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DOWNEY FINANCIAL CORP  
Form 8-K  
October 16, 2001

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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 8-K

CURRENT REPORT

PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

DATE OF REPORT (DATE OF EARLIEST EVENT REPORTED): OCTOBER 16, 2001

DOWNEY FINANCIAL CORP.

(Exact name of registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction of  
incorporation or organization)

33-0633413  
(I.R.S. employer  
identification number)

COMMISSION FILE NUMBER: 1-13578

3501 JAMBOREE ROAD  
NEWPORT BEACH, CALIFORNIA 92660  
(Address of principal executive offices and zip code)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (949)854-0300

ITEM 5. OTHER EVENTS.

On October 16, 2001, Downey Financial Corp. issued a press release reporting its results of operations during the three and nine months ended September 30, 2001.

ITEM 7. FINANCIAL STATEMENTS AND EXHIBITS.

(c) Exhibits

99.1 Press release dated October 16, 2001 reporting results of operations during the three and nine months ended September 30, 2001.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the

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undersigned hereunto duly authorized.

DOWNEY FINANCIAL CORP.

Date: October 16, 2001

By /s/ Thomas E. Prince

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Thomas E. Prince  
Executive Vice President and  
Chief Financial Officer

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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 June 30, 2017, this plan had 3,726,459 shares of common stock remaining available for future issuances.

### Short-term Incentive Compensation Programs

Under the provisions of Capstead's annual incentive compensation program, each participating executive has an overall target award opportunity equal 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 June 30, 2017 are annual incentive compensation accruals for participating executives, together with discretionary accruals for all other employees, totaling \$818,000. Recognized in Compensation-related expense are \$321,000 and \$818,000 related to annual incentive compensation for all employees for the quarter and six months ended June 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 second quarter 2017 DERs distribution amounts totaling \$110,000 that were paid in July 2017. Recognized in Compensation-related expense are \$110,000 and \$220,000 related to the DERs program for the quarter and six months ended June 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 Chief Executive Officer ("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. Recognized in Compensation-related expense are \$311,000 and \$623,000 related to outstanding RSUs for the quarter and six months ended June 30, 2017, respectively. Included in Common stock dividends payable at June 30, 2017 are estimated dividends payable pertaining to these awards of \$373,000.

#### 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 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, respectively, assuming service conditions are met. Included in Common Stock dividends payable at June 30, 2017 are dividends payable pertaining to these awards of \$89,000.

In January of 2017 and 2016 and December of 2014, respectively, the Committee granted 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, respectively, 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 2016, director common stock awards for a total of 41,881 shares with a grant date fair value of \$10.03 per share were granted that vested on July 15, 2017.

Performance-based and service-based stock award activity for the six months ended June 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	123,862	10.41
Forfeitures	(24,881 )	9.32
Vestings	(97,840 )	11.91
Unvested stock awards outstanding at June 30, 2017	306,708	9.90

During the quarter and six months ended June 30, 2017, the Company recognized in Compensation-related expense \$220,000 and \$440,000, 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 \$105,000 and \$210,000 related to amortization of the grant date fair value of director stock awards during the quarter and six months ended June 30, 2017, respectively. Unrecognized compensation expense for unvested stock awards for all employees and directors totaled \$1.7 million as of June 30, 2017, to be expensed over a weighted average period of 1.5 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 June 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 six months ended June 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 six months ended June 30, 2017, the Company recognized in Compensation-related expense \$57,000 and \$88,000 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 \$1.34 billion at June 30, 2017, consisting of \$1.04 billion of common and \$209 million of preferred stockholders' equity, together with \$98 million of unsecured borrowings maturing in 2035 and 2036 (recorded amounts).

Capstead's residential mortgage investments portfolio increased \$283 million during the first half of 2017 to \$13.60 billion at June 30, 2017. Secured borrowings increased \$309 million to \$12.45 billion. Portfolio leverage (secured borrowings divided by long-term investment capital) increased to 9.27 to one at June 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 \$18 million and \$40 million or \$0.14 and \$0.34 per diluted common share for the quarter and six months ended June 30, 2017, compared to \$22 million and \$49 million or \$0.19 and \$0.43 per diluted common share for the same periods in 2016, respectively. Earnings in 2017 were lower because of higher 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. The Company declared a second quarter 2017 common dividend of \$0.21 per share that was paid on July 20, 2017 to holders of record on June 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.

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### Capital Market Transactions

During the quarter and six months ended June 30, 2017, Capstead issued 385,000 and 398,000 shares of its 7.50% Series E Cumulative Redeemable Preferred Stock through an at-the-market continuous offering program at average prices of \$24.69 and \$24.68, net of underwriting fees and other costs, for net proceeds of \$9.5 million and \$9.8 million. No additional preferred shares were issued subsequent to quarter-end through August 4, 2017.

In April 2017 the Company suspended an unused \$100 million common stock repurchase program. Future repurchases or issuances of common and Series E preferred capital will be subject to market conditions, 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 (total stockholders' equity, less liquidation preferences for outstanding shares of preferred stock, divided by outstanding shares 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 six months ended June 30, 2017:

	Quarter Ended June 30, 2017	Six Months Ended June 30, 2017
Book value per common share, beginning of period	\$10.98	\$10.85
Change in net unrealized gains on mortgage		
securities classified as available-for-sale	(0.12 )	(0.08 )
Change in net unrealized gains and losses on interest rate		

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swap agreements designated as cash flow hedges of:				
Secured borrowings	(0.05 )		0.04	
Unsecured borrowings	(0.02 )		(0.01 )	
	(0.19 )	(1.8)%	(0.05 )	(0.5)%
Dividend distributions in excess of earnings	(0.07 )	(0.6)%	(0.08 )	(0.7)%
Book value per common share, end of period	\$10.72		\$10.72	
Decrease in book value per common share during the				
indicated periods	\$ (0.26 )	(2.4)%	\$ (0.13 )	(1.2)%

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## Residential Mortgage Investments

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

	Quarter Ended June 30, 2017	Six Months Ended June 30, 2017
Residential mortgage investments, beginning of period	\$13,413,624	\$13,316,282
Portfolio acquisitions (principal amount)	1,200,802	2,203,741
Investment premiums on acquisitions*	38,545	72,166
Portfolio runoff (principal amount)	(1,009,000 )	(1,921,829 )
Investment premium amortization	(33,661 )	(64,046 )
Decrease in net unrealized gains on securities classified as available-for-sale	(11,420 )	(7,424 )
Residential mortgage investments, end of period	\$13,598,890	\$13,598,890
Increase in residential mortgage investments during the indicated periods	\$185,266	\$282,608

\*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 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 June 30, 2017 (dollars in thousands):

ARM Type	Amortized Cost Basis (a)	Net WAC (b)	Fully		Average Net Margins (b)	Average Periodic Caps (b)	Average Lifetime Caps (b)	Months To Roll
			Indexed	WAC				
				(b)				
<b>Current-reset ARMs:</b>								
Fannie Mae Agency Securities	\$3,919,238	3.01 %	3.27 %		1.70 %	2.83 %	9.54 %	5.9
Freddie Mac Agency Securities	1,494,507	3.09	3.44		1.81	2.44	9.51	6.7
Ginnie Mae Agency Securities	1,614,091	2.31	2.75		1.51	1.07	8.27	6.3
Residential mortgage loans	1,657	3.81	3.38		2.07	1.65	11.03	5.0
(52% of total)	7,029,493	2.87	3.19		1.68	2.34	9.24	6.2
<b>Longer-to-reset ARMs:</b>								
Fannie Mae Agency Securities	3,297,436	2.71	3.36		1.63	3.30	7.71	43.7
Freddie Mac Agency Securities	2,085,889	2.72	3.39		1.65	2.80	7.79	40.5
Ginnie Mae Agency Securities	1,085,272	3.01	2.74		1.51	1.01	8.02	42.1
(48% of total)	6,468,597	2.76	3.27		1.61	2.75	7.79	42.4
	\$13,498,090	2.82	3.23		1.65	2.54	8.54	23.5
Gross WAC (rate paid by								
borrowers) (c)		3.41						

(a) Amortized cost basis represents the Company’s investment (unpaid principal balance plus unamortized investment premiums) before unrealized gains and losses. At June 30, 2017, the ratio of amortized cost basis to unpaid principal balance for the Company’s ARM holdings was 103.16. This table excludes \$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, 80% of current-reset ARMs were subject to periodic caps averaging 1.75%; 13% were subject to initial caps averaging 3.33%; and 7% were subject to lifetime caps averaging 7.27%. All longer-to-reset ARM securities at June 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 June 30, 2017 approximately 91%, 6% and 3% of the Company's ARM securities were backed by mortgage loans that reset annually, semi-annually and monthly, respectively. Approximately 87% 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 June 30, 2017 approximately 8% of the Company's ARM securities were backed by interest-only loans, with remaining interest-only payment periods averaging 23 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 June 30, 2017. After considering haircuts and related interest receivable on the collateral, as well as interest payable on these borrowings, the Company had \$665 million of capital at risk with its lending counterparties at June 30, 2017. The Company did not have capital at risk with any single counterparty exceeding 4.3% of total stockholders' equity at June 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 June 30, 2017 the Company's secured borrowings totaled \$12.45 billion with 22 counterparties at average rates of 1.30%, before the effects of currently-paying interest rate swap agreements held as cash flow hedges and 1.23% 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. At quarter-end the Company held \$8.60 billion notional amount of portfolio financing-related interest rate swap agreements with contract expirations occurring at various dates through the first quarter of 2020 and a weighted average expiration of 14 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 June 30, 2017 of 11¼ and 9¼ months, respectively, for a net duration gap of approximately 2 months – see pages 33 and 34 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.

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## 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 June 30, 2017 in comparison with December 31, 2016 (in thousands):

	Investments (a)	Secured Borrowings	Capital Employed	Potential Liquidity (b)	Portfolio Leverage
Balances as of June 30, 2017:					
Residential mortgage investments	\$ 13,598,890	\$ 12,454,183	\$ 1,144,707	\$ 528,808	
Cash collateral receivable from swap counterparties, net (c)			25,201	–	
Other assets, net of other liabilities			173,815	59,226	
			\$ 1,343,723	\$ 588,034	9.27:1
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. Potential liquidity at June 30, 2017 was approximately 5% lower than at December 31, 2016 primarily due to portfolio growth, higher mortgage securities

principal remittance receivables as a result of higher mortgage prepayment levels, and capital deployed to support swap positions.

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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			
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Total financing spreads: <sup>(a)</sup>								
Yields on all interest-earning assets	1.65 %	1.67 %	1.49 %	1.45 %	1.53 %	1.69 %	1.62 %	1.40 %
Borrowing rates on all interest-paying liabilities	1.13	0.99	0.94	0.89	0.89	0.87	0.79	0.74
Total financing spreads	0.52	0.68	0.55	0.56	0.64	0.82	0.83	0.66
Financing spreads on residential mortgage investments, a non-GAAP financial measure:								
Cash yields on residential mortgage investments <sup>(b)</sup>	2.66	2.60	2.55	2.52	2.50	2.47	2.44	2.42
Investment premium amortization <sup>(b)</sup>	(1.00)	(0.93)	(1.05)	(1.06)	(0.96)	(0.75)	(0.81)	(0.99)
Yields on residential mortgage investments	1.66	1.67	1.50	1.46	1.54	1.72	1.63	1.43
Unhedged secured borrowing rates <sup>(c)</sup>	1.09	0.89	0.79	0.69	0.67	0.65	0.48	0.45
Hedged secured borrowing rates <sup>(c)</sup>	1.08	0.96	0.95	0.93	0.96	0.93	0.87	0.84
Secured borrowing rates	1.08	0.93	0.89	0.84	0.84	0.82	0.73	0.69
Financing spreads on residential mortgage investments	0.58	0.74	0.61	0.62	0.70	0.90	0.90	0.74
Constant prepayment rate ("CPR")	24.69	22.93	25.59	25.80	23.19	18.23	19.62	23.21

- (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 1.02% and 0.89% for the second and first quarters of 2017, respectively, while the variable-rate payment adjustments equated to 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 increased five basis points during the first half of 2017 to 1.74% after increasing 51 basis points during 2016. Much of the increase in 2016 can be attributed to increased expectations for 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. Average mortgage prepayment levels increased 7.7% in the second quarter of 2017 compared to the first quarter of 2017, 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. This can create refinancing opportunities, particularly for borrowers whose loans have recently reset to higher levels.

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 mid-December 2016, mid-March and, to a lesser extent, mid-June 2017. Fixed swap rates increased throughout 2016 and thus far in 2017 as older, lower-rate swap agreements expired and new, 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 benefitted 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		
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Total financing spreads	0.52%	0.68%	0.55%	0.56%	0.64%	0.82%	0.83%	0.66%
Impact of yields on other								
interest-earning assets*	0.01	–	0.01	0.01	0.01	0.03	0.01	0.03
Impact of borrowing rates on								
other interest-paying liabilities*	0.05	0.06	0.05	0.05	0.05	0.05	0.06	0.05
Financing spreads on residential								
mortgage investments	0.58	0.74	0.61	0.62	0.70	0.90	0.90	0.74

Six Months  
Ended

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	June 30	
	2017	2016
Total financing spreads	0.60%	0.73%
Impact of yields on other interest-earning assets*	0.01	0.02
Impact of borrowing rates on other interest-paying liabilities*	0.05	0.05
Financing spreads on residential mortgage investments	0.66	0.80

\*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 7.74% and 7.71% for the second and first quarters of 2017, respectively) and, at times, cash collateral payable to interest rate swap counterparties.

## RESULTS OF OPERATIONS

	Quarter Ended		Six Months Ended	
	June 30		June 30	
	2017	2016	2017	2016
Income statement data: (in thousands, except per share data)				
Interest income on residential mortgage investments (before investment premium amortization)	\$89,764	\$86,361	\$174,990	\$171,872
Investment premium amortization	(33,661)	(33,052)	(64,046)	(59,063)
Related interest expense	(33,850)	(27,014)	(62,090)	(53,596)
	22,253	26,295	48,854	59,213
Other interest income (expense)	(1,662)	(1,848)	(3,400)	(3,633)
	20,591	24,447	45,454	55,580
Other revenue (expense):				
Compensation-related expense	(1,833)	(2,042)	(2,948)	(5,266)
Other general and administrative expense	(1,276)	(1,157)	(2,338)	(2,326)
Miscellaneous other revenue	67	382	82	995
	(3,042)	(2,817)	(5,204)	(6,597)
Net income	\$17,549	\$21,630	\$40,250	\$48,983
Net income per diluted common share	\$0.14	\$0.19	\$0.34	\$0.43
Average diluted shares outstanding	95,916	95,786	95,895	95,766
Key operating statistics: (dollars in millions)				
Average yields:				
Residential mortgage investments:				
Cash yields	2.66	% 2.50	% 2.63	% 2.48
Investment premium amortization	(1.00)	) (0.96)	) (0.96)	) (0.85)
Adjusted yields	1.66	1.54	1.67	1.63
Other interest-earning assets	0.76	0.42	0.65	0.34
Total average yields	1.65	1.53	1.66	1.61
Average borrowing rates:				
Secured borrowings:				
Unhedged borrowing rates	1.09	0.67	0.99	0.66
Hedged borrowing rates	1.08	0.96	1.02	0.95
Adjusted portfolio-related borrowing rates	1.08	0.84	1.01	0.83
Unsecured borrowings	7.74	8.07	7.73	8.07
Total average borrowing rates	1.13	0.89	1.06	0.88
Average total financing spreads	0.52	0.64	0.60	0.73
Average financing spreads on residential mortgage investments, a non-GAAP financial measure*	0.58	0.70	0.66	0.80
Average CPR	24.69	23.19	23.81	20.71
Average balance information:				
Residential mortgage investments (cost basis)	\$13,502	\$13,838	\$13,303	\$13,835
Other interest-earning assets	125	122	119	190
Secured borrowings	12,503	12,866	12,296	12,955
Unsecured borrowings (included in long-term	98	98	98	98

investment capital)							
Long-term investment capital ("LTIC")	1,359		1,388		1,360		1,393
Operating costs as a percentage of average LTIC	0.92	%	0.93	%	0.78	%	1.10
Return on average LTIC	5.74		6.84		6.53		7.64
Return on average common equity capital	5.13		6.55		6.15		7.57

\*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 29 for a reconciliation of these financial measures and the Company's rationale for using this non-GAAP financial measure.

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Capstead's net income totaled \$18 million and \$40 million or \$0.14 and \$0.34 per diluted common share for the quarter and six months ended June 30, 2017, respectively, compared to \$22 million and \$49 million or \$0.19 and \$0.43 per diluted common share for the same periods in 2016. Earnings in 2017 have been negatively impacted by higher investment premium amortization caused by higher mortgage prepayment levels and higher borrowing costs.

Interest income on residential mortgage investments was higher by \$2.8 million for the quarter ended June 30, 2017 and lower by \$1.9 million for the six months ended June 30, 2017, compared to the same periods in 2016. The increase for the quarter ended June 30, 2017 over the comparative period in 2016 is attributable to a \$4.1 million increase related to higher average yields, net of a \$1.3 million decrease related to lower average portfolio balances. The decrease for the six months ended June 30, 2017 over the comparative period in 2016 is attributable to a \$4.4 million decrease related to lower average portfolio balances, net of a \$2.5 million increase related to higher average yields.

Interest expense on secured borrowings was higher by \$6.8 million and \$8.5 million for the quarter and six months ended June 30, 2017, respectively, compared to the same periods in 2016. The increases are attributable to \$7.6 million and \$11.3 million increases related to higher average borrowing rates, net of \$800,000 and \$2.8 million decreases related to lower average borrowings for the comparative quarter and six month periods, respectively.

Total financing spreads were lower, averaging 0.52% and 0.60% for the quarter and six months ended June 30, 2017, compared to 0.64% and 0.73% for the same periods in 2016 as higher cash yields and rates on overnight investments were offset by higher investment premium amortization and higher secured borrowing rates. Financing spreads on residential mortgage investments were lower, averaging 0.58% and 0.66% for the quarter and six months ended June 30, 2017, compared to 0.70% and 0.80% for the same periods in 2016 as higher cash yields were offset by higher investment premium amortization and higher secured borrowing rates. Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on residential mortgage investments, net of secured borrowing rates adjusted for currently-paying interest rate swap agreements held for hedging purposes. See page 29 for the Company's rationale for using this non-GAAP financial measure and a reconciliation to total financing spreads.

Yields on residential mortgage investments were higher, averaging 1.66% and 1.67% during the quarter and six months ended June 30, 2017, compared to 1.54% and 1.63% for the same periods in 2016. Cash yields were higher, averaging 2.66% and 2.63% during the quarter and six months ended June 30, 2017, compared to 2.50% and 2.48% for the same periods in 2016, largely due to ARM loan coupon interest rates resetting higher to more current rates. Yield adjustments for investment premium amortization were also higher, averaging 100 and 96 basis points during the quarter and six months ended June 30, 2017, compared to 96 and 85 basis points for the same periods in 2016 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 were higher, averaging 1.08% and 1.01% during the quarter and six months ended June 30, 2017, respectively, compared to 0.84% and 0.83% for the same periods in 2016. 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 mid-December 2016, mid-March and, to a lesser extent, mid-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 102 and 96 basis points for the quarter and six months ended June 30, 2017, respectively, compared to 73 and 71 basis points for the same periods in 2016. Variable-rate payment adjustments equated to six basis points on average currently-paying swap notional



amounts outstanding for both the quarter and six months ended June 30, 2017, compared to 23 and 24 basis points, respectively, for the same periods in 2016. Currently-paying swap balances were higher, averaging \$8.58 billion and \$8.21 billion for the quarter and six months ended June 30, 2017, respectively, compared to \$7.45 billion and \$7.50 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. 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 six months ended June 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 June 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 \$12.45 billion at June 30, 2017, with all but \$2 million

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maturing within 90 days. Secured borrowings began the year at \$12.15 billion and averaged \$12.50 billion and \$12.30 billion during the quarter and six months ended June 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. At June 30, 2017 the Company held \$8.60 billion notional amount of portfolio financing-related interest rate swap agreements with contract expirations occurring at various dates through the first quarter of 2020 and a weighted average expiration of 14 months. Relative to the 20-year floating rate terms of the Company's \$100 million face amount of unsecured borrowings, the Company entered into forward-starting swap agreements to effectively lock in lower 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 six months ended June 30, 2017, Capstead issued an additional 385,000 and 398,000 shares of its 7.50% Series E Cumulative Redeemable Preferred Stock through an at-the-market continuous offering program at average prices of \$24.69 and \$24.68, net of underwriting fees and other costs, for net proceeds of \$9.5 million and \$9.8 million. No additional preferred shares were issued subsequent to quarter-end through August 4, 2017.

In April 2017 the Company suspended an unused \$100 million common stock repurchase program. Future repurchases or issuances of common and Series E preferred capital will be subject to market conditions, 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 June 30, 2017 the Company's residential mortgage investments and secured borrowings had estimated durations of 11¼ and 9¼ months, for a net duration gap of approximately 2 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. Given the present low level of interest rates, a floor of 0.00% is assumed. However, 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	10-year U.S.			
	Funds	Treasury	Down	Up	Up
	Rate	Rate	0.50%	0.50%	1.00%
Projected 12-month percentage change					
in net interest margins: <sup>(a)(b)</sup>					
June 30, 2017	1.00-1.25 %	2.31	% (6.9 )%	(3.4 )%	(13.3 )%
December 31, 2016	0.50-0.75	2.45	(9.5 )	(0.2 )	(5.8 )
Projected percentage change in portfolio					
and related derivative values: <sup>(a)</sup>					
June 30, 2017	1.00-1.25	2.31	–	(0.2 )	(0.5 )
December 31, 2016	0.50-0.75	2.45	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 increase in sensitivity in the Up 0.50% and 1.00% scenarios at June 30, 2017 compared to December 31, 2016 is in large part due to 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.

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## 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 effective portion of 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

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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 the purchase of U.S. Treasury securities and fixed-rate Agency Securities. This expansion of the Federal Reserve's balance sheet 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 buying additional Treasury and Agency Securities in late 2014, while continuing to replace portfolio runoff and has indicated that it intends to eventually curtail replacing portfolio runoff when economic conditions allow.

In general, QE has 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.

With the Federal Reserve concluding its bond buying program and eventually allowing its existing holdings to begin running off, pricing for ARM Agency securities could be negatively affected as the buy-side support of such a large market participant is removed. 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

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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. In 2010 the U.S. Congress enacted the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") in order to restrict certain business practices of systemically significant participants in the financial markets, which include many of the Company's lending counterparties. Additionally, changes in regulatory capital requirements and other leverage constraints are being implemented worldwide. It remains unclear how significant of an impact Dodd Frank and changes in regulatory capital requirements 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 12 full-time employees and one part-time employee, 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

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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.

#### 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.

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 and must monitor ongoing effectiveness on at least a quarterly basis. As long as the hedge relationship remains effective, the effective portion of changes in fair value of the derivative is recorded in Accumulated other comprehensive income and the ineffective portion is recorded in earnings as a component of Interest expense. The effective portion of changes in fair value is reclassified from Accumulated comprehensive income 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).

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 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 June 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 Chief Financial Officer ("CFO"), 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 CFO, concluded that the Company's disclosure controls and procedures were effective as of June 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 June 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.<sup>(1)</sup>
- 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.<sup>(2)</sup>
- 3.3 Amended and Restated Bylaws.<sup>(3)</sup>
- 4.1 Specimen of Common Stock Certificate.<sup>(4)</sup>
- 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.<sup>(2)</sup>
- 4.3 Junior Subordinated Indenture dated September 26, 2005.<sup>(5)</sup>
- 4.4 Indenture dated December 15, 2005.<sup>(5)</sup>
- 4.5 Indenture dated September 11, 2006.<sup>(5)</sup>
- 10.01 Amended and Restated Deferred Compensation Plan.<sup>(5)</sup>
- 10.02 Amended and Restated 2014 Flexible Incentive Plan.<sup>(6)</sup>
- 10.03 Amendment No. 1 to the Amended and Restated 2014 Flexible Incentive Plan.<sup>(7)</sup>
- 10.04 Second Amended and Restated Incentive Bonus Plan.<sup>(8)</sup>
- 10.05 Form of nonqualified stock option and stock award agreements for non-employee directors.<sup>(5)</sup>
- 10.06 2015 Long-Term Award Criteria.<sup>(9)</sup>
- 10.07 Form of performance unit agreement.<sup>(9)</sup>
- 10.08 2016 Annual Incentive Compensation Program.<sup>(10)</sup>
- 10.09 Form of restricted stock agreement for employees.<sup>(10)</sup>
- 10.10 2016 Long-Term Performance Unit Award Criteria.<sup>(10)</sup>
- 10.11 Form of performance unit agreement for employees.<sup>(10)</sup>
- 10.12 2017 Annual Incentive Compensation Program.<sup>(11)</sup>
- 10.13 Form of restricted stock agreement for employees.<sup>(11)</sup>
- 10.14 2017 Long-Term Performance Unit Award Criteria.<sup>(11)</sup>
- 10.15 Form of performance unit agreement for employees.<sup>(11)</sup>
- 10.16 Sales agreement, dated January 23, 2015, by and between the Company and its continuous offering program sales manager.<sup>(12)</sup>
- 10.17 Severance agreement, dated May 3, 2016, by and between the Company and Roy S. Kim.<sup>(13)</sup>
- 10.18 Consulting Agreement, dated July 14, 2016, by and between the Company and Andrew F. Jacobs.<sup>(14)</sup>
- 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: August 4, 2017 By: /s/ PHILLIP A. REINSCH  
Phillip A. Reinsch  
President and Chief Executive Officer,  
Chief Financial Officer and Secretary