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FBC - Q3 2014 Flagstar Bancorp Inc Earnings Call

EVENT DATE/TIME: OCTOBER 22, 2014 / 3:00PM GMT

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PRESENTATION

Operator

Good day, everyone, and welcome to the Flagstar Bank third-quarter Investor Relations conference call. Today's call is being recorded.

At this time, I would like to turn the call over to Jim Ciroli. Please go ahead.

Jim Ciroli *- Flagstar Bancorp Inc. - CFO*

Thank you, Ann, and good morning. Welcome to the Flagstar third-quarter 2014 earnings call. This is Jim Ciroli, Chief Financial Officer of Flagstar Bank.

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 nonexhaustive list of such factors, please see our 2013 Form 10-K and our first-quarter and second-quarter Form 10-Qs as filed with the SEC, as well as the legal disclaimer on slide 2 of our third-quarter 2014 earnings call slides that we have posted today on our Investor Relations site at Flagstar.com.

During the call we may also discussed non-GAAP financial measures regarding our financial performance. A non-GAAP financial measure is a metric that is not presented in accordance with US 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 results of Flagstar's operations on a run rate basis.

In today's presentation, in the press release we issued last evening, and in our subsequent SEC filings, we identify these non-GAAP financial measures as core operating measures, which adjust for significant items. We are providing a reconciliation of these measures to similar GAAP measures in the table to our press release, which we issued last night, or in the appendix to our earnings call slides.

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, Jim, and thank you, everyone, for joining us today. First, let me officially welcome Jim.

Jim has worked at a number of larger regional banks and brings 27 years of banking and finance experience to our team. Also with me today are Lee Smith, our Chief Operating Officer; Steve Figliuolo, our Chief Risk Officer, and Mike Flynn, our General Counsel.

We are changing the format of this call from previous quarters and I would 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 during the third quarter. After my comments, Jim will review the consolidated quarterly financial performance.

Lee will then provide a more detailed review of the results within each of our business segments. Following this, I will conclude with a view of our fourth quarter and then open the call for questions and answers. With that, let's begin.

During the third quarter of 2014, we reported a net loss of $27.6 million, or $0.61 per diluted share, as compared to net income of $25.5 million, or $0.33 per diluted share, in the second quarter of 2014. Our third-quarter results were materially impacted by our settlement with the CFPB, which we announced on September 29, and which I will describe in greater detail momentarily.

In addition to the $37.5 million which we paid the CFPB, we incurred legal and professional expenses related solely to this matter. Additionally, this quarter we paid certain indemnification claims related to FHA loans and increased our reps and warranties reserve to account for future FHA claims that may arise. I will provide additional detail on this as well.

If you were to adjust our reported earnings to remove these significant items, we would have achieved a modest profit in a difficult mortgage market. This supports the confidence we have expressed in our efforts to mitigate risk and to prudently manage and grow our operations.

Moving on to our continued focus on risk management, as we wrap up the third quarter, we believe that the bank is in a much better risk position. As I have already mentioned, in September we reached an agreement to settle with the CFPB. While the economic consequences of this settlement are certainly difficult to stomach for all of us, we firmly believe that this resolution is in the best interest of our shareholders because it allows us to continue to focus on improving operations and delivering long-term growth and value creation to our shareholders.

Also during the quarter, we paid indemnification claims on government-insured loans of $3.4 million and reserved an additional $7 million for indemnifications on similar loans that may be subject to future claims. One of my stated goals when becoming CEO was to continue to work through legacy issues in an effort to lower credit costs and this is consistent with that premise.

This is a significant credit cost so we have added it back to our calculation of core operating earnings. And while we are characterizing it as significant, we are certainly factoring this issue, as well as the costs associated with our 2012 settlement with the DOJ on behalf of HUD, into our thoughts about the profitability of the FHA originations business, as you have heard others discuss recently.

Another area of significant improvement in our risk management efforts relates to asset quality on the balance sheet. Key highlights of continued improvement in our asset quality were: reducing nonperforming assets as a percentage of total assets to 1.40% compared to 1.54% in the previous quarter, which represents the lowest level of nonperforming loans in over eight years; reducing our repurchase pipeline at the end of Q3 to $30.8 million, which is the lowest level achieved in over six years; and increasing the coverage of the allowance for loan losses to total loans held for investment to 7.6% from 7.4% at the end of the prior quarter.

The increase in the coverage ratio was primarily due to a slight increase in the average loss rate as a result of loan sales executed this quarter.

Finally, an important overall theme for our risk management efforts is that Flagstar is committed to maintaining our discipline and our focus. We will not chase yield or volume, especially in a difficult mortgage environment, at the expense of taking on increased risk or jeopardizing our pricing and profitability standards.

Now let's look at the results of the actions we took to grow in a safe and sound fashion and create value for our shareholders.

Earning assets rose 5% to $8.8 billion, which formed the basis for an increase in net interest income of 3%. While net interest income increased 3%, net interest margin declined 7 basis points to 2.91% on a consolidated basis and core operating noninterest income increased 3% despite a slight decline in gain on loan sales.

While Jim will provide further analysis of the income and balance sheet performance in his prepared remarks, I would like to highlight that our average commercial loan portfolio increased 10% during the quarter. We are pleased to have funded this increase in earning assets with an 8% increase in average total deposits. This again demonstrates the success we have had in attracting seasoned relationship managers who recognize the value of Flagstar being Michigan's bank.

While Lee will provide a more detailed analysis of noninterest expense in his remarks, we believe we are tracking to the top end of the full-year 2014 NIE guidance we provided on last quarter's call. We have previously demonstrated our discipline and ability to manage our expenses commensurate with our revenues and we remain committed to this level of discipline. We will be proactive in this regard and continue to invest where appropriate to grow the business and operate at acceptable efficiency levels.

Before turning the call over to Jim for a detailed financial review, I would like to emphasize a few items. First, we will continue to manage risk to maintain and improve asset quality and the consistency of credit costs. Second, remain committed to managing and controlling expenses to generate operating profits.

Third, we continue to pursue prudent revenue growth. And, lastly, we are confident in the future prospects for Flagstar as we continue to build a company that we believe will produce consistently strong earnings and grow shareholder value. As I said last quarter, we are deeply dedicated to the task at hand.

With that my colleagues will take you through a more detailed discussion of our financials and operations. I would now like to turn the call over to Jim.

Jim Ciroli - *Flagstar Bancorp Inc. - CFO*

Thanks, Sandro. Our core operating net income was $7.7 million, or $0.01 per share, in the third quarter. This compared to $14.4 million, or $0.13 per share, in the second quarter. Driving the overall decrease in core operating net income was the negative operating leverage for the quarter, 10% growth in expenses, partially offset by 3% growth in revenues.

Slide 7 provides a more detailed view of our third-quarter operations.

Our third-quarter net interest income increased to $64.4 million as compared to $62.4 million for the second quarter 2014. The increase in net interest income was attributable to growth in earning assets of 5% to $8.8 billion, partially offset by a 7 basis point decrease in the net interest margin to 2.91%. The higher level of earning assets was due to increases in commercial and consumer loans and higher security balances.

Our success in opportunistically growing our commercial book continued. We continued to add experienced relationship managers from our larger non-Michigan-based competitors. These relationship managers are finding traction with customers for whom being Michigan's bank is an important distinction for us. The consumer increase was from an expansion of our warehouse lending capability which, while growing, will also fluctuate with mortgage volumes.

Average total deposits increased 8% from the prior quarter, driven by higher retail savings and government deposits. At the end of the second quarter we began a promotional campaign to increase retail savings accounts.

The third-quarter provision for loan losses increased $1.9 million to $8.1 million for the quarter. This increase was attributable to charge-offs recorded when we sold jumbo and certain underperforming loans.

Core operating noninterest income increased to $95.6 million for the third quarter as compared to $92.5 million during the second quarter. This included loan fees and charges which increased $3.4 million, or 22%, primarily due to an increase in loan originations; other noninterest income, which increased $1.8 million due to security sales; and our rep and warranty provision, a contra revenue item, which was $3.0 million lower than the prior quarter.

This excluded the impact of expenses recognized for indemnifications on government-insured loans. As Sandro mentioned, our repurchase pipeline is at a six-year low.

These positive developments in noninterest income were partially offset by our net gain on loan sales, which decreased $2.6 million to $52.2 million, driven by a 6% quarterly decrease in mortgage lock volume; our margin of 83 basis points was little changed from the second quarter; and the net return on the mortgage servicing asset, which declined $3.7 million. This decrease was attributable to a negative fair value adjustment from increased prepayments and a reduced hedge performance.

Core operating noninterest expense increased 10% to $140.8 million in the third quarter as compared to $128.5 million in the second quarter. This included other noninterest expenses which increased due primarily to increases litigation costs, the normal accretion of our DOJ liability, and a charge to establish a reserve for unfunded loan commitments consistent with our commercial loan growth, and an increase in legal and professional fees of $3.3 million, which was attributable to higher consulting fees. These were partially offset by asset resolution costs, which decreased $4.3 million.

Slide 8 shows our key operating statistics.

We have already talked about the profitably metrics and I would like to focus on our operating leverage, which was negative 7% as operating revenues grew 3%, yet expenses rose 10%. As Sandro indicated earlier, we are strong operators that have demonstrated our ability to right-size expenses relative to our revenues. As we move forward, we will continue to evaluate our businesses and, as Sandro stated, we will remain committed to this level of discipline.

Our asset quality statistics improved and I will dive deeper into asset quality in a couple of slides, as well as capital, where ratios remained robust and well above peer median ratios.

Slide 9 highlights our balance sheet.

For the fourth consecutive quarter we remained under $10 billion in assets. While this will provide certain financial benefits, such as lowering our FDIC insurance costs and relief from Durban, we do not intend to remain under this level for long. Our capital and, more importantly, our infrastructure support a larger balance sheet and we expect to see growth in earning assets beginning in the fourth quarter.

Turning to slide 10, our allowance coverage was 7.6% of total loans at the end of the third quarter as compared to 7.4% at the end of the second quarter.

Taking a deeper look with respect to consumer loans, the allowance coverage was 9.0% at quarter end as compared to 8.6% at the end of the prior quarter. The increase in these coverage ratios during the quarter was primarily due to a small increase in the average loss rates, which was driven by charge-offs from our loan sales. We also established a reserve for unfunded loan commitments as previously mentioned, which was charged to other noninterest expense.

Nonperforming loans were $106.9 million at the end of the third quarter as compared to $120.2 million at the end of the second quarter. This is the lowest level of NPLs carried by the bank in more than eight years.

Third-quarter net charge-offs increased to $13.1 million, or 136 basis points, of associated loans compared to $7.2 million, or 78 basis points, in the second quarter. The increase in quarterly net charge-offs was due to $6.3 million of charge-offs incurred on loans sold during the quarter. Adjusting for these sales, loan -- third-quarter net charge-offs, in fact, decreased.

As we turn to slide 11 and look at the funding and liquidity, Flagstar maintains an enviable liquidity position with $1.5 billion of total liquid assets, that is cash and GSE-issued securities, and an additional $2.8 billion of FHLB borrowing capacity the end of the third quarter. Our available liquidity to total assets was 43%, while our wholesale funding ratio was 32% at the end of the third quarter.

You can see that we are maintaining a strong funding mix with average total deposits for the quarter increasing to $7.0 billion, of which $4.9 billion were retail deposits, $1.4 billion were government and commercial deposits, and $0.8 billion were company-controlled deposits. It is also worth noting that gross loans held for investment equaled 58% of total deposits at quarter end.

Turning to slide 12, we continued to maintain robust regulatory capital ratios. The Tier 1 leverage ratio for the bank was 12.4% for the third quarter compared to 12.5% for the second quarter. The Tier 1 capital ratio for the bank was 22.8% for the third quarter compared to 23.8% for the second quarter. And when I look forward to the fully phased-in implementation of Basel III, our Tier 1 leverage ratio would be 10.3% and our Tier 1 common ratio would be 19.7% at quarter end.

This 210 basis point impact to our Tier 1 leverage ratio is mostly driven by the detrimental treatment that mortgage servicing rights receive under Basel III. This impact comprises 140 basis points of the overall Basel III impact. We plan to continue MSR sales in the future to mitigate B III's impact to our capital.

Also, if we look at excluding the benefit of TARP, our consolidated Bancorp Tier 1 leverage and Tier 1 common ratios under Basel I would be 9.6% and 12.7%, respectively. We continue to evaluate all of our options with respect to TARP given the progress we continue to make executing on our plans of improving risk management, increasing our profitability, and putting our legacy issues behind us.

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

Lee Smith - *Flagstar Bancorp Inc. - COO*

Thanks, Jim, and good morning, everyone. As we start to focus more keenly on growth strategies across our three business line verticals, I want to start by outlining some of the key operating metrics from each segment during the quarter. We also continued to execute on our balance sheet derisking and cost optimization initiatives in order to create the foundations to grow in a prudent and effective manner.

Please turn to slide 14.

Third-quarter operating highlights for the mortgage origination business include fallout-adjusted gain on sale margin, which is what we use when reporting gain on loan sale, increased slightly to 83 basis points in the third quarter as compared to 82 basis points in the second quarter, although lock volume decreased to $6.3 billion from $6.7 billion during the same period in a challenging production environment.

Approximately 74% of mortgage production volumes were originated through correspondence during the quarter, which is consistent with the prior period. Purchase mortgages accounted for slightly more than 62% of origination volume in the third quarter as compared to just under 65% of origination volume in the second quarter. And we successfully utilized our new underwriting flexible capacity model with outsourcing to improve turn times and enhance the customer experience during the period. This in part helped closings increase from $5.9 billion in Q2 to $7.2 billion in Q3.

Moving to servicing, quarterly operating highlights for the mortgage servicing segment on slide 15 include: we executed on the sale of $4.9 billion in aggregate UPB, or 31,000 loans of residential MSRs, where we will act as sub servicer. The Bank's MSR to Tier 1 capital ratio increased slightly to 25.2% compared to 24.3% in the prior period.

Despite MSR sales during the period, the quarter's net loss, driven predominantly by our settlement with the CFPB, led to an increase in the concentration ratio. As you can see on slide 16, by the end of the quarter the repurchase pipeline had decreased to a six-year low of $30.8 million with only 15.7% of demands 180-plus days old, compared to $53.7 million and 42.3% of demands being 180-plus days old in the second quarter.

As Sandro noted, we did pay indemnification claims on government-insured loans of $3.4 million during the quarter and reserved an additional $7 million for indemnifications on similar loans that may be subject to future claims. And, of course, we also reached a settlement with the CFPB regarding certain default servicing and loss mitigation practices going back to 2011.

Servicing performing loans is very much part of our core strategy and a business we believe we can be very successful at. We continue to estimate for every 100,000 loans that we bring on to the platform it will generate between $5 million and $7 million of incremental pretax operating profit. We are currently servicing approximately 383,000 loans, of which 238,000 are subserviced for others and 145,000 are either owned by us or we own the mortgage servicing asset.

Furthermore, 96% of all the loans we service are performing loans, which means approximately 15,000 or less than 4% of our total portfolio are 60-plus days delinquent. We are always looking at ways to reduce the number of default and delinquent loans in our portfolio, given that servicing and working out delinquent loans is not part of our core growth strategy.

Please turn to slide 17.

Quarterly operating highlights for the Community Banking segment include average consumer loans rose 3% in Q3, driven primarily by a $130 million increase in average warehouse balances quarter over quarter. Average commercial loans increased 10% to $903 million for the third quarter as compared to $819 million for the second quarter.

The portfolio remained balanced among both industry type and collateral with 83% of the borrowers in our backyard here in Michigan. Where the borrower or property is not in Michigan, it is typically because we have followed a strong Michigan-based customer.

New commercial loan originations in the third quarter were $55.4 million. Commercial loan commitments grew 5% quarter over quarter to $1.64 billion. During the first nine months of this year, we have grown C&I lending by $134 million, CRE lending by $184 million, and warehouse lending by $171 million for a net increase in new loans of $488 million.

Average interest-bearing deposits increased by 6% in the period, driven by an increase in government and retail savings deposits. It is our intention to continue to grow our commercial and warehouse businesses in a controlled, safe, and sound manner as we have been doing to date. We continue to focus on the Michigan market, while optimizing our warehouse offering nationwide, and we are also looking at new products that leverage existing skill sets within the Bank.

Pertinent to our held-for-investment book, we sold approximately $48.2 million unpaid principal balance of jumbo loans during the quarter for a gain of $2.6 million. We also sold approximately $27 million unpaid principal balance of NPLs and TDRs during the quarter for a gain of $2.2 million and improving our ALLL to NPL coverage ratio to 295%. We have now sold approximately $570 million in UPB of NPLs and TDRs during the last 15 months as part of a concerted effort to derisk our balance sheet. We also sold 5.7 million unpaid principal balance of scratch-and-dent loans during the period for a small gain.

Moving now to expenses on slide 18.

Our core operating expense during the third quarter was $140.8 million. This compares to $128.5 million for the second quarter after adding back for the CFPB settlement and associated costs and the Department of Justice fair value adjustment.

Excluding one-time items, our current noninterest expense quarterly run rate is approximately $135 million to $140 million, which on a quarterly run rate basis is $45 million to $50 million less than where we were in the first half of 2013.

I want to emphasize that our expenses this quarter were in line with our guidance. We guided to $520 million to $540 million for the year last quarter. And if you take the noninterest expense results through Q3 and add to that what we are guiding for for Q4, excluding the CFPB fine, you will see that we are within the range we always expected to be in.

Managing our cost structure aggressively will continue to remain a focus for the organization, given the decrease in mortgage origination volumes and margins over the last 12 months. Our adjusted efficiency ratio for the quarter was 86.8% versus 80.2% last quarter after adjusting for the CFPB settlement and related costs this quarter of $38.6 million and $17.1 million in pretax significant items last quarter. The decrease in efficiency is the result of the $12 million quarter-over-quarter increase in noninterest expense after excluding the CFPB settlement.

We continue to work diligently on various initiatives to further optimize our cost base and make ourselves more efficient across the entire organization and expect such initiatives to start showing in our reported results through the first half of 2015.

Consistent with the last call, I will now provide detail on the IO portfolio. If you turn to slide 19, you will see that we have $741 million of interest-only loans on our balance sheet that are yet to reset. Of this, $72 million are due to reset during the remainder of the year. The anticipated payment shock associated with these resets versus current payments is approximately 98%.

If you turn to slide 20, you will see that since January 1, 2013, and through September 30, 2014, we have experienced 846 IO resets. Of this 846, 25.5% unpaid principal balance, or 196 loans, have paid in full; 19.5% UPB, or 148 loans, have been sold or modified; 6.7% UPB, or 57 loans, have been charged off or foreclosed on, and of this 54 defaulted prior to the reset and only three defaulted post reset.

3.5% UPB, or 29 loans, are delinquent and have been referred to default servicing. 41.5% UPB, or 378 loans, are cash flowing resets, of which 375 have been paying for three months or more and 265 of those have been paying for six months or more. 3.4% UPB, or 38 loans, are in the process of being resolved, the majority of which we anticipate will be cash flowing resets.

As I have previously mentioned, we have a dedicated team working hard with our borrowers to get ahead of these resets and be proactive in refinancing or modifying such loans if that is something our borrowers are interested in doing.

Another key metric is the right-party contact rate, which measures how often our team is getting in touch with the borrower directly. For Q3 we had a right-party contact rate of 100%. We are currently at 96.3% for Q4, where we have 438 IOs resetting, and 71.6% for Q1, where we have 412 IOs resetting.

Here is what else we are tracking and noticing. If you turn to slide 21, you will see the 47% of our IO portfolio are loans on properties in either California or Florida, two of the top six states for house price appreciation over the last 12 months.

Slide 22 shows the aging of all cash flowing resets. And as you can see, 99% of all cash flowing resets have been paying for three months or more, which include 70% that have been paying for six months or more.

With respect to overall quality, slide 23 shows that 83% of all remaining IOs have FICO scores greater than 660 and 85% of those same loans have LTVs less than 100%. The rolling 12-month average loss severity on the IO portfolio continues to be lower than on the non-IO portfolio through September 30, 2014, based on historical data. As you can see, it has been a busy quarter as we continue to clean up legacy issues, but in the long run we believe we have created the platform from which we can push on and grow in our three major business line verticals.

With that I will hand it back to Sandro.

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

Thanks, Lee. I am now going to close our prepared remarks with some guidance for the fourth quarter and then open the call for questions and answers. Please turn to slide 25, where we have itemized our guidance parameters for the fourth quarter.

We expect net interest income to increase slightly as we continue to grow earning assets. Net interest margin is expected to be relatively stable. While we expect mortgage locks to decline with normal seasonal fluctuations, we have seen strong October volume so far and believe that the favorable rate environment could continue to induce higher volumes.

We are obviously interested in Director Watt's recent comments and the FHFA's apparent desire to expand credit availability. This could be positive for our originations, but details are needed before we can evaluate this potential benefit.

We expect a modest improvement in gain on loan sale margin. We expect loan administration income and the net return on the mortgage servicing asset to be consistent with third-quarter performance. We expect to continue sales of the MSR asset in the normal course, to retain subservicing where it makes economic sense to do so, and we expect the ratio of our MSR to Tier 1 capital to be slightly below current levels.

We expect our total credit costs including provision for loan losses, representation and warranty, and asset resolution to be between $20 million and $25 million for the fourth quarter. And, as Lee noted, we expect noninterest expenses to total between $135 million and $140 million for the fourth quarter.

This concludes our prepared remarks and we will now open the call to questions from our listeners. Ann, please proceed with questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Bose George, KBW.

Bose George - *KBW - Analyst*

Good morning. First, just in terms of mortgage volumes in the fourth quarter, can you just talk about how much mortgage applications have increased just over the last two days? And also just in terms of the gain on sale margin guidance, is that based at all on increased demand you are seeing, or would you have expected gain on sale to be up even if you saw the normal seasonality where volumes are going down in the fourth quarter?

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

Bose, this is Sandro. So with respect to the uptick that I referred to in my comments so far this quarter, I can't be specific or I won't be specific in that regard. But clearly with the 10-year getting down under 2% last week we saw an increase in refinance volume.

Relative to our view of the margin in Q4, given the fact that the demand is a bit stronger, we believe that, based on what we've seen thus far this quarter, that overall the margin may be a little bit larger. But we are not estimating that to be a significant increase.

Bose George - *KBW - Analyst*

Okay, great. And then just actually switching to the indemnifications this quarter. Just curious what drove them and also the vintage of these loans; were they older loans, newer loans?

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

I guess I can't really speak to what drove them. Those are presented to us. All I can tell you is that the activity did increase during the quarter. Relative to vintage, there isn't anything specific about the vintage. It's pretty widespread across past years.

Jim Ciroli - *Flagstar Bancorp Inc. - CFO*

This is Jim. As we looked at the claims that we did pay, there was really no discernible trend or characteristic of what we received. As Sandro mentioned, it's across a large number of geographies and a large number of years.

Bose George - *KBW - Analyst*

Okay, great. Then just a related question on your comments about the FHA. Do you think lenders just need to raise rates more to protect against that risk with dealing with the FHA? Or do overlays need to increase? Or is the FHA kind of trying to work with people a little bit to make -- provide more transparency on this issue?

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

Well, here's what I think, Bose. I think that in order to be comfortable that we are getting paid for the risk that we are taking in the government lending business, there needs to be more clarity in terms of how the government is going to handle indemnifications and things of that nature. So for us we are going to just be very careful. I think it's a time of transition potentially in that regard, so we're going to watch it very closely.

Bose George - *KBW - Analyst*

Okay, great. Thanks.

Operator

Kevin Barker, Compass Point Research & Trading.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Good morning. Given the sale of the jumbos and the nonperforming loans, and you took a gain, do you expect to continue to sell jumbos and NPLs in the market in the coming quarters? And do you expect that to be -- is there a significant pipeline of sales over the next several quarters?

Lee Smith - *Flagstar Bancorp Inc. - COO*

Kevin, it's Lee. I wouldn't say there is a significant pipeline, but there is an opportunity to sell assets to further derisk the balance sheet and generate an appropriate return. We will consider such sales.

Kevin Barker - *Compass Point Research & Trading - Analyst*

So do you see this as a one-off event because there was an opportunity that presented itself, or is it something that's going to be a regular program?

Lee Smith - *Flagstar Bancorp Inc. - COO*

I think in terms of the jumbo and NPL sales, I wouldn't say they are regular. As I mentioned in my prepared remarks, we have sold $570 million of NPLs and TDRs over the last 15 months. As a result, we are down to about $107 million, which is the lowest level we have been for some time and if the opportunity presents itself, we will take it.

But I wouldn't say that we are going to be a regular seller of NPLs every quarter. It's just as and when it makes economic sense.

Now what I would say as it relates to MSR sales, given that we are looking to manage the concentration risk of MSR to Tier 1, you can't expect more regular MSR sales. And as Sandro noted, where it makes economic sense to do so, we will try and retain the subservicing on such sales.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Then in regards to the Series C preferred stock that is outstanding still, can you give us an update on your timing of repayment and what type --? How that's going to look and what you are expecting regarding the repayment of the Series C preferreds?

Jim Ciroli - *Flagstar Bancorp Inc. - CFO*

Kevin, this is Jim. Really, I don't think I can give you additional color on some of the things you are asking for. We continue to evaluate all of our options with respect to TARP and look for the right timing, considering, as I mentioned in my prepared remarks, what our progress is on risk management, improving the operating earnings of the Bank, and getting some of the legacy issues behind us.

Kevin Barker - *Compass Point Research & Trading - Analyst*

So do you see a delay in the repayment of Series C preferreds related to the recent settlements that you've done? Or is this something that is a -- something that is a capital or a regulatory process?

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

This is Sandro, Kevin. I don't think there's any delay. We have been saying that we are evaluating, it. We are getting more serious about where we go with that at this point, but it's just a little early for us to be very definitive about exactly what we think is going to happen.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Okay. And then if you were to repay them today or a future period, what would the amount of charges you would need to take in regards to the deferred dividends?

Jim Ciroli - *Flagstar Bancorp Inc. - CFO*

Right, so this is Jim. There's deferred dividends on the TARP of about $49 million and on the TruPS of about $19 million.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Thank you for taking my questions.

Operator

Paul Miller, FBR.

Unidentified Participant

This is actually Thomas on behalf of Paul. One quick question to follow up on Bose's question on the indemnification. The $3 million you took for this quarter, the $7 million you took for sort of future expectations; how many loans was that or UPB? Or can you provide color there?

Lee Smith - *Flagstar Bancorp Inc. - COO*

Yes, it was approximately 21 loans.

Unidentified Participant

21 loans, okay. And on the interest-only portfolio, we have now sort of had a couple quarters of reset data and the charge-offs 2Q to 3Q were pretty stable, right around 6.7% I'm thinking. Is there anything that you think could drastically change the sort of existing pace of charge-offs you were seeing in that portfolio, or do you guys feel pretty comfortable that that is sort of what the going forward rate could be?

Lee Smith - *Flagstar Bancorp Inc. - COO*

I think at this time we feel pretty comfortable. We are pleased with the performance and how we are dealing with this portfolio. We have been proactive in managing it. And as you mentioned, if you looked at the performance quarter over quarter, it is been pretty consistent.

Now I think the next two quarters are going to be key because in Q4 we have 438 IOs resetting, then 412 in Q1, so we are going to have -- we are going to basically double the amount of resets that we have currently seen in the next two quarters. So I think the next six months are going to be interesting. But again, given the robust process that we have in place, we feel pleased and good about what we see.

Unidentified Participant

Okay, great. Thank you, guys.

Operator

Scott Siefers, Sandler O'Neill & Partners.

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

Good morning, guys. I was just hoping you could kind of give a little more thoughts on just overall profitability as you look specifically into the fourth quarter and then next year. Because I think, just as I look at the guidance for the fourth quarter, depending on how a couple of things are interpreted, it looks like it could come in right around breakeven.

So, one, are you guys expecting to be profitable in the fourth quarter? And then just as you look into next year, I imagine for the time being probably the mortgage market or housing market more broadly would be the main revenue driver at least.

Lee, maybe you could speak in a bit more detail on some of the kind of efficiency opportunities you were talking about that hopefully would hit in the first half of next year. What kind of additional flexibility is there on the cost side in light of all that you guys have already done over the past couple of years?

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

All right, I think you've got a few things there, Scott, so while the guys are making sure we've got all the questions identified here, let me start with overall.

I'm not going to be specific about what we think profitability is going to be for Q4 or for 2015, but here's what I will tell you and it's probably nothing that I haven't already said. First of all, as it relates to the mortgage business, we have structured this business to get the costs structured in a way that assures us that we can be profitable even with the level of originations that we currently have.

The key is whether there is revenue sufficient there, to cover other costs of the organization as we continue to build our other businesses. So we have tried to give you as much color as we can relative to what we think will happen in our community banking business, where we have been very pleased with the overall results and growth of our earning assets and of our deposits. So if we can continue to grow that business, that will be very helpful obviously to the overall profitability of the Company.

Then, additionally, the servicing business. I think Lee has been pretty specific about what he thinks the opportunity is in the servicing business. Everybody is going to have to make their own estimates and guesses on where those things can go. We obviously have our own view of that and we are working hard to be certain that we will be profitable on a regular basis.

We're just not going to be any more specific than we already were with the guidance we gave relative to the fourth quarter. And, of course, we haven't given any guidance yet relative to 2015.

Anything, Lee, (multiple speakers) join in?

Lee Smith - *Flagstar Bancorp Inc. - COO*

Sure, Sandro. And, Scott, I would just add in terms of where there are potential cost reduction opportunities as we move forward here -- and, again, not getting into any specific guidance for 2015. We have given you guidance as to how we look at Q4.

But I think as we do move into 2015 we would be looking at asset resolution, legal and professional, and other than the management savings where we can further improve the cost base of the organization.

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

Okay, I appreciate that. And separately maybe, Sandro, just on kind of the notion of legacy issues, could you just sort of speak broadly where you think you are in resolving? In other words, are there other things that are left to be done?

Because I think one of the concerns, and it certainly gets incorporated into the valuation, is this notion that, say, tangible book value for example is not what is stated. In other words, there's kind of a vague concern that there could be additional charges that deteriorate that tangible book.

Where are you broadly? Are there any other kind of big picture items that you would hope to resolve going forward or are we pretty much done with all the legacy stuff?

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

Well, we think we've addressed everything. Everything we know about we certainly feel that we have appropriately addressed and we think that what we have done and communicated to all of you is pretty transparent. So there's nothing that I know about that gives me concern relative to legacy issues, again other than what we have already expressed to you.

So when you look at where are the risks in the Company, it is the held for investment loan portfolio we have and I think Lee has done a tremendous job of articulating the work we've done on the IOs and putting a fence around that risk. And I think when you look at our allowance for loan losses, we have taken some pretty aggressive action there and we feel very comfortable with where we stand in that regard.

I think this last piece that you saw this quarter relative to indemnifications, that was just responding to a change in behavior that we saw. And so, therefore, we looked at what we needed to do in order to be in the right place going forward.

So I think we've done everything we can relative to legacy issues. Even if you look at the commercial book, we have virtually nothing left in the SAG portfolio. I think it might be even all gone at this point. So we are pretty pleased with the amount of progress we've made on all those things over the last year-and-a-half, but I can't sit here and tell you it's impossible for something else to come up. I just don't know what else might come up, but everything that I know that I feel pretty good about.

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

Okay. All right, perfect. I appreciate that color. Then maybe, Jim, one kind of final question and it's sort of a follow-up from the TARP-related question a couple earlier. But you've got the -- I guess, all else equal, there would be the roughly $70 million or so of catch-up dividends between TARPs and TruPS.

Can you just clarify because there has obviously the noise that gets embedded in your diluted EPS calculation? But if you were to pay those -- pay off those instruments, does any of that then go through your equity? Or because you have been doing to catch-up accounting in diluted EPS, would there be no equity impact? How does that work?

Jim Ciroli - *Flagstar Bancorp Inc. - CFO*

You know, Scott, I would prefer to check that before I answer you so I can give you that answer later.

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

Okay. All right, thanks a lot.

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

Why don't we do this with that, Scott? We will make sure that we get more color on that in the 10-Q.

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

That's perfect, thank you.

Operator

Kevin Barker, Compass Point Research & Trading.

Kevin Barker - *Compass Point Research & Trading - Analyst*

In regards to the legacy issues you just addressed, you just completed a settlement with the CFPB. Is there any investigation or -- that you are seeing from the state Attorney Generals? We have seen several banks be party to the national mortgage settlement. Do you that as a risk?

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

Let me let our General Counsel, Mike Flynn, answer that question.

Mike Flynn - *Flagstar Bancorp Inc. - General Counsel*

As a general matter as a general policy we don't comment and we cannot comment on specific communications with regulators, but of course, we will continue to advise investors of all material events that materialize as we did with the CFPB negotiations.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Okay, thank you. Then in regards to the servicing operation, given a lot of the turmoil that's going on in special services and a lot of scrutiny there, do you see yourselves as a potential beneficiary to acquire servicing, given what is going on on that side of the business?

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

I will let Lee answer it, but just a quick thought before he does. I think relative to acquiring servicing, if you are talking about acquiring the asset, no, we don't have any intention of acquiring mortgage servicing assets from anyone else. But when it comes to subservicing, I think there could be opportunities there as I think Lee has talked about the past, specifically with the Fannie Mae contingent subservicing agreement we entered into. But let me let him put some more color around that.

Lee Smith - *Flagstar Bancorp Inc. - COO*

Sure. Thanks, Sandro. And I agree; we are not going to be an acquirer or buyer of MSRs. We are a seller of MSRs, given the concentration risk. But we do want to subservice the loans we sell and we do want to make our platform available for people who want loans serviced where we haven't originated those loans.

As I've said before, our focus is on servicing performing loans. That is what we are very good at. And as I mentioned in the prepared remarks, 96% of what we service today, the 383,000 loans, are performing loans.

As it relates to potential fallout, Kevin, as you mentioned, look, we certainly believe that our retooled servicing platform and the fact we are a bank provides certain competitive advantages. As a bank, we already have a robust infrastructure in place to address risk compliance and the regulatory environment in which we operate daily. So we do believe that provides certain competitive advantages and we want to use that plus the platform that we have in place to drive performing servicing business as we move forward.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Okay, I appreciate it. Thanks for answering my questions.

Operator

At this time I would like to turn the call back over to management for any additional or closing remarks.

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

I would like to close with just a few comments. First of all, I would like to thank all of you for your interest in Flagstar. This management team and the Board and the entire Flagstar family are together working very hard to build a great company. We continue to make good progress and the third quarter took us a little closer to where we want to be.

There is still much work ahead and we look forward to reporting further progress to you in the future. Thank you and have a great day.

Operator

This does conclude today's conference. We thank you for your participation.
