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FBC - Q4 2015 Flagstar Bancorp Inc Earnings Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Flagstar Bank fourth-quarter 2015 earnings conference call. Today's call is being recorded, and at this time, I would like to turn the conference over to David Urban, Director of Investor Relations. Please go ahead.

David Urban - *Flagstar Bancorp, Inc. - IR*

Thank you, Vicki, and good morning. Welcome to the Flagstar fourth-quarter 2015 earnings call.

Before we begin, I would like to mention that our fourth-quarter earnings release and presentation are available on our website at Flagstar.com.

I would also like to remind you that any forward-looking statements made during today's call are subject to risks and uncertainties. Factors that could materially change our current forward-looking assumptions are described on slide 2 of today's presentation, in our press release, and in our 2014 Form 10-K and subsequent reports on file with the SEC.

With that, I would like to now turn the call over to Sandro DiNello, our President and Chief Executive Officer.

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Thank you, Dave, and thank you, everyone, for joining us today. In addition to Dave, I am joined this morning by Jim Ciroli, our Chief Financial Officer; Lee Smith, our Chief Operating Officer; Steve Figliuolo, our Chief Risk Officer; and Len Israel, our President of Mortgage Banking.

I will start with the order of the call. First, I'm going to provide a high-level review of our performance for the quarter. Then I will turn the call over to Jim for a deep dive into our financial results. Lee will follow with a more detailed review of our business segments and strategic initiatives. And I will conclude with guidance for the first quarter 2016 before opening up the lines for questions.

As you know, last year we posted the highest annual level of pretax income since 2003. These strong results were led by positive operating leverage during the year.

Turning to the quarter, despite the headwinds of seasonality and TRID, we had good results. Earnings were solid and diversified, albeit down $0.25 per share versus the third quarter, but up an impressive $0.37 per share from the fourth quarter 2014, demonstrating the turnaround Flagstar has enjoyed.

We continue to add high-quality assets to our balance sheet, which helped to increase our net interest income. Our capital position remains solid, with plenty available to fuel our planned growth.

So we start 2016 with a strong balance sheet, excellent credit quality, and a more profitable and diversified business mix.

As expected, our mortgage revenues were seasonally lower in the fourth quarter. In connection with TRID, our approach was to be careful and take greater control in creating and delivering disclosure statements, and given the fact that third-party originations account for 95% of our loan production, we felt the effect of TRID more than other bank originators.

We expect to recapture a large portion of this business as we go through the year and get comfortable that the loans we are purchasing are TRID compliant. While the approach we took in connection with the implementation of TRID was careful, I think our focus on compliance will ultimately serve us well.

A positive development in our mortgage business is the success we are having adding retail loan officers and branches to our platform. As referenced earlier, our mortgage business has historically been a third-party business. We are one of the best in that space and will continue to be.

We have signaled our desire to expand our retail mortgage operation and we are now beginning to see the fruits of many discussions we have had since Len arrived at Flagstar, as evidenced by the addition of over 50 successful retail lenders from around the country to our retail staff already this year. And we have a full pipeline of others that we will be bringing aboard going forward. This will be a continuing focus throughout 2016.

We see the purchase money market continuing to get stronger and we think adding this horsepower in retail lending is the best way for us to take advantage of that environment.

Turning to banking, I'm very pleased with the performance of that business. Earning assets continue to grow, funding costs are at acceptable levels, credit is very strong, and expenses have been contained, even with our considerable growth. And importantly, we continue to add strong experienced bankers to our team.

Most recently, Drew Ottaway joined Flagstar in November, bringing more than 25 years of banking experience in southeast Michigan, primarily in commercial lending and credit administration. Drew is responsible for all non-mortgage lending and is focused on expanding lending activities in our banking business.

Finally, we continue to be encouraged by our progress with the OCC on the consent order and expect we will redeem our TARP preferred shares and restore interest payments on our trust preferred securities in the second half of 2016, thus optimizing our capital structure.

With that, my colleagues will take you through a more detailed discussion of our financials and operations. First up is Jim.

Jim Ciroli - *Flagstar Bancorp, Inc. - EVP, CFO*

Thanks, Sandro.

Turning to slide 6, our net income was $33 million, $0.44 per share, in the fourth quarter. This compared to net income of $47 million, $0.69 per share, in the third quarter.

Our earnings in the fourth quarter were led by solid earning asset growth and strong credit metrics. For the quarter, we posted an annualized return on assets of 1.0% and returns on equity and common equity of 8.6% and 7.9%, respectively.

Let's turn to slide 7. Our fourth-quarter net interest income increased 4% from the prior quarter to $76 million. These results were led by a 5% increase in earning assets, partially offset by a slight drop in net interest margin. Our NIM fell 6 basis points in the quarter to 2.69%, led by a lower yield on mortgage loans and loans repurchased with government guarantees.

Average earning assets increased $547 million or 5% in the quarter, led by a $284 million or 13% increase in loans held for sale and a $174 million or 9% increase in commercial loans.

During the quarter, we deliberately slowed our deliveries of salable mortgage loans to optimize profitability. The growth in commercial loans was driven by a 17% increase in commercial real estate loans, led by a higher draw rate on new commitments in the quarter. Average total deposits decreased 2% from the prior quarter, driven largely by seasonal factors.

The Company experienced a provision benefit in the fourth quarter of $1 million. I will provide additional detail on asset quality in a couple of slides.

Non-interest income decreased $31 million or 24% to $97 million in the fourth quarter, led by lower net gain on loan sales, a decline in loan fees, and a reduced net return on the mortgage servicing asset.

Let's dive deeper into each of these declines. Fourth-quarter net gain on loan sales decreased $22 million or 32%. We estimate about half that decline is due to seasonal factors and the other half related to the impact of TRID. We saw our fallout adjusted locks decrease 23%. We experienced more of an impact from TRID than other bank originators because 95% of our volume comes from brokers and correspondents.

The net gain on loan sale margin fell 13 basis points, led by seasonal price competition. Loan fees and charges declined $3 million in the fourth quarter on lower mortgage closings and the net return on the mortgage servicing asset fell $3 million in the fourth quarter, largely due to the smaller impact from the collection of performance incentives on prior-period MSR sales. Excluding the impact of these performance incentives, the return on the mortgage servicing asset was 11%, consistent with the prior quarter.

The returns in the past two quarters have been better than our long-term return target, as we benefited from slower prepayments and positive hedging results.

Moving now to expenses, non-interest expense decreased 2% to $129 million in the fourth quarter, as compared to $131 million in the third quarter, led by lower volume-driven categories, such as commissions and loan processing expenses, and also a decline in federal insurance premiums. These decreases were partially offset by a $2 million increase in asset resolution expense, largely due to a $2.5 million benefit in the third quarter for reimbursements.

The low level of asset resolution expense in the fourth quarter reflected the Company's success in derisking the balance sheet.

On the tax front, as anticipated, the Company's effective tax rate in the fourth quarter fell to 27%, as compared to 34% in the third quarter. The decline in the tax rate resulted primarily from benefits associated with state income taxes. We had an effective tax rate for the year of 34% and we anticipate that this reflects our longer-term blended tax rate.

Slide 8 highlights our average balance sheet. Average earning assets increased $547 million or 5% to $11.2 billion in the fourth quarter, led by a 13% rise in loans held for sale and a 9% increase in commercial loans. Much of this growth occurred later in the quarter. Ending total earning assets were $12.1 billion. Much of this planned growth occurred in the loans held for investment portfolio, where ending balances were up $838 million or 15% from prior quarter-end. This gives us a strong jumping-off point into the first quarter.

On the funding side, we maintained a strong balance sheet with stable funding.

A significant portion of the growth in earning assets was in loans held for sale and investment securities, which are highly liquid and which support our stable funding base as these earning assets are pledgable to the FHLB.

At year-end, our common equity to asset ratio remained solid at 9.2%, despite the increase of $1.2 billion in total assets during the quarter. Much of the point-to-point growth came from highly liquid, relatively credit risk free categories, like warehouse lending, investment securities, and loans held for sale, all of which require less capital support.

Let's look at asset quality on slide 9. At year-end, our allowance coverage was 3.0% of total loans, as compared to 3.7% at the end of Q3. Coverage dropped, largely due to the growth of higher credit quality assets. At year-end, we had a 4.2% allowance coverage of our consumer book, down 99 basis points from Q3. The commercial allowance coverage ratio remained at 1.4% in the fourth quarter, reflecting the continued lack of delinquent loans in this high-quality portfolio.

Our provision for loan losses in the fourth quarter was a $1 million benefit. This resulted from an allowance release of $8 million, of which $3 million related to the full payoff of a single commercial credit.

Net charge-offs were $9 million for the fourth quarter, including $2 million of net charge-offs associated with the sale of $17 million of nonperforming and scratch and dent loans. Excluding loan sales, net charge-offs were $7 million or 51 basis points of loans in the fourth quarter, compared to $8 million or 61 basis points of loans in the third quarter.

Also reflecting strong credit metrics, nonperforming loans were relatively stable at $66 million at the end of the fourth quarter, while the nonperforming loan ratio fell 10 basis points to 1.05%. Early-stage delinquencies remained at a low level in the fourth quarter.

Looking at consumer loans, only 38 basis points were over 30 days delinquent and still accruing, down 25 basis points from Q3 and a decrease of 129 basis points from Q4 2014. There continued to be no commercial loans at year-end that were more than 30 days delinquent.

Turning to slide 10, we continue to maintain robust regulatory capital ratios. On a partially phased-in basis at December 31, 2015, our Tier 1 leverage ratio was 11.5%, as compared to 11.7% at September 30, 2015. Our Tier 1 common ratio was 14.1% at December 31, 2015. The decrease in the Tier 1 leverage ratio resulted from the deployment of capital for balance-sheet growth as we invested 41 basis points of Tier 1 leverage capital, which was funded by 26 basis points of earnings retention. The balance-sheet growth was comprised of lower risk content assets.

This slide also presents an analysis of a Tier 1 leverage ratio, which is our constraining capital ratio, reflecting the pro forma impact of redeeming our TARP preferred shares. The pro forma impact also contemplates a reduction in equity from the payment of deferred preferred dividends, which at December 31 totaled $86 million.

As you can see on a pro forma basis, we would still have an 8.6% Tier 1 leverage ratio at December 31, a healthy stress buffer over the minimum level considered to be well capitalized, considering the composition of our balance sheet now has less risk. Over $10 billion of our year-end assets were in low-risk content assets, such as loans held for sale, investment securities, residential first mortgage loans, and warehouse loans. Nearly 80% of our residential first mortgage loans have been originated in the past two years.

We anticipate that our internal regulatory capital generation rate will continue to be strong over the next few years. Keep in mind that our Tier 1 capital at December 31, 2015, has already been reduced by $228 million, which is 183 basis points, for our NOL-related deferred tax assets. This should be earned back over the next few years.

It has also been further reduced by $95 million or 76 basis points for MSRs in excess of the amounts allowable under Basel III. As we continue to reduce our levels of MSRs and grow Tier 1 capital, these deductions from Tier 1 capital should also shrink significantly, resulting in, at least over the next few years, a higher level of regulatory capital growth.

I will now turn to Lee for more insight into each of our businesses.

Lee Smith - *Flagstar Bancorp, Inc. - EVP, COO*

Thanks, Jim, and good morning, everyone.

We are extremely pleased with our performance in 2015, where we generated $158 million of after-tax net income. We have accomplished a lot over the last 12 months as we continued to deliver on our strategic plan of building a diversified business model that is less exposed to cyclical fluctuations. The foundations are in place and 2015 was when we started to see the results of our actions.

During the year, we have grown average interest earning assets on the balance sheet by $2 billion, primarily through growth in our consumer and commercial loans held for investment. Remember, this growth has occurred at the same time we have sold over $1 billion of higher risk and lower performing assets in 2015 as we completed our balance-sheet derisking program.

The growth improved net interest income $40 million year over year and the derisking actions have been a major reason for the reduction in asset resolution costs of $42 million year over year. Excluding the rep and warranty reserve release benefits, we were also able to grow non-interest income revenues $80 million in 2015 and hold the line on non-interest expense, excluding asset resolution costs, which led to a significant improvement in our year-over-year efficiency ratio, from 95.4% in 2014 to 70.9% in 2015.

Most importantly, we have the right team in place that is focused on executing our strategy and delivering stronger and more consistent returns to our shareholders.

I will now outline some of the key operating metrics from each of our major business segments during the quarter. Please turn to slide 12.

Quarterly operating highlights for the community banking segment include average commercial loans increased $174 million or 9% to $2.2 billion. All commercial loan business lines reported robust growth during the quarter, with commercial real estate accounting for $115 million of the overall increase as a result of funded new commitments and draws on commitments that were closed in Q3.

During the last 12 months, we have grown total commercial loans by nearly $700 million, led by $430 million in warehouse lending, $153 million in CRE lending, and $116 million in C&I lending. Putting that into context, in 2015 our warehouse business grew 74%, largely due to our strategy change 18 months ago when we opened up our warehouse lines to correspondents who sold to investors other than Flagstar. And our C&I and CRE businesses have grown 30% when looking at period-end balances, as we continue to execute on our relationship-based approach with borrowers in many different industries.

Average consumer loans increased $56 million or 2% in the quarter and was led by a $77 million or a 3% increase in first residential mortgage loans, as we continue to add high-quality jumbo and agency originations to our balance sheet.

Average total interest bearing deposits increased 1.3% during the quarter to $6.4 billion, primarily due to increases in certificates of deposit on both the retail and government side. Over the last 12 months, average retail deposits have grown 10.1% to $5.6 billion, government deposits have grown 19.7% to $1 billion, and Company-controlled deposits have grown 60.6% to $1.2 billion.

There have been some exciting developments recently in our community banking business vertical that will allow us to build on the success of this last 12 months. First of all, and as Sandro mentioned, Drew Ottaway joined our team and will be responsible for all non-mortgage lending. Drew brings a wealth of knowledge and experience to the bank and we are thrilled to have him.

We have also recently added two new business lending functions to our lending platform. Firstly, we have brought a seasoned team of builder finance lenders on board who specialize in lending to homebuilders. This is a national platform and we believe it will also lead to significant positive synergies with our mortgage origination business.

We have also launched an MSR lending program, given the lending, servicing, and mortgage knowledge we have in house.

It is our intention to approach both of these endeavors in a safe and sound manner and with a focus on compliance and risk management.

Last quarter, we discussed our intent to be opportunistic with asset purchases, which fits our credit and risk profile. In this regard, we purchased approximately $200 million of jumbo mortgages in December as part of a rebalancing of the geographic concentration of our residential mortgage portfolio. We also added $311 million of jumbo and agency loans from our own originations in the quarter.

During 2015, we have added almost $2 billion of high-quality jumbo and agency loans from our own originations as we look to build a solid health reinvestment portfolio that generates consistent interest income.

On the technology front, we launched a new and improved online banking platform during the quarter that will enhance our overall service offering to our customers, and through today, we have replaced approximately 60% of our entire fleet of ATMs with state-of-the-art terminals, with the remaining 40% due to be swapped out by spring.

Overall, we are very encouraged by the sustained growth in the community bank, our positioning, and potential for the future.

Please turn to slide 13. Fourth-quarter operating highlights for the mortgage origination business include fallout adjusted lock volume decreased 23% to $5 billion, led by a seasonal decrease in mortgage applications and the implementation of TRID, where we adopted a thoughtful and careful approach by taking greater control in creating and delivering the disclosure documents, which caused a more pronounced impact in third-party loan applications and originations, particularly in the broker channel.

The net gain on loan sale margin decreased 13 basis points to 92 basis points quarter over quarter. The lower margin was largely reflective of pricing pressure in the industry, given the seasonal slowdown creates an increased capacity.

We have recently taken steps towards expanding our distributed and direct-to-consumer retail businesses and have added over 50 managers, loan officers, and sales assistants since the beginning of October; have a pipeline of further candidates; and have expanded our retail footprint into an additional eight states.

Similar to our third-party business, we want to leverage our national footprints. Given our comprehensive risk and compliance infrastructure, strong capital position, and our cost of funds, we believe we have a compelling business offering from a retail point of view and are well positioned to benefit from any dislocations in the market.

We continue to invest in technology as a way to further improve the topline performance and make us more efficient from an operating point of view. We launched Phase 2 of our consumer portal in early December, which allows our customers to shop for a mortgage and complete the application process online. It also acts as a document aggregator, driving further operating efficiencies, and we are continuing to invest in ways that will further enhance the capabilities of this portal.

Moving to servicing, quarterly operating highlights for the mortgage servicing segment on slide 14 include we executed on the sale of $2.5 billion in aggregate UPB, or 11,073 loans of residential MSRs during the quarter where we will be the subservicer of loans. We currently service approximately 361,000 loans, of which 212,000 are subserviced for others, making us the ninth largest subservicer in the nation. The remaining 150,000 are loans where we own the MSR or they are part of our HFI book.

Approximately 97% of our servicing book is performing loans and 3%, or approximately 10,000 loans, are 60-plus days delinquent.

Longer term, we remain focused on three areas -- growing our fee income generating subservicing business, which has the capacity to service up to 1 million loans; leveraging this platform to cross-selling across our three business line verticals; and executing on an MSR reduction strategy, given the requirements of Basel III.

Our goal is to reach the fully phased in MSR limit by the end of Q1 2018 through efficient bulk and flow sale transactions and we are on track in implementing the early phases of this plan. Given our capabilities as an originator and a subservicer, our ability to lend against servicing advances and now directly against the MSR asset, we believe we have a compelling business model and proposition for buyers of mortgage servicing rights.

Moving to asset quality, during the quarter we sold $16.6 million UPB of nonperforming and scratch-and-dent loans as we rounded out a very successful year of balance-sheet derisking where we sold over $1 billion UPB of lower performing and higher risk assets. Our balance-sheet derisking program is now complete and has led to significant cost savings in terms of lower asset resolution and FDIC expenses.

Digging into expenses on slide 15, our non-interest expense decreased $2 million to $129 million in the fourth quarter. The reduction in expenses was due to a decline in variable commission and loan processing costs of $4 million, given the reduced mortgage activity, offset by a $2 million increase in asset resolution costs, given the unusual nominal amount of expense in the third quarter and an increase in occupancy and equipment following the exiting of a significant lease, the benefits of which will be realized in 2016 and 2017.

As always, we remain focused on optimizing our cost infrastructure and looking at ways to drive further efficiencies throughout the organization. We estimate non-interest expense will be between $130 million and $135 million in the first quarter of 2016.

As discussed in my prepared remarks during last quarter's earnings call, our efficiency ratio is sensitive to revenue changes. With a decrease in non-interest income of $31 million quarter over quarter, our efficiency ratio increased from 65% to 75.2% in Q4. Our annual efficiency ratio of 70.9% in 2015 improved from 95.4% in 2014. This was due in large part to increased interest income of $40 million year over year as we grew interest-earning assets on the balance sheet.

Increased non-interest income of $80 million, excluding R&W reserve release resulting from higher origination volume driving higher gain on loan sales and lower costs as a result of our balance-sheet derisking program and implementing a more variable cost structure.

We have previously stated that our target efficiency ratio is in the mid-60%s and our immediate focus in achieving that goal is on growing revenues across all three major business lines, while continuing to build on the cost discipline and management we have instilled throughout the organization. We certainly appreciate some investment is needed for the new initiatives before the revenue streams materialize in a profitable way, and we are focused on managing this investment in order to grow in a diligent and optimal fashion.

As you can see, we continue to work tirelessly to develop and implement new revenue-generating initiatives, maximize revenues from existing channels, and further optimize our cost structure and drive greater efficiencies throughout the organization. We're executing against our strategic plan and our 2015 results bear this out. We are pleased with our progress and are committed to delivering strong returns for our shareholders.

With that, I will hand it back to Sandro.

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Thank you, Lee.

I am now going to close our prepared remarks with some guidance and then open the call for questions and answers. While our full-year results for 2015 were strong, there is a lot of work to do. As we look at 2016, I'm optimistic about the opportunities in front of us. I like our position and believe we have the right people, financial resources, and business plan to be successful.

Please turn to slide 17, where we have itemized our guidance parameters for the first quarter of 2016. We expect a modest rise in earning assets and a slightly lower net interest margin. We anticipate mortgage locks increasing approximately 15% as we regain market share in the broker channel. We expect a relatively stable gain on loan sale margin. We anticipate a moderate decline in the net return on the mortgage servicing asset, due to sales. We expect the MSR to Tier 1 ratio will be stable.

Net loan administration income should be relatively stable on steady servicing accounts. Other non-interest income should approximate the 2015 quarterly average. We expect our provision expense to match net charge-offs, which we believe will be consistent with the net charge-off ratio in Q4, adjusted for loan sales and loans with government guarantees. As Lee noted, non-interest expenses will probably rise a bit and be between $130 million and $135 million, due to investment in growth initiatives and seasonality.

And lastly, as Jim mentioned, we expect the effective tax rate will approximate the full-year 2015 tax rate of 34%.

This concludes our prepared remarks and we will now open the call to questions from our listeners.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Paul Miller, FBR.

Paul Miller - *FBR & Co. - Analyst*

Can you go back -- which slide is this? Well, I wanted to ask you a little bit more about TRID and how it has impacted the business, because you talked about you had some issues with TRID because you did a lot of third-party originations. But how did it really impact -- did that factor into the margin? Because your margin was pretty good year over year. Where exactly did those expenses flow through the income statement?

Jim Ciroli - *Flagstar Bancorp, Inc. - EVP, CFO*

First of all, with respect to your comment that we had issues, I wouldn't call them necessarily issues. We made some decisions there that, as we said in our prepared remarks, were careful from a compliance point of view. With the respect to the expenses associated the TRID implementation, I will let Lee take that.

Lee Smith - *Flagstar Bancorp, Inc. - EVP, COO*

Yes, so the incremental expenses, Paul, were nominal. As you can see from our non-interest expense run rate of $129 million, when you actually look at the reduction quarter over quarter, $4 million came from the variable loan processing and commissions, which was about a 16%, 17% reduction quarter over quarter. If you look at our lock volume, that was down 23% quarter over quarter, so the incremental expense because of TRID was actually pretty nominal.

And I think, coming back to the impact of TRID and what Sandro just mentioned, it wasn't so much issues. We just made the decision to take greater control over how the documents are delivered and we wanted to do that from a compliance point of view.

Paul Miller - *FBR & Co. - Analyst*

So it really wasn't issues. So, can you say then -- because I'm just trying to talk this out a little bit, so did that slow down the closings? Is that what it did, and added a little bit more expenses to it by taking total control?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

No, what it did was we were more selective in the purchasing of loans. So, and that's why we are projecting the increase in locks in Q1 because we think as time goes on we will be more comfortable with the compliance factors, and now -- so that will reduce that impact going forward.

Paul Miller - *FBR & Co. - Analyst*

Okay. And then -- so, okay, so what you did is you took control. You didn't buy as many loans as you would have normally or brought more in, loans, more than normally and that was the impact on the TRID?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Correct.

Paul Miller - *FBR & Co. - Analyst*

Okay. And then relative to where rates are today, have you seen any increase in -- I guess the point is, when do you think TRID will flow through the system and not have any impact on the financials?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

I think it's hard to predict, just from our perspective, when we will get back to what I would call normal. I think that it is going to be a gradual thing. We're pretty optimistic about it.

I think that as we continue to get more comfortable with compliance and purchase loans from more of our partners and then also build this retail business that we talk about, I think you'll see our overall market share be at least what was in the past, if not greater.

Paul Miller - *FBR & Co. - Analyst*

Okay. Guys, thank you very much.

Operator

Bose George, KBW.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Actually, just a follow-up on the TRID questions. I understand your quality control reduced your percentage at the end of the quarter, but do you think the retail originators also had a longer timeline to close and do you think that played into the market at all during the quarter?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

I think closing times were impacted, for sure. One of the things that, though we didn't call it out specifically in our prepared comments, that you saw in our business because of the warehouse business we had, you saw the growth in the balances, and that was in part because our correspondent bankers that we have lines with were slower in getting those loans off of the line.

So I think there was definitely an extension of the closing periods, but I would say we're getting back to normal on that regard.

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Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay. Okay, great, and then actually just switching to the retail channel, just fast forward. Going forward a couple of years, how large do you think that could become as a part of your business?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

I'm not a very good predictor, so I'm not going to take a shot at that. But, Bose, we clearly want to continue to diversify our mortgage originations and not be at 95% with our third-party business, and so that's the main goal, to do it in a gradual fashion and in a way that is strong from a risk governance point of view, so we're going to take it slow and easy, but it is going to be steady and we're very optimistic about our ability to be impactful in that channel.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, great, thanks. And then, actually, just one more. On the FHA, what was your percentage quarter over quarter? And strategically, how are you thinking about that business?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

So I think that was pretty flat. Len, you want to add on the FHA? Was it flat?

Len Israel - *Flagstar Bancorp, Inc. - President Mortgage Banking*

Yes, I think it is 16%. It is in one of the slides, the amount of FHA business. It is on the mortgage slide, Bose, so it's flat quarter over quarter as a percentage of overall business.

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

But it is certainly an important part of our business. I know some other originators have expressed concern about the FHA business. We have built a very, very strong risk infrastructure, which I think is what is most important in the FHA business, and we haven't dipped too low into the FICO score area.

So we have continued to maintain very, very strong compare ratios and we follow that very, very closely, and so we are comfortable with that business. And while it has been flat, I wouldn't be afraid to increase it a little bit if the market allowed us that opportunity.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, great. Thanks.

Operator

Scott Siefers, Sandler O'Neill & Partners.

Scott Siefers - *Sandler O'Neill & Partners - Analyst*

I just wanted to follow up on the TRID as well. Have you guys noticed any disruption with the brokers with whom you deal as you became more selective in what you brought on, given just the concerns about getting things right from a compliance and suitability standpoint?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Here is what I would say. No one really knows what is totally compliant at this point and that's part of the problem, so that's why we are being careful is that it is still a bit of a open question. So, I do think it will gradually resolve itself and we'll get more comfortable with that. And so, I don't think there is going to be any long-term issue here that is going to be problematic.

Scott Siefers - *Sandler O'Neill & Partners - Analyst*

Okay, all right. Perfect. And then, I think if I just look at the disconnect between what you guys would anticipate for fallout-adjusted locks being up versus what seasonally should be a slower origination quarter for total originations, I mean, I know you're hesitant to put a timetable on how quickly you recoup those things, but it seems like you should be recouping in fairly short order, even though to get back to full normalcy would be a more extended process. Is that an appropriate way to read it?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Yes, I think so. I think we have guided to that with the 15% increase in Q1 as compared to the market predicting a decline in Q1. So yes, we see that we will get some benefit in Q1 that will offset some of the negative impact we had in Q4.

Scott Siefers - *Sandler O'Neill & Partners - Analyst*

Yes, okay. And then maybe switching gears just a bit, I was hoping you guys could walk me through a little bit on the outlook for the stable gain on sale margin, if you can walk me through the nuance of how we keep that stable despite changes within the mix as broker comes back as a heavier component of the stream.

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Yes, well, for us, gain on sale margin is complicated, right, because we have so many different delivery channels and products. So as we go forward and we look to bring more of the broker business back online, together with more retail, it is going to be hard to look at it year over year and make sense of the comparison, but I will throw it to Jim and see if there is any more insight on that.

Jim Ciroli - *Flagstar Bancorp, Inc. - EVP, CFO*

No, I think that's right. Scott, you have to think about where the retail margins are, and since they're such a multiple of what we see in the correspondent or broker channels, that -- when you think about where you would be for the first quarter, you have to blend in that really robust level of gain on sale margin with the correspondent margins that are going to be maybe one-fifth or one-sixth of that.

Lee Smith - *Flagstar Bancorp, Inc. - EVP, COO*

I think, Scott, the only -- this is Lee -- the only thing I would add, similar to Q4 in the winter months you do have a seasonal impact. And I mean, in Q4, as we mentioned in prepared remarks, part of that is increased capacity in the industry, which has an impact on margin, which we obviously don't control directly. So I think you continue to have a bit of that phenomenon in Q1 as well, given we are still in the winter months.

Scott Siefers - *Sandler O'Neill & Partners - Analyst*

Okay, that's helpful. And then, final one is just more of a ticky-tack one. I want to make sure I understand the other non-interest income guidance on slide 17. What is the level of other non-interest income off which you are basing the guidance? Is that the $9 million specifically in other non-interest income or is that everything that you haven't otherwise called out, i.e., gain on loan sales, net servicing revenue, et cetera?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

I think what we look at, if you look at the full-year 2015 and you divide that number by 4, I think that's the ZIP code we are trying to guide you to.

Scott Siefers - *Sandler O'Neill & Partners - Analyst*

Okay, and you mean specifically, however, the other non-interest income line item that was $9 million (multiple speakers)

Jim Ciroli - *Flagstar Bancorp, Inc. - EVP, CFO*

Not total, correct, correct.

Scott Siefers - *Sandler O'Neill & Partners - Analyst*

Okay.

Jim Ciroli - *Flagstar Bancorp, Inc. - EVP, CFO*

Not total non-interest income.

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Yes, but just the other.

Scott Siefers - *Sandler O'Neill & Partners - Analyst*

Got you. Okay, perfect. That's what I was wondering. Perfect. Thank you, guys, very much.

Operator

(Operator Instructions). Jesus Bueno, Compass Point.

Jesus Bueno - *Compass Point Research & Trading - Analyst*

Thanks for taking my questions, guys. On the MSR sales, I noticed they dropped off a bit from the third quarter, but I guess as we're thinking, you had mentioned before putting out a glide path, but how should we think about the quarter-to-quarter MSR sales as we progress throughout 2016?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

It's going to be based on what the market opportunities bring us and it is going to be a combination of bulk and flow, as Lee said. But I will turn it to Lee for a little bit more color on that.

Lee Smith - *Flagstar Bancorp, Inc. - EVP, COO*

I think, Jesus, as you know, we have been a regular seller of MSRs over the last two years and we will continue to do so, given we are the 10th largest originator of mortgages in the country and the advent of Basel III. And we have done a nice job reducing that concentration in MSRs from the high point back in September 2013, and we are confident we will be where we need to be by the end of Q1 2018, which is when Basel III is fully phased in.

We intend to get there through a combination of bulk and flow sales, and we can use the sale of MSRs to benefit other areas in the bank, such as the subservicing business, where we retain the subservicing on the underlying loans being sold, or on the lending side if we were to lend against servicing advances or the MSR asset.

But I think the one thing I would probably draw your attention to, Jesus, is the $2.5 billion was -- that was a bulk transaction. We do have flow transactions in place, which don't get reflected in the sales numbers that we actually disclose because they are done as a co-issue, so the MSRs actually never hit our balance sheet in the first place. So, there is more activity going on behind the scenes, other than just the $2.5 billion that we discussed in the prepared remarks.

Jesus Bueno - *Compass Point Research & Trading - Analyst*

That's great. And just on the retention rate you mentioned, I guess, is that still running about 25% in terms of a subservicing retain on MSR sales?

Lee Smith - *Flagstar Bancorp, Inc. - EVP, COO*

I think we would like -- we would like to retain more than 25%. We would like to retain 50% to 75% in terms of the MSRs that we sell from a subservicing point of view. I would tell you that when you look at the sales that we executed in 2015, both in terms of flow and bulk, it was probably about 50-50. Ideally, we would get that closer to 75%.

Jesus Bueno - *Compass Point Research & Trading - Analyst*

Great, thank you. And looking over to -- on the provision guidance, it's been since about a year now that you have been guiding to provision equal to the prior quarter's net charge-offs and you have been steadily releasing and having a negative provision, a provision benefit.

I guess if you could comment just on the level of reserves you have and your comfort with those levels. Obviously, credit has improved pretty dramatically, but I guess, are you comfortable with the current level of allowance? And as we think about provision going forward, obviously there haven't been -- you have had this benefit as a tailwind. So, should we continue to expect that going forward?

Jim Ciroli - *Flagstar Bancorp, Inc. - EVP, CFO*

This is Jim. It is hard for me to say anything other than the allowance is where we think it should be as of year end. As we look forward and if we were to experience additional good times from a credit perspective, then I think we would have pressure to take that down if that level were unjustified.

But as you look at our portfolio, I would guide you to some of remarks I made, and you look at the residential mortgage loans and 80% of those have been originated in the past two years under this management team's watch, so we feel really good about that portfolio.

And when you think about the commercial portfolio, again, high-quality portfolio, no delinquencies, including the warehouse lending portfolio, which is a big component of that portfolio. We have the collateral. It is fully collateralized. It is a strong credit quality portfolio.

So, when you think about those components of that overall loan portfolio, you have to feel good about where we have the allowance at this point in time.

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Did that answer your question, Jesus?

Jesus Bueno - *Compass Point Research & Trading - Analyst*

That does. Thank you very much and thank you for taking my questions.

Operator

That is all the time we have for questions today, so I would like to take -- turn it back to Sandro for any additional or closing remarks.

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Thanks, Vicki. I appreciate your assistance. And thanks, everyone, for your interest in Flagstar. We were very pleased to report positive results for the fourth quarter and for all of 2015.

In retrospect, the quarter was about demonstrating that we can produce good results despite lower originations, consistently add high-quality assets to our balance sheet, and maintain a clean credit profile. With recent senior executive additions, like Drew Ottaway, we're making a really good management team great. The fact that Flagstar continues to attract talented executives is a vote of confidence in our business plan and it speaks volumes about how far we have come in moving Flagstar forward.

Our continuing focus is on positioning Flagstar for consistent, diversified, and sustainable earnings atop a safe and sound foundation. We remain optimistic about the future and very confident in our business plan.

A special callout to the entire Flagstar team for their many contributions to making 2015 a success. Thank you for your time this morning. I look forward to reporting Q1 results in April.

Operator

Thank you very much. That does conclude our conference for today. I would like to thank everyone for your participation and have a great day.
