

CAPSTEAD MORTGAGE CORP

Form 10-Q

November 04, 2016

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: September 30, 2016

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-08896

CAPSTEAD MORTGAGE CORPORATION

(Exact name of Registrant as specified in its Charter)

Maryland

(State or other jurisdiction of incorporation or organization)

75-2027937

(I.R.S. Employer Identification No.)

8401 North Central Expressway, Suite 800, Dallas, TX 75225-4404

(Address of principal executive offices)

(Zip Code)

(214) 874-2323

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES

NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock (\$0.01 par value) 95,988,971 as of November 4, 2016

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CAPSTEAD MORTGAGE CORPORATION  
FORM 10-Q  
FOR THE QUARTER ENDED SEPTEMBER 30, 2016

INDEX

PART I.  $\frac{3}{4}$  FINANCIAL INFORMATION

	<u>Page</u>
ITEM 1. Financial Statements (unaudited)	
<u>Consolidated Balance Sheets <math>\frac{3}{4}</math> September 30, 2016 and December 31, 2015</u>	3
<u>Consolidated Statements of Income <math>\frac{3}{4}</math> Quarter and Nine Months Ended September 30, 2016 and 2015</u>	4
<u>Consolidated Statements of Comprehensive Income (Loss) <math>\frac{3}{4}</math> Quarter and Nine Months Ended September 30, 2016 and 2015</u>	5
<u>Consolidated Statements of Cash Flows <math>\frac{3}{4}</math> Nine Months Ended September 30, 2016 and 2015</u>	6
<u>Notes to Consolidated Financial Statements</u>	7
ITEM 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	21
ITEM 3. <u>Quantitative and Qualitative Disclosure of Market Risk</u>	47
ITEM 4. <u>Controls and Procedures</u>	47
PART II. $\frac{3}{4}$ OTHER INFORMATION	
ITEM 6. <u>Exhibits</u>	48
<u>SIGNATURES</u>	50

Index

## ITEM 1. FINANCIAL STATEMENTS

## PART I. ¾ FINANCIAL INFORMATION

## CAPSTEAD MORTGAGE CORPORATION

## CONSOLIDATED BALANCE SHEETS

(in thousands, except pledged and per share amounts)

	September 30, 2016 (unaudited)	December 31, 2015
<b>Assets</b>		
Residential mortgage investments (\$13.09 and \$13.54 billion pledged at September 30, 2016 and December 31, 2015, respectively)	\$ 13,582,323	\$ 14,154,737
Cash collateral receivable from interest rate swap counterparties	73,191	50,193
Interest rate swap agreements at fair value	2,501	7,720
Cash and cash equivalents	83,697	54,185
Receivables and other assets	164,102	179,531
	\$ 13,905,814	\$ 14,446,366
<b>Liabilities</b>		
Secured borrowings	\$ 12,431,839	\$ 12,958,394
Interest rate swap agreements at fair value	46,954	26,061
Unsecured borrowings	98,065	97,986
Common stock dividend payable	22,687	25,979
Accounts payable and accrued expenses	36,159	39,622
	12,635,704	13,148,042
<b>Stockholders' equity</b>		
Preferred stock - \$0.10 par value; 100,000 shares authorized: 7.50% Cumulative Redeemable Preferred Stock, Series E, 8,204 and 8,156 shares issued and outstanding (\$205,107 and \$203,902 aggregate liquidation preferences) at September 30, 2016 and December 31, 2015, respectively	198,331	197,172
Common stock - \$0.01 par value; 250,000 shares authorized: 95,989 and 95,825 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	960	958
Paid-in capital	1,296,550	1,310,563
Accumulated deficit	(346,464	) (346,464
Accumulated other comprehensive income	120,733	136,095
	1,270,110	1,298,324
	\$ 13,905,814	\$ 14,446,366

See accompanying notes to consolidated financial statements.

IndexCAPSTEAD MORTGAGE CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME(in thousands, except per share amounts)  
(unaudited)

	Quarter Ended		Nine Months Ended	
	September 30		September 30	
	2016	2015	2016	2015
Interest income:				
Residential mortgage investments	\$49,845	\$49,485	\$162,654	\$158,471
Other	174	88	494	281
	50,019	49,573	163,148	158,752
Interest expense:				
Secured borrowings	(26,636)	(22,272)	(80,232)	(61,584)
Unsecured borrowings	(1,970)	(2,122)	(5,923)	(6,367)
	(28,606)	(24,394)	(86,155)	(67,951)
	21,413	25,179	76,993	90,801
Other revenue (expense):				
Compensation-related expense	(1,299)	(3,064)	(6,565)	(7,573)
Separation of service charge	(2,740)	–	(2,740)	–
Other general and administrative expense	(1,239)	(1,309)	(3,565)	(3,628)
Miscellaneous other revenue	305	261	1,300	368
	(4,973)	(4,112)	(11,570)	(10,833)
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Net income available to common stockholders:				
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Less preferred stock dividends	(3,846)	(3,809)	(11,515)	(11,339)
	\$12,594	\$17,258	\$53,908	\$68,629
Net income per common share:				
Basic and diluted	\$0.13	\$0.18	\$0.56	\$0.72
Weighted average common shares outstanding:				
Basic	95,678	95,530	95,647	95,500
Diluted	95,866	95,721	95,799	95,695
Cash dividends declared per share:				
Common	\$0.23	\$0.26	\$0.72	\$0.88
Series E preferred	0.47	0.47	1.41	1.41

See accompanying notes to consolidated financial statements.

IndexCAPSTEAD MORTGAGE CORPORATION  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands, unaudited)

	Quarter Ended		Nine Months Ended	
	September 30		September 30	
	2016	2015	2016	2015
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Other comprehensive income (loss)				
Amounts related to available-for-sale securities:				
Change in net unrealized gains	(19,155)	(11,130)	10,245	(23,770)
Amounts related to cash flow hedges:				
Change in net unrealized losses	12,558	(21,235)	(41,714)	(36,226)
Reclassification adjustment for amounts included in net income	4,927	7,183	16,107	20,494
	(1,670 )	(25,182)	(15,362)	(39,502)
Comprehensive income (loss)	\$14,770	\$(4,115 )	\$50,061	\$40,466

See accompanying notes to consolidated financial statements.

IndexCAPSTEAD MORTGAGE CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, unaudited)

	Nine Months Ended September 30	
	2016	2015
Operating activities:		
Net income	\$ 65,423	\$ 79,968
Noncash items:		
Amortization of investment premiums	95,139	92,458
Amortization of equity-based awards	1,241	1,708
Other depreciation and amortization	97	100
Change in measureable hedge ineffectiveness related to interest rate swap agreements designated as cash flow hedges	506	130
Net change in receivables, other assets, accounts payable and accrued expenses	(953 )	6,389
Net cash provided by operating activities	161,453	180,753
Investing activities:		
Purchases of residential mortgage investments	(2,319,819 )	(2,757,199 )
Interest receivable acquired with the purchase of residential mortgage investments	(3,139 )	(4,202 )
Principal collections on residential mortgage investments, including changes in mortgage securities principal remittance receivable	2,773,344	2,577,985
Decrease (increase) in lending counterparty investments	50,000	(46,002 )
Net cash provided by (used in) investing activities	500,386	(229,418 )
Financing activities:		
Proceeds from repurchase arrangements and similar borrowings	94,430,910	84,927,006
Principal payments on repurchase arrangements and similar borrowings	(92,332,463 )	(87,281,325 )
Proceeds from other secured borrowings	1,175,000	2,450,000
Principal payments on other secured borrowings	(3,800,000 )	(150,000 )
Increase in cash collateral receivable from interest rate swap counterparties	(22,998 )	(12,729 )
Proceeds from issuance of preferred shares	1,167	12,679
Other capital stock transactions	(57 )	(429 )
Dividends paid	(83,886 )	(103,561 )
Net cash used in financing activities	(632,327 )	(158,359 )
Net change in cash and cash equivalents	29,512	(207,024 )
Cash and cash equivalents at beginning of period	54,185	307,526
Cash and cash equivalents at end of period	\$ 83,697	\$ 100,502

See accompanying notes to consolidated financial statements.

Index

CAPSTEAD MORTGAGE CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2016  
(unaudited)

NOTE 1 ¾ BUSINESS

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a “REIT”) and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as “Capstead” or the “Company.” Capstead earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage (“ARM”) securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae, Freddie Mac, or by an agency of the federal government, Ginnie Mae. Residential mortgage pass-through securities guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae are referred to as “Agency Securities” and are considered to have limited, if any, credit risk.

NOTE 2 ¾ BASIS OF PRESENTATION

Interim Financial Reporting

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2016. For further information refer to the audited consolidated financial statements and footnotes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2015.

Recent Accounting Pronouncements

In November 2014 the Financial Accounting Standards Board issued ASU 2014-16, Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share is More Akin to Debt or to Equity (“ASU 2014-16”). ASU 2014-16 provides guidance in evaluating whether the nature of the host contract is more debt-like or equity-like when determining whether derivative financial instruments embedded in the hybrid financial instrument, such as call rights and conversion features, should be bifurcated and accounted for separately. The Company adopted ASU 2014-16 on January 1, 2016. The provisions of this ASU had no effect on the Company’s results of operations, financial condition, or cash flows.

NOTE 3 ¾ SEPARATION OF SERVICE CHARGE

Effective July 14, 2016, Mr. Andrew F. Jacobs resigned as a director of Capstead and from his positions as President and Chief Executive Officer (“CEO”). Pursuant to an agreement entered into with Mr. Jacobs, he is entitled to payments aggregating \$2.3 million in addition to continuing to participate in the Company’s short- and long-term incentive compensation and employee benefit programs through year-end. Currently estimated costs associated with Mr. Jacobs’ resignation, net of equity award cost accrual reversals, are recorded in Separation of service charge for the quarter ended September 30, 2016. Currently estimated amounts payable to Mr. Jacobs totaling \$2.8 million are included in Accounts payable and accrued expenses.





Index

## NOTE 4 ¾ NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income, after deducting dividends paid or accrued on preferred stock and allocating earnings to equity awards deemed to be participating securities pursuant to the two-class method, by the average number of shares of common stock outstanding, calculated excluding unvested stock awards. Participating securities include unvested equity awards that contain non-forfeitable rights to dividends prior to vesting.

Diluted net income per common share is computed by dividing the numerator used to compute basic net income per common share by the denominator used to compute basic net income per common share, further adjusted for the dilutive effect, if any, of equity awards and shares of preferred stock when and if convertible into shares of common stock. Shares of the Company's 7.50% Series E Cumulative Redeemable Preferred Stock are contingently convertible into shares of common stock only upon the occurrence of a change in control and therefore are not considered dilutive securities absent such an occurrence. Any unvested equity awards that are deemed participating securities are included in the calculation of diluted net income per common share, if dilutive, under either the two-class method or the treasury stock method, depending upon which method produces the more dilutive result. Components of the computation of basic and diluted net income per common share were as follows for the indicated periods (dollars in thousands, except per share amounts):

	Quarter Ended		Nine Months Ended	
	September 30		September 30	
	2016	2015	2016	2015
Basic net income per common share				
Numerator for basic net income per common share:				
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Preferred stock dividends	(3,846 )	(3,809 )	(11,515 )	(11,339 )
Earnings participation of unvested equity awards	(40 )	(28 )	(123 )	(95 )
	\$12,554	\$17,230	\$53,785	\$68,534
Denominator for basic net income per common share:				
Average number of shares of common stock outstanding	95,978	95,814	95,946	95,814
Average unvested stock awards outstanding	(300 )	(284 )	(299 )	(314 )
	95,678	95,530	95,647	95,500
	\$0.13	\$0.18	\$0.56	\$0.72
Diluted net income per common share				
Numerator for diluted net income per common share:				
Numerator for basic net income per common share	\$12,554	\$17,230	\$53,785	\$68,534
Denominator for diluted net income per common share:				
Denominator for basic net income per common share	95,678	95,530	95,647	95,500
Net effect of dilutive equity awards	188	191	152	195
	95,866	95,721	95,799	95,695
	\$0.13	\$0.18	\$0.56	\$0.72

Index

## NOTE 5 ¾ RESIDENTIAL MORTGAGE INVESTMENTS

Residential mortgage investments classified by collateral type and interest rate characteristics as of the indicated dates were as follows (dollars in thousands):

	Unpaid Principal Balance	Investment Premiums	Amortized Cost Basis	Carrying Amount <sup>(a)</sup>	Net WAC <sup>(b)</sup>	Average Yield <sup>(b)</sup>		
September 30, 2016								
Agency Securities:								
Fannie Mae/Freddie Mac:								
Fixed-rate	\$416	\$ 1	\$417	\$417	6.68	%	6.50	%
ARMs	10,030,859	319,319	10,350,178	10,506,371	2.69		1.56	
Ginnie Mae ARMs	2,964,263	98,330	3,062,593	3,071,174	2.55		1.16	
	12,995,538	417,650	13,413,188	13,577,962	2.66		1.46	
Residential mortgage loans:								
Fixed-rate	761	–	761	761	6.73		4.09	
ARMs	1,904	9	1,913	1,913	3.80		2.97	
	2,665	9	2,674	2,674	4.63		3.29	
Collateral for structured financings	1,659	28	1,687	1,687	8.16		7.59	
	\$12,999,862	\$ 417,687	\$13,417,549	\$13,582,323	2.66		1.46	
December 31, 2015								
Agency Securities:								
Fannie Mae/Freddie Mac:								
Fixed-rate	\$796	\$ 2	\$798	\$799	6.61	%	6.17	%
ARMs	10,014,401	317,545	10,331,946	10,487,785	2.55		1.68	
Ginnie Mae ARMs	3,542,541	119,225	3,661,766	3,660,455	2.61		1.49	
	13,557,738	436,772	13,994,510	14,149,039	2.57		1.63	
Residential mortgage loans:								
Fixed-rate	1,155	1	1,156	1,156	6.76		5.02	
ARMs	2,650	11	2,661	2,661	3.73		3.15	
	3,805	12	3,817	3,817	4.65		3.71	
Collateral for structured financings	1,850	31	1,881	1,881	8.12		7.82	
	\$13,563,393	\$ 436,815	\$14,000,208	\$14,154,737	2.57		1.63	

(a) Includes unrealized gains and losses for residential mortgage investments classified as available-for-sale.

Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments net of servicing and other fees as of the indicated balance sheet date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans

(b) underlying these investments. Average yield is presented for the quarter then ended, and is based on the cash component of interest income expressed as a percentage calculated on an annualized basis on average amortized cost basis (the “cash yield”) less the effects of amortizing investment premiums. Investment premium amortization is determined using the interest method and incorporates actual and anticipated future mortgage prepayments.

Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest is guaranteed by Fannie Mae and Freddie Mac, which are federally chartered corporations, or Ginnie Mae, which is an agency of the federal government. Residential mortgage loans held by Capstead were originated prior to 1995 when the Company operated a mortgage conduit and the related credit risk is borne by the Company. Collateral for structured financings consists of private residential mortgage securities that are backed by loans obtained through

this mortgage conduit and are pledged to secure repayment of related structured financings. Credit risk for these securities is borne by the related bondholders. The maturity of Residential mortgage investments is directly affected by prepayments of principal on the underlying mortgage loans. Consequently, actual maturities will be significantly shorter than the portfolio's weighted average contractual maturity of 288 months.

-9-

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## Index

Fixed-rate investments consist of residential mortgage loans and Agency Securities backed by residential mortgage loans with fixed rates of interest. Adjustable-rate investments generally are ARM Agency Securities backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, mortgage loans underlying ARM securities typically either (i) adjust annually based on specified margins over the one-year London interbank offered rate (“LIBOR”) or the one-year Constant Maturity U.S. Treasury Note Rate (“CMT”), (ii) adjust semiannually based on specified margins over six-month LIBOR, or (iii) adjust monthly based on specified margins over indices such as one-month LIBOR, the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index, usually subject to periodic and lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans.

Capstead classifies its ARM investments based on average number of months until coupon reset (“months to roll”). Months to roll is an indicator of asset duration which is a measure of market price sensitivity to interest rate movements. A shorter duration generally indicates less interest rate risk. Current-reset ARM investments have months to roll of less than 18 months while longer-to-reset ARM investments have months to roll of 18 months or greater. As of September 30, 2016, the average months to roll for the Company’s \$7.63 billion (amortized cost basis) in current-reset ARM investments was 6.2 months while the average months to roll for the Company’s \$5.78 billion (amortized cost basis) in longer-to-reset ARM investments was 42.1 months.

## NOTE 6 ¾ SECURED BORROWINGS

Capstead pledges its Residential mortgage investments as collateral for secured borrowings primarily in the form of repurchase arrangements with commercial banks and other financial institutions. In August 2015 the Company began supplementing its borrowings under repurchase arrangements with advances from the Federal Home Loan Bank (“FHLB”) of Cincinnati (collectively referred to as “counterparties” or “lending counterparties”). Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date and are accounted for as financings. The Company maintains the beneficial interest in the specific securities pledged during the term of each repurchase arrangement and receives the related principal and interest payments. FHLB advances differ from repurchase arrangements in that Capstead pledges collateral to the bank to secure each such advance rather than transferring ownership of the pledged collateral to the bank and simultaneously agreeing to repurchase the transferred assets at a future date. On January 12, 2016 the FHLB system regulator finalized rules originally proposed in 2014 that generally preclude captive insurers from remaining members beyond February 19, 2017 with transition rules that require outstanding advances to be repaid upon maturity or by that date. In response to this action, the Company has reduced outstanding FHLB advances to \$250 million as of September 30, 2016 and anticipates migrating remaining balances away from the FHLB in November 2016. FHLB stock held by the Company in connection with advance activity was reduced by \$20.0 million and \$50.0 million during the quarter and nine months ended September 30, 2016, respectively, with the remaining \$10.0 million held at September 30, 2016 expected to be redeemed by December 31, 2016.

The terms and conditions of secured borrowings are negotiated on a transaction-by-transaction basis when each such borrowing is initiated or renewed. The amount borrowed is generally equal to the fair value of the securities pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a “haircut.” Interest rates are generally fixed based on prevailing rates corresponding to the terms of the borrowings. Interest may be paid monthly or at the termination of a borrowing at which time the Company may enter into a new borrowing at prevailing haircuts and rates with the same lending counterparty or repay that counterparty and negotiate financing with a different lending counterparty. None of the Company’s lending counterparties are obligated to renew or otherwise enter into new borrowings at the conclusion of existing borrowings. In response to declines in fair value of pledged securities due to changes in market conditions or the publishing of monthly security pay-down factors, lending counterparties typically require the Company to post additional securities as collateral, pay down borrowings or fund cash margin

accounts with the counterparties in order to re-establish the agreed-upon collateral requirements. These actions are referred to as margin calls. Conversely, in response to increases in fair value of pledged securities, the Company routinely margin calls its lending counterparties in order to have previously pledged collateral returned.

-10-

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Index

Secured borrowings (and related pledged collateral, including accrued interest receivable), classified by collateral type and remaining maturities, and related weighted average borrowing rates as of the indicated dates were as follows (dollars in thousands):

Collateral Type	Collateral Carrying Amount	Accrued Interest Receivable	Borrowings Outstanding	Average Borrowing Rates	
September 30, 2016					
Borrowings under repurchase arrangements with maturities of 30 days or less:					
Agency Securities	\$ 11,302,826	\$ 24,045	\$ 10,741,746	0.71	%
Borrowings under repurchase arrangements with maturities greater than 30 days:					
Agency Securities (31 to 90 days)	1,365,926	2,881	1,299,305	0.72	
Agency Securities (greater than 90 days)	160,250	1,003	139,101	0.92	
Similar borrowings:					
Collateral for structured financings	1,687	–	1,687	8.16	
	12,830,689	27,929	12,181,839		
FHLB advances	259,367	1,039	250,000	0.71	
	\$ 13,090,056	\$ 28,968	\$ 12,431,839	0.72	
Quarter-end borrowing rates adjusted for effects of related derivative financial instruments (Derivatives) held as cash flow hedges				0.86	
December 31, 2015					
Borrowings under repurchase arrangements with maturities of 30 days or less:					
Agency Securities	\$ 9,080,363	\$ 18,504	\$ 8,585,336	0.67	%
Borrowings under repurchase arrangements with maturities greater than 30 days:					
Agency Securities (31 to 90 days)	423,710	861	346,177	0.63	
Agency Securities (greater than 90 days)	1,073,254	2,519	1,150,000	0.75	
Similar borrowings:					
Collateral for structured financings	1,881	–	1,881	8.12	
	10,579,208	21,884	10,083,394		
FHLB advances	2,956,908	11,422	2,875,000	0.43	
	\$ 13,536,116	\$ 33,306	\$ 12,958,394	0.62	
Year-end borrowing rates adjusted for effects of related Derivatives held as cash flow hedges				0.85	

Index

Average secured borrowings outstanding during the indicated periods differed from respective ending balances primarily due to changes in portfolio levels and differences in the timing of portfolio acquisitions relative to portfolio runoff as illustrated below (dollars in thousands):

	Quarter Ended			
	September 30, 2016		December 31, 2015	
	Average Borrowings	Average Rate	Average Borrowings	Average Rate
Average borrowings and rates adjusted for the effects of related Derivatives held as cash flow hedges for the indicated periods	\$12,731,035	0.84 %	\$13,160,703	0.73 %

**NOTE 7 ¾ USE OF DERIVATIVES, OFFSETTING DISCLOSURES AND CHANGES IN OTHER COMPREHENSIVE INCOME BY COMPONENT**

In addition to entering into longer-maturity secured borrowings when available at attractive rates and terms, Capstead attempts to mitigate exposure to higher interest rates by entering into currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements. These Derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate of current and forecasted 30- to 90-day secured borrowings. This hedge relationship establishes a relatively stable fixed rate on related borrowings because the variable-rate payments received on the swap agreements offset a significant portion of the interest accruing on the designated borrowings, leaving the fixed-rate swap payments as the Company's effective borrowing rate, subject to certain adjustments. These adjustments include differences between variable-rate payments received on the swap agreements and related unhedged borrowing rates as well as the effects of measured hedge ineffectiveness. Additionally, changes in fair value of these Derivatives tend to partially offset opposing changes in fair value of the Company's residential mortgage investments that can occur in response to changes in market interest rates.

During the quarter and nine months ended September 30, 2016 Capstead entered into swap agreements with notional amounts of \$500 million and \$2.95 billion requiring fixed-rate interest payments averaging 0.84% and 0.76% for two and three-year periods commencing on various dates between January and September 2016. Also during the quarter and nine months ended September 30, 2016, \$700 million and \$3.50 billion notional amount of swaps requiring fixed-rate interest payments averaging 0.56% and 0.51% matured. At September 30, 2016, the Company's portfolio financing-related swap positions had the following characteristics (dollars in thousands):

Period of Contract Expiration	Notional Amount	Average Fixed-Rate Payment Requirement
Fourth quarter 2016 (expired October 1, 2016)	\$800,000	0.66 %
First quarter 2017	1,000,000	0.72
Second quarter 2017	900,000	0.74
Third quarter 2017	400,000	0.74
Fourth quarter 2017	1,500,000	0.79
First quarter 2018	1,700,000	0.76
Second quarter 2018	600,000	0.79
Third quarter 2018	400,000	0.88
Second quarter 2019	450,000	0.77
Third quarter 2019	100,000	0.68
	\$7,850,000	



Index

In 2010 the Company entered into forward-starting, three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements with notional amounts totaling \$100 million and average fixed rates of 4.09% with 20-year payment terms coinciding with the floating-rate terms of the Company's Unsecured borrowings. These Derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate associated with the floating-rate terms of these long-term borrowings.

Interest rate swap agreements are measured at fair value on a recurring basis primarily using Level Two Inputs in accordance with ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820). In determining fair value estimates for these Derivatives, Capstead utilizes the standard methodology of netting the discounted future fixed cash payments and the discounted future variable cash receipts which are based on expected future interest rates derived from observable market interest rate curves. The related net interest payable at the balance sheet date is recorded separately. The Company also incorporates both its own nonperformance risk and its counterparties' nonperformance risk in determining fair value. In considering the effect of nonperformance risk, the Company considered the impact of netting and credit enhancements, such as collateral postings and guarantees, and has concluded that counterparty risk is not significant to the overall valuation. The following tables include fair value and other related disclosures regarding all Derivatives held as of and for the indicated periods (in thousands):

	Balance Sheet Location	September 30 2016	December 31 2015
Balance sheet-related			
Swap agreements in a gain position (an asset) related to Secured borrowings	(a)	\$ 2,501	\$ 7,720
Swap agreements in a loss position (a liability) related to:			
Secured borrowings	(a)	(5,981 )	(1,051 )
Unsecured borrowings	(a)	(40,973 )	(25,010 )
Related net interest payable	(b)	(11,727 )	(10,942 )
		\$ (56,180 )	\$ (29,283 )

The fair value of Derivatives with unrealized gains are aggregated and recorded as an asset on the face of the Balance Sheets separately from the fair value of Derivatives with unrealized losses that are recorded as a liability.

(a) The amount of net unrealized losses scheduled to be recognized in the Statements of Income over the next twelve months primarily in the form of fixed-rate swap payments in excess of current market rates totaled \$8.8 million at September 30, 2016.

(b) Included in "Accounts payable and accrued expenses" on the face of the Balance Sheets.

	Location of Gain or (Loss) Recognized		Quarter Ended		Nine Months Ended	
	in		September 30		September 30	
	2016	2015	2016	2015	2016	2015
Income statement-related						
Components of effect on interest expense:						
Amount of loss reclassified from Accumulated other comprehensive income related to the effective portion of active positions						
			\$ (4,927 )	\$ (7,183 )	\$ (16,107 )	\$ (20,494 )

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Amount of gain (loss) recognized (ineffective portion)		(323 )	(336 )	(1,210 )	(642 )
Increase in interest expense and decrease in Net income as a result of the use of Derivatives	*	\$(5,250 )	\$(7,519 )	\$(17,317 )	\$(21,136 )
Other comprehensive income-related					
Amount of gain (loss) recognized in Other comprehensive income (loss) (effective portion)		\$12,558	\$(21,235)	\$(41,714)	\$(36,226)

\*Included in "Interest expense: Secured borrowings" on the face of the Statements of Income.

-13-

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Index

Capstead's swap agreements and borrowings under repurchase arrangements are subject to master netting arrangements in the event of default on, or termination of, any one contract. See NOTE 6 for more information on the Company's use of secured borrowings. The following tables provide disclosures concerning offsetting of financial liabilities and Derivatives as of the indicated dates (in thousands):

	Offsetting of Derivative Assets			Gross Amounts Not Offset in the Balance Sheet <sup>(a)</sup>		
	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets Presented in the Balance Sheet	Financial Instruments	Cash Collateral Received	Net Amount
September 30, 2016						
Counterparty 4	\$1,126	\$ 1,375	\$ 2,501	\$ (2,501 )	\$ -	\$ -
December 31, 2015						
Counterparty 2	\$-	\$ 23	\$ 23	\$ (23 )	\$ -	\$ -
Counterparty 4	4,758	2,939	7,697	(7,697 )	-	-
	\$4,758	\$ 2,962	\$ 7,720	\$ (7,720 )	\$ -	\$ -
	Offsetting of Financial Liabilities and Derivative Liabilities					
	Gross Amounts of Recognized Liabilities <sup>(b)</sup>	Gross Amounts Offset in the Balance Sheet	Net Amounts of Liabilities Presented in the Balance Sheet <sup>(a)</sup>	Financial Instruments	Cash Collateral Pledged	Net Amount
September 30, 2016						
Derivatives by counterparty:						
Counterparty 1	\$42,029	\$ -	\$ 42,029	\$-	\$(42,029 )	\$ -
Counterparty 4	15,277	1,375	16,652	(2,501 )	(14,151 )	-
	57,306	1,375	58,681	(2,501 )	(56,180 )	-
Borrowings under repurchase arrangements	12,186,583	-	12,186,583	(12,186,583 )	-	-
	\$12,243,889	\$ 1,375	\$ 12,245,264	\$(12,189,084 )	\$(56,180 )	\$ -
December 31, 2015						
Derivatives by counterparty:						
Counterparty 1	\$26,311	\$ -	\$ 26,311	\$-	\$(26,311 )	\$ -
Counterparty 2	776	23	799	(23 )	(776 )	-
Counterparty 4	6,954	2,939	9,893	(7,697 )	(2,196 )	-
	34,041	2,962	37,003	(7,720 )	(29,283 )	-
Borrowings under repurchase arrangements	10,090,846	-	10,090,846	(10,090,846 )	-	-
	\$10,124,887	\$ 2,962	\$ 10,127,849	\$(10,098,566 )	\$(29,283 )	\$ -

Amounts presented are limited to recognized liabilities and cash collateral received associated with the indicated (a) counterparty sufficient to reduce the related Net Amount to zero in accordance with ASU No. 2011-11, as amended by ASU No. 2013-01.

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Amounts include accrued interest of \$11.7 million and \$10.9 million on interest rate swap agreements and \$6.4 (b) million and \$9.3 million on borrowings under repurchase arrangements, included in “Accounts payable and accrued expenses” on the face of the Balance Sheets as of September 30, 2016 and December 31, 2015, respectively.

Amounts presented are limited to recognized assets and collateral pledged associated with the indicated (c) counterparty sufficient to reduce the related Net Amount to zero in accordance with ASU No. 2011-11, as amended by ASU No. 2013-01.

-14-

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Index

Changes in Accumulated other comprehensive income by component for the quarter and nine months ended September 30, 2016 were as follows (in thousands):

	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available-for-Sale Securities	Total
Balance at June 30, 2016	\$ (61,526	) \$ 183,929	\$122,403
Activity for the quarter ended September 30, 2016:			
Other comprehensive income (loss) before reclassifications	12,558	(19,155	) (6,597 )
Amounts reclassified from accumulated other comprehensive income	4,927	–	4,927
Other comprehensive income (loss)	17,485	(19,155	) (1,670 )
Balance at September 30, 2016	\$ (44,041	) \$	