CAPSTEAD MORTGAGE CORP
Form 10-Q
August 04, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: June 30, 2017

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	75-2027937
(State or other jurisdiction of incorporation or organization)	(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, a 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 Accelerated filer Non-accelerated filer Smaller reporting company

Emerging growth company

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.

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) 96,104,662 as of August 4, 2017

CAPSTEAD MORTGAGE CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2017

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ITEM 1. FINANCIAL STATEMENTS

PART I. — FINANCIAL INFORMATION

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except pledged and per share amounts)

	June 30, 2017 (unaudited)	December 31, 2016
Assets		
Residential mortgage investments ($13.10 and $12.81 billion pledged at June 30, 2017 and December 31, 2016, respectively)	$13,598,890	$13,316,282
Cash collateral receivable from interest rate swap counterparties	47,518	29,660
Interest rate swap agreements at fair value	2,470	24,709
Cash and cash equivalents	59,226	56,732
Receivables and other assets	154,869	149,493
	$13,862,973	$13,576,876
Liabilities		
Secured borrowings	$12,454,183	$12,145,346
Interest rate swap agreements at fair value	24,787	24,417
Unsecured borrowings	98,140	98,090
Common stock dividend payable	20,611	22,634
Accounts payable and accrued expenses	19,669	38,702
	12,617,390	12,329,189
Stockholders' equity		
Preferred stock - $0.10 par value; 100,000 shares authorized:		
7.50% Cumulative Redeemable Preferred Stock, Series E, 8,631 and 8,234 shares issued and outstanding ($215,787 and $205,849 aggregate liquidation preferences) at June 30, 2017 and December 31, 2016, respectively	208,870	199,059
Common stock - $0.01 par value; 250,000 shares authorized: 96,063 and 95,989 shares issued and outstanding at June 30, 2017 and December 31, 2016, respectively	961	960
Paid-in capital	1,281,239	1,288,346
Accumulated deficit	(346,464)	(346,464)
Accumulated other comprehensive income	100,977	105,786
	1,245,583	1,247,687
	$13,862,973	$13,576,876

See accompanying notes to consolidated financial statements.

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(unaudited)

	Quarter Ended June 30		Six Months Ended June 30	
	2017	2016	2017	2016
Interest income:				
Residential mortgage investments	$56,103	$53,309	$110,944	$112,809
Other	238	128	391	320
	56,341	53,437	111,335	113,129
Interest expense:				
Secured borrowings	(33,850)	(27,014)	(62,090)	(53,596)
Unsecured borrowings	(1,900)	(1,976)	(3,791)	(3,953)
	(35,750)	(28,990)	(65,881)	(57,549)
	20,591	24,447	45,454	55,580
Other revenue (expense):				
Compensation-related expense	(1,833)	(2,042)	(2,948)	(5,266)
Other general and administrative expense	(1,276)	(1,157)	(2,338)	(2,326)
Miscellaneous other revenue	67	382	82	995
	(3,042)	(2,817)	(5,204)	(6,597)
Net income	$17,549	$21,630	$40,250	$48,983
Net income available to common stockholders:				
Net income	$17,549	$21,630	$40,250	$48,983
Less preferred stock dividends	(4,018)	(3,843)	(7,882)	(7,669)
	$13,531	$17,787	$32,368	$41,314
Net income per common share:				
Basic and diluted	$0.14	$0.19	$0.34	$0.43
Weighted average common shares outstanding:				
Basic	95,756	95,648	95,755	95,631
Diluted	95,916	95,786	95,895	95,766
Cash dividends declared per share:				
Common	$0.21	$0.23	$0.42	$0.49
Series E preferred	0.47	0.47	0.94	0.94

See accompanying notes to consolidated financial statements.

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands, unaudited)

	Quarter Ended June 30		Six Months Ended June 30	
	2017	2016	2017	2016
Net income	$17,549	$21,630	$40,250	$48,983
Other comprehensive income (loss)				
Amounts related to available-for-sale securities:				
Change in net unrealized gains	(11,420)	16,917	(7,424)	29,400
Amounts related to cash flow hedges:				
Change in net unrealized gains (losses)	(6,487)	(22,145)	1,609	(54,272)
Reclassification adjustment for amounts included in net income	(655)	5,826	1,006	11,180
	(18,562)	598	(4,809)	(13,692)
Comprehensive income (loss)	$(1,013)	$22,228	$35,441	$35,291

See accompanying notes to consolidated financial statements.

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, unaudited)

	Six Months Ended June 30	
	2017	2016
Operating activities:		
Net income	$40,250	$48,983
Noncash items:		
Amortization of investment premiums	64,046	59,063
Amortization of equity-based awards	1,274	1,189
Other depreciation and amortization	59	66
Change in measureable hedge ineffectiveness related to interest rate swap agreements designated as cash flow hedges	899	546
Net change in receivables, other assets, accounts payable and accrued expenses	1,716	(781)
Net cash provided by operating activities	108,244	109,066
Investing activities:		
Purchases of residential mortgage investments	(2,275,907)	(1,512,737)
Interest receivable acquired with the purchase of residential mortgage investments	(3,613)	(1,977)
Principal collections on residential mortgage investments, including changes in mortgage securities principal remittance receivable	1,913,662	1,706,266
Redemptions of lending counterparty investments	–	30,000
Net cash (used in) provided by investing activities	(365,858)	221,552
Financing activities:		
Proceeds from repurchase arrangements and similar borrowings	75,996,185	60,553,581
Principal payments on repurchase arrangements and similar borrowings	(75,687,347)	(58,584,344)
Proceeds from other secured borrowings	–	1,175,000
Principal payments on other secured borrowings	–	(3,300,000)
Increase in cash collateral receivable from interest rate swap counterparties	(17,858)	(42,977)
Net proceeds from interest rate swap settlements	9,775	–
Proceeds from issuance of preferred shares	9,845	1,167

Other capital stock transactions	(261)	(57)
Dividends paid	(50,231)	(58,002)
Net cash provided by (used in) financing activities	260,108	(255,632)
Net change in cash and cash equivalents	2,494	74,986
Cash and cash equivalents at beginning of period	56,732	54,185
Cash and cash equivalents at end of period	$59,226	$129,171

See accompanying notes to consolidated financial statements.

CAPSTEAD MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2017

(unaudited)

NOTE 1 — 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 — 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 six months ended June 30, 2017 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2017. 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, 2016.

Recent Accounting Pronouncements

In March 2016, the Financial Accounting Standards Board issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09") as part of its simplification initiative, which involves several aspects of accounting for share-based payment transactions, including related income tax effects, statutory withholding requirements, forfeitures and classification on the statement of cash flows. ASU 2016-09 is effective for public companies for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. The Company adopted ASU 2016-09 on January 1, 2017, which had no effect on its results of operations, financial condition or cash flows.

NOTE 3 — 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 June 30		Six Months Ended June 30	
	2017	2016	2017	2016
Basic net income per common share				
Numerator for basic net income per common share:				
Net income	$17,549	$21,630	$40,250	$48,983
Preferred stock dividends	(4,018)	(3,843)	(7,882)	(7,669)
Earnings participation of unvested equity awards	(40)	(39)	(80)	(83)
	$13,491	$17,748	$32,288	$41,231
Denominator for basic net income per common share:				
Average number of shares of common stock outstanding	96,063	95,947	96,062	95,930
Average unvested stock awards outstanding	(307)	(299)	(307)	(299)
	95,756	95,648	95,755	95,631
	$0.14	$0.19	$0.34	$0.43
Diluted net income per common share				
Numerator for diluted net income per common share:				
Numerator for basic net income per common share	$13,491	$17,748	$32,288	$41,231
Denominator for diluted net income per common share:				
Denominator for basic net income per common share	95,756	95,648	95,755	95,631
Net effect of dilutive equity awards	160	138	140	135
	95,916	95,786	95,895	95,766
	$0.14	$0.19	$0.34	$0.43

NOTE 4 — 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 [(a)]	Net WAC [(b)]	Average Yield [(b)]
June 30, 2017						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	$323	$–	$323	$323	6.55 %	6.31 %
ARMs	10,467,784	329,286	10,797,070	10,895,295	2.87	1.72
Ginnie Mae ARMs	2,615,428	83,935	2,699,363	2,699,349	2.59	1.41
	13,083,535	413,221	13,496,756	13,594,967	2.82	1.66
Residential mortgage loans:						
Fixed-rate	689	1	690	690	6.72	4.14
ARMs	1,649	8	1,657	1,657	3.81	3.13
	2,338	9	2,347	2,347	4.67	3.42
Collateral for structured financings	1,550	26	1,576	1,576	8.01	7.81
	$13,087,423	$413,256	$13,500,679	$13,598,890	2.82	1.66
December 31, 2016						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	$385	$1	$386	$386	6.65 %	6.44 %
ARMs	10,057,761	314,799	10,372,560	10,483,367	2.74	1.60
Ginnie Mae ARMs	2,743,160	90,300	2,833,460	2,828,288	2.51	1.14
	12,801,306	405,100	13,206,406	13,312,041	2.69	1.50
Residential mortgage loans:						
Fixed-rate	735	1	736	736	6.72	4.01
ARMs	1,839	9	1,848	1,848	3.80	2.96
	2,574	10	2,584	2,584	4.63	3.26
Collateral for structured financings	1,630	27	1,657	1,657	7.98	7.91
	$12,805,510	$405,137	$13,210,647	$13,316,282	2.69	1.50

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

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 June 30, 2017, the average months to roll for the Company's $7.03 billion (amortized cost basis) in current-reset ARM investments was 6.2 months while the average months to roll for the Company's $6.47 billion (amortized cost basis) in longer-to-reset ARM investments was 42.4 months.

NOTE 5 — SECURED borrowings

Capstead pledges its Residential mortgage investments as collateral for secured borrowings primarily in the form of repurchase arrangements with commercial banks, the Federal Home Loan Bank ("FHLB") of Cincinnati and other financial institutions (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.

In August 2015 the Company began supplementing its borrowings under repurchase arrangements with advances from the FHLB of Cincinnati. FHLB advances differ from repurchase arrangements in that Capstead pledged 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. In January 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 repaid all outstanding FHLB advances by November 2016 and all of the FHLB stock held by the Company in connection with advance activity was 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.

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	
June 30, 2017					
Borrowings under repurchase arrangements with maturities of 30 days or less:					
Agency Securities	$13,054,443	$ 30,348	$12,416,533	1.30	%
Borrowings under repurchase arrangements with maturities greater than 30 days:					
Agency Securities (31 to 90 days)	39,570	138	36,074	1.02	
Similar borrowings:					
Collateral for structured financings	1,576	–	1,576	8.01	
	$13,095,589	$ 30,486	$12,454,183	1.30	
Quarter-end borrowing rates adjusted for effects of related derivative financial instruments (Derivatives) held as cash flow hedges				1.23	
December 31, 2016					
Borrowings under repurchase arrangements with maturities of 30 days or less:					
Agency Securities	$12,643,359	$ 27,889	$11,991,532	0.96	%
Borrowings under repurchase arrangements with maturities greater than 30 days:					
Agency Securities (31 to 90 days)	162,551	351	152,157	0.93	
Similar borrowings:					

Collateral for structured financings	1,657	–	1,657	7.98
	$12,807,567	$ 28,240	$12,145,346	0.96
Year-end borrowing rates adjusted for effects of related Derivatives held as cash flow hedges				1.04

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			
	June 30, 2017		December 31, 2016	
	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	$12,503,039	1.08 %	$12,380,375	0.89 %

NOTE 6 — 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 one- and three-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 six months ended June 30, 2017 Capstead entered into swap agreements with notional amounts of $1.00 billion and $2.35 billion requiring fixed-rate interest payments averaging 1.53% and 1.58% for two and three-year periods commencing on various dates between January and June 2017. Also during the quarter and six months ended June 30, 2017, $900 million and $1.90 billion notional amount of swaps requiring fixed-rate interest payments averaging 0.74% and 0.73% matured. At June 30, 2017, 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
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
Fourth quarter 2018	800,000	1.15
First quarter 2019	950,000	1.58
Second quarter 2019	1,650,000	1.33
Third quarter 2019	100,000	0.68
Fourth quarter 2019	300,000	1.55
First quarter 2020	200,000	1.75
	$8,600,000	

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 which began on various dates between October 2015 and September 2016.

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 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.

Beginning in 2017, exchange traded swap agreements are deemed to be settled daily in accordance with recent legal interpretations. As a result, the fair value of exchange traded swap agreements held as cash flow hedges of Secured borrowings is calculated including accrued interest and net of variation margin amounts received or paid through the exchange, resulting in separately presenting on the balance sheet a significantly reduced fair value amount representing the unsettled fair value of these Derivatives. Non-exchange traded swap agreements held as cash flow hedges of Unsecured borrowings were not affected by these legal interpretations and continue to be reported at fair value calculated excluding accrued interest. At June 30, 2017, Cash collateral receivable from interest rate swap counterparties includes initial margin for all swap agreements and variation margin for non-exchange traded swap agreements. Accrued interest for non-exchange traded swap agreements is included in Accounts payable and accrued expenses. This change in presentation has had no further impact on the Company's accounting for derivatives.

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	June 30 2017	December 31 2016
Balance sheet-related			
Swap agreements in a gain position (an asset) related to:			
Secured borrowings	(a)	$2,470	$ 24,709
Swap agreements in a loss position (a liability) related to:			
Secured borrowings	(a)	–	(222)
Unsecured borrowings	(a)	(24,787)	(24,195)
Related net interest payable	(b)	(516)	(11,989)
		$(22,833)	$ (11,697)

(a) 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. The amount of net unrealized gains, net of unrealized losses, scheduled to be recognized in the Statements of Income over the next twelve months primarily in the form of current market rates in excess of fixed-rate swap payments totaled $14.6 million at June 30, 2017.

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

	Location of Gain or (Loss) Recognized in Net Income	Quarter Ended June 30 2017	2016	Six Months Ended June 30 2017	2016
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		$655	$(5,826)	$(1,006)	$(11,180)
Amount of loss recognized (ineffective portion)		(1,108)	(239)	(1,501)	(887)
Increase in interest expense and decrease in Net income as a result of the use of Derivatives	*	$(453)	$(6,065)	$(2,507)	$(12,067)
Other comprehensive income-related					
Amount of gain (loss) recognized in Other comprehensive income (loss) (effective portion)		$(6,487)	$(22,145)	$1,609	$(54,272)

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

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 5 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 of Recognized Assets (a)	Gross Amounts Offset in the Balance Sheet (a)	Net Amounts of Assets Presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet (b) Financial Instruments	Cash Collateral Received	Net Amount
June 30, 2017						
Counterparty 4	$20,574	$ (18,104)	$ 2,470	$ –	$ –	$2,470
December 31, 2016						
Counterparty 4	$18,100	$ 6,609	$ 24,709	$ (11,681)	$ –	$13,028

(a) Included in gross amounts of recognized assets at June 30, 2017 is the fair value of exchange traded swap agreements, calculated including accrued interest. Included in gross amounts offset in the balance sheet are variation margin amounts associated with these swaps at June 30, 2017.

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

Offsetting of Financial Liabilities and Derivative Liabilities

	Gross Amounts of Recognized Liabilities [(a)]	Gross Amounts Offset in the Balance Sheet [(a)]	Net Amounts of Liabilities Presented in the Balance Sheet [(b)]	Gross Amounts Not Offset in the Balance Sheet [(c)]		
				Financial Instruments	Cash Collateral Pledged	Net Amount
June 30, 2017						
Derivatives by counterparty:						
Counterparty 1	$25,303	$ –	$25,303	$–	$(25,303)	$ –
Counterparty 4	8,329	(8,329)	–	–	–	–
	33,632	(8,329)	25,303	–	(25,303)	–
Borrowings under repurchase arrangements [(d)]	12,459,187	–	12,459,187	(12,459,187)	–	–
	$12,492,819	$ (8,329)	$12,484,490	$(12,459,187)	$(25,303)	