CAPSTEAD MORTGAGE CORP
Form 10-Q
August 05, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: June 30, 2013

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**
(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 x NO ¨

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Common Stock ($0.01 par value)	95,761,015 as of August 5, 2013

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CAPSTEAD MORTGAGE CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2013

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ITEM 1. FINANCIAL STATEMENTS

PART I. FINANCIAL INFORMATION

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

	June 30, 2013 (unaudited)	*December 31, 2012*
Assets		
Residential mortgage investments ($13.28 and $13.45 billion pledged under repurchase arrangements at June 30, 2013 and December 31, 2012, respectively)	$ 13,811,497	$ 13,860,158
Cash collateral receivable from interest rate swap counterparties	16,314	49,972
Interest rate swap agreements at fair value	8,396	169
Cash and cash equivalents	207,431	425,445
Receivables and other assets	138,008	130,402
Investments in unconsolidated affiliates	3,117	3,117
	$ 14,184,763	$ 14,469,263
Liabilities		
Repurchase arrangements and similar borrowings	$ 12,624,572	$ 12,784,238
Cash collateral payable to interest rate swap counterparties	750	
Interest rate swap agreements at fair value	11,097	32,868
Unsecured borrowings	103,095	103,095
Common stock dividend payable	30,541	29,512
Accounts payable and accrued expenses	19,290	22,425
	12,789,345	12,972,138
Stockholders equity		
Preferred stock - $0.10 par value; 100,000 shares authorized:		
$1.60 Cumulative Preferred Stock, Series A, -0- and 186 shares issued and outstanding at June 30, 2013 and December 31, 2012, respectively		2,604
$1.26 Cumulative Convertible Preferred Stock, Series B, -0- and 16,493 shares issued and outstanding at June 30, 2013 and December 31, 2012, respectively		186,388
7.50% Cumulative Redeemable Preferred Stock, Series E, 6,800 and -0- shares issued and outstanding ($170,000 aggregate liquidation preference) at June 30, 2013 and December 31, 2012, respectively	164,310	
Common stock - $0.01 par value; 250,000 shares authorized: 95,761 and 96,229 shares issued and outstanding at June 30, 2013 and December 31, 2012, respectively	957	962
Paid-in capital	1,336,738	1,367,199
Accumulated deficit	(353,852)	(353,938)
Accumulated other comprehensive income	247,265	293,910
	1,395,418	1,497,125
	$ 14,184,763	$ 14,469,263

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(unaudited)

	Quarter Ended June 30		Six Months Ended June 30	
	2013	2012	2013	2012
Interest income:				
Residential mortgage investments	$ 51,572	$ 65,787	$ 110,040	$ 131,520
Other	107	176	219	326
	51,679	65,963	110,259	131,846
Interest expense:				
Repurchase arrangements and similar borrowings	(16,749)	(16,451)	(35,217)	(30,554)
Unsecured borrowings	(2,187)	(2,187)	(4,374)	(4,374)
	(18,936)	(18,638)	(39,591)	(34,928)
	32,743	47,325	70,668	96,918
Other revenue (expense):				
Miscellaneous other revenue (expense)	(135)	13	(165)	(156)
Incentive compensation	(123)	(1,295)	(474)	(2,833)
Salaries and benefits	(1,558)	(1,682)	(3,168)	(3,509)
Other general and administrative expense	(1,098)	(1,091)	(2,179)	(2,045)
	(2,914)	(4,055)	(5,986)	(8,543)
Income before equity in earnings of unconsolidated affiliates	29,829	43,270	64,682	88,375
Equity in earnings of unconsolidated affiliates	65	65	130	130
Net income	$ 29,894	$ 43,335	$ 64,812	$ 88,505
Net income available to common stockholders:				
Net income	$ 29,894	$ 43,335	$ 64,812	$ 88,505
Less dividends on preferred shares	(5,867)	(5,268)	(11,137)	(10,481)
Less redemption preference premiums paid	(19,924)		(19,924)	
	$ 4,103	$ 38,067	$ 33,751	$ 78,024
Net income per common share:				
Basic	$ 0.04	$ 0.40	$ 0.35	$ 0.85
Diluted	0.04	0.40	0.35	0.85
Weighted average common shares outstanding:				
Basic	95,126	93,857	95,073	91,653
Diluted	95,397	94,286	95,359	92,073

Cash dividends declared per share:				
Common	$ 0.310	$ 0.400	$ 0.620	$ 0.830
Series A Preferred	0.317	0.400	0.717	0.800
Series B Preferred	0.252	0.315	0.567	0.630
Series E Preferred	0.323		0.323	

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands, unaudited)

	Quarter Ended June 30		*Six Months Ended June 30*	
	2013	*2012*	*2013*	*2012*
Net income	$ 29,894	$ 43,335	$ 64,812	$ 88,505
Other comprehensive income (loss)				
Amounts related to available-for-sale securities:				
Change in net unrealized gains	(68,793)	27,061	(76,498)	67,673
Amounts related to cash flow hedges:				
Change in net unrealized losses	17,524	(15,334)	20,003	(17,085)
Reclassification adjustment for amounts included in net income	4,416	4,830	9,850	9,795
	(46,853)	16,557	(46,645)	60,383
Comprehensive income (loss)	$ (16,959)	$ 59,892	$ 18,167	$ 148,888

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, unaudited)

	Six Months Ended June 30 2013	2012
Operating activities:		
Net income	$ 64,812	$ 88,505
Noncash items:		
Amortization of investment premiums	62,028	40,195
Depreciation and other amortization	86	99
Amortization of equity-based awards	1,078	1,098
Change in measureable hedge ineffectiveness related to interest rate swap agreements designated as cash flow hedges	(146)	(147)
Gain on sales of real estate held for sale		(199)
Net change in receivables, other assets, accounts payable and accrued expenses	(1,162)	(3,582)
Net cash provided by operating activities	126,696	125,969
Investing activities:		
Purchases of residential mortgage investments	(1,833,501)	(2,684,789)
Interest receivable acquired with the purchase of residential mortgage investments	(3,137)	(4,382)
Proceeds from sales of real estate held for sale		1,415
Principal collections on residential mortgage investments, including changes in mortgage securities principal remittance receivable	1,735,407	1,161,850
Net cash used in investing activities	(101,231)	(1,525,906)
Financing activities:		
Proceeds from repurchase arrangements and similar borrowings	70,818,365	62,587,261
Principal payments on repurchase arrangements and similar borrowings	(70,978,025)	(61,210,906)
Decrease (increase) in cash collateral receivable from interest rate swap counterparties	33,658	(7,253)
Increase in cash collateral payable to interest rate swap counterparties	750	
Cash paid to redeem Series A & B preferred shares	(207,033)	
Common share repurchases	(7,292)	
Proceeds from capital raising activities:		
Issuance of preferred shares	164,310	4,479
Issuance of common shares		121,488
Other capital stock transactions	(522)	(419)
Dividends paid	(67,690)	(88,189)
Net cash (used in) provided by financing activities	(243,479)	1,406,461
Net change in cash and cash equivalents	(218,014)	6,524
Cash and cash equivalents at beginning of period	425,445	426,717
Cash and cash equivalents at end of period	$ 207,431	$ 433,241

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2013

(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 or Freddie Mac (together, the GSEs), or by an agency of the federal government, Ginnie Mae. Residential mortgage pass-through securities guaranteed by the GSEs or Ginnie Mae, referred to as Agency Securities, are considered to have limited, if any, credit risk.

NOTE 2 BASIS OF PRESENTATION

Interim Financial Reporting and Reclassifications

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter and six months ended June 30, 2013 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2013. 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, 2012. Certain prior period amounts have been reclassified to conform to the current year presentation. These include reclassification amounts associated with the change in mortgage securities principal remittance receivable for the six months ended June 30, 2012 that in order to properly present this change has been reclassified from operating activities to investing activities in the Statement of Cash Flows. The effect of this correction decreased cash provided by operating activities and cash used in investing activities by $15.8 million for the six months ended June 30, 2012.

Recent Accounting Developments

In December 2011 the FASB issued ASU No. 2011-11, *Disclosures about Offsetting Assets and Liabilities*. In January 2013, the FASB issued ASU No. 2013-01*, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. The Company adopted the requirements of ASU No. 2011-11 as amended by ASU No. 2013-01 with its first quarterly filing in 2013.

In February 2013 the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income* that amended ASU No. 2011-12 and ASU No. 2011-05. The Company adopted the requirements of ASU No. 2013-02 with its first quarterly filing in 2013.

The provisions of these ASUs are all disclosure-related and as such, their adoption by the Company had no effect on its results of operations, financial condition, or cash flows.

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NOTE 3 NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income, after deducting preferred share dividends and adjusting for the impact of unvested stock awards deemed to be participating securities, by the weighted average number of common shares outstanding, calculated excluding unvested stock awards.

Diluted net income per common share is computed by dividing net income available to common stockholders, after adding dividends on convertible preferred shares when such shares are dilutive, by the basic weighted average number of common shares and common share equivalents outstanding, giving effect to equity awards and convertible preferred shares when such awards and shares are dilutive. Prior to their redemption on June 13, 2013, the Series A and B preferred shares were considered dilutive whenever basic net income per common share exceeded each Series dividend divided by the conversion rate applicable for that period. Unvested stock 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 (dollars in thousands, except per share amounts):

	Quarter Ended June 30		*Six Months Ended June 30*	
	2013	*2012*	*2013*	*2012*
Basic net income per common share				
Numerator for basic net income per common share:				
Net income	$ 29,894	$ 43,335	$ 64,812	$ 88,505
Redemption premiums paid on Series A and Series B preferred shares*	(19,924)		(19,924)	
Preferred share dividends	(5,867)	(5,268)	(11,137)	(10,481)
Unvested stock award participation in earnings	(32)	(100)	(64)	(206)
	$ 4,071	$ 37,967	$ 33,687	$ 77,818
Denominator for basic net income per common share:				
Weighted average common shares outstanding	95,616	94,362	95,588	92,171
Average unvested stock awards outstanding	(490)	(505)	(515)	(518)
	95,126	93,857	95,073	91,653
	$ 0.04	$ 0.40	$ 0.35	$ 0.85
Diluted net income per common share				
Numerator for diluted net income per common share:				
Net income available to common stockholders	$ 4,071	$ 37,967	$ 33,687	$ 77,818
Dividends on dilutive convertible preferred shares		74	44	149
	$ 4,071	$ 38,041	$ 33,731	$ 77,967
Denominator for diluted net income per common share:				
Basic weighted average common shares outstanding	95,126	93,857	95,073	91,653
Net effect of dilutive stock and option awards	148	121	134	111
Net effect of dilutive convertible preferred shares	123	308	152	309
	95,397	94,286	95,359	92,073
	$ 0.04	$ 0.40	$ 0.35	$ 0.85

* *The Series A and Series B preferred shares were redeemed on June 13, 2013   See NOTE 9.*

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Potentially dilutive securities excluded from the computation of net income per common share because the effect of inclusion was antidilutive during the indicated periods were as follows (in thousands):

	Quarter Ended June 30		*Six Months Ended June 30*	
	2013	*2012*	*2013*	*2012*
Antidilutive convertible preferred shares*	16,570	16,493	16,570	16,493
Antidilutive equity awards excludable under the treasury stock method:				
Shares issuable under option awards	35	10	35	10
Unvested stock awards		3		3

* *The Series A and Series B preferred shares were redeemed on June 13, 2013 See NOTE 9.*

NOTE 4 RESIDENTIAL MORTGAGE INVESTMENTS

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

	Unpaid Principal Balance	*Investment Premiums*	*Amortized Cost Basis*	*Carrying Amount [(a)]*	*Net WAC [(b)]*	*Average Yield [(b)]*
June 30, 2013						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	$ 2,516	$ 7	$ 2,523	$ 2,526	6.68%	6.20%
ARMs	11,320,526	362,347	11,682,873	11,911,594	2.64	1.51
Ginnie Mae ARMs	1,805,657	60,645	1,866,302	1,887,529	2.63	1.61
	13,128,699	422,999	13,551,698	13,801,649	2.64	1.52
Residential mortgage loans:						
Fixed-rate	2,753	2	2,755	2,755	7.00	5.28
ARMs	4,637	19	4,656	4,656	3.85	3.47
	7,390	21	7,411	7,411	5.02	4.15
Collateral for structured financings	2,397	40	2,437	2,437	8.11	7.36
	$ 13,138,486	$ 423,060	$ 13,561,546	$ 13,811,497	2.64	1.53
December 31, 2012						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	$ 3,194	$ 9	$ 3,203	$ 3,208	6.70%	6.47%
ARMs	11,547,954	356,646	11,904,600	12,198,922	2.69	1.72
Ginnie Mae ARMs	1,566,749	48,248	1,614,997	1,647,119	2.77	1.95
	13,117,897	404,903	13,522,800	13,849,249	2.70	1.75
Residential mortgage loans:						
Fixed-rate	3,007	5	3,012	3,012	7.01	6.15

ARMs	5,031	20	5,051	5,051	3.87	3.85
	8,038	25	8,063	8,063	5.04	4.71
Collateral for structured financings	2,799	47	2,846	2,846	8.12	7.57
	$ 13,128,734	$ 404,975	$ 13,533,709	$ 13,860,158	2.71	1.76

(a) *Includes unrealized gains and losses for residential mortgage investments classified as available-for-sale (see NOTE 10).*

(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.*

Because of federal government support for the GSEs, Agency Securities are considered to have limited, if any, credit risk. Residential mortgage loans held by the Company were originated prior to 1995 when Capstead 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 292 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 either (i) adjust annually based on specified margins over the one-year Constant Maturity U.S. Treasury Note Rate (CMT) or the one-year London interbank offered rate (LIBOR), (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 securities based on each security s 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. Current-reset ARM securities have months to roll of less than 18 months while longer-to-reset ARM securities have months to roll of 18 months or greater. As of June 30, 2013, the average months to roll for the Company s $7.58 billion (amortized cost basis) in current-reset ARM securities was 5.7 months while the average months-to-roll for the Company s $5.97 billion (amortized cost basis) in longer-to-reset ARM securities was 42.2 months.

NOTE 5 INVESTMENTS IN UNCONSOLIDATED AFFILIATES

To facilitate the issuance of *Unsecured borrowings*, Capstead formed and capitalized three Delaware statutory trusts through the issuance to the Company of the trusts common securities totaling $3.1 million (see NOTE 8). The Company s equity in the earnings of the trusts consists solely of the common trust securities pro rata share in interest accruing on *Unsecured borrowings* issued to the trusts. Under variable interest accounting rules, the trusts are not considered variable interests at risk and as such are not consolidated.

NOTE 6 REPURCHASE ARRANGEMENTS AND SIMILAR BORROWINGS

Capstead generally pledges its *Residential mortgage investments* as collateral under repurchase arrangements with commercial banks and other financial institutions, referred to as counterparties, the terms and conditions of which are negotiated on a transaction-by-transaction basis when each borrowing is initiated or renewed. Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date, typically with terms of 30 to 90 days, and are accounted for as financings. The Company maintains the beneficial interest in the specific securities pledged during the term of the repurchase arrangement and receives the related principal and interest payments. The amount borrowed is generally equal to the fair value of the assets pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a haircut. Interest rates on these borrowings are fixed based on prevailing rates corresponding to the terms of the borrowings, and interest is paid at the termination of the repurchase arrangement at which time the Company may enter into a new repurchase arrangement at prevailing market rates with the same counterparty or repay that counterparty and negotiate financing with a different counterparty. None of the Company s counterparties are obligated to renew or otherwise enter into new repurchase arrangements at the conclusion of existing repurchase arrangements. 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, lenders typically require the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, referred to as margin calls.

Repurchase arrangements and similar 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 date were as follows (dollars in thousands):

Collateral Type	*Collateral Carrying Amount*	*Accrued Interest Receivable*	*Borrowings Outstanding*	*Average Borrowing Rates*
As of June 30, 2013:				
Borrowings with maturities of 30 days or less:				
Agency Securities	$ 13,230,844	$ 28,866	$ 12,583,045	0.37%
Borrowings with maturities greater than 30 days:				
Agency Securities (31 to 90 days)	42,266	50	39,090	0.45
Similar borrowings:				
Collateral for structured financings*	2,437		2,437	8.11
	$ 13,275,547	$ 28,916	$ 12,624,572	0.37
Quarter-end borrowing rates adjusted for effects of related derivative financial instruments (Derivatives) held as cash flow hedges (see NOTE 7)				0.50
As of December 31, 2012:				
Borrowings with maturities of 30 days or less:				
Agency Securities	$ 13,406,253	$ 32,807	$ 12,739,872	0.47%
Borrowings with maturities greater than 30 days:				
Agency Securities (31 to 90 days)	44,060	51	41,520	0.57
Similar borrowings:				
Collateral for structured financings*	2,846		2,846	8.12
	$ 13,453,159	$ 32,858	$ 12,784,238	0.47
Quarter-end borrowing rates adjusted for effects of related Derivatives held as cash flow hedges				0.65

* *The maturity of structured financings is directly affected by prepayments on the related mortgage pass-through securities pledged as collateral and these financings are subject to redemption by the residual bondholders.*

Average borrowings outstanding during the indicated quarters varied from borrowings outstanding at the indicated balance sheet dates due to differences in the timing and amount of portfolio acquisitions relative to portfolio runoff as illustrated below (dollars in thousands):

	Quarter Ended			
	June 30, 2013		*December 31, 2012*	
	Average Borrowings	*Average Rate*	*Average Borrowings*	*Average Rate*
	$ 12,670,277	0.53%	$ 13,228,535	0.63%

Average borrowings and rates for the indicated quarters, adjusted for the effects
of related Derivatives held as cash flow hedges

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NOTE 7 USE OF DERIVATIVE FINANCIAL INSTRUMENTS, OFFSETTING DISCLOSURES AND CHANGES IN OTHER COMPREHENSIVE INCOME BY COMPONENT

To help mitigate exposure to higher interest rates, Capstead typically uses currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that require interest payments for two-year terms. 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 borrowings under repurchase arrangements. This hedge relationship establishes a relatively stable fixed rate on related borrowings because the variable-rate payments received on the swap agreements largely offset interest accruing on the related borrowings, leaving the fixed-rate payments to be paid on the swap agreements as the Company s effective borrowing rate, subject to certain adjustments including the effects of measured hedge ineffectiveness and changes in spreads between variable rates on the swap agreements and actual borrowing rates. Additionally, changes in fair value of these Derivatives tend to at least partially offset opposing changes in fair value of the Company s residential mortgage investments that can occur in response to changes in market interest rates.

During the quarter and six months ended June 30, 2013 Capstead entered into new forward-starting swap agreements with notional amounts of $1.10 billion and $1.90 billion, respectively. These swap agreements require fixed rate interest payments averaging 0.46% and 0.47%, respectively, for two-year periods that commence on various dates between December 2013 and April 2014. Swap agreements with notional amounts totaling $700 million and $1.80 billion requiring fixed rate interest payments averaging 0.96% and 0.87%, respectively, expired during the quarter and six months ended June 30, 2013. At June 30, 2013, 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*
Currently-paying contracts:		
Third quarter 2013	$ 300,000	0.87%
Fourth quarter 2013	800,000	0.78
First quarter 2014	200,000	0.60
Second quarter 2014	400,000	0.51
Third quarter 2014	200,000	0.51
Fourth quarter 2014	500,000	0.58
First quarter 2015	1,100,000	0.50
Second quarter 2015	200,000	0.43
(average expiration: 12 months)	3,700,000	0.61
Forward-starting contracts:		
Third quarter 2015	400,000	0.47
Fourth quarter 2015	1,200,000	0.45
First quarter 2016	1,000,000	0.47
Second quarter 2016	400,000	0.45
(average expiration: 29 months)	3,000,000	0.46
(average expiration: 20 months)	$ 6,700,000	

In addition to portfolio financing-related swap positions, in 2010 the Company entered into three forward-starting three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements with notional amounts totaling $100 million, average fixed rates of 4.09% that begin in 2015 and 2016, and 20-year payment terms coinciding with the floating-rate terms of the Company s *Unsecured borrowings*. These Derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate associated with the floating-rate terms of these long-term borrowings (see NOTE 8).

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Interest rate swap agreements are measured at fair value on a recurring basis primarily using Level Two Inputs in accordance with Fair Value Measurements and Disclosures (ASC 820). In determining fair value estimates for these Derivatives, the Company 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 the fair value of these Derivatives. 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 of these agreements.

The following tables include fair value and other related disclosures regarding all Derivatives held as of and for the indicated periods (in thousands):

	Balance Sheet Location	*June 30, 2013*	*December 31, 2012*
Balance sheet-related			
Interest rate swap agreements in a gain position (an asset) related to borrowings under repurchase arrangements	*(a)*	$ 8,396	$ 169
Interest rate swap agreements in a loss position (a liability) related to:			
Borrowings under repurchase arrangements	*(a)*	(8,284)	(18,671)
Unsecured borrowings	*(a)*	(2,813)	(14,197)
Related net interest payable	*(b)*	(6,056)	(7,788)
		$ (8,757)	$ (40,487)

(a) The fair value of Derivatives with realized and unrealized gains are aggregated and recorded as an asset on the face of the Balance Sheet separately from the fair value of Derivatives with realized and unrealized losses that are recorded as a liability. The amount of unrealized losses at June 30, 2013 scheduled to be recognized in the Statement of Income over the next twelve months primarily in the form of fixed-rate swap payments in excess of current market rates totaled $10.5 million.

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

	Location of Gain or (Loss) Recognized in Net Income	*Quarter Ended June 30*		*Six Months Ended June 30*	
		2013	*2012*	*2013*	*2012*
Income statement-related					
Components of effect on interest expense:					
Amount of loss reclassified from *Accumulated other comprehensive income* related to the effective portion of active positions		$ (4,416)	$ (4,830)	$ (9,850)	$ (9,795)
Amount of gain (loss) recognized (ineffective portion)		(24)	(448)	96	(307)
Increase in interest expense and decrease in *Net income* as a result of the use of Derivatives	*(a)*	$ (4,440)	$ (5,278)	$ (9,754)	$ (10,102)
Other comprehensive income-related					
Amount of gain (loss) recognized in *Other comprehensive income (loss)* (effective portion)		$ 17,524	$ (15,334)	$ 20,003	$ (17,085)

(a) Included in Interest expense: Repurchase arrangements and similar borrowings on the face of the Statement of Income.

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

	Offsetting of Derivative Assets					
				Gross Amounts Not Offset in the Balance Sheet		
	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets Presented in the Balance Sheet	Financial Instruments	Cash Collateral Received	Net Amount
As of June 30, 2013:						
Counterparty 1	$ 3,536	$	$ 3,536	$ (3,536)	$	$
Counterparty 2	4,860		4,860	(4,860)		