact to the Company's financial statements during subsequent reporting periods.
The following table presents a summary of the assets and liabilities of the consolidated securitization trusts as reported on the condensed consolidated balance sheets:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Mortgage loans held-for-investment in securitization trusts | $1,428,890 | $792,390 |
| Accrued interest receivable | 7,137 | 4,506 |
| Total Assets | $1,436,027 | $796,896 |
| Collateralized borrowings in securitization trusts | $938,506 | $639,731 |
| Accrued interest payable | 2,933 | 1,596 |
| Accrued expenses | 3,563 | 2,724 |
| Total Liabilities | $945,002 | $644,051 |

Note 4. Discontinued Operations
On December 19, 2012, the Company completed the contribution of its equity interests in its wholly owned subsidiary, Two Harbors Property Investment LLC, to Silver Bay. Two Harbors Property Investment LLC previously held the Company's portfolio of single-family rental properties. Because the Company will not have any significant continuing involvement in Two Harbors Property Investment LLC, all of the associated operating results were removed from continuing operations and are presented separately as discontinued operations for the three and nine months ended September 30, 2014 and 2013.
Summarized financial information for the discontinued operations are presented below.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| (in thousands) | 2014 | 2013 | 2014 | 2013 |
| Income: | | | | |
| Gain on contribution of entity | $— | $871 | $— | $3,126 |
| Real estate related revenues | — | — | — | — |
| Total income | — | 871 | — | 3,126 |
| Expenses: | | | | |
| Management fees | — | — | — | — |
| Real estate related expenses | — | — | — | — |
| Other operating expenses | — | — | — | (138 ) |

| | | | | |
|---|---|---|---|---|
| Total expenses | — | — | — | (138 ) |
| Income from discontinued operations | $— | $871 | $— | $3,264 |

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In addition to the gain on contribution of entity that was recorded in 2012 in connection with the closing of the contribution, certain adjustments were agreed to be recognized in 2013. These include an installment sales gain of approximately $4.0 million from Silver Bay, a reduction of 2013 management fees payable to PRCM Advisers of $4.3 million, and an immaterial amount of additional working capital adjustments determined in accordance with the contribution agreement entered into with Silver Bay. Of these amounts, $0.9 million and $3.2 million of the installment sales gain was recorded as a gain on contribution of entity within discontinued operations for the three and nine months ended September 30, 2013, respectively, and the full $4.3 million of the reduction of 2013 management fees payable to PRCM Advisers was recorded within management fees, on the condensed consolidated statements of comprehensive income for the nine months ended September 30, 2013. The remaining $0.1 million recorded within discontinued operations on the condensed consolidated statements of comprehensive income for the nine months ended September 30, 2013 relates to accrual adjustments for transaction expenses related to the contribution. No further adjustments were recognized during 2014. See Note 24 - Related Party Transactions for additional information.

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

The Company holds available-for-sale, or AFS, investment securities, which are carried at fair value. AFS securities exclude the retained interests from the Company’s on-balance sheet securitizations, as they are eliminated in consolidation in accordance with U.S. GAAP. The following table presents the Company’s AFS investment securities by collateral type as of September 30, 2014 and December 31, 2013:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Mortgage-backed securities: | | |
| Agency | | |
| Federal Home Loan Mortgage Corporation | $2,086,057 | $2,977,291 |
| Federal National Mortgage Association | 5,477,888 | 4,435,820 |
| Government National Mortgage Association | 2,134,467 | 2,084,298 |
| Non-Agency | 2,999,496 | 2,759,318 |
| Total mortgage-backed securities | $12,697,908 | $12,256,727 |

At September 30, 2014 and December 31, 2013, the Company pledged AFS securities with a carrying value of $12.4 billion and $12.3 billion, respectively, as collateral for repurchase agreements and FHLB advances. See Note 16 - Repurchase Agreements and Note 18 - Federal Home Loan Bank of Des Moines Advances.

At September 30, 2014 and December 31, 2013, the Company did not have any securities purchased from and financed with the same counterparty that did not meet the conditions of ASC 860, Transfers and Servicing, or ASC 860, to be considered linked transactions and, therefore, classified as derivatives.

The following tables present the amortized cost and carrying value (which approximates fair value) of AFS securities by collateral type as of September 30, 2014 and December 31, 2013:

| | September 30, 2014 | | |
|---|---|---|---|
| (in thousands) | Agency | Non-Agency | Total |
| Face Value | $12,040,854 | $4,314,943 | $16,355,797 |
| Unamortized premium | 626,470 | — | 626,470 |
| Unamortized discount | | | |
| Designated credit reserve | — | (969,031) | (969,031) |
| Net, unamortized | (3,072,511) | (1,019,465) | (4,091,976) |
| Amortized Cost | 9,594,813 | 2,326,447 | 11,921,260 |
| Gross unrealized gains | 168,871 | 674,181 | 843,052 |

| | | | |
|---|---|---|---|
| Gross unrealized losses | (65,272) | (1,132) | (66,404) |
| Carrying Value | $9,698,412 | $2,999,496 | $12,697,908 |

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| | December 31, 2013 | | |
|---|---|---|---|
| (in thousands) | Agency | Non-Agency | Total |
| Face Value | $11,919,590 | $4,474,353 | $16,393,943 |
| Unamortized premium | 621,279 | — | 621,279 |
| Unamortized discount | | | |
| Designated credit reserve | — | (1,234,449) | (1,234,449) |
| Net, unamortized | (2,897,222) | (1,071,559) | (3,968,781) |
| Amortized Cost | 9,643,647 | 2,168,345 | 11,811,992 |
| Gross unrealized gains | 102,600 | 595,179 | 697,779 |
| Gross unrealized losses | (248,838) | (4,206) | (253,044) |
| Carrying Value | $9,497,409 | $2,759,318 | $12,256,727 |

The following tables present the carrying value of the Company’s AFS investment securities by rate type as of September 30, 2014 and December 31, 2013:

| | September 30, 2014 | | |
|---|---|---|---|
| (in thousands) | Agency | Non-Agency | Total |
| Adjustable Rate | $132,157 | $2,503,733 | $2,635,890 |
| Fixed Rate | 9,566,255 | 495,763 | 10,062,018 |
| Total | $9,698,412 | $2,999,496 | $12,697,908 |

| | December 31, 2013 | | |
|---|---|---|---|
| (in thousands) | Agency | Non-Agency | Total |
| Adjustable Rate | $1,006,621 | $2,403,078 | $3,409,699 |
| Fixed Rate | 8,490,788 | 356,240 | 8,847,028 |
| Total | $9,497,409 | $2,759,318 | $12,256,727 |

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

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The following table presents the changes for the nine months ended September 30, 2014 and 2013, of the unamortized net discount and designated credit reserves on non-Agency AFS securities.

| | Nine Months Ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2014 | | | 2013 | | |
| (in thousands) | Designated Credit Reserve | Unamortized Net Discount | Total | Designated Credit Reserve | Unamortized Net Discount | Total |
| Beginning balance at January 1 | $(1,234,448) | $(1,071,559) | $(2,306,007) | $(1,290,946) | $(996,490) | $(2,287,436) |
| Acquisitions | (69,663) | (57,174) | (126,837) | (181,122) | (390,269) | (571,391) |
| Accretion of net discount | — | 96,873 | 96,873 | 886 | 108,829 | 109,715 |
| Realized credit losses | 11,325 | — | 11,325 | 28,684 | — | 28,684 |
| Reclassification adjustment for other-than-temporary impairments | (212) | — | (212) | (1,662) | — | (1,662) |
| Transfers from (to) | 91,086 | (91,086) | — | 35,201 | (35,201) | — |
| Sales, calls, other | 232,881 | 103,481 | 336,362 | 36,331 | 151,310 | 187,641 |
| Ending balance at September 30 | $(969,031) | $(1,019,465) | $(1,988,496) | $(1,372,628) | $(1,161,821) | $(2,534,449) |

The following table presents the components comprising the carrying value of AFS securities not deemed to be other than temporarily impaired by length of time the securities had an unrealized loss position as of September 30, 2014 and December 31, 2013. At September 30, 2014, the Company held 1,423 AFS securities, of which 89 were in an unrealized loss position for less than twelve consecutive months and 200 were in an unrealized loss position for more than twelve consecutive months. At December 31, 2013, the Company held 1,431 AFS securities, of which 447 were in an unrealized loss position for less than twelve months and 114 were in an unrealized loss position for more than twelve consecutive months. Of the $1.4 billion and $4.9 billion of AFS securities in an unrealized loss position for less than twelve consecutive months as of September 30, 2014 and December 31, 2013, $1.3 billion, or 93.6%, and $4.8 billion, or 96.9%, respectively, were Agency AFS securities, whose principal and interest are guaranteed by government sponsored entities, or GSEs.

| | Unrealized Loss Position for | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 Months | | 12 Months or More | | Total | |
| (in thousands) | Estimated Fair Value | Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses |
| September 30, 2014 | $1,409,676 | $(5,261) | $1,605,423 | $(61,143) | $3,015,099 | $(66,404) |
| December 31, 2013 | $4,902,813 | $(171,651) | $1,186,692 | $(81,393) | $6,089,505 | $(253,044) |

Evaluating AFS Securities for Other-Than-Temporary Impairments

In order to evaluate AFS securities for OTTI, the Company determines whether there has been a significant adverse quarterly change in the cash flow expectations for a security. The Company compares the amortized cost of each security in an unrealized loss position against the present value of expected future cash flows of the security. The Company also considers whether there has been a significant adverse change in the regulatory and/or economic environment as part of this analysis. If the amortized cost of the security is greater than the present value of expected future cash flows using the original yield as the discount rate, an other-than-temporary credit impairment has occurred. If the Company does not intend to sell and is not more likely than not required to sell the security, the credit loss is recognized in earnings and the balance of the unrealized loss is recognized in other comprehensive (loss) income. If the Company intends to sell the security or will be more likely than not required to sell the security, the full unrealized loss is recognized in earnings.

The Company recorded a $0.2 million other-than-temporary credit impairment during the nine months ended September 30, 2014 on a total of three non-Agency RMBS where the future expected cash flows for each security were less than its amortized cost. The Company did not record any other-than-temporary credit impairments during the three months ended September 30,

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2014. As of September 30, 2014, impaired securities with a carrying value of $162.6 million had actual weighted average cumulative losses of 10.6%, weighted average three-month prepayment speed of 3.8%, weighted average 60+ day delinquency of 29.5% of the pool balance, and weighted average FICO score of 664. At September 30, 2014, the Company did not intend to sell the securities and determined that it was not more likely than not that the Company will be required to sell the securities; therefore, only the projected credit loss was recognized in earnings. During the nine months ended September 30, 2013, the Company recorded a $1.7 million other-than-temporary credit impairment on a total of four non-Agency RMBS where the future expected cash flows for the security were less than its amortized cost. The Company did not record any other-than-temporary impairments during the three months ended September 30, 2013.

The following table presents the changes in OTTI included in earnings for three and nine months ended September 30, 2014 and 2013:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| (in thousands) | 2014 | 2013 | 2014 | 2013 |
| Cumulative credit loss at beginning of period | $(8,061) | $(15,046) | $(9,467) | $(15,561) |
| Additions: | | | | |
| Other-than-temporary impairments not previously recognized | — | — | (91) | — |
| Increases related to other-than-temporary impairments on securities with previously recognized other-than-temporary impairments | — | — | (121) | (1,662) |
| Reductions: | | | | |
| Decreases related to other-than-temporary impairments on securities paid down | — | 1,446 | 464 | 1,677 |
| Decreases related to other-than-temporary impairments on securities sold | — | 406 | 1,154 | 2,352 |
| Cumulative credit loss at end of period | $(8,061) | $(13,194) | $(8,061) | $(13,194) |

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

Gross Realized Gains and Losses

Gains and losses from the sale of AFS securities are recorded as realized gains (losses) within gain (loss) on investment securities in the Company’s condensed consolidated statements of comprehensive income. For the three and nine months ended September 30, 2014, the Company sold AFS securities for $1.9 billion and $3.2 billion with an amortized cost of $1.8 billion and $3.1 billion, for net realized gains of $62.7 million and $59.9 million, respectively. For the three and nine months ended September 30, 2013, the Company sold AFS securities for $3.1 billion and $4.1 billion with an amortized cost of $3.3 billion and $4.2 billion, for net realized losses of $234.5 million and $163.2 million, respectively.

The following table presents the gross realized gains and losses on sales of AFS securities for the three and nine months ended September 30, 2014 and 2013:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| (in thousands) | 2014 | 2013 | 2014 | 2013 |
| Gross realized gains | $87,842 | $27,786 | $131,005 | $103,451 |
| Gross realized losses | (25,122) | (262,323) | (71,119) | (266,620) |

| | | | | |
|---|---|---|---|---|
| Total realized (losses) gains on sales, net | $62,720 | $(234,537) | $59,886 | $(163,169) |

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Note 6. Trading Securities, at Fair Value
The Company holds U.S. Treasuries in a TRS and classifies these securities as trading instruments due to short-term investment objectives. As of September 30, 2014 and December 31, 2013, the Company held U.S. Treasuries with an amortized cost of $2.0 billion and $996.1 million, and a fair value of $2.0 billion and $1.0 billion, respectively, classified as trading securities. Included within trading securities were unrealized losses of $2.8 million and unrealized gains of $4.1 million as of September 30, 2014 and December 31, 2013, respectively.
For the three and nine months ended September 30, 2014, the Company sold trading securities for $1.0 billion and $1.1 billion with an amortized cost of $996.9 million and $1.1 billion, resulting in realized gains of $5.1 million and $5.5 million, respectively, on the sale of these securities. For both the three and nine months ended September 30, 2013, the Company sold trading securities for $1.0 billion with an amortized cost of $997.9 million, resulting in realized gains of $3.1 million.
For the three and nine months ended September 30, 2014, trading securities experienced change in unrealized losses of $8.4 million and $6.9 million, respectively. For the three and nine months ended September 30, 2013, trading securities experienced change in unrealized gains of $1.4 million and change in unrealized losses of $0.2 million, respectively. Both realized and unrealized gains and losses are recorded as a component of gain (loss) on investment securities in the Company’s condensed consolidated statements of comprehensive income.
At September 30, 2014 and December 31, 2013, the Company pledged trading securities with a carrying value of $2.0 billion and $1.0 billion, respectively, as collateral for repurchase agreements. See Note 16 - Repurchase Agreements.

Note 7. Mortgage Loans Held-for-Sale, at Fair Value
Mortgage loans held-for-sale consists of residential mortgage loans carried at fair value as a result of a fair value option election. The following table presents the carrying value of the Company’s mortgage loans held-for-sale as of September 30, 2014 and December 31, 2013:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Unpaid principal balance | $445,692 | $680,840 |
| Fair value adjustment | (627) | (136,259) |
| Carrying value | $445,065 | $544,581 |

At September 30, 2014 and December 31, 2013, the Company pledged mortgage loans with a carrying value of $407.8 million and $200.8 million, respectively, as collateral for repurchase agreements and FHLB advances. See Note 16 - Repurchase Agreements and Note 18 - Federal Home Loan Bank of Des Moines Advances.

Note 8. Mortgage Loans Held-for-Investment 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 underlying residential mortgage loans held by the trusts, which are consolidated on the Company’s condensed consolidated balance sheet, are classified as 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 for additional information regarding consolidation of the securitization trusts. The following table presents the carrying value of the Company’s mortgage loans held-for-investment in securitization trusts as of September 30, 2014 and December 31, 2013:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Unpaid principal balance | $1,402,782 | $812,538 |
| Fair value adjustment | 26,108 | (20,148) |
| Carrying value | $1,428,890 | $792,390 |

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Note 9. Servicing Activities
Mortgage Servicing Rights, at Fair Value
On April 30, 2013, one of the Company's wholly owned subsidiaries acquired a company that has approvals from Fannie Mae, Freddie Mac and Ginnie Mae to hold and manage MSR. The MSR acquired in conjunction with this acquisition and those subsequently purchased represent the right to service mortgage loans. The Company and its subsidiaries do not originate or directly service mortgage loans, and instead contract with fully licensed subservicers to handle all servicing functions for the loans underlying the Company's MSR. The following table summarizes activity related to MSR for the three and nine months ended September 30, 2014 and 2013.

| (in thousands) | Three Months Ended September 30, 2014 | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2014 | Nine Months Ended September 30, 2013 |
|---|---|---|---|---|
| Balance at beginning of period | $500,490 | $1,452 | $514,402 | $— |
| Additions from purchases of servicing rights | 7,542 | 13,390 | 61,835 | 14,887 |
| Changes in fair value due to: | | | | |
| Changes in valuation inputs or assumptions used in the valuation model | 3,964 | — | (31,941) | — |
| Other changes in fair value (1) | (14,674) | 861 | (41,101) | 816 |
| Other changes (2) | 1,144 | — | (4,729) | — |
| Balance at end of period | $498,466 | $15,703 | $498,466 | $15,703 |

(1) Other changes in fair value primarily represents changes due to the realization of expected cash flows.
(2) Other changes includes purchase price adjustments, principally contractual prepayment protection, and changes due to the Company's repurchase of the underlying collateral.

As of September 30, 2014 and December 31, 2013, the key economic assumptions and sensitivity of the fair value of MSR to immediate 10% and 20% adverse changes in these assumptions were as follows:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Weighted average prepayment speed: | 10.7 % | 9.5 % |
| Impact on fair value of 10% adverse change | $(18,942) | $(19,305) |
| Impact on fair value of 20% adverse change | $(36,388) | $(37,187) |
| Weighted average delinquency: | 4.5 % | 4.0 % |
| Impact on fair value of 10% adverse change | $(3,489) | $(8,835) |
| Impact on fair value of 20% adverse change | $(7,477) | $(17,642) |
| Weighted average discount rate: | 9.5 % | 9.0 % |
| Impact on fair value of 10% adverse change | $(18,443) | $(21,037) |
| Impact on fair value of 20% adverse change | $(35,890) | $(40,642) |

These assumptions and sensitivities are hypothetical and should be considered with caution. Changes in fair value based on 10% and 20% variations in assumptions generally cannot be extrapolated because the relationship of the change in assumptions to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of MSR is calculated without changing any other assumptions. In reality, changes in one factor may result in changes in another (e.g., increased market interest rates may result in lower prepayments and increased credit losses) that could magnify or counteract the sensitivities. Further, these sensitivities show only the change in the asset balances and do not show any expected change in the fair value of the instruments used to manage the interest rates and prepayment risks associated with these assets.

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Risk Mitigation Activities
The primary risk of the Company's MSR is interest rate risk and the resulting impact on prepayments. A significant decline in interest rates could lead to higher-than-expected prepayments that could reduce the value of the MSR. The Company economically hedges the impact of these risks with AFS securities and derivative financial instruments. Refer to Note 12 - Derivative Instruments and Hedging Activities for additional information regarding the derivative financial instruments used to economically hedge MSR.
Mortgage Servicing Income
The following table presents the components of servicing income recorded on the Company's condensed consolidated statements of comprehensive income for the three and nine months ended September 30, 2014 and 2013:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| (in thousands) | 2014 | 2013 | 2014 | 2013 |
| Servicing fee income | $31,390 | $899 | $94,340 | $1,114 |
| Ancillary fee income | 874 | 90 | 2,233 | 120 |
| | $32,264 | $989 | $96,573 | $1,234 |

Mortgage Servicing Advances
In connection with the servicing of loans, the Company's subservicers make certain payments for property taxes and insurance premiums, default and property maintenance payments, as well as advances of principal and interest payments before collecting them from individual borrowers. Servicing advances, including contractual interest, are priority cash flows in the event of a loan principal reduction or foreclosure and ultimate liquidation of the real estate-owned property, thus making their collection reasonably assured. These servicing advances, which are funded by the Company, totaled $19.8 million and $7.3 million and were included in other assets on the condensed consolidated balance sheet as of September 30, 2014 and December 31, 2013, respectively.
Serviced Mortgage Assets
The Company's total serviced mortgage assets consist of loans owned and classified as mortgage loans held-for-sale, loans held in consolidated VIEs classified as mortgage loans held-for-investment in securitization trusts and loans underlying MSR. The following table presents the number of loans and unpaid principal balance of the mortgage assets for which the Company manages the servicing as of September 30, 2014 and December 31, 2013:

| (dollars in thousands) | September 30, 2014 | | December 31, 2013 | |
|---|---|---|---|---|
| | Number of Loans | Unpaid Principal Balance | Number of Loans | Unpaid Principal Balance |
| Mortgage loans held-for-sale | 825 | $445,692 | 2,890 | $680,840 |
| Mortgage loans held-for-investment in securitization trusts | 499 | 368,358 | 537 | 425,209 |
| Mortgage servicing rights [(1)] | 226,369 | 45,526,752 | 210,441 | 42,324,328 |
| Total serviced mortgage assets | 227,693 | $46,340,802 | 213,868 | $43,430,377 |

(1) Includes mortgage loans held-for-investment in securitization trusts for which the Company is the named servicing administrator.

Note 10. Restricted Cash
The Company is required to maintain certain cash balances with counterparties for securities and derivatives trading activity and collateral for the Company's repurchase agreements and FHLB advances in restricted accounts. The Company has also placed cash in a restricted account pursuant to a letter of credit on an office space lease.

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The following table presents the Company’s restricted cash balances as of September 30, 2014 and December 31, 2013:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Restricted cash balances held by trading counterparties: | | |
| For securities trading activity | $9,000 | $9,000 |
| For derivatives trading activity | 207,780 | 191,107 |
| As restricted collateral for repurchase agreements and Federal Home Loan Bank advances | 93,295 | 201,194 |
| | 310,075 | 401,301 |
| Restricted cash balance pursuant to letter of credit on office lease | 346 | 346 |
| Total | $310,421 | $401,647 |

Note 11. Accrued Interest Receivable
The following table presents the Company’s accrued interest receivable by collateral type:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Accrued Interest Receivable: | | |
| U.S. Treasuries | $3,709 | $2,361 |
| Mortgage-backed securities: | | |
| Agency | | |
| Federal Home Loan Mortgage Corporation | 7,826 | 10,583 |
| Federal National Mortgage Association | 18,950 | 15,034 |
| Government National Mortgage Association | 10,270 | 10,007 |
| Non-Agency | 3,543 | 3,676 |
| Total mortgage-backed securities | 40,589 | 39,300 |
| Mortgage loans held-for-sale | 1,170 | 4,136 |
| Mortgage loans held-for-investment in securitization trusts | 7,137 | 4,506 |
| Total | $52,605 | $50,303 |

Note 12. Derivative Instruments and Hedging Activities
The Company enters into a variety of derivative and non-derivative instruments in connection with its risk management activities. The Company’s primary objective for executing these derivative and non-derivative instruments is to mitigate the Company’s economic exposure to future events that are outside its control. The Company’s derivative financial instruments are utilized principally to manage market risk and cash flow volatility associated with interest rate risk (including associated prepayment risk) related to certain assets and liabilities. As part of its risk management activities, the Company may, at times, enter into various forward contracts, including short securities, Agency to-be-announced securities, or TBAs, options, futures, swaps, caps, credit default swaps and total return swaps. In executing on the Company’s current risk management strategy, the Company has entered into interest rate swap and swaption agreements, TBAs, put and call options for TBAs, constant maturity swaps, credit default swaps and total return swaps (based on the Markit IOS Index). The Company has also entered into a number of non-derivative instruments to manage interest rate risk, principally U.S. Treasuries and Agency interest-only securities.
The following summarizes the Company’s significant asset and liability classes, the risk exposure for these classes, and the Company’s risk management activities used to mitigate certain of these risks. The discussion includes both derivative and non-derivative instruments used as part of these risk management activities. While the Company uses

non-derivative and derivative instruments to achieve the Company’s risk management activities, it is possible that these instruments will not effectively mitigate all or a substantial portion of the Company’s market rate risk. In addition, the Company might elect, at times, not to enter into certain hedging arrangements in order to maintain compliance with REIT requirements.

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Balance Sheet Presentation

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

The following tables present the gross fair value and notional amounts of the Company's derivative financial instruments treated as trading instruments as of September 30, 2014 and December 31, 2013.

| (in thousands) | September 30, 2014 | | | |
|---|---|---|---|---|
| | Derivative Assets | | Derivative Liabilities | |
| Trading instruments | Fair Value | Notional | Fair Value | Notional |
| Inverse interest-only securities | $188,701 | $1,211,965 | $— | $— |
| Interest rate swap agreements | 62,560 | 27,770,655 | — | — |
| Credit default swaps | — | — | (1,825) | 125,000 |
| Swaptions, net | 94,388 | 7,660,000 | — | — |
| TBAs | 4,101 | 2,880,000 | (2,396) | 2,190,000 |
| Put and call options for TBAs, net | 3,410 | 2,000,000 | — | — |
| Constant maturity swaps | 190 | 18,000,000 | — | — |
| Markit IOS total return swaps | 439 | 611,985 | — | — |
| Forward purchase commitments | 104 | 326,376 | — | — |
| Total | $353,893 | $60,460,981 | $(4,221) | $2,315,000 |

| (in thousands) | December 31, 2013 | | | |
|---|---|---|---|---|
| | Derivative Assets | | Derivative Liabilities | |
| Trading instruments | Fair Value | Notional | Fair Value | Notional |
| Inverse interest-only securities | $221,364 | $1,525,845 | $— | $— |
| Interest rate swap agreements | 25,325 | 19,619,000 | — | — |
| Credit default swaps | — | — | (18,049) | 427,073 |
| Swaptions, net | 269,745 | 5,130,000 | — | — |
| TBAs | 33,425 | 4,097,000 | (125) | 400,000 |
| Constant maturity swaps | — | — | (3,773) | 10,000,000 |
| Markit IOS total return swaps | — | — | (134) | 49,629 |
| Forward purchase commitments | — | 12,063 | — | — |
| Total | $549,859 | $30,383,908 | $(22,081) | $10,876,702 |

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 debt portfolio. As a result, the Company is subject to volatility in its earnings due to movement in the unrealized gains and losses associated with its interest rate swaps and its other derivative instruments.

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The following table summarizes the location and amount of gains and losses on derivative instruments reported in the condensed consolidated 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 September 30, | | Nine Months Ended September 30, | |
| | | 2014 | 2013 | 2014 | 2013 |
| Interest rate risk management | | | | | |
| TBAs [1] | Gain (loss) on other derivative instruments | $1,031 | $71,751 | $(46,749) | $138,429 |
| Put and call options for TBAs [1] | Gain (loss) on other derivative instruments | (3,825) | (37,052) | (10,144) | 15,375 |
| Constant maturity swaps [1] | Gain (loss) on other derivative instruments | 1,306 | 71 | 6,734 | (13,986) |
| Short U.S. Treasuries [1] | Gain (loss) on other derivative instruments | — | — | (8) | (991) |
| Interest rate swap agreements - Receivers [1] | Gain (loss) on interest rate swap and swaption agreements | (2,749) | 7,852 | 104,193 | 7,852 |
| Interest rate swap agreements - Payers [1] | Gain (loss) on interest rate swap and swaption agreements | 21,288 | (8,691) | (38,473) | (8,371) |
| Swaptions [1] | Gain (loss) on interest rate swap and swaption agreements | (22,827) | 3,711 | (192,635) | 95,476 |
| Markit IOS total return swaps [1] | Gain (loss) on other derivative instruments | 48 | — | (1,324) | — |
| Interest rate swap agreements - Payers [2] | Gain (loss) on interest rate swap and swaption agreements | 32,807 | (58,282) | (66,113) | 128,431 |
| Credit risk management | | | | | |
| Credit default swaps - Receive protection [3] | Gain (loss) on other derivative instruments | (71) | (30,344) | 1,905 | (40,206) |
| Non-risk management | | | | | |
| TBAs | Gain (loss) on other derivative instruments | — | 10,322 | (4,701) | 668 |
| Inverse interest-only securities | Gain (loss) on other derivative instruments | 7,567 | 5,686 | 41,942 | (33,234) |
| Forward purchase commitments | (Loss) gain on mortgage loans held-for-sale | (1,446) | — | 2,300 | (20,015) |
| Total | | $33,129 | $(34,976) | $(203,073) | $269,428 |

(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 mortgage loans held-for-sale.

For the three and nine months ended September 30, 2014, the Company recognized $26.8 million and $59.5 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 $28.6 billion and $23.8 billion notional, respectively, to economically hedge a portion of the Company's interest rate risk on its short-term repurchase agreements, funding costs, and macro-financing risk and receiving either LIBOR interest or a fixed interest rate. For the three and nine months ended September 30, 2013, the Company recognized $15.1 million and $48.5 million, respectively, of

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expenses for the accrual and/or settlement of the net interest expense associated with its interest rate swaps on an average $19.9 billion and $17.5 billion notional.
The following tables present information with respect to the volume of activity in the Company’s derivative instruments during the three and nine months ended September 30, 2014 and 2013:
(in thousands)

| Three Months Ended September 30, | Beginning of Period Notional Amount | Additions | Settlement, Termination, Expiration or Exercise | End of Period Notional Amount | Average Notional Amount | Realized Gain (Loss), net (1) |
|---|---|---|---|---|---|---|
| 2014 | | | | | | |
| Inverse interest-only securities | $1,323,650 | $— | $(111,685) | $1,211,965 | $1,261,098 | $221 |
| Interest rate swap agreements | 23,628,148 | 12,206,450 | (8,063,943) | 27,770,655 | 28,607,951 | 4,197 |
| Credit default swaps | 125,000 | — | — | 125,000 | 125,000 | — |
| Swaptions, net | 11,450,000 | 2,710,000 | (6,500,000) | 7,660,000 | 7,972,500 | (49,509) |
| TBAs, net | (372,000) | (3,316,000) | 2,998,000 | (690,000) | 830,435 | (5,177) |
| Put and call options for TBAs, net | — | 2,000,000 | — | 2,000,000 | 336,957 | (1,016) |
| Constant maturity swaps | 6,000,000 | 24,000,000 | (12,000,000) | 18,000,000 | 15,032,609 | 344 |
| Markit IOS total return swaps | 576,478 | 49,669 | (14,162) | 611,985 | 593,092 | — |
| Forward purchase commitments | 647,941 | 721,551 | (1,043,116) | 326,376 | 547,904 | 1,893 |
| Total | $43,379,217 | $38,371,670 | $(24,734,906) | $57,015,981 | $55,307,546 | $(49,047) |
| 2013 | | | | | | |
| Inverse interest-only securities | $1,798,972 | $14,999 | $(165,735) | $1,648,236 | $1,735,973 | $— |
| Interest rate swap agreements | 18,485,000 | 3,698,000 | (4,608,000) | 17,575,000 | 19,884,272 | 69,729 |
| Credit default swaps | 1,630,404 | 700,000 | (868,239) | 1,462,165 | 1,525,716 | (9,937) |
| Swaptions, net | 6,250,000 | 230,000 | (2,050,000) | 4,430,000 | 6,002,717 | (28,958) |
| TBAs, net | (2,721,000) | (3,759,000) | 7,337,000 | 857,000 | 313,902 | 133,399 |
| Put and call options for TBAs, net | (210,000) | 3,000,000 | (290,000) | 2,500,000 | 413,043 | (3,187) |
| Constant maturity swaps | 19,000,000 | 2,000,000 | (13,000,000) | 8,000,000 | 10,032,609 | (4,645) |
| Forward purchase commitments | 29,229 | — | (29,229) | — | 6,672 | (1,204) |
| Total | $44,262,605 | $5,883,999 | $(13,674,203) | $36,472,401 | $39,914,904 | $155,197 |

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(in thousands)

| Nine Months Ended September 30, | Beginning of Period Notional Amount | Additions | Settlement, Termination, Expiration or Exercise | End of Period Notional Amount | Average Notional Amount | Realized Gain (Loss), net (1) |
|---|---|---|---|---|---|---|
| 2014 | | | | | | |
| Inverse interest-only securities | $1,525,845 | $— | $(313,880) | $1,211,965 | $1,367,332 | $414 |
| Interest rate swap agreements | 19,619,000 | 23,615,598 | (15,463,943) | 27,770,655 | 23,778,725 | 1,193 |
| Credit default swaps | 427,073 | — | (302,073) | 125,000 | 142,940 | (13,705) |
| Swaptions, net | 5,130,000 | 9,860,000 | (7,330,000) | 7,660,000 | 9,117,546 | (52,905) |
| TBAs, net | 603,000 | (6,240,000) | 4,947,000 | (690,000) | 673,509 | (19,854) |
| Put and call options for TBAs, net | — | 3,500,000 | (1,500,000) | 2,000,000 | 498,168 | (6,348) |
| Constant maturity swaps | 10,000,000 | 36,000,000 | (28,000,000) | 18,000,000 | 10,219,780 | 2,771 |
| Markit IOS total return swaps | 49,629 | 586,550 | (24,194) | 611,985 | 381,913 | — |
| Short U.S. Treasuries | — | (125,000) | 125,000 | — | 458 | 2 |
| Forward purchase commitments | 12,063 | 1,780,257 | (1,465,944) | 326,376 | 320,117 | 2,195 |
| Total | $37,366,610 | $68,977,405 | $(49,328,034) | $57,015,981 | $46,500,488 | $(86,237) |
| 2013 | | | | | | |
| Inverse interest-only securities | $1,909,351 | $245,260 | $(506,375) | $1,648,236 | $1,850,637 | $— |
| Interest rate swap agreements | 14,070,000 | 16,273,000 | (12,768,000) | 17,575,000 | 17,486,421 | 11,036 |
| Credit default swaps | 438,440 | 2,000,000 | (976,275) | 1,462,165 | 913,477 | (22,289) |
| Swaptions, net | 4,950,000 | 1,830,000 | (2,350,000) | 4,430,000 | 5,766,300 | (32,941) |
| TBAs, net | 953,000 | 341,000 | (437,000) | 857,000 | 608,634 | 153,513 |
| Put and call options for TBAs, net | — | 2,498,000 | 2,000 | 2,500,000 | 95,560 | 26,011 |
| Constant maturity swaps | — | 21,000,000 | (13,000,000) | 8,000,000 | 5,225,275 | (4,645) |
| Short U.S. Treasuries | — | (400,000) | 400,000 | — | 8,901 | (876) |
| Forward purchase commitments | 56,865 | 510,184 | (567,049) | — | 75,117 | (19,780) |
| Total | $22,377,656 | $44,297,444 | $(30,202,699) | $36,472,401 | $32,030,322 | $110,029 |

(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 loss (gain) on interest rate swaps and swaptions, unrealized (gain) loss on other derivative instruments, and (gain) loss on mortgage loans held-for-sale line items within the operating activities section of the condensed consolidated statements of cash flows. Realized losses on interest rate swap and swaption agreements are reflected within the loss on termination 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 decrease in due to counterparties, net line items within the investing activities section of the condensed consolidated statements of cash flows.

Interest Rate Sensitive Assets/Liabilities

The Company’s 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 financial instruments, primarily fixed-rate interest-only securities, which increase in value when interest rates increase. In addition, the Company has initiated TBA positions, put and call options for TBAs, constant maturity swaps and interest rate swap agreements to further mitigate its exposure to higher interest rates, decreased prepayment speeds and widening mortgage

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spreads. The objective is to reduce the risk of losses to the portfolio caused by interest rate changes and changes in prepayment speeds.

As of September 30, 2014 and December 31, 2013, the Company had outstanding fair value of $61.1 million and $75.6 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 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 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 mortgage loans and mortgage loans held-for-sale, such as interest rate swaps, swaptions, TBA positions, put and call options for TBAs 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 September 30, 2014, $2.2 billion of the Company’s long notional TBA positions and $2.9 billion of the Company’s short notional TBA positions were held in order to economically hedge portfolio risk. As of December 31, 2013, $0.4 billion of the Company’s long notional TBA positions and $1.9 billion of the Company’s short notional TBA positions were held in order to economically hedge portfolio risk, while the remaining $2.2 billion long notional TBA positions were held for non-risk management purposes (see “Non-Risk Management Activities” below). 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 September 30, 2014 and December 31, 2013:

| | As of September 30, 2014 | | | | |
|---|---|---|---|---|---|
| | | | | Net Carrying Value (4) | |
| (in thousands) | Notional Amount (1) | Cost Basis (2) | Market Value (3) | Derivative Assets | Derivative Liabilities |
| Purchase contracts | $2,190,000 | $2,149,844 | $2,152,274 | $2,430 | $— |
| Sale contracts | (2,880,000) | (2,936,898) | (2,937,623) | 1,671 | (2,396) |
| TBAs, net | $(690,000) | $(787,054) | $(785,349) | $4,101 | $(2,396) |

| | As of December 31, 2013 | | | | |
|---|---|---|---|---|---|
| | | | | Net Carrying Value (4) | |
| (in thousands) | Notional Amount (1) | Cost Basis (2) | Market Value (3) | Derivative Assets | Derivative Liabilities |
| Purchase contracts | $2,550,000 | $2,749,648 | $2,767,295 | $17,771 | $(125) |
| Sale contracts | (1,947,000) | (1,959,256) | (1,943,602) | 15,654 | — |
| TBAs, net | $603,000 | $790,392 | $823,693 | $33,425 | $(125) |

(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 September 30, 2014, the Company had purchased put options for TBAs with a total notional amount of $2.0 billion and paid upfront premiums of approximately $7.2 million. Each of the options will expire in December 2014. The put options had a net fair market value of $3.4 million, included in derivative assets, at fair value, in the

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condensed consolidated balance sheet as of September 30, 2014. The Company did not hold any put or call options for TBAs as of December 31, 2013.
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 September 30, 2014 and December 31, 2013:
(notional and dollars in thousands)
September 30, 2014

| Determination Date | Average Strike Swap Rate | Notional Amount | Fair Value | Upfront Premium Paid | Unrealized Gain/(Loss) |
|---|---|---|---|---|---|
| October 2014 | 0.563 % | $5,000,000 | $(527 ) | $— | $(527 ) |
| November 2014 | 0.591 % | 2,000,000 | (677 ) | — | (677 ) |
| December 2014 | 0.552 % | 7,000,000 | 323 | — | 323 |
| January 2015 | 0.518 % | 4,000,000 | 1,071 | — | 1,071 |
| Total | 0.552 % | $18,000,000 | $190 | $— | $190 |

(notional and dollars in thousands)
December 31, 2013

| Determination Date | Average Strike Swap Rate | Notional Amount | Fair Value | Upfront Premium Paid | Unrealized Gain/(Loss) |
|---|---|---|---|---|---|
| February 2014 | 0.768 % | $3,000,000 | $625 | $— | $625 |
| March 2014 | 0.850 % | 5,000,000 | (3,171 ) | — | (3,171 ) |
| June 2014 | 0.828 % | 2,000,000 | (1,227 ) | — | (1,227 ) |
| Total | 0.821 % | $10,000,000 | $(3,773 ) | $— | $(3,773 ) |

Interest Rate Swap Agreements - As of September 30, 2014 and December 31, 2013, 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)
September 30, 2014

| Swaps Maturities | Notional Amounts | Average Fixed Pay Rate | Average Receive Rate | Average Maturity (Years) |
|---|---|---|---|---|
| 2016 | $3,500,000 | 0.631 % | 0.234 % | 1.79 |
| 2017 | 2,000,000 | 1.070 % | 0.233 % | 2.79 |
| 2018 | 2,040,000 | 1.563 % | 0.234 % | 4.19 |
| 2019 and Thereafter | 1,314,178 | 2.266 % | 0.233 % | 6.02 |
| Total | $8,854,178 | 1.188 % | 0.233 % | 3.20 |

(notional in thousands)
December 31, 2013

| Swaps Maturities | Notional Amounts | Average Fixed Pay Rate | Average Receive Rate | Average Maturity (Years) |
|---|---|---|---|---|
| 2016 | $1,000,000 | 0.955 % | 0.239 % | 2.67 |
| 2018 and Thereafter | 2,040,000 | 1.563 % | 0.241 % | 4.94 |
| Total | $3,040,000 | 1.363 % | 0.240 % | 4.20 |

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Additionally, as of September 30, 2014 and December 31, 2013, 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)
September 30, 2014

| Swaps Maturities | Notional Amounts | Average Pay Rate | | Average Fixed Receive Rate | | Average Maturity (Years) |
|---|---|---|---|---|---|---|
| 2018 | $575,000 | 0.234 | % | 1.440 | % | 4.14 |
| 2019 and Thereafter | 2,701,477 | 0.235 | % | 2.751 | % | 9.57 |
| Total | $3,276,477 | 0.235 | % | 2.521 | % | 8.62 |

(notional in thousands)
December 31, 2013

| Swaps Maturities | Notional Amounts | Average Pay Rate | | Average Fixed Receive Rate | | Average Maturity (Years) |
|---|---|---|---|---|---|---|
| 2018 and Thereafter | $2,154,000 | 0.240 | % | 2.337 | % | 7.84 |
| Total | $2,154,000 | 0.240 | % | 2.337 | % | 7.84 |

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.

As of September 30, 2014 and December 31, 2013, 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)
September 30, 2014

| Swaps Maturities | Notional Amount | Average Fixed Pay Rate | | Average Receive Rate | | Average Maturity (Years) |
|---|---|---|---|---|---|---|
| 2016 | $6,100,000 | 0.622 | % | 0.234 | % | 1.82 |
| 2017 | 6,385,000 | 1.074 | % | 0.235 | % | 2.87 |
| 2018 | 1,125,000 | 1.314 | % | 0.234 | % | 3.74 |
| 2019 and Thereafter | 2,030,000 | 2.268 | % | 0.234 | % | 7.14 |
| Total | $15,640,000 | 1.070 | % | 0.234 | % | 3.08 |

(notional in thousands)
December 31, 2013

| Swaps Maturities | Notional Amount | Average Fixed Pay Rate | | Average Receive Rate | | Average Maturity (Years) |
|---|---|---|---|---|---|---|
| 2014 | $3,900,000 | 0.300 | % | 0.245 | % | 0.76 |
| 2015 | 1,000,000 | 0.383 | % | 0.244 | % | 1.04 |
| 2016 | 2,950,000 | 0.626 | % | 0.246 | % | 2.42 |
| 2017 | 5,300,000 | 0.920 | % | 0.217 | % | 3.49 |
| 2018 and Thereafter | 1,275,000 | 1.406 | % | 0.242 | % | 5.04 |
| Total | $14,425,000 | 0.698 | % | 0.235 | % | 2.50 |

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Interest Rate Swaptions - As of September 30, 2014 and December 31, 2013, 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:

| September 30, 2014 (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 | $190,208 | $130,263 | 45.89 | $5,210,000 | 4.27 % | 3M Libor | 8.8 |
| Total Payer | | $190,208 | $130,263 | 45.89 | $5,210,000 | 4.27 % | 3M Libor | 8.8 |
| | | | | | | | | |
| Receiver | < 6 Months | $5,181 | $776 | 2.17 | $3,250,000 | 3M Libor | 1.33 % | 5.4 |
| Total Receiver | | $5,181 | $776 | 2.17 | $3,250,000 | 3M Libor | 1.33 % | 5.4 |
| | | | | | | | | |
| Sale contracts: | | | | | | | | |
| Payer | ≥ 6 Months | $(81,248 ) | $(36,651 ) | 33.02 | $(800,000 ) | 3.44 % | 3M Libor | 10.0 |
| Total Payer | | $(81,248 ) | $(36,651 ) | 33.02 | $(800,000 ) | 3.44 % | 3M Libor | 10.0 |

| December 31, 2013 (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 | $10,431 | $10,458 | 2.78 | $675,000 | 3.33 % | 3M Libor | 10.0 |
| Payer | ≥ 6 Months | 223,504 | 353,108 | 39.14 | 6,000,000 | 4.27 % | 3M Libor | 9.0 |
| Total Payer | | $233,935 | $363,566 | 38.16 | $6,675,000 | 4.18 % | 3M Libor | 9.1 |
| | | | | | | | | |
| Receiver | < 6 Months | $3,991 | $681 | 1.93 | $275,000 | 3M Libor | 2.89 % | 10.0 |
| Total Receiver | | $3,991 | $681 | 1.93 | $275,000 | 3M Libor | 2.89 % | 10.0 |
| | | | | | | | | |
| Sale contracts: | | | | | | | | |
| Payer | < 6 Months | $(3,455 ) | $(7,679 ) | 1.93 | $(510,000 ) | 1.60 % | 3M Libor | 5.0 |
| Payer | ≥ 6 Months | (81,248 ) | (86,361 ) | 42.02 | (800,000 ) | 3.44 % | 3M Libor | 10.0 |
| Total Payer | | $(84,703 ) | $(94,040 ) | 33.68 | $(1,310,000) | 2.72 % | 3M Libor | 8.1 |
| | | | | | | | | |
| Receiver | < 6 Months | $(3,455 ) | $(462 ) | 1.93 | $(510,000 ) | 3M Libor | 1.60 % | 5.0 |
| Total Receiver | | $(3,455 ) | $(462 ) | 1.93 | $(510,000 ) | 3M Libor | 1.60 % | 5.0 |

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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 September 30, 2014 and December 31, 2013:

(notional and dollars in thousands)
September 30, 2014

| Maturity Date | Current Notional Amount | Fair Value | Upfront (Payable)/Receivable | Unrealized Gain/(Loss) |
|---|---|---|---|---|
| 1/12/2043 | $(421,143) | $318 | $(1,457) | $(1,139) |
| 1/12/2044 | (190,842) | 121 | (275) | (154) |
| Total | $(611,985) | $439 | $(1,732) | $(1,293) |

(notional and dollars in thousands)
December 31, 2013

| Maturity Date | Current Notional Amount | Fair Value | Upfront Payable | Unrealized Gain/(Loss) |
|---|---|---|---|---|
| 1/12/2043 | $(49,629) | $(134) | $(453) | $(587) |
| Total | $(49,629) | $(134) | $(453) | $(587) |

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 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 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 of "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 mortgage loans.

As of September 30, 2014, the Company held credit default swaps whereby the Company receives credit protection for a fixed premium. The maximum payouts for these credit default swaps are limited to the current notional amounts of each swap contract. Maximum payouts for credit default swaps do not represent the expected future cash requirements, as the Company's credit default swaps are typically liquidated or expire and are not exercised by the holder of the credit default swaps.

The following tables present credit default swaps whereby the Company is receiving protection held as of September 30, 2014 and December 31, 2013:

(notional and dollars in thousands)
September 30, 2014

| Protection | Maturity Date | Average Implied Credit Spread | Current Notional Amount | Fair Value | Upfront (Payable)/Receivable | Unrealized Gain/(Loss) |
|---|---|---|---|---|---|---|
| Receive | 6/20/2016 | 105.50 | $(100,000) | $(1,513) | $ (260) | $(1,773) |

| | | | | | |
|---|---|---|---|---|---|
| 12/20/2016 | 496.00 | (25,000) | (312) | (4,062) | (4,374) |
| Total | 183.60 | $(125,000) | $(1,825) | $ (4,322) | $(6,147) |

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(notional and dollars in thousands)
December 31, 2013

| Protection | Maturity Date | Average Implied Credit Spread | Current Notional Amount | Fair Value | Upfront Payable | Unrealized Gain/(Loss) |
|---|---|---|---|---|---|---|
| Receive | 6/20/2016 | 105.50 | $(100,000) | $(2,149) | $(260) | $(2,409) |
| | 12/20/2016 | 496.00 | (25,000) | (401) | (4,062) | (4,463) |
| | 12/20/2018 | 393.31 | (270,000) | (23,568) | 12,838 | (10,730) |
| | 5/25/2046 | 356.00 | (32,073) | 8,069 | (15,026) | (6,957) |
| | Total | 329.13 | $(427,073) | $(18,049) | $(6,510) | $(24,559) |

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 September 30, 2014, the fair value of derivative financial instruments as an asset and liability position was $353.9 million and $4.2 million, respectively.

The Company mitigates the credit risk exposure on derivative financial instruments by limiting the counterparties to those major banks and financial institutions that meet established credit guidelines. The Company also seeks to transact with several different counterparties in order to reduce the exposure to any single counterparty. Additionally, the Company reduces credit risk on the majority of its derivative instruments by entering into agreements that permit the closeout and netting of transactions with the same counterparty upon occurrence of certain events. To further mitigate the risk of counterparty default, the Company maintains collateral agreements with certain of its counterparties, which require both parties to maintain cash deposits in the event the fair values of the derivative financial instruments exceed established thresholds. As of September 30, 2014, the Company has received cash deposits from counterparties of $88.9 million and placed cash deposits of $211.9 million in accounts maintained by counterparties, of which the amounts are netted on a counterparty basis and classified within restricted cash, due from counterparties, or due to counterparties on the condensed consolidated balance sheet.

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.

Commitments to Purchase Mortgage Loans Held-for-Sale - Prior to a mortgage loan purchase, the Company may enter into forward purchase commitments with counterparties whereby the Company commits to purchasing the loans at a particular interest rate, provided the borrower elects to close the loan. These commitments to purchase mortgage loans have been defined as derivatives and are, therefore, recorded on the balance sheet as assets or liabilities and measured at fair value. Subsequent changes in fair value are recorded on the balance sheet as adjustments to the carrying value of these assets or liabilities with a corresponding adjustment recognized in current period earnings. As of September 30, 2014 and December 31, 2013, the Company had outstanding commitments to purchase $326.4 million and $12.1 million of mortgage loans, subject to fallout if the loans do not close, with a fair value asset of $0.1 million at September 30, 2014. As of December 31, 2013, no fair value was assigned to the derivative as there was not a meaningful change in market value from commitment date to December 31, 2013.

TBAs - As of December 31, 2013, the Company held $2.2 billion notional TBAs as a means of deploying capital until targeted investments are available, and to take advantage of temporary displacements in the marketplace. None of the Company’s TBAs were held for this purpose as of September 30, 2014.

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Inverse Interest-Only Securities - As of September 30, 2014 and December 31, 2013, inverse interest-only securities with a carrying value of $188.7 million and $221.4 million, including accrued interest receivable of $2.3 million and $2.9 million, respectively, are accounted for as derivative financial instruments in the condensed consolidated financial statements. The following table presents the amortized cost and carrying value (which approximates fair value) of inverse interest-only securities as of September 30, 2014 and December 31, 2013:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Face Value | $1,211,965 | $1,525,845 |
| Unamortized premium | — | — |
| Unamortized discount | | |
| Designated credit reserve | — | — |
| Net, unamortized | (1,029,960) | (1,292,785) |
| Amortized Cost | 182,005 | 233,060 |
| Gross unrealized gains | 10,589 | 5,891 |
| Gross unrealized losses | (6,196) | (20,442) |
| Carrying Value | $186,398 | $218,509 |

Note 13. Other Assets
Other assets as of September 30, 2014 and December 31, 2013 are summarized in the following table:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Property and equipment at cost | $4,519 | $2,285 |
| Accumulated depreciation (1) | (1,626) | (858) |
| Net property and equipment | 2,893 | 1,427 |
| Prepaid expenses | 1,065 | 1,818 |
| Deferred tax assets | 26,082 | — |
| Intangible assets | — | 533 |
| Servicing advances | 19,783 | 7,298 |
| Federal Home Loan Bank stock | 60,010 | 10 |
| Equity investments | 3,000 | — |
| Other receivables | 12,998 | 2,113 |
| Total other assets | $125,831 | $13,199 |

(1) Depreciation expense for the three and nine months ended September 30, 2014 was $303,870 and $767,361, respectively.

Note 14. Other Liabilities
Other liabilities as of September 30, 2014 and December 31, 2013 are summarized in the following table:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Accrued expenses | $28,202 | $20,025 |
| Deferred tax liabilities | — | 39,414 |
| Income taxes payable | 327 | 757 |
| Other | 13,019 | 7,284 |
| Total other liabilities | $41,548 | $67,480 |

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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 sheet. 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 classified 100% of its U.S. Treasuries as Level 1 fair value assets at September 30, 2014. The Company classified 100% of its RMBS AFS securities reported at fair value as Level 2 at September 30, 2014. AFS and trading securities account for 72.9% and 11.4%, respectively, of all assets reported at fair value at September 30, 2014.
Equity securities - The Company previously held shares of Silver Bay common stock that were carried at fair value in the condensed consolidated balance sheet as a result of a fair value option election. The Company determined fair value of these equity securities based on the closing market price at period end. Because the shares were distributed to the Company's stockholders in April 2013, equity securities are no longer recognized on the condensed consolidated

balance sheet.
Mortgage loans held-for-sale - The Company holds a portfolio of mortgage loans held-for-sale that are carried at fair value in the condensed consolidated balance sheet as a result of a fair value option election. The Company determines fair value of its 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 94.1% and 5.9% of its mortgage loans held-for-sale as Level 2 and Level 3 fair value assets, respectively, at September 30, 2014.

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Mortgage loans held-for-investment in securitization trusts - The Company recognizes on its condensed consolidated balance sheet mortgage loans held-for-investment in securitization trusts that are carried at fair value as a result of a fair value option election. The Company determines fair value of its 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 100% of its mortgage loans held-for-investment in securitization trusts as Level 2 fair value assets at September 30, 2014.

Mortgage servicing rights - The Company holds a portfolio of MSR that are carried at fair value on the condensed consolidated balance sheet. Although MSR transactions are observable in the marketplace, the valuation includes unobservable market data inputs (prepayment speeds, delinquency levels and discount rates). As a result, the Company classified 100% of its MSR as Level 3 fair value assets at September 30, 2014.

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, 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, credit default swaps, constant maturity swaps and total returns swaps reported at fair value as Level 2 at September 30, 2014.

The Company also enters into certain other derivative financial instruments, such as TBAs and inverse interest-only securities. These instruments are similar in form to the Company’s AFS securities and the Company utilizes a pricing service to value TBAs and broker quotes to value inverse interest-only securities. The Company classified 100% of its inverse interest-only securities at fair value as Level 2 at September 30, 2014. The Company reported 100% of its TBAs as Level 1 as of September 30, 2014.

The Company may also enter into forward purchase commitments on 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 September 30, 2014, the Company had outstanding commitments to purchase $326.4 million of mortgage loans, subject to fallout if the loans do not close, with a fair value asset of $0.1 million. The Company classified 100% of the forward purchase commitments reported at fair value as Level 2 at September 30, 2014.

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. Additionally, both the Company and the counterparty are required to post cash collateral based upon the net underlying market value of the Company’s open positions with the counterparty. 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 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 sheet collateralized borrowings that are carried at fair value as a result of a fair value option election. The Company determines fair value of its collateralized borrowings based on 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 September 30, 2014.

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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 September 30, 2014 | | | |
|---|---|---|---|---|
| (in thousands) | Level 1 | Level 2 | Level 3 | Total |
| Assets | | | | |
| Available-for-sale securities | $— | $12,697,908 | $— | $12,697,908 |
| Trading securities | 1,993,124 | — | — | 1,993,124 |
| Mortgage loans held-for-sale | — | 418,719 | 26,346 | 445,065 |
| Mortgage loans held-for-investment in securitization trusts | — | 1,428,890 | — | 1,428,890 |
| Mortgage servicing rights | — | — | 498,466 | 498,466 |
| Derivative assets | 4,101 | 349,792 | — | 353,893 |
| Total assets | $1,997,225 | $14,895,309 | $524,812 | $17,417,346 |
| Liabilities | | | | |
| Collateralized borrowings in securitization trusts | $— | $938,506 | $— | $938,506 |
| Derivative liabilities | 2,396 | 1,825 | — | 4,221 |
| Total liabilities | $2,396 | $940,331 | $— | $942,727 |

| | Recurring Fair Value Measurements At December 31, 2013 | | | |
|---|---|---|---|---|
| (in thousands) | Level 1 | Level 2 | Level 3 | Total |
| Assets | | | | |
| Available-for-sale securities | $— | $12,256,727 | $— | $12,256,727 |
| Trading securities | 1,000,180 | — | — | 1,000,180 |
| Mortgage loans held-for-sale | — | 119,855 | 424,726 | 544,581 |
| Mortgage loans held-for-investment in securitization trusts | — | 792,390 | — | 792,390 |
| Mortgage servicing rights | — | — | 514,402 | 514,402 |
| Derivative assets | 33,425 | 516,434 | — | 549,859 |
| Total assets | $1,033,605 | $13,685,406 | $939,128 | $15,658,139 |
| Liabilities | | | | |
| Collateralized borrowings in securitization trusts | $— | $639,731 | $— | $639,731 |
| Derivative liabilities | 125 | 21,956 | — | 22,081 |
| Total liabilities | $125 | $661,687 | $— | $661,812 |

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 September 30, 2014, 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 financial statements. The Company's valuation committee reviews all

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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.

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

| | Level 3 Recurring Fair Value Measurements | | | |
|---|---|---|---|---|
| | Three Months Ended September 30, 2014 | | Nine Months Ended September 30, 2014 | |
| (in thousands) | Mortgage Loans Held-For-Sale | Mortgage Servicing Rights | Mortgage Loans Held-For-Sale | Mortgage Servicing Rights |
| Beginning of period level 3 fair value | $22,797 | $500,490 | $424,726 | $514,402 |
| Gains/(losses) included in net income (loss): | | | | |
| Realized gains (losses) | 1,324 | (14,674) | 4,333 | (41,101) |
| Unrealized gains (losses) | 798 (1) | 3,964 (3) | (3,414) (1) | (31,941) (3) |
| Total net gains/(losses) included in net income (loss) | 2,122 | (10,710) | 919 | (73,042) |
| Other comprehensive income | — | — | — | — |
| Purchases | 22,347 | 7,542 | 36,905 | 61,835 |
| Sales | (14,263) | — | (419,847) | — |
| Settlements | (6,657) | 1,144 | (16,357) | (4,729) |
| Gross transfers into level 3 | — | — | — | — |
| Gross transfers out of level 3 | — | — | — | — |
| End of period level 3 fair value | $26,346 | $498,466 | $26,346 | $498,466 |
| Change in unrealized gains or losses for the period included in earnings for assets held at the end of the reporting period | $416 (2) | $3,964 (4) | $(5,391) (2) | $(31,941) (4) |

(1) For the three and nine months ended September 30, 2014, the change in unrealized gains or losses on mortgage loans held-for-sale was recorded in (loss) gain on mortgage loans held-for-sale on the condensed consolidated statements of comprehensive income.

(2) For the three and nine months ended September 30, 2014, the change in unrealized gains or losses on mortgage loans held-for-sale that were held at the end of the reporting period were recorded in (loss) gain on mortgage loans held-for-sale on the condensed consolidated statements of comprehensive income.

(3) For the three and nine months ended September 30, 2014, the change in unrealized gains or losses on MSR were recorded in (loss) gain on servicing asset on the condensed consolidated statements of comprehensive income.

(4) For the three and nine months ended September 30, 2014, the change in unrealized gains or losses on MSR that were held at the end of the reporting period were recorded in (loss) gain 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 for the nine months ended September 30, 2014. 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 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.

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The table below presents information about the significant unobservable inputs used in the fair value measurement of the Company's MSR classified as Level 3 fair value assets at September 30, 2014:

As of September 30, 2014

| Valuation Technique | Unobservable Input [1] | Range | Weighted Average |
|---|---|---|---|
| Discounted cash flow | Constant prepayment speed | 8.8 - 12.5 % | 10.7% |
| | Delinquency | 1.9 - 8.0 % | 4.5% |
| | Discount rate | 7.6 - 11.1 % | 9.5% |

(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 residential mortgage loans are carried within mortgage loans held-for-sale on the condensed consolidated balance sheet. 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 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 the equity securities previously carried on the condensed consolidated balance sheet, which consisted solely of shares of Silver Bay common stock. The Company determined fair value of these equity securities based on the closing market price at period end. Fair value adjustments were reported in gain (loss) on investment securities on the condensed consolidated statements of comprehensive income.

The Company also elected the fair value option for both the mortgage loans held-for-investment in securitization trusts and the collateralized borrowings in securitization trusts carried on the condensed consolidated balance sheet. 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.

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The following table summarizes the fair value option elections and information regarding the amounts recognized in earnings for each fair value option-elected item.

| (in thousands) | Changes included in the Condensed Consolidated Statements of Comprehensive Income | | | | | |
|---|---|---|---|---|---|---|
| Three Months Ended September 30, | Interest income (expense) | Gain (loss) on investment securities | (Loss) gain on mortgage loans held-for-sale | Other (loss) income | Total included in net income (loss) | Change in fair value due to credit risk |
| 2014 | | | | | | |
| Assets | | | | | | |
| Mortgage loans held-for-sale | $5,268 (1) | $— | $(941) | $— | $4,327 | $(299) (3) |
| Mortgage loans held-for-investment in securitization trusts | 9,526 (1) | — | — | (6,924) | 2,602 | — (2) |
| Liabilities | | | | | | |
| Collateralized borrowings in securitization trusts | (5,678) | — | — | 4,722 | (956) | — (2) |
| Total | $9,116 | $— | $(941) | $(2,202) | $5,973 | $(299) |
| 2013 | | | | | | |
| Assets | | | | | | |
| Mortgage loans held-for-sale | $9,297 (1) | $— | $(4,443) | $— | $4,854 | $— (3) |
| Mortgage loans held-for-investment in securitization trusts | 5,649 (1) | — | — | 1,698 | 7,347 | — (2) |
| Liabilities | | | | | | |
| Collateralized borrowings in securitization trusts | (3,125) | — | — | 7,076 | 3,951 | — (2) |
| Total | $11,821 | $— | $(4,443) | $8,774 | $16,152 | $— |

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| (in thousands) | Changes included in the Condensed Consolidated Statements of Comprehensive Income | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Nine Months Ended September 30, | Interest income (expense) | | Gain (loss) on investment securities | (Loss) gain on mortgage loans held-for-sale | | Other (loss) income | | Total included in net income (loss) | Change in fair value due to credit risk | |
| 2014 | | | | | | | | | | |
| Assets | | | | | | | | | | |
| Mortgage loans held-for-sale | $12,553 | (1) | $— | $3,933 | | $— | | $16,486 | $770 | (3) |
| Mortgage loans held-for-investment in securitization trusts | 25,180 | (1) | — | — | | 31,681 | | 56,861 | — | (2) |
| Liabilities | | | | | | | | | | |
| Collateralized borrowings in securitization trusts | (16,623 | ) | — | — | | (12,741 | ) | (29,364 ) | — | (2) |
| Total | $21,110 | | $— | $3,933 | | $18,940 | | $43,983 | $770 | |
| 2013 | | | | | | | | | | |
| Assets | | | | | | | | | | |
| Equity securities | $— | | $7,843 | $— | | $— | | $7,843 | $— | (2) |
| Mortgage loans held-for-sale | 15,409 | (1) | — | (5,247 | ) | — | | 10,162 | — | (3) |
| Mortgage loans held-for-investment in securitization trusts | 11,672 | (1) | — | — | | (23,059 | ) | (11,387 ) | — | (2) |
| Liabilities | | | | | | | | | | |
| Collateralized borrowings in securitization trusts | (6,112 | ) | — | — | | 39,680 | | 33,568 | — | (2) |
| Total | $20,969 | | $7,843 | $(5,247 | ) | $16,621 | | $40,186 | $— | |

(1) Interest income on mortgage loans held-for-sale and 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 on equity securities, mortgage loans held-for-investment in securitization trusts and collateralized borrowings in securitization trusts was due entirely to changes in market interest rates.

(3) The change in fair value due to credit risk on mortgage loans held-for-sale was quantified by holding yield constant in the cash flow model in order to isolate credit risk component.

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

| | September 30, 2014 | | December 31, 2013 | |
|---|---|---|---|---|
| (in thousands) | Unpaid Principal Balance | Fair Value (1) | Unpaid Principal Balance | Fair Value (1) |
| Mortgage loans held-for-sale | | | | |
| Total loans | $445,692 | $445,065 | $680,840 | $544,581 |
| Nonaccrual loans | $19,913 | $14,729 | $80,486 | $62,185 |
| Loans 90+ days past due | $18,944 | $14,041 | $63,152 | $48,786 |
| Mortgage loans held-for-investment in securitization trusts | | | | |
| Total loans | $1,402,782 | $1,428,890 | $812,538 | $792,390 |
| Nonaccrual loans | $717 | $706 | $— | $— |
| Loans 90+ days past due | $— | $— | $— | $— |
| Collateralized borrowings in securitization trusts | | | | |
| Total borrowings | $959,670 | $938,506 | $686,233 | $639,731 |

(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 sheet, for which fair value can be estimated.

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

- AFS securities, trading securities, mortgage loans held-for-sale, 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.
- 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.
- 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 $93.2 million of repurchase agreements and $1.5 billion of FHLB advances that are considered long-term. The Company's long-term repurchase agreements and FHLB advances have floating rates based on an index plus a spread and 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.

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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 September 30, 2014 and December 31, 2013.

| | September 30, 2014 | | December 31, 2013 | |
|---|---|---|---|---|
| (in thousands) | Carrying Value | Fair Value | Carrying Value | Fair Value |
| Assets | | | | |
| Available-for-sale securities | $12,697,908 | $12,697,908 | $12,256,727 | $12,256,727 |
| Trading securities | $1,993,124 | $1,993,124 | $1,000,180 | $1,000,180 |
| Mortgage loans held-for-sale | $445,065 | $445,065 | $544,581 | $544,581 |
| Mortgage loans held-for-investment in securitization trusts | $1,428,890 | $1,428,890 | $792,390 | $792,390 |
| Mortgage servicing rights | $498,466 | $498,466 | $514,402 | $514,402 |
| Cash and cash equivalents | $1,225,281 | $1,225,281 | $1,025,487 | $1,025,487 |
| Restricted cash | $310,421 | $310,421 | $401,647 | $401,647 |
| Derivative assets | $353,893 | $353,893 | $549,859 | $549,859 |
| Equity investments | $3,000 | $3,000 | $— | $— |
| Liabilities | | | | |
| Repurchase agreements | $12,274,878 | $12,274,878 | $12,250,450 | $12,250,450 |
| Collateralized borrowings in securitization trusts | $938,506 | $938,506 | $639,731 | $639,731 |
| Federal Home Loan Bank advances | $1,500,000 | $1,500,000 | $— | $— |
| Derivative liabilities | $4,221 | $4,221 | $22,081 | $22,081 |

Note 16. Repurchase Agreements

As of September 30, 2014, the Company had outstanding $12.3 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 0.70% and weighted average remaining maturities of 100 days as of September 30, 2014. As of December 31, 2013, the Company had outstanding $12.3 billion of repurchase agreements, including repurchase agreements funding the Company's U.S. Treasuries of $997.5 million. 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 0.75% and weighted average remaining maturities of 72 days as of December 31, 2013. As of September 30, 2014 and December 31, 2013, the debt associated with the Company's U.S. Treasuries had a weighted average borrowing rate of (0.97)% and 0.03%, respectively.

At September 30, 2014 and December 31, 2013, the repurchase agreement balances were as follows:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Short-term | $12,181,658 | $12,050,450 |
| Long-term | 93,220 | 200,000 |
| Total | $12,274,878 | $12,250,450 |

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At September 30, 2014 and December 31, 2013, the repurchase agreements had the following characteristics:

| (dollars in thousands) | September 30, 2014 | | December 31, 2013 | |
|---|---|---|---|---|
| Collateral Type | Amount Outstanding | Weighted Average Borrowing Rate | Amount Outstanding | Weighted Average Borrowing Rate |
| U.S. Treasuries | $1,986,250 | (0.97)% | $997,500 | 0.03% |
| Agency RMBS | 8,142,314 | 0.41% | 9,109,510 | 0.46% |
| Non-Agency RMBS [1] | 1,987,034 | 1.86% | 1,829,709 | 2.01% |
| Agency derivatives | 142,079 | 1.00% | 166,438 | 1.05% |
| Mortgage loans held-for-sale | 17,201 | 3.11% | 147,293 | 2.85% |
| Total | $12,274,878 | 0.43% | $12,250,450 | 0.69% |

(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.

At September 30, 2014 and December 31, 2013, the repurchase agreements had the following remaining maturities:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Within 30 days | $2,906,285 | $3,831,917 |
| 30 to 59 days | — | |
| 30 to 59 days | 2,860,071 | 2,013,733 |
| 60 to 89 days | — | 2,225,967 |
| 90 to 119 days | 2,289,504 | 1,386,371 |
| 120 to 364 days | 3,132,048 | 1,594,962 |
| Open maturity [1] | 993,750 | 997,500 |
| One year and over | 93,220 [2] | 200,000 |
| Total | $12,274,878 | $12,250,450 |

(1) 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.
(2) One year and over includes repurchase agreements with maturity dates of June 25, 2016.

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) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Available-for-sale securities, at fair value | $11,185,800 | $12,295,302 |
| Trading securities, at fair value | 1,993,124 | 1,000,180 |
| Mortgage loans held-for-sale, at fair value | 20,710 | 200,839 |
| Net economic interests in consolidated securitization trusts [1] | 301,549 | — |
| Cash and cash equivalents | 15,000 | 15,000 |
| Restricted cash | 93,295 | 201,194 |
| Due from counterparties | 23,070 | 21,579 |
| Derivative assets, at fair value | 184,924 | 216,365 |
| Total | $13,817,472 | $13,950,459 |

(1)

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

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

The following table summarizes certain characteristics of the Company's repurchase agreements and counterparty concentration at September 30, 2014 and December 31, 2013:

| | September 30, 2014 | | | | December 31, 2013 | | | |
|---|---|---|---|---|---|---|---|---|
| (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 | $1,280,084 | $393,951 | 10 % | 93.1 | $980,464 | $264,745 | 7 % | 88.2 |
| Barclays Capital Inc. | 1,119,776 | 270,340 | 7 % | 78.9 | 1,453,396 | 302,744 | 8 % | 74.6 |
| All other counterparties [2] [3] | 8,881,268 | 885,887 | 22 % | 85.0 | 8,819,090 | 1,107,341 | 29 % | 71.2 |
| Total | $11,281,128 | $1,550,178 | | | $11,252,950 | $1,674,830 | | |

(1) Represents the net carrying value of the securities and mortgage loans held-for-sale 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. At September 30, 2014, the Company had $31.1 million in payables due to broker counterparties for unsettled securities purchases. The payables are not included in the amounts presented above. At December 31, 2013, the Company did not have any payables due to broker counterparties for unsettled securities purchases..

(2) Excludes $993.8 million and $997.5 million of repurchase agreements collateralized by U.S. Treasuries with a rolling 1-day maturity as of September 30, 2014 and December 31, 2013, respectively.

(3) Represents amounts outstanding with 23 and 18 counterparties at September 30, 2014 and December 31, 2013, respectively.

The Company does not anticipate any defaults by its repurchase agreement counterparties.

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 sheet, 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 September 30, 2014 and December 31, 2013, collateralized borrowings in securitization trusts had a carrying value of $938.5 million and $639.7 million with a weighted average interest rate of 3.7% and 2.8%, respectively. The stated maturity dates for all collateralized borrowings were more than five years from both September 30, 2014 and December 31, 2013.

Note 18. Federal Home Loan Bank of Des Moines Advances

In December 2013, the Company's wholly owned subsidiary, TH Insurance Holdings, was accepted for membership in the FHLB. As a member of the FHLB, TH Insurance Holdings has access to a variety of products and services offered by the FHLB, including secured advances. As of September 30, 2014, TH Insurance Holdings had $1.5 billion in outstanding secured advances with a weighted average borrowing rate of 0.4%, and had an additional $1.0 billion of available uncommitted credit for borrowings due to an increase in capacity granted by the FHLB. To the extent TH Insurance Holdings has unused capacity, it may be adjusted at the sole discretion of the FHLB. As of December 31, 2013, TH Insurance Holdings had not requested any secured advances and had $1.0 billion of available uncommitted credit for borrowings.

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

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At September 30, 2014, FHLB advances had the following remaining maturities:

| (in thousands) | September 30, 2014 |
|---|---|
| ≤ 1 year | $33,738 |
| > 1 and ≤ 3 years | 651,238 |
| > 3 and ≤ 5 years | 815,024 |
| Total | $1,500,000 |

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) | September 30, 2014 |
|---|---|
| Available-for-sale securities, at fair value | $1,221,412 |
| Mortgage loans held-for-sale, at fair value | 387,083 |
| Net economic interests in consolidated securitization trusts [1] | 85,782 |
| Total | $1,694,277 |

(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 September 30, 2014 and December 31, 2013, the Company had stock in the FHLB totaling $60.0 million and $10,000, respectively, which is included in other assets on the condensed consolidated balance sheet at September 30, 2014 and December 31, 2013.

## 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 September 30, 2014, and the four immediately preceding quarters:

| Declaration Date | Record Date | Payment Date | Cash Dividend Per Share |
|---|---|---|---|
| September 16, 2014 | September 30, 2014 | October 21, 2014 | $0.26 |
| June 17, 2014 | July 2, 2014 | July 22, 2014 | $0.26 |
| March 17, 2014 | March 31, 2014 | April 21, 2014 | $0.26 |
| December 17, 2013 | December 27, 2013 | December 31, 2013 | $0.26 |
| September 11, 2013 | September 26, 2013 | October 23, 2013 | $0.28 |

### Special Dividend of Silver Bay Common Stock

On March 18, 2013, the Company’s board of directors declared a special dividend pursuant to which the Company distributed 17,824,647 shares of Silver Bay common stock the Company received in exchange for the contribution of its equity interests in Two Harbors Property Investment LLC to Silver Bay on December 19, 2012, on a pro rata basis, to the Company’s stockholders of record as of April 2, 2013. The final distribution ratio for the stock dividend was determined to be 0.048825853 shares of Silver Bay common stock for each share of the Company’s common stock outstanding as of April 2, 2013. The dividend was distributed on or about April 24, 2013.

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Accumulated Other Comprehensive Income
Accumulated other comprehensive income at September 30, 2014 and December 31, 2013 was as follows:

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Available-for-sale securities, at fair value | | |
| Unrealized gains | $843,052 | $697,779 |
| Unrealized losses | (66,404) | (253,044) |
| Accumulated other comprehensive income | $776,648 | $444,735 |

Reclassifications out of Accumulated Other Comprehensive Income
The following table summarizes reclassifications out of accumulated other comprehensive income for the three and nine months ended September 30, 2014 and 2013:

| (in thousands) | Affected Line Item in the Condensed Consolidated Statements of Comprehensive Income | Amount Reclassified out of Accumulated Other Comprehensive Income | | | |
|---|---|---|---|---|---|
| | | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | | 2014 | 2013 | 2014 | 2013 |
| Other-than-temporary-impairments on AFS securities | Total other-than-temporary impairment losses | $— | $— | $212 | $1,662 |
| Realized (gains) losses on sales of AFS securities | Gain (loss) on investment securities | (54,553) | 187,007 | (32,325) | 123,089 |
| | | $(54,553) | $187,007 | $(32,113) | $124,751 |

Public Offering
On March 22, 2013, the Company completed a public offering of 50,000,000 shares of its common stock and issued an additional 7,500,000 shares of common stock pursuant to the underwriters' over-allotments at a price of $13.46 per share, for gross proceeds of approximately $774.0 million. Net proceeds to the Company were approximately $762.9 million, net of issuance costs of approximately $11.1 million.
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 September 30, 2014, 194,990 shares have been issued under the plan for total proceeds of approximately $2.1 million, of which 15,268 and 38,742 shares were issued for total proceeds of $158,567 and $399,359 during the three and nine months ended September 30, 2014, respectively. During the three and nine months ended September 30, 2013, 12,085 and 53,749 shares were issued under the plan for total proceeds of $119,994 and $628,063, 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. As of September 30, 2014, 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 nine months ended September 30, 2014. During the three and nine months ended September 30, 2013, 1,450,700 and 2,450,700 shares were repurchased by the Company for a total cost of $13.4 million and $23.9 million, respectively.

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. As of September 30, 2014, 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 nine months ended September 30, 2014 and 2013.

Warrants

From January 1, 2013 to April 2, 2013, warrant holders exercised 8,720,690 warrants to purchase 8,720,690 shares of the Company’s common stock, at an exercise price of $11.00 per share.

On April 2, 2013, the exercise price of the warrants was lowered to $10.25 per warrant share and the number of shares of the Company’s common stock issuable for each warrant share exercised was increased to 1.0727 shares. These adjustments were required under the terms of the warrant agreement as a result of the special dividend of Silver Bay common stock. Calculation of the adjustments was determined based on, among other things, the closing price of the Company’s common stock on the business day immediately preceding the ex-dividend date for the stock dividend and the fair market value of the stock dividend to be received for each share of the Company’s common stock on the ex-dividend date.

From April 3, 2013 to the warrant expiration date, November 7, 2013, warrant holders exercised 1,130,460 warrants to purchase 1,212,607 shares of the Company’s common stock, at an exercise price of $10.25 per share. Total proceeds to the Company for warrant exercises during the year ended December 31, 2013 were approximately $107.5 million. Additionally, certain Capitol founders holding warrants containing cashless exercise provisions exercised 100,000 warrants on a cashless basis, resulting in the surrender of 93,649 shares of common stock and the issuance of 6,351 shares of common stock during the year ended December 31, 2013. No proceeds were received by the Company as a result of the cashless exercises.

At 5:00 p.m. EST on November 7, 2013, 3,580,279 warrants expired pursuant to the terms of the warrant agreement. No warrants remained outstanding as of September 30, 2014.

Note 20. Equity Incentive Plan

On May 21, 2013 and May 20, 2014, the Company granted 36,335 and 52,180 shares of restricted common stock, respectively, to its independent directors pursuant to the Plan. The estimated fair value of these awards was $11.56 and $10.31 per share, respectively, based on the closing price of the Company’s common stock on such date. The shares underlying the grants vested immediately.

On May 29, 2013 and February 5, 2014, the Company granted 1,020,969 and 1,103,162 shares of restricted common stock, respectively, to its executive officers and other key employees of PRCM Advisers pursuant to the Plan. The estimated fair value of these awards was $11.23 and $9.79 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 September 30, 2014 was $9.67 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 date of the grant, as long as such grantee complies with the terms and conditions of his or her applicable restricted stock award agreement.

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The following table summarizes the activity related to restricted common stock for the nine months ended September 30, 2014 and 2013:

| | Nine Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2014 | | 2013 | |
| (in thousands) | Shares | Weighted Average Grant Date Fair Market Value | Shares | Weighted Average Grant Date Fair Market Value |
| Outstanding at Beginning of Period | 1,024,454 | $11.22 | 25,325 | $9.69 |
| Granted | 1,155,342 | 9.81 | 1,057,304 | 11.24 |
| Vested | (443,088) | (11.12) | (58,170) | (10.80) |
| Forfeited | (4,597) | (9.79) | — | — |
| Outstanding at End of Period | 1,732,111 | $10.36 | 1,024,459 | $11.23 |

For the three and nine months ended September 30, 2014, the Company recognized compensation costs related to restricted common stock of $2.0 million and $8.9 million, respectively. For the three and nine months ended September 30, 2013, the Company recognized compensation costs related to restricted common stock of $1,494,260 and $2,493,028, respectively.

Note 21. Other Operating Expenses
Components of the Company’s other operating expenses for the three and nine months ended September 30, 2014 and 2013, are presented in the following table:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| (in thousands) | 2014 | 2013 | 2014 | 2013 |
| Other operating expenses: | | | | |
| General and administrative | $11,330 | $7,754 | $37,051 | $20,038 |
| Directors and officers’ insurance | 243 | 201 | 728 | 603 |
| Professional fees | 851 | 1,200 | 3,502 | 4,223 |
| Total other operating expenses | $12,424 | $9,155 | $41,281 | $24,864 |

Note 22. Income Taxes
For the three and nine months ended September 30, 2014 and 2013, 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 nine months ended September 30, 2014, the Company’s TRSs recognized a benefit from income taxes of $4.9 million and $62.0 million, respectively, which was primarily due to losses incurred on derivative instruments held in the Company’s TRSs. During the three and nine months ended September 30, 2013, the Company’s TRSs recognized a provision for income taxes of $23.7 million and $77.8 million, respectively, which was primarily due to income generated from 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 financial statements of a contingent tax liability for uncertain tax positions.

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Note 23. 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 nine months ended September 30, 2014 and 2013:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| (in thousands, except share data) | 2014 | 2013 | 2014 | 2013 |
| Numerator: | | | | |
| Net income (loss) from continuing operations | $193,590 | $(193,599) | $204,102 | $336,361 |
| Income from discontinued operations | — | 871 | — | 3,264 |
| Net income (loss) | $193,590 | $(192,728) | $204,102 | $339,625 |
| Denominator: | | | | |
| Weighted average common shares outstanding | 364,339,061 | 364,032,788 | 364,112,043 | 345,046,012 |
| Weighted average restricted stock shares | 1,779,805 | 1,024,979 | 1,826,107 | 483,599 |
| Basic weighted average shares outstanding | 366,118,866 | 365,057,767 | 365,938,150 | 345,529,611 |
| Dilutive weighted average warrants | — | 109,225 | — | 840,747 |
| Diluted weighted average shares outstanding | 366,118,866 | 365,166,992 | 365,938,150 | 346,370,358 |
| Basic Earnings (Loss) Per Share: | | | | |
| Continuing operations | $0.53 | $(0.53) | $0.56 | $0.97 |
| Discontinued operations | — | — | — | 0.01 |
| Net income (loss) | $0.53 | $(0.53) | $0.56 | $0.98 |
| Diluted Earnings (Loss) Per Share: | | | | |
| Continuing operations | $0.53 | $(0.53) | $0.56 | $0.97 |
| Discontinued operations | — | — | — | 0.01 |
| Net income (loss) | $0.53 | $(0.53) | $0.56 | $0.98 |

No warrants were outstanding during the three and nine months ended September 30, 2014; however, during the three and nine months ended September 30, 2013, the weighted average market value per share of the Company’s common stock, after factoring in the number of shares of the Company’s common stock issuable for each warrant of 1.0727 shares, was above the exercise price of the warrants, making the warrants dilutive.

Note 24. 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 $12.3 million and $36.6 million as a management fee to PRCM Advisers for the three and nine months ended September 30, 2014, respectively, and $12.0 million and $33.7 million as a management fee to PRCM Advisers for the three and nine months ended September 30, 2013, 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. Management fees for the nine months ended September 30, 2013 were reduced by $4.3 million on the condensed consolidated statements of comprehensive income in accordance with the contribution transaction entered into with Silver Bay. See further discussion of this adjustment below. 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 $4.3 million and $11.5 million for the three and nine months ended September 30, 2014, respectively, and $2.6 million and $7.1 million for the three and nine months ended September 30, 2013, 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.

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The Company recognized $2.0 million and $8.9 million of compensation expense during the three and nine months ended September 30, 2014, respectively, related to restricted common stock. The Company recognized $1.5 million and $2.5 million of compensation expense during the three and nine months ended September 30, 2013, respectively, related to restricted common stock. See Note 20 - Equity Incentive Plan for additional information.

On February 3, 2012, a subsidiary of the Company entered into an acquisition services agreement, a property management agreement and a side letter agreement regarding certain fees with Silver Bay Property Management LLC, or Silver Bay Property Management, which is a joint venture between Provident Real Estate Advisors LLC and an affiliate of PRCM Advisers and Pine River. Under the acquisition services agreement, Silver Bay Property Management assisted the Company’s subsidiaries in identifying and acquiring a portfolio of residential real properties in various geographic areas throughout the United States. Under the property management agreement, Silver Bay Property Management operated, maintained, repaired, managed and leased the residential properties and collected rental income for the benefit of the Company and its subsidiaries. Pursuant to the side letter, the Company’s subsidiary was obligated to pay Silver Bay Property Management for various services provided under the acquisition services and property management agreements. These agreements were terminated on December 19, 2012 in connection with the contribution of the Company’s single family rental property business to Silver Bay, as described below.

On December 19, 2012, the Company completed the contribution of its portfolio of single family rental properties to Silver Bay, a newly organized Maryland corporation intended to qualify as a REIT and focused on the acquisition, renovation, leasing and management of single-family residential properties for rental income and long-term capital appreciation. The Company contributed its equity interests in its wholly owned subsidiary, Two Harbors Property Investment LLC, to Silver Bay, and in exchange for its contribution, received shares of common stock of Silver Bay. Silver Bay completed its IPO of its common stock on December 19, 2012. See Note 4 - Discontinued Operations for additional information. In connection with the closing of the contribution, the acquisition services agreement, property management agreement and side letter agreement referenced above were each terminated, except for certain designated provisions (e.g., protection of confidential information and indemnification), which the parties agreed would survive the termination. Not included in the gain that was recorded on the contribution in 2012 are certain adjustments recognized in 2013. These include an installment sales gain of approximately $4.0 million from Silver Bay, a reduction of 2013 management fees payable to PRCM Advisers of $4.3 million, and an immaterial amount of additional working capital adjustments determined in accordance with the contribution agreement entered into with Silver Bay. Of these amounts, $0.9 million and $3.2 million of the installment sales gain was recorded in gain on contribution of entity within discontinued operations for the three and nine months ended September 30, 2013, respectively, and the full $4.3 million of the reduction of 2013 management fees payable to PRCM Advisers was recorded within management fees, on the condensed consolidated statements of comprehensive income for the nine months ended September 30, 2013.

## Note 25. Subsequent Events

Events subsequent to September 30, 2014, were evaluated through the date these financial statements were issued and no additional events were identified requiring further disclosure in these Condensed Consolidated Financial Statements.

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

The following discussion and analysis should be read in conjunction with 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, 2013.

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, 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 and advised 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 residential 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; and
- Other financial assets comprising approximately 5% to 10% of the portfolio.

We generally view our target assets in two 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 mortgage loans.

We believe our hybrid Agency and non-Agency RMBS investment model allows management to allocate capital across various sectors within the residential mortgage market, with a focus on security 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, asset allocation reflects management's opportunistic approach to investing in the marketplace.

During the three months ended September 30, 2014, we did not significantly modify our RMBS asset allocation between Agency and non-Agency RMBS. The following table provides the RMBS asset allocation between Agency and non-Agency RMBS as of September 30, 2014 and the four immediately preceding period ends:

| | As of September 30, 2014 | June 30, 2014 | March 31, 2014 | December 31, 2013 | September 30, 2013 |
|---|---|---|---|---|---|
| Agency RMBS | 76.7 % | 77.0 % | 78.1 % | 77.9 % | 77.1 % |
| Non-Agency RMBS | 23.3 % | 23.0 % | 21.9 % | 22.1 % | 22.9 % |

As our RMBS asset allocation shifts, our annualized yields and cost of financing shifts. Our investment decisions are not driven solely by annualized yields, but rather a multitude of macroeconomic drivers, including market environments and their respective impacts; for example, uncertainty of prepayment speeds, extension risk and credit events.

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For the three months ended September 30, 2014, our net interest spread realized on aggregate Agency and non-Agency RMBS was lower than previous periods. Based on recent experience, yields and net interest spreads on Agency and non-Agency RMBS are generally lower than what we have historically realized in our portfolio. Additionally, our cost of financing increased as a result of higher swap spread due to increased notional amounts and replacing some of our shorter interest rate swaps with longer-term swaps. The following table provides the average annualized yield on our Agency and non-Agency RMBS for the three months ended September 30, 2014, and the four immediately preceding quarters:

| | Three Months Ended | | | | |
|---|---|---|---|---|---|
| | September 30, 2014 | June 30, 2014 | March 31, 2014 | December 31, 2013 | September 30, 2013 |
| Average annualized yields (1) | | | | | |
| Agency RMBS | 3.3% | 3.4% | 3.3% | 3.1% | 2.8% |
| Non-Agency RMBS | 8.5% | 8.7% | 9.1% | 8.9% | 9.0% |
| Aggregate RMBS | 4.3% | 4.4% | 4.3% | 4.2% | 4.0% |
| Cost of financing (2) | 1.6% | 1.3% | 1.2% | 1.1% | 1.2% |
| Net interest spread | 2.7% | 3.1% | 3.1% | 3.1% | 2.8% |

(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.

The following table provides the average annualized yield expected on our Agency and non-Agency RMBS as of September 30, 2014, and the four immediately preceding period ends:

| | As of | | | | |
|---|---|---|---|---|---|
| | September 30, 2014 | June 30, 2014 | March 31, 2014 | December 31, 2013 | September 30, 2013 |
| Average annualized yields (1) | | | | | |
| Agency RMBS | 3.3% | 3.2% | 3.2% | 3.0% | 2.9% |
| Non-Agency RMBS | 8.2% | 8.6% | 9.0% | 9.0% | 9.0% |
| Aggregate RMBS | 4.2% | 4.2% | 4.2% | 4.1% | 4.1% |
| Cost of financing (2) | 1.6% | 1.3% | 1.2% | 1.1% | 1.2% |
| Net interest spread | 2.6% | 2.9% | 3.0% | 3.0% | 2.9% |

(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.

During the three months ended September 30, 2014, we continued to develop our strategic initiatives, which stem from the changing opportunities in the residential mortgage marketplace, including a mortgage loan conduit and securitization platform and an MSR platform. Within our mortgage loan conduit and securitization platform, 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. Within our MSR platform, we purchase the right to service mortgage loans from high-quality originators and contract with fully licensed third-party subservicers to handle all servicing functions for the underlying loans.

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 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 also finance our U.S. Treasuries, which we hold for trading purposes, and our mortgage loans. We believe the debt-to-equity ratio funding our Agency RMBS, non-Agency and mortgage loans held-for-sale is the most meaningful leverage measure as U.S. Treasuries are viewed to be highly liquid in nature and collateralized borrowings on 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

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regulatory developments. Over the past several quarterly periods, we have generally maintained a debt-to-equity ratio range of 3.0 to 5.0 times to finance our RMBS portfolio and mortgage loans held-for-sale, 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 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 loans, certain of our subsidiaries have obtained the requisite licenses and approvals to purchase and sell mortgage loans and to hold and manage MSR.

On December 19, 2012, we completed the contribution of our portfolio of single-family rental properties to Silver Bay Realty Trust Corp., or Silver Bay, a newly organized Maryland corporation intended to qualify as a REIT and focused on the acquisition, renovation, leasing and management of single family residential properties for rental income and long-term capital appreciation. We contributed our equity interests in the wholly owned subsidiary, Two Harbors Property Investment LLC, to Silver Bay, and in exchange for the contribution, received shares of common stock of Silver Bay. Silver Bay completed its initial public offering, or IPO, of its common stock on December 19, 2012. Because we will not have any significant continuing involvement in Two Harbors Property Investment LLC, all of the associated operating results were removed from continuing operations and are presented separately as discontinued operations for the three and nine months ended September 30, 2013. No remaining associated operating results were recognized during the three and nine months ended September 30, 2014.

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, o 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, 2013, 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.

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

- changes in interest rates and the market value of our target assets;
- changes in prepayment rates of mortgages underlying our target assets;
- the timing of credit losses within our portfolio;
- our exposure to adjustable-rate and negative amortization mortgage loans underlying our target assets;

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- 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 the mortgage and derivative industries or our business;
- the availability of target assets for purchase at attractive prices;
- the availability of financing for our target assets, including the availability of 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 statements of comprehensive income and balance sheets, including our stockholders' equity;
- our ability to generate the amount of cash flow we expect 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 successful relationships with loan originators;
- our ability to acquire mortgage loans in connection with our securitization plans;
- our ability to securitize the mortgage loans we acquire;
- our exposure to claims and litigation, 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;
- our ability to successfully diversify our business into new asset classes and manage the new risks they may expose us to;
- our ability to manage various operational and regulatory risks associated with our business;
- 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. Net interest income 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 loan portfolio.

Fair Value Measurement

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 willing market participants at the measurement date. It also establishes three levels of input to be used when measuring fair value:

| | |
|---|---|
| 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. |

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|---|---|
| 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. |

We follow the fair value hierarchy set forth above in order to prioritize the data utilized to measure fair value. We strive to obtain quoted market prices in active markets (Level 1 inputs). If Level 1 inputs are not available, we will attempt to obtain Level 2 inputs, observable market prices in inactive markets or derive the fair value measurement using observable market prices for similar assets or liabilities. When neither Level 1 nor Level 2 inputs are available, we use Level 3 inputs and independent pricing service models to estimate fair value measurements. At September 30, 2014, approximately 90.9% of total assets, or $17.4 billion, and approximately 6.3% of total liabilities, or $942.7 million, consisted of financial instruments recorded at fair value. As of September 30, 2014, we had $524.8 million, or 2.7% of total assets, reported at fair value using Level 3 inputs. 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.

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. 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. Starting in 2007, markets for asset-backed securities, including RMBS, have experienced severe dislocations. While these market disruptions continue, our assets and liabilities will be subject to valuation adjustment as well as changes in the inputs we use to measure fair value.

For the three months ended September 30, 2014, 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. However, for the nine months ended September 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 nine months ended September 30, 2014. Our financial results for the three months ended September 30, 2014 were negatively affected by unrealized fair value losses on certain U.S. Treasuries classified as trading instruments due to their short-term investment objectives, mortgage loans held-for-sale and MSR. Our financial results for the nine months ended September 30, 2014 were positively affected by unrealized fair value gains on mortgage loans held-for-sale. Unrealized losses on trading securities and MSR, however, negatively affected our financial results.

For the three and nine months ended September 30, 2013, our unrealized fair value gains on interest rate swap and swaption agreements positively affected our financial results. The change in fair value of the interest rate swaps was a result of the realization of losses on interest rates swaps unwound and subsequent resetting of interest rate swaps at more favorable rates, combined with changes to LIBOR, the swap curve and corresponding counterparty borrowing rates during the three and nine months ended September 30, 2013. Our financial results for the three and nine months ended September 30, 2013 were negatively affected by unrealized fair value losses on certain U.S. Treasuries classified as trading instruments and mortgage loans held-for-sale.

In addition, our financial results for the three and nine months ended September 30, 2014 and 2013 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, put and call options for TBAs, constant maturity swaps, Markit IOS total return swaps, inverse interest-only securities and forward mortgage loan purchase commitments. Any temporary

change in the fair value of our available-for-sale securities is recorded as a component of accumulated other comprehensive income and does not impact our earnings.
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 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 mortgage loans and MSR, vendors use pricing models that generally incorporate observable inputs such as principal balance, note rate, address, 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, subject to internally-established hierarchy and override procedures.
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, interest rates and employment. Home price performance and unemployment are particularly important to our non-Agency portfolio. Home price appreciation slowed throughout the summer of 2014 following several quarters of elevated growth. Forecasts call for home prices to appreciate over the next several years, albeit at a slower pace than in the recent past. Despite the improvement in housing prices, tight credit standards have had the effect of limiting a borrower’s ability to refinance notwithstanding low interest rates and government programs that promote refinancing. The interest rate curve flattened during the three months ended September 30, 2014, as long-term rates fell, while near to mid-term rates remained fairly stable. Overall, interest rates remain at historically low levels despite modestly improving employment statistics and other economic indicators. The low interest rate environment is expected to persist, as the Federal Reserve has made commentary that suggests it will likely keep short-term interest rates at low levels until the economy can support higher rates. As a result, it is anticipated that low interest rates should benefit funding costs for the next few years. Additionally, the Federal Reserve officially announced the final reduction in its Quantitative Easing, or QE, asset purchases at its October 2014 meeting. However, even with the end of QE, it appears the Federal Reserve will continue to reinvest in mortgage-backed security principal repayments for the foreseeable future. Employment market conditions have improved somewhat; however, underemployment levels remain stubbornly high. Other than LTV ratios, employment is the most powerful determinant of a homeowner’s ongoing likelihood to pay their mortgage. Overall, the U.S. economy continues to navigate headwinds that include global economic lethargy, geopolitical unrest across various regions worldwide, the ongoing European debt crisis, persistently high underemployment, stagnant 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 2015; the strict “ability-to-repay” and “qualified mortgage” regulations promulgated by the Consumer Financial Protection Bureau, or the CFPB; the adoption of Regulation AB II by the SEC; and the finalization 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. The Corker-Warner bill, the Johnson-Crapo bill, and the Delaney-Carney-Himes Partnership to Strengthen Homeownership bill, all propose replacing the GSEs with a new government agency, the Federal Mortgage Insurance Corporation, or FMIC. The Housing Opportunities Move the Economy (HOME) Forward Act recommends replacing the GSEs with a new lender-owned cooperative. Finally, the Protecting American Taxpayers and Homeowners (PATH) Act suggests ending the taxpayer-funded bailout of the GSEs while phasing them out over five years. It remains uncertain if any proposal will ultimately become

legislation. However, it does not appear that any GSE reform will take place until well after the midterm elections in November. We will continue to monitor these and other regulatory and policy activities closely.
The Federal Housing Finance Agency, or FHFA, recently published a proposed rulemaking regarding membership in the Federal Home Loan Bank system. Among other effects, the rulemaking would exclude captive insurers from membership. We believe we have a strong relationship with the FHLB and our mission aligns well with that of the Federal Home Loan Bank system. Even if the rulemaking were implemented in its current form, it appears that final rules would not take effect for some time. We continue to closely monitor matters that could impact our FHLB membership.
We believe our blended Agency and non-Agency strategies and our investing expertise, as well as our strategic initiatives, will allow us to better navigate the dynamic RMBS environment 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 and prime nonconforming residential mortgage 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 continuing purchases of RMBS 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) | September 30, 2014 | | | December 31, 2013 | | |
|---|---|---|---|---|---|---|
| Agency | | | | | | |
| Fixed Rate | $9,566,255 | 74.3 | % | $8,490,788 | 68.0 | % |
| Hybrid ARMs | 132,157 | 1.0 | % | 1,006,621 | 8.1 | % |
| Total Agency | 9,698,412 | 75.3 | % | 9,497,409 | 76.1 | % |
| Agency Derivatives | 186,398 | 1.4 | % | 218,509 | 1.8 | % |
| Non-Agency | | | | | | |
| Senior | 2,473,644 | 19.2 | % | 2,282,132 | 18.3 | % |
| Mezzanine | 517,712 | 4.0 | % | 468,667 | 3.8 | % |
| Interest-only securities | 8,140 | 0.1 | % | 8,519 | — | % |
| Total Non-Agency | 2,999,496 | 23.3 | % | 2,759,318 | 22.1 | % |
| Total | $12,884,306 | | | $12,475,236 | | |

Prepayment speeds and volatility due to interest rates
Our Agency RMBS portfolio is subject to inherent prepayment risk because, 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, but will cause the market value of our fixed coupon Agency pools to increase. The inverse relationship occurs when interest rates increase and prepayments slow. Housing prices have increased over the past few years, but are still generally much lower than at the peak of the housing market. This fact, combined with elevated unemployment rates and housing inventory, leads us to expect that there will not be a significant increase in prepayment speeds in the remainder of 2014. However, given the overall low level of interest rates and the extension of HARP 2.0 to the end of 2015, prepayment speeds, particularly due to refinancings, may increase on many RMBS. These government actions, combined with other potential government programs, could also lead to a further increase in prepayment speeds in 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 2014 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 (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.

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

| | As of September 30, 2014 | | | | | |
|---|---|---|---|---|---|---|
| | Agency RMBS AFS | | Agency | Total Agency RMBS | | |
| (dollars in thousands) | Fixed Rate | Hybrid ARMs | Derivatives | | | |
| Other low loan balances | $2,741,640 | $— | $— | $2,741,640 | 28 | % |
| Home equity conversion mortgages | 1,764,083 | — | — | 1,764,083 | 18 | % |
| $85K Max Pools | 1,696,932 | — | — | 1,696,932 | 17 | % |
| 2006 and subsequent vintages | 1,421,302 | 29,910 | — | 1,451,212 | 15 | % |
| High LTV (predominantly MHA) | 742,386 | — | — | 742,386 | 7 | % |
| Pre-pay lock-out or penalty-based | 494,511 | 3,707 | — | 498,218 | 5 | % |
| Seasoned (2005 and prior vintages) | 238,374 | 98,540 | 134,072 | 470,986 | 5 | % |
| 2006 and subsequent vintages - discount | 346,335 | — | 52,326 | 398,661 | 4 | % |
| Low FICO | 120,692 | — | — | 120,692 | 1 | % |
| Total | $9,566,255 | $132,157 | $186,398 | $9,884,810 | 100 | % |

| | As of December 31, 2013 | | | | | |
|---|---|---|---|---|---|---|
| | Agency RMBS AFS | | Agency | Total Agency RMBS | | |
| (dollars in thousands) | Fixed Rate | Hybrid ARMs | Derivatives | | | |
| Other low loan balances | $505,565 | $— | $— | $505,565 | 5 | % |
| Home equity conversion mortgages | 1,792,937 | — | — | 1,792,937 | 19 | % |
| $85K Max Pools | 1,313,097 | — | — | 1,313,097 | 14 | % |
| 2006 and subsequent vintages | 872,334 | 519,047 | — | 1,391,381 | 14 | % |
| High LTV (predominantly MHA) | 2,319,464 | — | — | 2,319,464 | 24 | % |
| Pre-pay lock-out or penalty-based | 495,796 | 6,551 | — | 502,347 | 5 | % |
| Seasoned (2005 and prior vintages) | 270,549 | 110,324 | 148,221 | 529,094 | 5 | % |
| 2006 and subsequent vintages - discount | 241,710 | 370,699 | 70,288 | 682,697 | 7 | % |
| Low FICO | 679,336 | — | — | 679,336 | 7 | % |
| Total | $8,490,788 | $1,006,621 | $218,509 | $9,715,918 | 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 September 30, 2014 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (in thousands) | Principal and Interest Securities | | | | Interest-Only | Total | | |
| | Senior | | Mezzanine | | Securities | | | |
| Face Value | $3,386,615 | | $632,319 | | $296,009 | $4,314,943 | | |
| Unamortized discount | | | | | | | | |
| Designated credit reserve | (895,149 | ) | (73,882 | ) | — | (969,031 | ) | |

| | | | | |
|---|---|---|---|---|
| Unamortized net discount | (582,519) | (147,798) | (289,148) | (1,019,465) |
| Amortized Cost | $1,908,947 | $410,639 | $6,861 | $2,326,447 |

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| (in thousands) | As of December 31, 2013 Principal and Interest Securities Senior | Mezzanine | Interest-Only Securities | Total |
|---|---|---|---|---|
| Face Value | $3,496,359 | $644,636 | $333,358 | $4,474,353 |
| Unamortized discount | | | | |
| Designated credit reserve | (1,124,838) | (109,611) | — | (1,234,449) |
| Unamortized net discount | (594,726) | (151,187) | (325,646) | (1,071,559) |
| Amortized Cost | $1,776,795 | $383,838 | $7,712 | $2,168,345 |

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 portfolio and mortgage loans. However, 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. In addition, the discounted purchase prices paid on our non-Agency RMBS and credit sensitive residential mortgage loans, or CSL, provide additional insulation from credit losses in the event we receive less than 100% of par on such assets. We evaluate credit risk on our non-Agency investments and CSL through a comprehensive asset selection process, which is predominantly focused on quantifying and pricing credit risk, including extensive initial modeling and scenario analysis. We review on an ongoing basis our non-Agency RMBS and CSL based on a quantitative and qualitative analysis of the risk-adjusted returns on such investments and through on-going asset surveillance. Specific to our non-Agency RMBS, 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. Nevertheless, unanticipated credit losses could occur, adversely impacting our operating results.

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 September 30, 2014, we had entered into repurchase agreements with 30 counterparties, 25 of which had outstanding balances at September 30, 2014, including two facilities that provide short-term financing for our mortgage loan collateral with outstanding balances at September 30, 2014. In addition, we held both short- and long-term secured advances from the FHLB at September 30, 2014. As of September 30, 2014, we had a total consolidated debt to equity ratio of 3.6 times. As of September 30, 2014, we had $1.2 billion in cash and cash equivalents, approximately $76.6 million of unpledged Agency securities and derivatives and $269.9 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 $243.0 million. We also had approximately $15.2 million of unpledged prime nonconforming residential mortgage loans and $22.0 million of unpledged CSL and an overall estimated unused borrowing capacity on unpledged mortgage loans held-for-sale of approximately $25.8 million. If borrowing rates and collateral requirements change in the near term, we believe we are subject to less earnings volatility than if we carried a higher leverage. Additionally, in January 2014 the Basel Committee announced it would loosen its leverage ratio definition for banks, which we believe may dispel any concern of increased volatility in the securities financing market in the near term. We will continue to monitor these and other regulatory and policy activities closely.

We also monitor exposure to our mortgage loan conduit and MSR counterparties. In connection with these transactions, we are required to make certain representations and warranties to the purchasers of the loans underlying the assets we own. If the representations and warranties that we are required to make to the purchasers of the underlying loans in these transactions prove to be inaccurate, we may be obligated to repurchase certain mortgage loans, which may impact the profitability of these investments. Although we obtain similar representations and warranties from the counterparty from whom we acquired the relevant asset, if those representations and warranties do not directly mirror those we make to the purchaser of the underlying loans, 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.

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Summary of Results of Operations and Financial Condition

Our reported GAAP net income was $193.6 million and $204.1 million ($0.53 and $0.56 per diluted weighted share) for the three and nine months ended September 30, 2014, respectively, as compared to net loss of $192.7 million and net income $339.6 million ($(0.53) and $0.98 per diluted weighted share) for the three and nine months ended September 30, 2013, respectively.

With our accounting treatment for AFS securities, unrealized fluctuations in the market values of securities do not impact our GAAP or taxable income but are recognized on our balance sheet 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 GAAP to taxable income timing differences, than if the portfolio were accounted as trading instruments. For the three months ended September 30, 2014 and 2013, net unrealized losses on AFS securities recognized as other comprehensive loss were $41.0 million and net unrealized gains on AFS securities recognized as other comprehensive income were $246.8 million, respectively, which resulted in comprehensive income of $152.6 million for the three months ended September 30, 2014 as compared to $54.0 million for the three months ended September 30, 2013. For the nine months ended September 30, 2014 and 2013, net unrealized gains on AFS securities recognized as other comprehensive income were $331.9 million and net unrealized losses on AFS securities recognized as other comprehensive loss were $183.7 million, respectively, which resulted in comprehensive income of $536.0 million for the nine months ended September 30, 2014 as compared to $155.9 million for the nine months ended September 30, 2013.

On September 16, 2014, we declared a cash dividend of $0.26 per diluted share. Our GAAP book value per diluted common share was $11.25 at September 30, 2014, an increase from $10.56 book value per diluted common share at December 31, 2013. During this nine month period, we recognized an increase in accumulated other comprehensive income due to net unrealized gains on available-for-sale securities of $331.9 million driving the overall increase in book value, which was offset by cash dividends declared of $285.6 million.

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The following tables present the components of our comprehensive income for the three and nine months ended September 30, 2014 and 2013:

| (in thousands, except share data) | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| Income Statement Data: | September 30, | | September 30, | |
| | 2014 | 2013 | 2014 | 2013 |
| Interest income: | (unaudited) | | (unaudited) | |
| Available-for-sale securities | $123,056 | $121,303 | $374,574 | $386,246 |
| Trading securities | 4,308 | 1,509 | 8,174 | 4,034 |
| Mortgage loans held-for-sale | 5,268 | 9,297 | 12,553 | 15,409 |
| Mortgage loans held-for-investment in securitization trusts | 9,526 | 5,649 | 25,180 | 11,672 |
| Cash and cash equivalents | 145 | 216 | 506 | 773 |
| Total interest income | 142,303 | 137,974 | 420,987 | 418,134 |
| Interest expense: | | | | |
| Repurchase agreements | 17,509 | 21,802 | 56,684 | 67,373 |
| Collateralized borrowings in securitization trusts | 5,678 | 3,125 | 16,623 | 6,112 |
| Federal Home Loan Bank advances | 1,531 | — | 2,439 | — |
| Total interest expense | 24,718 | 24,927 | 75,746 | 73,485 |
| Net interest income | 117,585 | 113,047 | 345,241 | 344,649 |
| Other-than-temporary impairment losses | — | — | (212) | (1,662) |
| Other income: | | | | |
| Gain (loss) on investment securities | 59,471 | (230,111) | 58,504 | (152,280) |
| Gain (loss) on interest rate swap and swaption agreements | 28,519 | (55,410) | (193,028) | 223,388 |
| Gain (loss) on other derivative instruments | 6,056 | 20,434 | (12,345) | 66,055 |
| (Loss) gain on mortgage loans held-for-sale | (2,387) | (4,443) | 6,233 | (25,262) |
| Servicing income | 32,264 | 989 | 96,573 | 1,234 |
| (Loss) gain on servicing asset | (10,711) | 861 | (73,042) | 816 |
| Other (loss) income | (1,515) | 8,938 | 19,948 | 16,837 |
| Total other income (loss) | 111,697 | (258,742) | (97,157) | 130,788 |
| Expenses: | | | | |
| Management fees | 12,258 | 12,036 | 36,559 | 29,388 |
| Securitization deal costs | 3,355 | 2,125 | 3,355 | 4,153 |
| Servicing expenses | 12,513 | 862 | 24,595 | 1,200 |
| Other operating expenses | 12,424 | 9,155 | 41,281 | 24,864 |
| Total expenses | 40,550 | 24,178 | 105,790 | 59,605 |
| Income (loss) from continuing operations before income taxes | 188,732 | (169,873) | 142,082 | 414,170 |
| (Benefit from) provision for income taxes | (4,858) | 23,726 | (62,020) | 77,809 |
| Net income (loss) from continuing operations | 193,590 | (193,599) | 204,102 | 336,361 |
| Income from discontinued operations | — | 871 | — | 3,264 |
| Net income (loss) | $193,590 | $(192,728) | $204,102 | $339,625 |

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| (in thousands) Income Statement Data: | Three Months Ended September 30, 2014 (unaudited) | 2013 | Nine Months Ended September 30, 2014 (unaudited) | 2013 |
|---|---|---|---|---|
| Basic earnings (loss) per weighted average share: | | | | |
| Continuing operations | $0.53 | $(0.53) | $0.56 | $0.97 |
| Discontinued operations | — | — | — | 0.01 |
| Net income (loss) | $0.53 | $(0.53) | $0.56 | $0.98 |
| Diluted earnings (loss) per weighted average share: | | | | |
| Continuing operations | $0.53 | $(0.53) | $0.56 | $0.97 |
| Discontinued operations | — | — | — | 0.01 |
| Net income (loss) | $0.53 | $(0.53) | $0.56 | $0.98 |
| Dividends declared per share | $0.26 | $0.28 | $0.78 | $0.91 |
| Weighted average number of shares of common stock: | | | | |
| Basic | 366,118,866 | 365,057,767 | 365,938,150 | 345,529,611 |
| Diluted | 366,118,866 | 365,166,992 | 365,938,150 | 346,370,358 |
| Comprehensive income: | | | | |
| Net income (loss) | $193,590 | $(192,728) | $204,102 | $339,625 |
| Other comprehensive (loss) income: | | | | |
| Unrealized (loss) gain on available-for-sale securities, net | (40,982) | 246,777 | 331,913 | (183,684) |
| Other comprehensive (loss) income | (40,982) | 246,777 | 331,913 | (183,684) |
| Comprehensive income | $152,608 | $54,049 | $536,015 | $155,941 |

| (in thousands) Balance Sheet Data: | September 30, 2014 (unaudited) | December 31, 2013 |
|---|---|---|
| Available-for-sale securities | $12,697,908 | $12,256,727 |
| Total assets | $19,154,825 | $17,173,862 |
| Repurchase agreements | $12,274,878 | $12,250,450 |
| Federal Home Loan Bank advances | $1,500,000 | $— |
| Total stockholders’ equity | $4,118,099 | $3,854,995 |

Results of Operations

The following analysis focuses on the results generated during the three and nine months ended September 30, 2014 and 2013.

Interest Income and Average Portfolio Yield

For the three and nine months ended September 30, 2014, we recognized $123.1 million and $374.6 million, respectively, of interest income from our Agency and non-Agency RMBS AFS portfolio. Our RMBS AFS portfolio’s average amortized cost of securities was approximately $12.0 billion in each of the three and nine months ended September 30, 2014, resulting in an annualized net yield of approximately 4.1% and 4.2%, respectively. For the three and nine months ended September 30, 2013, we recognized $121.3 million and $386.2 million, respectively, of interest income from our Agency and non-Agency RMBS AFS portfolio. Our RMBS AFS portfolio’s average amortized cost of securities was approximately $12.0 billion and $13.3 billion for the three and nine months ended September 30, 2013, resulting in an annualized net yield of approximately 4.0% and 3.9%, respectively.

For the three and nine months ended September 30, 2014, we recognized $39.5 million and $105.4 million, respectively, of net premium amortization on our Agency RMBS AFS, including our interest-only securities. This resulted in an overall net asset yield of approximately 3.0% and 3.1%, respectively, excluding Agency Derivatives. For the three and nine months ended September 30, 2014, we recognized $32.8 million and $96.9 million of accretion income from the discounts on our non-Agency portfolio resulting in an overall net yield of approximately 8.5% and 8.7%, respectively. For the three and nine months ended September 30, 2013, we recognized $42.3 million and $127.2 million, respectively, of net premium amortization on our

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Agency RMBS AFS, including our interest-only securities. This resulted in an overall net asset yield of approximately 2.8% for both respective periods, excluding Agency Derivatives. For the three and nine months ended September 30, 2013, we recognized $37.2 million and $109.7 million of accretion income from the discounts on our non-Agency portfolio resulting in an overall net yield of approximately 9.0% for both respective periods. The increase in net yields on Agency RMBS AFS in the third quarter of 2014 compared to the third quarter of 2013 was predominantly driven by slower prepayments on premium-priced RMBS and interest-only products. However, the decrease in net yields on non-Agency RMBS was due to the sale of bonds at higher yields that we believe had reached maximum value, which were replaced with bonds at lower 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 (ratios for the periods have been annualized):

| | Three Months Ended September 30, 2014 | | | Nine Months Ended September 30, 2014 | | |
|---|---|---|---|---|---|---|
| | Agency | Non-Agency | Total | Agency | Non-Agency | Total |
| Gross Yield/Stated Coupon | 4.7 % | 2.9 % | 4.3 % | 4.5 % | 3.0 % | 4.3 % |
| Net (Premium Amortization)/Discount Accretion | (1.7 )% | 5.6 % | (0.2 )% | (1.4 )% | 5.7 % | (0.1 )% |
| Net Yield [(1)] | 3.0 % | 8.5 % | 4.1 % | 3.1 % | 8.7 % | 4.2 % |

| | Three Months Ended September 30, 2013 | | | Nine Months Ended September 30, 2013 | | |
|---|---|---|---|---|---|---|
| | Agency | Non-Agency | Total | Agency | Non-Agency | Total |
| Gross Yield/Stated Coupon | 4.5 % | 2.8 % | 4.2 % | 4.3 % | 2.8 % | 4.0 % |
| Net (Premium Amortization)/Discount Accretion | (1.7 )% | 6.2 % | (0.2 )% | (1.5 )% | 6.2 % | (0.1 )% |
| Net Yield [(1)] | 2.8 % | 9.0 % | 4.0 % | 2.8 % | 9.0 % | 3.9 % |

(1) 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 September 30, 2014 | | | Nine Months Ended September 30, 2014 | | |
|---|---|---|---|---|---|---|
| (dollars in thousands) | Agency | Non-Agency | Total | Agency | Non-Agency | Total |
| Average amortized cost | $9,608,340 | $2,357,570 | $11,965,910 | $9,704,620 | $2,284,110 | $11,988,730 |
| Coupon interest | 112,409 | 17,321 | 129,730 | 330,933 | 52,154 | 383,087 |
| Net (premium amortization)/discount accretion | (39,454 ) | 32,780 | (6,674 ) | (105,377 ) | 96,864 | (8,513 ) |
| Interest income | $72,955 | $50,101 | $123,056 | $225,556 | $149,018 | $374,574 |
| Net asset yield | 3.0 % | 8.5 % | 4.1 % | 3.1 % | 8.7 % | 4.2 % |

| | Three Months Ended September 30, 2013 | | | Nine Months Ended September 30, 2013 | | |
|---|---|---|---|---|---|---|
| (dollars in thousands) | Agency | Non-Agency | Total | Agency | Non-Agency | Total |
| Average amortized cost | $9,628,604 | $2,414,066 | $12,042,670 | $10,953,710 | $2,343,169 | $13,296,879 |
| Coupon interest | 109,391 | 17,033 | 126,424 | 354,887 | 48,886 | 403,773 |
| Net (premium amortization)/discount accretion | (42,325 ) | 37,204 | (5,121 ) | (127,242 ) | 109,715 | (17,527 ) |
| Interest income | $67,066 | $54,237 | $121,303 | $227,645 | $158,601 | $386,246 |
| Net asset yield | 2.8 % | 9.0 % | 4.0 % | 2.8 % | 9.0 % | 3.9 % |

For the three and nine months ended September 30, 2014, we recognized $4.3 million and $8.2 million of interest income, respectively, associated with our trading U.S. Treasuries, or approximately 0.9% and 0.8% annualized net yield on average

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amortized cost, respectively. For the three and nine months ended September 30, 2013, we recognized $1.5 million and $4.0 million of interest income, respectively, associated with our trading U.S. Treasuries, or approximately 0.6% and 0.5% annualized net yield on average amortized cost. The increase in yields on U.S. Treasuries for the three and nine months ended September 30, 2014 as compared to the same periods in 2013, was the result of increases in Treasury rates.

For the three and nine months ended September 30, 2014, we recognized $5.3 million and $12.6 million of interest income, respectively, associated with our mortgage loans held-for-sale, or approximately 4.0% annualized net yield on average carrying value for both respective periods. For the three and nine months ended September 30, 2013, we recognized $9.3 million and $15.4 million of interest income, respectively, associated with our mortgage loans held-for-sale, or approximately 4.5% and 4.7% annualized net yield on average carrying value. The decrease in yields on mortgage loans held-for-sale for the three and nine months ended September 30, 2014 as compared to the same period in 2013, was the result of the sale of substantially all of our CSL portfolio during the first quarter of 2014.

For the three and nine months ended September 30, 2014, we recognized $9.5 million and $25.2 million of interest income associated with our mortgage loans held-for-investment in securitization trusts, or approximately 3.9% annualized net yield on average carrying value for both respective periods. For the three and nine months ended September 30, 2013, we recognized $5.6 million and $11.7 million of interest income associated with our mortgage loans held-for-investment in securitization trusts, or approximately 4.1% annualized net yield on average carrying value for both respective periods. The decrease in yields on mortgage loans held-for-investment in securitization trusts for the three and nine months ended September 30, 2014 as compared to the same periods in 2013, was generally the result of the securitization transactions completed in the third quarter of 2014 at lower yields.

Interest Expense and the Cost of Funds

For the three and nine months ended September 30, 2014, we recognized $18.8 million and $55.7 million, respectively, in interest expense on our borrowed funds collateralized by RMBS AFS. For the same three and nine month periods, our average outstanding balance under repurchase agreements and FHLB advances to fund RMBS AFS was approximately $11.2 billion and $11.1 billion, respectively. The average cost of funds, excluding interest spread expense associated with interest rate swaps, for the three and nine months ended September 30, 2014, was 0.7% for both respective periods. For the three and nine months ended September 30, 2013, we recognized $19.2 million and $62.3 million, respectively, in interest expense on our borrowed funds collateralized by RMBS AFS. For the same three and nine month periods, our average outstanding balance under repurchase agreements and FHLB advances to fund RMBS AFS was approximately $10.8 billion and $12.0 billion, respectively. The average cost of funds, excluding interest spread expense associated with interest rate swaps, for the three and nine months ended September 30, 2013, was 0.7% for both respective periods. We have continued to replace a portion of our leverage on our RMBS AFS under repurchase agreements with FHLB advances, resulting in our ability to extend our maturity profile without an increase in interest expense on all borrowed funds collateralized by RMBS AFS for the three and nine months ended September 30, 2014, as compared to the same periods in 2013.

For the three and nine months ended September 30, 2014, we recognized $0.4 million of negative interest expense (interest income) and $0.8 million of interest expense associated with the financing of our U.S. Treasuries and Agency Derivatives, or an average cost of funds of approximately (0.1)% and 0.1%, respectively. For the three and nine months ended September 30, 2013, we recognized $0.7 million and $2.7 million, respectively, of interest expense associated with the financing of our U.S. Treasuries and Agency Derivatives, or an average cost of funds of approximately 0.2% and 0.3%. The negative interest expense (interest income) and corresponding decrease in average cost of funds on our U.S. Treasuries and Agency Derivatives for the three and nine months ended September 30, 2014, as compared to the same periods in 2013, was due to counterparties granting a negative borrowing rate on repurchase agreements financing our U.S. Treasuries.

For the three and nine months ended September 30, 2014, we recognized $0.7 million and $2.7 million, respectively, of interest expense associated with the financing of our mortgage loans held-for-sale, or an average cost of funds of approximately 0.9% and 1.8%. For the three and nine months ended September 30, 2013, we recognized $1.9 million and $2.4 million, respectively, of interest expense associated with the financing of our mortgage loans held-for-sale, or an average cost of funds of approximately 2.7% for both respective periods. The decrease in interest expense associated with the financing of mortgage loans held-for-sale for the three and nine months ended September 30, 2014, as compared to the same periods in 2013, 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.

For the three and nine months ended September 30, 2014, we also recognized $5.7 million and $16.6 million, respectively, of interest expense associated with the financing of our mortgage loans held-for-investment in securitization trusts, or an average cost of funds of approximately 3.7% and 3.4%. For the three and nine months ended September 30, 2013, we also recognized $3.1 million and $6.1 million, respectively, of interest expense associated with the financing of our mortgage loans held-for-investment in securitization trusts, or an average cost of funds of approximately 2.7% and 2.4%. The increase in interest expense associated with the financing of mortgage loans held-for-investment in securitization trusts for the three and nine months ended September 30, 2014, as compared to the same periods in 2013, was generally the result of the securitization transactions completed in the third quarter of 2014.

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Net Interest Income

For the three and nine months ended September 30, 2014, net interest income on our RMBS AFS portfolio was $104.3 million and $318.9 million, respectively, resulting in a net interest spread of approximately 3.4% and 3.5%, respectively. For the three and nine months ended September 30, 2013, net interest income on our RMBS AFS portfolio was $102.1 million and $324.0 million, respectively, resulting in a net interest spread of approximately 3.3% and 3.2%, respectively. The increase in net interest spread across comparative periods was predominantly driven by slower prepayments due to the rising interest rate environment.

The following tables provide the interest income and expense incurred on our RMBS AFS portfolio in the three and nine months ended September 30, 2014 and 2013:

| | Three Months Ended September 30, 2014 | | | Nine Months Ended September 30, 2014 | | |
|---|---|---|---|---|---|---|
| (dollars in thousands) | Agency[1] | Non-Agency | Total | Agency[1] | Non-Agency | Total |
| Average available-for-sale securities held [2] | $9,608,340 | $2,357,570 | $11,965,910 | $9,704,620 | $2,284,110 | $11,988,730 |
| Total interest income | $72,955 | $50,101 | $123,056 | $225,556 | $149,018 | $374,574 |
| Yield on average investment securities | 3.0 % | 8.5 % | 4.1 % | 3.1 % | 8.7 % | 4.2 % |
| Average balance of borrowings | $8,979,861 | $2,185,600 | $11,165,461 | $9,111,613 | $2,002,067 | $11,113,680 |
| Total interest expense [3] [4] | $9,397 | $9,401 | $18,798 | $28,575 | $27,107 | $55,682 |
| Average cost of funds [4] | 0.4 % | 1.7 % | 0.7 % | 0.4 % | 1.8 % | 0.7 % |
| Net interest income | $63,558 | $40,700 | $104,258 | $196,981 | $121,911 | $318,892 |
| Net interest rate spread | 2.6 % | 6.8 % | 3.4 % | 2.7 % | 6.9 % | 3.5 % |

| | Three Months Ended September 30, 2013 | | | Nine Months Ended September 30, 2013 | | |
|---|---|---|---|---|---|---|
| (dollars in thousands) | Agency[1] | Non-Agency | Total | Agency[1] | Non-Agency | Total |
| Average available-for-sale securities held [2] | $9,628,604 | $2,414,066 | $12,042,670 | $10,953,710 | $2,343,169 | $13,296,879 |
| Total interest income | $67,066 | | | | | |