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EDITED TRANSCRIPT

FBC - Q1 2015 Flagstar Bancorp Inc Earnings Call

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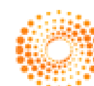

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Operator

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PRESENTATION

Operator

Good day and welcome to the Flagstar Bank first quarter 2015 earnings conference call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. David Urban. Please go ahead, sir.

David Urban - *Flagstar Bancorp - Director, IR*

Thank you, Jennifer, and good morning. Welcome to the Flagstar first quarter 2015 earnings call. This is David Urban, Director of Investor Relations.

Before we begin, I would like to remind you that the presentation today may contain forward-looking statements, regarding both our financial condition and our financial and operating results. These statements involve certain risks that may cause actual results in the future to be different from our current expectations. For a non-exhaustible list of such factors, please see our 2014 Form 10-K as well as legal disclaimer on slide 1 of our first quarter 2015 earnings call slides that we have posted today on our Investor Relations site at flagstar.com.

During the call, we may also discuss non-GAAP financial measures regarding our financial performance. A non-GAAP financial measure is a metric that is not presented in accordance with U.S. GAAP. We believe that our use of these non-GAAP financial measures in addition to the GAAP results can provide investors with additional information that is useful in assessing the results of Flagstar's operations on a run rate basis.

In today's presentation, in the press release we issued this morning and in our subsequent SEC filings, we identify these non-GAAP financial measures as adjusted measures which modify for significant items. We are providing a reconciliation of these measures to similar GAAP measures in the tables to the press release that we issued this morning or in the appendix to our earnings call slides.

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

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Thanks, Dave; and thank you, everyone, for joining us today. Let me first apologize in advance for my voice. I'm a little under the weather today. In addition to Dave, I am joined this morning by Jim Ciroli, our Chief Financial Officer; Lee Smith, our Chief Operating Officer; and Steve Figliuolo, our Chief Risk Officer. I'd like to take a moment to describe the order of the call. First, I'm going to highlight the key items and actions we undertook

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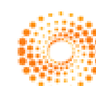
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during the first quarter. After my remarks, Jim will review the consolidated quarterly financial performance. Lee will then provide a more detailed review of our business segments and strategic initiatives. Following this, I will conclude with a view of our 2015 second quarter and then open the call for questions and answers. With that, let's begin.

We reported net income of $31.5 million or $0.43 per diluted share for the first quarter of 2015 as compared to $11.1 million or $0.07 per diluted share in the fourth quarter of 2014. That's a significant rise in profitability that resulted from a 15% increase in revenue coupled with a 2% decrease in expenses. This positive operating leverage is what we have been working hard to achieve. While we are pleased with these results, we are even more pleased with the fundamentals behind the numbers as we continue to improve in all key operating areas; net interest income, credit costs, non-interest income and operating expenses.

First, our mortgage business had a very strong quarter. Mortgage originations were up 10%. Locks were up 17%. Gain on sale margin was up 46% and gain on sale income was up 71%. These numbers reflect the power of our national origination platform and provide concrete evidence that our efforts to reposition our mortgage franchise are working. With these results, we have outpaced the performance of virtually every other mortgage originator who has released Q1 results to-date.

Second, net interest income continued to grow on the strength of an 8% increase in average earning assets for Q1, driven by growth in loans held for sale and in the investment portfolio. The loan growth was led by a 15% increase in warehouse lending. We believe we are increasing market share in warehouse as our operating model has fundamentally changed. Where once we were the primary purchaser of loans funded by our warehouse lending, now, loans purchased by other investors represent the majority of our fundings.

Take a look at how this business has changed over the last year. At March 31, 2014, we had $409 million in outstanding warehouse lines with 31% funding loans purchased by other investors. At March 31, 2015, we had $1.1 billion in outstanding warehouse lines with 60% funding loans purchased by other investors. As these numbers show, we have successfully re-engineered this business in a very positive fashion.

Third, we substantially improved credit quality, primarily via loan sales. Performing TDRs declined by 69% and non-performing loans were down 30% from the fourth quarter of 2014. NPLs are now comfortably below $100 million, a lever Flagstar has not seen since 2006. And finally, in the face of rising business levels throughout the Company, we reduced operating expenses. This management team is focused on improving efficiency and we'll continue to be relentless in pursuing that goal.

Now, let's take a deeper dive into the mortgage business, so you can get a better picture of the dynamics of our results. We were able to capitalize on a drop in the 10-year treasury rate as well as FHA's mortgage insurance premium reduction that created an attractive refinance environment. We were very focused and proactive in pursuing the window that opened for us in refis and conducted a direct marketing campaign to bring in the business.

We're further encouraged by the benefit we're seeing from the operational changes we made to our mortgage origination business. For example, we've become smarter in working with the third-party originators. We're doing more business and better business with fewer TPLs with no reduction in market share. We've also adjusted stance of control in the sales organization, which we believe has produced improved performance. And not only did we increase originations and lock significantly, we also maintained service levels throughout a period of high volume. In fact, we carefully managed volume through pricing to ensure we met our customer service expectations. As I said before, we are fully committed to building our mortgage business and this entire Bank on the foundation of industry-leading service.

Another positive for the quarter was the growth of our balance sheet, beyond the $10 billion threshold. As we said last quarter, we expected to see balance sheet growth in 2015 and now we're delivering it. The diversification of our revenue is critically important to our strategy and we will continue to focus on this objective through the growth of our structural balance sheet.

On the credit side, we took another big step forward in the first quarter with the sale of $331 million of lower-performing loans. This was accomplished with no negative financial impact, another validation of the accuracy of the marks in our books.

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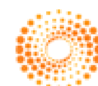
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On the expense side, as I mentioned earlier, non-interest expenses declined 2%. Rest assured that our leadership team is focused on continuing to find efficiency opportunities. We will cover expenses more specifically in remarks.

Now, a few other items of note. We remain ever vigilant with our interest-only portfolio and continue to aggressively manage it with positive results. Lee will tell you more about that. And while I can't tell you when our OCC consent order will be lifted, I can tell you that we are making meaningful progress toward that end, that we are engaged in daily dialog with the OCC and that we appreciate their efforts to help Flagstar be the best institution that it can be.

With respect to our TARP preferred, we continue to investigate all options that may be available. That said, there are a number of considerations, including the need for regulatory approval that makes it difficult for us to pinpoint with exact certainty when we will redeem these securities. In any event, we expect that it will be no later than the second half of 2016.

All in all, it was a solid performance for the quarter, characterized at the highest level by the positive operating leverage and further de-risking of our balance sheet. We remain focused on compliance and risk management, as those are evergreen. And right there with that is the overarching goal of improving our core profitability. With that, my colleagues will take you through a more detailed discussion of our financials and operations. So let me now turn the call over to Jim.

Jim Ciroli - *Flagstar Bancorp - CFO*

Thanks, Sandro. Turning to slide six, our net income was $31.5 million or $0.43 per share in the first quarter as compared to net income of $11.1 million or $0.07 per share in the fourth quarter. Our earnings this quarter were shaped by the structural improvements we've made over the past year, combined with the resurgence in refinance activity. Revenue rose a solid 15%, while expenses fell 2%. Our first quarter net interest income rose to $64.9 million as compared to $61.3 million in the fourth quarter of 2014. The increase in net interest income was led by earning asset growth, partially offset by net interest margin reduction. Our NIM dropped 5 basis points in the quarter to 2.75% mainly due to increased borrowing costs as we lengthened Federal Home Loan Bank borrowings to provide a more stable funding for planned loan growth and improve our interest rate sensitivity. Earning assets rose 8% last quarter due to growth in loans held for sale in the investment portfolio. Our successful optimistically growing our loan book continued last quarter with solid growth in warehouse, commercial real estate and C&I loans. Average deposits increased $223 million for the prior quarter, driven by higher non-interest bearing escrow deposits in growth in retail savings. We had continued success with our promotional campaign to increase retail savings accounts. The quarterly provision for loan losses was a benefit of $3.5 million for the first quarter versus a provision of $5.0 million in the fourth quarter as we reduced the overall size of the allowance in conjunction with the sale of $331 million of lower-performing loans. Our net charge-offs of $40.5 million for the first quarter included $36.0 million of net charge-offs associated with the aforementioned sale. Excluding this amount, net charge-offs were $4.5 million or 45 basis points of applicable loans. I'll provide additional detail on asset quality in a couple of slides.

Non-interest income increased $19.9 million or 20% to $118.3 million in the first quarter. The main improvement in non interest income was a $37.8 million or 71% increase in gains on loan sales, which Lee will provide further details on. This positive development in non interest income was partially offset by three items. First, a $4.6 million decline in R&W reflecting Q4 recoveries and a reduction in the reserve recorded in the fourth quarter 2014. We kept the R&W reserve unchanged this quarter. Our claims experience continues to perform better than we had modeled and we're encouraged by government efforts to assess risk-based penalties on documentation flaws instead of forcing repurchases. Slide 37 in our appendix provides further information on this reserve.

Second, our returns on the MSR asset were $2.4 million negative, $4 million worse than last quarter's return. The return was pushed negative by a $4.2 million increase in the amortization of the asset as prepayment speeds rose to 22% for the portfolio in the first quarter, up from 15% in the prior quarter. Additionally, we had $4 million of net hedge losses from interest rate volatility earlier in the quarter and $1.6 million in net transaction costs. Please refer to slide 33 in the appendix for further details.

And finally, the $6.3 million decrease in other non-interest income due to a $5.5 million reduction in the fair value of certain HELOCs. To help you understand the change in fair value, I'd like to provide some background on our HELOC portfolio. Pursuant to the settlement we struck in 2013 with Assured Guaranty, we consolidate two securitization trusts, they formally insured and carry the underlying assets of $112 million of HELOCs

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at fair value. This fair value was 88% of UPB at March 31 2015. The HELOCs are serviced by a third party and the loans are structured to become due and payable at the end of the draw period. As the HELOCs from the trust are coming to the end of their draw period, we've noted that more HELOCs that we would like are not being repaid in full of end of draw.

Consequently, we reviewed the servicing strategies with the third-party servicer that we believe that Flagstar is better positioned to service these loans at the end of draw, so we're taking greater control of these assets. Simply put, we have more options at our disposal and we don't have to operate under a trust indenture as our servicer does. So, we're electing to exercise our clean-up call, where we can. Slide 44 in the appendix provides more detail.

Until we take control and demonstrate our ability to resolve these loans better, we have reflected a higher level of delinquencies in our fair value estimate, resulting in net charge. Moving to expenses, non-interest expense fell 2%, $100.0 million in the first quarter as compared to $139.2 million in the fourth quarter. This included its $5.6 million decline in asset resolution costs, which fell sharply to $7.8 million, the result of process improvements and lower levels of problem assets and a $1.8 million decrease in legal and professional fees, driven by a lower level of foreclosure actions and the completion of various consulting projects. These were partially offset by approximately $3 million of higher compensation commissions and loan processing expenses related to the increased mortgage activity.

Slide eight highlights our period-end balance sheet. Total assets increased 18% to $11.6 billion in the first quarter, led by growth in HFS loans, the investment portfolio and warehouse loans. Average deposits increased 3% resulting from higher levels of escrow deposits and a 5% increase in retail savings deposit. When rates dropped early in the quarter as we considered funding for planned loan growth, we saw an opportunity to lengthen the duration of our funding by adding $625 million of longer-term FHLB advances with an average maturity of 5.5 years and an all-in cost of 1.68%. This action improved our liquidity position and increased our assets of sensitivity. We maintained a strong balance sheet with ample liquidity. Our common equity to asset ratio remained solid at 10% , while on balance sheet liquidity improved to 21% of total assets.

Turning to slide nine, our allowance coverage was 5.7% of total loans at the end of the first quarter as compared to 7.0% at the end of the fourth quarter. Coverage dropped as a result of the sale of lower-quality loans and the continued migration of our loan portfolio in the higher-quality assets such as our warehouse loan book for credit losses are low. At quarter end, we had 9.5% allowance coverage and our consumer loan book down 146 basis points from the prior quarter end consistent with a sizable drop in consumer delinquencies and fewer lower quality assets. The commercial loan allowance coverage remain fairly stable at 1.5% in Q1, reflecting the low levels of problem loans in this portfolio and growth of higher-quality loans such as warehouse loans during the quarter. Non-performing loans were 84 million at the end of the first quarter as compared to 120 million at the end of the fourth quarter. This 36 million decrease was driven by the sale of lower performing loans. Performing TDRs, fell 251 million to 111 million in the first quarter, reflecting the benefit of this recent loan sale.

Early-stage delinquencies were down from Q4.

Looking at consumer loans, 1.2% of consumer loans were over 30 days delinquent still accruing, an improvement of 47 basis points from the fourth quarter. There were no commercial loans at March 31, there were more than 30 days delinquent. Turning to slide 10,we continue to maintain robust regulatory capital ratios in the first quarter with the partial phase-in of Basel III and they partially phased in basis. Our Tier 1 leverage ratio was 12.0% and our Tier 1 common ratio was 15.4%. Diving deeper into each of these ratios, the partial phase in reduced our Tier 1 leverage ratio by 57 basis points when compared to the same ratio under Basel I.

Interestingly, our common equity Tier 1 ratio increased 247 basis points under the phasing rules as the absorption of the write-off of excess MSRs and NOL dependent deferred tax assets are born only 40% by common equity Tier 1 in the first year of the phase-in. The remaining NOL dependent DTAs and MSRs above the Basel III limits are written-off against the non-common elements of Tier 1 capital, namely the TARP preferred and the trust preferreds in this first year of phase-in.

Looking at the impact of a fully phased in implementation of Basel III, our Tier 1 leverage ratio would have been 10.3%. And our Tier 1 common ratio 9.4% at the end of the quarter. This 170 basis point adverse impact to our Tier 1 leverage ratio is mostly driven by the detrimental treatment that mortgage servicing rights receive under Basel III. Over the long term, we plan to continue to reduce our MSRs to Tier 1 leverage ratio, taking into consideration market conditions to guide our pace of MSR reduction. Excluding our preferred stock and now $63 million of preferred deferred

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dividends from our Tier 1 capital are consolidated Bancorp Tier 1 leverage and Tier 1 common ratio under Basel III, fully phased would be 7.0% and 8.3% respectively.

At March 31, 2015, we had $279 million of MSRs representing 22.2% Tier 1 capital, relatively unchanged from the end of Q4. I will now turn to Lee for more insight in each of our businesses.

Lee Smith - *Flagstar Bancorp - EVP & COO*

Thanks, Jim; and good morning to everyone. On previous earnings calls, we've talked about creating a solid foundation through de-risking the balance sheet and optimizing the cost structure, from which to growing our three major business lines of mortgage originations, mortgage servicing and community banking. As we have pivoted to the growth stage of our strategy, we believe our efforts over the last two years to create that foundation are demonstrated in the positive operating leverage and improved efficiency that you see in the first quarter results. We're encouraged by the progress we've made and will look to build on these results, both in the second quarter and beyond. I will now outline some of the key operating metrics from each segment during the quarter.

Please turn to slide 12. Quarterly operating highlights for the Community Banking segments include average commercial loans increased 10% to $1.7 billion versus the prior quarter, primarily as a result of growth in our warehouse business. Commercial loan commitments grew 3% quarter-over-quarter to $3.2 billion. Warehouse loan balances increased $79 million or 15% this quarter as a result of increased mortgage origination activity and overall market share gains driven predominantly by an increase in the funding of loans purchased by other investors.

During the last 12 months, we've grown warehouse loan balances by $674 million, C&I loan balances by $132 million and CRE loan balances $122 million for a net increase in new commercial loan balances of $928 million. Average consumer loans increased $106 million or 4% during the quarter. This is a net increase even after accounting for the sale of $331 million UPB in residential TDRs, NPLs, and scratch and dent loans. We added $259 million of jumbo conventional product to our HFI portfolio during the quarter as added high quality interest earning assets to the balance sheet. Average deposits increased more than 3% during the first quarter nearly 19% over the last 12 months, predominantly due to increases in savings deposits. It is our intention to continue to grow our commercial businesses, including warehouse lending in a controlled sight and sound manner as we have been doing to-date. We are encouraged by the growth we've seen in the warehouse business during the first quarter. I will look to build on that further as we move forward.

In the C&I and CRE segments, we continue to focus on the Michigan market and we're also looking to expand our consumer loan offerings, given the experience of the team we now have in place. We will also continue to de-risk the balance sheet of riskier assets when it makes economic sense to do so and replace them with higher quality loans in order to maximize interest income.

Please turn to slide 13. First quarter operating highlights for the mortgage origination business include fall out of just the lot volume increased 17% to $7.2 billion. Refinance mortgages accounted for slightly more than 63% of origination volume in the first quarter as compared to slightly more than 46% of origination volume in the fourth quarter. Fall-out adjusted gain on sale margin, which is what we used when reporting gain on loan sale increased 40 basis points or 46% to 127 basis points in the first quarter as compared to 87 basis points in the fourth quarter. The increase in margin was driven by stronger market pricing power as we priced the balance volumes in capacity, as well as improved business performance. The Company made fundamental changes in its mortgage origination business towards the end of last year to enhance customer service and profitability.

While we took advantage of the drop in interest rates at the beginning of the quarter, as the 10-year bottomed out 1.67% on February 2 and the reduction in FHA mortgage insurance premiums, which went into effect at the end of January. We certainly believe the operational enhancements we made have created a degree of permanent improvements. We continue to remain focused on providing service excellence, while at the same time, implementing strategies to create a more variable cost structure on the fulfillment side of the business. These efforts have allowed us to realize significant operating leverage during the quarter, unoptimized overall returns in our mortgage business.

As we look forward into Q2, we believe the low interest rate environment will continue to be beneficial to our origination business together with the seasonal uptick created by the spring buying season. We are investing in technology as a way to further improve the topline performance and

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make us more efficient from an operating point of view. And we remain on target to be ready for the new RESPA/TILA disclosure requirements that go into effect in August of this year. Finally, we are committed to growing our retail origination business on both the retail distribution and direct to consumer side; and we'll keep you apprised of progress on these fronts on future calls.

Moving to servicing, quarterly operating highlights for the mortgage servicing segment on slide 14 include, we executed on the sale of $2.8 billion in aggregate UPB or 10,300 loans of residential MSRs during the quarter. We currently service approximately 385,000 loans, of which 231,000 are sub-service for others. The remaining 154,000 are loans where we own the MSR or they are part of HFI book. Approximately 96% of our servicing book is performing loans, which means 4% or approximately 15,000 loans are 60 plus days delinquent. We are always looking at ways to reduce the number of default and delinquent loans in our portfolio given the significant cost associated with servicing delinquent loans and servicing and working out delinquent loans is not part of our core growth strategy. We remained focused on growing at fee income-generating subservicing platform and also want to better leverage the cross-selling we're able to do across our three business line verticals in order to increase share of our mortgage customer's wallet and the number of accounts per household. Moving to asset quality. We continued with our sustained efforts to be risk the balance sheet. We sold approximately $331 million unpaid principal balance of TDRs, NPLs, and scratch and dent loans during the quarter. We've now sold almost $1 billion in UPB of NPLs, TDRs and scratching -- loans over the last 2 years as part of a concerted effort to de-risk that balance sheet and reduce the cost associated with non-performing and lower-quality assets. Other significant effects of these Q1 sale transactions include our NPL stand at $84 million or less than 1% of our overall balance sheet at the end of the quarter, the lowest level, it's been at almost 10 years. A decrease in NPLs as a percent of loans held for investment to 1.8% at the end of Q1 compared to 2.7% at the end of Q4. A reduction of $269 million in TDRs in HIF portfolio. The sale should lead to a continued reduction in asset resolution expenses in future periods, as well as lower your FDIC premiums in 2016. We continue to see strong performance from actively managing our IO portfolio.

If you turn to slide 15, you will see that we have $552 million of interest-only loans on our balance sheet that have yet to reset. Of this $236 million or 43% we said during the remainder of 2015. The anticipated payment shock associated with these resets versus current payments is approximately 106%. The slide on page 16 of the earnings presentation contains a lot of key data points around this portfolio. So you can see how we're handling and tracking IO book rather than reciting the metrics from these slides verbatim, I want to focus on a few key highlights. But before that, I would just say that we continue to be extremely pleased and encouraged with the performance of this portfolio. Key takeaways include of the 1,696 IO loans that have reset through March 31, 2015, 24.9% unpaid principal balance or 367 loans have paid in full, 40.9% UPB or 759 loans, are cash flowing resets, of which 748 have been paying for three months or more and 477 or 63% of this specific population have been paying for six months or more. 7.1% UPB or 141 loans have been charged off or foreclosed on. And of this, 122 defaulted prior to the reset date and only 19 defaulted post reset date. The rolling 12-month average loss severity on the IO portfolio is 33%.

With respect to overall quality, slide 15 shows that 84% of all remaining IOs have FICO scores greater than 660 and 89% of those same loans have LTVs less than 100%. We're currently at 97.5% right party contact rate for Q2, where we have 175 IOs or 47.3 million UPB resetting. In summary, it's been another productive quarter as we continued to reduce risk and strengthen the balance sheet.

Moving now to expenses on slide 17. Our non interest expense during the first quarter was $137 million versus $139.3 million in the fourth quarter. Variable costs, including commissions and loan processing expenses increased a little over $2 million during the quarter, as a result of the increased mortgage origination volume, while fixed costs declined $4.5 million due to lower asset resolution expense, as a result of our process improvements and de-risking efforts over the last few months. We believe that current non-interest expense quarterly run rate is approximately $135 million to $140 million.

Managing our cost structure aggressively will continue to remain a focus. Our goal is to reduce excess capacity and create a more variable cost structure, which is highlighted in the quarterly non interest expense chart on slide 17. We will continue to build on the work we've done today around management of procurement expenses, asset resolution costs, legal and professional fees and optimizing our real estate portfolio. Our efficiency ratio improved to 74.8% in the first quarter from 87.2% in the fourth quarter. The improvement was driven by an increase in revenues of $23.5 million quarter-over-quarter and a decrease in non-interest expense of $2.2 million despite the increase in topline revenue.

We continue to work tirelessly to further optimize our cost structure and drive greater efficiencies. As a result of our expense management and discipline, what we expect you should see as we look further forward is a cost base that increases at a lower rate than revenues as we continue to

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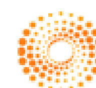

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grow that three major business line verticals. Our first quarter results demonstrate this positive operating leverage and expense discipline that has been instilled within the organization, even as we invest some of these savings into our future growth strategies.

With that, I'll hand it back to Sandro.

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Thank you, Lee. I'm now going to close our prepared remarks with some guidance for the second quarter and then open the call for questions and answers. Please turn to slide 19 for those itemized guidance parameters.

We expect net interest income to increase approximately 10%, as we continue to grow earning assets. Mortgage locks are expected to remain flat with originations up 10% to 15%. We expect a decline again in month of March. Loan administration income is expected to remain at the Q1 level. We expect the net return and our mortgage servicing assets to remain under pressure given elevated prepayment rates. The ratio of our MSR to Tier 1 capital is expected to be consistent with March, 31 2015 levels.

We expect our provision expense to match net charge-offs, consistent with the net charge-off ratio in Q1, adjusted for loan sales. As Lee noted, non-interest expenses should remain relatively flat. And lastly we expected effective tax rate in Q1 to remain constant and Q2 to remain constant.

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

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). Scott Siefers, Sandler O'Neill.

Unidentified Participant

Hey, good morning, guys, this is actually [Bertonazzi] on the line from Scott's team. I was hoping we could start out with a little more color on the gain on sale margin. Obviously, you had some really nice expansion here. In the release, you commented on some fundamental in the changes the mortgage origination business that will help going forward, but other calls for a slight decline in the margin. Could you give us a sense of the magnitude of this decline in the 2Q? Will it be closer maybe to this quarter's result or the 4Q figure?

Sandro DiNello - *Flagstar Bancorp - President & CEO*

My best guess would be it's going to be somewhere in-between. I know that's not as specific as you'd like to hear. But it's difficult for us to be able to pinpoint just how the gain on sale margin will react going forward. A lot of things took place in Q1. There was a lot of activity because of the decline in the tenure, there was the impact of the FHA, MIP reduction and then some of the things we did in terms of how we score our third-party originators who we're doing business with, how we deliver prices to our third-party originators. So there's a lot of things that came into play in Q1 that produced the results we had. So it's just really difficult for me to be more specific going forward. I guess what I would say is I think we executed pretty strongly on every aspect of that business in Q1, and we're optimistic that we'll be able to do so going forward.

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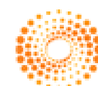

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Scott Siefers - *Sandler O'Neill - Analyst*

That's great, thank you for the color there. And then, I was hoping we could shift over to the mortgage warehouse. It was definitely a very strong driver of this quarter's loan growth. You guys seem very optimistic looking forward to the year. Could you give us a sense of how it's going to look in the second quarter and then maybe kind of also update us just in the context of how you were thinking about the warehouse 90 days ago?

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Well, I think the change in the thinking on the warehouse started really quite some time ago. And in the prepared remarks, I referred to the March 31 levels of outstanding as well and more importantly, I noted, how much of that outstanding is related to loans that were being purchased by other investors and that's a real fundamental change in the way we think about that business today. So we're going up market, if you will, and we're reaching out to larger originators, many that don't need Flagstar as an aggregator. And so I think the opportunity is pretty significant. We're not providing any specific guidance in that area, but we're going to continue to look for the right opportunities going forward.

Scott Siefers - *Sandler O'Neill - Analyst*

That's all and thank you very much for the color guys.

Sandro DiNello - *Flagstar Bancorp - President & CEO*

You're welcome.

Operator

Thank you. (Operator Instructions) Bose George, KBW.

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Hi, Bose.

Bose George - *KBW - Analyst*

Hi, guys. Good morning, congratulations on the quarter. I just had a follow-up on the gain on sale question. In terms of the optimization of the mortgage business commentary you had, can you just discuss that a little further? Is that sort of efficiencies on the cost side that is flowing through the gain on sale line item?

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Well, one of the other things that I didn't mention in the prepared remarks or in my answer to the earlier question is and Lee has talked a lot about this in the past in terms of building a variable capacity model, a model that could adjust to increasing volumes quickly and would minimize the fixed expenses in the business. And I think in Q1, with the way the volume surged that we were able to do that. If you can see the expenses associated with that business didn't increase particularly significantly in Q1. So I think there's a lot of things, like I mentioned, both in the speech, and in the answer to the earlier question. But on top of that, I think it's the model and the way the model works and I think it's pretty efficient and we've got a real chance to see that work in real time here over the last few months.

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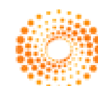

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Bose George - *KBW - Analyst*

That definitely makes sense and we saw that on the cost side, but I'm just curious, just the piece that goes through the gain on sale margin itself. So, there's both a sort of strength in the market, but also the cost side of what flows through the gain on sale margin that's also improving. So is there sort of two pieces of that that benefited this quarter?

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Yes, I'd say that. That's each one of those things. But as I said in my earlier response, it's just really hard for me to get specific with you as to where exactly I think it is and where it's going to be. So, right now, we feel real good about it and one quarter doesn't tell the whole story for the future. So we need to see how things go here, going forward. But I can tell you we're pretty optimistic about our ability to continue to execute pretty effectively.

Bose George - *KBW - Analyst*

Okay, great. And then, actually just switching over to the FHA volume, the FHA percentage, it looks like it went down a little, both on actually percentage and dollar count despite the premium cut. So just curious, how FHA is playing into a mix. Was that just reflective of the market? Did you guys back away a little bit from FHA or anything else?

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Yes. So with the government business, the capacity model is a little bit different with the government business, because you can't outsource as much of the process as you can with the conventional business. So we chose to slow down that business in order to be able to keep the service levels in place and then we just worked with wider margins for the business that was coming in. So we balanced it pretty well and we got real good results.

Bose George - *KBW - Analyst*

Okay, great. And then, just actually last one on the growth in the balance sheet, the investment portfolio growth, can you just discuss what those assets are and just how we should think about the investment portfolio going forward?

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Yes. Let me let Jim take that one.

Jim Ciroli - *Flagstar Bancorp - CFO*

Yes, thanks. Thanks, Bose. We added some securities at the early parts of the quarter in that portfolio, but the security we added are very consistent with the securities that we sold at the end of Q4. If you recall, we sold some securities at the end of Q4 in order to standard that $10 billion mark. But the portfolio continue to yield around 2.5 with just under a four-year duration.

Bose George - *KBW - Analyst*

Okay, great. Thanks a lot.

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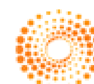

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Sandro DiNello - *Flagstar Bancorp - President & CEO*

You're welcome.

Operator

Thank you. Kevin Barker, Compass Point.

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Hi, Kevin.

Kevin Barker - *Compass Point - Analyst*

Hi, good morning. Your Tier 1 leverage ratio for the repayment of TARP increased from 6.9% to 7.1% fully phased in for Basel III. What are you doing to get that number higher and at what level do you feel most comfortable given how your business model is set up today?

Jim Ciroli - *Flagstar Bancorp - CFO*

So there is still quite a quite a bit of change that we need to do and think about as we approach any payoff we might have of TARP. Sandro made some comments in his prepared remarks about that. So we continue to look at growing this by just optimizing the balance sheet and putting on better-quality assets that's a key element of all of this, both in terms of how you look at it from a regulatory ratio and how the regulators look at capital as well and just earnings retention.

Kevin Barker - *Compass Point - Analyst*

So you expect purely just a lot of blocking and tackling that you're already doing as opposed to any reshuffling of the balance sheet?

Jim Ciroli - *Flagstar Bancorp - CFO*

I think that's sort of a way to think about it.

Kevin Barker - *Compass Point - Analyst*

Okay. And then, do you think the regulators are focusing on the fully phased-in numbers or the current Basel III ratios when assessing your capital adequacy?

Jim Ciroli - *Flagstar Bancorp - CFO*

We really haven't had that conversation with the regulators. But I don't know how you would focus on the phase-in numbers because we're managing this Bank for the long term. And I don't know why we would look at something that's going to gone in just couple of years.

Kevin Barker - *Compass Point - Analyst*

Yes, great. And another thing that's housekeeping, your tax rate was relatively high this quarter compared to past quarters and you guided to the same tax rates going forward. Was there anything in particular that's driving that?

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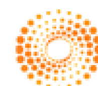

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Jim Ciroli - *Flagstar Bancorp - CFO*

No, the reason why we're at roughly 37% is just the state tax provision. And if you compare Q1 to Q4 we had small state tax benefit in Q4, and I think the benefits -- the way I explained the benefit is at the end of the year, we always true ourselves up to whatever we return less and we had small benefit flow through Q4 along with lower level that what we saw this quarter pre-tax income level.

Kevin Barker - *Compass Point - Analyst*

So would you say it would probably stay consistent 37% absent some one-off or seasonal items that may happen in the beginning or end of the year?

Jim Ciroli - *Flagstar Bancorp - CFO*

Yes, that's what we've said on that last slide.

Kevin Barker - *Compass Point - Analyst*

Okay. And then. one last one, considering how proactive you've been on distressed loan portfolio, could you help quantify the decline in operating expenses that you expect going forward due to a decline in FDIC insurance and asset resolution expense?

Sandro DiNello - *Flagstar Bancorp - President & CEO*

So I'll let Lee get into a little bit more detail there, but just on the FDIC expense, one thing I'll say is remember, we're under the small bank FDIC expense in 2015 because we were under $10 billion at the last point in time when that's evaluated; and in 2016 though, we would expect that we would go into the large bank pricing. So therefore, we're trying to position the balance sheet with the right kind of assets, looking forward to what the FDIC expenses are going to be in 2016. So that's why in a couple of places, there was a reference made to a reduction of FDIC in 2016 as opposed to 2015.

Lee, a little bit more on the expenses.

Lee Smith - *Flagstar Bancorp - EVP & COO*

Yes. So on asset resolution, Kevin, you obviously saw a significant decline this quarter versus last quarter in asset resolution. I think as we look into Q2, the run rate for asset resolution is going to be pretty consistent with where it was in Q1. So we feel as though the de-risking efforts we've undertaken not just in Q1 but prior to that as well are beginning to -- they've showing through basically in the asset resolution results. And so, I would assume that the current run rate for asset resolution is going to be consistent with Q1, and if you sort of go back and look at where asset resolution expenses were in 2014 full year and 2013, you'll see dramatic decline year-over-year.

Sandro DiNello - *Flagstar Bancorp - President & CEO*

So just to reiterate, we're guiding to $135 million to $140 million expense level for Q2.

Lee Smith - *Flagstar Bancorp - EVP & COO*

Correct.

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Kevin Barker - *Compass Point - Analyst*

Thank you for taking my question.

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Thanks, Kevin.

Operator

Paul Miller, FBR Capital Markets.

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Hi, Paul.

Paul Miller - *FBR Capital Markets - Analyst*

Hey, how are you guys doing? And a follow-up on the asset resolution question. I mean, can we assume that you'll continue to sell your TDRs and your NPLs as much as possible?

Lee Smith - *Flagstar Bancorp - EVP & COO*

So a couple of things, Paul. If it makes economic sense to do so, then, we will always evaluate asset sales. And furthermore, as I mentioned in my prepared remarks, part of our core strategy as we move forward here is not to sort of work out lower-performing assets, NPLs, as such. So, if the opportunity is there and it makes sense to do so, we'll take that opportunity.

Paul Miller - *FBR Capital Markets - Analyst*

Now, I know one of the pushbacks I get with you guys selling the TDRs that you sold to really good TDRs and probably the TDRs they couldn't get a good bid probably were kept on the balance sheet. I mean how would you answer that question?

Lee Smith - *Flagstar Bancorp - EVP & COO*

Yes. I know we have got -- if you look at the overall TDR balances that are left on the balance sheet now, it's a very small number. So I don't think there was any cherrypicking as such. I think the TDRs that were sold, the characteristics are reflective of the TDRs that remain.

Paul Miller - *FBR Capital Markets - Analyst*

Okay. And then, you made a -- seems like I got this correct, right. The consent order, on the timing of that consent order, you made two comments, right. You're working with the OCC to get rid of that consent order. And secondly, it says, on the TruPS, correct me if I'm wrong guys, that you should have the TruPS gone no later than the second half of 2016. Could that happen sooner and then what type of timing can you give us of the consent order. Is it something that can be gone in 2015 or is that going to take a little -- 2016 or 2017 event?

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Sandro DiNello - *Flagstar Bancorp - President & CEO*

So first of all, with respect to the preferreds, sure it could be sooner. But we can't be specific about that, but we definitely expect that we'll be able to complete it by the second half of 2016. And the other part of your question was --

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Paul Miller - *FBR Capital Markets - Analyst*

[Your consent order].

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Yes. I mean we can't talk specifically about regulatory matters like that. But in our comments were meant to be positive in that we feel very good about the progress we're making. But to tell you whether I think it's [2000], 2016, I just can't go there.

Jim Ciroli - *Flagstar Bancorp - CFO*

Yes. Paul, this is Jim. I just want to make sure that we're talking TARP and not the TruPS.

Paul Miller - *FBR Capital Markets - Analyst*

Yes, I'm sorry, TARP, yes.

Jim Ciroli - *Flagstar Bancorp - CFO*

Okay.

Paul Miller - *FBR Capital Markets - Analyst*

Yes. And are [these events] mutually, are they inclusive or exclusive one another? In other words, do you have to do one to get the other gone or they're just two independent events?

Jim Ciroli - *Flagstar Bancorp - CFO*

With the TruPS and the TARP or are you talking to the consent order and TARP --?

Paul Miller - *FBR Capital Markets - Analyst*

The consent order and TARP, yes. I think I've gotten confused now.

Sandro DiNello - *Flagstar Bancorp - President & CEO*

They are not necessarily connected.

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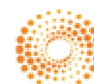

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Paul Miller - *FBR Capital Markets - Analyst*

Okay. Okay guys, thank you very much.

Sandro DiNello - *Flagstar Bancorp - President & CEO*

You're welcome.

Jim Ciroli - *Flagstar Bancorp - CFO*

Thanks, Paul.

Operator

There no further questions at this time. I'll turn it back over to Sandro for any additional or closing remarks.

Sandro DiNello - *Flagstar Bancorp - President & CEO*

Thank you, Jennifer, and thanks for your assistance today and to all of you for your interest in Flagstar. Looking back at the quarter, we were encouraged to see the hard decisions we made to improve our mortgage originations business are paying off. Reduction in NPLs was also a big plus and our overall business strategy continues to evolve positively.

I also want to thank all my Flagstar colleagues that are listening. Their commitment and great work is the backbone of the progress that we reported this morning. And I can assure everyone that the entire Flagstar team remains focused on operating in a safe and sound manner, and we are all committed to building a great company that builds value for our shareholders. Thank you for your time this morning. I look forward to reporting on Q2 results in July.

Operator

That does conclude today's conference. Thank you for your participation.

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