CAPSTEAD MORTGAGE CORP
Form 10-Q
November 03, 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: September 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 November 3, 2017

CAPSTEAD MORTGAGE CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2017

INDEX

	Page
PART I. — FINANCIAL INFORMATION	
ITEM 1. Financial Statements (unaudited)	
Consolidated Balance Sheets — September 30, 2017 and December 31, 2016	3
Consolidated Statements of Income — Quarter and Nine Months Ended September 30, 2017 and 2016	4
Consolidated Statements of Comprehensive Income — Quarter and Nine Months Ended September 30, 2017 and 2016	5
Consolidated Statements of Cash Flows — Nine Months Ended September 30, 2017 and 2016	6
Notes to Consolidated Financial Statements	7
ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	22
ITEM 3. Quantitative and Qualitative Disclosure of Market Risk	48
ITEM 4. Controls and Procedures	48
PART II. — OTHER INFORMATION	
ITEM 6. Exhibits	49
SIGNATURES	51

ITEM 1. FINANCIAL STATEMENTS

PART I. — FINANCIAL INFORMATION

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except pledged and per share amounts)

	September 30, 2017 (unaudited)	December 31, 2016
Assets		
Residential mortgage investments ($13.13 and $12.81 billion pledged at September 30, 2017 and December 31, 2016, respectively)	$ 13,605,583	$ 13,316,282
Cash collateral receivable from interest rate swap counterparties	47,250	29,660
Interest rate swap agreements at fair value	2,022	24,709
Cash and cash equivalents	93,454	56,732
Receivables and other assets	153,339	149,493
	$ 13,901,648	$ 13,576,876
Liabilities		
Secured borrowings	12,467,387	$ 12,145,346
Interest rate swap agreements at fair value	24,759	24,417
Unsecured borrowings	98,166	98,090
Common stock dividend payable	18,688	22,634
Accounts payable and accrued expenses	19,245	38,702
	12,628,245	12,329,189
Stockholders' equity		
Preferred stock - $0.10 par value; 100,000 shares authorized: 7.50% Cumulative Redeemable Preferred Stock, Series E, 10,329 and 8,234 shares issued and outstanding ($258,226 and $205,849 aggregate liquidation preferences) at September 30, 2017 and December 31, 2016, respectively	250,946	199,059
Common stock - $0.01 par value; 250,000 shares authorized: 96,105 and 95,989 shares issued and outstanding at September 30, 2017 and December 31, 2016, respectively	961	960
Paid-in capital	1,275,442	1,288,346
Accumulated deficit	(346,570)	(346,464)
Accumulated other comprehensive income	92,624	105,786

1,273,403	1,247,687
$ 13,901,648	$ 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 September 30		Nine Months Ended September 30	
	2017	2016	2017	2016
Interest income:				
Residential mortgage investments	$57,073	$49,845	$168,017	$162,654
Other	366	174	757	494
	57,439	50,019	168,774	163,148
Interest expense:				
Secured borrowings	(36,655)	(26,636)	(98,745)	(80,232)
Unsecured borrowings	(1,910)	(1,970)	(5,701)	(5,923)
	(38,565)	(28,606)	(104,446)	(86,155)
	18,874	21,413	64,328	76,993
Other revenue (expense):				
Compensation-related expense	(1,073)	(4,039)	(4,021)	(9,305)
Other general and administrative expense	(1,097)	(1,239)	(3,435)	(3,565)
Miscellaneous other revenue	48	305	130	1,300
	(2,122)	(4,973)	(7,326)	(11,570)
Net income	$16,752	$16,440	$57,002	$65,423
Net income available to common stockholders:				
Net income	$16,752	$16,440	$57,002	$65,423
Less preferred stock dividends	(4,718)	(3,846)	(12,600)	(11,515)
	$12,034	$12,594	$44,402	$53,908
Net income per common share:				
Basic and diluted	$0.13	$0.13	$0.46	$0.56
Weighted average common shares outstanding:				
Basic	95,792	95,678	95,768	95,647
Diluted	95,923	95,866	95,905	95,799
Cash dividends declared per share:				
Common	$0.19	$0.23	$0.61	$0.72
Series E preferred	0.47	0.47	1.41	1.41

See accompanying notes to consolidated financial statements.

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, unaudited)

	Quarter Ended September 30		Nine Months Ended September 30	
	2017	2016	2017	2016
Net income	$16,752	$16,440	$57,002	$65,423
Other comprehensive income (loss)				
Amounts related to available-for-sale securities:				
Change in net unrealized gains	(7,072)	(19,155)	(14,496)	10,245
Amounts related to cash flow hedges:				
Change in net unrealized gains (losses)	1,827	12,558	3,541	(41,714)
Reclassification adjustment for amounts included in net income	(3,213)	4,927	(2,207)	16,107
	(8,458)	(1,670)	(13,162)	(15,362)
Comprehensive income	$8,294	$14,770	$43,840	$50,061

See accompanying notes to consolidated financial statements.

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, unaudited)

	Nine Months Ended September 30	
	2017	2016
Operating activities:		
Net income	$57,002	$65,423
Noncash items:		
Amortization of investment premiums	98,996	95,139
Amortization of equity-based awards	1,671	1,241
Other depreciation and amortization	89	97
Change in recorded measureable hedge ineffectiveness on interest rate swap agreements designated as cash flow hedges	36	506
Net change in receivables, other assets, accounts payable and accrued expenses	1,877	(953)
Net cash provided by operating activities	159,671	161,453
Investing activities:		
Purchases of residential mortgage investments	(3,380,199)	(2,319,819)
Interest receivable acquired with the purchase of residential mortgage investments	(5,410)	(3,139)
Principal collections on residential mortgage investments, including changes in mortgage securities principal remittance receivable	2,972,002	2,773,344
Redemptions of lending counterparty investments	–	50,000
Net cash (used in) provided by investing activities	(413,607)	500,386
Financing activities:		
Proceeds from repurchase arrangements and similar borrowings	126,991,975	94,430,910
Principal payments on repurchase arrangements and similar borrowings	(126,669,933)	(92,332,463)
Proceeds from other secured borrowings	–	1,175,000
Principal payments on other secured borrowings	–	(3,800,000)
Increase in cash collateral receivable from interest rate swap counterparties	(17,590)	(22,998)
Net proceeds from interest rate swap settlements	8,842	–

Proceeds from issuance of preferred shares	52,051	1,167
Other capital stock transactions	(261)	(57)
Dividends paid	(74,426)	(83,886)
Net cash provided by (used in) financing activities	290,658	(632,327)
Net change in cash and cash equivalents	36,722	29,512
Cash and cash equivalents at beginning of period	56,732	54,185
Cash and cash equivalents at end of period	$93,454	$83,697

See accompanying notes to consolidated financial statements.

CAPSTEAD MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 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 nine months ended September 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 ("FASB") issued Accounting Standards Update No. 2016-09, Compensation–Stock Compensation: Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09") with the objective of simplifying accounting for these transactions, including 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.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities ("ASU 2017-12") with the objective of improving the financial reporting of hedging

relationships by, among other things, eliminating the requirement to separately measure and record hedge ineffectiveness. ASU 2017-12 is effective for public companies for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early application is permitted using a modified retrospective method effective as of the beginning of the fiscal year. The Company elected to early-adopt ASU 2017-12 on August 31, 2017 and, as a result, $863,000 of expense related to hedge ineffectiveness recognized in Interest expense during the six months ended June 30, 2017 on designated swaps outstanding on August 31, 2017 was reversed. Additionally, $105,000 of

ineffectiveness income recognized prior to 2017 for these swaps was reclassified to Accumulated deficit from Accumulated other comprehensive income effective January 1, 2017.

Reclassification

Included in Compensation-related expense for the quarter and nine months ended September 30, 2016 is $2.7 million previously classified as a separation of service charge related to the July 2016 resignation of the Company's former chief executive officer ("CEO").

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 September 30		Nine Months Ended September 30	
	2017	2016	2017	2016
Basic net income per common share				
Numerator for basic net income per common share:				
Net income	$16,752	$16,440	$57,002	$65,423
Preferred stock dividends	(4,718)	(3,846)	(12,600)	(11,515)
Earnings participation of unvested equity awards	(36)	(40)	(116)	(123)
	$11,998	$12,554	$44,286	$53,785
Denominator for basic net income per common share:				
Average number of shares of common stock outstanding	96,094	95,978	96,073	95,946
Average unvested stock awards outstanding	(302)	(300)	(305)	(299)
	95,792	95,678	95,768	95,647
	$0.13	$0.13	$0.46	$0.56
Diluted net income per common share				
Numerator for diluted net income per common share:				
Numerator for basic net income per common share	$11,998	$12,554	$44,286	$53,785

Denominator for diluted net income per common share:				
Denominator for basic net income per common share	95,792	95,678	95,768	95,647
Net effect of dilutive equity awards	131	188	137	152
	95,923	95,866	95,905	95,799
	$0.13	$0.13	$0.46	$0.56

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]
September 30, 2017						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	$294	$–	$294	$294	6.52 %	6.27 %
ARMs	10,358,892	322,475	10,681,367	10,771,142	2.94	1.72
Ginnie Mae ARMs	2,743,838	85,219	2,829,057	2,830,421	2.68	1.57
	13,103,024	407,694	13,510,718	13,601,857	2.88	1.69
Residential mortgage loans:						
Fixed-rate	667	1	668	668	6.73	4.38
ARMs	1,507	8	1,515	1,515	3.85	3.49
	2,174	9	2,183	2,183	4.73	3.76
Collateral for structured financings	1,518	25	1,543	1,543	7.99	7.89
	$13,106,716	$407,728	$13,514,444	$13,605,583	2.88	1.69
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 290 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 September 30, 2017, the average months to roll for the Company's $6.93 billion (amortized cost basis) in current-reset ARM investments was 6.5 months while the average months to roll for the Company's $6.58 billion (amortized cost basis) in longer-to-reset ARM investments was 42.9 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 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 Federal Home Loan Bank ("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	
September 30, 2017					
Borrowings under repurchase arrangements with maturities of 30 days or less:					
Agency Securities	$13,091,941	$ 30,246	$12,432,771	1.33	%
Borrowings under repurchase arrangements with maturities greater than 30 days:					
Agency Securities (greater than 90 days)	36,309	132	33,073	1.53	
Similar borrowings:					
Collateral for structured financings	1,543	–	1,543	7.99	
	$13,129,793	$ 30,378	$12,467,387	1.33	
Quarter-end borrowing rates adjusted for effects of related derivative financial instruments (Derivatives) held as cash flow hedges				1.21	
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					
	September 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	$12,549,893	1.17	%	$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 any 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, 2017 Capstead entered into swap agreements with notional amounts of $650 million and $3.00 billion requiring fixed-rate interest payments each averaging 1.58% for two and three-year periods commencing on various dates between January and September 2017. Also during the quarter and nine months ended September 30, 2017, $400 million and $2.30 billion notional amount of swaps requiring fixed-rate interest payments averaging 0.74% and 0.73% matured. At September 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	
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	550,000	1.40
Fourth quarter 2019	300,000	1.55
First quarter 2020	200,000	1.75
Third quarter 2020	200,000	1.64
	$8,850,000	

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 contractual 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.

In accordance with recent legal interpretations, exchange-traded swap agreements are now deemed to be settled daily. As a result, beginning in 2017, 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 September 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	September 30 2017	December 31 2016
Balance sheet-related			
Swap agreements in a gain position (an asset) related to:			
Secured borrowings	(a)	$ 2,022	$ 24,709
Swap agreements in a loss position (a liability) related to:			
Secured borrowings	(a)	–	(222)
Unsecured borrowings	(a)	(24,759)	(24,195)
Related net interest payable	(b)	(1,015)	(11,989)
		$ (23,752)	$ (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 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 $12.3 million at September 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 September 30		Nine Months Ended September 30	
		2017	2016	2017	2016
Income statement-related					
Components of Secured borrowings-related effects on interest expense:					
Amount of gain (loss) reclassified from Accumulated other comprehensive income		$3,912	$(4,261)	$4,412	$(14,134)
Amount of gain (loss) recognized in income		1,141	(323)	(360)	(1,210)
	(a)	5,053	(4,584)	4,052	(15,344)
Component of Unsecured borrowings-related effects on interest expense:					
Amount of loss reclassified from Accumulated other comprehensive income	(b)	(699)	(666)	(2,205)	(1,973)
Decrease (increase) in interest expense and increase (decrease) in Net income as a result of the use of Derivatives		$4,354	$(5,250)	$1,847	$(17,317)
Other comprehensive income-related					
Amount of gain (loss) recognized in Other comprehensive income		$1,827	$12,558	$3,541	$(41,714)

(a) Included in “Interest expense: Secured borrowings” on the face of the Statements of Income.
(b) Included in “Interest expense: Unsecured 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 Offset in the Balance Sheet	Net Amounts of Assets Presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet [d]	
Gross Amounts of				Cash

	Recognized Assets [c]	the Balance Sheet [c]	the Balance Sheet	Financial Instruments	Collateral Received	Net Amount
September 30, 2017						
Counterparty 4	$16,461	$ (14,439)	$ 2,022	$ –	$ –	$2,022
December 31, 2016						
Counterparty 4	$18,100	$ 6,609	$ 24,709	$ (11,681)	$ –	$13,028

(c) Included in gross amounts of recognized assets at September 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 September 30, 2017.

(d) 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
September 30, 2017						
Derivatives by counterparty:						
Counterparty 1	$25,774	$ –	$25,774	$–	$(25,774)	$ –
Counterparty 4	5,597	(5,597)	–	–	–	–
	31,371	(5,597)	25,774	–	(25,774)	–
Borrowings under repurchase arrangements [d]	12,470,704	–	12,470,704	(12,470,704)	–	–
	$12,502,075	$ (5,597)	$12,496,478	$(12,470,704)	$(25,774)	$ –
December 31, 2016						
Derivatives by counterparty:						
Counterparty 1	$24,725	$ –	$24,725	$–	$(24,725)	$ –
Counterparty 4	5,072	6,609	11,681	(11,681)	–	–
	29,797	6,609	36,406	(11,681)	(24,725)	–
Borrowings under repurchase arrangements [d]	12,151,122	–	12,151,122	(12,151,122)	–	–
	$12,180,919	$ 6,609	$12,187,528	$(12,162,803)	$(24,725)	$ –

(a) Included in gross amounts of recognized liabilities at September 30, 2017 is the fair value of non-exchange traded swap agreements (Counterparty 1) and exchange-traded swap agreements (Counterparty 4), calculated including accrued interest. Included in gross amounts offset in the balance sheet are variation margin amounts associated with exchange-traded swap agreements at September 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.

(c) Amounts presented are limited to recognized assets and collateral pledged 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.

(d) Amounts include accrued interest payable of $4.9 million and $7.4 million on borrowings under repurchase arrangements as of September 30, 2017 and December 31, 2016, respectively.

Changes in Accumulated other comprehensive income by component for the quarter and nine months ended September 30, 2017 were as follows (in thousands):

	Unrealized Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available-for-Sale Securities	Total
Balance at June 30, 2017	$ 2,871	$ 98,211	$101,082
Activity for the quarter ended September 30, 2017:			
Other comprehensive income (loss) before reclassifications	1,827	(7,072)	(5,245)
Amounts reclassified from accumulated other comprehensive income	(3,213)	–	(3,213)
Other comprehensive income (loss)	(1,386)	(7,072)	(8,458)
Balance at September 30, 2017	$ 1,485	$ 91,139	$92,624
Balance at December 31, 2016	$ 151	$ 105,635	$105,786
Activity for the nine months ended September 30, 2017:			
Other comprehensive income (loss) before reclassifications	3,541	(14,496)	(10,955)
Amounts reclassified from accumulated other comprehensive income	(2,207)	–	(2,207)
Other comprehensive income (loss)	1,334	(14,496)	(13,162)
Balance at September 30, 2017	$ 1,485	$ 91,139	$92,624

NOTE 7 — unsecured BORROWINGS

Unsecured borrowings consist of 30-year junior subordinated notes issued in 2005 and 2006 and maturing in 2035 and 2036, for a total face amount of $100 million. Note balances net of deferred issuance costs, and related weighted average interest rates as of the indicated dates (calculated including issuance cost amortization and adjusted for effects of related Derivatives held as cash flow hedges) were as follows (dollars in thousands):

	September 30, 2017		December 31, 2016	
	Borrowings Outstanding	Average Rate	Borrowings Outstanding	Average Rate

Junior subordinated notes maturing in:						
October 2035 ($35,000 face amount)	$34,305	7.90	%	$34,276	7.91	%
December 2035 ($40,000 face amount)	39,311	7.66		39,282	7.67	
September 2036 ($25,000 face amount)	24,550	7.70		24,532	7.71	
	$98,166	7.75		$98,090	7.77	

NOTE 8 — Capital transactions

During the quarter and nine months ended September 30, 2017, Capstead issued an additional 1.7 million and 2.1 million shares of its 7.50% Series E Cumulative Redeemable Preferred Stock through an at-the-market continuous offering program at average prices of $24.79 and $24.77, net of underwriting fees and other costs, for net proceeds of $42.1 million and $51.9 million, respectively. No additional preferred shares were issued subsequent to quarter-end through November 3, 2017.

NOTE 9 — DISCLOSURES REGARDING FAIR VALUES OF FINANCIAL INSTRUMENTS

This note provides fair value-related disclosures as of the indicated balance sheet dates for Capstead's financial assets and liabilities, most of which are influenced by changes in, and market expectations for changes in, interest rates and market liquidity conditions, as well as other factors beyond the control of management. With the exception of the fair value of lending counterparty investments, all fair values were determined using Level 2 Inputs in accordance with ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820). Lending counterparty investments are nonmarketable securities classified as assets for which Level 3 Inputs are used to determine fair value. These assets are considered strategic investments that are carried at cost and periodically valued and evaluated for impairment. No impairment charges have been recorded relative to these investments and the Company's cost basis is deemed to approximate fair value.

Residential mortgage investments, nearly all of which are mortgage securities classified as available-for-sale, are measured at fair value on a recurring basis. In determining fair value estimates the Company considers recent trading activity for similar investments and pricing levels indicated by lenders in connection with designating collateral for secured borrowings, provided such pricing levels are considered indicative of actual market clearing transactions. In determining fair value estimates for Secured borrowings with initial terms of greater than 120 days, the Company considers pricing levels indicated by lenders for entering into new transactions using similar pledged collateral with terms equal to the remaining terms of the these borrowings. The Company currently bases fair value for Unsecured borrowings on discounted cash flows using Company estimates for market yields. Excluded from these disclosures are financial instruments for which cost basis is deemed to approximate fair value due primarily to the short duration of these instruments, which are valued using primarily Level 1 measurements, including Cash and cash equivalents, Cash collateral receivable from, or payable to, interest rate swap counterparties, receivables, payables and secured borrowings with initial terms of 120 days or less. See NOTE 6 for information relative to the valuation of interest rate swap agreements.

Fair value-related disclosures for financial instruments other than debt securities were as follows as of the indicated dates (in thousands):

	September 30, 2017		December 31, 2016	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Residential mortgage loans	$2,183	$2,200	$2,584	$2,600
Lending counterparty investments	5,002	5,002	5,002	5,002
Secured borrowings-related interest rate swap agreements	2,022	2,022	24,709	24,709
Financial liabilities:				
Secured borrowings with initial terms of greater than 120 days	33,073	33,100	139,101	139,100
Unsecured borrowings	98,166	71,600	98,090	68,800
Interest rate swap agreements:				
Secured borrowings-related	–	–	222	222

Unsecured borrowings-related	24,759	24,759	24,195	24,195

Fair value-related disclosures for debt securities were as follows as of the indicated dates (in thousands):

	Amortized Cost Basis	Gross Unrealized Gains	Losses	Fair Value
September 30, 2017				
Agency Securities classified as available-for-sale:				
Fannie Mae/Freddie Mac	$10,681,367	$102,336	$12,561	$10,771,142
Ginnie Mae	2,829,057	10,234	8,870	2,830,421
Residential mortgage securities classified as				
held-to-maturity	1,837	19	–	1,856
December 31, 2016				
Agency Securities classified as available-for-sale:				
Fannie Mae/Freddie Mac	10,372,566	134,797	23,990	10,483,373
Ginnie Mae	2,833,460	10,141	15,313	2,828,288
Residential mortgage securities classified as				
held-to-maturity	2,037	24	–	2,061

	September 30, 2017		December 31, 2016	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities in an unrealized loss position:				
One year or greater	$1,220,505	$ 9,584	$1,050,221	$ 8,418
Less than one year	3,544,982	11,847	4,418,674	30,885
	$4,765,487	$ 21,431	$5,468,895	$ 39,303

Capstead's investment strategy involves managing a leveraged portfolio of relatively short-duration ARM Agency Securities and management expects these securities will be held until payoff absent a major shift in strategy or a severe contraction in the Company's ability to obtain financing to support its portfolio. Declines in fair value caused by increases in interest rates are typically modest for investments in short-duration ARM Agency Securities compared to investments in longer-duration ARM or fixed-rate assets. These declines are generally recoverable in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then-current interest rate environment.

From a credit risk perspective, federal government support for Fannie Mae and Freddie Mac helps ensure that fluctuations in value due to credit risk associated with these securities will be limited. Given that (a) any existing unrealized losses on mortgage securities held by the Company are not attributable to credit risk and declines in fair value of ARM securities due to changes in interest rates are generally recoverable in a relatively short period of time, (b) the Company typically holds its investments to maturity, and (c) it is more likely than not that the Company will not be required to sell any of its investments given the resiliency of the financing market for Agency Securities, none

of these investments were considered other-than-temporarily impaired at September 30, 2017.

NOTE 10 — COMPENSATION PROGRAMS

The compensation committee of Capstead's board of directors (the "Committee") is responsible for establishing, implementing, and monitoring the Company's compensation programs and practices. Incentive compensation programs adopted by the Committee for key executives are largely nondiscretionary, formulaic and target-based, utilizing multiple pre-established performance goals (referred to as "metrics") and defined threshold, target and maximum award amounts determined by reference to established percentages of base salaries. Prior to granting awards, the Committee reviews the Company's programs, implementing any desired changes in performance metrics and the composition of

mortgage REIT industry peer groups used for relative performance metric measurement purposes, as well as establishing each executive's targeted award opportunity. Equity-based awards and other long-term incentive awards are made pursuant to the Company's Amended and Restated 2014 Flexible Incentive Plan that was approved by stockholders in May 2014. At September 30, 2017, this plan had 3,684,662 shares of common stock remaining available for future issuances.

Short-term Incentive Compensation Programs

Under the provisions of Capstead's annual incentive compensation program, participating executives have overall target award opportunities ranging from 75% to 125% of base salary. Awards are earned based on (a) relative and absolute economic return (change in book value per share of common stock plus common stock dividends divided by beginning book value per share), (b) relative operating cost efficiency (operating expenses divided by Unsecured borrowings and Stockholders' equity), and (c) attainment of individual goals and objectives. Each performance metric is assigned a weighting and performance relative to each metric is calculated separately. No awards can be earned for performance below defined threshold return levels and awards are capped for performance above defined maximum return levels. Included in Accounts payable and accrued expenses at September 30, 2017 are annual incentive compensation accruals for participating executives, together with discretionary accruals for all other employees, totaling $694,000. The Company recognized $(124,000) and $694,000 in Compensation-related expense related to 2017 annual incentive compensation for all employees for the quarter and nine months ended September 30, 2017, respectively. An adjustment to the annual incentive compensation accrual related to finalizing 2016 program results reduced Compensation-related expense during the quarter ended March 31, 2017 by $938,000.

The Committee administers an additional performance-based short-term incentive compensation program for key executives that provides for quarterly cash payments equal to per share dividends declared on Capstead's common stock multiplied by a notional amount of non-vesting shares of common stock ("Dividend Equivalent Rights" or "DERs"). DERs only represent the right to receive the same cash distributions that the Company's common stockholders are entitled to receive during the term of the grants, subject to certain conditions, including continuous service. Included in Accounts payable and accrued expenses are third quarter 2017 DERs distribution amounts totaling $100,000 that were paid in October 2017. Recognized in Compensation-related expense are $100,000 and $320,000 related to the DERs program for the quarter and nine months ended September 30, 2017, respectively.

In January 2017 the Committee adjusted the annual incentive compensation program for 2017 to lower the absolute return threshold and target performance levels to reflect current market conditions. In addition, the Committee re-authorized the DERs program with the same terms and conditions, with adjustments made to the amount of individual grants in recognition of current executive responsibilities.

Long-term Equity-based Awards – Performance-based RSUs

Capstead's performance-based long-term incentive compensation program for key executives provides for the grant of performance-based RSUs that are convertible into shares of common stock following three-year performance periods, contingent upon whether, and to what extent, defined performance levels established for certain relative and absolute return performance metrics are met or exceeded. The relative return metrics measure the Company's performance on the basis of relative economic return and relative total stockholder return (change in stock price plus reinvested dividends). The absolute economic return metric measures performance against defined performance levels. For conversion purposes, each performance metric is assigned a weighting and the Company's performance relative to each metric is calculated separately. The actual number of shares of common stock the units can convert into for each of the metrics, if any, can range from one-half of a share per unit if that metric's threshold level of performance is met, to two shares per unit if the related maximum level of performance is met or exceeded, adjusted for the weighting assigned to the metric. If a metric's threshold performance level is

not met, no shares are issuable under that metric. Dividends accrue from the date of grant and will be paid in cash to the extent the units convert into shares of common stock following completion of related performance periods.

Pursuant to this program, in January 2017, February 2016, January 2015 and December 2013 the Committee granted 148,894, 269,354, 247,512 and 242,505 RSUs with three-year performance periods ending December 31, 2019, 2018, 2017 and 2016, respectively. Initial grant date fair values developed for compensation cost purposes of $10.52, $8.03, $8.83 and $12.45 were assigned to the units of each grant, respectively. RSUs granted to the Company's former CEO totaling 99,257 granted in 2016 and 93,058 granted in 2015 were forfeited subsequent to year-end in accordance with the terms of his 2016 separation agreement with the resulting reversal of compensation cost included in earnings in 2016. RSUs granted to a departed executive totaling 37,199 in 2015 and 36,467 in 2013 were forfeited in 2015. The December 2013 RSUs did not meet the criteria for conversion into shares of common stock pursuant to the applicable performance criteria and, accordingly, remaining awards under this grant were forfeited in the first quarter 2017. The Company recognized $73,000 and $696,000 in Compensation-related expense related to outstanding RSUs for the quarter and nine months ended September 30, 2017, respectively. Included in Common stock dividend payable at September 30, 2017 are estimated dividends payable pertaining to these awards of $339,000.

Long-term Equity-based Awards – Stock Awards

Under a performance-based stock award program last utilized in 2012, the Committee granted common stock awards to all employees with staggered three-year vesting periods with vesting subject to the Company generating returns in excess of established return levels. The last awards granted under this program totaling 62,137 shares with a grant date fair value of $11.67 vested in January 2017, together with related deferred dividends.

In January 2017 and February 2016, respectively, the Committee granted three-year service-based stock awards for 74,446 and 67,337 shares of common stock with grant date fair values of $10.41 and $9.32 per share to executives awarded RSUs. Stock awards granted in 2016 to the Company's former CEO totaling 24,881 shares were forfeited subsequent to year-end in accordance with the terms of his 2016 separation agreement with the resulting reversal of compensation cost included in earnings in 2016. Remaining awards and related deferred dividends are scheduled to vest in January 2020 and February 2019 assuming service conditions are met. Included in Common stock dividend payable at September 30, 2017 are dividends payable pertaining to these awards of $114,000.

In January of 2017 and 2016 and December of 2014, respectively, the Committee granted three-year service-based stock awards for 49,416, 61,272 and 37,237 shares of common stock with grant date fair values of $10.41, $7.87 and $12.47 per share to employees not awarded RSUs. These awards vest in January of 2020, 2019 and 2018 assuming service conditions are met. Similar stock awards granted in December 2013 for a total of 35,703 shares of common stock vested January 3, 2017.

As a component of the Company's director compensation program, directors are granted service-based stock awards annually upon election or re-election to the board of directors that vest approximately one year from issuance. In July 2017, director common stock awards for a total of 41,881 shares granted in July 2016 with a grant date fair value of $10.03 per share vested on July 15, 2017 and new awards, for a total of 41,797 shares, with a grant date fair value of $10.05 per share were granted that will vest on July 25, 2018.

Performance-based and service-based stock award activity for the nine months ended September 30, 2017 is summarized below:

	Number of Shares	Weighted Average Grant Date Fair Value
Unvested stock awards outstanding at December 31, 2016	305,567	$ 10.29
Grants	165,659	10.32
Forfeitures	(24,881)	9.32
Vestings	(139,721)	11.35
Unvested stock awards outstanding at September 30, 2017	306,624	9.90

During the quarter and nine months ended September 30, 2017, the Company recognized in Compensation-related expense $220,000 and $660,000, respectively, related to amortization of the grant date fair value of employee stock awards. In addition, the Company recognized in Other general and administrative expense $106,000 and $316,000 related to amortization of the grant date fair value of director stock awards during the quarter and nine months ended September 30, 2017, respectively. Unrecognized compensation expense for unvested stock awards for all employees and directors totaled $1.8 million as of September 30, 2017, to be expensed over a weighted average period of 1.4 years.

Service-based stock awards issued to directors and to employees not awarded RSUs receive dividends on a current basis without risk of forfeiture if the related awards do not vest. Stock awards issued to executives awarded RSUs defer the payment of dividends accruing between the grant dates and the end of related service periods. If these awards do not vest, the related accrued dividends will be forfeited.

Long-term Equity-based Awards – Option Awards

At September 30, 2017 option awards for 30,000 shares of common stock were outstanding with a weighted average strike price of $12.28. These awards are currently exercisable, have no aggregate intrinsic value and have a weighted average remaining contractual term of 1.3 years. No option award activity occurred during the quarter and nine months ended September 30, 2017. All outstanding option awards were granted prior to 2010, have ten-year contractual terms and were issued with strike prices equal to the closing market price of Capstead’s common stock on the dates of grant. The fair value of these awards was estimated at that time using a Black-Scholes option pricing model and was expensed over the related vesting periods.

Other Benefit Programs

Capstead sponsors a qualified defined contribution retirement plan for all employees and a nonqualified deferred compensation plan for certain of its executives. In general the Company matches up to 50% of a participant’s voluntary contribution up to a maximum of 6% of a participant’s base salary and annual incentive compensation payments. The Company also makes discretionary contributions of up to another 3% of such compensation regardless of participation in the plans. Company contributions are subject to certain vesting requirements that have been met by nearly all of Capstead’s current employees. During the quarter and nine months ended September 30, 2017, the

Company recognized in Compensation-related expense $31,000 and $119,000 related to contributions to these plans, respectively.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

FINANCIAL CONDITION

Overview

Capstead operates as a self-managed REIT earning income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of short-duration ARM Agency Securities, which reset to more current interest rates within a relatively short period of time and are considered to have limited, if any, credit risk. See NOTE 1 to the consolidated financial statements (included under Item 1 of this report) for defined terms used in this discussion and analysis. By investing in short-duration ARM Agency Securities, the Company is positioned to benefit from future recoveries in financing spreads that typically contract during periods of rising interest rates and to experience smaller fluctuations in portfolio values compared to leveraged portfolios containing a significant amount of longer-duration ARM or fixed-rate mortgage securities. Duration is a common measure of market price sensitivity to interest rate movements. A shorter duration generally indicates less interest rate risk.

Capstead finances its residential mortgage investments by leveraging its long-term investment capital with secured borrowings consisting primarily of borrowings under repurchase arrangements with commercial banks and other financial institutions. Long-term investment capital totaled $1.37 billion at September 30, 2017, consisting of $1.02 billion of common and $251 million of preferred stockholders' equity, together with $98 million of unsecured borrowings maturing in 2035 and 2036 (recorded amounts). Long-term investment capital increased $26 million in 2017 as relatively modest declines in common equity capital related to changes in unrealized portfolio and interest rate swap gains and dividends in excess of earnings were more than offset by $52 million in preferred equity capital raised through an at-the-market continuous offering program.

Book value per share of common stock (total stockholders' equity, less liquidation preferences for outstanding shares of preferred stock, divided by outstanding shares of common stock) declined 2.7% ($0.29) to $10.56 per share, of which 1.3% ($0.14) was related to changes in unrealized portfolio and swap gains and 1.4% ($0.15) was returned to stockholders in the form of dividends in excess of earnings.

Capstead's residential mortgage investments portfolio increased $289 million in 2017 to $13.61 billion at September 30, 2017. Secured borrowings increased $322 million to $12.47 billion. Portfolio leverage (secured borrowings divided by long-term investment capital) increased to 9.09 to one at September 30, 2017 from 9.02 to one at December 31, 2016. Management believes current portfolio leverage levels represent an appropriate use of leverage under current market conditions for a portfolio consisting of seasoned, short-duration ARM Agency Securities.

Capstead reported net income of $17 million and $57 million or $0.13 and $0.46 per diluted common share for the quarter and nine months ended September 30, 2017, compared to $16 million and $65 million or $0.13 and $0.56 per diluted common share for the same periods in 2016, respectively. Earnings in 2017 were negatively impacted by high

mortgage prepayment levels and higher borrowing costs. Higher borrowing costs were partially offset by higher coupon interest rates on adjustable-rate mortgages underlying the Company's residential mortgage investments. Earnings also benefited from lower compensation-related accruals. The Company declared a third quarter 2017 common dividend of $0.19 per share that was paid on October 20, 2017 to holders of record on September 30, 2017.

The size and composition of Capstead's investment portfolio depends on investment strategies being implemented by management, as well as overall market conditions, including the availability of attractively priced investments and suitable financing to leverage the Company's investment capital. Market conditions are influenced by, among other things, current and future expectations for short-term interest rates, mortgage prepayments and market liquidity.

Risk Factors and Critical Accounting Policies

Under the captions "Risk Factors" and "Critical Accounting Policies" are discussions of risk factors and critical accounting policies affecting Capstead's financial condition and earnings that are an integral part of this discussion and analysis. Readers are strongly urged to consider the potential impact of these factors and accounting policies on the Company and its financial results.

Capital Market Transactions

During the quarter and nine months ended September 30, 2017, Capstead issued 1.7 million and 2.1 million shares of its 7.50% Series E Cumulative Redeemable Preferred Stock through an at-the-market continuous offering program at average prices of $24.79 and $24.77, net of underwriting fees and other costs, for net proceeds of $42 million and $52 million. No additional preferred shares were issued subsequent to quarter-end through November 3, 2017.

On November 1, 2017, Capstead's board of directors authorized the reinstatement of its previously unused $100 million common stock repurchase program. No shares were repurchased pursuant to this program as of November 3, 2017. The authorization does not obligate the Company to acquire any particular amount of common stock and repurchases under the program and the program itself may be suspended or discontinued at the Company's discretion without prior notice.

The timing, manner, price and amount of any future common and preferred issuances and any common stock repurchases pursuant to these programs will be made in the open market at the Company's discretion, subject to economic and market conditions, stock price, compliance with federal securities laws and tax regulations as well as blackout periods associated with the dissemination of important Company-specific news.

Book Value per Common Share

All but $4 million of Capstead's residential mortgage investments portfolio and all of its interest rate swap agreements are recorded at fair value on the Company's balance sheet and are therefore included in the calculation of book value per share of common stock. The Company's borrowings, however, are not recorded at fair value on the balance sheet. See NOTE 9 to the consolidated financial statements (included under Item 1 of this report) for additional disclosures regarding fair values of financial instruments held or issued by the Company.

Fair value is impacted by market conditions, including changes in interest rates, and the availability of financing at reasonable rates and leverage levels, among other factors. The Company's investment strategy attempts to mitigate these risks by focusing on investments in Agency Securities, which are considered to have little, if any, credit risk and

are collateralized by ARM loans with interest rates that reset periodically to more current levels, generally within five years. Because of these characteristics, the fair value of the Company's portfolio is considerably less vulnerable to significant pricing declines caused by credit concerns or rising interest rates compared to leveraged portfolios containing a significant amount of non-agency securities or longer-duration ARM and/or fixed-rate Agency Securities.

The following table illustrates the progression of Capstead's book value per share of common stock as well as changes in book value expressed as percentages of beginning book value for the quarter and nine months ended September 30, 2017:

	Quarter Ended		Nine Months Ended	
	September 30, 2017		September 30, 2017	
Book value per common share, beginning of period	$10.72		$10.85	
Change in net unrealized gains on mortgage securities classified as available-for-sale	(0.07)		(0.15)	
Change in net unrealized gains and losses on interest rate swap agreements designated as cash flow hedges of:				
Secured borrowings	(0.02)		0.02	
Unsecured borrowings	–		(0.01)	
	(0.09)	(0.8)%	(0.14)	(1.3)%
Capital transactions:				
Dividend distributions in excess of earnings	(0.06)		(0.15)	
Other	(0.01)		–	
	(0.07)	(0.7)%	(0.15)	(1.4)%
Book value per common share, end of period	$10.56		$10.56	
Decrease in book value per common share during the indicated periods	$(0.16)	(1.5)%	$(0.29)	(2.7)%

Residential Mortgage Investments

The following table illustrates the progression of Capstead's portfolio of residential mortgage investments for the quarter and nine months ended September 30, 2017 (dollars in thousands):

	Quarter Ended September 30, 2017	Nine Months Ended September 30, 2017
Residential mortgage investments, beginning of period	$13,598,890	$13,316,282
Portfolio acquisitions (principal amount)	1,074,870	3,278,611
Investment premiums on acquisitions*	29,422	101,588
Portfolio runoff (principal amount)	(1,055,577)	(2,977,406)
Investment premium amortization	(34,950)	(98,996)
Decrease in net unrealized gains on securities classified as available-for-sale	(7,072)	(14,496)
Residential mortgage investments, end of period	$13,605,583	$13,605,583

Increase in residential mortgage investments during the indicated periods	$ 6,693	$ 289,301

*Residential mortgage investments typically are acquired at a premium to the securities' unpaid principal balances. Investment premiums are recognized in earnings as portfolio yield adjustments using the interest method over the estimated lives of the related investments. As such, the level of mortgage prepayments impacts how quickly investment premiums are amortized.

Capstead's investment strategy focuses on managing a portfolio of residential mortgage investments consisting almost exclusively of ARM Agency Securities. 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. Federal government support for Fannie Mae and Freddie Mac has largely alleviated market concerns regarding the ability of Fannie Mae and Freddie Mac to fulfill their guarantee obligations.

By focusing on investing in short-duration ARM Agency Securities, changes in fair value caused by changes in interest rates are typically relatively modest compared to changes in fair value of longer-duration ARM or fixed-rate assets. Declines in fair value caused by increases in interest rates are generally recoverable in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then-current interest rate environment. This investment strategy positions the Company to benefit from potential recoveries in financing spreads that typically contract during periods of rising interest rates.

ARM securities are backed by mortgage loans that generally have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. These coupon interest rate adjustments are 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. After the initial fixed-rate period, if applicable, the coupon interest rates of mortgage loans underlying the Company's ARM securities typically adjust either (a) 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"), (b) semiannually based on specified margins over six-month LIBOR, or (c) 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.

Capstead classifies its ARM securities based on the average length of time until the loans underlying each security reset to more current rates ("months-to-roll") (less than 18 months for "current-reset" ARM securities, and 18 months or greater for "longer-to-reset" ARM securities). The Company's ARM holdings featured the following characteristics at September 30, 2017 (dollars in thousands):

ARM Type	Amortized Cost Basis [a]	Net WAC [b]	Fully Indexed WAC [b]	Average Net Margins [b]	Average Periodic Caps [b]	Average Lifetime Caps [b]	Months To Roll
Current-reset ARMs:							
Fannie Mae Agency Securities	$3,893,098	3.11 %	3.33 %	1.70 %	2.85 %	9.44 %	6.4
Freddie Mac Agency Securities	1,491,730	3.19	3.50	1.82	2.54	9.39	7.4
Ginnie Mae Agency Securities	1,543,547	2.39	2.83	1.51	1.07	8.28	5.9
Residential mortgage loans	1,515	3.85	3.46	2.08	1.64	11.06	4.9
(51% of total)	6,929,890	2.97	3.26	1.68	2.38	9.17	6.5
Longer-to-reset ARMs:							
Fannie Mae Agency Securities	3,317,609	2.74	3.38	1.59	3.08	7.75	43.4
Freddie Mac Agency Securities	1,978,930	2.73	3.42	1.64	2.69	7.80	40.3
Ginnie Mae Agency Securities	1,285,510	3.02	2.81	1.50	1.01	8.02	45.7
(49% of total)	6,582,049	2.79	3.28	1.59	2.56	7.82	42.9
	$13,511,939	2.88	3.27	1.64	2.47	8.51	24.3

Gross WAC (rate paid by borrowers) [(c)]	3.48

(a) Amortized cost basis represents the Company's investment (unpaid principal balance plus unamortized investment premiums) before unrealized gains and losses. At September 30, 2017, the ratio of amortized cost basis to unpaid principal balance for the Company's ARM holdings was 103.16. This table excludes less than $3 million in fixed-rate agency-guaranteed mortgage pass-through securities, residential mortgage loans and private residential mortgage pass-through securities held as collateral for structured financings.

(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 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. As such, it is similar to the cash yield on the portfolio which is calculated using amortized cost basis. Fully indexed WAC represents the weighted average coupon upon one or more resets using interest rate indexes and net margins as of the indicated date. Average net margins represent the weighted average levels over the underlying indexes that the portfolio can adjust to upon reset, usually subject to initial, periodic and/or lifetime caps on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans. ARM securities with initial fixed-rate periods of five years or longer typically have either 200 or 500 basis point initial caps with 200 basis point periodic caps.

Additionally, certain ARM securities held by the Company are subject only to lifetime caps or are not subject to a cap. For presentation purposes, average periodic caps in the table above reflect initial caps until after an ARM security has reached its initial reset date and lifetime caps, less the current net WAC, for ARM securities subject only to lifetime caps. At quarter-end, 79% of current-reset ARMs were subject to periodic caps averaging 1.76%; 14% were subject to initial caps averaging 3.59%; and 7% were subject to lifetime caps averaging 7.14%. All longer-to-reset ARM securities at September 30, 2017 were subject to initial caps.

(c) Gross WAC is the weighted average interest rate of the mortgage loans underlying the indicated investments, including servicing and other fees paid by borrowers, as of the indicated balance sheet date.

After consideration of any applicable initial fixed-rate periods, at September 30, 2017 approximately 90%, 5% and 3% of the Company's ARM securities were backed by mortgage loans that reset annually, semi-annually and monthly, respectively, while approximately 2% reset every five years. Approximately 86% of the Company's current-reset ARM securities have reached an initial coupon reset date, while none of its longer-to-reset ARM securities have reached an initial coupon reset date. Additionally, at September 30, 2017 approximately 6% of the Company's ARM securities were backed by interest-only loans, with remaining interest-only payment periods averaging 25 months. All percentages are based on averages of the characteristics of mortgage loans underlying each security and calculated using unpaid principal balances as of the indicated date.

Secured Borrowings

Capstead finances its residential mortgage investments by leveraging its long-term investment capital with secured borrowings consisting primarily of borrowings under repurchase arrangements with commercial banks and other financial institutions. 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.

The terms and conditions of secured borrowings are negotiated on a transaction-by-transaction basis when each such borrowing is initiated or renewed. None of the Company's counterparties are obligated to renew or otherwise enter into new borrowings at the conclusion of existing borrowings. Collateral requirements in excess of amounts borrowed (referred to as "haircuts") averaged 4.5 percent and ranged from 3.0 to 5.0 percent of the fair value of pledged residential mortgage pass-through securities at September 30, 2017. After considering haircuts and related interest receivable on the collateral, as well as interest payable on these borrowings, the Company had $688 million of capital at risk with its lending counterparties at September 30, 2017. The Company did not have capital at risk with any single counterparty exceeding 4.5% of total stockholders' equity at September 30, 2017.

Secured borrowing 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 counterparty or repay that counterparty and negotiate financing with a different counterparty. When the fair value of pledged securities declines due to changes in market conditions or the publishing of monthly security pay-down factors, lenders 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, referred to as margin calls. Conversely, if collateral fair values increase, lenders are required to release collateral back to the Company pursuant to Company-issued margin calls.

As of September 30, 2017 the Company's secured borrowings totaled $12.47 billion with 22 counterparties at average rates of 1.33%, before the effects of currently-paying interest rate swap agreements held as cash flow hedges and 1.21% including the effects of these derivatives. To help mitigate exposure to rising short-term interest rates, the Company uses one- and three-month LIBOR-indexed, pay-fixed, receive-variable interest rate swap agreements with two- and three-year interest payment terms supplemented with longer-maturity secured borrowings, when available at attractive rates

and terms. Excluding $600 million notional amount of swap agreements that expired October 2, 2017, at quarter-end the Company held $8.25 billion notional amount of portfolio financing-related interest rate swap agreements with contract expirations occurring at various dates through the third quarter of 2020 and a weighted average expiration of 13 months.

After consideration of all portfolio financing-related swap positions entered into as of quarter-end, the Company's residential mortgage investments and secured borrowings had estimated durations at September 30, 2017 of 11¼ and 8½ months, respectively, for a net duration gap of approximately 2¾ months – see pages 34 and 35 under the caption "Interest Rate Risk" for further information about the Company's sensitivity to changes in market interest rates. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-maturity secured borrowings, if available at attractive rates and terms.

Utilization of Long-term Investment Capital and Potential Liquidity

Capstead's investment strategy involves managing an appropriately leveraged portfolio of ARM Agency Securities that management believes can produce attractive risk-adjusted returns over the long term, while reducing, but not eliminating, sensitivity to changes in interest rates. The potential liquidity inherent in the Company's unencumbered residential mortgage investments is as important as the actual level of cash and cash equivalents carried on the balance sheet because secured borrowings generally can be increased or decreased on a daily basis to meet cash flow requirements and otherwise manage capital resources efficiently. Potential liquidity is affected by, among other factors:

- current portfolio leverage levels,
- changes in market value of assets pledged and interest rate swap agreements held for hedging purposes as determined by lending and swap counterparties,
- mortgage prepayment levels,
- collateral requirements of lending and swap counterparties, and
- general conditions in the commercial banking and mortgage finance industries.

Capstead's utilization of its long-term investment capital and its estimated potential liquidity were as follows as of September 30, 2017 in comparison with December 31, 2016 (in thousands):

	Investments [a]	Secured Borrowings	Capital Employed	Potential Liquidity [b]	Portfolio Leverage
Balances as of September 30, 2017:					
Residential mortgage investments	$13,605,583	$12,467,387	$1,138,196	$ 522,924	
Cash collateral receivable from swap counterparties, net [c]			24,513	–	
Other assets, net of other liabilities			208,860	93,454	
			$1,371,569	$ 616,378	9.09:1
Balances as of December 31, 2016	$13,316,282	$12,145,346	$1,345,777	$ 616,898	9.02:1

(a) Investments are stated at balance sheet carrying amounts, which generally reflect estimated fair value as of the indicated dates.

(b) Potential liquidity is based on maximum amounts of borrowings available under existing uncommitted financing arrangements considering management's estimate of the fair value of residential mortgage investments held as of the indicated dates adjusted for other sources of liquidity such as cash and cash equivalents.

(c) Cash collateral receivable from swap counterparties is presented net of cash collateral payable to swap counterparties, if applicable, and the fair value of interest rate swap positions as of the indicated date.

In order to efficiently manage its liquidity and capital resources, Capstead attempts to maintain sufficient liquidity reserves to fund borrowing and interest rate swap margin calls under stressed market conditions, including margin calls resulting from monthly principal payments (remitted to the Company 20 to 45 days after any given month-end), as well as reasonably possible declines in the market value of pledged assets and swap positions. Should market conditions deteriorate, management may reduce portfolio leverage and increase liquidity by raising new equity capital, selling mortgage securities and/or curtailing the replacement of portfolio runoff. Additionally, the Company routinely does business with a large number of lending counterparties, which bolsters financial flexibility to address challenging market conditions and limits exposure to any individual counterparty.

Future levels of portfolio leverage will be dependent on many factors, including the size and composition of the Company's investment portfolio (see "Liquidity and Capital Resources"). Management believes current portfolio leverage levels represent an appropriate use of leverage under current market conditions for a portfolio consisting of seasoned, short-duration ARM Agency Securities.

Supplemental Analysis of Quarterly Financing Spreads

Quarterly financing spreads and mortgage prepayment rates were as follows for the indicated periods:

	2017			2016				2015
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4
Total financing spreads: [a]								
Yields on all interest-earning assets	1.68 %	1.65 %	1.67 %	1.49 %	1.45 %	1.53 %	1.69 %	1.62 %
Borrowing rates on all interest-paying liabilities	1.22	1.13	0.99	0.94	0.89	0.89	0.87	0.79
Total financing spreads	0.46	0.52	0.68	0.55	0.56	0.64	0.82	0.83
Financing spreads on residential mortgage investments, a non-GAAP financial measure:								
Cash yields on residential mortgage investments [b]	2.72	2.66	2.60	2.55	2.52	2.50	2.47	2.44
Investment premium amortization [b]	(1.03)	(1.00)	(0.93)	(1.05)	(1.06)	(0.96)	(0.75)	(0.81)
Yields on residential mortgage investments	1.69	1.66	1.67	1.50	1.46	1.54	1.72	1.63
Unhedged secured borrowing	1.33	1.09	0.89	0.79	0.69	0.67	0.65	0.48

rates [c]								
Hedged secured borrowing rates [c]	1.10	1.08	0.96	0.95	0.93	0.96	0.93	0.87
Secured borrowing rates	1.17	1.08	0.93	0.89	0.84	0.84	0.82	0.73
Financing spreads on residential mortgage investments	0.52	0.58	0.74	0.61	0.62	0.70	0.90	0.90
Constant prepayment rate ("CPR")	25.77	24.69	22.93	25.59	25.80	23.19	18.23	19.62

(a) All interest-earning assets include residential mortgage investments, overnight investments and cash collateral receivable from interest rate swap counterparties. All interest-paying liabilities include unsecured borrowings and cash collateral payable to interest rate swap counterparties.

(b) Cash yields are based on the cash component of interest income. Investment premium amortization is determined using the interest method which incorporates actual and anticipated future mortgage prepayments. Both are expressed as a percentage calculated on average amortized cost basis for the indicated periods.

(c) Unhedged borrowing rates represent average rates on secured borrowings, before consideration of related currently-paying interest rate swap agreements. Hedged borrowing rates represent the average fixed-rate payments made on currently-paying interest rate swap agreements held for portfolio hedging purposes adjusted for differences between LIBOR-based variable-rate payments received on these swaps and unhedged borrowing rates, as well as the effects of any hedge ineffectiveness. Average fixed-rate swap payments were 1.08%, 1.02% and 0.89% for the third, second and first quarters of 2017, respectively, while the variable-rate payment adjustments equated to 0.02%, 0.06% and 0.07% on average currently-paying swap notional amounts outstanding for the same periods. During 2016, fixed-rate swap payments averaged 0.74% while variable-rate payment adjustments averaged 0.20% on average notional amounts outstanding.

Cash yields continue to benefit from higher coupon interest rates as mortgage loans underlying the Company's current-reset ARM securities reset to higher rates based on higher prevailing six- and 12-month interest rate indices. The majority of these loans reset annually based on margins over indices such as 12-month LIBOR, which has increased considerably since late in 2015 with higher short-term interest rates and money market reform.

Portfolio yield adjustments for investment premium amortization are primarily driven by mortgage prepayment and investment premium levels. Mortgage prepayment levels are heavily influenced by the availability of mortgage financing at attractive terms and the overall health of the housing markets, as well as seasonal factors. After declining in the first quarter of 2017, average mortgage prepayment levels returned to elevated levels through the end of the third quarter of 2017. This is largely attributable to seasonal factors and a flattening of the yield curve as longer term rates have not increased in tandem with shorter term rates since year-end, allowing for refinancing opportunities in many instances, particularly for borrowers whose loans have recently reset to higher levels. Mortgage prepayments are expected to decline in the coming quarters with the end of the summer selling season and other factors.

Higher unhedged borrowing rates thus far in 2017 are primarily attributable to higher rates negotiated with lending counterparties after the three 25 basis point Federal Funds Rate increases in December 2016, March and June 2017. Fixed swap rates generally increased over the periods presented as older, lower-rate swap agreements expired and newer, higher-rate swaps were entered into in order to provide important balance sheet and future financing spread protection, particularly as it pertains to additions to the longer-to-reset portion of the Company's ARM securities portfolio. Hedged borrowing rates have benefited from higher short-term LIBOR-based variable-rate swap receipts relative to unhedged borrowing rates.

Reconciliation of GAAP and non-GAAP Financing Spread Disclosures

Financing spreads on residential mortgage investments differ from total financing spreads, an all-inclusive GAAP measure, that is based on all interest-earning assets and liabilities. Management believes presenting financing spreads on residential mortgage investments provides useful information for evaluating portfolio performance. The following reconciles these measures for the indicated periods:

	2017			2016				2015
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4
Total financing spreads	0.46%	0.52%	0.68%	0.55%	0.56%	0.64%	0.82%	0.83%
Impact of yields on other interest-earning assets*	0.01	0.01	-	0.01	0.01	0.01	0.03	0.01
Impact of borrowing rates on other interest-paying liabilities*	0.05	0.05	0.06	0.05	0.05	0.05	0.05	0.06
Financing spreads on residential mortgage investments	0.52	0.58	0.74	0.61	0.62	0.70	0.90	0.90

	Nine Months Ended September 30	
	2017	2016
Total financing spreads	0.54%	0.67%
Impact of yields on other interest-earning assets*	0.01	0.01
Impact of borrowing rates on other interest-paying liabilities*	0.06	0.06
Financing spreads on residential mortgage investments	0.61	0.74

* Other interest-earning assets consist of overnight investments and cash collateral receivable from interest rate swap counterparties. Other interest-paying liabilities consist of unsecured borrowings (at average borrowing rates of 7.78%, 7.74% and 7.71% for the third, second and first quarters of 2017, respectively) and, at times, cash collateral payable to interest rate swap counterparties.

RESULTS OF OPERATIONS

	Quarter Ended September 30		Nine Months Ended September 30	
	2017	2016	2017	2016
Income statement data: (in thousands, except per share data)				
Interest income on residential mortgage investments (before investment premium amortization)	$92,023	$85,921	$267,013	$257,793
Investment premium amortization	(34,950)	(36,076)	(98,996)	(95,139)
Related interest expense	(36,655)	(26,636)	(98,745)	(80,232)
	20,418	23,209	69,272	82,422
Other interest income (expense)	(1,544)	(1,796)	(4,944)	(5,429)
	18,874	21,413	64,328	76,993
Other revenue (expense):				
Compensation-related expense	(1,073)	(4,039)	(4,021)	(9,305)
Other general and administrative expense	(1,097)	(1,239)	(3,435)	(3,565)
Miscellaneous other revenue	48	305	130	1,300
	(2,122)	(4,973)	(7,326)	(11,570)
Net income	$16,752	$16,440	$57,002	$65,423
Net income per diluted common share	$0.13	$0.13	$0.46	$0.56
Average diluted shares outstanding	95,923	95,866	95,905	95,799
Key operating statistics: (dollars in millions)				
Average yields:				
Residential mortgage investments:				
Cash yields	2.72 %	2.52 %	2.66 %	2.49 %
Investment premium amortization	(1.03)	(1.06)	(0.99)	(0.92)
Adjusted yields	1.69	1.46	1.67	1.57
Other interest-earning assets	0.98	0.38	0.78	0.29
Total average yields	1.68	1.45	1.66	1.56
Average borrowing rates:				
Secured borrowings:				
Unhedged borrowing rates	1.33	0.69	1.11	0.67
Hedged borrowing rates	1.10	0.93	1.04	0.94
Adjusted secured borrowing rates	1.17	0.84	1.06	0.83
Unsecured borrowings	7.78	8.04	7.75	8.06
Total average borrowing rates	1.22	0.89	1.12	0.89
Average total financing spreads	0.46	0.56	0.54	0.67
Average financing spreads on residential mortgage investments, a non-GAAP financial measure [(a)]	0.52	0.62	0.61	0.74
Average CPR	25.77	25.80	24.46	22.41
Average balance information:				
Residential mortgage investments (cost basis)	$13,514	$13,629	$13,374	$13,771
Other interest-earning assets	150	182	130	187
Secured borrowings	12,550	12,731	12,382	12,879
Unsecured borrowings (included in long-term	98	98	98	98

investment capital)								
Long-term investment capital ("LTIC")	1,354		1,380		1,358		1,389	
Operating costs as a percentage of average LTIC [(b)]	0.64	%	0.73	%	0.73	%	0.97	%
Return on average LTIC	5.47		6.10		6.17		7.13	
Return on average common equity capital	4.61		4.62		5.64		6.59	

(a) Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on Capstead's residential mortgage investments, net of secured borrowing rates, adjusted for currently-paying interest rate swap agreements held for hedging purposes. This measure differs from total financing spreads, an all-inclusive GAAP measure that includes yields on all interest-earning assets, as well as rates paid on all interest-bearing liabilities, principally unsecured borrowings. See page 30 for a reconciliation of these financial measures and the Company's rationale for using this non-GAAP financial measure.

(b) Calculated excluding a $2.7 million July 2016 separation of service charge recorded in Compensation-related expense.

Capstead's net income totaled $17 million and $57 million or $0.13 and $0.46 per diluted common share for the quarter and nine months ended September 30, 2017, respectively, compared to $16 million and $65 million or $0.13 and $0.56 per diluted common share for the same periods in 2016. Earnings in 2017 benefited from higher cash yields while being negatively impacted by high investment premium amortization caused by high mortgage prepayment levels and higher borrowing costs. Earnings also compared favorably to the prior year due to lower compensation-related accruals, including a $2.7 million separation of service charge ($0.03 per diluted common share) related to the July 2016 resignation of the Company's former CEO that is recorded in Compensation-related expense in the 2016 periods.

Interest income on residential mortgage investments was higher by $7.2 million and $5.4 million for the quarter and nine months ended September 30, 2017, respectively, compared to the same periods in 2016. The increases are attributable to $7.7 million and $10.4 million in increases related to higher average yields, net of $500,000 and $5.0 million in decreases related to lower average portfolio balances for the comparative quarter and nine month periods, respectively.

Interest expense on secured borrowings was higher by $10.0 million and $18.5 million for the quarter and nine months ended September 30, 2017, respectively, compared to the same periods in 2016. The increases are attributable to $10.3 million and $21.8 million in increases related to higher average borrowing rates, net of $300,000 and $3.3 million in decreases related to lower average borrowings for the comparative quarter and nine month periods, respectively.

Yields on residential mortgage investments increased 23 and ten basis points, averaging 1.69% and 1.67% during the quarter and nine months ended September 30, 2017, respectively. Cash yields increased 20 and 17 basis points, averaging 2.72% and 2.66% during the quarter and nine months ended September 30, 2017, respectively, largely due to ARM loan coupon interest rates resetting higher to more current rates. Yield adjustments for investment premium amortization declined three basis points during the quarter ended September 30, 2017 to average (103) basis points, while increasing seven basis points during the nine months ended September 30, 2017 to average (99) basis points, primarily as a result of higher mortgage prepayment rates. Mortgage prepayment levels are influenced by the availability of mortgage financing at attractive terms and the health of the housing markets as well as seasonal factors.

Secured borrowing rates adjusted for currently-paying interest rate swap agreements held for hedging purposes increased 33 and 23 basis points during the quarter and nine months ended September 30, 2017 to average 1.17% and 1.06%. Unhedged borrowing rates accounted for most of the increase, with the remainder attributable to higher interest rate swap costs. Market conditions, including the three 25 basis point increases in the Federal Funds Rate in December 2016, March and June 2017, contributed to higher borrowing rates. Swap costs were impacted by the expiration of older, lower-rate swaps and the addition of new higher-rate swaps, partially offset by higher variable rate swap receipts as a result of higher short-term LIBOR rates. Average fixed-rate swap payments were 108 and 100 basis points for the quarter and nine months ended September 30, 2017, respectively, compared to 75 and 72 basis points for the same periods in 2016. Variable-rate payment adjustments equated to two and four basis points on average currently-paying swap notional amounts outstanding for both the quarter and nine months ended September 30, 2017, compared to 18 and 22 basis points, respectively, for the same periods in 2016. Currently-paying swap balances were higher, averaging $8.78 billion and $8.40 billion for the quarter and nine months ended September 30, 2017, respectively, compared to $7.60 billion and $7.54 billion for the same periods in 2016. Future secured borrowing rates will be dependent on market conditions, including overall levels of market interest rates as well as the availability of longer-maturity borrowings and interest rate swap agreements at attractive rates.

Operating costs (compensation, general and administrative expenses) as a percentage of long-term investment capital is a metric widely used in the mortgage REIT industry as a measure of operating cost efficiency. Capstead, by virtue of its strategy of focusing exclusively on agency-guaranteed ARM securities and being internally managed, is widely recognized as an industry leader in this regard. In

comparison to prior year periods, operating costs were impacted by post year-end adjustments to annual incentive compensation accruals of $938,000 and $(655,000) for the three months ended March 31, 2017 and 2016, respectively. These adjustments were related to finalizing program results for the years ended December 31, 2016 and 2015, respectively. Operating costs for the third quarter 2017 benefited from adjustments to the Company's performance-based compensation programs. As further described in NOTE 10 to the accompanying consolidated financial statements (included in Item 1 of this report), the Company's compensation programs are based in part on relative and absolute economic return performance metrics. Economic return is defined as the change in book value per share of common stock plus common stock dividends declared divided by beginning book value per share.

Miscellaneous other revenue was lower for the quarter and nine months ended September 30, 2017 compared to the same periods in 2016 primarily because of the inclusion in 2016 of dividends on Federal Home Loan Bank ("FHLB") stock held by the Company in connection with FHLB advance activity. The Company repaid its last advance in November 2016 after the FHLB system regulator precluded most captive insurers from continuing to borrow from the FHLBs.

liquidity and capital resources

Capstead's primary sources of funds are secured borrowings and monthly principal and interest payments on its investments. Other sources of funds may include proceeds from debt and equity offerings and asset sales. The Company generally uses its liquidity to pay down secured borrowings to reduce borrowing costs and otherwise efficiently manage its long-term investment capital. Because the level of these borrowings can generally be adjusted on a daily basis, the Company's potential liquidity inherent in its unencumbered residential mortgage investments is as important as the level of cash and cash equivalents carried on the balance sheet. The table included under "Utilization of Long-term Investment Capital and Potential Liquidity" on page 27 illustrates management's estimate of additional funds potentially available to the Company at September 30, 2017 and the accompanying discussion provides insight into the Company's perspective on what level of portfolio leverage to employ under current market conditions. The Company currently believes that it has sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings and the payment of cash dividends as required for the Company's continued qualification as a REIT.

Capstead finances its residential mortgage investments primarily by borrowing under repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis, when each such borrowing is initiated or renewed.

None of the Company's borrowing counterparties are obligated to renew or otherwise enter into new borrowings at the conclusion of existing borrowings. Future borrowings are dependent upon the willingness of lenders to participate in the financing of Agency Securities, lender collateral requirements and the lenders' determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates and liquidity conditions within the commercial banking and mortgage finance industries. Secured borrowings totaled $12.47 billion at September 30, 2017, with all but $33 million maturing within 90 days. Secured borrowings began the year at $12.15 billion and averaged $12.55 billion and $12.38 billion during the quarter and nine months ended September 30, 2017. Average secured borrowings can differ from period-end balances for a number of reasons including portfolio growth or contraction, as well as differences in the timing of portfolio acquisitions relative to portfolio runoff.

To help mitigate exposure to rising short-term interest rates, the Company uses one- and three-month LIBOR-indexed, pay-fixed, receive-variable interest rate swap agreements supplemented with longer-maturity secured borrowings when available at attractive rates and terms. Excluding $600 million notional amount of swap agreements that expired

October 2, 2017, at September 30, 2017 the Company held $8.25 billion notional amount of portfolio financing-related interest rate swap agreements with contract

expirations occurring at various dates through the third quarter of 2020 and a weighted average expiration of 13 months. Relative to the 20-year floating rate terms of the Company's $100 million face amount of unsecured borrowings, in 2010 the Company entered into forward-starting swap agreements to effectively lock in fixed rates of interest on these borrowings. The Company intends to continue to utilize suitable derivative financial instruments such as interest rate swap agreements and longer-maturity secured borrowings to manage interest rate risk when available at attractive rates and terms.

During the quarter and nine months ended September 30, 2017, Capstead issued an additional 1.7 million and 2.1 million shares of its 7.50% Series E Cumulative Redeemable Preferred Stock through an at-the-market continuous offering program at average prices of $24.79 and $24.77, net of underwriting fees and other costs, for net proceeds of $42 million and $52 million. No additional preferred shares were issued subsequent to quarter-end through November 3, 2017.

On November 1, 2017, Capstead's board of directors authorized the reinstatement of its previously unused $100 million common stock repurchase program. No shares were repurchased pursuant to this program as of November 3, 2017. The authorization does not obligate the Company to acquire any particular amount of common stock and repurchases under the program and the program itself may be suspended or discontinued at the Company's discretion without prior notice.

The timing, manner, price and amount of any future common and preferred issuances and any common stock repurchases pursuant to these programs will be made in the open market at the Company's discretion, subject to economic and market conditions, stock price, compliance with federal securities laws and tax regulations as well as blackout periods associated with the dissemination of important Company-specific news.

Interest Rate Risk

Because Capstead's residential mortgage investments consist almost entirely of Agency Securities, which are considered to have limited, if any, credit risk, interest rate risk is the primary market risk faced by the Company. Interest rate risk is highly sensitive to a number of factors, including economic conditions, government fiscal policy, central bank monetary policy and banking regulation. By focusing on investing in relatively short-duration ARM Agency Securities, declines in fair value caused by increases in interest rates are typically relatively modest compared to investments in longer-duration ARM or fixed-rate assets. These declines can be recovered in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then-current interest rate environment. This strategy also positions the Company to benefit from future recoveries in financing spreads that typically contract during periods of rising interest rates.

To further reduce exposure to higher short-term interest rates, the Company uses interest rate swap agreements that typically require interest payments for two-year terms, as well as longer-maturity secured borrowings, if available at attractive rates and terms. These transactions lengthen the effective duration of the Company's secured borrowings to more closely match the duration of its portfolio of residential mortgage investments. After consideration of portfolio financing-related swap positions held to hedge changes in short-term interest rates, at September 30, 2017 the Company's residential mortgage investments and secured borrowings had estimated durations of 11¼ and 8½ months, respectively, for a net duration gap of approximately 2¾ months. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements and longer-maturity secured borrowings, if

available at attractive rates and terms.

Capstead performs sensitivity analyses using a model to estimate the effects that specific interest rate changes can reasonably be expected to have on net interest margins and portfolio values. All investments, secured borrowings and related derivative financial instruments held are included in these analyses. For net interest margin modeling purposes, the model incorporates management's assumptions for mortgage prepayment levels for a given interest rate change using market-based estimates of prepayment speeds for the purpose of amortizing investment premiums and reinvesting portfolio runoff. These assumptions are developed through a combination of historical analysis and expectations for future pricing behavior under normal market conditions unaffected by changes in market liquidity. For portfolio valuation modeling purposes, a static portfolio is assumed.

This model is the primary tool used by management to assess the direction and magnitude of changes in net interest margins and portfolio values resulting solely from changes in interest rates. Key modeling assumptions include mortgage prepayment speeds, adequate levels of market liquidity, current market conditions, and portfolio leverage levels. It is assumed that borrowing rates cannot decline beyond a floor of 0.15%. These assumptions are inherently uncertain and, as a result, modeling cannot precisely estimate the impact of higher or lower interest rates. Actual results will differ from simulated results due to the timing, magnitude and frequency of interest rate changes, other changes in market conditions, changes in management strategies and other factors.

The table below reflects the estimated impact of instantaneous parallel shifts in the yield curve on net interest margins and the fair value of Capstead's portfolio of residential mortgage investments and related derivative financial instruments as of the indicated dates, subject to the modeling parameters described above.

	Federal Funds Rate	10-year U.S. Treasury Rate	Down 1.00%	Down 0.50%	Up 0.50%	Up 1.00%
Projected 12-month percentage change in net interest margins: [a][b]						
September 30, 2017	1.00-1.25%	2.33%	0.6%	(3.6)%	(6.5)%	(18.9)%
December 31, 2016	0.50-0.75	2.45	n/a	(9.5)	(0.2)	(5.8)
Projected percentage change in portfolio and related derivative values: [a]						
September 30, 2017	1.00-1.25	2.33	0.1	0.1	(0.3)	(0.5)
December 31, 2016	0.50-0.75	2.45	n/a	0.1	(0.3)	(0.5)

(a) Sensitivity of net interest margins as well as portfolio and related derivative values to changes in interest rates is determined relative to the actual rates at the applicable date. Note that the projected 12-month net interest margin change is predicated on acquisitions of similar assets sufficient to replace runoff. There can be no assurance that suitable investments will be available for purchase at attractive prices, if investments made will behave in the same

fashion as assets currently held or if management will choose to replace runoff with such assets.

(b) The variance in sensitivity in the Down 0.50%, Up 0.50% and Up 1.00% scenarios at September 30, 2017 compared to December 31, 2016 is in large part due to higher forecasted portfolio and leverage coupled with lower forecasted interest rate swap balances. Also affecting the rate sensitivity are more loans underlying the portfolio becoming subject to periodic caps, as well as the effects of lower projected net interest margins in the base scenario. See page 25 for further discussion of the characteristics of the Company's residential ARM portfolio.

risk factors

An investment in securities issued by Capstead involves various risks. An investor should carefully consider the following risk factors in conjunction with the other information contained in this document before purchasing the Company's securities. The risks discussed herein can adversely affect the Company's business, liquidity, operating results, financial condition and future prospects, causing the market price of the Company's securities to decline, which could cause an investor to lose all or part of an investment in Company stock. The risk factors described below are not the only risks that may affect the Company. Additional risks and uncertainties not presently known to the Company also may adversely affect its business, liquidity, earnings and financial condition.

Risks Related to Capstead's Business

An increase in prepayments may adversely affect Capstead's liquidity, financial condition and earnings. When short- and long-term interest rates are at nearly the same levels (i.e., a "flat yield curve" environment), or when long-term interest rates decrease, the rate of principal prepayments on mortgage loans underlying mortgage securities generally increases due to the availability of lower mortgage interest rates to homeowners. Mortgage interest rates and the general availability of mortgage credit can also be impacted by regulatory changes in Agency guarantee fees, loan level pricing adjustments, down payment requirements, as well as other underwriting requirements. Prolonged periods of high mortgage prepayments can significantly reduce the expected life of the Company's portfolio of residential mortgage investments; therefore, actual yields the Company realizes can be lower due to faster amortization of investment premiums, which could adversely affect earnings. High levels of mortgage prepayments can also lead to larger than anticipated demands on the Company's liquidity from its lending counterparties, as more fully described below. Additionally, periods of high prepayments can adversely affect pricing for Agency Securities in general and, as a result, book value per common share can be adversely affected due to declines in the fair value of the Company's remaining portfolio and the elimination of any unrealized gains on that portion of the portfolio that prepays.

Changes in interest rates, whether increases or decreases, may adversely affect Capstead's liquidity, financial condition and earnings. Capstead's earnings depend primarily on the difference between the interest received on its residential mortgage investments and the interest paid on its secured borrowings, adjusted for the effects of derivative financial instruments held for hedging purposes. The Company finances its investments primarily at 30- to 90-day interest rates. Coupon interest rates on only a portion of the ARM loans underlying the Company's securities reset each month and the terms of these ARM loans generally limit the amount of any increases during any single interest rate adjustment period and over the life of a loan. Consequently, interest rates on secured borrowings not effectively fixed through the use of interest rate swap agreements or similar derivatives can rise to levels that may exceed yields on these securities in a rising short-term interest rate environment. This can contribute to lower, or in more extreme circumstances, negative financing spreads and, therefore, adversely affect earnings. Because rising interest rates can put downward pressure on financial asset prices, Capstead may be presented with substantial margin calls during such periods, adversely affecting the Company's liquidity. If the Company is unable or unwilling to pledge additional collateral, the Company's lenders can liquidate the collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining secured borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

During periods of relatively low short-term interest rates, declines in the indices used to determine coupon interest rate resets for ARM loans may adversely affect yields on the Company's ARM securities as the underlying ARM loans reset at lower rates. If declines in these indices exceed declines in the Company's borrowing rates, earnings would be adversely affected.

Periods of illiquidity in the mortgage markets may reduce amounts available under secured borrowing arrangements due to declines in the perceived value of related collateral, which could adversely impact Capstead's liquidity, financial condition and earnings. Capstead finances its residential mortgage investments by pledging them as collateral under uncommitted secured borrowing arrangements. The amount borrowed is limited to a percentage of the market value of the pledged collateral. The portion of the pledged collateral held by or pledged to the lender in excess of the amount borrowed is referred to as margin collateral and the resulting margin percentage is required to be maintained throughout the term of the borrowing. If the perceived market value of the pledged collateral as determined by the Company's lenders declines, the Company may be subject to margin calls wherein the lender requires the Company to pledge additional collateral to reestablish the agreed-upon margin percentage. Because market illiquidity tends to put downward pressure on asset prices, the Company may be presented with substantial margin calls during such periods. If the Company is unable or unwilling to pledge additional collateral, lenders can liquidate the collateral or seek other remedies, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining secured borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

Periods of illiquidity in the mortgage markets may reduce the number of counterparties willing to lend to the Company and/or the amounts individual counterparties are willing to lend, which could adversely affect the Company's liquidity, financial condition and earnings. Capstead enters into secured borrowing arrangements with numerous commercial banks and other financial institutions, both foreign and domestic, routinely with maturities of 30 to 90 days. The Company's ability to achieve its investment objectives depends on its ability to re-establish or roll maturing secured borrowings on a continuous basis and none of the Company's counterparties are obligated to enter into new borrowing transactions at the conclusion of existing transactions. If a counterparty chooses not to roll a maturing borrowing, the Company must pay off the borrowing, generally with cash available from another secured borrowing arrangement entered into with another counterparty. If the Company determines that it does not have sufficient borrowing capacity with its remaining counterparties, it could be forced to sell assets under potentially adverse market conditions, which could result in losses. An industry-wide reduction in the availability of secured borrowings could adversely affect pricing levels for Agency Securities leading to further declines in the Company's liquidity and book value per common share. Under these conditions, the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

If Capstead is unable to negotiate favorable terms and conditions on future secured borrowings with one or more of the Company's lending counterparties, the Company's liquidity, financial condition and earnings could be adversely impacted. The terms and conditions of each secured borrowing arrangement are negotiated on a transaction-by-transaction basis. Key terms and conditions include interest rates, maturity dates, asset pricing procedures and margin requirements. The Company cannot assure investors that it will be able to continue to negotiate favorable terms and conditions on future secured borrowings. During periods of market illiquidity or due to perceived credit deterioration of the collateral pledged or the Company itself, a lender may require that less favorable asset pricing procedures be employed, margin requirements be increased and/or may choose to limit or completely curtail lending to the Company. Under these conditions, the Company may determine it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining secured borrowings, which could result in losses.

Capstead's use of borrowings under repurchase arrangements may expose the Company to losses if a lending counterparty seeks bankruptcy protection, or otherwise defaults on its obligation to deliver pledged collateral back to the Company. Repurchase arrangements involve the sale and transfer of pledged collateral to the lending counterparty and a simultaneous agreement to repurchase the transferred

assets at a future date. This may make it difficult for the Company to recover its pledged assets if a lender files for bankruptcy or otherwise fails to deliver pledged collateral back to the Company and subject the Company to losses to the extent of any margin amounts (pledged assets in excess of amounts borrowed) held by the lending counterparty.

Capstead's use of borrowings under repurchase arrangements may give lending counterparties greater rights if the Company seeks bankruptcy protection, exposing the Company to losses. Borrowings under repurchase arrangements may qualify for special treatment under the U.S. Bankruptcy Code. If the Company files for bankruptcy, these lending counterparties could avoid the automatic stay provisions of the U.S. Bankruptcy Code and liquidate pledged collateral without delay, which could result in losses to the extent of any margin amounts held by the lending counterparties.

Capstead may sell assets for various reasons, including a change in the Company's investment focus, which could increase earnings volatility. Capstead may periodically sell assets to enhance its liquidity during periods of market illiquidity or rising interest rates or the Company may change its investment focus requiring it to sell some portion of its existing investments. Gains or losses resulting from any such asset sales, or from terminating any related longer-maturity secured borrowings or interest rate swap agreements, could increase the Company's earnings volatility.

Capstead may invest in derivative financial instruments such as interest rate swap agreements to mitigate or hedge the Company's interest rate risk, which may adversely affect the Company's liquidity, financial condition or earnings. The Company may invest in such instruments from time to time with the goal of partially offsetting changes in value of its residential mortgage investments as a result of changes in interest rates and achieving more stable borrowing costs over an extended period. However, these activities may not have the desired beneficial impact on the Company's liquidity, financial condition or earnings. For instance, the pricing of residential mortgage investments and the pricing of related derivatives may deteriorate at the same time leading to margin calls by counterparties to both the borrowings supporting these investments and the derivatives, adversely impacting the Company's liquidity and financial condition. In addition, counterparties could fail to honor their commitments under the terms of the derivatives or have their credit quality downgraded impairing the value of the derivatives. In the event of any defaults by counterparties, the Company may have difficulty recovering its cash collateral receivable from its counterparties and may not receive payments provided for under the terms of the derivatives and as a result, the Company may incur losses. No such hedging activity can completely insulate the Company from the risks associated with changes in interest rates.

Derivative financial instruments held may fail to qualify for hedge accounting introducing potential volatility to Capstead's earnings. The Company typically qualifies derivatives held as cash flow hedges for accounting purposes in order to record the change in fair value of designated derivatives as a component of stockholders' equity rather than in earnings. If the hedging relationship for any derivative held ceases to qualify for hedge accounting treatment for any reason, including failing to meet documentation and ongoing hedge effectiveness requirements, the Company would be required to record in earnings the total change in fair value of any such derivative. In addition the Company could elect to no longer avail itself of cash flow hedge accounting for its derivative positions. Such changes could introduce a potentially significant amount of volatility to earnings reported by the Company.

The lack of availability of suitable investments at attractive pricing may adversely affect Capstead's earnings. The pricing of investments is determined by a number of factors including interest rate levels and expectations, market liquidity conditions, and competition among investors for these investments, many of whom have greater financial resources and lower return requirements than Capstead. Additionally, in recent years the Federal Reserve has been an active buyer of Agency Securities which has had the effect of supporting, if not increasing, pricing for these securities. To the extent the proceeds from prepayments on Capstead's mortgage investments are not reinvested or cannot be reinvested at rates of return at least equal to the rates previously earned on those investments, the Company's earnings may

be adversely affected. Similarly, if proceeds from capital raising activities are not deployed or cannot be deployed at rates of return being earned on existing capital, earnings may be adversely affected. Capstead cannot assure investors that the Company will be able to acquire suitable investments at attractive pricing and in a timely manner to replace portfolio runoff as it occurs or to deploy new capital as it is raised. Neither can the Company assure investors that it will maintain the current composition of its investments, consisting primarily of ARM Agency Securities.

Monetary policy actions by the Federal Reserve could adversely affect Capstead's liquidity, financial condition and earnings. Since 2008 the Federal Reserve has employed a number of relatively unorthodox policy initiatives, most notably by inserting itself into the markets as a dominant buyer of U.S. Treasury securities and fixed-rate Agency Securities. This market intervention resulted in a significant expansion of the Federal Reserve's balance sheet and is often referred to as quantitative easing or QE. The policy goals of the QE initiatives were to support Fannie Mae, Freddie Mac and the housing markets, and otherwise improve economic and labor market conditions by exerting downward pressure on longer term interest rates, including mortgage interest rates. The Federal Reserve ceased increasing its holdings of Treasury and Agency Securities in late 2014, while continuing to replace portfolio runoff through open market purchases.

In general, QE elevated pricing levels for Agency Securities resulting in lower yields on new purchases, lower mortgage interest rates and higher mortgage prepayment rates. The Company's net interest margins, and therefore earnings, were adversely affected over time as existing, lower-cost portfolio was replaced with higher-cost, lower-yielding securities. See previous discussion regarding the negative effects of higher mortgage prepayment levels.

In October 2017, the Federal Reserve began reducing its existing bond holdings of U.S. Treasury securities and fixed-rate Agency Securities by gradually decreasing the amount of bonds it would purchase to replace portfolio runoff, with the stated goal of reducing the portfolio by $10 billion per month in the fourth quarter of 2017, with such reductions increasing quarterly until reaching $50 billon per month in October 2018. As the buy-side support of such a large market participant is removed, pricing for fixed-rate, and to a lesser extent, ARM Agency Securities could be negatively affected. In addition, should the Federal Reserve decide to eventually reduce its holdings of fixed-rate Agency Securities through asset sales, the pricing for all Agency Securities could decline. These actions could adversely affect the Company's liquidity, earnings and book value per common share, as more fully described above.

Potential changes in the relationship between the federal government and Fannie Mae and Freddie Mac could adversely affect Capstead's liquidity, financial condition and earnings. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest on these securities are guaranteed by Fannie Mae, Freddie Mac or by Ginnie Mae. Only the guarantee by Ginnie Mae is explicitly backed by the full faith and credit of the federal government. The high actual or perceived credit quality of Agency Securities allows the Company to finance its portfolio using secured borrowing arrangements with favorable interest rate terms and margin requirements that otherwise would not be available. As a result of deteriorating housing market conditions that began in 2007, Fannie Mae and Freddie Mac incurred substantial losses due to high levels of mortgagor defaults and in 2008 the Federal Housing Finance Agency placed Fannie Mae and Freddie Mac into conservatorship, allowing it to operate them without forcing them to liquidate. Additionally, the federal government, through the U.S. Treasury and the Federal Reserve, undertook other actions to provide financial support to these entities and the housing market, including the acquisition of large holdings of Agency Securities. These and other steps taken by the federal government were designed to support market stability and mortgage availability at favorable rates in part by providing additional confidence to investors in Agency Securities.

It is anticipated that over the next several years U.S. policy makers will reach a consensus on what the long-term role of the federal government in general, and Fannie Mae and Freddie Mac in particular, will

have in the housing markets. In this regard there have been numerous proposals put forth by members of Congress, the Treasury Department and federal regulators regarding Fannie Mae and Freddie Mac reform. The actual or perceived credit quality of Agency Securities could be adversely affected by market uncertainty over any legislative or regulatory initiatives that impact the relationship between Fannie Mae, Freddie Mac and the federal government. A significantly reduced role by the federal government or other changes in the guarantees provided by Fannie Mae, Freddie Mac or Ginnie Mae, or their successors could adversely affect the credit profile and pricing of existing holdings and/or future issuances of Agency Securities and whether the Company's strategy of holding a leveraged portfolio of short-duration Agency Securities remains viable, which could adversely affect earnings and book value per common share.

Failure of the federal government to reduce future annual federal budget deficits could adversely impact Capstead's liquidity, financial condition and earnings. The increasing amount of outstanding federal debt relative to the size of the U.S. economy, particularly in light of projected growth in federal government spending and resulting federal budget deficits, could eventually lead to a decline in the market's perception of the creditworthiness of the federal government. Because market participants rely on the federal government's continued support of Fannie Mae and Freddie Mac, the perception of credit risk associated with Agency Securities and, therefore, the pricing of existing holdings of Agency Securities could be adversely affected. In addition, political discord over U.S. fiscal policy could create broader financial turmoil and uncertainty, which may weigh heavily on the global banking system and limit the availability and/or terms and conditions of secured borrowings which could adversely impact the Company's liquidity, earnings and book value per common share, as more fully described above.

Legislative and additional regulatory actions could adversely affect the availability and/or terms and conditions of secured borrowings and consequently, the Company's liquidity, financial condition and earnings. Changes in regulatory capital requirements and other leverage constraints continue to be implemented worldwide. It remains unclear how significant of an impact these changes will have on the financial markets in general and on the Company's strategy of holding a leveraged portfolio of Agency Securities. However, it is possible that the availability and/or terms and conditions of secured borrowings could be adversely affected which could adversely affect the Company's liquidity, earnings and book value per common share, as more fully described above.

Capstead is dependent on its executives and employees and the loss of one or more of its executive officers could harm the Company's business and its prospects. As a self-managed REIT with 14 employees, Capstead is dependent on the efforts of its key officers and employees, most of whom have significant experience in the mortgage industry. While certain of the Company's named executive officers and other employees are parties to severance agreements, the Company's key officers and employees are not subject to employment agreements with non-compete clauses, nor has Capstead acquired key man life insurance policies on any of these individuals. The loss of any of their services could have an adverse effect on the Company's operations.

Risks Related to Capstead's Status as a REIT and Other Tax Matters

Capstead may be subject to adverse legislative or regulatory tax changes that could reduce the market price of the Company's securities. Federal income tax laws or the administrative interpretations of those laws can change at any time. Any such changes in laws or interpretations thereof may apply retroactively and could adversely affect Capstead or its stockholders. The Company cannot predict any impact on the value of its securities from adverse legislative or regulatory tax changes.

If Capstead does not qualify as a REIT, the Company will be subject to tax as a regular corporation and face substantial tax liability. Capstead has elected to be taxed as a REIT for federal income tax purposes and intends to

continue to so qualify. Qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which only a limited number of judicial or administrative interpretations exist. Even a technical or inadvertent mistake could jeopardize the

Company's REIT status. Furthermore, new tax legislation, administrative guidance or court decisions, in each instance potentially with retroactive effect, could make it more difficult or impossible for the Company to qualify as a REIT.

If Capstead fails to qualify as a REIT in any tax year, then:

- the Company would be taxed as a regular domestic corporation, which, among other things, means that the Company would be unable to deduct dividends paid to its stockholders in computing taxable income and would be subject to federal income tax on its taxable income at regular corporate rates;
- any resulting tax liability could be substantial and would reduce the cash available for distribution to stockholders;
- the Company would not be required to make income distributions; and
- unless Capstead were entitled to relief under applicable statutory provisions, the Company would be disqualified from treatment as a REIT for the subsequent four taxable years and, as a result, the Company's cash available for distribution to stockholders would be reduced during these years.

Even if Capstead remains qualified as a REIT, the Company may face other tax liabilities that reduce its earnings. Even if Capstead remains qualified for taxation as a REIT, the Company may be subject to certain federal, state and local taxes on its income and assets. For example, the Company:

- will be required to pay tax on any undistributed REIT taxable income,
- may be subject to the "alternative minimum tax" on any tax preference items, and
- may operate taxable REIT subsidiaries subject to tax on any taxable income earned.

Complying with REIT requirements may limit Capstead's ability to hedge effectively. The REIT provisions of the Code may limit Capstead's ability to hedge mortgage securities and related borrowings by requiring it to limit its income in each year from unqualified hedges, together with any other income not generated from qualified real estate assets, to no more than 25% of gross income. In addition, the Company must limit its aggregate income from nonqualified hedging transactions, from providing certain services, and from other non-qualifying sources to not more than 5% of annual gross income. As a result, the Company may have to limit its use of advantageous hedging techniques. This could result in greater risks associated with changes in interest rates than the Company would otherwise incur. If the Company were to violate the 25% or 5% limitations, it may have to pay a penalty tax equal to the amount of gross income in excess of those limitations, multiplied by a fraction intended to reflect the profitability of these transactions or activities. If the Company fails to satisfy the REIT gross income tests it could lose its REIT status for federal income tax purposes unless the failure was due to reasonable cause and not due to willful neglect.

Complying with REIT requirements may cause Capstead to forego otherwise attractive opportunities. To qualify as a REIT for federal income tax purposes, Capstead must continually satisfy tests concerning, among other things, the sources of its income, the nature and diversification of its assets, the amounts that it distributes to its stockholders, and the ownership of its stock. The Company may be required to make distributions to stockholders at disadvantageous times or when it does not have funds readily available for distribution. As a result, compliance with the REIT requirements may hinder the Company's ability to operate solely on the basis of maximizing profits.

Complying with REIT requirements may force Capstead to liquidate otherwise attractive investments. To qualify as a REIT, Capstead must also ensure that at the end of each calendar quarter at least 75% of the value of its assets consists of cash, cash items, United States government securities and qualified REIT real

estate assets. The remainder of the Company's investments in securities (other than government securities and qualified 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 the Company's assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 25% of the value of its total securities can be represented by securities of one or more taxable REIT subsidiaries. Beginning in 2018 the threshold for this limitation is reduced to 20%. If the Company fails to comply with these requirements at the end of any calendar quarter, it must correct such failure within 30 days after the end of the calendar quarter to avoid losing its REIT status and suffering adverse tax consequences. As a result, the Company may be required to liquidate otherwise attractive investments.

Complying with REIT requirements may force Capstead to borrow to make distributions to stockholders. As a REIT, Capstead must distribute at least 90% of its annual taxable income (subject to certain adjustments) to its stockholders. To the extent that the Company satisfies the distribution requirement, but distributes less than 100% of its taxable income, the Company will be subject to federal corporate income tax on its undistributed taxable income. In addition, the Company will be subject to a 4% nondeductible excise tax if the actual amount that it pays out to its stockholders in a calendar year is less than a minimum amount specified under the federal tax laws. From time to time, the Company may generate taxable income greater than its net income for financial reporting purposes or its taxable income may be greater than the Company's cash flow available for distribution to stockholders. If the Company does not have other funds available in these situations, it could be required to borrow funds, sell investments at disadvantageous prices or find another alternative source of funds to make distributions sufficient to enable it to pay out enough of its taxable income to satisfy the distribution requirement and to avoid corporate income tax or the 4% excise tax in a particular year. These alternatives could increase the Company's costs and reduce its long-term investment capital.

Distributions payable by Capstead do not qualify for the reduced tax rates applicable to “qualified dividends.” The maximum tax rate applicable to income from non-REIT corporate qualified dividends payable to domestic stockholders that are individuals, trusts or estates is currently 20%. Distributions of ordinary income payable by REITs, however, generally are not eligible for the reduced rates. Although this does not adversely affect the taxation of REITs or distributions payable by REITs, the more favorable rates applicable to regular corporate qualified dividends could cause investors who are individuals, trusts or 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 REIT stocks.

Recognition of excess inclusion income by Capstead could have adverse consequences to its stockholders. If the Company were to modify its investment strategy to invest in Real Estate Mortgage Investment Conduit (“REMIC”) residual interests, or if any of its assets were deemed to be taxable mortgage pools for federal income tax purposes, the Company could recognize “excess inclusion income.” Any such excess inclusion income would be allocated to stockholders in proportion to dividends paid and would not be eligible to be offset by any losses of the stockholders. Further, any such income allocated to stockholders that are tax-exempt entities and not “disqualified organizations,” as described below, would be fully taxable as unrelated business taxable income under Section 512 of the Code. Any stockholders that are foreign persons would be subject to federal income tax at the maximum tax rate and withholding will be required without reduction or exemption pursuant to any otherwise applicable income tax treaties. Finally, to the extent that Capstead stock is owned by disqualified organizations (such as certain government-related entities and tax exempt entities that are not subject to tax on unrelated business income), the Company’s charter provides that, in order to prevent the imposition of a penalty tax on the Company, the Company may redeem or refuse to transfer any of its shares to such disqualified organizations.

An investment in Capstead's securities has various federal, state and local income tax risks that could affect the value of an investor's investment. The Company strongly urges investors to consult their own tax advisor concerning the effects of federal, state and local income tax law on an investment in the Company's securities, because of the complex nature of the tax rules applicable to REITs and their stockholders.

Capstead may in the future choose to pay dividends in its own stock, in which case stockholders may be required to pay tax in excess of the cash they receive. Capstead may distribute taxable dividends that are payable in part in its stock. In accordance with guidance issued by the Internal Revenue Service, a publicly traded REIT should generally be eligible to treat a distribution of its own stock as fulfilling its REIT distribution requirements if each stockholder is permitted to elect to receive his or her distribution in either cash or stock of the REIT (even where there is a limitation on the percentage of the distribution payable in cash, provided that the limitation is at least 20%), subject to the satisfaction of certain guidelines. If too many stockholders elect to receive cash, each stockholder electing to receive cash generally must receive a portion of his or her distribution in cash (with the balance of the distribution paid in stock). If these and certain other requirements are met, for U.S. federal income tax purposes, the amount of the distribution paid in stock generally will be a taxable distribution in an amount equal to the amount of cash that could have been received instead of stock. Taxable stockholders receiving such dividends would be required to include the full amount of the dividend as ordinary income (or as long-term capital gain to the extent such distribution is properly designated as a capital gain dividend) to the extent of the Company's current and accumulated earnings and profits for United States federal income tax purposes. As a result, a U.S. holder (as defined in "Federal Income Tax Consequences of Our Status as a REIT") may be required to pay tax with respect to such dividends in excess of any cash received. If a U.S. holder sells the stock it receives as a dividend in order to pay this tax, it may be subject to transaction fees (e.g., broker fees or transfer agent fees) and the sales proceeds may be less than the amount included in income with respect to the dividend, depending on the market price of its stock at the time of the sale. Furthermore, with respect to Non-U.S. holders (as defined in "Federal Income Tax Consequences of Our Status as a REIT"), the Company may be required to withhold U.S. tax with respect to such dividends, including in respect of all or a portion of such dividend that is payable in stock. In addition, if a significant number of the Company's stockholders determine to sell shares of its stock in order to pay taxes owed on dividends, it may put downward pressure on the trading price of the Company's stock. It is uncertain whether and to what extent the Company will pay dividends in cash and its stock.

Risk Factors Related to Capstead's Corporate Structure

There are no assurances of Capstead's ability to pay dividends in the future. Capstead intends to continue paying quarterly dividends and to make distributions to its stockholders in amounts such that all or substantially all of the Company's taxable income in each year, subject to certain adjustments, is distributed. This, along with other factors, should enable the Company to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. However, the Company's ability to pay dividends may be adversely affected by the risk factors described in this filing. All distributions will be made at the discretion of the Company's board of directors and will depend upon the Company's earnings, its financial condition, maintenance of its REIT status and such other factors as the board may deem relevant from time to time. There are no assurances of the Company's ability to pay dividends in the future.

Failure to maintain an exemption from the Investment Company Act of 1940 would adversely affect Capstead's results of operations. The Investment Company Act of 1940 (the "40 Act") exempts from regulation as an investment company any entity that is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Capstead believes that it conducts its business in a manner that allows the Company to avoid registration as an investment company under the 40 Act. For over 30 years, the staff of the SEC has interpreted the provisions of the 40 Act to require, among other things, a REIT to maintain at least 55% of its assets directly in qualifying real estate interests and at least 80% of its assets in real estate-related assets in order to be exempt from

regulation as an investment company. Critical to the Company's exemption from regulation as an investment company is the long-standing SEC staff interpretation that so-called whole loan mortgage securities, in which an investor holds all issued certificates with respect to an underlying pool of mortgage loans, constitute qualifying real estate interests for purposes of the staff's 55% qualifying real estate interest requirement.

Conversely, so-called partial pool mortgage securities presently do not qualify for purposes of meeting the 55% requirement, although they are considered by the staff to be real estate-related assets for purposes of meeting the staff's 80% real estate-related asset requirement.

In August 2011, the SEC staff issued a request for information (Concept Release No. IC-29778) from industry participants and investors regarding, among other things, its past interpretations of the 40 Act real estate exemption, including the interpretations described above, raising concerns that the SEC may issue a proposal for rulemaking that could overturn some of the staff's past interpretations regarding the real estate exemption. If the SEC or its staff adopts contrary interpretations of the 40 Act and the Company and other similar REITs become subject to regulation as investment companies, the industry's use of leverage would be substantially reduced. Absent a restructuring of the Company's business operations to avoid such regulation, this could require the sale of most of the Company's portfolio of Agency Securities under potentially adverse market conditions resulting in losses and significantly reduce future net interest margins and earnings.

Pursuant to Capstead's charter, its board of directors has the ability to limit ownership of the Company's capital stock, to the extent necessary to preserve its REIT qualification. For the purpose of preserving Capstead's REIT qualification, the Company's charter gives the board the ability to repurchase outstanding shares of capital stock from existing stockholders if the directors determine in good faith that the concentration of ownership by such individuals, directly or indirectly, would cause the Company to fail to qualify or be disqualified as a REIT. Constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed constructively owned by one individual or entity. As a result, the acquisition of outstanding stock by an individual or entity could cause that individual or entity to own constructively a greater concentration of the Company's outstanding stock than is acceptable for REIT purposes, thereby giving the board the ability to repurchase any excess shares.

Because provisions contained in Maryland law and Capstead's charter may have an anti-takeover effect, investors may be prevented from receiving a "control premium" for their shares. Provisions contained in Capstead's charter and Maryland general corporation law can delay, defer or prevent a takeover attempt, which may prevent stockholders from receiving a "control premium" for their shares. For example, these provisions may defer or prevent tender offers for the Company's common stock or purchases of large blocks of the Company's common stock, thereby limiting the opportunities for its stockholders to receive a premium over then-prevailing market prices. These provisions include the following:

- Repurchase rights – Repurchase rights granted to Capstead's board in its charter limit related investors, including, among other things, any voting group, from owning common stock if the concentration owned would jeopardize the Company's REIT status.
- Classification of preferred stock – Capstead's charter authorizes the board to issue preferred stock and establish the preferences and rights of any class of preferred stock issued. These actions can be taken without soliciting stockholder approval and could have the effect of delaying or preventing someone from taking control of the Company.
- Statutory provisions – Capstead is subject to provisions of Maryland statutory law that restrict business combinations with interested stockholders and restrict voting rights of certain shares acquired in control share acquisitions. The board has not taken any action to exempt the Company from these provisions.

- Other Maryland law elections – A provision of Maryland law allows Capstead's board, without stockholder approval, to implement various provisions that may deter stockholder efforts to change the composition of its Board of Directors by, among other things, implementing a staggered board, providing that directors are removable only for cause, requiring that a majority of the outstanding shares request a special meeting of stockholders, and providing directors the exclusive right to fill vacancies on the board. Capstead's board has not taken any action to limit its ability to implement any of these provisions in the future, other than to provide, through an unrelated provision of Maryland law, that imposes a majority requirement for the calling of a special meeting of stockholders.

Maryland statutory law provides that an act of a director relating to or affecting an acquisition or a potential acquisition of control of a corporation may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director. Hence, directors of Maryland corporations may not be required to act in takeover situations under the same standards as apply in Delaware and certain other corporate jurisdictions.

There are risks associated with ownership of Capstead's Series E preferred stock. Risks associated with ownership of the Company's Series E preferred stock include:

- Redemption rights – The Series E preferred stock is redeemable by the Company, in whole or in part, at any time on or after May 13, 2018, or pursuant to a Special Optional Redemption Right upon the occurrence of a Change of Control, as both terms are defined in the Series E Articles Supplementary, at a cash redemption price of $25.00 plus all accrued and unpaid dividends to, but not including, the date of redemption, which may be less than the prevailing market price for shares of the Series E preferred stock.
- Limited conversion rights – Holders of shares of the Series E preferred stock may convert into shares of common stock only upon the occurrence of a Change of Control, and only if the Company does not exercise its Special Optional Redemption Right. Even if this were to occur, it may not be economically advantageous to convert based on then-existing conversion ratios and trading levels of the common stock.
- Subordination – The Series E preferred stock is subordinate to all of the Company's existing and future debt. None of the provisions relating to the Series E preferred stock limit the Company's ability to incur future debt. Future debt may include restrictions on the Company's ability to pay dividends on, redeem, or pay the liquidation preference on shares of the Series E preferred stock.
- Dilution through issuance of additional shares of preferred stock – The Company's charter currently authorizes the issuance of up to 100 million shares of preferred stock in one or more series. The issuance of additional preferred stock on parity with or senior to the Series E preferred stock would dilute the interests of Series E preferred stockholders, and could affect the Company's ability to pay dividends on, redeem, or pay the liquidation preference on, the Series E preferred stock. None of the provisions relating to the Series E preferred stock limit the Company's ability to issue additional preferred stock on parity with Series E preferred stock.
- Limited voting rights – Voting rights as a holder of Series E preferred stock are limited. The Company's common stock is currently the only class of stock carrying full voting rights. Voting rights for holders of shares of Series E preferred stock exist primarily with respect to (i) adverse changes in the terms of the Series E preferred stock, (ii) the creation of additional classes or series of preferred stock that are senior to the Series E preferred stock, and (iii) the non-payment of six quarterly Series E dividends (whether or not consecutive).

Capstead may change its policies without stockholder approval. Capstead's board and management determine all of its policies, including its investment, financing and distribution policies and may amend or revise these policies at any time without a vote of the Company's stockholders. Policy changes could

adversely affect the Company's financial condition, results of operations, the market price of its common and preferred stock or the Company's ability to pay dividends or distributions.

CRITICAL ACCOUNTING POLICIES

Management's discussion and analysis of financial condition and results of operations is based upon Capstead's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that can affect the reported amounts of assets, liabilities (including contingencies), revenues and expenses, as well as related disclosures. These estimates are based on available internal and market information and appropriate valuation methodologies believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the expected useful lives and carrying values of assets and liabilities which can materially affect the determination of net income and book value per common share. Actual results may differ from these estimates under different assumptions or conditions.

Management believes the following are critical accounting policies in the preparation of Capstead's consolidated financial statements that involve the use of estimates requiring considerable judgment:

- Amortization of investment premiums on residential mortgage investments – Investment premiums on residential mortgage investments are recognized in earnings as adjustments to interest income by the interest method over the estimated lives of the related assets. The single largest determinant in amortizing investment premiums is actual portfolio runoff (scheduled and unscheduled principal paydowns) for a given accounting period. This is because the investment premium associated with actual runoff is amortized when the runoff occurs pursuant to the interest method. Amortization is also affected by estimates and judgments related to future levels of mortgage prepayments used in determining additional amortization that may be necessary to achieve the required effective yield over the estimated life of the related investment.

Mortgage prepayment expectations can change based on how current and projected changes in interest rates impact the economic attractiveness of mortgage refinance opportunities, if available, and other factors such as lending industry underwriting practices and capacity constraints, regulatory changes, borrower credit profiles and the health of the economy and housing markets. Management estimates future mortgage prepayments based on these factors and past experiences with specific investments within the portfolio. Should actual prepayment rates differ materially from these estimates, investment premiums would be expensed at a different pace.

- Fair value and impairment accounting for residential mortgage investments – Nearly all of Capstead's residential mortgage investments are held in the form of mortgage securities that are classified as available-for-sale and recorded at fair value on the balance sheet with unrealized gains and losses recorded in Stockholders' equity as a component of Accumulated other comprehensive income. As such, these unrealized gains and losses enter into the calculation of book value per common share, a key financial metric used by investors in evaluating the Company. Fair values fluctuate with current and projected changes in interest rates, prepayment expectations and other factors such as market liquidity conditions and the perceived credit quality of Agency Securities. Judgment is required to interpret market data and develop estimated fair values, particularly in circumstances of deteriorating credit quality and market liquidity. See NOTE 9 to the consolidated financial statements (included under Item 1 of this report) for discussion of how Capstead values its residential mortgage investments.

Generally, gains or losses are recognized in earnings only if securities are sold; however, if a decline in fair value of a mortgage security below its amortized cost occurs that is determined to be other-than-temporary, the difference between amortized cost and fair value would be recognized in earnings as a component of Other revenue (expense) if the decline was credit-related or it was determined to be more likely than not that the Company will incur a loss via an asset sale. Other-than-temporary

impairment of a mortgage security due to other factors would be recognized in Accumulated other comprehensive income.

- Accounting for derivative financial instruments – Capstead uses derivatives for risk management purposes. Derivatives are recorded as assets or liabilities and carried at fair value and consequently, changes in value of these instruments enter into the calculation of book value per common share. Fair values fluctuate with current and projected changes in interest rates and other factors such as the Company's and its counterparties' nonperformance risk. Judgment is required to develop estimated fair values.

The accounting for changes in fair value of each derivative held depends on whether it has been designated as an accounting hedge, as well as the type of hedging relationship identified. To qualify as a cash flow hedge for accounting purposes, at the inception of the hedge relationship the Company must anticipate and document that the hedge relationship will be highly effective. As long as the hedge relationship remains highly effective, changes in fair value of the derivative are recorded in Accumulated other comprehensive income and reclassified to earnings over the term of the derivative, primarily in the form of derivative cash flows that are either in excess of or lower than market rates. Changes in fair value of derivatives not held as accounting hedges, or for which the hedge relationship is deemed to no longer be highly effective and as a result hedge accounting is terminated, are recorded in earnings as a component of Other revenue (expense). See NOTE 2 to the consolidated financial statements (included under Item 1 of this report) for information regarding the Company's early-adoption of ASU 2017-12.

The Company currently uses interest rate swap agreements in hedge relationships accounted for as cash flow hedges in order to hedge variability in borrowing rates due to changes in the underlying benchmark interest rate related to a designated portion of current and anticipated future 30- and 90-day secured borrowings and the 20-year floating-rate periods of unsecured borrowings. Variable-rate payments to be received on swap agreements and any measured hedge ineffectiveness on interest rate swap agreements that expired prior to the early-adoption of ASU 2017-12 are recorded in interest expense as an offset to interest owed on related designated borrowings while fixed-rate swap payments to be made are also recorded in interest expense resulting in an effectively fixed borrowing rate on these borrowings, subject to certain adjustments. See NOTE 6 to the consolidated financial statements (included under Item 1 of this report) and "Financial Condition – Residential Mortgage Investments" for additional information regarding the Company's current use of derivatives and its related risk management policies.

STATEMENT CONCERNING FORWARD-LOOKING STATEMENTS

This document contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements, and may contain the words "believe," "anticipate," "expect," "estimate," "intend," "will be," "will likely continue," "will likely result," or words or phrases of similar meaning. Forward-looking statements are based largely on the expectations of management and are subject to a number of risks and uncertainties including, but not limited to, the following:

- changes in general economic conditions;
- fluctuations in interest rates and levels of mortgage prepayments;
- the effectiveness of risk management strategies;
- the impact of differing levels of leverage employed;
- liquidity of secondary markets and credit markets;
- the availability of financing at reasonable levels and terms to support investing on a leveraged basis;

- the availability of new investment capital;
- the availability of suitable qualifying investments from both an investment return and regulatory perspective;
- changes in market conditions as a result of federal corporate and individual income tax reform, federal government fiscal challenges and Federal Reserve monetary policy, including policy regarding its holdings of Agency and U.S. Treasury Securities;
- deterioration in credit quality and ratings of existing or future issuances of Fannie Mae, Freddie Mac or Ginnie Mae securities;
- changes in legislation or regulation affecting Fannie Mae, Freddie Mac, Ginnie Mae, the Federal Home Loan Bank system and similar federal government agencies and related guarantees;
- changes in legislation or regulation affecting exemptions for mortgage REITs from regulation under the Investment Company Act of 1940;
- other changes in legislation or regulation affecting the mortgage and banking industries; and
- increases in costs and other general competitive factors.

In addition to the above considerations, actual results and liquidity are affected by other risks and uncertainties which could cause actual results to be significantly different from those expressed or implied by any forward-looking statements included herein. It is not possible to identify all of the risks, uncertainties and other factors that may affect future results. In light of these risks and uncertainties, the forward-looking events and circumstances discussed herein may not occur and actual results could differ materially from those anticipated or implied in the forward-looking statements. Forward-looking statements speak only as of the date the statement is made and the Company undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Accordingly, readers of this document are cautioned not to place undue reliance on any forward-looking statements included herein.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE OF MARKET RISKS

The information required by this Item is incorporated by reference to the information included in Item 2. “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

Item 4. Controls and Procedures

As of September 30, 2017, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer (“CEO”) and Principal Accounting Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and Principal Accounting Officer, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2017. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to September 30, 2017.

PART II. — OTHER INFORMATION

ITEM 6. EXHIBITS

Exhibit Number	DESCRIPTION
3.1	Charter, including Articles of Incorporation, Articles Supplementary for each series of preferred shares no longer outstanding and all other amendments to such Articles of Incorporation.(1)
3.2	Articles Supplementary classifying and designating the Registrant's 7.50% Series E Cumulative Redeemable Preferred Stock, liquidation preference $25.00 per share, par value $0.10 per share.(2)
3.3	Amended and Restated Bylaws.(3)
4.1	Specimen of Common Stock Certificate.(4)
4.2	Specimen of stock certificate evidencing the 7.50% Series E Cumulative Redeemable Preferred Stock of the Registrant, liquidation preference $25.00 per share, par value $0.10 per share.(2)
4.3	Junior Subordinated Indenture dated September 26, 2005.(5)
4.4	Indenture dated December 15, 2005.(5)
4.5	Indenture dated September 11, 2006.(5)
10.01	Amended and Restated Deferred Compensation Plan.(5)
10.02	Amended and Restated 2014 Flexible Incentive Plan.(6)
10.03	Amendment No. 1 to the Amended and Restated 2014 Flexible Incentive Plan.(7)
10.04	Second Amended and Restated Incentive Bonus Plan.(8)
10.05	Form of nonqualified stock option and stock award agreements for non-employee directors.(5)
10.06	2015 Long-Term Award Criteria.(9)
10.07	Form of performance unit agreement.(9)
10.08	2016 Annual Incentive Compensation Program.(10)
10.09	Form of restricted stock agreement for employees. (10)
10.10	2016 Long-Term Performance Unit Award Criteria. (10)
10.11	Form of performance unit agreement for employees. (10)
10.12	2017 Annual Incentive Compensation Program.(11)
10.13	Form of restricted stock agreement for executive employees. (11)
10.14	2017 Long-Term Performance Unit Award Criteria. (11)
10.15	Form of performance unit agreement for executive employees. (11)
10.16	Sales agreement, dated January 23, 2015, by and between the Company and its continuous offering program sales manager.(12)
10.17	Severance agreement, dated May 3, 2016, by and between the Company and Roy S. Kim. (13)
10.18	Consulting Agreement, dated July 14, 2016, by and between the Company and Andrew F. Jacobs. (14)
12	Computation of ratio of net income to fixed charges and ratio of net income to combined fixed charges and preferred stock dividends.*
31.1	Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002*
32	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

Exhibit Number	DESCRIPTION
101.INS	XBRL Instance Document*
101.SCH	XBRL Taxonomy Extension Schema*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase*
101.DEF	XBRL Additional Taxonomy Extension Definition Linkbase*
101.LAB	XBRL Taxonomy Extension Label Linkbase*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase*

(1) Incorporated by reference to the Registrant's Annual Report on Form 10-K/A (No. 001-08896) for the year ended December 31, 2012.
(2) Incorporated by reference to the Registrant's Registration of Certain Classes of Securities on Form 8-A (No. 001-08896) dated May 13, 2013.
(3) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on February 3, 2014, for the event dated January 29, 2014.
(4) Incorporated by reference to the Registrant's Registration Statement on Form S-3 (No. 333-63358) dated June 19, 2001.
(5) Incorporated by reference to the Registrant's Annual Report on Form 10-K (No. 001-08896), for the year ended December 31, 2011.
(6) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on May 30, 2014, for the event dated May 28, 2014.
(7) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on February 20, 2015, for the event dated February 20, 2015.
(8) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on May 5, 2011, for the event dated May 4, 2011.
(9) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on January 6, 2015, for the event dated January 2, 2015.
(10) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on February 4, 2016, for the event dated February 1, 2016.
(11) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on January 5, 2017, for the event dated January 3, 2017.
(12) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on January 29, 2015, for the event dated January 23, 2015.
(13) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q (No. 001-08896) for the quarter ended March 31, 2016.
(14) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on July 15, 2016, for the event dated July 14, 2016.

*Filed herewith
**Furnished herewith

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CAPSTEAD MORTGAGE CORPORATION

Registrant

Date: November 3, 2017 By: /s/ PHILLIP A. REINSCH
Phillip A. Reinsch
Chief Executive Officer and
Principal Accounting Officer