TWO HARBORS INVESTMENT CORP.
Form 10-K
February 27, 2019

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended: December 31, 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)

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class:	**Name of Exchange on Which Registered:**
Common Stock, par value $0.01 per share	New York Stock Exchange
8.125% Series A Cumulative Redeemable Preferred Stock	New York Stock Exchange
7.625% Series B Cumulative Redeemable Preferred Stock	New York Stock Exchange
7.25% Series C Cumulative Redeemable Preferred Stock	New York Stock Exchange
7.75% Series D Cumulative Redeemable Preferred Stock	New York Stock Exchange
7.50% Series E Cumulative Redeemable Preferred Stock	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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 every Interactive Data File required to be submitted 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 such files). Yes x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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.

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o	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

As of June 30, 2018, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was approximately $2.7 billion based on the closing sale price as reported on the NYSE on that date.

As of February 22, 2019 there were 251,080,610 shares of common stock, par value $.01 per share, issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for the 2019 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission under Regulation 14A within 120 days after the end of registrant's fiscal year covered by this Annual Report, are incorporated by reference into Part III.

TWO HARBORS INVESTMENT CORP.
2018 ANNUAL REPORT ON FORM 10-K
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PART I

Item 1. Business

Overview

Our Company

Two Harbors Investment Corp. is a Maryland corporation focused on 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, which we collectively refer to as our target assets. We operate as a real estate investment trust, or REIT, as defined under the Internal Revenue Code of 1986, as amended, or the Code. The terms “Two Harbors,” “we,” “our,” “us” and the “company” refer to Two Harbors Investment Corp. and its subsidiaries as a consolidated entity.

We were 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 our wholly owned indirect subsidiary as a result of the merger. Our common stock is listed on the New York Stock Exchange, or NYSE, under the symbol “TWO”.

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

Our target assets include the following:

- Agency RMBS, meaning RMBS whose principal and interest payments are guaranteed by the Government National Mortgage Association (or Ginnie Mae), the Federal National Mortgage Association (or Fannie Mae), or the Federal Home Loan Mortgage Corporation (or Freddie Mac);
- Non-Agency securities that are not issued or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac;
- MSR; and
- Other financial assets comprising approximately 5% to 10% of the portfolio.

We seek to deploy moderate leverage as part of our investment strategy. We generally finance our Agency RMBS and non-Agency securities through short- and long-term borrowings structured as repurchase agreements and advances from the Federal Home Loan Bank of Des Moines, or the FHLB. We also finance our MSR through repurchase agreements and revolving credit facilities.

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

Our Manager

We are externally managed and advised by PRCM Advisers LLC, or PRCM Advisers, a wholly-owned subsidiary of Pine River Capital Management L.P, or Pine River. Pine River formed PRCM Advisers for the purpose of providing management services to us. PRCM Advisers is responsible for administering our business activities and day-to-day operations. Pursuant to the terms of the management agreement between us and PRCM Advisers, PRCM Advisers provides us with our management team, including our executive officers and support personnel. In addition, PRCM Advisers provides us with the expertise of a dedicated team of investment professionals and other support. PRCM

Advisers is at all times subject to the supervision and oversight of our board of directors. Each of our executive officers is an employee or partner of Pine River; we do not have any employees. We do not pay any of our executive officers cash compensation; rather, we pay PRCM Advisers a base management fee equal to 1.5% per annum of our stockholders' equity, adjusted to exclude any unrealized gains, losses or other items that do not affect realized net income, among other adjustments, as defined by the management agreement. We also reimburse PRCM Advisers for the allocable share of the compensation paid by Pine River to its personnel serving as our principal financial officer and general counsel and other reimbursable costs under the management agreement. We do not pay PRCM Advisers any incentive-based fees or other incentive-based compensation.

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Through our relationship with PRCM Advisers, we benefit from Pine River's disciplined and highly analytical investment approach and extensive long-term relationships in the financial community. Pine River's disciplined investment process utilizes a cross-product approach, conducting top-down market assessments with respect to various subsets of the securities and mortgage market in order to identify the most attractive segments and investment opportunities. Our investment process leverages proprietary and third-party analytic tools to conduct a detailed analysis of factors that influence our target assets. We select our target assets after extensive analysis of the asset, including the underlying collateral, prepayment trends, average remaining life, amortization schedules, fixed versus floating interest rates, geographic concentration, property type, loan-to-value ratios and credit scores, among others. The dedicated team of investment professionals provided to us by PRCM Advisers has broad experience in managing our target assets and has demonstrated the ability to generate attractive risk-adjusted returns under different market conditions and cycles. Pine River maintains extensive long-term relationships with financial intermediaries, including prime brokers, investment banks, broker-dealers and asset custodians. We believe these relationships enhance our ability to source, finance, protect and hedge our investments and, thus, enable us to succeed in various credit and interest rate environments. We also benefit from Pine River's risk management, accounting, operations, legal, compliance and information technology teams. Through the contribution of resources employed by Pine River who have significant experience in managing our target assets and the use of experienced outside advisors, we believe that we have sufficient experience to execute on our business strategies.

Note Regarding Forward-Looking Statements

This Annual Report on Form 10-K contains, or incorporates by reference, not only historical information, but also forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act, and that are subject to the safe harbors created by such sections. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as "anticipate," "estimate," "will," "should," "expect," "target," "believe," "inten "plan," "goals," "future," "likely," "may," and similar expressions or their negative forms, or by references to strategy, plans, o intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in this Annual Report on Form 10-K under the caption "Risk Factors." Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected are described below and may be described from time to time in reports we file with the Securities and Exchange Commission, or the SEC, including our Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update or revise any such forward-looking statements, whether as a result of new information, future events, or otherwise.

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

- changes in interest rates and the market value of our target assets;
- changes in prepayment rates of mortgages underlying our target assets;
- the occurrence, extent and timing of credit losses within our portfolio;
- our exposure to adjustable-rate and negative amortization mortgage loans underlying our target assets;
- the state of the credit markets and other general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers;
- the concentration of the credit risks to which we are exposed;
- legislative and regulatory actions affecting our business;
- the availability and cost of our target assets;
- the availability and cost of financing for our target assets, including repurchase agreement financing, lines of credit, revolving credit facilities and financing through the FHLB;

- declines in home prices;
- increases in payment delinquencies and defaults on the mortgages comprising and underlying our target assets;
- changes in liquidity in the market for real estate securities, the re-pricing of credit risk in the capital markets, inaccurate ratings of securities by rating agencies, rating agency downgrades of securities, and increases in the supply of real estate securities available-for-sale;
- changes in the values of securities we own and the impact of adjustments reflecting those changes on our consolidated statements of comprehensive (loss) income and balance sheets, including our stockholders' equity;
- our ability to generate cash flow from our target assets;
- our ability to effectively execute and realize the benefits of strategic transactions and initiatives we have pursued or may in the future pursue;

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- changes in the competitive landscape within our industry, including changes that may affect our ability to attract and retain personnel;
- our exposure to legal and regulatory claims, penalties or enforcement activities, including those arising from our ownership and management of MSR and prior securitization transactions;
- our exposure to counterparties involved in our MSR business and prior securitization transactions and our ability to enforce representations and warranties made by them;
- our ability to acquire MSR and successfully operate our seller-servicer subsidiary and oversee the activities of our subservicers;
- our ability to successfully diversify our business into new asset classes, and manage the new risks to which they may expose us;
- our ability to manage various operational and regulatory risks associated with our business;
- interruptions in or impairments to our communications and information technology systems;
- our ability to maintain appropriate internal controls over financial reporting;
- our ability to establish, adjust and maintain appropriate hedges for the risks in our portfolio;
- our ability to maintain our REIT qualification for U.S. federal income tax purposes; and
- limitations imposed on our business due to our REIT status and our status as exempt from registration under the 1940 Act.

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

Our Business

Our Investment Strategy

Our investment objective is to provide attractive risk-adjusted total return to our stockholders over the long-term, primarily through dividends and secondarily through capital appreciation. We intend to achieve this objective by constructing a well-balanced portfolio consisting of Agency RMBS, non-Agency securities, MSR and other financial assets, with a focus on managing various associated risks, including interest rate, prepayment, credit, mortgage spread and financing risk. The preservation of book value is of paramount importance to our ability to generate total return on an ongoing basis. Consistent with the objective of achieving attractive risk-adjusted total return over various market cycles, we intend to maintain a balanced approach to these various risks.

We rely on PRCM Advisers’ expertise in identifying assets within our target asset classes. PRCM Advisers makes investment decisions based on a rigorous asset selection process that takes into consideration a variety of factors, including expected cash yield, risk-adjusted returns, current and projected credit fundamentals, current and projected macroeconomic considerations, current and projected supply and demand, credit and market risk concentration limits, liquidity, cost of financing and financing availability. It is our intention to select our assets in such a way as to maintain our REIT qualification and our exemption from registration under the 1940 Act.

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Our Target Assets

Our portfolio can be categorized into two strategies based on investment characteristics, which embodies our hybrid investment approach. Both strategies are managed by our Chief Investment Officer and resources are allocated and financial performance is assessed on a consolidated basis. The categories and their respective target asset classes are as follows:

- *Rates Strategy* - Includes Agency RMBS, MSR and related hedging transactions. The performance of this strategy is most affected by changes in interest rates, prepayments and mortgage spreads. These assets have minimal exposure to the underlying credit performance of the investments.

Agency RMBS	Agency RMBS collateralized by fixed rate mortgage loans, adjustable-rate mortgage (or ARM) loans or hybrid mortgage loans, or derivatives thereof, including: • mortgage pass-through certificates; • collateralized mortgage obligations; • Freddie Mac gold certificates; • Fannie Mae certificates; • Ginnie Mae certificates; • “to-be-announced” forward contracts, or TBAs, which are pools of mortgages with specific investment terms to be issued by government sponsored entities, or GSEs, at a future date; and • interest-only and inverse interest-only securities.
MSR	The right to control the servicing of mortgage loans and receive the servicing income therefrom; the actual servicing functions are outsourced to appropriately licensed third-party subservicers, which service the loans in their own names.

- *Credit Strategy* - Includes non-Agency securities and related hedging transactions. The performance of this strategy is most affected by changes in credit performance of the underlying collateral. These assets have interest rate and mortgage spread exposure, although such exposures are not viewed to be the main drivers of performance.

Non-Agency securities	Non-Agency securities collateralized by prime mortgage loans, Alt-A mortgage loans, pay-option ARM loans and subprime mortgage loans, which may have fixed rate, adjustable rate or hybrid rate terms. Non-Agency securities includes both senior and mezzanine securities. Senior refers to non-Agency securities that

represent the senior-most tranches (that is, the tranches which have the highest priority claim to cash flows from the related collateral pool) within the securities' structure. Mezzanine refers to subordinated tranches within the collateral pool. The non-Agency securities we purchase may include investment-grade and non-investment grade classes, including non-rated securities. Hybrid mortgage loans have terms with interest rates that are fixed for a specified period of time and, thereafter, generally adjust annually to an increment over a specified interest rate index. ARMs refer to hybrid and adjustable-rate mortgage loans which typically have interest rates that adjust annually to an increment over a specified interest rate index.

Other assets include financial and mortgage-related assets other than the target assets in our rates and credit strategies, including previously held commercial real estate assets, residential mortgage loans and certain non-hedging transactions that may produce non-qualifying income for purposes of the REIT gross income tests.

Our Investment Activities

The following is a summary of our investment activities related to the target assets in our rates and credit strategies for the year ended December 31, 2018. We believe our investment model allows management to allocate capital across various sectors within the mortgage market, with a focus on asset selection and the implementation of a relative value investment approach. Our capital allocation decisions factor in the opportunities in the marketplace, the cost of financing and the cost of hedging interest rate, prepayment, credit and other portfolio risks. As a result, allocation among our target assets reflects management's flexible approach to investing in the marketplace.

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Rates Strategy
Our Agency RMBS portfolio is comprised of adjustable rate and fixed rate mortgage-backed securities backed by single-family and multi-family mortgage loans. All of our principal and interest Agency RMBS are Fannie Mae or Freddie Mac mortgage pass-through certificates or collateralized mortgage obligations that carry an implied rating of "AAA," or Ginnie Mae mortgage pass-through certificates, which are backed by the guarantee of the U.S. government. The majority of these securities consist of whole pools in which we own all of the investment interests in the securities.
One of our wholly owned subsidiaries holds the requisite approvals from Fannie Mae and Freddie Mac to own and manage MSR, which represent a contractual right to service a mortgage loan and collect a fee for performing servicing activities, such as collecting principal and interest from a borrower and distributing those payments to the owner of the loan. We do not directly service the mortgage loans underlying the MSR we acquire; rather, we contract with appropriately licensed third-party subservicers to handle substantially all servicing functions in the name of the subservicer for the loans underlying our MSR.
We believe MSR are a natural fit for our portfolio over the long term. Our MSR business leverages our core competencies in prepayment and credit risk analytics and the MSR assets are a natural hedge to our Agency RMBS, hedging both interest rate and mortgage spread risk. Our goal is to create long-lasting relationships with high quality originators in both flow and bulk acquisitions of MSR.
Credit Strategy
Within our non-Agency securities portfolio, we have a substantial emphasis on "legacy" securities, which consist of securities issued prior to 2009, many of which are subprime. We believe these deeply discounted securities can add relative value as the economy and housing markets continue to improve, as there remains upside optionality to lower delinquencies, higher recoveries and faster prepays. We also hold "new issue" non-Agency securities, which we believe have enabled us to find attractive returns and further diversify our non-Agency securities portfolio.
Our Investment Guidelines
Our board of directors has approved the following investment guidelines:
- no investment shall be made that would cause us to fail to qualify as a REIT for U.S. federal income tax purposes;
- no investment shall be made that would cause us to be regulated as an investment company under the 1940 Act;
- we will primarily invest within our target assets, consisting primarily of Agency RMBS, non-Agency securities, residential mortgage loans, MSR and commercial real estate assets, inclusive of commercial real estate loans, commercial real property, CMBS, commercial corporate debt and loans and other commercial real estate related investments in the U.S; approximately 5% to 10% of our portfolio may include other financial assets; and
- until appropriate investments can be identified, we will invest available cash in interest-bearing and short-term investments that are consistent with (i) our intention to qualify as a REIT and (ii) our exemption from investment company status under the 1940 Act.

These investment guidelines may be changed from time to time by our board of directors in its discretion without the approval of our stockholders.
Within the constraints of the foregoing investment guidelines, PRCM Advisers has broad authority to select, finance and manage our investment portfolio. As a general matter, our investment strategy is designed to enable us to:
- build an investment portfolio consisting of Agency RMBS, non-Agency securities, MSR and other financial assets that will generate attractive returns while having a moderate risk profile;
- manage financing, interest, prepayment rate, credit and similar risks;
- capitalize on discrepancies in the relative valuations in the mortgage and housing markets; and
- provide regular quarterly dividend distributions to stockholders.

Within the requirements of the investment guidelines, PRCM Advisers makes determinations as to the percentage of our assets that will be invested in each of our target assets. Our investment decisions depend on prevailing market conditions and may change over time in response to opportunities available in different interest rate, economic and credit environments. As a result, we cannot predict the percentage of our assets that will be invested in any of our target asset classes at any given time. We believe that the diversification of our portfolio of assets and the flexibility of our strategy, combined with the expertise of PRCM Advisers and its affiliates, will enable us to achieve attractive risk-adjusted total return under a variety of market conditions and economic cycles.

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Financing Strategy

We deploy moderate leverage to increase potential returns to our stockholders and to fund the acquisition of our target assets. We are not required to maintain any particular leverage ratio. The amount of leverage we deploy for particular investments in our target assets depends upon a variety of factors, including without limitation: general economic, political and financial market conditions; the anticipated liquidity and price volatility of our assets; the gap between the duration of assets and liabilities, including hedges; the availability and cost of financing the assets; our opinion of the credit worthiness of financing counterparties; the health of the U.S. residential mortgage and housing markets; our outlook for the level, slope and volatility of interest rates; the credit quality of the loans underlying our Agency and non-Agency securities; the rating assigned to securities; and our outlook for asset spreads relative to the London Interbank Offered Rate, or LIBOR, curve and benchmark rate curves.

Our primary financing sources for Agency RMBS and non-Agency securities are repurchase agreements and FHLB advances. Repurchase agreements are financings pursuant to which one party, the seller/borrower, sells assets to the repurchase agreement counterparty, the buyer/lender, for an agreed price with the obligation to repurchase the assets from the buyer at a future date and at a price higher than the original purchase price. The amount of financing available under a repurchase agreement is limited to a specified percentage of the estimated market value of the assets. The difference between the sale price and repurchase price is the interest expense of financing under a repurchase agreement. Under repurchase agreement financing arrangements, if the value of the collateral decreases, the buyer could require the seller to provide additional cash collateral to re-establish the ratio of value of the collateral to the amount of borrowing (*i.e.*, a margin call). In the current economic climate, lenders under repurchase agreements generally advance approximately 90% to 97% of the market value of the Agency RMBS financed (a discount from market value, generally referred to as a haircut, of 3% to 10%) and 50% to 75% of the market value of the non-Agency securities financed (*i.e.*, a haircut of 25% to 50%).

To finance MSR, we enter into repurchase agreements and revolving credit facilities collateralized by the value of the MSR pledged. If the value of our MSR pledged as collateral for the agreements decreases, the respective lender could require us to provide additional collateral to re-establish the ratio of value of the collateral to the amount of the debt outstanding. Due to certain GSE requirements, we may be restricted as to the frequency in which we are able to pledge additional MSR collateral to counterparties. As a result, we may choose to over-collateralize certain repurchase agreements and revolving credit facilities in order to avoid having to provide cash as additional collateral. Lenders generally advance approximately 65% to 70% of the market value of the MSR financed (*i.e.*, a haircut of 30% to 35%).

A significant decrease in the advance rate or an increase in the haircut could result in our having to sell assets in order to meet additional margin requirements by the lender. We expect to mitigate our risk of margin calls under repurchase agreements by deploying leverage at an amount that is below what could be used under current advance rates.

In order to reduce our exposure to risks associated with lender counterparty concentration, we generally seek to diversify our exposure by entering into repurchase agreements with multiple counterparties. At December 31, 2018, we had $23.1 billion of outstanding balances under repurchase agreements with 30 counterparties, with a maximum net exposure (the difference between the amount loaned to us, including interest payable, and the value of the assets pledged by us as collateral, including accrued interest receivable on such assets) to any single lender of $342.7 million, or 8.1% of equity.

Our wholly owned subsidiary, TH Insurance Holdings Company LLC, or TH Insurance, is a member of the FHLB. As a member of the FHLB, TH Insurance currently has access to a variety of products and services offered by the FHLB, including secured advances. Eligible collateral may include conventional 1-4 family residential loans, commercial real estate loans, Agency RMBS and non-Agency securities with a rating of A and above.

We use FHLB advances to finance our Agency and non-Agency securities. Similar to repurchase agreements, if the value of our assets pledged to the FHLB as collateral for advances decreases, the FHLB could require us to provide additional collateral to re-establish the ratio of value of the collateral to the amount of advances outstanding. The FHLB generally advances approximately 90% to 95% of the market value of the Agency RMBS financed (*i.e.*, a haircut of 5% to 10%) and 85% to 90% of the market value of the non-Agency securities financed (*i.e.*, a haircut of 10% to 15%).

In January 2016, the FHFA released a final rule regarding membership in the Federal Home Loan Bank system. Among other effects, the ruling excludes captive insurers from membership eligibility, including our subsidiary member, TH Insurance. Since TH Insurance was admitted as a member in 2013, it is eligible for a membership grace period that runs through February 19, 2021, during which new advances or renewals that mature beyond the grace period will be prohibited. However, any existing advances that mature beyond this grace period will be permitted to remain in place subject to their terms insofar as we maintain good standing with the FHLB. If any new advances or renewals occur, TH Insurance's outstanding advances will be limited to 40% of its total assets.

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Interest Rate Hedging and Risk Management Strategy

We may enter 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 our floating-rate borrowings into fixed-rate borrowings to more closely match the duration of our 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 our portfolio as well as our cash flows, we 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, cap and swaption agreements and Markit IOS total return swaps. In addition, because MSR are negative duration assets, they provide a natural hedge to interest rate exposure on our Agency RMBS portfolio. In hedging interest rate risk, we seek to reduce the risk of losses on the value of our investments that may result from changes in interest rates in the broader markets, improve risk-adjusted returns and, where possible, obtain a favorable spread between the yield on our assets and the cost of our financing.

Management Agreement

Pursuant to the management agreement between us and PRCM Advisers, PRCM Advisers provides a dedicated team of investment and management professionals to carry out our business strategy as well as operational and administrative infrastructure to support our operations, subject to ongoing oversight by our board of directors. PRCM Advisers is responsible for, among other duties, (i) performing all of our day-to-day functions; (ii) determining investment criteria in conjunction with our board of directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; and (iv) performing asset management duties.

The current term of the management agreement expires on October 28, 2019, and will continue to automatically renew thereafter for successive one-year terms unless terminated in accordance with the agreement. Our independent directors review PRCM Advisers' performance annually and the management agreement may be terminated by us without cause upon the vote of at least two-thirds of our independent directors or by a vote of the holders of a majority of the outstanding shares of our common stock, based upon: (i) PRCM Advisers' unsatisfactory performance that is materially detrimental to us or (ii) our determination that the management fees payable to PRCM Advisers are not fair, subject to PRCM Advisers' right to prevent termination based on unfair fees by accepting a reduction of management fees agreed to by at least two-thirds of our independent directors. We are required to provide PRCM Advisers with 180 days' prior notice of such termination. Upon termination of the management agreement by us without cause or by PRCM Advisers due to our material breach of the management agreement, we are required to pay a termination fee equal to three times the sum of the average annual base management fee earned by PRCM Advisers during the 24-month period immediately preceding the date of termination, calculated as of the end of the most recently completed fiscal quarter prior to the date of termination. We may terminate the management agreement with 30 days' prior notice from our board of directors, without payment of a termination fee, for cause, as defined in the management agreement. PRCM Advisers may terminate the management agreement if we become required to register as an investment company under the 1940 Act, with such termination deemed to occur immediately before such event, and may also decline to renew the management agreement by providing us with 180 days' prior notice; in either case, we would not be required to pay a termination fee.

Base Management Fee

The base management fee paid to PRCM Advisers is 1.5% of our stockholders' equity per annum, calculated and payable quarterly in arrears.

For purposes of calculating the management fee, our stockholders' equity means the sum of the net proceeds from all issuances of our equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus our retained earnings at the end of the most recently completed calendar quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less the consolidated stockholders' equity of Granite Point Mortgage Trust Inc., or Granite Point, during the time Granite Point was consolidated on our balance sheet (i.e. prior to spin off in 2017) the weighted average cost basis of Granite Point common stock purchased, the outstanding principal balance of the promissory note due from the sale of Granite Point preferred stock and any amount that we have paid for repurchases of our common stock since inception, and excluding any unrealized gains, losses or other items that do not affect realized net income (regardless of whether such items are included in other comprehensive income or loss, or in net income). In connection with the acquisition of CYS Investments, Inc., or CYS, in 2018, the management agreement was amended to (i) reduce PRCM Advisers' base management fee with respect to the additional equity under management resulting from the merger to 0.75% from the effective time through the first anniversary of the effective time and (ii) for the fiscal quarter in which closing of the merger occured, to make a one-time downward adjustment of Pine River's management fees payable by Two Harbors for such quarter by $15.0 million to offset the cash consideration payable to stockholders of CYS, plus an

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additional downward adjustment of up to $3.3 million for certain transaction-related expenses. This amount will be adjusted to exclude one-time events pursuant to changes in accounting principles generally accepted in the United States of America, or U.S. GAAP, and certain non-cash items after discussions between PRCM Advisers and our independent directors and approval by a majority of our independent directors. To the extent asset impairments reduce our retained earnings at the end of any completed calendar quarter it will reduce the base management fee for such quarter. Our stockholders' equity for the purposes of calculating the base management fee could be greater than the amount of stockholders' equity shown on the consolidated financial statements.

Expense Reimbursement

We reimburse PRCM Advisers for (i) our allocable share of the compensation paid by Pine River to its personnel serving as our principal financial officer and general counsel and personnel employed by Pine River as in-house legal, tax, accounting, consulting, auditing, administrative, information technology, valuation, computer programming and development, and back-office resources to us and (ii) any amounts for personnel of Pine River's affiliates arising under a shared facilities and services agreement. We also have certain costs allocated to us by PRCM Advisers for data services and technology, but most direct expenses with third-party vendors are paid directly by us.

Operating and Regulatory Structure

Our business is subject to extensive regulation by U.S. federal and state governmental authorities, self-regulatory organizations and securities exchanges. We are required to comply with numerous federal and state laws, including those described below. The laws, rules and regulations comprising this regulatory framework change frequently, as can the interpretation and enforcement of existing laws, rules and regulations. Some of the laws, rules and regulations to which we are subject are intended primarily to safeguard and protect consumers, rather than stockholders or creditors. From time to time, we may receive requests from U.S. federal and state agencies for records, documents and information regarding our policies, procedures and practices regarding our business activities. We incur significant ongoing costs to comply with these government regulations.

REIT Qualification

We elected to be taxed as a REIT under the Code, commencing with our taxable period ended December 31, 2009. Our qualification as a REIT depends upon our ability to meet on a continuing basis, through actual investment and operating results, various complex requirements under the Code relating to, among other things, the sources of our gross income, the composition and value of our assets, our distribution levels and the diversity of ownership of our shares. We believe that we are organized in conformity with the requirements for qualification and taxation as a REIT under the Code, and we conduct our operations in a manner which will enable us to continue to meet the requirements for qualification and taxation as a REIT. Certain activities that we may perform may cause us to earn income that will not be qualifying income for REIT purposes. We have designated certain of our subsidiaries as TRSs to engage in such activities, and we may in the future form additional TRSs.

As long as we continue to qualify as a REIT, we generally will not be subject to U.S. federal income tax on the REIT taxable income we distribute currently to our stockholders. If we fail to qualify as a REIT in any taxable year and do not qualify for certain statutory relief provisions, we will be subject to U.S. federal income tax at regular corporate rates and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year during which we lost our REIT qualification. Even if we qualify for taxation as a REIT, we may be subject to certain U.S. federal, state and local taxes on our income or property.

Investment Company Act of 1940

We conduct our operations so that we are not required to register as an investment company under the 1940 Act. If we were to fall within the definition of an investment company, we would be unable to conduct our business as described in this Annual Report on Form 10-K.

Section 3(a)(1)(A) of the 1940 Act defines an investment company as any issuer that "is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading in securities." Section 3(a)(1)(C) of the 1940 Act also defines an investment company as any issuer that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire investment securities having a value exceeding 40% of the value of the issuer's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis." Excluded from the term "investment securities," among other things, are U.S. government securities and securities issued by majority-owned subsidiaries that are not themselves investment companies and are not relying on the exclusion from the definition of investment company set forth in Section 3(c)(1) or Section 3(c)(7) of the 1940 Act.

We are organized as a holding company that conducts business primarily through our subsidiaries. Any business conducted through our subsidiaries will be conducted in such a manner as to ensure that we do not meet the definition of "investment company" because less than 40% of the value of our total assets on an unconsolidated basis would consist of "investment securities."

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To avoid registration as an investment company, certain of our subsidiaries rely on certain exemptions from the 1940 Act, including Section 3(c)(5)(C), which exempts entities that are “primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.” Under the SEC staff’s current guidance, to qualify for this exemption, we must maintain (i) at least 55% of our assets in qualifying interests (referred to as the 55% Test) and (ii) at least 80% of our assets in qualifying interest plus other real estate related assets (referred to as the 80% Test). Qualifying interests for this purpose include mortgage loans and other assets, such as whole pool Agency and non-Agency RMBS, which are considered the functional equivalent of mortgage loans for the purposes of the 1940 Act. We expect each of our subsidiaries relying on Section 3(c)(5)(C) to invest at least 55% of its assets in qualifying interests in accordance with SEC staff guidance, and an additional 25% of its assets in either qualifying interests or other types of real estate related assets that do not constitute qualifying interests. We believe that we conduct our business so that we are exempt from the 1940 Act under Section 3(c)(5)(C), but rapid changes in the values of our assets could disrupt prior efforts to conduct our business to meet the 55% Test and the 80% Test. Our efforts to comply with the 55% Test and the 80% Test could require us to acquire or dispose of certain assets at unfavorable prices and limit our ability to pursue certain investment opportunities.

The SEC has previously solicited public comment on issues relating to the exemptions set forth in Section 3(c)(5)(C) of the 1940 Act, including what types of assets should be deemed qualifying interests and whether REITs that invest in RMBS should be regulated in a manner similar to investment companies. Although we believe that we are properly relying on Section 3(c)(5)(C) of the 1940 Act to exempt us from regulation under the 1940 Act, any modifications to the 1940 Act exemption rules or interpretations may require us to change our business and operations in order for us to continue to rely on such exemption. We will continue to monitor our compliance with the Section 3(c)(5)(C) exemptions.

Mortgage Industry Regulation

Although we do not originate or service residential mortgage loans, we must comply with various federal and state laws, rules and regulations as a result of owning MSR. These rules generally focus on consumer protection and include, among others, rules promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act, or the Dodd-Frank Act, and the Gramm-Leach-Bliley Financial Modernization Act of 1999, or the Gramm-Leach-Bliley Act. We are also required to maintain qualifications and licenses in certain states in order to own certain of our assets. These requirements can and do change as statutes and regulations are enacted, promulgated or amended, or as regulatory guidance or interpretations evolve or change, and the trend in recent years among federal and state lawmakers and regulators has been toward increasing laws, regulations and investigative proceedings in relation to the mortgage industry generally.

The Gramm-Leach-Bliley Act imposes additional obligations on us to safeguard the information we maintain on mortgage loan borrowers, requires that we provide mortgage borrowers with notices describing how we collect, use and share their personal information, and allows mortgage borrowers to “opt-out” of sharing certain information with third parties and affiliates. In addition, certain states have passed a variety of laws to further protect borrower information, including laws that regulate the use and storage of personally identifiable information, require notifications to borrowers if the security of their personal information is breached, or require us to encrypt personal information when it is transmitted electronically. These federal and state laws require ongoing review and changes to our operations, increased compliance costs, and affect our ability to use and share information with third parties.

The Dodd-Frank Act significantly changed the regulation of financial institutions and the financial services industry, including the mortgage industry. The Dodd-Frank Act tasked many agencies with issuing a variety of new regulations, including rules related to mortgage origination, mortgage servicing, securitization transactions and derivatives.

The Dodd-Frank Act created the Consumer Financial Protection Bureau, or the CFPB, which is responsible for regulating the offering and provision of financial products and services for personal, family and household purposes. The CFPB has broad rulemaking authority with respect to many of the federal consumer protection laws applicable to the mortgage industry. In addition to its rulemaking authority, the CFPB has supervision, examination and enforcement authority over consumer financial products and services by certain non-depository institutions, including

our company.
The CFPB has issued a series of rules as part of ongoing efforts to affect reforms and create uniform standards for the mortgage lending and servicing industries. These rules include requirements addressing how lenders must evaluate a consumer's ability to repay a mortgage loan, what specific communications must be made to consumers at various stages in the mortgage lending and servicing processes, how consumer account records must be maintained and how servicers must respond to written borrower requests, complaints and notices of errors. The rules also provide specific guidance relating to servicing delinquent loans, undertaking loss mitigation efforts and commencing foreclosure proceedings. These rules have led to increased costs to originate and service loans across the mortgage industry, and given their complexity, it is anticipated the originators, servicers and other mortgage industry participants will be exposed to greater regulatory scrutiny from federal and state regulators and increased litigation and complaints from both consumers and government officials. We expect the CFPB will continue to interpret and modify the rules, regulations and guidance related to mortgage lending and servicing industries and we will continue to evaluate these actions in order to understand the impact on our business and the industry, generally.
We have implemented and will continue to implement new policies and procedures in order to ensure ongoing compliance with the laws, rules and regulations applicable to our business. We have incurred and expect to incur ongoing operational costs

to comply with existing and future rules and regulations. We continue to monitor and evaluate rulemaking and other developments regarding the Dodd-Frank Act.

Competition

Our net income depends, in large part, on our ability to acquire assets at favorable spreads over our borrowing costs. In acquiring our target assets, we compete with other REITs, specialty finance companies, savings and loan associations, banks, mortgage bankers, insurance companies, mutual funds, institutional investors, investment banking firms, financial institutions, governmental agencies, mortgage loan servicers, asset management firms and other entities. Some of these entities may not be subject to the same regulatory constraints that we are (*i.e.*, REIT compliance or maintaining an exemption under the 1940 Act). Many of our competitors are significantly larger than us, have access to greater capital and other resources and may have other advantages over us. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish different counterparty relationships than us. Further, we may from time to time face competition from government agencies in connection with initiatives designed to stimulate the U.S. economy or the mortgage market. Market conditions may from time to time attract more competitors for certain of our target assets, which will not only affect the supply of assets but may also increase the competition for sources of financing for these assets. An increase in the competition for sources of funding could adversely affect the availability and cost of financing, and thereby adversely affect our financial results.

Financial Information

Financial information concerning our business for each of 2018, 2017 and 2016 is set forth in "*Management's Discussion and Analysis of Financial Condition and Results of Operations*," "*Qualitative and Quantitative Disclosures about Market Risk*" and the consolidated financial statements and the notes thereto, and the supplemental financial information, which are in Part II, Items 7, 7A and 8 of this Annual Report on Form 10-K.

Available Information

Our website can be found at *www.twoharborsinvestment.com*. We make available, free of charge on our website (on the Investor Relations page under "SEC Filings"), our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports, as are filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as well as our proxy statement with respect to our annual meeting of stockholders, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Our Exchange Act reports filed with, or furnished to, the SEC are also available at the SEC's website at *www.sec.gov*. The content of any website referred to in this Annual Report on Form 10-K is not incorporated by reference into this Form 10-K unless expressly noted.

We also make available, free of charge, the charters for our Audit Committee, Compensation Committee, Nominating and Corporate Governance Committee and Risk Oversight Committee, as well as our Corporate Governance Guidelines, Code of Business Conduct and Ethics, Whistleblowing Procedures and Stockholder Communication Policy. Within the time period required by the SEC and the NYSE, we will post on our website any amendment to the Code of Ethics and any waiver applicable to any executive officer, director or senior officer (as defined in the Code of Ethics).

Our Investor Relations Department can be contacted at:

Two Harbors Investment Corp.
Attn: Investor Relations
575 Lexington Avenue, Suite 2930
New York, NY 10022
(612) 629-2500
investorrelations@twoharborsinvestment.com

Item 1A. Risk Factors

The following is a summary of the significant risk factors known to us that we believe could have a material adverse effect on our business, financial condition and results of operations. In addition to understanding the key risks described below, investors should understand that it is not possible to predict or identify all risk factors and, consequently, the following is not a complete discussion of all potential risks or uncertainties.

Risks Related to Our Business and Operations

The value of your investment is subject to the significant risks affecting our business described below. If any of the events described below occur, our business, financial condition, liquidity and/or results of operations could be adversely affected in a material way.

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Difficult conditions in the residential mortgage and real estate markets, the financial markets and the economy generally may adversely impact our business, results of operations and financial condition.

Our results of operations are materially affected by conditions in the residential mortgage and real estate markets, the financial markets and the economy generally. In past years, concerns about the mortgage market, declines in home prices, increases in home foreclosures, high unemployment, the availability and cost of credit and rising government debt levels, as well as inflation, energy costs, global economic lethargy, geopolitical unrest across various regions worldwide, European sovereign debt issues, the U.K.'s planned exit from the European Union, U.S. budget debates, federal government shutdowns and and international trade disputes, have from time to time contributed to increased volatility and uncertainty in the economy and financial markets. More recently, home prices increased modestly through 2018 and are expected to gradually appreciate over the next several years, albeit at a slower rate. Credit standards in the mortgage market have eased in recent years, though the availability of credit remains well below levels prior to the 2008 financial crisis. Employment market conditions remain solid as jobless claims, unemployment and payroll data continue to show improvement at this state of the business cycle, although new job creation has yet to generate meaningful wage growth. Adverse developments with respect to any of these market conditions may have an impact on new demand for homes, which may compress the home ownership rates and weigh heavily on future home price performance. There is a strong correlation between home price growth rates (or losses) and mortgage loan delinquencies. Any stagnation in or deterioration of the residential mortgage or real estate markets may limit our ability to acquire our target assets on attractive terms or cause us to experience losses related to our assets. Declines in the market values of our investments may adversely affect our results of operations and credit availability and cost, which may reduce earnings and, in turn, cash available for distribution to our stockholders.

Actions of the U.S. government, including the U.S. Congress, U.S. Federal Reserve, U.S. Treasury and other governmental and regulatory bodies, to stabilize or reform the financial markets may not achieve their intended effects and may adversely affect our business.

The U.S. government, including the U.S. Congress, U.S. Federal Reserve, U.S. Treasury and other governmental and regulatory bodies have from time to time taken actions designed to stabilize and reform the financial markets. In recent years, these activities have included the Federal Reserve's purchasing of Treasury and mortgage bonds in connection with its quantitative easing programs. In 2017, the Federal Reserve announced plans to reduce its mortgage bond holdings, with the intention to gradually reduce the reinvestment of principal and interest in such securities. During periods in which the Federal Reserve further reduces or ceases reinvestment of principal and interest or undertakes outright sales of its securities portfolio, the price of Agency RMBS and U.S. Treasury securities could decline, mortgage spreads could widen, refinancing volumes could be lower and market volatility could be considerably higher than would have been the case absent such actions, which could adversely impact our financial condition and results of operations.

There can be no assurance as to how, in the long term, actions by the U.S. government will impact the efficiency and stability of the mortgage markets or U.S. financial markets. To the extent the mortgage or financial markets do not respond favorably to any of these actions or such actions do not function as intended, our business may be harmed. In addition, because the programs may be designed, in part, to improve the markets for certain of our target assets, the establishment of these programs may result in increased competition to acquire our target assets or, in the case of government-backed mortgage refinancing and modification programs, may have the effect of reducing the revenues associated with certain of our target assets. We cannot predict whether or when additional government actions or initiatives may occur or the potential impact to our business, operations and financial condition.

Our business model depends in part upon the continuing viability of Fannie Mae and Freddie Mac, or similar institutions, and any significant changes to their structure or creditworthiness could have an adverse impact on us.

We purchase Agency RMBS that are protected from the risk of default on the underlying mortgages by guarantees from Fannie Mae, Freddie Mac or, in the case of the Ginnie Mae, the U.S. government. Fannie Mae and Freddie Mac have from time to time reported substantial losses and a need for significant amounts of additional capital. In 2008, in response to the deteriorating financial condition of Fannie Mae and Freddie Mac, the U.S. government and U.S.

Treasury undertook a series of actions designed to stabilize these GSEs, including placing them into a federal conservatorship, under which the Federal Housing Finance Agency, or FHFA, operates Fannie Mae and Freddie Mac. In December 2009, the U.S. government committed virtually unlimited capital to ensure the continued existence of Fannie Mae and Freddie Mac. More recently, in February 2018, Fannie Mae reported a substantial loss for the fourth quarter of 2017 due to the impact of the recently passed Tax Cuts and Jobs Act, and indicated that the FHFA would seek a taxpayer infusion from the U.S. Treasury. Despite projections that the U.S. Treasury will continue to provide financing, there is no assurance that such capital will continue to be available or that the GSEs will honor their guarantees or other obligations. If these GSEs fail to honor their guarantees, the value of any Agency RMBS that we hold would decline.

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The continued flow of residential mortgage-backed securities from the GSEs is essential to the operation of the mortgage markets in their current form, and crucial to our business model. In the wake of the 2008 Financial Crisis, Fannie Mae and Freddie Mac became the dominant, and in some cases, the only source of mortgage financing in the U.S. Although any reform would be expected to take several years to implement, if the structure of Fannie Mae or Freddie Mac were altered, or if they were eliminated altogether, the amount and type of Agency RMBS and other mortgage-related assets available for investment would be significantly affected. A reduction in supply of Agency RMBS and other mortgage-related assets would result in increased competition for those assets and likely lead to a significant increase in the price we would have to pay for such assets.

A number of legislative proposals have been introduced in recent years that would wind down or phase out the GSEs, including a 2018 Trump administration proposal to end the conservatorship and privatize Fannie Mae and Freddie Mac. It is not possible to predict the scope and nature of the actions that the U.S. government, including the Trump administration, will ultimately take with respect to the GSEs. As a result, market uncertainty with respect to the treatment of the GSEs, including that which may be created by proposed legislation or the eventual adoption of laws affecting the GSEs, could have the effect of reducing the actual or perceived quality of, and therefore the market value for, the Agency RMBS that we currently hold in our portfolio. Moreover, if the guarantee obligations of Freddie Mac or Fannie Mae were repudiated by FHFA, payments of principal and/or interest to holders of Freddie Mac or Fannie Mae securities would be reduced in the event of any borrower's late payments or failure to pay, or a servicer's failure to remit, borrower payments to the trust. In that case, trust administration and servicing fees could be paid from mortgage payments prior to distributions to holders of agency securities. Any actual direct compensatory damages owed due to the repudiation of Freddie Mac or Fannie Mae's guarantee obligations may not be sufficient to offset any shortfalls experienced by holders of agency securities.

All of the foregoing could materially adversely affect the availability, pricing, liquidity, market value and financing of our target assets and materially adversely affect our business, operations and financial condition.

We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations.

We operate in a highly regulated environment and are subject to rules, regulations, approvals, licensing, reporting and examination requirements of various federal and state authorities. Any change in applicable federal or state laws, rules and regulations, or the interpretation or enforcement thereof, could have a substantial impact on our assets, operating expenses, business strategies and results of operations. Our inability or failure to comply with the rules, regulations or reporting requirements, to obtain or maintain approvals and licenses applicable to our businesses, or to satisfy annual or periodic examinations may impact our ability to do business and expose us to fines, penalties or other claims and, as a result, could harm our business. Additionally, legislation and regulations may be enacted or adopted in the future that could significantly affect our business and operations, which could have a material adverse effect on our financial condition and results of operations.

The Dodd-Frank Act and regulations implementing such legislation have had a substantial impact on the mortgage industry and the MBS markets; these regulations as well as new or modified regulations implemented under Dodd-Frank may have an adverse impact on our business, results of operations and financial condition.

On July 21, 2010, President Obama signed into law the Dodd-Frank Act, which has changed and continues to change the regulation of financial institutions and the financial services industry, including the mortgage industry. The Dodd-Frank Act tasked many agencies with issuing a variety of new regulations, including rules related to mortgage origination, mortgage servicing, securitization transactions and derivatives. The Trump administration has previously called for a comprehensive review of the Dodd-Frank Act and, in 2018, President Trump signed into law legislation that rolls back key provisions of the Act, easing mortgage regulations on small- and medium-sized lenders. Consequently, it is not possible to predict how additional regulatory changes under or the further repeal of any provisions of the Dodd-Frank Act will affect our business, and there can be no assurance that new or revised rules and regulations will not have an adverse effect on our business, results of operations and financial condition.

The Dodd-Frank Act created the CFPB, which is responsible for regulating the offering and provision of financial products and services for personal, family and household purposes. In addition to assuming many of the consumer financial protection functions exercised by other federal regulators under certain enumerated financial protection statutes, such as the Truth in Lending Act (TILA), the Real Estate Settlement Procedures Act (RESPA) and the Fair Credit Reporting Act, the CFPB was granted broad rule-making and enforcement authority to protect consumers from unfair, deceptive or abusive acts and practices. The CFPB issued a series of rules as part of ongoing efforts to effect reforms and create uniform standards for the mortgage lending and servicing industries. These mortgage lending rules include requirements addressing how lenders must evaluate a consumer’s ability to repay a mortgage loan and what specific disclosures and communications must be made to consumers at various stages in the mortgage lending process.

Mortgage servicing rules promulgated by the CFPB to implement certain sections of Dodd-Frank include provisions relating to periodic billing statements and disclosures, responding to borrower inquiries and complaints, maintenance of consumer account records, lender-placed insurance, and adjustable rate mortgage interest rate adjustment notices. Further, the mortgage servicing rules require servicers to, among other things, make good faith early intervention efforts to notify delinquent borrowers of loss mitigation options, to implement specified loss mitigation procedures, and if feasible, exhaust all loss mitigation options before proceeding to foreclosure. Amendments to these rules designed to expand protections for struggling homeowners were adopted by the CFPB in 2016 and took effect in late 2017 and early 2018. These amendments impact the manner in which servicers are required to communicate with borrowers who are in bankruptcy or have applied for loss mitigation, and also provide additional protections for successors in interest.

The foregoing rules have led increased costs to originate and service loans across the mortgage industry, and given their complexity, originators, servicers and other mortgage industry participants have been exposed to greater regulatory scrutiny from federal and state regulators, and increased litigation and complaints from consumers and government officials.

We have incurred and expect to incur in the future operational and system costs necessary to maintain processes to ensure compliance with the rules and regulations applicable to us as well as to monitor compliance by our business partners. Additional rules and regulations implemented by the CFPB, as well as any changes to existing rules as a result of the reassessment, could lead to changes in the way we conduct our business and increased costs of compliance, both of which may have an adverse impact on our business and financial condition.

If we were required to register with the CFTC as a Commodity Pool Operator, it could adversely affect our business model, our financial condition and our results of operations.

Under the Dodd-Frank Act, the U.S. Commodity Futures Trading Commission, or CFTC, was given jurisdiction over the regulation of swaps. Under rules implemented by the CFTC, companies that utilize swaps as part of their business model, including many mortgage REITs, are deemed to fall within the statutory definition of Commodity Pool Operator, or CPO, and are required to register with the CFTC as a CPO. On December 7, 2012, the CFTC issued no-action relief that permits a CPO to receive relief from registration requirements if it meets certain criteria. While we believe we meet the criteria for such relief, there can be no assurance that the CFTC will not withdraw the no-action letter in the future or that we will continue to satisfy the criteria to qualify for relief from CPO registration. If we were required to register as a CPO in the future or change our business model to ensure we can continue to satisfy the criteria to qualify for the no-action relief, it could impact our ability to operate our business and adversely affect our financial condition and results of operations.

We operate in a highly competitive market and we may not be able to compete successfully.

We operate in a highly competitive market. Our profitability depends, in large part, on our ability to acquire a sufficient supply of our target assets at favorable prices. In acquiring assets, we compete with a variety of investors, including other mortgage REITs, specialty finance companies, public and private investment funds, asset managers, commercial and investment banks, broker-dealers, commercial finance and insurance companies, the GSEs, mortgage servicers and other financial institutions. Many of our competitors are substantially larger and have greater financial, technical, marketing and other resources than we do. Certain competitors may also have a broader investment mandate or higher risk tolerance, which may allow them to consider a wider variety of potential investments. Additionally, we may face competition from governmental actions and initiatives designed to stimulate the U.S. economy and mortgage market. Competition for our target assets may lead to the price of such assets increasing and their availability decreasing, which may limit our ability to generate desired returns, reduce our earnings and, in turn, decrease the cash available for distribution to our stockholders.

We may change any of our strategies, policies or procedures without stockholder consent.

We may change any of our strategies, policies or procedures with respect to investments, asset allocation, growth, operations, indebtedness, financing strategy and distributions at any time without the consent of stockholders, which could result in our making investments that are different from, and possibly riskier than, the types of investments described in this Annual Report on Form 10-K. Changes in strategy could also result in the elimination of certain investments and business activities that we no longer view as attractive or in alignment with our business model. Shifts in strategy may increase our exposure to credit risk, interest rate risk, financing risk, default risk, regulatory risk and real estate market fluctuations. We also cannot assure you that we will be able to effectively execute or to realize the potential benefits of changes in strategy. Any such changes could adversely affect our financial condition, risk profile, results of operations, the market price of our common stock and our ability to make distributions to stockholders.

We have invested in and may in the future invest in a variety of mortgage-related and other financial assets that may or may not be closely related to our current business. Additionally, we may enter other operating businesses that may or may not be closely related to our current business. These new assets or business operations may have new, different or increased risks than what we are currently exposed to in our business and we may not be able to manage these risks successfully. Additionally, when investing in new assets or businesses we will be exposed to the risk that those assets, or income generated by those assets or businesses, will affect our ability to meet the requirements to maintain our REIT status or our status as exempt from registration under the 1940 Act. If we are not able to successfully manage the risks associated with new assets types or businesses, it could have an adverse effect on our business, results of operations and financial condition.

Our risk management policies and procedures may not be effective.

We have established and maintain risk management policies and procedures designed to identify, monitor and mitigate financial risks, such as credit risk, interest rate risk, prepayment risk and liquidity risk, as well as operational risks related to our business, assets and liabilities. These policies and procedures may not sufficiently identify all of the risks to which we are or may become exposed or mitigate the risks we have identified. Any expansion of our business activities may result in our being exposed to risks to which we have not previously been exposed or may increase our exposure to certain types of risks. Alternatively, any narrowing of our business activities may increase the concentration of our exposure to certain types of risk. Any failure to effectively identify and mitigate the risks to which we are exposed could have an adverse effect on our business, results of operations and financial condition.

Maintaining our exemptions from registration as an investment company under the 1940 Act imposes limits on our operations.

We intend to conduct our operations so as not to become required to register as an investment company under the 1940 Act. Section 3(a)(1)(A) of the 1940 Act defines an investment company as any issuer that is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading in securities. Section 3(a)(1)(C) of the 1940 Act defines an investment company as any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire investment securities having a value exceeding 40% of the value of the issuer's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis. Excluded from the term "investment securities," among other things, are U.S. government securities and securities issued by majority-owned subsidiaries that are not themselves investment companies and are not relying on the exception from the definition of investment company set forth in Section 3(c)(1) or Section 3(c)(7) of the 1940 Act.

We are organized as a holding company that conducts its businesses primarily through our subsidiaries. We intend to conduct the operations of Two Harbors and its subsidiaries so that they do not come within the definition of an investment company, either because less than 40% of the value of their total assets on an unconsolidated basis will consist of "investment securities" or because they meet certain other exceptions or exemptions set forth in the 1940 Act based on the nature of their business purpose and activities, such as the Rule 3a-7 structured finance exemption for issuers of asset-backed securities or the Section 3(c)(3) exemption for insurance companies.

Certain of our subsidiaries intend to rely upon the exemption set forth in Section 3(c)(5)(C) of the 1940 Act, which is available for entities "primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." This exemption generally means that at least 55% of each such subsidiary's portfolio must be comprised of qualifying assets and at least 80% of its portfolio must be comprised of qualifying assets and real estate-related assets under the 1940 Act. Qualifying assets for this purpose include mortgage loans and other assets, such as whole pool Agency and non-Agency RMBS, which are considered the functional equivalent of mortgage loans for the purposes of the 1940 Act. We expect each of our subsidiaries relying on Section 3(c)(5)(C) to invest at least 55% of its assets in whole pool Agency and non-Agency RMBS and other interests in real estate that constitute qualifying assets in accordance with SEC staff guidance and an additional 25% of its assets in either qualifying assets and other types of real estate related assets that do not constitute qualifying assets.

As a result of the foregoing restrictions, we are limited in our ability to make or dispose of certain investments. To the extent the SEC publishes new or different guidance with respect to these matters, we may be required to adjust our strategy accordingly. In addition, we may be limited in our ability to make certain investments, which could result in a subsidiary holding assets that we might wish to sell or selling assets that we might wish to hold. Although we monitor the portfolios of our subsidiaries relying on the Section 3(c)(5)(C) exemption periodically and prior to each acquisition or disposition of assets, there can be no assurance that such subsidiaries will be able to maintain this exemption.

We make the determination as to whether a subsidiary is considered a majority-owned subsidiary. The 1940 Act defines a majority-owned subsidiary of a person as a company 50% or more of the outstanding voting securities of which are owned by such person, or by another company which is a majority-owned subsidiary of such person. The 1940 Act further defines voting securities as any security presently entitling the owner or holder thereof to vote for the election of directors of a company. We treat companies in which we own at least a majority of the outstanding voting securities as majority-owned subsidiaries for purposes of the 40% test. We have not requested the SEC staff to approve our treatment of any company as a majority-owned subsidiary and the SEC staff has not done so. If the SEC or its staff were to disagree with our treatment of one or more companies as majority-owned subsidiaries, we may need to adjust our strategy and our assets in order to continue to pass the 40% test. Any such adjustment in our strategy could have a material adverse effect.

Qualification for exemptions from registration under the 1940 Act limits our ability to make certain investments. For example, these restrictions limit the ability of our subsidiaries to invest directly in mortgage-backed securities that represent less than the entire ownership in a pool of mortgage loans, debt and equity tranches of securitizations and certain asset backed securities and real estate companies or in assets not related to real estate.

Loss of our 1940 Act exemptions would adversely affect us, the market price of shares of our common stock and our ability to distribute dividends, and could result in the termination of our management agreement with PRCM Advisers and certain of our financing or other agreements.

As described above, we intend to conduct operations so that we are not required to register as an investment company under the 1940 Act. Although we monitor our portfolio and our activities periodically, there can be no assurance that we will be able to maintain our exemption from investment company registration under the 1940 Act. The SEC has previously solicited public comment on a wide range of issues relating to the exemptions set forth in Section 3(c)(5)(C) of the 1940 Act, including what types of assets should be deemed qualifying interests and whether REITs that invest in RMBS should be regulated in a manner similar to investment companies. Although we believe that we are properly relying on Section 3(c)(5)(C) to exempt us from regulation under the 1940 Act, any modifications to the 1940 Act exemption rules or interpretations may require us to change our business and operations in order for us to continue to rely on such exemption. Additionally, any uncertainty regarding our 1940 Act exemption could negatively impact our ability to raise capital, borrow money, or engage in certain other types of business transactions, which could materially and adversely affect our business, operations, and financial condition. There can be no assurance that the rules, regulations and interpretations governing the exemptions available under the 1940 Act will not change in a manner that adversely affects our operations. If we were no longer able to qualify for exemptions from registration under the 1940 Act, we could be required to restructure our activities or the activities of our subsidiaries, including effecting sales of assets in a manner that, or at a time when, we would not otherwise choose, which could negatively affect the value of our common stock, the sustainability of our business model, and our ability to make distributions. Such sales could occur during adverse market conditions, and we could be forced to accept prices below that which we believe are appropriate. The loss of our 1940 Act exemptions may also result in a default under or permit certain of our counterparties to terminate the many repurchase agreements, financing facilities or other agreements we have in place, including permitting PRCM Advisers to terminate our management agreement. The termination of any of these agreements could result in a material adverse effect on our business and results of operations.

Rapid changes in the values of our assets may make it more difficult for us to maintain our qualification as a REIT or our exemption from the 1940 Act.

If the market value or income potential of our assets declines as a result of increased interest rates, prepayment rates, general market conditions, government actions or other factors, we may need to increase our real estate assets and income or liquidate our non-qualifying assets in order to maintain our REIT qualification or our exemption from the 1940 Act. If the decline in real estate asset values or income occurs quickly, this may be difficult to accomplish. This difficulty may be exacerbated by the illiquid nature of certain assets we own, including MSR. We may have to make decisions that we otherwise would not make absent the REIT and 1940 Act considerations.

The lack of liquidity of our assets may adversely affect our business, including our ability to value, finance and sell our assets.

We have and may in the future acquire assets or other instruments with limited or no liquidity, including securities, MSR and other instruments that are not publicly traded. Market conditions could also significantly and negatively affect the liquidity of our assets. It may be difficult or impossible to obtain third-party pricing on such illiquid assets and validating third-party pricing for illiquid assets may be more subjective than more liquid assets. Illiquid assets typically experience greater price volatility, as a ready market may not exist for such assets, and such assets can be more difficult to value.

Any illiquidity in our assets may make it difficult for us to sell such assets if the need or desire arises. Unlike equity securities, bonds or other exchange-traded instruments with highly liquid markets, the ability to quickly sell certain of our target assets, such as certain securities and MSR, may be constrained by a number of factors, including a small number of willing buyers, lack of transparency as to current market terms and price, and time delays resulting from the buyer's desire to conduct due diligence on the assets, negotiation of a purchase and sale agreement, compliance with any applicable contractual or regulatory requirements, and for certain assets like MSR, the need for certain approvals from the investor in the underlying mortgage loan (*e.g.*, Fannie Mae or Freddie Mac), all of which can result in a sale process that takes several weeks or months. Moreover, certain of our assets may not be registered under the relevant securities laws, resulting in prohibitions against their transfer, sale, pledge or their disposition except in transactions that are exempt from registration requirements or are otherwise in accordance with such laws. Consequently, even if we identify a buyer for certain of our securities and MSR, there is no assurance that we would be able to sell such assets in a timely manner if the need or desire arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may be forced to sell our assets at a price that is significantly less than the value at which we previously attributed to such assets.

Assets that are illiquid are typically more difficult and costly to finance. As a result, we may be required to finance the assets at unattractive rates or hold them on our balance sheet without the use of leverage. Assets tend to become less liquid during times of financial stress, which is often the time that liquidity is most needed. To the extent that we use leverage to finance assets that later become illiquid, we may lose that leverage if the financing counterparty determines that the collateral is no longer sufficient to secure the financing, or the counterparty could reduce the amount of money that it is willing to lend against the asset.

The illiquidity of certain of our assets may, therefore, adversely impact our ability to manage our portfolio and adversely affect our financial condition and results of operations.

We use leverage in executing our business strategy, which may adversely affect the return on our assets and may reduce cash available for distribution to our stockholders, as well as increase losses when economic conditions are unfavorable.

We use leverage to finance many of our investments and to enhance our financial returns. Our primary source of leverage is short-term repurchase agreement financing for our Agency RMBS and non-Agency securities. We also use revolving credit facilities and repurchase agreements to finance MSR. Other sources of leverage may include credit facilities (including term loans, revolving facilities and FHLB advances) as well as the public issuance of debt securities.

Through the use of leverage, we may acquire positions with market exposure significantly greater than the amount of capital committed to the transaction. For example, by entering into repurchase agreements with advance rates, or haircut levels, of 5% (which is not an atypical haircut for Agency RMBS), we could leverage capital allocated to Agency RMBS by a ratio of as much as 20 to 1. It is not uncommon for investors in Agency RMBS to obtain leverage equal to ten or more times equity through the use of repurchase agreement financing. Subject to market conditions, we anticipate that we may deploy, on a debt-to-equity basis, up to ten times leverage on our Agency RMBS and up to two times on our non-Agency securities; however, there is no specific limit on the amount of leverage that we may use. Leverage will magnify both the gains and the losses of our positions. Leverage will increase our returns as long as we earn a greater return on investments purchased with borrowed funds than our cost of borrowing such funds. However, if we use leverage to acquire an asset and the value of the asset decreases, the leverage will increase our losses. Even if the asset increases in value, if the asset fails to earn a return that equals or exceeds our cost of borrowing, the leverage will decrease our returns.

We may be required to post large amounts of cash as collateral or margin to secure our leveraged positions. In the event of a sudden, precipitous drop in value of our financed assets, we might not be able to liquidate assets quickly enough to repay our borrowings, further magnifying losses. Even a small decrease in the value of a leveraged asset may require us to post additional margin or cash collateral. This may adversely affect our financial condition and results of operations, and decrease the cash available to us for distributions to stockholders.

We may not be able to raise the capital required to finance our assets and grow our business.

The operation of our business may require access to debt and equity capital that may or may not be available on favorable terms or at the desired times, or at all. In addition, we invest in certain assets, including MSR, for which financing has historically been difficult or costly to obtain and is otherwise subject to the consent of and the terms and conditions required by the GSEs. Any limitation on our ability to obtain financing for our target assets could require us to seek equity or debt capital that may be more costly or unavailable to us. We cannot assure you that we will have access to any debt or equity capital on favorable terms or at the desired times, or at all. Our inability to raise such capital or obtain financing on favorable terms could materially adversely impact our business, operations, financial condition, liquidity, and our ability to make distributions to stockholders.

We depend on repurchase agreements and other credit facilities to execute our business plan and any limitation on our ability to access funding through these sources could have a material adverse effect on our results of operations, financial condition and business.

Our ability to purchase and hold assets is affected by our ability to secure repurchase agreements and other credit facilities on acceptable terms. We currently have repurchase agreements, revolving credit facilities and other credit facilities in place with several counterparties, including national banks and the FHLB. In the future, we may enter into additional or increase commitment amounts under our existing repurchase agreements, revolving credit facilities and credit facilities, but we can provide no assurance that lenders will be willing or able to provide us with sufficient financing through the repurchase markets or otherwise. In addition, with respect to MSR financing, there can be no assurance that the GSEs will consent to such transactions. Because repurchase agreements and similar credit facilities are generally short-term commitments of capital, changes in conditions in the financing markets may make it more difficult for us to secure continued financing during times of market stress. During certain periods of a credit cycle, lenders may lose their ability or curtail their willingness to provide financing. If we are not able to arrange for replacement financing on acceptable terms, or if we default on our covenants or are otherwise unable to access funds under any of our repurchase agreements and credit facilities, we may have to curtail our asset acquisition activities and/or dispose of assets.

Our ability to efficiently access financing through our repurchase agreements may be adversely impacted by counterparty requirements regarding the type of assets that may be sold and the timing and process for such sales. In order for us to borrow funds under our repurchase agreements, counterparties must first review the assets for which we are seeking financing and approve such assets in their sole discretion. This review and approval process may delay the timing in which funding may be provided, or preclude funding altogether. For MSR, delays may also occur due to the need to obtain GSE approval of the collateral to be posted, the need for third party valuations of the MSR collateral or the agreement of the relevant servicing party to be party to the financing agreement.

It is possible that the lenders that provide us with financing could experience changes in their ability to advance funds to us, independent of our creditworthiness or the value of our assets. For example, the Basel III regulatory capital reform rules or other regulatory changes, may have the effect of significantly changing or eliminating the sources of financing that are customarily available to us. If regulatory requirements imposed on our lenders change, they may be required to significantly increase the cost of the financing that they provide to us or eliminate it altogether. Our lenders also may revise their eligibility requirements for the types of assets they are willing to finance or the terms of such financings, based on, among other factors, the regulatory environment and their management of perceived risk.

In January 2016, the FHFA issued a final rule that excluded captive insurers from ongoing FHLB membership. Our subsidiary, TH Insurance Holdings Company LLC, or TH Insurance, is a licensed captive insurer and has been a member of the FHLB of Des Moines since 2013. Pursuant to the final rule, TH Insurance will be allowed to remain an FHLB member through February 19, 2021. During this grace period, any new advances or renewals that mature beyond the grace period will be prohibited. However, any existing advances that mature beyond this grace period will be permitted to remain in place subject to their terms insofar as TH Insurance maintains good standing with the FHLB. If any new advances or renewals occur, TH Insurance’s outstanding advances will be limited to forty percent of its assets. While our reliance upon the FHLB as a source of financing has diminished in recent years relative to alternative sources of funding, we cannot assure you that, in the future, we will be able to obtain financing on terms similar to the FHLB, if at all, which could have material adverse impact on our business.

Changes in the financing markets could adversely affect the marketability of the assets in which we invest, and this could negatively affect the value of our assets. If our lenders are unwilling or unable to provide us with financing, or if the financing is only available on terms that are uneconomical or otherwise not satisfactory to us, we could be forced to sell assets when prices are depressed. The amount of financing we receive under our repurchase agreements, revolving credit facilities or other credit facilities will be directly related to the lenders’ valuation of the assets that secure the outstanding borrowings. Typically, repurchase agreements and similar lending arrangements grant the respective lender the right to reevaluate the market value of the assets that secure outstanding borrowings at any time.

If a lender determines that the value of the assets has decreased, it has the right to initiate a margin call, requiring us to transfer additional assets to such lender or repay a portion of the outstanding borrowings. Any such margin call could have a material adverse effect on our results of operations, financial condition, business, liquidity and ability to make distributions to stockholders, and could cause the value of our common stock to decline. We may be forced to sell assets at significantly depressed prices to meet margin calls and to maintain adequate liquidity, which could cause us to incur losses. Moreover, to the extent that we are forced to sell assets because of availability of financing or changes in market conditions, other market participants may face similar pressures, which could exacerbate a difficult market environment and result in significantly greater losses on the sale of such assets. In an extreme case of market duress, a market may not exist for certain of our assets at any price.

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Although we generally seek to reduce our exposure to lender concentration-related risk by entering into repurchase agreements and other credit facilities with multiple counterparties, we are not required to observe specific diversification criteria, except as may be set forth in the investment guidelines adopted by our board of directors. To the extent that the number of or net exposure under our lending arrangements may become concentrated with one or more lenders, the adverse impacts of defaults or terminations by such lenders may be significantly greater. As of December 31, 2018, repurchase agreement and other lenders for whom our net exposure (generally, the value of assets sold under repurchase agreements or posted as loan collateral, less the amount of the associated liabilities) exceeded 5% of stockholders' equity included the Royal Bank of Canada. See Note 10 - *Repurchase Agreements* and Note 12 - *Federal Home Loan Bank of Des Moines Advances* to the consolidated financial statements, included in this Annual Report on Form 10-K, for additional information.

Our inability to meet certain financial covenants related to our repurchase agreements, revolving credit facilities or other credit facilities could adversely affect our financial condition, results of operations and cash flows.

In connection with certain of our repurchase agreements, revolving credit facilities and other credit facilities, we are required to comply with certain financial covenants, the most restrictive of which are disclosed within Item 7, "*Management's Discussion and Analysis of Financial Conditions and Results of Operations*" of this Annual Report on Form 10-K. Compliance with these financial covenants will depend on market factors and the strength of our business and operating results. Various risks, uncertainties and events beyond our control could affect our ability to comply with the financial covenants. Failure to comply with our financial covenants could result in an event of default, termination of the lending facility, acceleration of all amounts owing under the lending facility, and may give the counterparty the right to exercise certain other remedies under the lending agreement, including without limitation the sale of the asset subject to repurchase at the time of default, unless we were able to negotiate a waiver. Any such waiver could be conditioned on an amendment to the lending agreement and any related guaranty agreement on terms that may be unfavorable to us. If we are unable to negotiate a covenant waiver or replace or refinance our assets under a new lending facility on favorable terms or at all, our financial condition, results of operations, cash flows and ability to pay dividends could be adversely affected.

If a counterparty to a repurchase agreement defaults on its obligation to resell the underlying security back to us at the end of the purchase agreement term, or if the value of the underlying asset has declined as of the end of that term, or if we default on our obligations under the repurchase agreement, we may incur losses.

When we enter into repurchase agreements, we sell the assets to lenders (*i.e.*, repurchase agreement counterparties) and receive cash from the lenders. The lenders are obligated to resell the same assets back to us at the end of the term of the repurchase agreement. Because the cash that we receive from the lender when we initially sell the assets to the lender is less than the value of those assets (the difference being the "haircut"), if the lender defaults on its obligation to resell the same assets back to us, we would incur a loss on the repurchase agreement equal to the amount of the haircut (assuming there was no change in the value of the securities). We would also incur losses on a repurchase agreement if the value of the underlying assets has declined as of the end of the repurchase agreement term, because we would have to repurchase the assets for their initial value but would receive assets worth less than that amount. Further, if we default on our obligations under a repurchase agreement, the lender will be able to terminate the repurchase agreement and cease entering into any other repurchase agreements with us. Typically, our repurchase agreements contain cross-default provisions, so that if a default occurs under any repurchase agreement, lenders can also declare a default with respect to all other repurchase agreements. If a default occurs under any of our repurchase agreements and a lender terminates one or more of its repurchase agreements, we may need to enter into replacement repurchase agreements with different lenders. There can be no assurance that we will be successful in entering into such replacement repurchase agreements on the same terms as the repurchase agreements that were terminated or at all. Any losses that we incur on our repurchase agreements could adversely affect our earnings and thus our cash available for distribution to stockholders.

Our rights under our repurchase agreements are subject to the effects of bankruptcy laws in the event of the bankruptcy or insolvency of us or our lenders under the repurchase agreements.

In the event of our insolvency or bankruptcy, certain repurchase agreements may qualify for special treatment under the U.S. Bankruptcy Code, the effect of which, among other things, would be to allow the lender under the applicable repurchase agreement to avoid the automatic stay provisions of the U.S. Bankruptcy Code and to foreclose on the collateral agreement without delay. In the event of the insolvency or bankruptcy of a lender during the term of a repurchase agreement, the lender may be permitted, under applicable insolvency laws, to repudiate the contract, and our claim against the lender for damages may be treated simply as an unsecured creditor. In addition, if the lender is a broker or dealer subject to the Securities Investor Protection Act of 1970, or an insured depository institution subject to the Federal Deposit Insurance Act, our ability to exercise our rights to recover our assets under a repurchase agreement or to be compensated for any damages resulting from the lender's insolvency may be further limited by those statutes. These claims would be subject to significant delay and, if and when received, may be substantially less than the damages we actually incur.

The impairment or negative performance of other financial institutions could adversely affect us.

We have exposure to and routinely execute transactions with counterparties in the financial services industry, including broker-dealers, commercial banks, investment banks, investment funds and other institutions. The operations of U.S. and global financial services institutions are highly interconnected and a decline in the financial condition of one or more financial services institutions may expose us to credit losses or defaults, limit our access to liquidity or otherwise disrupt the operations of our businesses. While we regularly assess our exposure to different counterparties, the performance and financial strength of specific institutions are subject to rapid change, the timing and extent of which cannot be known.

Downgrades in the credit or financial strength ratings assigned to the counterparties with whom we transact or other adverse reputational impacts to such counterparties could create the perception that our business or financial condition will be adversely impacted as a result of potential future defaults by such counterparties. Additionally, we could be adversely affected by a general, negative perception of financial institutions caused by the downgrade or other adverse impact to the reputation of other financial institutions. Accordingly, ratings downgrades or other adverse reputational impacts for other financial institutions could adversely affect our business and financial condition and could limit access to or increase our cost of capital.

We may not have the ability to raise funds necessary to pay principal amounts owed upon maturity of our outstanding convertible senior notes or to purchase such notes upon a fundamental change.

In January 2017, we issued through an underwritten public offering $287.5 million in aggregate principal amount of 6.25% convertible senior notes due January 2022. To the extent these notes are not converted by the noteholders prior to their maturity date, we will be obligated to repay the principal amount of all outstanding notes upon maturity. In addition, if a fundamental change occurs (as described in the First Supplemental Indenture governing the notes) noteholders have the right to require us to purchase for cash any or all of their notes. The fundamental change purchase price will equal 100% of the principal amount of the notes to be purchased, plus accrued and unpaid interest, if any, to, but excluding, the fundamental change purchase date. We may not have sufficient funds available at the time we are required to repay principal amounts or to purchase the notes upon a fundamental change, and we may not be able to arrange necessary financing for such payments on acceptable terms, if at all. In addition, our ability to purchase the notes may be limited by law, by regulatory authority or by the agreements governing our other indebtedness outstanding at the time. If we fail to pay any amounts associated with the notes when due, we may be in default under the indenture governing the notes. A default under the indenture or a fundamental change itself could also constitute a default under the agreements governing our other existing and future indebtedness, which would further restrict our ability to make required payments under the notes. As a consequence of the foregoing matters, our business, financial condition and results of operations may be adversely affected.

An increase in our borrowing costs relative to the interest that we receive on our leveraged assets may adversely affect our profitability and our cash available for distribution to stockholders.

As our repurchase agreements and other short-term borrowings mature, we must enter into new borrowings, find other sources of liquidity or sell assets. An increase in short-term interest rates at the time that we seek to enter into new borrowings would reduce the spread between the returns on our assets and the cost of our borrowings. This would adversely affect the returns on our assets, which might reduce earnings and, in turn, cash available for distribution to stockholders.

We are highly dependent on information technology and security breaches or systems failures could significantly disrupt our business, which may, in turn, negatively affect the market price of our common stock and our ability to pay dividends.

Our business is highly dependent on information technology. In the ordinary course of our business, we may store sensitive data, including our proprietary business information and that of our business partners, and personally identifiable information of mortgage borrowers, on our networks. The secure maintenance and transmission of this information is critical to our operations.

Computer malware, viruses, hacking and phishing attacks have become more prevalent and sophisticated in recent years and we are from time to time the target of attempted cyber threats. We continuously monitor and develop our information technology networks and infrastructure to prevent , detect, address and mitigate the risk of unauthorized access, misuse, computer viruses and other events that could have a security impact. Despite these security measures, our information technology and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance or other disruptions. Any such breach could compromise our networks and the information stored there could be accessed, publicly disclosed, lost or stolen. Any such access, disclosure or other loss of information could result in legal claims or proceedings, liability under laws that protect the privacy of personal information, regulatory penalties, disrupt our operations, disrupt our trading activities or damage our reputation, which could have a material adverse effect on our financial results and negatively affect the market price of our common stock and our ability to pay dividends to stockholders.

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The resources required to protect our information technology and infrastructure, and to comply with the laws and regulations related to data and privacy protection, are subject to uncertainty. Even in circumstances where we are able to successfully protect such technology and infrastructure from attacks, we may incur significant expenses in connection with our responses to such attacks. In addition, recent well-publicized security breaches have led to enhanced government and regulatory scrutiny of the measures taken by companies to protect against cyber-security attacks, and may in the future result in heightened cyber-security requirements and/or additional regulatory oversight. As cyber-security threats and government and regulatory oversight of associated risks continue to evolve, we may be required to expend additional resources to enhance or expand upon the security measures we currently maintain. Any such actions may adversely impact our results of operations and financial condition.

Natural disasters, terrorist attacks, other acts of violence or war, or other unexpected events may affect the value of our investments, the markets in which we operate and our results of operations.

Natural disasters, terrorist attacks, other acts of violence or war, or other unexpected events may negatively affect our operations, the market price of our capital stock and the value of our investments. There can be no assurance that events like these will not occur or have a direct impact on our business. Such events could materially interrupt our business operations, cause consumer confidence and spending to decrease or result in increased volatility in the U.S. and worldwide financial markets and economy. They also could result in or prolong an economic recession in the U.S. or abroad. Any of these occurrences could have a significant adverse impact on our operating results and revenues and on the market price of our capital stock and on the value of our investments.

The occurrence of natural disasters, terrorist attacks or a significant adverse climate changes may cause a sudden decrease in the value of real estate in the area or areas affected and would likely reduce the value of the properties securing the mortgages collateralizing our non-Agency securities or underlying our MSR. Because certain natural disasters may not be covered by the standard hazard insurance policies maintained by borrowers (such as hurricanes or certain flooding), or the proceeds payable under any such policy are not sufficient to cover the related repairs, the affected borrowers may have to pay for any repairs themselves. Under these circumstances, borrowers may decide not to repair their property or may stop paying their mortgages. This would likely cause defaults and credit loss severities to increase and would negatively impact our securities and MSR portfolios.

We enter into hedging transactions that expose us to contingent liabilities in the future, which may adversely affect our financial results or cash available for distribution to stockholders.

We engage in transactions intended to hedge against various risks to our portfolio, including the exposure to changes in interest rates. The extent of our hedging activity varies in scope based on, among other things, the level and volatility of interest rates, the type of assets held and other market conditions. Although these transactions are intended to reduce our exposure to various risks, hedging may fail to adequately protect or could adversely affect us because, among other things:

- hedging can be expensive, particularly during periods of volatile or rapidly changing interest rates;
- available hedges may not correspond directly with the risks for which protection is sought;
- the duration of the hedge may not match the duration of the related liability;
- the amount of income that a REIT may earn from certain hedging transactions (other than through our TRSs) is limited by U.S. federal income tax provisions;
- the credit quality of a hedging counterparty may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and
- the hedging counterparty may default on its obligations.

Subject to maintaining our qualification as a REIT and satisfying the criteria for no-action relief from the CFTC’s CPO registration rules, there are no current limitations on the hedging transactions that we may undertake. Our hedging transactions could require us to fund large cash payments in certain circumstances (*e.g.*, the early termination of the hedging instrument caused by an event of default or other early termination event, or a demand by a counterparty that we make increased margin payments).

Our ability to fund these obligations will depend on the liquidity of our assets and our access to capital at the time. The need to fund these obligations could adversely affect our financial condition. Further, hedging transactions, which are intended to limit losses, may actually result in losses, which would adversely affect our earnings and could in turn reduce cash available for distribution to stockholders.

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The Dodd-Frank Act regulates derivative transactions, including certain hedging instruments we use in our risk management activities. Rules implemented by the CFTC pursuant to the Dodd-Frank Act require, among other things, that certain derivatives be cleared through a registered clearing facility and traded on a designated exchange or swap execution facility. These regulations could increase the operational and transactional cost of derivatives contracts and affect the number and/or creditworthiness of available counterparties. Furthermore, the enforceability of agreements underlying hedging transactions may depend on compliance with applicable statutory and commodity and other regulatory requirements and, depending on the identity of the counterparty, applicable international requirements. The business failure of a hedging counterparty will most likely result in its default. Default by a hedging counterparty may result in the loss of unrealized profits and force us to cover our commitments, if any, at the then current market price. Although generally we seek to reserve the right to terminate our hedging positions, it may not always be possible to dispose of or close out a hedging position without the consent of the hedging counterparty and we may not be able to enter into an offsetting contract in order to cover our risk. We cannot assure you that a liquid secondary market will exist for hedging instruments purchased or sold, and we may be required to maintain a position until exercise or expiration, which could result in losses.

Our results may experience greater fluctuations due to our decision not to elect hedge accounting treatment on our derivative instruments.

We have elected to not qualify for hedge accounting treatment under Accounting Standards Codification (ASC) 815, *Derivatives and Hedging,* or ASC 815, for our current derivative instruments. The economics of our derivative hedging transactions are not affected by this election; however, our earnings (losses) for U.S. GAAP purposes, or GAAP net income (loss), may be subject to greater fluctuations from period to period as a result of this accounting treatment for changes in fair value of derivative instruments or for the accounting of the underlying hedged assets or liabilities in our financial statements, as it does not necessarily align with the accounting used for derivative instruments.

We depend on third-party service providers, including mortgage loan servicers, for a variety of services related to our business. We are, therefore, subject to the risks associated with third-party service providers.

We depend on a variety of services provided by third-party service providers related to our investments in Agency RMBS, non-Agency securities and MSR as well as for general operating purposes. For example, we rely on the mortgage servicers who service the mortgage loans underlying our Agency RMBS, non-Agency securities and MSR to, among other things, collect principal and interest payments on such mortgage loans and perform loss mitigation services in accordance with applicable laws and regulations. Mortgage servicers and other service providers, such as trustees, bond insurance providers, due diligence vendors and document custodians, may fail to perform or otherwise not perform in a manner that promotes our interests.

For example, any legislation intended to reduce or prevent foreclosures through, among other things, loan modifications may reduce the value of mortgage loans, including those underlying our Agency RMBS, non-Agency securities and MSR. Mortgage servicers may be required or otherwise incentivized by the Federal or state governments to pursue such loan modifications, as well as forbearance plans and other actions intended to prevent foreclosure, even if such loan modifications and other actions are not in the best interests of the beneficial owners of the mortgage loans. Similarly, legislation delaying the initiation or completion of foreclosure proceedings on specified types of residential mortgage loans or otherwise limiting the ability of mortgage servicers to take actions that may be essential to preserve the value of the mortgage loans may also reduce the value of mortgage loans underlying our Agency RMBS and non-Agency securities. Any such limitations are likely to cause delayed or reduced collections from mortgagors and generally increase servicing costs. As a consequence of the foregoing matters, our business, financial condition and results of operations may be adversely affected.

In addition, in connection with our ownership of MSR, we possess personally identifiable information that is shared with third party service providers, including our sub-servicers, as required or permitted by law. In the event the information technology networks and infrastructure of our third party service providers is breached, we may be liable for losses suffered by individuals whose personal information is stolen as a result of such breach and any such liability could be material. Even if we are not liable for such losses, any breach of these third party systems could expose us to material costs related to notifying affected individuals or other parties and providing credit monitoring services, as well as to regulatory fines or penalties. In addition, any breach of these systems could disrupt our normal business operations and expose us to reputational damage or adversely impact our financial condition and results of operations.

We may be subject to fines, penalties or other enforcement actions based on the conduct of third-party mortgage loan servicers who service the loans underlying the MSR we acquire, which could adversely impact our results of operations, financial condition and business.

We contract with third-party mortgage loan servicers to perform the actual day-to-day servicing obligations on the mortgage loans underlying our MSR. We and the mortgage loan servicers operate in a highly regulated industry and are required to comply with various federal, state and local laws and regulations. Although the servicing activity is conducted primarily in the name of the mortgage loan servicers, to the extent these servicers fail to comply with applicable laws and regulations, we could be subject to governmental actions such as denial, suspension or revocation of licenses, be fined or incur losses or be subject to lawsuits, any of which could adversely impact our business, financial condition, results of operations and our ability to make distributions to our stockholders. While some of these laws and regulations may not explicitly hold us responsible for the legal violations of third party servicers, federal and state agencies have increasingly sought to impose such liability. Accordingly, the conduct of third-party mortgage loan servicers or our failure to adequately oversee their compliance with these laws and regulations may subject us to increased regulatory risk and could result in regulatory fines, penalties, civil liabilities or other limitations in our ability to acquire and manage MSR. Further, it is possible that a third-party servicer’s failure to comply with the new and evolving servicing rules or standards could adversely affect the value of our MSR.

A failure to protect our reputation could adversely affect our businesses.

Our reputation is critical to the success of our business. Damage to our reputation may arise from numerous sources, including for example legal or regulatory actions, failing to deliver minimum or required standards of service, compliance failures, perceived or actual weakness in our financial condition, technological or other security breaches or misconduct on the part of our manager or third-party service providers. In addition, adverse developments with respect to our industry generally or with respect to one or more of our competitors may also, by association, negatively impact our reputation. Negative perceptions or publicity regarding the foregoing matters could lead to difficulties in developing and maintaining relationships with our business counterparties, limit the sources of available funding and/or result in additional legal and regulatory scrutiny, all of which could adversely impact our business and results of operations.

Our ability to own and manage MSR is subject to terms and conditions established by the GSEs, which are subject to change.

Our subsidiary’s continued approval to own and manage MSR by the GSEs is subject to compliance with each of their respective selling and servicing guidelines, minimum capital requirements and other conditions they may impose from time to time at their discretion. Failure to meet such guidelines and conditions could result in the unilateral termination of our subsidiary’s approved status by one or more GSEs. In addition, the implementation of more restrictive or operational intensive guidance may increase the costs associated with owning and managing MSR as well as our ability to finance MSR.

GSEs generally require mortgage servicers to be paid a minimum servicing fee for the services provided. Changes in minimum servicing fee amounts for loans purchased or guaranteed by government-related entities could occur at any time and could negatively impact the value of the income derived from MSR on new origination that we may acquire in the future under our flow agreements or through bulk transactions.

We may not be able to acquire MSR.

MSR is a critical component of our overall portfolio management strategy, and our ability to source a sufficient amount of MSR may be adversely impacted for many reasons. We may be unable to locate originators or other sellers that are able or willing to sell MSR that meet our standards or on acceptable terms and conditions. Additionally, competition for MSR may drive down supply or drive up prices, making it uneconomical to purchase. General economic factors, such as recession, declining home values, unemployment and high interest rates, may limit the supply of available MSR. As a result, we may incur additional costs to acquire a sufficient volume of MSR or be unable to acquire MSR at a reasonable price. If we cannot source an adequate volume of MSR on desirable terms, our results of operations may be adversely impacted.

Our past securitization activities expose us to risk of litigation, which may materially and adversely affect our business and financial condition.

In connection with our past securitization transactions, we prepared disclosure documentation, including term sheets and offering memorandums, which contain disclosures regarding the securitization transactions and the assets securitized. If our disclosure documentation is alleged or found to contain inaccuracies or omissions, we may be liable under federal securities laws, state securities laws or other applicable laws for damages to third parties that invest in these securitization transactions, including in circumstances in which we relied on a third party in preparing accurate disclosures, or we may incur other expenses and costs in connection with disputing these allegations or settling claims. We have also sold or contributed residential mortgage loans to third parties who, in turn, securitize those loans. In these circumstances, we may have also prepared disclosure documentation, including documentation that is included in term sheets and offering memorandums relating to those securitization transactions. We could be liable under federal securities laws, state securities laws, or other applicable laws for damages to third parties that invest in these securitization transactions, including liability for disclosures prepared by third parties or with respect to loans that we did not sell or contribute to the securitization.

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In recent years, there has also been debate as to whether there are defects in the legal process and legal documents governing transactions in which securitization trusts and other secondary purchasers take legal ownership of residential mortgage loans and establish their rights as first priority lien holders on underlying mortgaged property. To the extent there are problems with the manner in which title and lien priority rights were established or transferred, securitization transactions that we sponsored and third-party sponsored securitizations that we hold investments in, we may experience losses.

Defending a lawsuit can consume significant resources and may divert management’s attention from our operations. We may be required to establish reserves for potential losses from litigation, which could be material. To the extent we are unsuccessful in our defense of any lawsuit, we could suffer losses which could be in excess of any reserves established relating to that lawsuit and these losses could be material.

We may be subject to representation and warranty risk in our capacity as an owner of MSR as well as in connection with our prior securitization transactions and our sales of MSR and other assets.

The MSR we acquire may be subject to existing representations and warranties made to the applicable investor (including, without limitation, the GSEs) regarding, among other things, the origination and prior servicing of those mortgage loans, as well as future servicing practices following our acquisition of such MSR. If such representations and warranties are inaccurate, we may be obligated to repurchase certain mortgage loans or indemnify the applicable investor for any losses suffered as a result of the origination or prior servicing of the mortgage loans, either of which may result in a loss. As such, the applicable investor will have direct recourse to us for such origination and/or prior servicing issues.

In connection with our prior securitization transactions and with the sales of our MSR and other assets from time to time, we may have been or be required to make representations and warranties to the purchasers of the assets regarding certain characteristics of those assets. If our representations and warranties are inaccurate, we may be obligated to repurchase the assets, which may result in a loss. Even if we obtain representations and warranties from the parties from whom we acquired the asset, as applicable, they may not correspond with the representations and warranties we make or may otherwise not protect us from losses. Additionally, the loan originator or other parties from whom we acquired the MSR may be insolvent or otherwise unable to honor their respective representation and warranties. For example, if representations and warranties we obtain from those parties do not exactly align with the representations and warranties we make, or if the representations and warranties made to us are not enforceable or if we cannot collect damages for a breach (*e.g.*, due to the financial condition of the party that made the representation or warranty to us or statutes of limitations), we may incur losses.

Risks Related To Our Assets

Declines in the market values of our assets may adversely affect our results of operations and financial condition.

A substantial portion of our assets are classified for accounting purposes as “available-for-sale.” Changes in the market values of those assets will be directly charged or credited to stockholders’ equity. As a result, a decline in values may result in connection with factors that are out of our control and adversely affect our book value. Moreover, if the decline in value of an available-for-sale security is other than temporary, such decline will reduce our earnings.

We may not realize gains or income from our assets.

We seek to generate current income and capital appreciation for our stockholders. However, the assets that we acquire may not appreciate in value and, in fact, may decline in value. Additionally, the securities that we acquire, or the loans underlying certain of our assets, may experience defaults of interest and/or principal payments, which could result in significant losses related to such assets. Accordingly, we may not be able to realize gains or income from our assets. Any gains that we do realize may not be sufficient to offset other losses that we experience. Any income that we realize may not be sufficient to offset our expenses.

Changes in mortgage prepayment rates may adversely affect the value of our assets.

The value of our assets is affected by prepayment rates on mortgage loans, and our investment strategy includes making investments based on our expectations regarding prepayment rates. A prepayment rate is the measurement of how quickly borrowers pay down the unpaid principal balance of their loans or how quickly loans are otherwise brought current, modified, liquidated or charged off.

With respect to our securities portfolio, typically the value of a mortgage-backed security includes market assumptions regarding the speed at which the underlying mortgages will be prepaid. Faster than expected prepayments could adversely affect our profitability, including in the following ways:

- We may purchase securities that have a higher interest rate than the market interest rate at the time. In exchange for this higher interest rate, we may pay a premium over the par value to acquire the security. In accordance with U.S. GAAP, we may amortize this premium over the estimated term of the security. If the security is prepaid in whole or in part prior to its maturity date, however, we may be required to expense the premium that was prepaid at the time of the prepayment.
- A substantial portion of our adjustable-rate Agency RMBS and non-Agency securities may bear interest rates that are lower than their fully indexed rates, which are equivalent to the applicable index rate plus a margin. If an adjustable-rate security is prepaid prior to or soon after the time of adjustment to a fully-indexed rate, we will have held that security while it was least profitable and lost the opportunity to receive interest at the fully indexed rate over the remainder of its expected life.
- If we are unable to acquire new Agency RMBS and non-Agency securities similar to the prepaid security, our financial condition, results of operations and cash flows would suffer.

Prepayment rates also significantly affect the value of MSR because such rights are priced on an assumption of a stable repayment rate. If the prepayment rate is significantly greater than expected, the fair value of the MSR could decline and we may be required to record a non-cash charge, which would have a negative impact on our financial results. Furthermore, a significant increase in the prepayment rate could materially reduce the ultimate cash flows we receive from MSR, and we could ultimately receive substantially less than what we paid for such assets.

Prepayment rates may be affected by a number of factors including the availability of mortgage credit, the relative economic vitality of the area in which the related properties are located, the average remaining life of the loans, the average size of the remaining loans, the servicing of the mortgage loans, changes in tax laws, other opportunities for investment, homeowner mobility and other economic, social, geographic, demographic and legal factors. Consequently, prepayment rates cannot be predicted with certainty. In making investment decisions, we depend on certain assumptions based upon historical trends with respect to the relationship between interest rates and prepayments under normal market conditions. If dislocations in the residential mortgage market or other developments change the way that prepayment trends have historically responded to interest rate changes, our ability to (i) assess the market value of target assets, (ii) implement hedging strategies and (iii) implement techniques to hedge prepayment risks would be significantly affected, which could materially adversely affect our financial position and results of operations. If we make erroneous assumptions regarding prepayment rates, we may experience significant investment losses.

A prolonged economic slowdown, a lengthy or severe recession or declining real estate values could impair our assets and harm our operations.

The risks associated with our business are more severe during periods of economic slowdown or recession, especially if these periods are accompanied by declining real estate values. The ability of a borrower to repay a loan secured by a residential property typically is dependent upon the income or assets of the borrower. During an economic slowdown, unemployment rises and increasing numbers of borrowers have difficulty in making payments on their debts, including on mortgage loans. When a recession is combined with declining real estate values, as was the case following the 2008 financial crisis, defaults on mortgages may increase dramatically.

Owners of Agency RMBS are protected from the risk of default on the underlying mortgages by guarantees from Fannie Mae, Freddie Mac or, in the case of the Ginnie Mae, the U.S. government. However, we also own non-Agency securities, which are backed by residential real property but, in contrast to Agency RMBS, the principal and interest payments are not guaranteed by GSEs or the U.S. government. Our non-Agency securities are therefore particularly sensitive to recessions and declining real estate values.

In the event of a default on a mortgage loan that we hold in our portfolio or a mortgage loan underlying a non-Agency security in our portfolio, we bear the risk of loss as a result of the potential deficiency between the value of the

collateral and the debt owed on the mortgage, as well as the costs and delays of foreclosure or other remedies, and the costs of maintaining and ultimately selling a property after foreclosure. Delinquencies and defaults on mortgage loans for which we own the servicing rights will adversely affect the amount of servicing fee income we receive and may result in increased servicing costs and operational risks due to the increased complexity of servicing delinquent and defaulted mortgage loans. If an investor in the mortgage loans for which we own the servicing rights determines that the rate of delinquencies or defaults for the loans it owns is unacceptable, we bear the risk of losing the right to service the related mortgage loans which could adversely affect our revenues, business prospects and financial condition.
Any sustained period of increased payment delinquencies, defaults, foreclosures or losses on our non-Agency securities, mortgage loans, mortgage loans for which we own the servicing rights could adversely affect our revenues, results of operations, financial condition, business prospects and ability to make distributions to stockholders.

Changes in inter-bank lending rate reporting practices or the method pursuant to which LIBOR is determined may adversely affect the value of our assets and financial obligations that are linked to LIBOR.

LIBOR and other "benchmark" indices have been the subject of recent national, international and other regulatory guidance and proposals for reform. These reforms may cause such benchmarks to perform differently than in the past, or have other consequences which cannot be predicted. In particular, regulators and law enforcement agencies in the U.K. and elsewhere are conducting criminal and civil investigations into whether the banks that contributed information to the British Bankers' Association, or BBA, in connection with the daily calculation of LIBOR may have been under-reporting or otherwise manipulating or attempting to manipulate LIBOR. A number of BBA member banks have entered into settlements with their regulators and law enforcement agencies with respect to this alleged manipulation of LIBOR. Actions by the regulators or law enforcement agencies may result in changes to the manner in which LIBOR is determined or the establishment of alternative reference rates. For example, in July 2017, the U.K. Financial Conduct Authority announced that it intends to stop persuading or compelling banks to submit LIBOR rates after 2021.

At this time, it is not possible to predict the effect of any such changes, any establishment of alternative reference rates or any other reforms to LIBOR that may be implemented in the U.K. or elsewhere. Uncertainty as to the nature of such potential changes, alternative reference rates or other reforms may adversely affect the market for or value of any securities on which the interest or dividend is determined by reference to LIBOR, loans, derivatives and other financial obligations or on our overall financial condition or results of operations. More generally, any of the above changes or any other consequential changes to LIBOR or any other "benchmark" index as a result of international, national or other proposals for reform or other initiatives or investigations, or any further uncertainty in relation to the timing and manner of implementation of such changes, could have a material adverse effect on the value of and return on any of our securities based on or linked to such a "benchmark."

Our delayed delivery transactions, including TBAs, subject us to certain risks, including price risks and counterparty risks.

We may purchase Agency RMBS through delayed delivery transactions, including TBAs. In a delayed delivery transaction, we enter into a forward purchase agreement with a counterparty to purchase either (i) an identified Agency RMBS, or (ii) a to-be-issued (or "to-be-announced") Agency RMBS with certain terms. As with any forward purchase contract, the value of the underlying Agency RMBS may decrease between the contract date and the settlement date. Furthermore, a transaction counterparty may fail to deliver the underlying Agency RMBS at the settlement date. If any of the above risks were to occur, our financial condition and results of operations may be materially adversely affected.

It may be uneconomical to roll our TBA dollar roll transactions or we may be unable to meet margin calls on our TBA contracts, which could negatively affect our financial condition and results of operations.

We utilize TBA dollar roll transactions as a means of investing in and financing Agency RMBS. TBA contracts enable us to purchase or sell, for future delivery, Agency RMBS with certain principal and interest terms and certain types of collateral, but the specific securities to be delivered are not identified until shortly before the TBA settlement date. Prior to settlement of the TBA contract we may choose to move the settlement of the securities to a later date by entering into an offsetting position (referred to as a "pair off"), net settling the paired off positions for cash, and simultaneously purchasing a similar TBA contact for a later settlement date, collectively referred to as a "dollar roll". The Agency RMBS purchased for a forward settlement date under the TBA contracts are typically priced at a discount to Agency RMBS for settlement in the current month. This difference (or discount) is referred to as the "price drop." The price drop is the economic equivalent of net interest carry income on the underlying Agency RMBS over the roll period (interest income less implied financing cost) and is commonly referred to as a "dollar roll income." Consequently, dollar roll transactions and such forward purchase of Agency RMBS represent a form of off-balance sheet financing and increase our "at-risk" leverage.

Under certain market conditions, TBA dollar roll transactions may result in negative carry income whereby the Agency RMBS purchase for a forward settlement date under TBA contracts are priced at a premium to Agency

RMBS by the Fed could adversely impact the dollar roll market. Under such conditions, it may be uneconomical to roll our TBA positions prior to the settlement date and we could have to take physical delivery of the underlying securities and settle our obligations for cash. We may not have sufficient funds or alternative financing sources available to settle such obligations. In addition, pursuant to the margin provisions established by the Mortgage-Backed Securities Division ("MBSD") of the FICC, we are subject to margin calls on our TBA contracts. Further, our prime brokerage agreements may require us to post additional margin above the levels established by the MBSD. Negative carry income on TBA dollar roll transactions or failure to procure adequate financing to settle our obligations or meet margin calls under our TBA contracts could result in defaults or force us to sell assets under adverse market conditions or through foreclosure and adversely affect our financial condition and results of operations.

We acquire RMBS collateralized by subprime mortgage loans, which are subject to increased risks.

Among other assets, we acquire RMBS backed by collateral pools of subprime mortgage loans, which are mortgage loans that have been originated using underwriting standards that are less conservative than those used in underwriting prime mortgage loans (mortgage loans that generally conform to GSE underwriting guidelines) and Alt-A mortgage loans (mortgage loans made to borrowers whose qualifying mortgage characteristics do not conform to GSE underwriting guidelines and generally allow homeowners to qualify for a mortgage loan with reduced or alternate forms of documentation). These lower standards include mortgage loans made to borrowers having imperfect or impaired credit histories, mortgage loans where the amount of the loan at origination is 80% or more of the value of the mortgage property, mortgage loans made to borrowers with low credit scores, mortgage loans made to borrowers who have other debt that represents a large portion of their income and mortgage loans made to borrowers whose income is not required to be disclosed or verified. Due to economic conditions, including increased interest rates and lower home prices, as well as aggressive lending practices, subprime mortgage loans have in recent periods experienced increased rates of delinquency, foreclosure, bankruptcy and loss, and they are likely to continue to experience delinquency, foreclosure, bankruptcy and loss rates that may be substantially higher, than those experienced by mortgage loans underwritten in a more traditional manner. In acquiring these assets, we endeavor to factor the risk of losses on the underlying mortgages into the purchase price of the asset. If we underestimate those losses, however, the performance of RMBS backed by subprime mortgage loans that we acquire could be adversely affected, which could adversely affect our results of operations, financial condition and business.

Our portfolio of assets may be concentrated in terms of credit risk.

Although as a general policy we seek to acquire and hold a diverse portfolio of assets, we are not required to observe specific diversification criteria, except as may be set forth in the investment guidelines adopted by our board of directors. Therefore, our asset portfolio may at times be concentrated in certain property types that are subject to higher risk of foreclosure, or secured by properties concentrated in a limited number of geographic locations. To the extent that our portfolio is concentrated in any one region or type of asset, downturns relating generally to such region or type of asset may result in defaults on a number of our assets within a short time period, which may reduce our net income and the value of our shares and accordingly reduce our ability to pay dividends to our stockholders. The portfolio may contain other concentrations of risk, and we may fail to identify, detect or hedge against those risks, resulting in large or unexpected losses.

Our subordinated RMBS may be in the "first loss" position, subjecting us to greater risk of losses.

We invest in certain tranches of RMBS that are only entitled to a portion of the principal and interest payments made on mortgage loans underlying the securities issued by the trust. In general, losses on a mortgage loan included in such a trust will be borne first by the equity holder of the issuing trust, and then by the "first loss" subordinated security holder and then by the "second loss" mezzanine holder. We may acquire securities at every level of such a trust, from the equity holder to the most senior tranche. In the event of default and the exhaustion of any classes of securities junior to those which we acquire, our securities will suffer losses as well. In addition, if we overvalue the underlying mortgage portfolio, or if the values subsequently decline and, as a result, less collateral is available to satisfy interest and principal payments due on the related RMBS, the securities which we acquire may effectively become the "first loss" position behind the more senior securities, which may result in significant losses. The prices of lower credit quality securities are generally less sensitive to interest rate changes than more highly rated securities, but more sensitive to adverse economic downturns or individual issuer developments. A projection of an economic downturn could cause a decline in the value of lower credit quality securities because the ability of obligors of mortgages underlying RMBS to make principal and interest payments may be impaired. In such event, existing credit support in the securitization structure may be insufficient to protect us against loss of our principal on these securities.

Increases in interest rates could adversely affect the value of our assets and cause our interest expense to increase, which could result in reduced earnings or losses and negatively affect our profitability as well as the cash available for distribution to stockholders.

Our operating results will depend in large part on the difference between the income from our assets, net of credit losses, and financing costs. We anticipate that, in many cases, the income from our assets will respond more slowly to interest rate fluctuations than the cost of our borrowings. Consequently, changes in interest rates, particularly short-term interest rates, may significantly influence our financial results.

Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. For example, the Federal Reserve continued to modestly raise the federal funds target rate in 2017 and 2018, though has more recently communicated a roughly balanced outlook. We cannot predict the impact that recent rate increases, or any future actions or non-actions with respect to the federal funds rate, may have on the markets or the economy. Interest rate fluctuations present a variety of risks, including the risk of a narrowing of the difference between asset yields and borrowing rates, flattening or inversion of the yield curve and fluctuating prepayment rates.

In a normal yield curve environment, fixed income assets, including many Agency RMBS and non-Agency securities, decline in value if interest rates increase. If long-term rates increased significantly, not only will the market value of these assets be expected to decline, but the duration and weighted-average life of the assets could increase as well because borrowers are less likely to prepay mortgages. Further, an increase in short-term interest rates would increase the rate of interest payable on any repurchase agreements required to finance these securities.

We endeavor to hedge our exposure to changes in interest rates, but there can be no assurances that our hedges will be successful, or that we will be able to enter into or maintain such hedges. As a result, interest rate fluctuations can cause significant losses, reductions in income, and limitations on our cash available for distribution to stockholders.

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An increase in interest rates may cause a decrease in the availability of certain of our target assets, which could adversely affect our ability to acquire target assets that satisfy our investment objectives and to generate income and pay dividends.

Rising interest rates generally reduce the demand for mortgage loans due to the higher cost of borrowing. A reduction in the volume of mortgage loans originated may affect the volume of certain target assets available to us, which could adversely affect our ability to acquire assets that satisfy our investment and business objectives. Rising interest rates may also cause certain target assets that were issued prior to an interest rate increase to provide yields that are below prevailing market interest rates. If rising interest rates cause us to be unable to acquire a sufficient volume of our target assets with a yield that is above our borrowing cost, our ability to satisfy our investment objectives and to generate income and pay dividends may be materially and adversely affected.

The assets in our portfolio are recorded at fair value, but there may be substantial uncertainty as to the value of certain assets.

Some of the assets in our portfolio are not publicly traded. The fair value of securities and other assets that are not publicly traded may not be readily determinable. We value these assets quarterly at fair value, as determined in accordance with ASC 820, *Fair Value Measurements and Disclosures*, which may include unobservable inputs. Because such valuations are subjective, the fair value of certain of our assets may fluctuate over short periods of time and our determinations of fair value may differ materially from the values that would have been used if a ready market for these securities existed. The value of our common stock could be adversely affected if our determinations regarding the fair value of these assets are materially higher than the values that we ultimately realize upon their disposal.

Our MSR are recorded at fair value on our consolidated balance sheets based upon significant estimates and assumptions. The determination of the fair value of MSR requires our management to make numerous estimates and assumptions. Such estimates and assumptions include, without limitation, estimates of future cash flows associated with MSR based upon assumptions involving interest rates as well as the prepayment rates, delinquencies and foreclosure rates of the underlying mortgage loans. The ultimate realization of the value of MSR may be materially different than the fair values of such MSR as may be reflected in our consolidated balance sheets as of any particular date. The use of different estimates or assumptions in connection with the valuation of these assets could produce materially different fair values for such assets, which could have a material adverse effect on our business, financial condition, results of operations and cash flows. Accordingly, there may be material uncertainty about the fair value of any MSR we acquire.

The value of our Agency RMBS, non-Agency securities and MSR may be adversely affected by deficiencies in servicing and foreclosure practices, as well as related delays in the foreclosure process.

Deficiencies in servicing and foreclosure practices among servicers of residential mortgage loans have raised and may in the future raise concerns relating to such practices, including the improper execution of the documents used in foreclosure proceedings (so-called “robo signing”), inadequate documentation of transfers and registrations of mortgages and assignments of loans, improper handling and processing of loan modifications, violations of representations and warranties at the date of securitization and failure to enforce put-backs. The integrity of the servicing and foreclosure processes is critical to the value of our Agency RMBS, non-Agency securities and MSR, and our financial results could be adversely affected by deficiencies in the conduct of those processes. For example, delays in the foreclosure process that may result from improper servicing practices may adversely affect the values of, and our losses on, our mortgage-related assets. Foreclosure delays may also increase the administrative expenses of the securitization trusts for non-Agency securities or result in the curtailment of payments to the GSEs, thereby resulting in additional expense and reducing the amount of funds available for distribution to investors. In addition, the subordinate classes of securities issued by the securitization trusts may continue to receive interest payments while the defaulted loans remain in the trusts, rather than absorbing the default losses. This may reduce the amount of credit support available for any senior classes we own, thus possibly adversely affecting these securities.

While we believe that our servicers would be in violation of their servicing contracts to the extent that they have improperly serviced mortgage loans or improperly executed documents in foreclosure or bankruptcy proceedings, or do not comply with the terms of servicing contracts and applicable laws and regulations when assessing loss mitigation options for affected borrowers, it may be difficult, expensive, and time consuming for us to enforce our contractual rights. Such failure to comply may also expose us to regulatory risks. We continue to monitor and review the issues raised by improper servicing practices. While we cannot predict exactly how servicing, loss mitigation and foreclosure matters or any resulting litigation, regulatory actions or settlement agreements will affect our business, there can be no assurance that these matters will not have an adverse impact on our results of operations and financial condition.

Risks Related to our Management and Relationship with PRCM Advisers and Pine River

We are dependent on PRCM Advisers and Pine River and may not find a suitable replacement if we or PRCM Advisers terminates the management agreement.

We have no employees. Instead, we are completely reliant on the employees provided to us by PRCM Advisers, which has significant discretion as to the implementation and execution of our business strategies and risk management practices. PRCM

Advisers may not have sufficient access to Pine River's employees, systems and facilities in order to comply with its obligations under the management agreement. We are also subject to the risk that PRCM Advisers will terminate the management agreement and that no suitable replacement will be found.

The current term of the management agreement expires on October 28, 2019 and will automatically renew for successive one-year terms unless terminated by us or PRCM Advisers as set forth in the management agreement. If the management agreement is terminated and no suitable replacement is found to manage Two Harbors or we are unable to hire our own qualified employees, we may not be able to continue to execute our business plan.

We will have no recourse to Pine River if it does not fulfill its obligations under the shared facilities and services agreement with PRCM Advisers.

Neither we nor PRCM Advisers has any employees, and PRCM Advisers does not have separate facilities. As a result, PRCM Advisers has entered into a shared facilities and services agreement with Pine River pursuant to which PRCM Advisers is provided with the personnel, services and resources necessary for PRCM Advisers to perform its obligations and responsibilities under the management agreement in exchange for certain amounts payable by PRCM Advisers. Because we are not a party to the shared facilities and services agreement, we will not have any recourse to Pine River if it does not fulfill its obligations under the shared facilities and services agreement, or if Pine River and PRCM Advisers choose to amend or terminate the shared facilities and services agreement.

There are conflicts of interest in our relationship with Pine River and its affiliates, including PRCM Advisers, which could result in decisions that are not in the best interests of our stockholders.

We are subject to conflicts of interest arising out of our relationship with Pine River and its affiliates, including PRCM Advisers. PRCM Advisers is wholly owned by Pine River. Each of Thomas Siering (a director, and our Chief Executive Officer and President), and Bill Roth (a director, and our Chief Investment Officer) is a partner and owner of equity interests in Pine River. All of our other executive officers are employees of Pine River. As a result, the management agreement with PRCM Advisers was negotiated between related parties, and its terms, including fees payable to PRCM Advisers, may not be as favorable to us as if they had been negotiated with an unaffiliated third party. In addition, we may choose not to enforce, or to enforce less vigorously, our rights under the management agreement because of our desire to maintain our ongoing relationship with PRCM Advisers.

The management agreement with PRCM Advisers does not prevent PRCM Advisers and its affiliates from engaging in additional management or investment opportunities. Pine River and its affiliates, including PRCM Advisers, may engage in additional management or investment opportunities that have overlapping objectives with us, and thus face conflicts in the allocation of resources between us, any other funds they manage and for their own accounts. For example, Pine River serves as the external manager for Granite Point Mortgage Trust Inc. (NYSE: GPMT) ("Granite Point"). In 2017, we contributed our commercial real estate business to Granite Point and subsequently distributed to our common stockholders the shares of Granite Point common stock that we received in connection with that contribution. Each of Thomas Siering and Bill Roth serves as a director of Granite Point, and a number of Pine River non-investment personnel who provide services to Two Harbors have also continued to provide support to Granite Point's operations.

The ability of PRCM Advisers, Pine River and the officers and employees providing services to Two Harbors under the management agreement to engage in other business activities reduces the time PRCM Advisers spends managing Two Harbors. While there are a number of employees of Pine River who allocate 100% of their time to Two Harbors, certain employees who provide services to Two Harbors allocate some, or a material portion, of their time to other businesses and activities of Pine River. Under the management agreement, none of these individuals is required to devote a specific amount of time to Two Harbors' affairs. Accordingly, we compete with Pine River, its existing funds, investment vehicles and other ventures, including Granite Point, for the time and attention of these officers and other personnel.

We may enter into additional transactions with Pine River, its affiliates or the investment vehicles that it manages. In particular, we may purchase assets from Pine River or its affiliates or make co-purchases alongside Pine River or its affiliates. These transactions may not be the result of arm's length negotiations and may involve conflicts between our interests and the interests of Pine River and/or its affiliates. There can be no assurance that any procedural protections will be sufficient to assure that these transactions will be made on terms that will be at least as favorable to us as those that would have been obtained in an arm's length transaction.

We compete with current and future investment entities affiliated with Pine River for access to certain of the benefits that our relationship with Pine River provides to us, including access to investment opportunities.

There may be conflicts of interest in allocating investment opportunities among Two Harbors and other funds, investment vehicles and ventures managed by Pine River, including Granite Point. There may be overlap in the assets and investment strategies of Two Harbors and Pine River's private funds, and additional areas of overlap may develop in the future. Although PRCM Advisers and Pine River have a dedicated team of trading and investment personnel to serve Two Harbors full-time, in some cases certain non-investment personnel may provide services to both entities as well as Granite Point. Additionally, there are other members of the Pine River investment team that are dedicated full-time to other Pine River strategies and clients and, therefore, do not devote any of their time to Two Harbors and its trading activities. Pine River and its affiliates may in the future form additional funds or sponsor additional investment vehicles and ventures that have overlapping objectives with Two Harbors and therefore may compete with us for investment opportunities and Pine River resources. Pine River has an allocation policy that addresses the manner in which investment opportunities are allocated among the various entities and strategies for which they provide investment management services. However, we cannot assure you that Pine River and PRCM Advisers will always allocate investment opportunities in a manner that is advantageous for us; indeed, we may expect that the allocation of investment opportunities will at times result in our receiving only a portion of, or none of, certain investment opportunities.

The loss of our access to Pine River's investment professionals and principals may adversely affect our ability to achieve our investment objectives.

We depend on PRCM Advisers' access, through a shared facilities and services agreement, to the investment professionals and principals of Pine River and the information opportunities generated by Pine River's investment professionals and principals. These investment professionals and principals evaluate, negotiate, structure, close and monitor our investments and our financing activities and we depend on their continued service. The departure of a significant number of the investment professionals or principals of Pine River could have a material adverse effect on our ability to achieve our investment objectives. Certain Pine River investment personnel and principals are dedicated to strategies and clients other than Two Harbors and, as a result, Two Harbors will not benefit from the investment opportunities they generate. Further, we cannot assure you that PRCM Advisers will remain as Two Harbors' manager, that Pine River will continue to be able to support our business and operations consistent with historical practice or that we will continue to have access to Pine River's investment professionals or principals.

Our board of directors has approved very broad investment guidelines for Two Harbors and will not review or approve each investment decision made by PRCM Advisers.

Our board of directors periodically reviews and updates our investment guidelines and also reviews our investment portfolio but does not review or approve specific investments. PRCM Advisers has great latitude within the broad parameters of the investment guidelines set by our board of directors in determining our investments and investment strategies, which could result in investment returns that are substantially below expectations or that result in material losses.

The manner of determining the management fee may not provide sufficient incentive to PRCM Advisers to maximize risk-adjusted returns on our investment portfolio because it is based on our stockholders' equity and not on our financial performance.

PRCM Advisers is entitled to receive a management fee that is based on our stockholders' equity at the end of each quarter, regardless of our financial performance. Accordingly, significant management fees will be payable to PRCM Advisers even if we have a net loss during a quarter. PRCM Advisers' right to such compensation may not provide sufficient incentive to PRCM Advisers to devote sufficient time and effort to maximize risk-adjusted returns on our investment portfolio, which could, in turn, adversely affect our financial results. Further, the management fee structure gives PRCM Advisers the incentive to maximize stockholders' equity by the issuance of new common or preferred stock or the retention of existing equity, regardless of the effect of these actions on existing stockholders. In other words, the management fee structure rewards PRCM Advisers primarily based on the size of Two Harbors, and not on our returns to stockholders.

Termination of the management agreement may be difficult and costly, which may adversely affect our inclination to end our relationship with PRCM Advisers.

Termination of the management agreement with PRCM Advisers without cause is difficult and costly. We have the right to terminate for cause; however, the term "cause" is limited to certain specifically described circumstances. In the absence of cause, we may only terminate it after October 28, 2019, upon the vote of at least two-thirds of all of our independent directors or by a vote of the holders of a majority of the outstanding shares of our common stock, and only for the reasons set forth in the management contract. Additionally, upon a termination by Two Harbors without cause (or upon a termination by PRCM Advisers due to our material breach), the management agreement requires us to pay PRCM Advisers a termination payment equal to three times the sum of the average annual base management fee received by PRCM Advisers during the 24-month period before such termination, calculated as of the end of the most recently completed fiscal quarter. This provision increases the effective cost to us of terminating our relationship with PRCM Advisers, even if we believe that PRCM Advisers' performance is not satisfactory.

The liability of PRCM Advisers and Pine River is limited under the management agreement, and we have agreed to indemnify PRCM Advisers and its affiliates and advisers, including Pine River, against certain liabilities. As a result, we could experience poor performance or losses for which PRCM Advisers and Pine River would not be liable.

Pursuant to the management agreement, PRCM Advisers does not assume any responsibility other than to render the services called for thereunder and will not be responsible for any action of our board of directors in following or declining to follow its advice or recommendations. PRCM Advisers and its officers, stockholders, members, managers, personnel and directors, any person controlling or controlled by PRCM Advisers and any person providing sub-advisory services to PRCM Advisers will not be liable to Two Harbors, any of our subsidiaries, any of our directors, stockholders or partners or any subsidiary's stockholders, members or partners for acts or omissions performed in accordance with or pursuant to the management agreement, except by reason of acts constituting reckless disregard of PRCM Advisers' duties under the management agreement which has a material adverse effect on Two Harbors, willful misconduct or gross negligence, as determined by a final non-appealable order of a court of competent jurisdiction. We have agreed to indemnify PRCM Advisers and its affiliates and sub-advisers, including Pine River, with respect to all expenses, losses, damages, liabilities, demands, charges and claims arising from willful misconduct, gross negligence or acts or omissions of such indemnified parties not constituting reckless disregard of PRCM Advisers' duties under the management agreement which has a material adverse effect on Two Harbors. As a result, if we experience poor performance or losses, PRCM Advisers would not be liable.

Risks Related to Our Organization and Structure

Certain provisions of Maryland law could inhibit changes in control.

Certain provisions of the Maryland General Corporation Law, or MGCL, may have the effect of deterring a third party from making a proposal to acquire us or of impeding a change in control under circumstances that otherwise could provide the holders of shares of our common stock with the opportunity to realize a premium over the then-prevailing market price of such shares.

We are subject to the "business combination" provisions of the MGCL that, subject to limitations, prohibit certain business combinations (including a merger, consolidation, share exchange, or, in circumstances specified in the statute, an asset transfer or issuance or reclassification of equity securities) between our company and an "interested stockholder" (defined generally as any person who beneficially owns 10% or more of our then outstanding voting stock or an affiliate or associate of our company who, at any time within the two-year period immediately prior to the date in question, was the beneficial owner of 10% or more of the voting power of our then outstanding stock) or an affiliate thereof for five years after the most recent date on which the stockholder becomes an interested stockholder. After the five-year prohibition, any business combination between our company and an interested stockholder generally must be recommended by our board of directors and approved by the affirmative vote of at least (1) 80% of the votes entitled to be cast by holders of outstanding shares of our voting stock; and (2) two-thirds of the votes entitled to be cast by holders of voting stock of the corporation other than shares held by the interested stockholder with whom or with whose affiliate the business combination is to be effected or held by an affiliate or associate of the interested stockholder. These super-majority vote requirements do not apply if our common stockholders receive a minimum price, as defined under Maryland law, for their shares in the form of cash or other consideration in the same form as previously paid by the interested stockholder for its shares. These provisions of the MGCL do not apply to business combinations that are approved or exempted by a board of directors prior to the time that the interested stockholder becomes an interested stockholder. Pursuant to the statute, our board of directors has by resolution exempted business combinations (1) between our company and any person, provided that such business combination is first approved by our board of directors (including a majority of our directors who are not affiliates or associates of such person) and (2) between our company and Pine River or its affiliates. Consequently, the five-year prohibition and the super-majority vote requirements will not apply to any business combination between our company and any person if such combination is approved in accordance with the foregoing procedures. As a result, any person, including Pine River, may be able to enter into business combinations with Two Harbors that may not be in the best interests of our stockholders, without compliance with the super-majority vote requirements and the other provisions of the statute.

The “control share” provisions of the MGCL provide that “control shares” of a Maryland corporation (defined as voting shares of stock which, if aggregated with all other shares of stock owned by the acquirer or in respect of which the acquirer is able to exercise or direct the exercise of voting power (except solely by virtue of a revocable proxy), would entitle the acquirer to exercise one of three increasing ranges of voting power in electing directors) acquired in a “control share acquisition” (defined as the direct or indirect acquisition of ownership or control of “control shares”) have no voting rights except to the extent approved by our stockholders by the affirmative vote of at least two-thirds of all the votes entitled to be cast on the matter, excluding votes entitled to be cast by the acquirer of control shares, our officers and employees who are also our directors. Our bylaws contain a provision exempting from the control share acquisition statute any and all acquisitions by any person of shares of our stock. There can be no assurance that this provision will not be amended or eliminated at any time in the future.

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The "unsolicited takeover" provisions of the MGCL (Title 3, Subtitle 8 of the MGCL) permit our board of directors, without stockholder approval and regardless of what is currently provided in our charter or bylaws, to implement takeover defenses, some of which (for example, a classified board) we do not currently have. These provisions may have the effect of inhibiting a third party from making an acquisition proposal for our company or of delaying, deferring or preventing a change in control of our company under circumstances that otherwise could provide the holders of shares of our common stock with the opportunity to realize a premium over the then current market price. Our charter contains a provision whereby our company has elected to be subject to the provisions of Title 3, Subtitle 8 of the MGCL relating to the filling of vacancies on its board of directors.

Our authorized but unissued shares of common and preferred stock and the ownership limitations contained in our charter may prevent a change in control.

Our charter authorizes Two Harbors to issue additional authorized but unissued shares of common or preferred stock. In addition, our board of directors may, with the approval of a majority of the entire board and without stockholder approval, amend our charter to increase or decrease the aggregate number of shares of our stock or the number of shares of stock of any class or series that Two Harbors has the authority to issue and classify or reclassify any unissued shares of common or preferred stock and set the terms of the classified or reclassified shares. As a result, our board may establish a series of shares of common or preferred stock that could delay or prevent a transaction or a change in control that might involve a premium price for shares of our common stock or otherwise be in the best interests of stockholders.

In addition, our charter contains restrictions limiting the ownership and transfer of shares of our common stock and other outstanding shares of capital stock. The relevant sections of our charter provide that, subject to certain exceptions, ownership of shares of our common stock by any person is limited to 9.8% by value or by number of shares, whichever is more restrictive, of our outstanding shares of common stock (the common share ownership limit), and no more than 9.8% by value or number of shares, whichever is more restrictive, of our outstanding capital stock (the aggregate share ownership limit). The common share ownership limit and the aggregate share ownership limit are collectively referred to herein as the "ownership limits." These charter provisions will restrict the ability of persons to purchase shares in excess of the relevant ownership limits.

Our charter contains provisions that make removal of our directors difficult, which could make it difficult for stockholders to effect changes in management.

Our charter provides that, subject to the rights of any series of preferred stock, a director may be removed only by the affirmative vote of at least two-thirds of all the votes entitled to be cast generally in the election of directors. Our charter and bylaws provide that vacancies generally may be filled only by a majority of the remaining directors in office, even if less than a quorum. These requirements make it more difficult to change management by removing and replacing directors and may prevent a change in control that is in the best interests of stockholders.

Our rights and stockholders' rights to take action against directors and officers are limited, which could limit recourse in the event of actions not in the best interests of stockholders.

As permitted by Maryland law, our charter eliminates the liability of its directors and officers to Two Harbors and its stockholders for money damages, except for liability resulting from:

- actual receipt of an improper benefit or profit in money, property or services; or
- a final judgment based upon a finding of active and deliberate dishonesty by the director or officer that was material to the cause of action adjudicated.

In addition, pursuant to our charter we have agreed contractually to indemnify our present and former directors and officers for actions taken by them in those capacities to the maximum extent permitted by Maryland law. Further, our bylaws require us to indemnify each present or former director or officer, to the maximum extent permitted by Maryland law, who is made, or threatened to be made, a party to any proceeding because of his or her service to Two Harbors. As part of these indemnification obligations, we may be obligated to fund the defense costs incurred by our directors and officers.

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Our amended and restated bylaws designate certain Maryland courts as the sole and exclusive forum for certain types of actions and proceedings that may be initiated by our stockholders, which could limit our stockholders' ability to obtain a favorable judicial forum for disputes with us or our directors, officers or employees.

Our amended and restated bylaws provided that, unless we consent in writing to the selection of an alternative forum, the Circuit Court for Baltimore City, Maryland, or, if that Court does not have jurisdiction, the United States District Court for the District of Maryland, Baltimore Division, shall be the sole and exclusive forum for the following: any derivative action or proceeding brought on behalf of the corporation; any action asserting a claim of breach of any duty owed by any of our directors, officers or other employees to the corporation or to our stockholders; any action asserting a claim against the corporation or any of our directors, officers or other employees arising pursuant to any provision of the MGCL or our charter or bylaws; or any action asserting a claim against the corporation or any of our directors, officers or other employees that is governed by the internal affairs doctrine. This choice of forum provision may limit a stockholder's ability to bring a claim in a judicial forum that the stockholder believes is favorable for disputes with us or our directors, officers or other employees, which may discourage lawsuits against us and our directors, officers and employees. Alternatively, if a court were to find these provisions of our amended and restated certificate of incorporation inapplicable to, or unenforceable in respect of, one or more of the specified types of actions or proceedings, we may incur additional costs associated with resolving such matters in other jurisdictions, which could adversely affect our business, financial condition or results of operations.

Risks Related to Our Securities

Future issuances and sales of shares of our common stock may depress the market price of our common stock or have adverse consequences for our stockholders.

We have 450,000,000 authorized shares of common stock and we may increase our authorized common stock without stockholder approval. As of December 31, 2018, 248,085,721 shares of common stock were issued and outstanding. In May 2015, our stockholders approved our Second Restated 2009 Equity Incentive Plan, or the Plan, which provides for grants of restricted common stock and other equity-based awards, subject to a ceiling of 6,500,000 shares available for issuance under the Plan. As of December 31, 2018, an aggregate of 2,125,725 shares of common stock remained available for issuance to our independent directors and Pine River employees pursuant to the Plan. Additionally, shares of our common stock have also been reserved for issuance in connection with the conversion of our 6.25% convertible senior notes due January 2022 and our Series A, Series B, Series C, Series D and Series E preferred stock. We cannot predict the effect, if any, of future issuances or sales of our common stock on the market price of our common stock. We also cannot predict the amounts and timing of restricted stock awards to be issued pursuant to the Plan, nor can we predict the amount and timing of any conversions of our 6.25% convertible senior notes due January 2022 or our Series A, Series B Series C, Series D and Series E preferred stock into shares of our common stock. Any stock awards or conversions resulting in the issuance of substantial amounts of common stock, or the perception that such awards or conversions could occur, may adversely affect the market price for our common stock.

Also, we may issue additional shares in subsequent public offerings or private placements to raise capital, acquire new assets or for other purposes. We are not required to offer any such shares to existing stockholders on a preemptive basis. Therefore, it may not be possible for existing stockholders to participate in such future share issuances, which may dilute the existing stockholders' interests.

Any future offerings of our securities could dilute our existing stockholders and may rank senior for purposes of dividend and liquidating distributions.

In order to grow our business, we may rely on additional issuances of securities which may rank senior and/or be dilutive to our stockholders. For example, in 2017, we completed an offering of senior unsecured notes due January 2022 that are convertible into shares of our common stock at the election of the noteholder. In addition, our Series A, Series B Series C, Series D and Series E preferred shares may be converted into shares of our common stock following the occurrence of certain events, as set forth in the Articles Supplementary for each series. Any election by noteholders or preferred stockholders to convert their notes or preferred shares into shares of our common stock will dilute the interests of other common stockholders. In addition, upon liquidation, holders of our debt securities would receive a distribution of our available assets before holders of our shares.

In the future, we may again elect to raise capital through the issuance of convertible or non-convertible debt or common or preferred equity securities. Upon liquidation, holders of our debt securities and preferred stock, if any, and lenders with respect to other borrowings will be entitled to our available assets prior to the holders of our common stock. Convertible debt and convertible preferred stock may have anti-dilution provisions which are unfavorable to our common stockholders. Additional equity offerings may dilute the holdings of our existing stockholders or reduce the market price of our common stock, or both. Any preferred stock could have a preference on liquidating distributions or a preference on dividend payments that could limit our ability to pay dividends to our stockholders or favorable conversion rights. Sales of substantial amounts of our common stock or the sale of securities which have rights and preferences that are superior to our common stock, or the perception that these sales could occur, may have a material adverse effect on the price of our common stock. Because our decision to issue debt or equity securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Thus, our stockholders bear the risk of our future offerings reducing the market price of our common stock and diluting the value of their holdings.

We have not established a minimum distribution payment level and we cannot assure you of our ability to pay distributions in the future.

We intend to continue to pay quarterly distributions and to make distributions to our stockholders in an amount such that we distribute all or substantially all of our REIT taxable income in each year, subject to certain adjustments. We have not established a minimum distribution payment level and our ability to pay distributions may be adversely affected by a number of factors, including the risk factors described herein. All distributions will be made, subject to Maryland law, at the discretion of our board of directors and will depend on our earnings, our financial condition, any debt covenants, maintenance of our REIT qualification and other factors as our board of directors may deem relevant from time to time. We cannot assure you that we will achieve results that will allow us to make a specified level of cash distributions and distributions in future periods may be significantly lower than in prior quarterly periods.

The market price of our common stock could fluctuate and could cause you to lose a significant part of your investment.

The market price of our common stock may be highly volatile and subject to wide fluctuations. In addition, the trading volume in our common stock may fluctuate and cause significant price variations to occur. The stock market has experienced and may in the future experience extreme price and volume fluctuations that have affected the market price of many companies in industries similar or related to ours and that have been unrelated to these companies' operating performances. If the market price of our common stock declines significantly, you may be unable to resell your shares of our common stock at a gain. Further, fluctuations in the trading price of our common stock may adversely affect the liquidity of the trading market for our common stock and, in the event that we seek to raise capital through future equity financings, our ability to raise such equity capital. We cannot assure you that the market price of our common stock will not fluctuate or decline significantly in the future.

The market price of our common stock may be influenced by many factors, some of which are beyond our control, including those described above and the following:

- changes in financial estimates by analysts;
- fluctuations in our results of operations or financial condition or the results of operations or financial condition of companies perceived to be similar to us;
- general economic and financial and real estate market conditions;
- changes in market valuations of similar companies;
- monetary policy and regulatory developments in the U.S.; and
- additions or departures of key personnel at Pine River.

Resulting fluctuations in the market price of our common stock could cause you to lose a significant part of your investment.

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Tax Risks

Our failure to qualify as a REIT would subject us to U.S. federal income tax and potentially increased state and local taxes, which would reduce the amount of our income available for distribution to our stockholders.

We operate in a manner that will enable us to qualify as a REIT and have elected to be taxed as a REIT for U.S. federal income tax purposes commencing with our taxable year ended December 31, 2009. We have not requested and do not intend to request a ruling from the Internal Revenue Service, or IRS, that we qualify as a REIT. The U.S. federal income tax laws governing REITs and the assets they hold are complex, and judicial and administrative interpretations of the U.S. federal income tax laws governing REIT qualification are limited. To continue to qualify as a REIT, we must meet, on an ongoing basis, various tests regarding the nature of our assets and income, the ownership of our outstanding shares, and the amount of our distributions. Moreover, new legislation, court decisions, administrative guidance or actions by federal agencies or others to modify or re-characterize our assets, as a whole or in part, as other than real estate assets, in each case possibly with retroactive effect, may make it more difficult or impossible for us to qualify as a REIT. Thus, while we intend to operate so that we qualify as a REIT, given the highly complex nature of the rules governing REITs, the ongoing importance of factual determinations, and the possibility of future changes in our circumstances, no assurance can be given that we will so qualify for any particular year. These considerations also might restrict the types of assets that we can acquire in the future.

If we fail to qualify as a REIT in any taxable year, and do not qualify for certain statutory relief provisions, we would be required to pay U.S. federal income tax on our taxable income, and distributions to our stockholders would not be deductible by us in determining our taxable income. In such a case, we might need to borrow money or sell assets in order to pay taxes. Our payment of income tax would decrease the amount of income available for distribution to stockholders. Furthermore, if we fail to maintain our qualification as a REIT, we no longer would be required to distribute substantially all of our net taxable income to stockholders. In addition, unless we were eligible for certain statutory relief provisions, we could not re-elect to be taxed as a REIT until the fifth calendar year following the year in which we failed to qualify.

Complying with REIT requirements may cause us to forego otherwise attractive investment opportunities or financing or hedging strategies.

In order to qualify as a REIT for U.S. federal income tax purposes, we must continually satisfy various tests on an annual and quarterly basis regarding the sources of our income, the nature and diversification of our assets, the amounts we distribute to stockholders and the ownership of our stock. To meet these tests, we may be required to forego investments we might otherwise make. We may be required to make distributions to stockholders at disadvantageous times or when we do not have funds readily available for distribution, and may be unable to pursue investments that would be otherwise advantageous to us in order to satisfy the source of income or asset diversification requirements for qualifying as a REIT. Thus, compliance with the REIT requirements may hinder our investment performance.

Complying with REIT requirements may force us to liquidate otherwise profitable assets.

In order to continue to qualify as a REIT, we must ensure that at the end of each calendar quarter, at least 75% of the value of our assets consists of cash, cash items, government securities and designated real estate assets, including certain mortgage loans and shares in other REITs. Subject to certain exceptions, our ownership of securities, other than government securities and securities that constitute real estate assets, generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of our assets, other than government securities and securities that constitute real estate assets, can consist of the securities of any one issuer, and no more than 20% of the value of our total securities can be represented by securities of one or more TRSs. If we fail to comply with these requirements at the end of any calendar quarter after the first calendar quarter for which we qualified as a REIT, we must generally correct such failure within 30 days after the end of such calendar quarter to avoid losing our REIT qualification. As a result, we may be required to liquidate otherwise profitable assets prematurely, which could reduce our return on assets, which could adversely affect our results of operations and financial condition.

The Protecting Americans from Tax Hikes Act of 2015 changed certain aspects of the U.S. federal income tax rules applicable to REITs. In particular, the act reduced the maximum allowable value of assets attributable to our TRSs from 25% to 20%, which is applicable with respect to tax years beginning after December 31, 2017. In addition, the act adjusted the way we may calculate certain earnings and profits calculations to avoid double taxation at the stockholder level. These modifications could result in changes in our tax positions or investments and may adversely impact our financial condition and results of operations.

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Potential characterization of distributions or gain on sale may be treated as unrelated business taxable income to tax exempt investors.

If (i) all or a portion of our assets are subject to the rules relating to taxable mortgage pools, (ii) we are a "pension held REIT," (iii) a tax exempt stockholder has incurred debt to purchase or hold our common stock, or (iv) we purchase residual REMIC interests that generate "excess inclusion income," then a portion of the distributions to and, in the case of a stockholder described in clause (iii), gains realized on the sale of common stock by such tax exempt stockholder may be subject to U.S. federal income tax as unrelated business taxable income under the Code.

Complying with REIT requirements may limit our ability to hedge effectively.

The REIT provisions of the Code may limit our ability to hedge our assets and operations. Under these provisions, on an annual basis we must derive 75% of our gross income from real estate assets, and 95% of our income from real estate assets and certain other qualifying income sources, in order to maintain our REIT status. Any income that we generate from transactions intended to hedge our interest rate and currency risks will generally be excluded from gross income for purposes of the 75% and 95% gross income tests if the instrument hedges interest rate risk or foreign currency exposure on liabilities used to carry or acquire real estate or income or gain that would be qualifying income under the 75% or 95% gross income tests, and such instrument is properly identified under applicable Treasury regulations. In addition, any income from other hedges would generally constitute non-qualifying income for purposes of both the 75% and 95% gross income tests. As a result of these rules, we may have to limit our use of hedging techniques that might otherwise be advantageous, which could result in greater risks associated with interest rate or other changes than we would otherwise incur.

The failure of our Agency RMBS and non-Agency securities that are subject to a repurchase agreement to qualify as real estate assets would adversely affect our ability to qualify as a REIT.

We may enter into repurchase agreements under which we will nominally sell certain of our Agency RMBS or non-Agency securities to a counterparty and simultaneously enter into an agreement to repurchase the sold assets. We believe that we will be treated for U.S. federal income tax purposes as the owner of the securities that are the subject of any such agreement notwithstanding that such agreement may transfer record ownership of the assets to the counterparty during the term of the agreement. It is possible, however, that the IRS could assert that we did not own the securities during the term of the repurchase agreement, in which case we could fail to qualify as a REIT.

REIT distribution requirements could adversely affect our ability to execute our business plan and may require us to incur debt, sell assets or take other actions to make such distributions.

In order to continue to qualify as a REIT, we must distribute to stockholders, each calendar year, at least 90% of our REIT taxable income (including certain items of non-cash income), determined without regard to the deduction for dividends paid and excluding net capital gain. To the extent that we satisfy the 90% distribution requirement, but distribute less than 100% of our taxable income, we will be subject to U.S. federal corporate income tax on our undistributed income. In addition, we will incur a 4% nondeductible excise tax on the amount, if any, by which our distributions in any calendar year are less than a minimum amount specified under U.S. federal income tax law.

We intend to distribute our net income to stockholders in a manner intended to satisfy the 90% distribution requirement and to avoid both corporate income tax and the 4% nondeductible excise tax. Our taxable income may substantially exceed our net income as determined by U.S. GAAP or differences in timing between the recognition of taxable income and the actual receipt of cash may occur in which case we may have taxable income in excess of cash flow from our operating activities. In such event, we may generate less cash flow than taxable income in a particular year and find it difficult or impossible to meet the REIT distribution requirements in certain circumstances. In such circumstances, in order to satisfy the distribution requirement and to avoid U.S. federal corporate income tax and the 4% nondeductible excise tax in that year, we may be required to: (i) sell assets in adverse market conditions, (ii) borrow on unfavorable terms, (iii) distribute amounts that would otherwise be invested in future acquisitions, capital expenditures or repayment of debt or (iv) make a taxable distribution of our shares as part of a distribution in which stockholders may elect to receive shares or (subject to a limit measured as a percentage of the total distribution) cash, in order to comply with the REIT distribution requirements. Thus, compliance with the REIT distribution requirements may require us to take actions that may not otherwise be advisable given existing market conditions and hinder our ability to grow, which could adversely affect the value of our common stock.

Even though we have elected to be taxed as a REIT, we may be required to pay certain taxes.

Even though we have elected to be taxed as a REIT, we may be subject to certain U.S. federal, state and local taxes on our income and assets, including taxes on any undistributed income, prohibited transactions, tax on income from some activities conducted as a result of a foreclosure, and state or local income, franchise, property and transfer taxes, including mortgage recording taxes. In addition, we will hold some of our assets through wholly owned TRSs. Our TRSs and any other taxable corporations in which we own an interest will be subject to U.S. federal, state and local corporate taxes. Payment of these taxes generally would reduce our cash flow and the amount available to distribute to stockholders.

Our qualification as a REIT may depend on the accuracy of legal opinions or advice rendered or given or statements by the issuers of assets we acquire, including with respect to the treatment of our TBA securities and transactions for tax purposes.

When purchasing securities, we may rely on opinions or advice of counsel for the issuer of such securities, or statements made in related offering documents, for purposes of determining, among other things, whether such securities represent debt or equity securities for U.S. federal income tax purposes, the value of such securities, and also to what extent those securities constitute qualified real estate assets for purposes of the REIT asset tests and produce qualified income for purposes of the 75% gross income test. In addition, we may from time to time obtain and rely upon opinions of counsel regarding the qualification of certain assets and income as real estate assets. The inaccuracy of any such opinions, advice or statements may adversely affect our ability to qualify as a REIT and result in significant corporate-level tax.

We may utilize TBAs as a means of investing and financing Agency RMBS. There is no direct authority with respect to the qualification of TBAs as real estate assets or U.S. government securities for purposes of the 75% asset test or the qualification of income or gains from dispositions of TBAs as gains from the sale of real property (including interests in real property and interests in mortgages on real property) or other qualifying income for purposes of the 75% gross income test. We intend to treat our TBAs as qualifying assets for purposes of the 75% asset test, to the extent set forth in an opinion from Sidley Austin LLP substantially to the effect that, for purposes of the 75% asset test, our ownership of a TBA should be treated as ownership of the underlying Agency RMBS, and to treat income and gains from our TBAs as qualifying income for purposes of the gross income test, to the extent set forth in an opinion from Sidley Austin LLP substantially to the effect that, for purposes of the gross income test, any gain recognized by us in connection with the settlement of our TBAs should be treated as gain from the sale or disposition of the underlying Agency RMBS. Such opinions of counsel are not binding on the IRS, and there can be no assurance that the IRS will not successfully challenge the conclusions set forth therein. In addition, the opinion of Sidley Austin LLP is based on various assumptions relating to our TBAs and is conditioned upon fact-based representations and covenants made by our management regarding our TBAs. If the IRS were to successfully challenge the opinion of Sidley Austin LLP, we could be subject to a penalty tax or we could fail to remain qualified as a REIT if a sufficient portion of our assets consists of TBAs or a sufficient portion of our income consists of income or gains from the disposition of TBAs.

Although our use of TRSs may be able to partially mitigate the impact of meeting the requirements for qualification as a REIT, our ownership of and relationship with our TRSs is limited and a failure to comply with the limits would jeopardize our REIT qualification and may result in the application of a 100% excise tax.

A REIT may own up to 100% of the stock of one or more TRSs. Other than certain activities relating to lodging and healthcare facilities, a TRS generally may engage in any business and may hold assets and earn income that would not be qualifying assets or income if held or earned directly by a REIT. Overall, no more than 20% of the value of a REIT’s assets may consist of stock or securities of one or more TRSs. In addition, the TRS rules limit the deductibility of interest paid or accrued by a TRS to its parent REIT to assure that the TRS is subject to an appropriate level of corporate taxation. The rules also impose a 100% excise tax on certain transactions between a TRS and its parent REIT that are not conducted on an arm’s length basis.

Our TRSs will pay U.S. federal, state and local income tax on their taxable income, and their after-tax net income will be available for distribution to Two Harbors but are not required to be distributed to Two Harbors. We anticipate that the aggregate value of the securities of our TRSs will be less than 20% of the value of our total assets (including our TRS securities). Furthermore, we intend to monitor the value of our respective investments in our TRSs for the purpose of ensuring compliance with TRS ownership limitations. In addition, we will review all of our transactions with TRSs to ensure that they are entered into on arm’s-length terms to avoid incurring the 100% excise tax described above. There can be no assurance, however, that we will be able to comply with the 20% limitation or to avoid application of the 100% excise tax discussed above.

As discussed above, the Protecting Americans from Tax Hikes Act of 2015 reduced the maximum allowable value of assets attributable to our TRSs from 25% to 20%, which is applicable with respect to tax years beginning after December 31, 2017. This modification, as well as other changes promulgated by the act, could result in changes in our tax positions or investments and may adversely impact our financial condition and results of operations.

We may be required to report taxable income with respect to certain of our investments in excess of the economic income we ultimately realize from them.

We may acquire interests in debt instruments in the secondary market for less than their face amount. The discount at which such interests in debt instruments are acquired may reflect doubts about their ultimate collectability rather than current market interest rates. The amount of such discount may nevertheless be treated as “market discount” for U.S. federal income tax purposes. Market discount on a debt instrument may accrue based on the assumption that all future payments on the debt instrument will be made. Accrued market discount is reported as income when, and to the extent that, any payment of principal of the debt instrument is made. In the case of residential mortgage loans, principal payments are ordinarily made monthly, and consequently, accrued market discount may have to be included in income each month as if the debt instrument were assured of ultimately being collected in full. If we collect less on a debt instrument than its purchase price plus the market discount we had previously reported as income, we may not be able to benefit from any offsetting loss deduction in a subsequent taxable year.

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Similarly, some of the mortgage-backed securities that we purchase will likely have been issued with original issue discount, or OID. We may be required to report such OID based on a constant yield method and income would accrue over the period we own the underlying security. This may lead to an accrual of OID income in excess of the amount that is collected. An offsetting loss deduction will become available only in the later year in which uncollectability is provable or ultimate disposition; and may be subject to limitation.

Finally, in the event that any debt instruments or mortgage-backed securities acquired by us are delinquent as to mandatory principal and interest payments, or in the event a borrower with respect to a particular debt instrument acquired by us encounters financial difficulty rendering it unable to pay stated interest as due, we may nonetheless be required to continue to recognize the unpaid interest as taxable income as it accrues, despite doubt as to its ultimate collectability. Similarly, we may be required to accrue interest income with respect to subordinate mortgage-backed securities at their stated rate regardless of whether corresponding cash payments are received or are ultimately collectible. In each case, while we would in general ultimately have an offsetting loss deduction available to us when such interest was determined to be uncollectable; the utility of that deduction would depend on our having taxable income in that later year or thereafter subject to carryforward limitations.

Dividends payable by REITs generally do not qualify for the reduced tax rates on dividend income from regular corporations, which could adversely affect the value of our shares.

The maximum U.S. federal income tax rate for dividends payable to domestic stockholders that are individuals, trusts and estates is 20%. Dividends payable by REITs, however, are generally not eligible for these reduced rates. Although the reduced U.S. federal income tax rate applicable to dividend income from regular corporate dividends does not adversely affect the taxation of REITs or dividends paid by REITs, the more favorable rates applicable to regular corporate dividends could cause investors who are individuals, trusts and estates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of the shares of REITs, including our shares of common stock.

The Tax Cuts and Jobs Act of 2017 ("TCJA") made many significant changes to the U.S. federal income tax laws applicable to businesses and their owners, including REITs and their stockholders. Pursuant to the TCJA, as of January 1, 2018, the highest marginal individual income tax rate is reduced to 37%. In addition, individuals, estates and trusts may deduct up to 20% of certain pass-through income, including ordinary REIT dividends that are not "capital gain dividends" or "qualified dividend income," subject to complex limitations. For taxpayers qualifying for the full deduction, the effective maximum tax rate on ordinary REIT dividends would be 29.6% (through taxable years ending in 2025). The maximum rate of withholding with respect to our distributions to non-U.S. stockholders that are treated as attributable to gains from the sale or exchange of U.S. real property interests is also reduced from 35% to 21%. There can be no assurance as to how these or any other tax rate changes in the future will impact the attractiveness of an investment in our shares or the value of our securities.

We may be subject to adverse legislative or regulatory tax changes that could reduce the market price of our shares.

At any time, the U.S. federal income tax laws or regulations governing REITs or the administrative interpretations of those laws or regulations may be changed. We cannot predict if or when any new U.S. federal income tax law, regulation or administrative interpretation, or any amendment to any existing U.S. federal income tax law, regulation or administrative interpretation, will be adopted, promulgated or become effective or whether any such law, regulation or interpretation may take effect retroactively. We and our stockholders could be adversely affected by any such change in, or any new, U.S. federal income tax law, regulation or administrative interpretation.

The TCJA made many significant changes to the U.S. federal income tax laws applicable to businesses, including REITs, and may lessen the relative competitive advantage of operating as a REIT rather than as a C corporation. Pursuant to the TCJA, as of January 1, 2018, the federal income tax rate applicable to corporations was reduced to 21% and the corporate alternative minimum tax was repealed. In addition, the deduction of net interest expense is limited for all businesses; provided that certain businesses, including real estate businesses, may elect not to be subject to such limitations and instead to depreciate their real property related assets over longer depreciable lives. This

limitation could adversely affect our TRSs.
Additional changes to the tax laws are likely to continue to occur, and we cannot assure you that any such changes will not adversely affect the taxation of us or our stockholders. Any such changes could have an adverse effect on an investment in our shares or on the market value or the resale potential of our assets. You are urged to consult with your tax advisor with respect to the impact of any legislative, regulatory or administrative developments or proposals and their potential effect on an investment in our shares.
REIT limitations may affect our ability to dispose of real properties we may acquire in the course of our MSR business, or in meeting our obligations under prior securitization transactions.
The provisions of the Code relating to REITs may limit our ability to sell properties at a profit without incurring unfavorable tax consequences. Generally, sales of property within two years of acquisition, and sale of multiple properties within one year, may result in the gains from such sales being subject to 100% taxation. To the extent we own real property within the REIT, we may face significant restrictions in our ability to dispose of this property.

We could incur adverse tax consequences if CYS failed to qualify as a REIT for U.S. federal income tax purposes.
In connection with our acquisition of CYS, we assumed, based on public filings, that CYS has qualified as a REIT for U.S. federal income tax purposes prior to the completion of the merger pursuant to that certain Agreement and Plan of Merger, dated April 25, 2018, by and among us, Eiger Merger Subsidiary LLC, or Merger Sub, and CYS pursuant to which, on July 31, 2018, Merger Sub merged with and into CYS, with CYS continuing as the surviving corporation. This merger resulted in CYS becoming our indirect, wholly owned subsidiary. However, if CYS failed to qualify as a REIT, we and Merger Sub generally would succeed to or incur significant tax liabilities (including the significant tax liability that would result from the deemed sale of assets by CYS pursuant to the merger), and we could possibly lose our REIT status should disqualifying activities continue after the acquisition.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our principal place of business is located at 575 Lexington Avenue, Suite 2930, New York, New York 10022. We also have offices located at 601 Carlson Parkway, Suite 1400, Minnetonka, Minnesota 55305, 8625 Tamiami Trail North, Naples, Florida 34108 and 10 CityPoint, Waltham, Massachusetts 02451. In accordance with the shared facilities and services agreement between PRCM Advisers and Pine River, we may from time to time utilize additional Pine River office space in Minnetonka and New York.
In New York, we lease 5,103 square feet of office space pursuant to a lease that expires in August 2023. Additionally in New York, we lease, and are subleasing to an unaffiliated third party through March 2019, 8,934 square feet of office space at a different location pursuant to a lease that expires in April 2019. In Minnetonka, we lease 27,982 square feet of office space pursuant to a lease that expires in June 2022. In Naples, we lease 4,522 square feet of office space pursuant to a lease that expires in May 2021. In Waltham, we lease, and are subleasing to an unaffiliated third party through June 2019, 9,942 square feet of office space pursuant to a lease that expires in July 2023.

Item 3. Legal Proceedings

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

Item 4. Mine Safety Disclosures

None.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities

Market Information

Our common stock is listed on the NYSE under the symbol "TWO". As of February 22, 2019, 251,080,610 shares of common stock were issued and outstanding.

On September 14, 2017, our board of directors approved a one-for-two reverse stock split of our outstanding shares of common stock. The reverse stock split was effected on November 1, 2017 at 5:01 p.m. Eastern time, following the special dividend of Granite Point common stock. At the effective time, every two issued and outstanding shares of our common stock were converted into one share of common stock. No fractional shares were issued in connection with the reverse stock split; instead, each stockholder holding fractional shares was entitled to receive, in lieu of such fractional shares, cash in an amount determined on the basis of the volume weighted average price of our common stock on the NYSE on November 1, 2017. In connection with the reverse stock split, the number of authorized shares of our common stock was also reduced on a one-for-two basis, from 900 million to 450 million. The par value of each share of common stock remained unchanged. All per share amounts, common shares outstanding and restricted shares for all periods presented have been adjusted on a retroactive basis to reflect the reverse stock split.

The following table shows the high and low sales prices for our common stock, adjusted on a retroactive basis to reflect the reverse stock split, as reported on the NYSE during the calendar years ended December 31, 2018 and 2017:

Quarter Ended	**Common Stock**	
2018	**High**	**Low**
December 31	$15.06	$12.63
September 30	$16.23	$14.48
June 30	$16.27	$15.02
March 31	$16.30	$13.85
2017		
December 31	$20.42	$15.21
September 30	$20.51	$19.16
June 30	$21.08	$19.10
March 31	$19.64	$17.02

Holders

As of February 21, 2019, there were 639 registered holders and approximately 118,265 beneficial owners of our common stock.

Dividends

The following table, which has been adjusted to reflect the reverse stock split, presents cash dividends declared on our common stock for the years ended December 31, 2018 and 2017:

Declaration Date	**Record Date**	**Payment Date**	**Cash Dividend Per Share**
December 18, 2018	December 31, 2018	January 28, 2019	$0.47000
September 20, 2018	October 1, 2018	October 29, 2018	$0.31163
July 13, 2018	July 25, 2018	July 30, 2018	$0.15837

June 19, 2018	June 29, 2018	July 27, 2018	$ 0.47000
March 20, 2018	April 2, 2018	April 27, 2018	$ 0.47000
December 14, 2017	December 26, 2017	December 29, 2017	$ 0.47000
September 14, 2017	September 29, 2017	October 27, 2017	$ 0.52000
June 15, 2017	June 30, 2017	July 27, 2017	$ 0.52000
March 14, 2017	March 31, 2017	April 27, 2017	$ 0.50000

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All dividend distributions are authorized by our board of directors, in its discretion, and will depend on such items as our REIT taxable earnings, financial condition, maintenance of REIT status, and other factors that the board of directors may deem relevant from time to time. The holders of our common stock share proportionally on a per share basis in all declared dividends on our common stock. Dividends cannot be paid on our common stock unless we have paid full cumulative dividends on all classes of our preferred stock. We have paid full cumulative dividends on all classes of our preferred stock from the respective dates of issuance through December 31, 2018. We intend to continue to pay quarterly dividends on our common stock and to distribute on our common stockholders as dividends 100% of our REIT taxable income, continue to on an annual basis.

We have not established a minimum dividend distribution level for our common stock. See Item 1A, "*Risk Factors*" and Item 7, "*Management's Discussion and Analysis of Financial Conditions and Results of Operations*" of this Annual Report on Form 10-K for information regarding the sources of funds used for dividends and for a discussion of factors, if any, which may adversely affect our ability to pay dividends in 2019 and thereafter.

Our stock transfer agent and registrar is Equiniti Trust Company. Requests for information from Equiniti Trust Company can be sent to Equiniti Trust Company, P.O. Box 64874, St. Paul, MN 55164-0874 and their telephone number is 1-800-468-9716.

Securities Authorized for Issuance under Equity Compensation Plans

Our Second Restated 2009 Equity Incentive Plan was adopted by our board of directors and approved by our stockholders for the purpose of enabling us to provide equity compensation to attract and retain qualified directors, officers, advisers, consultants and other personnel, including affiliates and personnel of PRCM Advisers and its affiliates, and any joint venture affiliates of ours. The Plan is administered by the compensation committee of our board of directors and permits the granting of restricted shares of common stock, phantom shares, dividend equivalent rights and other equity-based awards. For a detailed description of the Plan, see Note 17 - *Equity Incentive Plan* of the consolidated financial statements included under Item 8 of this Annual Report on Form 10-K.

The following table presents certain information about the Plan as of December 31, 2018:

	December 31, 2018		
Plan Category	**Number of securities to be issued upon exercise of outstanding options, warrants and rights**	**Weighted-average exercise price of outstanding options, warrants and rights**	**Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in the first column of this table)**
Equity compensation plans approved by stockholders [1]	—	$ —	2,125,725
Equity compensation plans not approved by stockholders	—	—	—
Total	—	$ —	2,125,725

(1) For a detailed description of the Plan, see Note 17 - *Equity Incentive Plan* of the consolidated financial statements included under Item 8 of this Annual Report on Form 10-K.

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Performance Graph

The following graph compares the stockholder's cumulative total return, assuming $100 invested at December 31, 2013, with all reinvestment of dividends, as if such amounts had been invested in: (i) our common stock; (ii) the stocks included in the Standard and Poor's 500 Stock Index, or S&P 500; and (iii) the stocks included in the Bloomberg REIT Mortgage Index.

COMPARISON OF CUMULATIVE TOTAL RETURN
Among Two Harbors Investment Corp.,
S&P 500 and Bloomberg REIT Mortgage Index

	December 31,				
Index	**2018**	**2017**	**2016**	**2015**	**2014**
Two Harbors Investment Corp.	$146.62	$163.79	$129.51	$107.80	$119.47
S&P 500	$150.27	$157.17	$129.02	$115.24	$113.68
Bloomberg REIT Mortgage Index	$153.65	$158.25	$131.58	$107.61	$119.43

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Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Our board of directors has adopted a share repurchase program that allows for the repurchase of up to an aggregate of 37,500,000 shares of our common stock. Shares may be repurchased from time to time through privately negotiated transactions or open market transactions, pursuant to a trading plan in accordance with Rules 10b5-1 and 10b-18 under the Exchange Act or by any combination of such methods. The manner, price, number and timing of share repurchases are subject to a variety of factors, including market conditions and applicable SEC rules. The share repurchase program does not require the purchase of any minimum number of shares, and, subject to SEC rules, purchases may be commenced or suspended at any time without prior notice. The share repurchase program does not have an expiration date. As of December 31, 2018, a total of 12,067,500 shares had been repurchased under the program for an aggregate cost of $200.4 million. We did not repurchase shares during the three and twelve months ended December 31, 2018.

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Item 6. Selected Financial Data

Our selected financial data set forth below should be read in conjunction with our consolidated financial statements and the accompanying notes included under Item 8 of this Annual Report on Form 10-K. Certain amounts for prior periods have been reclassified to conform to the 2018 presentation. All per share amounts and common shares outstanding for all periods presented have been adjusted on a retroactive basis to reflect the one-for-two reverse stock split effected on November 1, 2017.

(in thousands)	For the Years Ended December 31,				
	2018	2017	2016	2015	2014
Interest income:					
Available-for-sale securities [1]	$847,325	$631,853	$414,050	$458,515	$506,268
Residential mortgage loans held-for-investment in securitization trusts	—	102,886	133,993	95,740	41,220
Other [1]	22,707	10,350	27,037	38,624	29,719
Total interest income	870,032	745,089	575,080	592,879	577,207
Interest expense:					
Repurchase agreements [1]	469,437	210,430	88,850	72,653	76,177
Collateralized borrowings in securitization trusts	—	82,573	97,729	57,216	26,760
Federal Home Loan Bank advances	20,417	36,911	26,101	11,921	4,513
Revolving credit facilities	10,820	2,341	604	—	—
Convertible senior notes	18,997	17,933	—	—	—
Total interest expense	519,671	350,188	213,284	141,790	107,450
Net interest income	350,361	394,901	361,796	451,089	469,757
Other-than-temporary impairment losses	(470)	(789)	(1,822)	(535)	(392)
Other (loss) income:					
(Loss) gain on investment securities [1]	(341,312)	(34,695)	(107,374)	363,379	87,201
Servicing income	343,096	209,065	143,579	127,398	128,160
Loss on servicing asset	(69,033)	(91,033)	(83,531)	(99,584)	(128,388)
Gain (loss) on interest rate swap, cap and swaption agreements	16,043	(9,753)	45,371	(210,621)	(345,647)
(Loss) gain on other derivative instruments	(54,857)	(70,159)	99,379	(5,049)	(17,529)
Other income (loss)	3,037	30,141	9,964	(7,686)	35,836
Total other (loss) income	(103,026)	33,566	107,388	167,837	(240,367)
Expenses:					
Management fees	30,272	40,472	39,261	49,116	48,803
Servicing expenses	61,136	35,289	32,119	28,028	25,925
Securitization deal costs	—	—	6,152	8,971	4,638
Other operating expenses	62,983	54,160	56,605	56,764	56,231
Merger transaction costs [1]	86,703	—	—	—	—
Restructuring charges [1]	8,238	—	2,990	—	—
Total expenses	249,332	129,921	137,127	142,879	135,597
(Loss) income from continuing operations before income taxes	(2,467)	297,757	330,235	475,512	93,401
Provision for (benefit from) income taxes	41,823	(10,482)	12,314	(16,560)	(73,738)
Net (loss) income from continuing operations	(44,290)	308,239	317,921	492,072	167,139
Income from discontinued operations, net of tax	—	44,146	35,357	138	—
Net (loss) income	(44,290)	352,385	353,278	492,210	167,139
	—	3,814	—	—	—

Income from discontinued operations attributable to noncontrolling interest					
Net (loss) income attributable to Two Harbors Investment Corp.	(44,290)	348,571	353,278	492,210	167,139
Dividends on preferred stock	65,395	25,122	—	—	—
Net (loss) income attributable to common stockholders	$(109,685)	$323,449	$353,278	$492,210	$167,139

(1) During the year-ended December 31, 2018, the activity disclosed within was impacted by the acquisition of CYS, on July 31, 2018. Refer to Note 3 - *Acquisition of CYS Investments, Inc.* for further information.

(in thousands, except share data)	For the Years Ended December 31,				
	2018	2017	2016	2015	2014
Basic (loss) earnings per weighted average share:					
Continuing operations	$(0.53)	$ 1.62	$ 1.83	$ 2.70	$ 0.91
Discontinued operations	—	0.23	0.20	—	—
Net (loss) income	$(0.53)	$ 1.85	$ 2.03	$ 2.70	$ 0.91
Diluted (loss) earnings per weighted average share:					
Continuing operations	$(0.53)	$ 1.60	$ 1.83	$ 2.70	$ 0.91
Discontinued operations	—	0.21	0.20	—	—
Net (loss) income	$(0.53)	$ 1.81	$ 2.03	$ 2.70	$ 0.91
Dividends declared per common share	$1.88	$ 2.01	$ 1.86	$ 2.08	$ 2.08
Weighted average number of shares of common stock:					
Basic	206,020,502	174,433,999	174,036,852	182,623,869	183,005,928
Diluted	206,020,502	188,133,341	174,036,852	182,623,869	183,005,928
Comprehensive (loss) income:					
Net (loss) income	$(44,290)	$ 352,385	$ 353,278	$ 492,210	$ 167,139
Other comprehensive (loss) income, net of tax:					
Unrealized (loss) gain on available-for-sale securities, net	(233,914)	135,586	(159,834)	(496,728)	411,054
Other comprehensive (loss) income	(233,914)	135,586	(159,834)	(496,728)	411,054
Comprehensive (loss) income	(278,204)	487,971	193,444	(4,518)	578,193
Comprehensive income attributable to noncontrolling interest	—	3,814	—	—	—
Comprehensive (loss) income attributable to Two Harbors Investment Corp.	(278,204)	484,157	193,444	(4,518)	578,193
Dividends on preferred stock	65,395	25,122	—	—	—
Comprehensive (loss) income attributable to common stockholders	$(343,599)	$ 459,035	$ 193,444	$ (4,518)	$ 578,193

(in thousands)	At December 31,				
	2018	2017	2016	2015	2014
Available-for-sale securities	$25,552,604	$21,220,819	$13,116,171	$7,825,320	$14,341,102
Mortgage servicing rights	$1,993,440	$1,086,717	$693,815	$493,688	$452,006
Total assets	$30,132,479	$24,789,313	$20,112,056	$14,575,772	$21,084,309
Repurchase agreements	$23,133,476	$19,451,207	$8,865,184	$4,948,926	$12,932,463
Federal Home Loan Bank advances	$865,024	$1,215,024	$4,000,000	$3,785,000	$2,500,000
Total stockholders’ equity	$4,254,489	$3,571,424	$3,401,112	$3,576,561	$4,068,042

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations
The following discussion and analysis should be read in conjunction with the consolidated financial statements and accompanying notes included elsewhere in this Annual Report on Form 10-K.

General
We are a Maryland corporation focused on 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, which we collectively refer to as our target assets. We operate as a real estate investment trust, or REIT, as defined under the Internal Revenue Code of 1986, as amended, or the Code. We are externally managed by PRCM Advisers LLC, or PRCM Advisers, which is a wholly owned subsidiary of Pine River Capital Management L.P., or Pine River.
Our objective is to provide attractive risk-adjusted total return to our stockholders over the long term, primarily through dividends and secondarily through capital appreciation. We selectively acquire and manage an investment portfolio of our target assets, which is constructed to generate attractive returns through market cycles. We focus on asset selection and implement a relative value investment approach across various sectors within the mortgage market.
Our target assets include the following:

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

We generally view our target assets in two strategies that are based on our core competencies of understanding and managing prepayment and credit risk. Our rates strategy includes assets that are sensitive to changes in interest rates and prepayment speeds, specifically Agency RMBS and MSR. Our credit strategy includes assets with inherent credit risk, including non-Agency securities. Other assets include financial and mortgage-related assets other than the target assets in our rates and credit strategies, including certain non-hedging transactions that may produce non-qualifying income for purposes of the REIT gross income tests.
As opportunities in the residential mortgage marketplace change, we continue to evolve our business model. From a capital allocation perspective, we expect to continue to increase our allocation towards MSR over time and allocate capital towards Agency RMBS based on opportunities in the marketplace, the cost of financing and the cost of hedging interest rate, prepayment, credit and other portfolio risks. Within our non-Agency securities portfolio, we have a substantial emphasis on "legacy" securities, which consist of securities issued prior to 2009. We have also allocated capital towards "new issue" non-Agency securities, which we believe have enabled us to find attractive returns and further diversify our non-Agency securities portfolio.
Within our MSR business, we purchase the right to control the servicing of residential mortgage loans from high-quality originators. We do not directly service the mortgage loans on our consolidated balance sheet, nor the mortgage loans underlying the MSR we acquire; rather, we contract with appropriately licensed third-party subservicers to handle substantially all servicing functions in the name of the subservicer.
On April 26, 2018, we announced that we had entered into a definitive merger agreement pursuant to which we 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 Two Harbors and CYS on July 27, 2018, and the merger was completed on July 31, 2018, at which time CYS became our wholly owned subsidiary. In exchange for all of the shares of CYS common stock outstanding immediately prior to the effective time of the merger, we 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, we 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. The financial results of CYS since the closing date of the acquisition have been included in our consolidated financial statements.

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We believe our investment model allows management to allocate capital across various sectors within the mortgage market, with a focus on asset selection and the implementation of a relative value investment approach. Our capital allocation decisions factor in the opportunities in the marketplace, the cost of financing and the cost of hedging interest rate, prepayment, credit and other portfolio risks. As a result, capital allocation reflects management's flexible approach to investing in the marketplace. The following table provides our capital allocation in each of our investment strategies as of December 31, 2018 and the four immediately preceding period ends:

	As of December 31, 2018	**September 30, 2018**	**June 30, 2018**	**March 31, 2018**	**December 31, 2017**
Rates strategy	74%	76%	68%	69%	68%
Credit strategy	26%	24%	32%	31%	32%

As our capital allocation shifts, our annualized yields and cost of financing shift. Our capital allocation at December 31, 2018 was 74% to our rates strategy and 26% to our credit strategy. The increased allocation to our rates strategy during the year was driven by the acquisition of CYS's Agency portfolio and the continued growth of our MSR portfolio. In 2019, we expect to
continue to reallocate capital from Agency RMBS into what we believe are the most attractive investment opportunities, including MSR and non-Agency securities, though we do not have a fixed allocation target between our rates and credit strategies. As previously discussed, our investment decisions are not driven solely by annualized yields, but rather a multitude of macroeconomic drivers, including market environments and their respective impacts (*e.g.,* uncertainty of prepayment speeds, extension risk and credit events).
For the three months ended December 31, 2018, our net yield realized on the portfolio was higher than the most recent period due to the purchase of Agency RMBS at attractive yields and slower prepayment speeds on MSR, offset by an increase in our cost of financing as a result of increases in LIBOR and correlated borrowing rates offered by counterparties. The following table provides the average annualized yield on our assets, including Agency RMBS, non-Agency securities and MSR for the three months ended December 31, 2018, and the four immediately preceding quarters:

	Three Months Ended				
	December 31, 2018	**September 30, 2018**	**June 30, 2018**	**March 31, 2018**	**December 31, 2017**
Average annualized portfolio yield (1)	4.14%	3.76%	3.91%	3.77%	3.69%
Cost of financing (2)	2.53%	2.28%	1.98%	1.84%	1.72%
Net portfolio yield	1.61%	1.48%	1.93%	1.93%	1.97%

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

We seek to deploy moderate leverage as part of our investment strategy. We generally finance our Agency RMBS and non-Agency securities through short- and long-term borrowings structured as repurchase agreements and advances from the Federal Home Loan Bank of Des Moines, or the FHLB. We also finance our MSR through repurchase agreements and revolving credit facilities. In addition, in January 2017, we closed an underwritten public offering of $287.5 million aggregate principal amount of convertible senior notes due 2022. The notes are unsecured, pay interest semiannually at a rate of 6.25% per annum and are convertible at the option of the holder into shares of our common stock. The notes will mature in January 2022, unless earlier converted or repurchased in accordance with their terms. We do not have the right to redeem the notes prior to maturity, but may be required to repurchase the notes from holders under certain circumstances. The net proceeds from the offering were approximately $282.2 million after deducting underwriting discounts and estimated offering expenses. The majority of these proceeds were used to help fund our MSR assets, which previously had largely been funded with cash. As of December 31, 2018, the notes had a conversion rate of 62.4003 shares of common stock per $1,000 principal amount of the notes.

Our Agency RMBS, given their liquidity and high credit quality, are eligible for higher levels of leverage, while non-Agency securities and MSR, with less liquidity and/or more exposure to credit risk, utilize lower levels of leverage. As a result, our debt-to-equity ratio is determined by our portfolio mix as well as many additional factors, including the liquidity of our portfolio, the sustainability and price of our financing, diversification of our counterparties and their available capacity to finance our assets, and anticipated regulatory developments. Over the past several quarters, we have generally maintained a debt-to-equity ratio range of 5.0 to 6.0 times to finance our securities portfolio and MSR, on a fully deployed capital basis. Our debt-to-equity ratio is directly correlated to the composition of our portfolio; specifically, the higher percentage of Agency RMBS we hold, the higher our debt-to-equity ratio is, while the higher percentage of non-Agency securities and MSR we hold, the lower our debt-to-equity ratio is. We may alter the percentage allocation of our portfolio among our target assets depending on the relative value of the assets that are available to purchase from time to time, including at times when we are deploying proceeds from offerings we conduct. As we allocate capital toward Agency RMBS and deploy financing on MSR, our debt-to-equity ratio may increase beyond 6.0 times in the future. See the section titled *"Management's Discussion and Analysis of Financial Condition and Results of Operations - Financial Condition - Repurchase Agreements"* for further discussion.

We recognize that investing in our target assets is competitive and we compete with other entities for attractive investment opportunities. We rely on our management team and our dedicated team of investment professionals provided by our external manager to identify investment opportunities. We believe that our significant focus in the residential market, the extensive mortgage market expertise of our investment team, our strong analytics and our disciplined relative value investment approach give us a competitive advantage versus our peers.

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

Overview

Our efforts in 2018 focused on three strategic objectives that we believe have positioned us for long-term success.

- *Managing an investment portfolio to generate attractive returns with balanced risks.* We operate a hybrid REIT model, diversifying our portfolio across Agency RMBS and non-Agency securities in combination with MSR and derivative hedging instruments. We manage to an overall low level of interest rate exposure and leverage relative to our peers. We believe effectively managing an appropriate balance of risks within our portfolio is critical to providing attractive risk-adjusted returns to our stockholders and our ability to adjust our allocations and deploy capital across sectors allows us to optimize portfolio results over time.
- *Continuing to grow shareholder base and market capitalization.* In 2018, we completed the acquisition of CYS, growing the company's market capitalization and shareholder base, increasing the liquidity of the company's stock and driving expense lower.
- *Maintaining "best in class" corporate governance, investor relations and disclosure practices.*

Factors Affecting our Operating Results

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

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Fair Value Measurement

A significant portion of our assets and liabilities are reported at fair value and, therefore, our consolidated balance sheets and statements of comprehensive (loss) income are significantly affected by fluctuations in market prices. At December 31, 2018, approximately 92.5% of our total assets, or $27.9 billion, consisted of financial instruments recorded at fair value. See Note 9 - *Fair Value* to the consolidated financial statements, included in this Annual Report on Form 10-K, for descriptions of valuation methodologies used to measure material assets and liabilities at fair value and details of the valuation models, key inputs to those models and significant assumptions utilized. Although we execute various hedging strategies to mitigate our exposure to changes in fair value, we cannot fully eliminate our exposure to volatility caused by fluctuations in market prices. Although markets for asset-backed securities, including RMBS, have modestly stabilized since the severe dislocations experienced as a result of the 2008 Financial Crisis, these markets continue to experience volatility and, as a result, our assets and liabilities will be subject to valuation adjustment as well as changes in the inputs we use to measure fair value.

Any temporary change in the fair value of our available-for-sale, or AFS, securities, excluding Agency interest-only mortgage-backed securities, is recorded as a component of accumulated other comprehensive income and does not impact our earnings. Our reported (loss) earnings for U.S. GAAP purposes, or GAAP net (loss) income, is affected, however, by fluctuations in market prices on the remainder of our financial assets and liabilities recorded at fair value, including interest rate swap, cap and swaption agreements and certain other derivative instruments (*i.e.*, TBAs, put and call options for TBAs, Markit IOS total return swaps and inverse interest-only securities), which are accounted for as derivative trading instruments under U.S. GAAP, Agency interest-only mortgage-backed securities and MSR.

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

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

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

Considerable judgment is used in forming conclusions and estimating inputs to our Level 3 fair value measurements. Level 3 inputs such as interest rate movements, prepayments speeds, credit losses and discount rates are inherently difficult to estimate. Changes to these inputs can have a significant effect on fair value measurements. Accordingly, there is no assurance that our estimates of fair value are indicative of the amounts that would be realized on the ultimate sale or exchange of these assets. The Company classified 7.0% of its total assets as Level 3 fair value assets at December 31, 2018.

Critical Accounting Estimates

The preparation of financial statements in accordance with U.S. GAAP requires us to make certain judgments and assumptions, based on information available at the time of our preparation of the financial statements, in determining accounting estimates used in preparation of the statements. Our significant accounting policies are described in Note 2 to the consolidated financial statements, included under Item 8 of this Annual Report on Form 10-K.

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Accounting estimates are considered critical if the estimate requires us to make assumptions about matters that were highly uncertain at the time the accounting estimate was made and if different estimates reasonably could have been used in the reporting period or changes in the accounting estimate are reasonably likely to occur from period to period that would have a material impact on our financial condition, results of operations or cash flows.

The methods used by us to estimate fair value for AFS securities, MSR, residential mortgage loans, equity securities and collateralized borrowings may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while we believe that our valuation methods are appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. We use inputs that are current as of the measurement date, which in periods of market dislocation, may have reduced transparency.

Classification and Valuation of Available-for-Sale Securities

Our securities investments consist primarily of Agency RMBS and non-Agency securities that we classify as available-for-sale, or AFS. All assets classified as AFS, excluding Agency interest-only mortgage-backed securities, are reported at estimated fair value with changes in fair value included in accumulated other comprehensive income, a separate component of stockholders' equity, on an after-tax basis. On July 1, 2015, we elected the fair value option for Agency interest-only securities acquired on or after such date. All Agency interest-only securities acquired on or after July 1, 2015 are carried at estimated fair value with changes in fair value recorded as a component of loss on investment securities in the consolidated statements of comprehensive (loss) income.

When the estimated fair value of an AFS security is less than amortized cost, we consider whether there is an other-than-temporary impairment in the value of the security that is required to be recognized in GAAP net (loss) income. The determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. Consideration is given to whether we (i) have the intent to sell the investment securities, (ii) are more likely than not to be required to sell the investment securities before recovery, or (iii) do not expect to recover the entire amortized cost basis of the investment securities. Investments with unrealized losses are not considered other-than-temporarily impaired if we have the ability and intent to hold the investments for a period of time, to maturity if necessary, sufficient for a forecasted market price recovery up to or beyond the amortized cost basis of the investments. If an impairment is determined to be solely driven by the inability to fully recover the entire amortized cost basis over the remaining life of the security, the security is further analyzed for credit loss (the difference between the present value of cash flows expected to be collected and the amortized cost basis). The credit loss, if any, is then recognized in GAAP net (loss) income, while the balance of impairment related to other factors is recognized in other comprehensive (loss) income.

Classification and Valuation of Mortgage Servicing Rights

We account for our MSR at fair value, with changes in fair value recorded in GAAP net (loss) income, rather than at amortized cost. Fair value is generally determined based on prices obtained from third-party pricing providers. Although MSR transactions are observable in the marketplace, the valuation includes unobservable market data inputs (prepayment speeds, delinquency levels and discount rates).

Interest Income Recognition

Our interest income on our Agency RMBS and non-Agency securities is accrued based on the actual coupon rate and the outstanding principal balance of such securities. Premiums and discounts are amortized or accreted into interest income over the lives of the securities using the effective yield method, as adjusted for actual prepayments. We estimate prepayments for our Agency interest-only securities, which represent our right to receive a specified portion of the contractual interest flows of specific Agency and collateralized mortgage obligations, or CMO, securities. As a result, if prepayments increase (or are expected to increase), we will accelerate the rate of amortization on the premiums. Conversely, if prepayments decrease (or are expected to decrease), we will decelerate the rate of amortization on the premiums.

Our interest income on our non-Agency securities rated below AA, including unrated securities, is recognized in accordance with estimated cash flows. Cash flows from a security are estimated by applying assumptions used to determine the fair value of such security and the excess of the future cash flows over the investment are recognized as interest income under the effective yield method. We review and, if appropriate, make adjustments to our cash flow projections at least quarterly and monitor these projections based on input and analysis received from external sources, internal models, and our judgment about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in interest income recognized on, or the carrying value of, such securities.

For non-Agency securities purchased at a discount, we account for differences between contractual cash flows and cash flows expected to be collected from our initial investment in debt securities acquired if those differences are attributable, at least in part, to credit quality. We limit the yield that may be accreted (accretable yield) to the excess of an estimate of undiscounted expected principal, interest, and other cash flows (cash flows expected at acquisition to be collected) over the initial investment. The excess of contractual cash flows over cash flows expected to be collected (nonaccretable difference or designated credit reserve) is not recognized as an adjustment of yield, loss accrual, or valuation allowance. Subsequent increases in cash flows expected to be collected is recognized prospectively through adjustment of the yield over the remaining life of the security. Decreases in cash flows expected to be collected are recognized as impairments.

Derivative Financial Instruments and Hedging Activities

We apply the provisions of ASC 815, which requires the recognition of all derivatives as either assets or liabilities on our consolidated balance sheets and to measure those instruments at fair value. The fair value adjustments of our current derivative instruments affect net income as the hedge for accounting purposes is being treated as an economic, or trading, hedge and not as a qualifying hedging instrument.

Derivatives are primarily used for hedging purposes rather than speculation. We utilize third-party pricing providers and broker quotes to value our financial derivative instruments. If our hedging activities do not achieve their desired results, our reported GAAP net (loss) income may be adversely affected.

Income Taxes

Our financial results are generally not expected to reflect provisions for current or deferred income taxes, except for those taxable benefits or provisions recognized by our TRSs. We estimate, based on existence of sufficient evidence, the ability to realize the remainder of any deferred tax asset our TRSs recognize. Any adjustments to such estimates will be made in the period such determination is made. We plan to operate in a manner that will allow us to qualify for taxation as a REIT. As a result of our expected REIT qualification, we do not generally expect to pay U.S. federal corporate level taxes. However, many of the REIT requirements are highly technical and complex. If we were to fail to meet the REIT requirements, we would be subject to U.S. federal, state and local income taxes.

The Tax Cuts and Jobs Act of 2017 (“TCJA”) significantly changed how the U.S. taxes corporations. The TCJA requires complex computations to be performed that were not previously required in U.S. tax law, significant judgments to be made in interpretation of the provisions of the TCJA and significant estimates in calculations, and the preparation and analysis of information not previously relevant or regularly produced. We have completed our determination of the accounting implications of the TCJA on our tax accruals and determined there is no impact recorded to our 2018 financial statements. Technical corrections or other amendments of the TCJA or administrative guidance interpreting the TCJA may be forthcoming at any time. While we do not anticipate a material effect on our operations, we continue to analyze and monitor the application of the TCJA to our business, our peers and the economic environment.

Market Conditions and Outlook

The key macroeconomic factors that impact our business are U.S. residential property prices, national employment rates and the interest rate environment. Home prices continued to increase modestly during the fourth quarter of 2018 and are expected to gradually appreciate over the next several years, albeit at a slower rate. Employment market conditions remain solid as jobless claims, unemployment and payroll data continue to show improvement at this stage of the business cycle, although new job creation has yet to generate excessive wage growth. Other than LTV ratios and cash reserves, we believe employment is the most powerful determinant of homeowners’ ongoing likelihood to pay their mortgages. Home price performance and employment are particularly important to our non-Agency portfolio.

The Federal Reserve raised the federal funds target rate by a total of 100 basis points during 2018, while more recently noting a roughly balanced outlook. The market’s expectations at the end of 2018 were for the Federal Reserve to cease raising rates during 2019. At the same time, due in part to the absence of meaningful inflation, the spread between long and short end interest rates narrowed during 2018 leading to a flat interest rate curve. The Trump administration continues to focus on several issues that could impact interest rates, the U.S. economy and U.S. businesses, including deregulation, trade and taxes. While there is much uncertainty regarding the timing and specifics of many policy changes, any such actions could affect our business. While interest rates have increased, they are still at historically low levels, and the Federal Reserve has reiterated it will take a measured and conservative approach to future interest rate decisions. While the Federal Reserve has begun to reduce its mortgage-backed securities holdings through cessation of reinvesting principal and interest payments, the approach has generally been to move gradually and cautiously. Mortgage investments could be impacted by a decision to increase or decrease the overall size, or the rate of change, of Federal Reserve's System Open Market Account (SOMA) mortgage holdings.

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We believe our blended Agency and non-Agency securities portfolio and our investing expertise, as well as our operational capabilities to invest in MSR, will allow us to better navigate the dynamic mortgage market while future regulatory and policy activities take shape. Having a diversified portfolio allows us to mitigate a variety of risks, including interest rate and RMBS spread volatility.

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

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

(dollars in thousands)	**December 31, 2018**		**December 31, 2017**	
Agency				
Fixed Rate	$21,665,960	84.6%	18,215,505	85.5%
Hybrid ARM	19,073	0.1 %	23,220	0.1 %
Total Agency	21,685,033	84.7%	18,238,725	85.6%
Agency Derivatives	70,257	0.3 %	90,975	0.4 %
Non-Agency				
Senior	2,854,731	11.1%	1,956,145	9.2 %
Mezzanine	928,632	3.6 %	960,865	4.5 %
Interest-only securities	84,208	0.3 %	65,084	0.3 %
Total Non-Agency	3,867,571	15.0%	2,982,094	14.0%
Total	$25,622,861		$21,311,794	

Prepayment speeds and volatility due to interest rates

Our Agency RMBS portfolio is subject to inherent prepayment risk. We seek to offset a portion of our Agency pool exposure to prepayment speeds through our MSR and interest-only Agency RMBS portfolios. Generally, a decline in interest rates that leads to rising prepayment speeds will cause the market value of our interest-only securities and MSR to deteriorate, and our fixed coupon Agency pools to increase. The inverse relationship occurs when interest rates increase and prepayments slow. As previously discussed, despite the Federal Reserve raising rates throughout 2017 and 2018, the low interest rate environment is expected to persist in the near term. However, changes in home price performance, key employment metrics and government programs, among other macroeconomic factors, could cause prepayment speeds to increase on many RMBS, which could lead to less attractive reinvestment opportunities. Nonetheless, we believe our portfolio management approach, including our asset selection process, positions us to respond to a variety of market scenarios, including an overall faster prepayment environment.

The following table provides the three-month weighted average constant prepayment rate, or CPR, on our Agency RMBS for the three months ended December 31, 2018, and the four immediately preceding quarters:

Agency RMBS	**Three Months Ended**				
	December 31, 2018	**September 30, 2018**	**June 30, 2018**	**March 31, 2018**	**December 31, 2017**
Weighted Average CPR	6.8%	8.1 %	9.2 %	7.0 %	7.6 %

Although we are unable to predict the movement in interest rates in the remainder of 2019 and beyond, our diversified portfolio management strategy is intended to generate attractive yields with a low level of sensitivity to changes in the yield curve, prepayments and interest rate cycles.

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Our Agency RMBS are collateralized by pools of fixed-rate mortgage loans and hybrid adjustable-rate mortgage loans, or hybrid ARMs, which are mortgage loans that have interest rates that are fixed for an initial period and adjustable thereafter. Our Agency portfolio also includes securities with implicit or explicit prepayment protection, including lower loan balances (securities collateralized by loans of less than $175,000 in initial principal balance), higher LTVs (securities collateralized by loans with LTVs greater than or equal to 80%), certain geographic concentrations and lower FICO scores. Our overall allocation of Agency RMBS and holdings of pools with specific characteristics are viewed in the context of our aggregate rates strategy, including MSR and related derivative hedging instruments. Additionally, the selection of securities with certain attributes is driven by the perceived relative value of the securities, which factors in the opportunities in the marketplace, the cost of financing and the cost of hedging interest rate, prepayment, credit and other portfolio risks. As a result, Agency RMBS capital allocation reflects management's flexible approach to investing in the marketplace.

The following tables provide the carrying value of our Agency RMBS portfolio by underlying mortgage loan rate type:

	December 31, 2018						
(dollars in thousands)	**Principal/ Current Face**	**Carrying Value**	**% of Agency Portfolio**	**% Prepayment Protected**	**Weighted Average Coupon Rate**	**Amortized Cost**	**Weighted Average Loan Age (months)**
Agency RMBS AFS:							
30-Year Fixed							
3.0-3.5%	$234,323	$234,521	1.1 %	100.0 %	3.5 %	$235,514	19
4.0-4.5%	18,877,967	19,533,066	89.8 %	91.8 %	4.3 %	19,812,426	19
≥ 5%	1,367,700	1,452,170	6.7 %	74.4 %	5.1 %	1,449,256	24
	20,479,990	21,219,757	97.6 %	90.7 %	4.3 %	21,497,196	19
15-Year & Other Fixed	277,860	270,787	1.2 %	0.3 %	4.7 %	272,435	149
Hybrid ARM	17,940	19,073	0.1 %	— %	5.1 %	18,855	177
Interest-only	3,115,967	175,416	0.8 %	— %	2.0 %	209,901	92
Agency Derivatives	476,299	70,257	0.3 %	— %	4.0 %	69,496	173
Total Agency RMBS	$24,368,056	$21,755,290	100.0 %	88.4 %		$22,067,883	

	December 31, 2017						
(dollars in thousands)	**Principal/ Current Face**	**Carrying Value**	**% of Agency Portfolio**	**% Prepayment Protected**	**Weighted Average Coupon Rate**	**Amortized Cost**	**Weighted Average Loan Age (months)**
Agency RMBS AFS:							
30-Year Fixed							
3.0-3.5%	$4,370,847	$4,509,743	24.6 %	95.9 %	3.5 %	$4,569,946	13
4.0-4.5%	11,990,911	12,764,960	69.7 %	99.1 %	4.2 %	12,812,335	17
≥ 5%	453,054	500,880	2.7 %	100.0 %	5.4 %	489,312	90
	16,814,812	17,775,583	97.0 %	98.3 %	4.1 %	17,871,593	18
15-Year & Other Fixed	245,383	244,834	1.3 %	0.6 %	4.9 %	242,033	153
Hybrid ARM	21,654	23,220	0.1 %	—%	5.0 %	22,831	166
Interest-only	2,941,772	195,088	1.1 %	—%	2.2 %	223,289	77
Agency Derivatives	588,246	90,975	0.5 %	—%	4.9 %	86,734	163
Total Agency RMBS	$20,611,867	$18,329,700	100.0 %	95.4 %		$18,446,480	

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

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The following tables provide net unamortized discount/premium information on our non-Agency securities portfolio:

	December 31, 2018				
(in thousands)	Principal/ Current Face	Un-amortized Premium	Accretable Purchase Discount	Credit Reserve Purchase Discount	Amortized Cost
Principal and interest securities					
Senior	$4,227,631	$ 5,381	$(477,682)	$(1,204,325)	$2,551,005
Mezzanine	1,132,493	1,301	(216,437)	(118,437)	798,920
Total P&I securities	5,360,124	6,682	(694,119)	(1,322,762)	3,349,925
Interest-only	5,137,169	83,846	—	—	83,846
Total Non-Agency	$10,497,293	$ 90,528	$(694,119)	$(1,322,762)	$3,433,771

	December 31, 2017				
(in thousands)	Principal/ Current Face	Un-amortized Premium	Accretable Purchase Discount	Credit Reserve Purchase Discount	Amortized Cost
Principal and interest securities					
Senior	$2,552,972	$ 2,435	$(424,580)	$(534,160)	$1,596,667
Mezzanine	1,205,162	322	(251,453)	(119,453)	834,578
Total P&I securities	3,758,134	2,757	(676,033)	(653,613)	2,431,245
Interest-only	5,614,925	65,667	—	—	65,667
Total Non-Agency	$9,373,059	$ 68,424	$(676,033)	$(653,613)	$2,496,912

Credit losses

Although our Agency portfolio is supported by U.S. government agency and federally chartered corporation guarantees of payment of principal and interest, we are exposed to credit risk in our non-Agency securities.

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

Counterparty exposure and leverage ratio

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

As of December 31, 2018, we had entered into repurchase agreements with 46 counterparties, 30 of which had outstanding balances at December 31, 2018. In addition, we held short- and long-term secured advances from the FHLB, short- and long-term borrowings under revolving credit facilities and long-term unsecured convertible senior notes. As of December 31, 2018, the debt-to-equity ratio funding our AFS securities, MSR and Agency Derivatives, which includes unsecured borrowings under convertible senior notes, was 5.8:1.0.

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As of December 31, 2018, we held $409.8 million in cash and cash equivalents, approximately $3.6 million of unpledged Agency securities and derivatives and $0.4 billion of unpledged non-Agency securities. As a result, we had an overall estimated unused borrowing capacity on our unpledged securities of approximately $0.3 billion. As of December 31, 2018, we held approximately $849.5 million of unpledged MSR and had an overall estimated unused borrowing capacity on MSR financing facilities of $160.0 million. Generally, unused borrowing capacity may be the result of our election not to utilize certain financing, as well as delays in the timing in which funding is provided or the inability to meet lenders' eligibility requirements for specific types of asset classes. If borrowing rates and collateral requirements change in the near term, we believe we are subject to less earnings volatility than if we carried higher leverage.

We also monitor exposure to our MSR counterparties. We may also be required to make representations and warranties to investors in the loans underlying the MSR we own; however, some of our MSR were purchased on a bifurcated basis, meaning the representation and warranty obligations remain with the seller. If the representations and warranties we make prove to be inaccurate, we may be obligated to repurchase certain mortgage loans, which may impact the profitability of our portfolio. Although we obtain similar representations and warranties from the counterparty from which we acquired the relevant asset, if those representations and warranties do not directly mirror those we make to the investor, or if we are unable to enforce the representations and warranties against the counterparty for a variety of reasons, including the financial condition or insolvency of the counterparty, we may not be able to seek indemnification from our counterparties for any losses attributable to the breach.

Summary of Results of Operations and Financial Condition

Our GAAP net loss attributable to common stockholders was $573.5 million and $109.7 million ($(2.31) and $(0.53) per diluted weighted average share) for the three and twelve months ended December 31, 2018, as compared to GAAP net income attributable to common stockholders of $154.0 million and $323.4 million ($0.84 and $1.81 per diluted weighted average share) for the three and twelve months ended December 31, 2017.

With our accounting treatment for AFS securities, unrealized fluctuations in the market values of AFS securities, excluding Agency interest-only securities, do not impact our GAAP net (loss) income or taxable income but are recognized on our consolidated balance sheets as a change in stockholders' equity under "accumulated other comprehensive income." As a result of this fair value accounting through stockholders' equity, we expect our net (loss) income to have less significant fluctuations and result in less U.S. GAAP to taxable income timing differences, than if the portfolio were accounted for as trading instruments. For the three and twelve months ended December 31, 2018, net unrealized gains on AFS securities recognized as other comprehensive income, net of tax, were $265.5 million and net unrealized losses on AFS securities recognized as other comprehensive loss, net of tax, were $233.9 million, respectively. This, combined with GAAP net loss attributable to common stockholders of $573.5 million and $109.7 million, resulted in comprehensive loss attributable to common stockholders of $307.9 million and $343.6 million for the three and twelve months ended December 31, 2018, respectively. For the three and twelve months ended December 31, 2017, net unrealized losses on AFS securities recognized as other comprehensive loss, net of tax, were $88.3 million and net unrealized gains of AFS securities recognized as other comprehensive income, net of tax, were $135.6 million, respectively. This, combined with GAAP net income attributable to common stockholders of $154.0 million and $323.4 million, resulted in comprehensive income attributable to common stockholders of $65.7 million and $459.0 million for the three and twelve months ended December 31, 2017, respectively.

Our book value per common share for U.S. GAAP purposes was $13.11 at December 31, 2018, a decrease from $16.31 book value per common share at December 31, 2017. During this twelve month period, we declared dividends of $452.0 million and recognized comprehensive loss attributable to common stockholders of $343.6 million, which drove the overall decrease in book value.

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The following tables present the components of our comprehensive (loss) income for the three and twelve months ended December 31, 2018 and 2017, and the twelve months ended December 31, 2016:

(in thousands, except share data)	Three Months Ended		Year Ended		
Income Statement Data:	**December 31,**		**December 31,**		
	2018	**2017**	**2018**	**2017**	**2016**
Interest income:					
Available-for-sale securities	$242,535	$182,712	$847,325	$631,853	$414,050
Residential mortgage loans held-for-investment in securitization trusts	—	10,567	—	102,886	133,993
Other	9,420	1,826	22,707	10,350	27,037
Total interest income	251,955	195,105	870,032	745,089	575,080
Interest expense:					
Repurchase agreements	146,702	74,674	469,437	210,430	88,850
Collateralized borrowings in securitization trusts	—	8,374	—	82,573	97,729
Federal Home Loan Bank advances	5,762	6,357	20,417	36,911	26,101
Revolving credit facilities	5,044	614	10,820	2,341	604
Convertible senior notes	4,793	4,776	18,997	17,933	—
Total interest expense	162,301	94,795	519,671	350,188	213,284
Net interest income	89,654	100,310	350,361	394,901	361,796
Other-than-temporary impairment losses	(107)	(360)	(470)	(789)	(1,822)
Other (loss) income:					
Loss on investment securities	(245,763)	(19,210)	(341,312)	(34,695)	(107,374)
Servicing income	104,623	60,597	343,096	209,065	143,579
Loss on servicing asset	(171,284)	(593)	(69,033)	(91,033)	(83,531)
(Loss) gain on interest rate swap, cap and swaption agreements	(239,492)	57,237	16,043	(9,753)	45,371
(Loss) gain on other derivative instruments	(39,122)	(3,831)	(54,857)	(70,159)	99,379
Other income	342	9,088	3,037	30,141	9,964
Total other (loss) income	(590,696)	103,288	(103,026)	33,566	107,388
Expenses:					
Management fees	12,152	10,671	30,272	40,472	39,261
Servicing expenses	18,610	10,135	61,136	35,289	32,119
Securitization deal costs	—	—	—	—	6,152
Other operating expenses	15,943	9,787	62,983	54,160	56,605
Acquisition transaction costs	—	—	86,703	—	
Restructuring charges	—	—	8,238	—	2,990
Total expenses	46,705	30,593	249,332	129,921	137,127
(Loss) income from continuing operations before income taxes	(547,854)	172,645	(2,467)	297,757	330,235
Provision for (benefit from) income taxes	6,681	10,618	41,823	(10,482)	12,314
Net (loss) income from continuing operations	(554,535)	162,027	(44,290)	308,239	317,921
Income from discontinued operations, net of tax	—	4,977	—	44,146	35,357
Net (loss) income	(554,535)	167,004	(44,290)	352,385	353,278
Income from discontinued operations attributable to noncontrolling interest	—	1,100	—	3,814	—
	(554,535)	165,904	(44,290)	348,571	353,278

Net (loss) income attributable to Two Harbors Investment Corp.					
Dividends on preferred stock	18,950	11,949	65,395	25,122	—
Net (loss) income attributable to common stockholders	$(573,485)	$153,955	$(109,685)	$323,449	$353,278

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(in thousands)	**Three Months Ended**		**Year Ended**		
Income Statement Data:	**December 31,**		**December 31,**		
	2018	**2017**	**2018**	**2017**	**2016**
Basic (loss) earnings per weighted average share:	(unaudited)				
Continuing operations	$(2.31)	$0.86	$(0.53)	$1.62	$1.83
Discontinued operations	—	0.02	—	0.23	0.20
Net (loss) income	$(2.31)	$0.88	$(0.53)	$1.85	$2.03
Diluted (loss) earnings per weighted average share:					
Continuing operations	$(2.31)	$0.82	$(0.53)	$1.60	$1.83
Discontinued operations	—	0.02	—	0.21	0.20
Net (loss) income	$(2.31)	$0.84	$(0.53)	$1.81	$2.03
Dividends declared per common share	$0.47	$0.47	$1.88	$2.01	$1.86
Weighted average number of shares of common stock:					
Basic	248,081,168	174,490,106	206,020,502	174,433,999	174,036,852
Diluted	248,081,168	188,938,030	206,020,502	188,133,341	174,036,852
Comprehensive (loss) income:					
Net (loss) income	$(554,535)	$167,004	$(44,290)	$352,385	$353,278
Other comprehensive income (loss), net of tax:					
Unrealized gain (loss) on available-for-sale securities	265,546	(88,227)	(233,914)	135,586	(159,834)
Other comprehensive income (loss)	265,546	(88,227)	(233,914)	135,586	(159,834)
Comprehensive (loss) income	(288,989)	78,777	(278,204)	487,971	$193,444
Comprehensive income attributable to noncontrolling interest	—	1,100	—	3,814	—
Comprehensive (loss) income attributable to Two Harbors Investment Corp.	(288,989)	77,677	(278,204)	484,157	193,444
Dividends on preferred stock	18,950	11,949	65,395	25,122	—
Comprehensive (loss) income attributable to common stockholders	$(307,939)	$65,728	$(343,599)	$459,035	$193,444

(in thousands)	**December 31,**	**December 31,**
Balance Sheet Data:	**2018**	**2017**
	(unaudited)	
Available-for-sale securities	$25,552,604	$21,220,819
Mortgage servicing rights	$1,993,440	$1,086,717
Total assets	$30,132,479	$24,789,313
Repurchase agreements	$23,133,476	$19,451,207
Federal Home Loan Bank advances	$865,024	$1,215,024
Total stockholders’ equity	$4,254,489	$3,571,424

Results of Operations

The following analysis focuses on financial results during the three and twelve months ended December 31, 2018 and 2017.

Interest Income

Interest income increased from $195.1 million and $745.1 million for the three and twelve months ended December 31, 2017, respectively, to $252.0 million and $870.0 million for the same periods in 2018 due to the growth of our AFS securities portfolio as a result of the acquisition of CYS and purchases of Agency securities with higher yields, offset by sales of retained interests from our on-balance sheet securitizations resulting in the deconsolidation of all securitization trusts in the fourth quarter of 2017.

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Interest Expense

Interest expense increased from $94.8 million and $350.2 million for the three and twelve months ended December 31, 2017, respectively, to $162.3 million and $519.7 million for the same periods in 2018 due to increased financing on AFS securities as a result of the acquisition of CYS and on MSR due to portfolio growth, an increase in the proportion of total borrowings financed through repurchase agreements (relative to FHLB advances) and increases in the borrowing rates offered by counterparties, offset by sales of retained interests from our on-balance sheet securitizations resulting in the deconsolidation of all securitization trusts in the fourth quarter of 2017.

Net Interest Income

The following tables present the components of interest income and average annualized net asset yield earned by asset type, the components of interest expense and average annualized cost of funds on borrowings incurred by liability and/or collateral type, and net interest income and average annualized net interest rate spread for the three and twelve months ended December 31, 2018 and 2017:

	Three Months Ended December 31, 2018			Year Ended December 31, 2018		
(dollars in thousands)	**Average Balance** [1]	**Interest Income/Expense**	**Net Yield/Cost of Funds** [2]	**Average Balance** [1]	**Interest Income/Expense**	**Net Yield/Cost of Funds** [2]
Interest-earning assets						
Agency available-for-sale securities	$21,401,757	$ 176,997	3.3 %	$19,782,775	$ 620,582	3.1 %
Non-Agency available-for-sale securities	3,405,550	65,538	7.7 %	2,935,601	226,743	7.7 %
Other	28,551	9,420	4.1 %	30,148	22,707	4.2 %
Total interest income/net asset yield	$24,835,858	$ 251,955	4.1 %	$22,748,524	$ 870,032	3.8 %
Interest-bearing liabilities						
Repurchase agreements, FHLB advances, revolving credit facilities and borrowings in securitization trusts collateralized by:						
Agency available-for-sale securities	$19,796,348	$ 125,014	2.5 %	$18,603,631	$ 396,786	2.1 %
Non-Agency available-for-sale securities	2,569,298	23,802	3.7 %	2,278,651	79,772	3.5 %
Agency derivatives [3]	48,018	404	3.4 %	56,393	1,650	2.9 %
Mortgage servicing rights [4]	579,348	8,288	5.7 %	407,085	22,466	5.5 %
Other unassignable						
Convertible senior notes	283,755	4,793	6.8 %	283,347	18,997	6.7 %
Total interest expense/cost of funds	$23,276,767	162,301	2.8 %	$21,629,107	519,671	2.4 %
Net interest income/spread [5]		$ 89,654	1.3 %		$ 350,361	1.4 %

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(dollars in thousands)	Three Months Ended December 31, 2017			Year Ended December 31, 2017		
	Average Balance (1)	Interest Income/Expense	Net Yield/Cost of Funds (2)	Average Balance (1)	Interest Income/Expense	Net Yield/Cost of Funds (2)
Interest-earning assets						
Agency available-for-sale securities	$17,842,609	$ 137,331	3.1 %	$15,561,985	$ 470,619	3.0 %
Non-Agency available-for-sale securities	2,381,956	45,381	7.6 %	1,970,055	161,234	8.2 %
Residential mortgage loans held-for-investment in securitization trusts	1,103,946	10,567	3.8 %	2,641,277	102,886	3.9 %
Other	33,124	1,826	3.9 %	35,517	10,350	4.8 %
Total interest income/net asset yield	$21,361,635	$ 195,105	3.7 %	$20,208,834	$ 745,089	3.7 %
Interest-bearing liabilities						
Repurchase agreements, FHLB advances, revolving credit facilities and borrowings in securitization trusts collateralized by:						
Agency available-for-sale securities	$17,254,668	$ 65,788	1.5 %	$14,877,129	$ 193,283	1.3 %
Non-Agency available-for-sale securities	1,876,009	14,169	3.0 %	1,522,437	44,691	2.9 %
Residential mortgage loans held-for-investment in securitization trusts	1,084,285	8,774	3.2 %	2,593,750	85,940	3.3 %
Agency derivatives (3)	73,545	401	2.2 %	82,387	1,661	2.0 %
Mortgage servicing rights (4)	58,071	856	5.9 %	43,033	2,582	6.0 %
Other unassignable						
Convertible senior notes	282,733	4,776	6.8 %	272,376	17,933	6.6 %
Other		31			4,098	
Total interest expense/cost of funds	$20,629,311	94,795	1.8 %	$19,391,112	350,188	1.8 %
Net interest income/spread (5)		$ 100,310	1.9 %		$ 394,901	1.9 %

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

(2) Cost of funds does not include the accrual and settlement of interest associated with interest rate swaps and caps. In accordance with U.S. GAAP, those costs are included in (loss) gain on interest rate swap, cap and swaption agreements in the consolidated statements of comprehensive (loss) income. For the three and twelve months ended December 31, 2018, our total average cost of funds on the assets assigned as collateral for borrowings shown in the table above, including interest spread expense associated with interest rate swaps and caps, was 2.8% and 2.3%, respectively, compared to 1.9% and 1.9% for the same periods in 2017.

(3) Yields on Agency Derivatives not shown as interest income is included in (loss) gain on other derivative instruments in the consolidated statements of comprehensive (loss) income.

(4) Yields on mortgage servicing rights not shown as these assets do not earn interest.

(5) Net interest spread does not include the accrual and settlement of interest associated with interest rate swaps and caps. In accordance with U.S. GAAP, those costs are included in (loss) gain on interest rate swap, cap and swaption agreements in the consolidated statements of comprehensive (loss) income. For the three and twelve months ended December 31, 2018, our total average net interest rate spread on the assets and liabilities shown in the table above, including interest spread expense associated with interest rate swaps and caps, was 1.1% and 1.5%, respectively, compared to 1.8% and 1.8% for the same periods in 2017.

The increase in yields on Agency AFS securities for the three and twelve months ended December 31, 2018, as compared to the same periods in 2017, was predominantly driven by purchases of pools with higher yields and sales of pools with lower yields. The increase in cost of funds associated with the financing of Agency AFS securities for the three and twelve months ended December 31, 2018, as compared to the same periods in 2017, was the result of increases in the borrowing rates offered by financing counterparties.

The decrease in yields on non-Agency securities for the three and twelve months ended December 31, 2018, as compared to the same period in 2017, was predominantly driven by purchases of non-Agency securities at lower yields than our existing portfolio. The increase in cost of funds associated with the financing of non-Agency AFS securities for the three and twelve months ended December 31, 2018, as compared to the same periods in 2017, was the result of increases in the borrowing rates offered by counterparties.

The increase in cost of funds associated with the financing of Agency Derivatives for the three and twelve months ended December 31, 2018, as compared to the same periods in 2017, was the result of increases in the borrowing rates offered by counterparties.

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The decrease in cost of funds associated with the financing of MSR for the three and twelve months ended December 31, 2018, as compared to the same periods in 2017, was the result of an increase in the proportion of total average borrowings financed through repurchase agreements (relative to revolving credit facilities, which have higher interest rates) and improvement in MSR financing rates in the market.

Our convertible senior notes were issued in January 2017, are unsecured and pay interest semiannually at a rate of 6.25% per annum. The cost of funds associated with our convertible senior notes for the three and twelve months ended December 31, 2018, as compared to the same periods in 2017, was consistent.

The following tables present the components of the yield earned by investment type on our AFS securities portfolio as a percentage of our average amortized cost of securities for the three and twelve months ended December 31, 2018 and 2017:

	Three Months Ended December 31, 2018			**Year Ended December 31, 2018**		
	Agency (1)	**Non-Agency**	**Total**	**Agency (1)**	**Non-Agency**	**Total**
Gross yield/stated coupon	4.1 %	4.8 %	4.2 %	4.1 %	4.7 %	4.1 %
Net (premium amortization) discount accretion	(0.8)%	2.9 %	(0.3)%	(1.0)%	3.0 %	(0.4)%
Net yield (2)	3.3 %	7.7 %	3.9 %	3.1 %	7.7 %	3.7 %

	Three Months Ended December 31, 2017			**Year Ended December 31, 2017**		
	Agency (1)	**Non-Agency**	**Total**	**Agency (1)**	**Non-Agency**	**Total**
Gross yield/stated coupon	4.0 %	4.1 %	4.1 %	4.0 %	3.7 %	4.0 %
Net (premium amortization) discount accretion	(0.9)%	3.5 %	(0.5)%	(1.0)%	4.5 %	(0.4)%
Net yield (2)	3.1 %	7.6 %	3.6 %	3.0 %	8.2 %	3.6 %

(1) Excludes Agency Derivatives. For the three and twelve months ended December 31, 2018, the average annualized net yield on total Agency RMBS, including Agency Derivatives, was 3.3% and 3.2%, respectively, compared to 3.1% and 3.1% for the same periods in 2017.
(2) These yields have not been adjusted for cost of delay and cost to carry purchase premiums.

Other-Than-Temporary Impairments

We review each of our securities on a quarterly basis to determine if an OTTI charge is necessary. During the three and twelve months ended December 31, 2018, we recorded \$0.1 million and \$0.5 million in other-than-temporary credit impairments on a total of three non-Agency securities where the future expected cash flows for each security were less than its amortized cost. During the three and twelve months ended December 31, 2017, we recorded \$0.4 million and \$0.8 million in other-than-temporary credit impairments on two non-Agency securities where the future expected cash flows for the security were less than their amortized cost. For further information about evaluating AFS securities for OTTI, refer to Note 4 - *Available-for-Sale Securities, at Fair Value* of the notes to the consolidated financial statements.

Loss on Investment Securities

During the three and twelve months ended December 31, 2018, we sold AFS securities for \$6.0 billion and \$15.2 billion with an amortized cost of \$6.3 billion and \$15.6 billion, for net realized losses of \$248.8 million and \$349.6 million, respectively. During the three and twelve months ended December 31, 2017, we sold AFS securities for \$2.9 billion and \$8.7 billion with an amortized cost of \$3.0 billion and \$8.7 billion, for net realized losses of \$11.5 million and \$32.5 million, respectively. We do not expect to sell assets on a frequent basis, but may sell assets to reallocate capital into new assets that we believe have higher risk-adjusted returns.

For the three and twelve months ended December 31, 2018, Agency interest-only mortgage-backed securities experienced a change in unrealized gains of \$3.1 million and \$5.1 million, respectively. For the three and twelve months ended December 31, 2017, Agency interest-only mortgage-backed securities experienced a change in unrealized gains of $7.8 million and $2.3 million, respectively. The change in unrealized gains for the three and twelve months ended December 31, 2018, as compared to the same periods in 2017, was predominantly driven by higher prepayment expectations on Agency interest-only mortgage-backed securities.

For the year ended December 31, 2018, we recognized $1.3 million in dividend income on equity securities. We did not recognize any dividend income on equity securities during the three months ended December 31, 2018. For the year ended December 31, 2018, equity securities experienced a change in unrealized gains of $0.6 million. Additionally, for the year ended December 31, 2018, we sold equity securities for $31.2 million with a cost basis of $30.1 million for net realized gains of $1.2 million. For both the three and twelve months ended December 31, 2017, we recognized $0.7 million in dividend income on equity securities and experienced a change in unrealized losses of $0.6 million due to declines in the market price of the securities.

Servicing Income

For the three and twelve months ended December 31, 2018, we recognized total servicing income from our MSR portfolio of $104.6 million and $343.1 million, respectively. These amounts include servicing fee income of $94.1 million and $312.1 million, ancillary and other fee income of $0.3 million and $1.3 million, and float income of $10.3 million and $29.7 million, respectively. For the three and twelve months ended December 31, 2017, we recognized total servicing income of $60.6 million and $209.1 million, respectively. These amounts include servicing fee income of $56.0 million and $197.9 million, ancillary and other fee income of $0.4 million and $1.0 million, and float income of $4.2 million and $10.2 million, respectively. The increase in servicing income for the three and twelve months ended December 31, 2018, as compared to the same periods in 2017, was the result of an increase in the size of our MSR portfolio. Additionally, the increase in float income was the result of both the increased size of our MSR portfolio and increased float earning rates.

Loss on Servicing Asset

For the three and twelve months ended December 31, 2018, loss on servicing asset of $171.3 million and $69.0 million, respectively, includes a decrease in fair value of MSR due to changes in valuation inputs or assumptions of $129.4 million and an increase in fair value of MSR due to changes in valuation inputs or assumptions of $80.2 million, respectively, offset by a decrease in fair value of MSR due to realization of cash flows (runoff) of $42.1 million and $149.9 million, respectively. Additionally, we recognized gains on sales of MSR of $0.2 million and $0.6 million for the three and twelve months ended December 31, 2018, respectively. For the three and twelve months ended December 31, 2017, loss on servicing asset of $0.6 million and $91.0 million, respectively, includes an increase in fair value of MSR due to changes in valuation inputs or assumptions of $29.4 million and $6.3 million, respectively, and a decrease in fair value of MSR due to realization of cash flows (runoff) of $30.2 million and $96.8 million, respectively. The increase in loss on servicing asset for the three and twelve months ended December 31, 2018, as compared to the same periods in 2017, was predominantly driven by an increase in market demand, and higher portfolio runoff during the three and twelve months ended December 31, 2018 due to an increase in the size of our MSR portfolio, offset by a decrease in prepayment speed assumptions.

(Loss) gain on Interest Rate Swap, Cap and Swaption Agreements

For the three and twelve months ended December 31, 2018, we recognized $15.3 million and $49.2 million of income, respectively, for the accrual and/or settlement of the net interest expense associated with our interest rate swaps and caps. 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 $32.5 billion and $29.4 billion notional, respectively, held to economically hedge/mitigate portfolio interest rate exposure (or duration) risk. For the three and twelve months ended December 31, 2017, we recognized $2.0 million of income and $8.8 million of expenses for the accrual and/or settlement of the net interest expense associated with our interest rate swaps and caps. The income and 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 $24.9 billion and $19.4 billion notional, respectively, held to economically hedge/mitigate portfolio interest rate exposure (or duration) risk.

During the three and twelve months ended December 31, 2018, we terminated, had agreements mature or had options expire on 58 and 174 interest rate swap, cap and swaption positions of $26.0 billion and $95.5 billion notional, respectively. Upon settlement of the early terminations and option expirations, we paid $1.1 million and $19.2 million in full settlement of our net interest spread asset/liability and recognized $35.8 million and $3.6 million in realized losses on the swaps, caps and swaptions for the three and twelve months ended December 31, 2018, respectively, including early termination penalties. During the three and twelve months ended December 31, 2017, we terminated, had agreements mature or had options expire on 30 and 151 interest rate swap, cap and swaption positions of $12.2 billion and $67.7 billion notional, respectively. Upon settlement of the early terminations and option expirations, we paid $0.2 million and $19.7 million in full settlement of our net interest spread liability and recognized $5.7 million in realized losses and $63.2 million in realized gains on the swaps, caps and swaptions for the three and twelve months ended December 31, 2017, respectively, including early termination penalties. We elected to terminate certain swaps and swaptions during these periods to align with our investment portfolio.

Also included in our financial results for the three and twelve months ended December 31, 2018, was the recognition of a change in unrealized valuation losses of $219.1 million and $29.6 million, respectively, on our interest rate swap, cap and swaption agreements that were accounted for as trading instruments, compared to a change in unrealized valuation gains of $60.9 million and losses of $64.1 million for the same periods in 2017. The change in fair value of interest rate swaps and caps was a result of changes to LIBOR, the swap curve and corresponding counterparty borrowing rates during the three and twelve months ended December 31, 2018 and 2017. Since these swaps, caps and swaptions are used for purposes of hedging our interest rate exposure, their unrealized valuation gains and losses are generally offset by unrealized losses and gains in our Agency RMBS AFS portfolio, which are recorded either directly to stockholders' equity through other comprehensive (loss) income, net of tax, or to loss on investment securities, in the case of Agency interest-only securities.

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

(in thousands)	Three Months Ended December 31, 2018	2017	Year Ended December 31, 2018	2017
Net interest spread	$15,331	$2,044	$49,217	$(8,823)
Early termination, agreement maturation and option expiration (losses) gains	(35,757)	(5,685)	(3,593)	63,169
Change in unrealized (loss) gain on interest rate swap, cap and swaption agreements, at fair value	(219,066)	60,878	(29,581)	(64,099)
(Loss) gain on interest rate swap, cap and swaption agreements	$(239,492)	$57,237	$16,043	$(9,753)

Loss on Other Derivative Instruments

Included in our financial results for the three and twelve months ended December 31, 2018, was the recognition of $39.1 million and $54.9 million of losses, respectively, on other derivative instruments we hold for purposes of both hedging and non-hedging activities, principally TBAs, put and call options for TBAs, Markit IOS total return swaps and inverse interest-only securities. Included within these results for the three and twelve months ended December 31, 2018, was the recognition of $1.4 million and $6.5 million of interest income, net of accretion on inverse interest-only securities on an average amortized cost basis of $71.3 million and $78.0 million, respectively, and interest expense on short U.S. treasuries of $5.6 million and $9.3 million, respectively. The remainder represented realized and unrealized net gains (losses) on other derivative instruments.

Included in our financial results for the three and twelve months ended December 31, 2017, was the recognition of $3.8 million and $70.2 million of losses, respectively, on other derivative instruments we hold for purposes of both hedging and non-hedging activities, principally TBAs, put and call options for TBAs, Markit IOS total return swaps and inverse interest-only securities. Included within these results for the three and twelve months ended December 31, 2017, was the recognition of $2.8 million and $12.7 million of interest income, net of accretion on inverse interest-only securities on an average amortized cost basis of $88.6 million and $92.8 million, respectively. The remainder represented realized and unrealized net gains (losses) on other derivative instruments. As these derivative instruments are considered trading instruments, our financial results include both realized and unrealized gains (losses) associated with these instruments.

Other Income

For the three and twelve months ended December 31, 2018, we recorded other income of $0.3 million and $3.0 million. For the three and twelve months ended December 31, 2017, we recorded other income of $9.1 million and $30.1 million. The decrease in other income for the three and twelve months ended December 31, 2018, as compared to the same periods in 2017, was predominantly driven by sales of retained interests from our on-balance sheet securitizations resulting in the deconsolidation of all securitization trusts in the fourth quarter of 2017.

Management Fees

We incurred management fees of $12.2 million and $30.3 million for the three and twelve months ended December 31, 2018 and $10.7 million and $40.5 million for the three and twelve months ended December 31, 2017, respectively, which are payable to PRCM Advisers, our external manager, under the terms of our management agreement, dated as of October 28, 2009 and subsequently amended. The management fee is calculated based on our stockholders' equity with certain adjustments outlined in the management agreement.

In connection with the acquisition of CYS, the management agreement was amended to (i) reduce PRCM Advisers' base management fee with respect to the additional equity under management resulting from the merger to 0.75% from the effective time through the first anniversary of the effective time and (ii) for the fiscal quarter in which closing of the merger occurs, to make a one-time downward adjustment of Pine River's management fees payable by Two

Harbors for such quarter by $15.0 million to offset the cash consideration payable to stockholders of CYS, plus an additional downward adjustment of up to $3.3 million for certain transaction-related expenses. For the year ended December 31, 2018, the total downward adjustment to management fees was $17.5 million. We do not anticipate any further downward adjustments to management fees for transaction-related expenses.

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Servicing Expenses

For the three and twelve months ended December 31, 2018, we recognized $18.6 million and $61.1 million, respectively, in servicing expenses generally related to the subservicing of MSR and residential mortgage loans, compared to $10.1 million and $35.3 million for the same periods in 2017. The increase in servicing expenses during the three and twelve months ended December 31, 2018, as compared to the same periods in 2017, was largely the result of an increase in the size of our MSR portfolio.

Other Operating Expenses

For the three and twelve months ended December 31, 2018, we recognized $15.9 million and $63.0 million of other operating expenses, which represents an annualized expense ratio of 1.4% and 1.6% of average equity, respectively. Excluding non-cash equity compensation expenses (amortization of restricted stock), our annualized expense ratio was 1.1% and 1.3% of average equity for the three and twelve months ended December 31, 2018, respectively. For the three and twelve months ended December 31, 2017, we recognized $9.8 million and $54.2 million of other operating expenses, which, for the year ended December 31, 2017, includes $2.2 million of transaction expenses associated with the contribution of TH Commercial Holdings LLC to Granite Point. Excluding these transaction expenses, our annualized expense ratio was 1.1% and 1.4% of average common equity for the three and twelve months ended December 31, 2017, respectively. Excluding non-cash equity compensation expenses (and transaction expenses associated with the contribution of TH Commercial Holdings LLC to Granite Point), our annualized expense ratio was 1.1% and 1.2% of average equity for the three and twelve months ended December 31, 2017, respectively.

Included in other operating expenses are direct and allocated costs incurred by PRCM Advisers on our behalf and reimbursed by us. For the three and twelve months ended December 31, 2018, these direct and allocated costs totaled approximately $5.5 million and $26.3 million, respectively, compared to $5.9 million and $27.9 million for the same periods in 2017. Included in these reimbursed costs was compensation paid to employees of Pine River serving as our principal financial officer and general counsel of $0.2 million and $1.8 million for the three and twelve months ended December 31, 2018 and $0.2 million and $1.7 million for the three and twelve months ended December 31, 2017, respectively. The allocation of compensation paid to employees of Pine River serving as our principal financial officer and general counsel is based on time spent overseeing our company’s activities in accordance with the management agreement; we do not reimburse PRCM Advisers for any expenses related to the compensation of our chief executive officer or chief investment officer. Equity based compensation expense for the three and twelve months ended December 31, 2018 also includes the amortization of restricted stock awarded to our executive officers, including our chief executive officer, chief investment officer, principal financial officer and general counsel of $1.8 million and $6.8 million, compared to $(0.2) million and $6.2 million for the three and twelve months ended December 31, 2017, respectively. The increase in amortization of restricted stock was due to the decline in our share price following the special dividend of Granite Point common stock in the fourth quarter of 2017.

We have direct relationships with the majority of our third-party vendors. We will continue to have certain costs allocated to us by PRCM Advisers for compensation, data services, technology and certain office lease payments, but most of our expenses with third-party vendors are paid directly by us.

Acquisition Transaction Costs

The acquisition of CYS was treated as an asset purchase under U.S. GAAP. Given there were no meaningful nonfinancial assets and non-current assets acquired in the merger with CYS and no identified intangible assets to assign value, the excess consideration and costs associated with the transaction were recognized in the consolidated statements of comprehensive (loss) income as acquisition transaction costs. For the twelve months ended December 31, 2018, these acquisition transaction costs totaled approximately $86.7 million.

Restructuring Charges

In connection with the acquisition of CYS, we incurred restructuring charges, including termination benefits, contract terminations and other associated costs, of $8.2 million for the twelve months ended December 31, 2018.

Income Taxes

During the three and twelve months ended December 31, 2018, our TRSs recognized a provision for income taxes of $6.7 million and $41.8 million, which was primarily due to realized gains on sales of AFS securities held in the TRSs as well as the write-down of net deferred tax assets resulting from the deemed liquidation of one of our TRSs due to its TRS election revocation, offset by net losses incurred on derivative instruments held in the TRSs. During the three months ended December 31, 2017, our TRSs recognized a provision for income taxes of $10.6 million which was primarily due to changes in our deferred tax asset and liability balances at December 31, 2017 as a result of a decrease in the future federal statutory tax rate due to recent tax reform, partially offset by net losses incurred on derivative instruments held in our TRSs. During the year ended December 31, 2017, our TRSs recognized a benefit from income taxes of $10.5 million, which was primarily due to realized losses on sales of AFS securities and net losses incurred on derivative instruments held in our TRSs, offset by a decrease in the future federal statutory tax rate due to recent tax reform. As of December 31, 2018, no valuation allowance was recorded. As of December 31, 2017, a $2.7 million valuation allowance was recorded because we determined that it was more likely than not that the associated deferred tax asset would not be realized. We currently intend to distribute 100% of our REIT taxable income and comply with all requirements to continue to qualify as a REIT.

The Tax Cuts and Jobs Act of 2017, or TCJA, significantly revised the U.S. corporate income tax laws by, among other things, lowering the federal income tax rate applicable to corporations from 35% to 21% and repealing the corporate alternative minimum tax. We have completed our analysis of the accounting implications of the TCJA on our tax accruals and determined there is no impact recorded to our 2018 financial statements. Additionally, we recorded a provisional tax provision of $17.5 million in our 2017 financial statements, which was included as a component of income tax expense from continuing operations. This amount represents the remeasurement of federal net deferred tax assets resulting from the permanent reduction in the U.S. statutory corporate tax rate from 35% to 21%. This provisional amount has been finalized without any changes. Technical corrections or other amendments to the TCJA or administrative guidance interpreting the TCJA may be forthcoming at any time. While we do not anticipate a material effect on our operations, we will continue to analyze and monitor the application of the TCJA to our business, our peers and the economic environment.

Year Ended December 31, 2017 Compared to Year Ended December 31, 2016

The following analysis focuses on financial results during the years ended December 31, 2017 and 2016.

Interest Income

Interest income increased from $575.1 million for the year ended December 31, 2016, respectively, to $745.1 million for the year ended December 31, 2017 due to the growth of our AFS securities portfolio, offset by the sale of substantially all of our remaining prime nonconforming residential mortgage loans held-for-sale during the latter half of 2016 as well as sales of retained interests from our on-balance sheet securitizations resulting in the deconsolidation of all securitization trusts in the fourth quarter of 2017.

Interest Expense

Interest expense increased from $213.3 million for the year ended December 31, 2016 to $350.2 million for the year ended December 31, 2017 due to increased financing on AFS securities due to purchases, increases in the borrowing rates offered by counterparties, the addition of revolving credit facilities for financing of MSR and the issuance of convertible senior notes, offset by sales of retained interests from our on-balance sheet securitizations resulting in the deconsolidation of all securitization trusts in the fourth quarter of 2017.

Net Interest Income

The following tables present the components of interest income and average annualized net asset yield earned by asset type, the components of interest expense and average annualized cost of funds on borrowings incurred by liability and/or collateral type, and net interest income and average annualized net interest rate spread for the years ended December 31, 2017 and 2016:

	Year Ended December 31, 2017			Year Ended December 31, 2016		
(dollars in thousands)	**Average Balance** [1]	**Interest Income/Expense**	**Net Yield/Cost of Funds** [2]	**Average Balance** [1]	**Interest Income/Expense**	**Net Yield/Cost of Funds** [2]
Interest-earning assets						
Agency available-for-sale securities	$15,561,985	$ 470,619	3.0 %	$10,341,218	$ 293,498	2.8 %
Non-Agency available-for-sale securities	1,970,055	161,234	8.2 %	1,436,769	120,552	8.4 %
Residential mortgage loans held-for-investment in securitization trusts	2,641,277	102,886	3.9 %	3,470,272	133,993	3.9 %
Other	35,517	10,350	4.8 %	566,239	27,037	4.8 %
Total interest income/net asset yield	$20,208,834	$ 745,089	3.7 %	$15,814,498	$ 575,080	3.6 %
Interest-bearing liabilities						
Repurchase agreements, FHLB advances, revolving credit facilities and borrowings in securitization trusts collateralized by:						
Agency available-for-sale securities	$14,877,129	$ 193,283	1.3 %	$9,834,224	$ 73,864	0.8 %
Non-Agency available-for-sale securities	1,522,437	44,691	2.9 %	1,165,498	28,897	2.5 %
Residential mortgage loans held-for-investment in securitization trusts	2,593,750	85,940	3.3 %	3,377,687	103,039	3.1 %
Agency derivatives [3]	82,387					