

CAPSTEAD MORTGAGE CORP  
Form 10-Q  
May 06, 2016

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: March 31, 2016

OR

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

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

Commission File Number: 001-08896

CAPSTEAD MORTGAGE CORPORATION  
(Exact name of Registrant as specified in its Charter)

Maryland 75-2027937  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

8401 North Central Expressway, Suite 800, Dallas, TX 75225-4404  
(Address of principal executive offices) (Zip Code)

(214) 874-2323  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Common Stock (\$0.01 par value) 95,947,090 as of May 6, 2016

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CAPSTEAD MORTGAGE CORPORATION  
FORM 10-Q  
FOR THE QUARTER ENDED MARCH 31, 2016

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## ITEM 1. FINANCIAL STATEMENTS

## PART I. ¾ FINANCIAL INFORMATION

## CAPSTEAD MORTGAGE CORPORATION

## CONSOLIDATED BALANCE SHEETS

(in thousands, except pledged and per share amounts)

	March 31, 2016 (unaudited)	December 31, 2015
<b>Assets</b>		
Residential mortgage investments (\$13.29 and \$13.54 billion pledged at March 31, 2016 and December 31, 2015, respectively)	\$ 13,835,131	\$ 14,154,737
Cash collateral receivable from interest rate swap counterparties	72,037	50,193
Interest rate swap agreements at fair value	802	7,720
Cash and cash equivalents	52,054	54,185
Receivables and other assets	149,915	179,531
	\$ 14,109,939	\$ 14,446,366
<b>Liabilities</b>		
Secured borrowings	\$ 12,623,699	\$ 12,958,394
Interest rate swap agreements at fair value	46,309	26,061
Unsecured borrowings	98,014	97,986
Common stock dividend payable	25,592	25,979
Accounts payable and accrued expenses	32,932	39,622
	12,826,546	13,148,042
<b>Stockholders' equity</b>		
Preferred stock - \$0.10 par value; 100,000 shares authorized: 7.50% Cumulative Redeemable Preferred Stock, Series E, 8,164 and 8,156 shares issued and outstanding (\$204,109 and \$203,902 aggregate liquidation preferences) at March 31, 2016 and December 31, 2015, respectively	197,370	197,172
Common stock - \$0.01 par value; 250,000 shares authorized: 95,947 and 95,825 shares issued and outstanding at March 31, 2016 and December 31, 2015, respectively	959	958
Paid-in capital	1,309,723	1,310,563
Accumulated deficit	(346,464 )	(346,464 )
Accumulated other comprehensive income	121,805	136,095
	1,283,393	1,298,324
	\$ 14,109,939	\$ 14,446,366

See accompanying notes to consolidated financial statements.

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

	Quarter Ended	
	March 31	
	2016	2015
Interest income:		
Residential mortgage investments	\$59,500	\$58,645
Other	192	94
	59,692	58,739
Interest expense:		
Secured borrowings	(26,582)	(19,214)
Unsecured borrowings	(1,977 )	(2,123 )
	(28,559)	(21,337)
	31,133	37,402
Other revenue (expense):		
Salaries and benefits	(1,157 )	(1,049 )
Short-term incentive compensation	(1,422 )	(692 )
Long-term incentive compensation	(645 )	(608 )
Other general and administrative expense	(1,169 )	(1,149 )
Miscellaneous other revenue	613	53
	(3,780 )	(3,445 )
Net income	\$27,353	\$33,957
Net income available to common stockholders:		
Net income	\$27,353	\$33,957
Less preferred stock dividends	(3,826 )	(3,742 )
	\$23,527	\$30,215
Net income per common share:		
Basic and diluted	\$0.25	\$0.32
Weighted average common shares outstanding:		
Basic	95,614	95,469
Diluted	95,745	95,674
Cash dividends declared per share:		
Common	\$0.26	\$0.31
Series E Preferred	0.47	0.47

See accompanying notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, unaudited)

	Quarter Ended	
	March 31	
	2016	2015
Net income	\$27,353	\$33,957
Other comprehensive income (loss)		
Amounts related to available-for-sale securities:		
Change in net unrealized gains	12,483	6,107
Amounts related to cash flow hedges:		
Change in net unrealized losses	(32,127)	(18,391)
Reclassification adjustment for amounts included in net income	5,354	6,448
	(14,290)	(5,836 )
Comprehensive income	\$13,063	\$28,121

See accompanying notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, unaudited)

	Quarter Ended March 31	
	2016	2015
Operating activities:		
Net income	\$27,353	\$33,957
Noncash items:		
Amortization of investment premiums	26,011	25,078
Amortization of equity-based awards	745	724
Other depreciation and amortization	32	33
Change in measurable hedge ineffectiveness related to interest rate swap agreements designated as cash flow hedges	393	185
Net change in receivables, other assets, accounts payable and accrued expenses	(5,740 )	(1,131 )
Net cash provided by operating activities	48,794	58,846
Investing activities:		
Purchases of residential mortgage investments	(462,759 )	(959,548 )
Interest receivable acquired with the purchase of residential mortgage investments	(696 )	(1,534 )
Principal collections on residential mortgage investments, including changes in mortgage securities principal remittance receivable	768,187	703,688
Redemption of Federal Home Loan Bank stock	30,000	—
Net cash provided by (used in) investing activities	334,732	(257,394 )
Financing activities:		
Proceeds from repurchase arrangements and similar borrowings	29,191,066	29,887,321
Principal payments on repurchase arrangements and similar borrowings	(27,400,760)	(29,755,657)
Proceeds from other secured borrowings	1,175,000	—
Principal payments on other secured borrowings	(3,300,000 )	—
Increase in cash collateral receivable from interest rate swap counterparties	(21,844 )	(8,530 )
Proceeds from issuance of preferred shares	200	10,651
Other capital stock transactions	(57 )	(429 )
Dividends paid	(29,262 )	(36,719 )
Net cash (used in) provided by financing activities	(385,657 )	96,637
Net change in cash and cash equivalents	(2,131 )	(101,911 )
Cash and cash equivalents at beginning of period	54,185	307,526
Cash and cash equivalents at end of period	\$52,054	\$205,615

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
MARCH 31, 2016  
(unaudited)

NOTE 1 ¾ BUSINESS

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

NOTE 2 ¾ BASIS OF PRESENTATION

Interim Financial Reporting

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

Recent Accounting Pronouncements

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



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## NOTE 3 ¾ NET INCOME PER COMMON SHARE

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

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

	Quarter Ended March 31	
	2016	2015
Basic net income per common share		
Numerator for basic net income per common share:		
Net income	\$ 27,353	\$ 33,957
Preferred stock dividends	(3,826 )	(3,742 )
Earnings participation of unvested equity awards	(44 )	(34 )
	\$ 23,483	\$ 30,181
Denominator for basic net income per common share:		
Average number of shares of common stock outstanding	95,913	95,825
Average unvested stock awards outstanding	(299 )	(356 )
	95,614	95,469
	\$ 0.25	\$ 0.32
Diluted net income per common share		
Numerator for diluted net income per common share:		
Numerator for basic net income per common share	\$ 23,483	\$ 30,181
Denominator for diluted net income per common share:		
Denominator for basic net income per common share	95,614	95,469
Net effect of dilutive equity awards	131	205
	95,745	95,674
	\$ 0.25	\$ 0.32

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## NOTE 4 ¾ RESIDENTIAL MORTGAGE INVESTMENTS

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

	Unpaid Principal Balance	Investment Premiums	Amortized Cost Basis	Carrying Amount <sup>(a)</sup>	Net WAC <sup>(b)</sup>	Average Yield <sup>(b)</sup>		
March 31, 2016								
Agency Securities:								
Fannie Mae/Freddie Mac:								
Fixed-rate	\$599	\$ 2	\$601	\$601	6.62	%	5.82	%
ARMs	9,815,446	311,049	10,126,495	10,285,165	2.60		1.78	
Ginnie Mae ARMs	3,421,518	114,475	3,535,993	3,544,335	2.59		1.55	
	13,237,563	425,526	13,663,089	13,830,101	2.60		1.72	
Residential mortgage loans:								
Fixed-rate	857	1	858	858	6.77		3.42	
ARMs	2,322	10	2,332	2,332	3.81		3.21	
	3,179	11	3,190	3,190	4.60		3.27	
Collateral for structured financings	1,811	29	1,840	1,840	8.12		7.94	
	\$13,242,553	\$ 425,566	\$13,668,119	\$13,835,131	2.60		1.72	
December 31, 2015								
Agency Securities:								
Fannie Mae/Freddie Mac:								
Fixed-rate	\$796	\$ 2	\$798	\$799	6.61	%	6.17	%
ARMs	10,014,401	317,545	10,331,946	10,487,785	2.55		1.68	
Ginnie Mae ARMs	3,542,541	119,225	3,661,766	3,660,455	2.61		1.49	
	13,557,738	436,772	13,994,510	14,149,039	2.57		1.63	
Residential mortgage loans:								
Fixed-rate	1,155	1	1,156	1,156	6.76		5.02	
ARMs	2,650	11	2,661	2,661	3.73		3.15	
	3,805	12	3,817	3,817	4.65		3.71	
Collateral for structured financings	1,850	31	1,881	1,881	8.12		7.82	
	\$13,563,393	\$ 436,815	\$14,000,208	\$14,154,737	2.57		1.63	

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

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

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

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

this mortgage conduit and are pledged to secure repayment of related structured financings. Credit risk for these securities is borne by the related bondholders. The maturity of Residential mortgage investments is directly affected by prepayments of principal on the underlying mortgage loans. Consequently, actual maturities will be significantly shorter than the portfolio's weighted average contractual maturity of 290 months.

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

Capstead classifies its ARM investments based on average number of months until coupon reset (“months to roll”). Months to roll is an indicator of asset duration which is a measure of market price sensitivity to interest rate movements. A shorter duration generally indicates less interest rate risk. Current-reset ARM investments have months to roll of less than 18 months while longer-to-reset ARM investments have months to roll of 18 months or greater. As of March 31, 2016, the average months to roll for the Company’s \$7.89 billion (amortized cost basis) in current-reset ARM investments was 6.2 months while the average months to roll for the Company’s \$5.77 billion (amortized cost basis) in longer-to-reset ARM investments was 41.8 months.

## NOTE 5 ¾ SECURED BORROWINGS

Capstead pledges its Residential mortgage investments as collateral for secured borrowings primarily in the form of repurchase arrangements with commercial banks and other financial institutions. In August 2015 the Company began supplementing its borrowings under repurchase arrangements with advances from the Federal Home Loan Bank (“FHLB”) of Cincinnati (collectively referred to as “counterparties” or “lending counterparties”). Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date and are accounted for as financings. The Company maintains the beneficial interest in the specific securities pledged during the term of each repurchase arrangement and receives the related principal and interest payments. FHLB advances differ from repurchase arrangements in that Capstead pledges collateral to the bank to secure each such advance rather than transferring ownership of the pledged collateral to the bank and simultaneously agreeing to repurchase the transferred assets at a future date. On January 12, 2016 the FHLB system regulator finalized rules originally proposed in 2014 that generally preclude captive insurers from remaining members beyond February 19, 2017 with transition rules that require outstanding advances to be repaid upon maturity or by that date. In response to this action, the Company has reduced outstanding FHLB advances to \$750 million as of March 31, 2016 and anticipates migrating remaining balances away from the FHLB by November 2016. FHLB stock held by the Company in connection with advance activity was reduced by \$30.0 million during the quarter ended March 31, 2016 and the remaining \$30.0 million held at March 31, 2016 is expected to be redeemed by December 31, 2016.

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

referred to as margin calls. Conversely, in response to increases in fair value of pledged securities, the Company routinely margin calls its lending counterparties in order to have previously pledged collateral returned.

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

Collateral Type	Collateral Carrying Amount	Accrued Interest Receivable	Borrowings Outstanding	Average Borrowing Rates	
March 31, 2016					
Borrowings under repurchase arrangements with maturities of 30 days or less:					
Agency Securities	\$ 10,815,418	\$ 22,692	\$ 10,267,015	0.66	%
Borrowings under repurchase arrangements with maturities greater than 30 days:					
Agency Securities (31 to 90 days)	500,212	1,150	461,665	0.67	
Agency Securities (greater than 90 days)	1,200,086	2,819	1,143,179	0.79	
Similar borrowings:					
Collateral for structured financings	1,840	–	1,840	8.12	
	12,517,556	26,661	11,873,699		
FHLB advances	768,513	3,152	750,000	0.64	
	\$ 13,286,069	\$ 29,813	\$ 12,623,699	0.67	
Quarter-end borrowing rates adjusted for effects of related derivative financial instruments (Derivatives) held as cash flow hedges				0.84	
December 31, 2015					
Borrowings under repurchase arrangements with maturities of 30 days or less:					
Agency Securities	\$ 9,080,363	\$ 18,504	\$ 8,585,336	0.67	%
Borrowings under repurchase arrangements with maturities greater than 30 days:					
Agency Securities (31 to 90 days)	423,710	861	346,177	0.63	
Agency Securities (greater than 90 days)	1,073,254	2,519	1,150,000	0.75	
Similar borrowings:					
Collateral for structured financings	1,881	–	1,881	8.12	
	10,579,208	21,884	10,083,394		
FHLB advances	2,956,908	11,422	2,875,000	0.43	
	\$ 13,536,116	\$ 33,306	\$ 12,958,394	0.62	
Year-end borrowing rates adjusted for effects of related Derivatives held as cash flow hedges				0.85	

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

	Quarter Ended		December 31, 2015	
	March 31, 2016		Average	Average
	Average	Average	Borrowings	Rate
	Borrowings	Rate	Borrowings	Rate
Average borrowings and rates adjusted for the effects of related				
Derivatives held as cash flow hedges for the indicated periods	\$13,042,541	0.82 %	\$13,160,703	0.73 %

#### NOTE 6 ¾ USE OF DERIVATIVES, OFFSETTING DISCLOSURES AND CHANGES IN OTHER COMPREHENSIVE INCOME BY COMPONENT

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

During the quarter ended March 31, 2016 Capstead entered into swap agreements with notional amounts of \$1.50 billion requiring fixed-rate interest payments averaging 0.73% for two-year periods commencing on various dates between January 2016 and April 2016. Also during the quarter ended March 31, 2016, \$1.70 billion notional amount of swaps requiring fixed-rate interest payments averaging 0.51% matured, while \$300 million notional amount of forward-starting swaps requiring fixed-rate interest payments averaging 0.92% moved into current-pay status. At March 31, 2016, the Company's financing-related swap positions had the following characteristics (dollars in thousands):

Period of Contract Expiration	Notional Amount	Average Fixed-Rate Payment Requirement
Currently-paying contracts:		
Second quarter 2016 (expired April 1, 2016)	\$1,100,000	0.47 %
Third quarter 2016	700,000	0.56
Fourth quarter 2016		