TWO HARBORS INVESTMENT CORP.
Form 10-Q
August 08, 2018

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: June 30, 2018

Commission File Number 001-34506

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

Maryland	27-0312904
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
575 Lexington Avenue, Suite 2930 New York, New York	10022
(Address of Principal Executive Offices)	(Zip Code)

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

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

Large accelerated filer x		Accelerated filer o
Non-accelerated filer o	(Do not check if a smaller reporting company)	Smaller reporting company o
		Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
As of August 7, 2018 there were 248,072,557 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 (unaudited)
(in thousands, except share data)

ASSETS	June 30, 2018	December 31, 2017
Available-for-sale securities, at fair value	$19,293,354	$21,220,819
Mortgage servicing rights, at fair value	1,450,261	1,086,717
Residential mortgage loans held-for-sale, at fair value	28,813	30,414
Cash and cash equivalents	417,515	419,159
Restricted cash	564,705	635,836
Accrued interest receivable	61,108	68,309
Due from counterparties	35,385	842,303
Derivative assets, at fair value	257,917	309,918
Other assets	166,930	175,838
Total Assets	$22,275,988	$24,789,313
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Repurchase agreements	$17,205,823	$19,451,207
Federal Home Loan Bank advances	865,024	1,215,024
Revolving credit facilities	170,000	20,000
Convertible senior notes	283,268	282,827
Derivative liabilities, at fair value	39,429	31,903
Due to counterparties	25,957	88,898
Dividends payable	96,219	12,552
Accrued interest payable	84,296	87,698
Other liabilities	25,727	27,780
Total Liabilities	18,795,743	21,217,889
Stockholders' Equity		
Preferred stock, par value $0.01 per share; 50,000,000 shares authorized:		
8.125% Series A cumulative redeemable: 5,750,000 and 5,750,000 shares issued and outstanding, respectively ($143,750 liquidation preference)	138,872	138,872
7.625% Series B cumulative redeemable: 11,500,000 and 11,500,000 shares issued and outstanding, respectively ($287,500 liquidation preference)	278,094	278,094
7.25% Series C cumulative redeemable: 11,800,000 and 11,800,000 shares issued and outstanding, respectively ($295,000 liquidation preference)	285,584	285,571
Common stock, par value $0.01 per share; 450,000,000 shares authorized and 175,470,398 and 174,496,587 shares issued and outstanding, respectively	1,755	1,745
Additional paid-in capital	3,678,586	3,672,003
Accumulated other comprehensive (loss) income	(34,933)	334,813
Cumulative earnings	2,850,985	2,386,604
Cumulative distributions to stockholders	(3,718,698)	(3,526,278)
Total Stockholders' Equity	3,480,245	3,571,424
Total Liabilities and Stockholders' Equity	$22,275,988	$24,789,313

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 (unaudited)
(in thousands, except share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Interest income:				
Available-for-sale securities	$183,467	$149,910	$374,183	$285,237
Residential mortgage loans held-for-investment in securitization trusts	—	30,826	—	62,454
Residential mortgage loans held-for-sale	349	503	656	901
Other	3,544	3,502	6,540	5,303
Total interest income	187,360	184,741	381,379	353,895
Interest expense:				
Repurchase agreements	97,812	43,806	184,392	76,062
Collateralized borrowings in securitization trusts	—	24,843	—	50,229
Federal Home Loan Bank advances	4,896	11,444	9,354	20,237
Revolving credit facilities	999	597	1,803	1,026
Convertible senior notes	4,707	4,591	9,425	8,412
Total interest expense	108,414	85,281	204,974	155,966
Net interest income	78,946	99,460	176,405	197,929
Other-than-temporary impairments:				
Total other-than-temporary impairment losses	(174)	(429)	(268)	(429)
Other income (loss):				
(Loss) gain on investment securities	(31,882)	31,249	(52,553)	(21,103)
Servicing income	77,665	51,308	148,855	91,081
Gain (loss) on servicing asset	9,853	(46,630)	81,660	(61,195)
Gain (loss) on interest rate swap and swaption agreements	29,133	(76,710)	179,678	(66,783)
Gain (loss) on other derivative instruments	7,675	(19,540)	15,728	(47,404)
Other income	730	3,126	1,788	12,622
Total other income (loss)	93,174	(57,197)	375,156	(92,782)
Expenses:				
Management fees	11,453	9,847	23,161	19,655
Servicing expenses	11,539	11,296	26,093	16,594
Other operating expenses	15,515	17,471	30,007	31,235
Total expenses	38,507	38,614	79,261	67,484
Income from continuing operations before income taxes	133,439	3,220	472,032	37,234
(Benefit from) provision for income taxes	(6,051)	8,759	(2,267)	(15,758)
Net income (loss) from continuing operations	139,490	(5,539)	474,299	52,992
Income from discontinued operations, net of tax	—	14,197	—	27,651
Net income	139,490	8,658	474,299	80,643
Income from discontinued operations attributable to noncontrolling interest	—	40	—	40
Net income attributable to Two Harbors Investment Corp.	139,490	8,618	474,299	80,603
Dividends on preferred stock	13,747	4,285	27,494	4,285
Net income attributable to common stockholders	$125,743	$4,333	$446,805	$76,318

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 (unaudited), continued
(in thousands, except share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Basic earnings per weighted average common share:				
Continuing operations	$0.72	$ (0.06)	$2.55	$ 0.28
Discontinued operations	—	0.08	—	0.16
Net income	$0.72	$ 0.02	$2.55	$ 0.44
Diluted earnings per weighted average common share:				
Continuing operations	$0.68	$ (0.06)	$2.36	$ 0.28
Discontinued operations	—	0.08	—	0.16
Net income	$0.68	$ 0.02	$2.36	$ 0.44
Dividends declared per common share	$0.47	$ 0.52	$0.94	$ 1.02
Weighted average number of shares of common stock:				
Basic	175,451,989	174,473,168	175,299,822	174,378,095
Diluted	193,212,877	174,473,168	193,016,793	174,378,095
Comprehensive income:				
Net income	$139,490	$ 8,658	$474,299	$ 80,643
Other comprehensive (loss) income, net of tax:				
Unrealized (loss) gain on available-for-sale securities	(34,887)	81,628	(379,664)	155,390
Other comprehensive (loss) income	(34,887)	81,628	(379,664)	155,390
Comprehensive income	104,603	90,286	94,635	236,033
Comprehensive income attributable to noncontrolling interest	—	42	—	42
Comprehensive income attributable to Two Harbors Investment Corp.	104,603	90,244	94,635	235,991
Dividends on preferred stock	13,747	4,285	27,494	4,285
Comprehensive income attributable to common stockholders	$90,856	$ 85,959	$67,141	$ 231,706

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 (unaudited)
(in thousands, except share data)

	Series A Preferred Stock	Series B Preferred Stock	Series C Preferred Stock	Common Stock Par Value	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Cumulative Earnings	Cumulative Distributions to Stockholders	Total Stockholders' Equity	No co In
Balance, December 31, 2016	$—	$—	$—	$1,739	$3,661,711	$199,227	$2,038,033	$(2,499,599)	$3,401,111	$-
Net income	—	—	—	—	—	—	80,603	—	80,603	40
Other comprehensive income before reclassifications, net of tax expense of $27,014	—	—	—	—	—	151,789	—	—	151,789	2
Amounts reclassified from accumulated other comprehensive income, net of tax benefit of $2,722	—	—	—	—	—	3,595	—	—	3,595	—
Other comprehensive income, net of tax expense of $24,292	—	—	—	—	—	155,384	—	—	155,384	2
Contribution of TH Commercial Holdings LLC to Granite Point	—	—	—	—	(13,777)	6	—	—	(13,771)	19
Issuance of preferred stock, net of offering costs	138,872	—	—	—	—	—	—	—	138,872	—
Issuance of common stock, net of offering costs	—	—	—	—	256	—	—	—	256	—
Preferred dividends declared	—	—	—	—	—	—	—	(4,285)	(4,285)	—

Common dividends declared	—	—	—	—	—	—	—	(177,963)	(177,963)	—
Non-cash equity award compensation	—	—	—	7	8,207	—	—	—	8,214	—
Balance, June 30, 2017	$138,872	$—	$—	$1,745	$3,656,398	$354,617	$2,118,636	$(2,681,847)	$3,588,421	$1
Balance, December 31, 2017	$138,872	$278,094	$285,571	$1,745	$3,672,003	$334,813	$2,386,604	$(3,526,278)	$3,571,424	$-
Cumulative effect of adoption of new accounting principle	—	—	—	—	—	9,918	(9,918)	—	—	—
Adjusted balance, January 1, 2018	138,872	278,094	285,571	1,745	3,672,003	344,731	2,376,686	(3,526,278)	3,571,424	—
Net income	—	—	—	—	—	—	474,299	—	474,299	—
Other comprehensive loss before reclassifications, net of tax benefit of $658	—	—	—	—	—	(402,218)	—	—	(402,218)	—
Amounts reclassified from accumulated other comprehensive income, net of tax benefit of $0	—	—	—	—	—	22,554	—	—	22,554	—
Other comprehensive loss, net of tax benefit of $658	—	—	—	—	—	(379,664)	—	—	(379,664)	—
Issuance of preferred stock, net of offering costs	—	—	13	—	—	—	—	—	13	—
Issuance of common stock, net of offering costs	—	—	—	—	195	—	—	—	195	—
Preferred dividends declared	—	—	—	—	—	—	—	(27,494)	(27,494)	—
Common dividends	—	—	—	—	—	—	—	(164,926)	(164,926)	—

declared										
Non-cash equity award compensation	—	—	—	10	6,388	—	—	—	6,398	—
Balance, June 30, 2018	$138,872	$278,094	$285,584	$1,755	$3,678,586	$(34,933)	$2,850,985	$(3,718,698)	$3,480,245	$-

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 (unaudited)
(in thousands)

	Six Months Ended June 30,	
	2018	2017
Cash Flows From Operating Activities:		
Net income from continuing operations	$474,299	$52,992
Adjustments to reconcile net income from continuing operations to net cash provided by operating activities:		
Amortization of premiums and discounts on investment securities, net	44,891	23,293
Amortization of deferred debt issuance costs on convertible senior notes	441	176
Other-than-temporary impairment losses	268	429
Realized and unrealized losses on investment securities	53,846	21,103
(Gain) loss on servicing asset	(81,660)	61,195
Gain on residential mortgage loans held-for-sale	(556)	(1,794)
Gain on residential mortgage loans held-for-investment and collateralized borrowings in securitization trusts	—	(8,077)
Realized and unrealized (gain) loss on interest rate swaps and swaptions	(162,029)	56,305
Unrealized loss on other derivative instruments	22,040	35,111
Equity based compensation	6,398	8,214
Depreciation of fixed assets	348	550
Purchases of residential mortgage loans held-for-sale	—	(567)
Proceeds from sales of residential mortgage loans held-for-sale	—	3,708
Proceeds from repayment of residential mortgage loans held-for-sale	1,754	4,532
Net change in assets and liabilities:		
Decrease (increase) in accrued interest receivable	7,201	(10,217)
Increase in deferred income taxes, net	(1,954)	(16,078)
(Increase) decrease in income taxes receivable	(316)	80
Increase in prepaid and fixed assets	(143)	(253)
(Increase) decrease in other receivables	(2,267)	4,637
Decrease in servicing advances	2,332	5,031
(Decrease) increase in accrued interest payable	(3,402)	25,797
Increase in income taxes payable	—	51
Decrease in accrued expenses and other liabilities	(2,053)	(6,695)
Net cash provided by operating activities of discontinued operations	—	16,838
Net cash provided by operating activities	$359,438	$276,361

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 (unaudited), continued
(in thousands)

	Six Months Ended June 30, 2018	2017
Cash Flows From Investing Activities:		
Purchases of available-for-sale securities	$(3,221,949)	$(8,883,595)
Proceeds from sales of available-for-sale securities	3,719,959	5,092,318
Principal payments on available-for-sale securities	949,116	627,277
Purchases of mortgage servicing rights, net of purchase price adjustments	(282,283)	(266,003)
Proceeds from sales of mortgage servicing rights	399	627
(Purchases) short sales of derivative instruments, net	(78,944)	(33,562)
Proceeds from sales and settlement (payments for termination and settlement) of derivative instruments, net	278,460	15,905
Proceeds from repayment of residential mortgage loans held-for-investment in securitization trusts	—	181,806
Redemptions of Federal Home Loan Bank stock	12,981	33,080
Increase (decrease) in due to counterparties, net	743,977	(54,152)
Net cash used in investing activities of discontinued operations	—	(366,204)
Net cash provided by (used in) investing activities	2,121,716	(3,652,503)
Cash Flows From Financing Activities:		
Proceeds from repurchase agreements	64,622,311	78,592,898
Principal payments on repurchase agreements	(66,867,695)	(74,781,325)
Principal payments on collateralized borrowings in securitization trusts	—	(179,717)
Principal payments on Federal Home Loan Bank advances	(350,000)	(761,238)
Proceeds from revolving credit facilities	170,000	74,000
Principal payments on revolving credit facilities	(20,000)	(104,000)
Proceeds from convertible senior notes	—	282,469
Proceeds from issuance of preferred stock, net of offering costs	13	138,872
Proceeds from issuance of common stock, net of offering costs	195	256
Dividends paid on preferred stock	(25,696)	—
Dividends paid on common stock	(83,057)	(170,665)
Net cash provided by financing activities of discontinued operations	—	370,832
Net cash (used in) provided by financing activities	(2,553,929)	3,462,382
Net (decrease) increase in cash, cash equivalents and restricted cash	(72,775)	86,240
Cash, cash equivalents and restricted cash of continuing operations at beginning of period	1,054,995	758,916
Cash, cash equivalents and restricted cash of discontinued operations at beginning of period	—	56,279
Cash, cash equivalents and restricted cash at beginning of period	1,054,995	815,195
Cash, cash equivalents and restricted cash at end of period	$982,220	$901,435

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 (unaudited), continued
(in thousands)

	Six Months Ended June 30, 2018	2017
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$208,377	$89,296
Cash paid for taxes	$3	$192
Noncash Activities:		
Transfers of residential mortgage loans held-for-sale to other receivables for foreclosed government-guaranteed loans	$403	$2,292
Transfer of fair value of mortgage servicing rights to fair value of Ginnie Mae residential mortgage loans held-for-sale upon buyout	$—	$9
Additions to mortgage servicing rights due to sale of residential mortgage loans held-for-sale	$—	$20
Cumulative-effect adjustment for adoption of new accounting principle	$9,918	$—
Dividends declared but not paid at end of period	$96,219	$95,049
Reconciliation of residential mortgage loans held-for-sale:		
Residential mortgage loans held-for-sale at beginning of period	$30,414	$40,146
Purchases of residential mortgage loans held-for-sale	—	567
Transfers to other receivables for foreclosed government-guaranteed loans	(403)	(2,292)
Transfer of fair value of mortgage servicing rights to fair value of Ginnie Mae residential mortgage loans held-for-sale upon buyout	—	(9)
Proceeds from sales of residential mortgage loans held-for-sale	—	(3,708)
Proceeds from repayment of residential mortgage loans held-for-sale	(1,754)	(4,532)
Realized and unrealized gains on residential mortgage loans held-for-sale	556	1,774
Residential mortgage loans held-for-sale at end of period	$28,813	$31,946

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 investing in, financing and managing Agency residential mortgage-backed securities, or Agency RMBS, non-Agency securities, mortgage servicing rights, or MSR, and other financial assets. The Company's Chief Investment Officer manages the investment portfolio as a whole and resources are allocated and financial performance is assessed on a consolidated basis. 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. 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 of the Company 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. 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.

On June 28, 2017, the Company completed the contribution of its portfolio of commercial real estate assets to Granite Point Mortgage Trust Inc., or Granite Point, a newly formed Maryland corporation intended to qualify as a REIT, externally managed and advised by Pine River, and focused on directly originating, investing in and managing senior commercial mortgage loans and other debt and debt-like commercial real estate investments. The Company contributed its equity interests in its wholly owned subsidiary, TH Commercial Holdings LLC, to Granite Point and, in exchange for its contribution, received approximately 33.1 million shares of common stock of Granite Point, which represented approximately 76.5% of the outstanding stock of Granite Point upon completion of the initial public offering, or IPO, of its common stock on June 28, 2017. On November 1, 2017, the Company distributed, on a pro rata basis, the 33.1 million shares of Granite Point common stock that it acquired in connection with the contribution to stockholders holding shares of Two Harbors common stock outstanding as of the close of business on October 20, 2017.

On April 26, 2018, the Company announced that it had entered into a definitive merger agreement pursuant to which the Company would acquire CYS Investments, Inc., or CYS, a Maryland corporation investing in primarily Agency RMBS and treated as a REIT for U.S. federal income tax purposes. The transaction was approved by the stockholders of both the Company and CYS on July 27, 2018, and the merger was completed on July 31, 2018, at which time CYS became a wholly owned subsidiary of the Company. In exchange for all of the shares of CYS common stock outstanding immediately prior to the effective time of the merger, the Company issued approximately 72.6 million new shares of common stock, as well as aggregate cash consideration of $15.0 million, to CYS common stockholders. In addition, the Company issued 3 million shares of newly classified Series D cumulative redeemable preferred stock and 8 million shares of newly classified Series E cumulative redeemable preferred stock in exchange for all shares of CYS's Series A and Series B cumulative redeemable preferred stock outstanding prior to the effective time of the merger.

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.

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

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. All per share amounts, common shares outstanding and restricted shares for all prior periods presented have been adjusted on a retroactive basis to reflect the Company's one-for-two reverse stock split effected on November 1, 2017 (refer to Note 17 - Stockholders' Equity for additional information). 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, 2017. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at June 30, 2018 and results of operations for all periods presented have been made. The results of operations for the three and six months ended June 30, 2018 should not be construed as indicative of the results to be expected for future periods or the full year.

Due to its controlling ownership interest in Granite Point through November 1, 2017, the Company consolidated Granite Point on its financial statements. Effective November 1, 2017 (the date the 33.1 million shares of Granite Point common stock were distributed to the Company's common stockholders), the Company no longer has a controlling interest in Granite Point and, therefore, has deconsolidated Granite Point and its subsidiaries from its financial statements and reclassified all of Granite Point's prior period assets, liabilities and results of operations to discontinued operations.

The Company retains debt securities and excess servicing rights purchased from securitization trusts sponsored by either third parties or the Company's subsidiaries. The securitization trusts are considered variable interest entities, or VIEs, for financial reporting purposes and, thus, are reviewed for consolidation under the applicable consolidation guidance. Whenever the Company has both the power to direct the activities of a trust 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 trust. During the majority of 2017, the Company retained the most subordinate security in each of the securitization trusts, which gave the Company the power to direct the activities of the trusts that most significantly impact the trusts' performance and the obligation to absorb losses or the right to receive benefits of the securitization trusts that could be significant. As a result, the Company consolidated all of the securitization trusts on its condensed consolidated balance sheet. During the fourth quarter of 2017, the Company sold all of the retained subordinated securities thereby removing the Company's power to direct the activities of the trusts and the obligation to absorb losses or the right to receive benefits of the securitization trusts. As a result, the securitization trusts are no longer consolidated on the Company's condensed consolidated balance sheet and the remaining retained securities are included withing non-Agency available-for-sale, or AFS, securities.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make a number of significant estimates. These 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 as of the date of the 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.

Significant Accounting Policies

Included in Note 2 to the Consolidated Financial Statements of the Company's 2017 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 six months ended June 30, 2018.

Offsetting Assets and Liabilities

Certain of the Company’s repurchase agreements are governed by underlying agreements that provide for a right of setoff in the event of default by 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, or central clearing exchange agreements, in the case of centrally cleared interest rate swaps. The Company and the counterparty or clearing agency are required to post cash collateral based upon the net underlying market value of the Company’s open positions with the counterparty. Additionally, the Company’s centrally cleared interest rate swaps require that the Company posts an “initial margin” amount determined by the clearing exchange, which is generally intended to be set at a level sufficient to protect the exchange from the interest rate swap’s maximum estimated single-day price movement. The Company also exchanges “variation margin” based upon daily changes in fair value, as measured by the exchange.

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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. As a result of amendments to rules governing certain central clearing activities, the exchange of variation margin is considered a settlement of the interest rate swap, as opposed to pledged collateral. Accordingly, beginning in the first quarter of 2018 and in subsequent periods, the Company accounts for the receipt or payment of variation margin as a direct reduction to the carrying value of the interest rate swap asset or liability. The receipt or payment of initial margin will continue to be accounted for separate from the interest rate swap asset or liability. As of December 31, 2017, variation margin pledged or received was netted on a counterparty basis and classified within restricted cash, due from counterparties, or due to counterparties on the Company's condensed consolidated balance sheets.

The Company presents repurchase agreements subject to master netting arrangements or similar agreements on a gross basis and derivative assets and liabilities (other than centrally cleared interest rate swaps) 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 (other than variation margin on centrally cleared interest swaps) on a net basis, based on counterparty, in its condensed consolidated balance sheets. However, the Company does not offset repurchase agreements or derivative assets and liabilities (other than centrally cleared interest rate swaps) with the associated cash collateral on its condensed consolidated balance sheets.

The following tables present information about the Company's assets and liabilities that are subject to master netting arrangements or similar agreements and can potentially be offset on the Company's condensed consolidated balance sheets as of June 30, 2018 and December 31, 2017:

	June 30, 2018					
				Gross Amounts Not Offset with Financial Assets (Liabilities) in the Consolidated Balance Sheets [1]		
(in thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets (Liabilities) Presented in the Consolidated Balance Sheets	Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets						
Derivative assets	$520,557	$ (262,640)	$257,917	$(39,429)	$ —	$218,488
Total Assets	$520,557	$ (262,640)	$257,917	$(39,429)	$ —	$218,488
Liabilities						
Repurchase agreements	$(17,205,823)	$ —	$(17,205,823)	$17,205,823	$ —	$—
Derivative liabilities	(302,069)	262,640	(39,429)	39,429	—	—
Total Liabilities	$(17,507,892)	$ 262,640	$(17,245,252)	$17,245,252	$ —	$—

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	December 31, 2017					
				Gross Amounts Not Offset with Financial Assets (Liabilities) in the Consolidated Balance Sheets (1)		
(in thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets (Liabilities) Presented in the Consolidated Balance Sheets	Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets						
Derivative assets	$340,576	$ (30,658)	$309,918	$(31,903)	$ —	$278,015
Total Assets	$340,576	$ (30,658)	$309,918	$(31,903)	$ —	$278,015
Liabilities						
Repurchase agreements	$(19,451,207)	$ —	$(19,451,207)	$19,451,207	$ —	$—
Derivative liabilities	(62,561)	30,658	(31,903)	31,903	—	—
Total Liabilities	$(19,513,768)	$ 30,658	$(19,483,110)	$19,483,110	$ —	$—

(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

Revenue from Contracts with Customers

In May 2014, the Financial Accounting Standards Board, or FASB, issued ASU No. 2014-09, which is a comprehensive revenue recognition standard that supersedes virtually all existing revenue guidance under U.S. GAAP. The standard's core principle is that an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. As a result of the issuance of ASU No. 2015-14 in August 2015 deferring the effective date of ASU No. 2014-09 by one year, the ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2017, with early adoption prohibited. The Company has evaluated the new guidance and determined that interest income, gains and losses on financial instruments and income from servicing residential mortgage loans are outside the scope of ASC 606, Revenues from Contracts with Customers, or ASC 606. For income from servicing residential mortgage loans, the Company considered that the FASB Transition Resource Group members generally agreed that an entity should look to ASC 860, Transfers and Servicing, to determine the appropriate accounting for these fees and ASC 606 contains a scope exception for contracts that fall under ASC 860. As a result, the adoption of this ASU did not have a material impact on the Company's financial condition, results of operations or financial statement disclosures.

Lease Classification and Accounting

In February 2016, the FASB issued ASU No. 2016-02, which requires lessees to recognize on their balance sheets both a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2018, with early adoption permitted. The Company has determined this ASU will not have a material impact on the Company’s financial condition, results of operations or financial statement disclosures.

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Measurement of Credit Losses on Financial Instruments

In June 2016, the FASB issued ASU No. 2016-13, which changes the impairment model for most financial assets and certain other instruments. Valuation allowances for credit losses on AFS debt securities will be recognized, rather than direct reductions in the amortized cost of the investments, regardless of whether the impairment is considered to be other-than-temporary. The new model also requires the estimation of lifetime expected credit losses and corresponding recognition of allowance for losses on trade and other receivables, held-to-maturity debt securities, loans, and other instruments held at amortized cost. The ASU requires certain recurring disclosures and is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2019, with early adoption permitted for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2018. The Company is evaluating the adoption of this ASU to determine the impact it may have on its condensed consolidated financial statements, which at the date of adoption, is expected to increase the allowance for credit losses with a resulting negative adjustment to retained earnings, with offsetting impacts to accumulated other comprehensive income.

Clarifying the Definition of a Business

In January 2017, the FASB issued ASU No. 2017-01, which changes the definition of a business to assist entities with evaluating when a set of transferred assets and activities is a business. The ASU requires an entity to evaluate if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets; if so, the set of transferred assets and activities is not a business. The guidance also requires a business to include at least one substantive process and narrows the definition of outputs by more closely aligning it with how outputs are described in ASC 606. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2017, with early adoption permitted. The Company's adoption of this ASU did not have a material impact on the Company's financial condition, results of operations or financial statement disclosures, but will impact how the Company accounts for any future transfers of sets of assets and activities.

Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income

In February 2018, the FASB issued ASU No. 2018-02, which permits entities to reclassify tax effects stranded in accumulated other comprehensive income as a result of the Tax Cuts and Jobs Act, or TCJA, to retained earnings and requires entities to disclose whether or not they elected to reclassify the tax effects related to the TCJA as well as their policy for releasing income tax effects from accumulated other comprehensive income. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2018, with early adoption permitted. Early adoption of this ASU was elected and applied by recording a cumulative-effect adjustment of $9.9 million to retained earnings, with the offsetting impact to accumulated other comprehensive income as of January 1, 2018.

Accounting for Share-Based Payments to Nonemployees

In June 2018, the FASB issued ASU No. 2018-07 to simplify the accounting for share-based payments to nonemployees by aligning it with the accounting for share-based payments to employees, with certain exceptions. Under the guidance, equity-classified nonemployee awards will be measured on and fixed at the grant date, rather than measured at fair value at each reporting date until the date at which the nonemployee's performance is complete. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2018, with early adoption permitted. Early adoption of this ASU was elected subsequent to quarter-end on July 1, 2018 and applied by recording a cumulative-effect adjustment to retained earnings as of January 1, 2018, which did not have a material impact on the Company's financial condition, results of operations or financial statement disclosures.

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Note 3. Discontinued Operations

On June 28, 2017, the Company contributed its equity interests in its wholly owned subsidiary, TH Commercial Holdings LLC, to Granite Point and, in exchange for its contribution, received approximately 33.1 million shares of common stock of Granite Point, representing approximately 76.5% of the outstanding stock of Granite Point upon completion of the IPO of its common stock on June 28, 2017. On November 1, 2017, the Company distributed, on a pro rata basis, the 33.1 million shares of Granite Point common stock that it acquired in connection with the contribution to stockholders holding shares of Two Harbors common stock outstanding as of the close of business on October 20, 2017. Due to the Company's controlling ownership interest in Granite Point through November 1, 2017, its results of operations and financial condition through such date reflect Granite Point's commercial strategy, which includes as target assets first mortgages, mezzanine loans, B-notes and preferred equity. As of November 1, 2017, the Company no longer has a controlling interest in Granite Point and, therefore, has deconsolidated Granite Point and its subsidiaries from its financial statements and reclassified all of Granite Point's prior period assets, liabilities and results of operations to discontinued operations. In accordance with ASC 845, Nonmonetary Transactions, the pro rata distribution of a consolidated subsidiary is recognized at carrying amount within stockholders' equity. As a result, no gain or loss was recognized on the distribution.

Summarized financial information for the discontinued operations are presented below.

(in thousands)	November 1, 2017
Assets:	
Commercial real estate assets	$2,233,080
Available-for-sale securities, at fair value	12,814
Cash and cash equivalents	84,183
Restricted cash	2,838
Accrued interest receivable	6,588
Other assets	22,774
Total Assets	$2,362,277
Liabilities:	
Repurchase agreements	$1,516,294
Dividends payable	48
Other liabilities	10,337
Total Liabilities	$1,526,679

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	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
(in thousands)	2018	2017	2018	2017
Interest income:				
Commercial real estate assets	$—	$25,840	$—	$49,410
Available-for-sale securities	—	256	—	502
Other	—	4	—	6
Total interest income	—	26,100	—	49,918
Interest expense	—	7,773	—	13,879
Net interest income	—	18,327	—	36,039
Expenses:				
Management fees	—	1,925	—	3,587
Servicing expenses	—	307	—	629
Other operating expenses	—	1,900	—	4,173
Total expenses	—	4,132	—	8,389
Income from discontinued operations before income taxes	—	14,195	—	27,650
Benefit from income taxes	—	(2)	—	(1)
Income from discontinued operations	—	14,197	—	27,651
Income from discontinued operations attributable to noncontrolling interest	—	40	—	40
Income from discontinued operations attributable to common stockholders	$—	$14,157	$—	$27,611

Note 4. Available-for-Sale Securities, at Fair Value

The Company holds AFS investment securities which are carried at fair value on the condensed consolidated balance sheets. The following table presents the Company's AFS investment securities by collateral type as of June 30, 2018 and December 31, 2017:

(in thousands)	June 30, 2018	December 31, 2017
Agency		
Federal National Mortgage Association	$12,102,934	$13,920,721
Federal Home Loan Mortgage Corporation	3,017,056	3,616,967
Government National Mortgage Association	669,001	701,037
Non-Agency	3,504,363	2,982,094
Total available-for-sale securities	$19,293,354	$21,220,819

At June 30, 2018 and December 31, 2017, the Company pledged AFS securities with a carrying value of $19.0 billion and $21.0 billion, respectively, as collateral for repurchase agreements and advances from the Federal Home Loan Bank of Des Moines, or the FHLB. See Note 13 - Repurchase Agreements and Note 14 - Federal Home Loan Bank of Des Moines Advances.

At June 30, 2018 and December 31, 2017, the Company did not have any securities purchased from and financed with the same counterparty that did not meet the conditions of ASC 860, to be considered linked transactions and, therefore, classified as derivatives.

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The Company is not required to consolidate VIEs for which it has concluded it does not have both the power to direct the activities of the VIEs 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's investments in these unconsolidated VIEs include all non-Agency securities, which are classified within available-for-sale securities, at fair value on the condensed consolidated balance sheets. As of June 30, 2018 and December 31, 2017, the carrying value, which also represents the maximum exposure to loss, of all non-Agency securities in unconsolidated VIEs was $3.5 billion and $3.0 billion, respectively.
The following tables present the amortized cost and carrying value (which approximates fair value) of AFS securities by collateral type as of June 30, 2018 and December 31, 2017:

	June 30, 2018							
(in thousands)	Principal/ Current Face	Un-amortized Premium	Accretable Purchase Discount	Credit Reserve Purchase Discount	Amortized Cost	Unrealized Gain	Unrealized Loss	Carrying Value
Agency								
Principal and interest	$15,178,924	$960,177	$(24,315)	$—	$16,114,786	$9,494	$(532,602)	$15,591,678
Interest-only	3,377,698	229,293	—	—	229,293	15,728	(47,708)	197,313
Total Agency	18,556,622	1,189,470	(24,315)	—	16,344,079	25,222	(580,310)	15,788,991
Non-Agency								
Principal and interest	4,470,380	6,425	(664,948)	(923,834)	2,888,023	549,072	(7,707)	3,429,388
Interest-only	5,349,634	73,708	—	—	73,708	3,843	(2,576)	74,975
Total Non-Agency	9,820,014	80,133	(664,948)	(923,834)	2,961,731	552,915	(10,283)	3,504,363
Total	$28,376,636	$1,269,603	$(689,263)	$(923,834)	$19,305,810	$578,137	$(590,593)	$19,293,354

	December 31, 2017							
(in thousands)	Principal/ Current Face	Un-amortized Premium	Accretable Purchase Discount	Credit Reserve Purchase Discount	Amortized Cost	Unrealized Gain	Unrealized Loss	Carrying Value
Agency								
Principal and interest	$17,081,849	$1,079,246	$(24,638)	$—	$18,136,457	$42,149	$(134,969)	$18,043,637
Interest-only	2,941,772	223,289	—	—	223,289	10,955	(39,156)	195,088
Total Agency	20,023,621	1,302,535	(24,638)	—	18,359,746	53,104	(174,125)	18,238,725
Non-Agency								
Principal and interest	3,758,134	2,757	(676,033)	(653,613)	2,431,245	488,931	(3,166)	2,917,010
Interest-only	5,614,925	65,667	—	—	65,667	2,163	(2,746)	65,084
Total Non-Agency	9,373,059	68,424	(676,033)	(653,613)	2,496,912	491,094	(5,912)	2,982,094
Total	$29,396,680	$1,370,959	$(700,671)	$(653,613)	$20,856,658	$544,198	$(180,037)	$21,220,819

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The following tables present the carrying value of the Company’s AFS securities by rate type as of June 30, 2018 and December 31, 2017:

	June 30, 2018		
(in thousands)	Agency	Non-Agency	Total
Adjustable Rate	$20,611	$ 3,175,732	$3,196,343
Fixed Rate	15,768,380	328,631	16,097,011
Total	$15,788,991	$ 3,504,363	$19,293,354

	December 31, 2017		
(in thousands)	Agency	Non-Agency	Total
Adjustable Rate	$23,220	$ 2,622,710	$2,645,930
Fixed Rate	18,215,505	359,384	18,574,889
Total	$18,238,725	$ 2,982,094	$21,220,819

The following table presents the Company’s AFS securities according to their estimated weighted average life classifications as of June 30, 2018:

	June 30, 2018		
(in thousands)	Agency	Non-Agency	Total
≤ 1 year	$7,054	$ 82,833	$89,887
> 1 and ≤ 3 years	39,666	109,416	149,082
> 3 and ≤ 5 years	275,305	410,861	686,166
> 5 and ≤ 10 years	12,156,899	2,151,623	14,308,522
> 10 years	3,310,067	749,630	4,059,697
Total	$15,788,991	$ 3,504,363	$19,293,354

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 the Company does not expect to collect the entire discount 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 three and six months ended June 30, 2018 and 2017 of the net unamortized discount/premium and designated credit reserves on non-Agency AFS securities.

	Six Months Ended June 30,					
	2018			2017		
(in thousands)	Designated Credit Reserve	Net Unamortized Discount/Premium	Total	Designated Credit Reserve	Net Unamortized Discount/Premium	Total
Beginning balance at January 1	$(653,613)	$ (607,609)	$(1,261,222)	$(367,437)	$ (623,440)	$(990,877)
Acquisitions	(310,985)	(14,025)	(325,010)	(100,558)	(78,796)	(179,354)
Accretion of net discount	—	44,611	44,611	—	44,301	44,301
Realized credit losses	14,810	—	14,810	8,424	—	8,424
Reclassification adjustment for other-than-temporary impairments	(268)	—	(268)	(429)	—	(429)
Transfers from (to)	26,222	(26,222)	—	22,676	(22,676)	—
Sales, calls, other	—	18,430	18,430	3,588	52,063	55,651
Ending balance at June 30	$(923,834)	$ (584,815)	$(1,508,649)	$(433,736)	$ (628,548)	$(1,062,284)

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 that the securities had an unrealized loss position as of June 30, 2018 and December 31, 2017. At June 30, 2018, the Company held 1,464 AFS securities, of which 525 were in an unrealized loss position for less than twelve consecutive months and 228 were in an unrealized loss position for more than twelve consecutive months. At December 31, 2017, the Company held 1,435 AFS securities, of which 253 were in an unrealized loss position for less than twelve consecutive months and 234 were in an unrealized loss position for more than twelve consecutive months. Of the $13.5 billion and $12.2 billion of AFS securities in an unrealized loss position for less than twelve consecutive months as of June 30, 2018 and December 31, 2017, $13.1 billion, or 97.0%, and $12.0 billion, or 98.5%, respectively, were Agency AFS securities, whose principal and interest are guaranteed by the 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
June 30, 2018	$13,496,177	$(404,135)	$2,291,284	$(186,458)	$15,787,461	$(590,593)
December 31, 2017	$12,198,870	$(65,313)	$2,464,544	$(114,724)	$14,663,414	$(180,037)

Evaluating AFS Securities for Other-Than-Temporary Impairments

In evaluating 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 will not be 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 either other comprehensive (loss) income, net of tax, or (loss) gain on investment securities, depending on the accounting treatment. 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.

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During the three and six months ended June 30, 2018, the Company recorded $0.2 million and $0.3 million in other-than-temporary credit impairments on a total of two non-Agency securities where the future expected cash flows for each security were less than its amortized cost. During both the three and six months ended June 30, 2017, the Company recorded $0.4 million in other-than-temporary credit impairments on one non-Agency security where its future expected cash flows were less than its amortized cost. As of June 30, 2018, impaired securities with a carrying value of $127.6 million had actual weighted average cumulative losses of 6.7%, weighted average three-month prepayment speed of 8.3%, weighted average 60+ day delinquency of 20.3% of the pool balance, and weighted average FICO score of 662. At June 30, 2018, 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.

The following table presents the changes in OTTI included in earnings for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
(in thousands)	2018	2017	2018	2017
Cumulative credit loss at beginning of period	$(6,489)	$(5,606)	$(6,395)	$(5,606)
Additions:				
Other-than-temporary impairments not previously recognized	(85)	(429)	(85)	(429)
Increases related to other-than-temporary impairments on securities with previously recognized other-than-temporary impairments	(89)	—	(183)	—
Reductions:				
Decreases related to other-than-temporary impairments on securities paid down	—	—	—	—
Decreases related to other-than-temporary impairments on securities sold	—	—	—	—
Cumulative credit loss at end of period	$(6,663)	$(6,035)	$(6,663)	$(6,035)

Cumulative credit losses related to OTTI may be reduced for securities sold as well as for securities that mature, are paid 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 (loss) gain on investment securities in the Company’s condensed consolidated statements of comprehensive income. For the three and six months ended June 30, 2018, the Company sold AFS securities for $1.7 billion and $3.7 billion with an amortized cost of $1.7 billion and $3.8 billion for net realized losses of $39.0 million and $58.6 million, respectively. For the three and six months ended June 30, 2017, the Company sold AFS securities for $2.7 billion and $5.1 billion with an amortized cost of $2.6 billion and $5.1 billion for net realized gains of $33.3 million and losses of $17.1 million, respectively.

The following table presents the gross realized gains and losses on sales of AFS securities for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
(in thousands)	2018	2017	2018	2017
Gross realized gains	$1,559	$47,994	$9,754	$56,725

Gross realized losses	(40,559)	(14,649)	(68,317)	(73,783)
Total realized (losses) gains on sales, net	$(39,000)	$33,345	$(58,563)	$(17,058)

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Note 5. Servicing Activities
Mortgage Servicing Rights, at Fair Value
One of the Company's wholly owned subsidiaries has approvals from Fannie Mae and Freddie Mac to own and manage MSR, which represent the right to control the servicing of mortgage loans. The Company and its subsidiaries do not originate or directly service mortgage loans, and instead contract with appropriately licensed subservicers to handle substantially all servicing functions in the name of the subservicer for the loans underlying the Company's MSR.
The following table summarizes activity related to MSR for the three and six months ended June 30, 2018 and 2017.

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2018	2017	2018	2017
Balance at beginning of period	$1,301,023	$747,580	$1,086,717	$693,815
Additions from purchases of mortgage servicing rights	132,366	196,920	279,265	273,876
Additions from sales of residential mortgage loans	—	—	—	20
Subtractions from sales of mortgage servicing rights	—	(946)	—	(946)
Changes in fair value due to:				
Changes in valuation inputs or assumptions used in the valuation model	46,221	(26,111)	146,930	(22,929)
Other changes in fair value (1)	(36,467)	(19,951)	(65,669)	(37,948)
Other changes (2)	7,118	533	3,018	(7,863)
Balance at end of period	$1,450,261	$898,025	$1,450,261	$898,025

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

At June 30, 2018 and December 31, 2017, the Company pledged MSR with a carrying value of $1.3 billion and $0.6 billion, respectively, as collateral for repurchase agreements and revolving credit facilities. See Note 13 - Repurchase Agreements and Note 15 - Revolving Credit Facilities.
As of June 30, 2018 and December 31, 2017, 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:

(dollars in thousands)	June 30, 2018	December 31, 2017
Weighted average prepayment speed:	7.7 %	9.8 %
Impact on fair value of 10% adverse change	$(41,381)	$(40,100)
Impact on fair value of 20% adverse change	$(80,635)	$(77,483)
Weighted average delinquency:	1.2 %	1.7 %
Impact on fair value of 10% adverse change	$(5,124)	$(4,274)
Impact on fair value of 20% adverse change	$(10,152)	$(8,875)
Weighted average discount rate:	10.0 %	9.9 %
Impact on fair value of 10% adverse change	$(48,632)	$(35,137)
Impact on fair value of 20% adverse change	$(94,122)	$(68,246)

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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.

Risk Mitigation Activities

The primary risk associated with 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 its Agency RMBS portfolio.

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 six months ended June 30, 2018 and 2017:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
(in thousands)	2018	2017	2018	2017
Servicing fee income	$70,883	$49,434	$137,332	$87,934
Ancillary and other fee income	324	165	646	305
Float income	6,458	1,709	10,877	2,842
Total	$77,665	$51,308	$148,855	$91,081

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 $28.7 million and $31.1 million and were included in other assets on the condensed consolidated balance sheets as of June 30, 2018 and December 31, 2017, respectively.

Serviced Mortgage Assets

The Company's total serviced mortgage assets consist of residential mortgage loans underlying MSR, residential mortgage loans held in previous on-balance sheet securitization trusts for which the Company is the named servicing administrator and loans owned and classified as residential mortgage loans held-for-sale. 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 June 30, 2018 and December 31, 2017:

	June 30, 2018		December 31, 2017	
(dollars in thousands)	Number of Loans	Unpaid Principal Balance	Number of Loans	Unpaid Principal Balance
Mortgage servicing rights	530,395	$119,531,589	454,028	$101,344,054
Residential mortgage loans in securitization trusts	3,723	2,500,663	3,845	2,618,016
Residential mortgage loans held-for-sale	215	34,965	236	37,632
Other assets	21	1,846	24	2,590

Total serviced mortgage assets	534,354	$122,069,063	458,133	$104,002,292

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Note 6. Residential Mortgage Loans Held-for-Sale, at Fair Value
Residential 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 residential mortgage loans held-for-sale as of June 30, 2018 and December 31, 2017:

(in thousands)	June 30, 2018	December 31, 2017
Unpaid principal balance	$34,965	$ 37,632
Fair value adjustment	(6,152)	(7,218)
Carrying value	$28,813	$ 30,414

Note 7. Cash, Cash Equivalents and Restricted Cash
Cash and cash equivalents include cash held in bank accounts and cash held in money market funds on an overnight basis.
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.
The following table presents the Company’s restricted cash balances as of June 30, 2018 and December 31, 2017:

(in thousands)	June 30, 2018	December 31, 2017
Restricted cash balances held by trading counterparties:		
For securities and loan trading activity	$27,050	$ 27,050
For derivatives trading activity	187,769	191,421
As restricted collateral for repurchase agreements and Federal Home Loan Bank advances	349,539	417,018
Total restricted cash balances held by trading counterparties	564,358	635,489
Restricted cash balance pursuant to letter of credit on office lease	347	347
Total	$564,705	$ 635,836

The following table provides a reconciliation of cash, cash equivalents, and restricted cash reported on the Company’s condensed consolidated balance sheets as of June 30, 2018 and December 31, 2017 that sum to the total of the same such amounts shown in the statements of cash flows:

(in thousands)	June 30, 2018	December 31, 2017
Cash and cash equivalents	$417,515	$ 419,159
Restricted cash	564,705	635,836
Total cash, cash equivalents and restricted cash	$982,220	$ 1,054,995

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Note 8. Accrued Interest Receivable
The following table presents the Company's accrued interest receivable by collateral type as of June 30, 2018 and December 31, 2017:

(in thousands)	June 30, 2018	December 31, 2017
Available-for-sale securities:		
Agency		
Federal National Mortgage Association	$40,430	$ 46,517
Federal Home Loan Mortgage Corporation	10,591	12,255
Government National Mortgage Association	4,727	4,635
Non-Agency	5,207	4,740
Total available-for-sale securities	60,955	68,147
Residential mortgage loans held-for-sale	153	162
Total	$61,108	$ 68,309

Note 9. Derivative Instruments and Hedging Activities
The Company enters into a variety of derivative and non-derivative instruments in connection with its risk management activities. The 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, principally market risk and cash flow volatility associated with interest rate risk (including associated prepayment risk). Specifically, the Company enters into derivative and non-derivative instruments to economically hedge interest rate risk or "duration mismatch (or gap)" by adjusting the duration of its floating-rate borrowings into fixed-rate borrowings to more closely match the duration of its assets. This particularly applies to floating-rate borrowing agreements with maturities or interest rate resets of less than six months. Typically, the interest receivable terms (i.e., LIBOR) of certain derivatives match the terms of the underlying debt, resulting in an effective conversion of the rate of the related borrowing agreement from floating to fixed. The objective is to manage the cash flows associated with current and anticipated interest payments on borrowings, as well as the ability to roll or refinance borrowings at the desired amount by adjusting the duration.
To help manage the adverse impact of interest rate changes on the value of the Company's portfolio as well as its cash flows, the Company may, at times, enter into various forward contracts, including short securities, Agency to-be-announced securities, or TBAs, options, futures, swaps, caps and 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 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 MSR and Agency interest-only securities (see discussion below).
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 these risks. The discussion includes both derivative and non-derivative instruments used as part of these risk management activities. Any of the Company's derivative and non-derivative instruments may be entered into in conjunction with one another in order to mitigate risks. As a result, the following discussions of each type of instrument should be read as a collective representation of the Company's risk mitigation efforts and should not be considered independent of one another. While the Company uses derivative and non-derivative instruments to achieve the Company's risk management activities, it is possible that these instruments will not effectively mitigate all or a substantial portion of the Company's market rate risk. In addition, the Company might elect, at times, not to enter into certain hedging arrangements in order to maintain compliance with REIT requirements.
Balance Sheet Presentation

In accordance with ASC 815, Derivatives and Hedging, or ASC 815, the Company records derivative financial instruments on its condensed consolidated balance sheets 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 are designated or qualifying as hedge instruments. Due to the volatility of the credit markets and difficulty in effectively matching pricing or cash flows, the Company has not designated any current derivatives as hedging instruments.

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The following tables present the gross fair value and notional amounts of the Company’s derivative financial instruments treated as trading derivatives as of June 30, 2018 and December 31, 2017.

	June 30, 2018			
	Derivative Assets		Derivative Liabilities	
(in thousands)	Fair Value	Notional	Fair Value	Notional
Inverse interest-only securities	$74,328	$529,056	$—	$—
Interest rate swap agreements	161,863	21,410,697	—	4,636,567
Swaptions, net	9,474	155,000	(12,305)	583,000
TBAs	12,252	5,877,000	(18,190)	2,828,000
Put and call options for TBAs, net	—	—	(8,639)	320,000
Markit IOS total return swaps	—	—	(295)	51,541
Total	$257,917	$27,971,753	$(39,429)	$8,419,108

	December 31, 2017			
	Derivative Assets		Derivative Liabilities	
(in thousands)	Fair Value	Notional	Fair Value	Notional
Inverse interest-only securities	$91,827	$588,246	$—	$—
Interest rate swap agreements	206,773	21,516,125	(29,867)	6,966,000
Swaptions, net	10,405	2,666,000	—	—
TBAs	913	733,000	(1,930)	1,306,000
Markit IOS total return swaps	—	—	(106)	63,507
Total	$309,918	$25,503,371	$(31,903)	$8,335,507

Comprehensive Income Statement Presentation
The Company has not applied hedge accounting to its current derivative portfolio held to mitigate interest rate risk and credit risk. As a result, the Company is subject to volatility in its earnings due to movement in the unrealized gains and losses associated with its 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:

Derivative Instruments	Location of Gain (Loss) Recognized in Income on Derivatives	Amount of Gain (Loss) Recognized in Income on Derivatives			
		Three Months Ended		Six Months Ended	
(in thousands)		June 30,		June 30,	
		2018	2017	2018	2017
Interest rate risk management					
TBAs	Gain (loss) on other derivative instruments	$12,131	$(15,321)	$(10,535)	$(28,780)
Put and call options for TBAs	Gain (loss) on other derivative instruments	(2,396)	(7,822)	29,839	(19,062)
Interest rate swap agreements - Payers	Gain (loss) on interest rate swap and swaption agreements	63,991	(72,873)	307,096	(45,145)
Interest rate swap agreements - Receivers	Gain (loss) on interest rate swap and swaption agreements	(43,907)	25,527	(197,722)	28,093
Swaptions	Gain (loss) on interest rate swap and swaption agreements	9,049	(29,364)	70,304	(49,731)
Markit IOS total return swaps	Gain (loss) on other derivative instruments	(220)	(790)	673	(687)
Non-risk management					
Inverse interest-only securities	Gain (loss) on other derivative instruments	(1,840)	4,393	(4,249)	1,125
Total		$36,808	$(96,250)	$195,406	$(114,187)

For the three and six months ended June 30, 2018, the Company recognized $13.8 million and $17.6 million, respectively, of income for the accrual and/or settlement of the net interest expense associated with its interest rate swaps. The income results from receiving either LIBOR interest or a fixed interest rate and paying either a fixed interest rate or LIBOR interest on an average $25.4 billion and $23.3 billion notional, respectively. For the three and six months ended June 30, 2017, the Company recognized $2.6 million and $10.5 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 and receiving either LIBOR interest or a fixed interest rate on an average $17.5 billion and $18.1 billion notional, respectively.
The following tables present information with respect to the volume of activity in the Company's derivative instruments during the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30, 2018					
(in thousands)	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net [(1)]
Inverse interest-only securities	$558,942	$—	$(29,886)	$529,056	$545,159	$—
Interest rate swap agreements	23,598,825	7,740,752	(5,292,313)	26,047,264	25,377,155	(35,568)
Swaptions, net	(6,175,000)	(23,000)	5,460,000	(738,000)	(4,263,868)	15,119
TBAs, net	445,000	6,482,000	(3,878,000)	3,049,000	2,341,879	6,222
Put and call options for TBAs, net	(60,000)	(1,468,000)	1,208,000	(320,000)	203,429	(19,661)

Markit IOS total return swaps	61,521	—	(9,980)	51,541	59,594	(249)
Total	$18,429,288	$12,731,752	$(2,542,179)	$28,618,861	$24,263,348	$(34,137)

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	Three Months Ended June 30, 2017					
(in thousands)	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net (1)
Inverse interest-only securities	$698,826	$—	$(39,058)	$659,768	$681,216	$—
Interest rate swap agreements	18,252,440	4,476,986	(7,964,707)	14,764,719	17,470,672	(39,626)
Swaptions, net	(3,880,000)	(375,000)	5,605,000	1,350,000	1,249,341	9,543
TBAs, net	(993,000)	(1,039,400)	892,400	(1,140,000)	(24,728)	(31,021)
Put and call options for TBAs, net	1,770,000	1,285,000	(1,770,000)	1,285,000	96,319	(14,623)
Markit IOS total return swaps	87,269	—	(18,640)	68,629	75,282	(181)
Total	$15,935,535	$4,347,586	$(3,295,005)	$16,988,116	$19,548,102	$(75,908)

	Six Months Ended June 30, 2018					
(in thousands)	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net (1)
Inverse interest-only securities	$588,246	$—	$(59,190)	$529,056	$559,844	$—
Interest rate swap agreements	28,482,125	25,349,632	(27,784,493)	26,047,264	23,272,892	4,138
Swaptions, net	2,666,000	(1,238,000)	(2,166,000)	(738,000)	(3,092,050)	67,892
TBAs, net	(573,000)	17,713,000	(14,091,000)	3,049,000	1,563,801	(5,614)
Put and call options for TBAs, net	—	4,602,000	(4,922,000)	(320,000)	(327,917)	38,542
Markit IOS total return swaps	63,507	—	(11,966)	51,541	60,864	(249)
Total	$31,226,878	$46,426,632	$(49,034,649)	$28,618,861	$22,037,434	$104,709

	Six Months Ended June 30, 2017					
(in thousands)	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise	End of Period Notional Amount	Average Notional Amount	Realized Gain (Loss), net (1)
Inverse interest-only securities	$740,844	$—	$(81,076)	$659,768	$700,941	$—
Interest rate swap agreements	20,371,063	13,529,809	(19,136,153)	14,764,719	18,085,752	11,520
Swaptions, net	225,000	(4,255,000)	5,380,000	1,350,000	(98,923)	24,428
TBAs, net	(1,489,000)	(4,125,400)	4,474,400	(1,140,000)	(12,431)	(42,427)
Put and call options for TBAs, net	(1,136,000)	2,555,000	(134,000)	1,285,000	(63,387)	24,146
Markit IOS total return swaps	90,593	—	(21,964)	68,629	81,686	(181)
Total	$18,802,500	$7,704,409	$(9,518,793)	$16,988,116	$18,693,638	$17,486

(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. Realized gains and losses and derivative fair value adjustments are reflected within the realized and unrealized (gain) loss on interest rate swaps and swaptions and unrealized loss on other derivative instruments line items within the operating activities section of the condensed consolidated statements of cash flows. The remaining cash flow activity related to derivative instruments is reflected within the (purchases) short sales of other derivative instruments, proceeds from sales (payments for termination) of other derivative instruments, net and increase (decrease) in due to counterparties, net line items within the investing activities section of the condensed consolidated statements of cash flows.

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Interest Rate Sensitive Assets/Liabilities
The Company’s Agency RMBS portfolio is generally subject to change in value when mortgage rates decline or increase, depending on the type of investment. Rising mortgage rates generally result in a slowing of refinancing activity, which slows prepayments and results in a decline in the value of the Company’s fixed-rate Agency pools. To mitigate the impact of this risk on the Company’s fixed-rate Agency pool portfolio, the Company maintains a portfolio of fixed-rate interest-only securities and MSR, which increase in value when interest rates increase. As of June 30, 2018 and December 31, 2017, the Company had $146.9 million and $117.8 million, respectively, of interest-only securities, and $1.5 billion and $1.1 billion, respectively, of MSR in place to economically hedge its Agency RMBS. Interest-only securities are included in AFS securities, at fair value, in the condensed consolidated balance sheets.
The Company monitors its borrowings under repurchase agreements, FHLB advances and revolving credit facilities, which are generally floating-rate debt, in relation to the rate profile of its portfolio. In connection with its risk management activities, the Company enters into a variety of derivative and non-derivative instruments to economically hedge interest rate risk or “duration mismatch (or gap)” by adjusting the duration of its floating-rate borrowings into fixed-rate borrowings to more closely match the duration of its assets. 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 certain derivatives match the terms of the underlying debt, resulting in an effective conversion of the rate of the related borrowing agreement from floating to fixed. The objective is to manage the cash flows associated with current and anticipated interest payments on borrowings, as well as the ability to roll or refinance borrowings at the desired amount by adjusting the duration. To help manage the adverse impact of interest rate changes on the value of the Company’s portfolio as well as its cash flows, 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 interest rate risk management strategy, the Company has entered into TBAs, put and call options for TBAs, interest rate swap and swaption agreements and Markit IOS total return swaps.
TBAs. At times, the Company may use TBAs as a means of deploying capital until targeted investments are available or to take advantage of temporary displacements, funding advantages or valuation differentials in the marketplace. Additionally, the Company may use TBAs independently, or in conjunction with other derivative and non-derivative instruments, in order to mitigate risks. 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.
The Company may hold both long and short notional TBA positions, which are disclosed on a gross basis according to the unrealized gain or loss position of each TBA contract regardless of long or short notional position. The following tables present the notional amount, cost basis, market value and carrying value (which approximates fair value) of the Company’s TBA positions as of June 30, 2018 and December 31, 2017:

	June 30, 2018				
				Net Carrying Value (4)	
(in thousands)	Notional Amount (1)	Cost Basis (2)	Market Value (3)	Derivative Assets	Derivative Liabilities
Purchase contracts	$5,877,000	$6,098,606	$6,110,858	$12,252	$—
Sale contracts	(2,828,000)	(2,796,996)	(2,815,186)	—	(18,190)
TBAs, net	$3,049,000	$3,301,610	$3,295,672	$12,252	$(18,190)

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	December 31, 2017				
				Net Carrying Value (4)	
(in thousands)	Notional Amount (1)	Cost Basis (2)	Market Value (3)	Derivative Assets	Derivative Liabilities
Purchase contracts	$733,000	$769,446	$770,359	$913	$ —
Sale contracts	(1,306,000)	(1,316,367)	(1,318,297)	—	(1,930)
TBAs, net	$(573,000)	$(546,921)	$(547,938)	$913	$ (1,930)

(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. The Company may use put and call options for TBAs independently, or in conjunction with other derivative and non-derivative instruments, in order to mitigate risks. As of June 30, 2018, the Company had purchased put and call options for TBAs with a notional amount of $4.8 billion and short sold put and call options for TBAs with a notional amount of $5.1 billion. The put and call options had a fair market value of $8.6 million included in derivative liabilities, at fair value, on the condensed consolidated balance sheet as of June 30, 2018. The Company did not hold any put and call options for TBAs as of December 31, 2017.

Interest Rate Swap Agreements. The Company may use interest rate swaps independently, or in conjunction with other derivative and non-derivative instruments, in order to mitigate risks. As of June 30, 2018 and December 31, 2017, the Company held the following interest rate swaps that were utilized as economic hedges of interest rate exposure (or duration) whereby the Company receives interest at a three-month LIBOR rate:

(notional in thousands)
June 30, 2018

Swaps Maturities	Notional Amount (1)	Weighted Average Fixed Pay Rate (2)	Weighted Average Receive Rate (2)	Weighted Average Maturity (Years) (2)
2018	$2,020,000	1.289 %	2.318 %	0.35
2019	4,336,897	1.769 %	2.358 %	1.29
2020	2,890,000	1.785 %	2.327 %	2.31
2021	2,417,000	1.788 %	2.339 %	3.42
2022 and Thereafter	6,510,929	2.407 %	2.345 %	8.03
Total	$18,174,826	1.926 %	2.341 %	3.84

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(notional in thousands)
December 31, 2017

Swaps Maturities	Notional Amount (1)	Weighted Average Fixed Pay Rate (2)	Weighted Average Receive Rate (2)	Weighted Average Maturity (Years) (2)
2018	$4,320,000	1.155 %	1.508 %	0.50
2019	5,448,135	1.767 %	1.386 %	1.79
2020	5,490,000	1.945 %	1.509 %	2.87
2021	2,417,000	1.788 %	1.628 %	3.92
2022 and Thereafter	5,245,000	1.764 %	1.516 %	6.44
Total	$22,920,135	1.694 %	1.493 %	3.01

(1) Notional amount includes $874.8 million and $570.0 million in forward starting interest rate swaps as of June 30, 2018 and December 31, 2017, respectively.
(2) Weighted averages exclude forward starting interest rate swaps. As of June 30, 2018 and December 31, 2017, the weighted average fixed pay rate on forward starting interest rate swaps was 2.6% and 2.1%, respectively.

Additionally, as of June 30, 2018 and December 31, 2017, the Company held the following interest rate swaps in order to mitigate mortgage interest rate exposure (or duration) risk whereby the Company pays interest at a three-month LIBOR rate:
(notional in thousands)
June 30, 2018

Swaps Maturities	Notional Amounts	Weighted Average Pay Rate	Weighted Average Fixed Receive Rate	Weighted Average Maturity (Years)
2020	$450,000	1.984 %	2.362 %	1.80
2021	2,977,438	2.499 %	2.362 %	2.71
2022 and Thereafter	4,445,000	2.534 %	2.333 %	6.87
Total	$7,872,438	2.489 %	2.345 %	5.01

(notional in thousands)
December 31, 2017

Swaps Maturities	Notional Amounts	Weighted Average Pay Rate	Weighted Average Fixed Receive Rate	Weighted Average Maturity (Years)
2020	$200,000	1.391 %	1.642 %	2.60
2021	500,000	1.357 %	1.327 %	3.05
2022 and Thereafter	4,861,990	1.475 %	2.325 %	8.34
Total	$5,561,990	1.462 %	2.211 %	7.66

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Interest Rate Swaptions. The Company may use 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) independently, or in conjunction with other derivative and non-derivative instruments, in order to mitigate risks. As of June 30, 2018 and December 31, 2017, the Company had the following outstanding interest rate swaptions that were utilized as macro-economic hedges:

	June 30, 2018							
(notional and dollars in thousands)	Option				Underlying Swap			
Swaption	Expiration	Cost Basis	Fair Value	Average Months to Expiration	Notional Amount	Average Pay Rate	Average Receive Rate	Average Term (Years)
Purchase contracts:								
Payer	< 6 Months	$9,680	$10,664	0.85	$2,545,000	2.91 %	3M Libor	5.9
Sale contracts:								
Payer	≥ 6 Months	$(6,808)	$(4,846)	8.20	$(280,000)	2.99 %	3M Libor	10.0
Receiver	< 6 Months	$(9,730)	$(3,187)	3.75	$(2,723,000)	3M Libor	2.40 %	5.9
Receiver	≥ 6 Months	$(6,962)	$(5,462)	8.20	$(280,000)	3M Libor	2.99 %	10.0

	December 31, 2017							
(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	$21,380	$17,736	4.03	$7,200,000	2.27 %	3M Libor	3.8
Receiver	< 6 Months	$4,660	$2,982	3.72	$2,300,000	3M Libor	2.10 %	10.0
Sale contracts:								
Payer	< 6 Months	$(7,950)	$(5,619)	4.66	$(1,693,000)	2.70 %	3M Libor	10.0
Receiver	< 6 Months	$(16,260)	$(4,694)	5.17	$(5,141,000)	3M Libor	1.89 %	5.6

Markit IOS Total Return Swaps. The Company may use 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) independently, or in conjunction with other derivative and non-derivative instruments, in order to mitigate risks. The Company enters into total return swaps to help mitigate the potential impact of larger increases or decreases in interest rates on the performance of our portfolio (referred to as "convexity risk"). Total return swaps based on the Markit IOS Index are intended to synthetically replicate the performance of interest-only securities. The Company had the following total return swap agreements in place

at June 30, 2018 and December 31, 2017:
(notional and dollars in thousands)
June 30, 2018

Maturity Date	Current Notional Amount	Fair Value	Cost Basis	Unrealized Gain (Loss)
January 12, 2043	$(22,808)	$(117)	$ 201	$ (318)
January 12, 2044	(28,733)	(178)	288	(466)
Total	$(51,541)	$(295)	$ 489	$ (784)

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(notional and dollars in thousands)
December 31, 2017

Maturity Date	Current Notional Amount	Fair Value	Cost Basis	Unrealized Gain (Loss)
January 12, 2043	$(24,362)	$(24)	$ 201	$ (225)
January 12, 2044	(39,145)	(82)	366	(448)
Total	$(63,507)	$(106)	$ 567	$ (673)

Credit Risk
The Company’s exposure to credit losses on its Agency RMBS portfolio is limited due to implicit or explicit backing from the GSEs. The payment of principal and interest on the Freddie Mac and Fannie Mae mortgage-backed securities are guaranteed by those respective agencies, and the payment of principal and interest on the Ginnie Mae mortgage-backed securities are backed by the full faith and credit of the U.S. government.
For non-Agency investment securities and residential mortgage loans, the Company may enter into credit default swaps to hedge credit risk. In future periods, the Company could enhance its credit risk protection, enter into further paired derivative positions, including both long and short credit default swaps, and/or seek opportunistic trades in the event of a market disruption (see discussion under “Non-Risk Management Activities” below). The Company also has processes and controls in place to monitor, analyze, manage and mitigate its credit risk with respect to non-Agency securities and residential mortgage loans.
Derivative financial instruments contain an element of credit risk if counterparties are unable to meet the terms of the agreements. Credit risk associated with derivative financial instruments is measured as the net replacement cost should the counterparties that owe the Company under such contracts completely fail to perform under the terms of these contracts, assuming there are no recoveries of underlying collateral, as measured by the market value of the derivative financial instruments. As of June 30, 2018, the fair value of derivative financial instruments as an asset and liability position was $257.9 million and $39.4 million, respectively.
The Company attempts to mitigate its credit risk exposure on derivative financial instruments by limiting its counterparties to banks and financial institutions that meet established credit guidelines. The Company also seeks to spread its credit risk exposure across multiple counterparties in order to reduce its exposure to any single counterparty. Additionally, the Company reduces credit risk on the majority of its derivative instruments by entering into agreements that permit the closeout and netting of transactions with the same counterparty or clearing agency, in the case of centrally cleared interest rate swaps, upon the occurrence of certain events. To further mitigate the risk of counterparty default, the Company maintains collateral agreements with certain of its counterparties and clearing agencies, which require both parties to maintain cash deposits in the event the fair values of the derivative financial instruments exceed established thresholds. The Company’s centrally cleared interest rate swaps require that the Company posts an “initial margin” amount determined by the clearing exchange, which is generally intended to be set at a level sufficient to protect the exchange from the interest rate swap’s maximum estimated single-day price movement. The Company also exchanges “variation margin” based upon daily changes in fair value, as measured by the exchange. As a result of amendments to rules governing certain central clearing activities, the exchange of variation margin is considered a settlement of the interest rate swap, as opposed to pledged collateral. Accordingly, beginning in the first quarter of 2018 and in subsequent periods, the Company accounts for the receipt or payment of variation margin as a direct reduction to the carrying value of the interest rate swap asset or liability. As of December 31, 2017, variation margin pledged or received was netted on a counterparty basis and classified within restricted cash, due from counterparties, or due to counterparties on the Company’s condensed consolidated balance sheets.
Non-Risk Management Activities

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

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Inverse Interest-Only Securities. As of June 30, 2018 and December 31, 2017, inverse interest-only securities with a carrying value of $74.3 million and $91.8 million, including accrued interest receivable of $0.7 million and $0.9 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 June 30, 2018 and December 31, 2017:

(in thousands)	June 30, 2018	December 31, 2017
Face Value	$529,056	$ 588,246
Amortized Cost	$77,740	$ 86,734
Gross unrealized gains	3,415	6,843
Gross unrealized losses	(7,505)	(2,602)
Market Value	$73,650	$ 90,975

Note 10. Other Assets
Other assets as of June 30, 2018 and December 31, 2017 are summarized in the following table:

(in thousands)	June 30, 2018	December 31, 2017
Property and equipment at cost	$6,870	$ 6,776
Accumulated depreciation (1)	(5,924)	(5,550)
Net property and equipment	946	1,226
Equity securities, at fair value	30,425	29,413
Prepaid expenses	1,830	1,755
Income taxes receivable	446	130
Deferred tax assets, net (2)	28,568	25,956
Servicing advances	28,718	31,050
Federal Home Loan Bank stock	40,845	53,826
Equity investments	3,000	3,000
Other receivables	32,152	29,482
Total other assets	$166,930	$ 175,838

(1) Depreciation expense for the three and six months ended June 30, 2018 was $0.2 million and $0.3 million, respectively.
(2) Net of valuation allowance of $2.4 million and $2.7 million, respectively.

Note 11. Other Liabilities
Other liabilities as of June 30, 2018 and December 31, 2017 are summarized in the following table:

(in thousands)	June 30, 2018	December 31, 2017
Accrued expenses	$23,999	$ 24,737
Other	1,728	3,043
Total other liabilities	$25,727	$ 27,780

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Note 12. Fair Value

Fair Value Measurements

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.

The 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.

Available-for-sale securities. The Company holds a portfolio of AFS securities that are carried at fair value in the condensed consolidated balance sheets and primarily comprised of Agency RMBS and non-Agency securities. The Company determines the fair value of its 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 securities, 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 principally to 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 99.2% and 0.8% of its AFS securities as Level 2 and Level 3 fair value assets, respectively, at June 30, 2018. AFS securities account for 91.6% of all assets reported at fair value at June 30, 2018.

Mortgage servicing rights. The Company holds a portfolio of MSR that are carried at fair value on the condensed consolidated balance sheets. The Company determines fair value of its MSR based on prices obtained from third-party pricing providers. Although MSR transactions are observable in the marketplace, the valuation is based upon cash flow models that include unobservable market data inputs (including prepayment speeds, delinquency levels and discount rates). As a result, the Company classified 100% of its MSR as Level 3 fair value assets at June 30, 2018.

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Residential mortgage loans held-for-sale. The Company holds residential mortgage loans held-for-sale that are carried at fair value in the condensed consolidated balance sheets as a result of a fair value option election. The Company determines fair value of its residential mortgage loans based on prices obtained from third-party pricing providers and other applicable market data. If observable market prices are not available or insufficient to determine fair value due principally to illiquidity in the marketplace, then fair value is based upon cash flow models that are primarily based on observable market-based inputs but also include unobservable market data inputs (including prepayment speeds, delinquency levels and credit losses). The Company classified 1.6% and 98.4% of its residential mortgage loans held-for-sale as Level 2 and Level 3 fair value assets, respectively, at June 30, 2018.

Derivative instruments. The Company may enter into a variety of derivative financial instruments as part of its hedging strategies. The Company principally executes over-the-counter, or OTC, derivative contracts, such as interest rate swaps, swaptions, put and call options for TBAs and Markit IOS total return swaps. The Company utilizes third-party pricing providers to value its financial derivative instruments. The Company classified 100% of the interest rate swaps, swaptions, put and call options for TBAs and Markit IOS total returns swaps reported at fair value as Level 2 at June 30, 2018.

The Company may also enter into certain other derivative financial instruments, such as TBAs, short U.S. Treasuries and inverse interest-only securities. These instruments are similar in form to the Company’s AFS securities and the Company utilizes a pricing service to value TBAs and broker quotes to value short U.S. Treasuries and inverse interest-only securities. The Company classified 100% of its inverse interest-only securities at fair value as Level 2 at June 30, 2018. The Company reported 100% of its TBAs as Level 1 as of June 30, 2018. The Company did not hold any short U.S. Treasuries at June 30, 2018.

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

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

Equity securities. The Company’s equity securities are carried at fair value and reported in other assets on the condensed consolidated balance sheets. Changes in fair value are recorded as a component of (loss) gain on investment securities in the condensed consolidated statements of comprehensive income. The Company determines fair value of its equity securities based on the closing market price of the securities at period end.

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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			
	June 30, 2018			
(in thousands)	Level 1	Level 2	Level 3	Total
Assets				
Available-for-sale securities	$—	$19,139,930	$153,424	$19,293,354
Mortgage servicing rights	—	—	1,450,261	1,450,261
Residential mortgage loans held-for-sale	—	462	28,351	28,813
Derivative assets	12,252	245,665	—	257,917
Equity securities	30,425	—	—	30,425
Total assets	$42,677	$19,386,057	$1,632,036	$21,060,770
Liabilities				
Derivative liabilities	$18,190	$21,239	$—	$39,429
Total liabilities	$18,190	$21,239	$—	$39,429

	Recurring Fair Value Measurements			
	December 31, 2017			
(in thousands)	Level 1	Level 2	Level 3	Total
Assets				