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EDITED TRANSCRIPT

FBC - Q2 2014 Flagstar Bancorp Inc Earnings Call

EVENT DATE/TIME: JULY 23, 2014 / 3:00PM GMT

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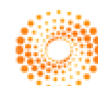

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PRESENTATION

Operator

Good day and welcome to the Flagstar 2014 second-quarter earnings call. Today's conference is being recorded. At this time, I would like to turn the conference over to Paul Borja, Chief Financial Officer. Please go ahead, sir.

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Thank you. Good morning. I'd like to welcome you to our second-quarter 2014 earnings call. My name is Paul Borja and I'm the 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. These factors include, among other things, changes in economic conditions, changes in interest rates, the outcome of pending litigation, competitive pressures within the financial services industry and legislative or regulatory requirements that may affect our businesses. For additional factors, we urge you to review the press release we issued last night or SEC documents, such as our most recent Form 10-K and Form 10-Q, as well as the legal disclaimer on page 2 of our second-quarter 2014 earnings call slides that we posted today on our Investor Relations page at Flagstar.com.

During the call, we may also discuss non-GAAP measures regarding our financial performance. A reconciliation of these measures to similar GAAP measures is provided in the tables to our press release, which we issued last night, as well as 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, Inc. - President & CEO*

Thank you, Paul and thank you, everyone, for joining us today. In addition to Paul, also with me today are Lee Smith, our Chief Operating Officer; Mike Flynn, our General Counsel; and Steve Figliuolo, who recently joined Flagstar as our Chief Risk Officer subject to regulatory approval. Steve will be responsible for managing the office of enterprise risk management, which oversees credit risk, operations risk, modeling and analytics, mortgage risk and loan review operations. Welcome, Steve.

Let me first lay out the order of the call. I am going to begin by reviewing the key items and actions we undertook during the first quarter, which we believe position our Company for growth and success during 2014 and beyond. I then want to go into the key drivers of our second-quarter financial performance. After my comments, Lee will update you on our operations areas, including the servicing business and noninterest expense

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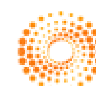

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initiatives. Paul will then take a deeper dive into the financial results for the second quarter and provide our outlook for the third quarter. With that, let's begin.

During the first quarter of 2014, we undertook specific actions that we identified during our last earnings call to reserve against future losses, to address regulatory matters, to prudently grow our balance sheet, to finalize the efforts to right-size our noninterest expense and to begin the execution of revenue diversification initiatives. Our actions reflected our continued focus on derisking, as well as a new focus on positioning our Company to prudently regrow our balance sheet and to begin to explore diversifying our operations. We believe our second-quarter performance demonstrates that we have made good progress towards these goals.

For the second quarter of 2014, we leveraged our efforts from prior quarters to reach profitability by undertaking actions that achieved the following. We maintained marketshare in a challenging mortgage environment while not significantly compromising margin. We continued down the path of establishing a formidable subservicing business. We continue the prudent growth of our loan portfolio particularly warehouse and C&I lending and I think it is important to point out that the warehouse growth was not just seasonally-related. Our team has been successful in growing relationships with larger TPOs that do not sell to Flagstar and this has fueled the warehouse loan growth.

We funded asset growth with increased core deposits. We maintained our net interest margin by growing our higher-yielding assets and focusing on growing our more cost-effective funding sources and we monitored and addressed outstanding and emerging issues regarding our loan loss reserves, particularly as it relates to our portfolio of interest-only residential first mortgages and end-of-term seconds and HELOCs.

Now let's turn to slide 3 and our financial performance. We are pleased to report second-quarter net income and fully diluted earnings per share of $25.5 million and $0.33 per share respectively. Our results validate the hard work and careful efforts we have put in during 2013 and the first half of 2014 to reposition Flagstar. Apart from two noncore items that I will highlight momentarily, our second-quarter results are consistent with the guidance we provided during our last call. In a very competitive market, we were able to execute in a manner that yielded both incremental and profitable growth.

As highlighted on slide 4, a quick review of our results demonstrates this performance. We increased net interest income by 7.3% as compared to our 10% guidance. We earned, as guided, a relatively flat bank net interest margin of 3.06%. We increased mortgage locks 38% compared to our guidance of 25%. We realized a gain-on-sale margin of 82 basis points against guidance of 93 basis points, but this miss was largely offset by the higher-than-projected lock level. We reduced the concentration of MSR assets to 24.3% of Tier 1 capital compared to our guidance of approximately 22.6%. We experienced charge-offs of $7.2 million below the guidance, which was that we would be slightly below the Q1 level of $12.3 million and while total noninterest expense was within guidance, we did have asset resolution expenses that were approximately $7 million more than expected as the challenges associated with managing this expense have yet to abate.

Our strategic initiatives remain designed to enhance our core net interest margin primarily through the growth of our community bank, to improve our mortgage banking platform, to build the subservicing business and to deliver improved operating efficiencies systemwide. We believe our continuing focus on these key strategies will serve to further develop the consistent sustainable earnings platform that we have previously discussed.

While we are certainly pleased with the progress we are seeing, which has been confirmed by our core results, our second-quarter results were also favorably impacted by two noncore items totaling approximately $20 million pretax. About half of this was related to loan fees and charges. The other half was attributable to a change in the estimated timing of payments impacting the fair value of the liability associated with our previous DOJ settlement.

With regard to our net interest income and margin, as shown on slide 5, second-quarter net interest income increased to $62.4 million from $58.2 million in the first quarter and our bank net interest margin remained steady at 3.06% as compared to 3.05% in the first quarter. This is a result of our successful efforts to increase interest-earning assets and to fund that increase in a way that didn't negatively impact margin.

Now let's turn to slide 6 and 7 and talk about the mortgage business. During Q2, mortgage originations increased to $6 billion compared to $4.9 billion in the first quarter and fallout adjusted mortgage rate lock commitments increased to $6.7 billion compared to $4.9 billion in the first quarter. We again saw compression in gain-on-sale margins due to market forces and competitive dynamics. This caused our margin to decrease by 11

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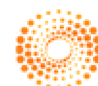

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basis points during the quarter. However, accepting this slightly lower margin allowed us to increase locks and in turn gain-on-sale income during Q2 increased to $54.8 million from $45.3 million in the first quarter. Approximately half of the noted decrease in margin related to a reduction in base pricing and the other half related to other costs associated with the volatility of interest rates. So despite the decrease in margin, we are encouraged by these results as they clearly reflect our successful efforts to balance production against revenue.

As noted in trade publications, industry origination volumes are at cyclical lows, but did improve seasonally during the second quarter and we believe that Flagstar's second-quarter volumes improved proportionate to the industry. As discussed in previous calls, we have been working hard to reduce our MSR to Tier 1 capital level in a way that does not significantly compromise our business model. In that regard, while we have prudently managed our ratio from over 50% to 24.3% at June 30, 2014, when selling MSRs, we have, for the most part, been able to enter into companion subservicing agreements thereby maintaining customer relationships and supporting the growth of our subservicing business. This approach to managing our MSR levels has the potential to bear lots of fruit going forward as compared to simply selling MSRs on a servicing release basis.

Moving to noninterest expenses, Lee will delve into operating efficiencies a little later, but we are pleased with the success we've had in reducing and managing our noninterest expenses. Our commitment to managing NIE will not wane.

Turning to loan quality, please turn to slides 8 and 9. Our charge-offs declined again this quarter, another very encouraging metric and our reserve levels remain well above our levels of nonperforming loans. Charge-offs were $7.2 million in the second quarter compared to $12.3 million in the first quarter, a decrease of 42%. The provision for loan losses decreased to $6.2 million in the second quarter compared to $112.3 million in the first quarter. You may recall that a substantial portion of the first-quarter provision resulted from increasing the Company's loss estimation period and from increasing the reserve related to the reset risk on interest-only residential first mortgages.

Finally, the ratio of allowance for loan losses to nonperforming loans held for investment still remains strong at 263% at June 30 compared to 287% at March 31.

With respect to delinquencies, we saw a decline in the 30 to 89 days past due category of $15.1 million. This improvement was partially offset by a $9.4 million increase in the 90 plus days past due category. Also, though NPLs increased about $10 million, REO was unchanged. As such, we remain optimistic that we will continue to see improvements in the overall quality of our HFI portfolio.

Prior to my closing comments, I'd like to take a moment to discuss our intentions regarding our TARP-preferred securities. In that regard, we believe that there are three options available to us -- refinance the TARP-preferred, redeploy excess capital at returns in excess of 9% or repay the TARP-preferred with existing sources of liquidity. It's important to note that we may be limited in our current ability to repay TARP as a result of certain regulatory restrictions. Consequently, we are focusing on the first two alternatives. We will evaluate these options carefully while taking into account the intrinsic value of the Flagstar platform over time.

In closing, I'd like to emphasize a few items. First, we remain committed to controlling noninterest expenses. Second, we remain committed to growing net interest income in a prudent fashion. Third, we remain committed to being a leading player in the mortgage industry in terms of both originations and servicing and lastly, we continue to be optimistic about the future prospects for Flagstar as we 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 operations and financials. I'd like to now turn the call over to Lee.

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

Thanks, Sandro and good morning, everyone. During the quarter, we continued to execute on our cost optimization and derisking initiatives, as well as commence certain revenue-enhancement strategies. As we've previously articulated, this sequencing was critical in order to create a solid platform from which we can grow successfully and profitably across our mortgage origination, servicing and community bank business lines.

Please turn to slide 19. Our total noninterest expense during the second quarter was $121.4 million. This compares to $139.3 million for the first quarter and for the fourth quarter, $150 million after normalizing for the prepayment adjustment with respect to the FHLB advances and the

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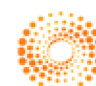

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additional Department of Justice estimated liability. If we add back the $10 million noncore Department of Justice fair value adjustment to our noninterest expense, we get a normalized noninterest expense run rate of $131.4 million this quarter.

We've previously provided guidance for noninterest expense to range from $520 million to $540 million on an annualized basis and our first and second-quarter run (technical difficulty) puts us squarely within this range at approximately $534 million after subtracting the one-time severance and outplacement expense in Q1 of $3.6 million.

For the first six months of 2013, our annualized noninterest expense run rate was $742 million. So in 12 months, we've been able to reduce noninterest expense costs by $208 million, or 28% on an annualized basis, of which approximately $138 million have been fixed cost reductions and $70 million have been variable cost reductions because of reduced mortgage origination volumes.

From a fixed cost perspective, our cost optimization efforts have been focused around optimizing headcounts and structure, centralizing vendor management and procurement, outsourcing noncore operations, containing asset resolution costs and realigning our real estate footprint. The significant cost reductions were necessary given the decrease in mortgage origination volumes and margins over the last 12 months. We generated approximately $100 million of gain-on-loan sale during the first six months of this year versus $282 million during the same period last year. This is a reduction of 65% on a relative basis.

So as you can see, we needed to rightsize our cost base in order to properly align overall expenses with revenue projections before any one-time adjustments and we believe we've done exactly that. Our reported adjusted efficiency ratio for the quarter was 71.3% versus 91.3% last quarter. However, after adjusting for the $20 million in pretax noncore items that Sandro discussed earlier, we get an efficiency ratio of 82% versus 91.3% last quarter. The improvement in efficiency is predominantly the result of the $8 million quarter-over-quarter improvement in noninterest expense after excluding the noncore DOJ item, higher interest income and higher gain-on-loan sale income. We believe we have now rightsized the cost structure of the organization to the point where we can generate profitable pre-credit cost earnings at any time during the mortgage banking cycle.

But just because we've hit our noninterest expense target does not mean we are going to stop looking for additional efficiencies. We continue to work diligently on various initiatives to further optimize our cost base and make ourselves more efficient across the entire organization. We continue to be active in terms of derisking and positioning the balance sheet for future growth during the quarter. If you turn to slide 20, you will see that we have $802 million of interest-only loans on our balance sheet that have yet to reset. Of this, $117.5 million are due to reset during the remainder of the year. The anticipated payment shock associated with these resets versus current mortgage payments is approximately 100%.

During the last earnings call, I mentioned that we would be sharing considerably more information around the IO portfolio and that is exactly what the next few slides are intended to do. If you turn to slide 21, you will see that since January 1, 2013 and through June 30, 2014, we have experienced 695 IO resets. Of these 695, 144 have paid in full, 117 have been sold or modified, 47 have been charged off or foreclosed on, 21 are delinquent and have been referred to default servicing, 297 are cash-flowing resets, of which 284 have been paying for three months or more and 69 are in the process of being resolved, the majority of which we anticipate will be cash-flowing resets.

As I've mentioned, we have put a dedicated team together to get ahead of these resets. We want to make our borrowers aware of the upcoming event and lay out the various options available to them. It is allowing us to get ahead of the reset date and be proactive in refinancing or modifying such loans if that's 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 Q2, we had a right party contact rate of 99.8%. We are already at 97.4% for Q3 where we have 151 IOs resetting and 82.6% for Q4 where we have 438 IOs resetting.

Here is what else we are tracking and noticing. If you turn to page 22, you will see that 47% of our IO portfolio are loans on properties in either California or Florida, two of the top five states for house price appreciation over the last 12 months. Page 23 shows the aging of all cash-flowing resets and as you can see, 96% of all cash-flowing resets have been paying for three months or more and 30% have been paying for six months or more.

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With respect to overall quality, page 24 shows that 83% of all remaining IOs have FICO scores greater than 660 and 80% of those same loans have LTVs less than 100%. The rolling 12-month average loss severity on the IO portfolio is lower than on the non-IO portfolio through June 30, 2014 based on historical data. At the end of Q2, we had a fast five ALLL reserve against our IO portfolio of $91.1 million versus $101.5 million at the end of Q1. The reduction in the reserve of $10.4 million can be directly attributed to lower loss rates and more granular reporting. We are very pleased with the proactive way we are managing this portfolio and the strong metrics and statistics surrounding it and we intend to update these metrics on future earnings calls.

During the quarter, we sold approximately $9 billion of MSRs and retained the subservicing on $5 billion of these sales, or 22,000 loans. As of June 30, 2014, we had $289 million of MSR assets on our balance sheet represented by $25.3 billion of underlying loans and an MSR Tier 1 ratio of 24.3%. We will continue to sell MSR assets if we believe it makes economic and operational sense to do so and when economically advantageous, we will retain the subservicing of the loans from such sales.

As we've said before, in a perfect world and everything else being equal, if you value the MSR asset correctly, there should be no gain and no loss on sale other than the associated transaction costs. The value of our MSR asset is estimated using fair value accounting and our MSR book contains many products with different interest rates and vintages. The asset is also hedged. As a result, you cannot back into a blended valuation of this asset given the different characteristics of each MSR cohort that roll up to the consolidated MSR valuation, the mark-to-market movements and associated hedging risks.

The MSR asset is high-yielding and whilst we will look for opportunities to reduce our concentration further, assuming it makes economic sense to do so, we wouldn't want to ever entirely eliminate the MSR asset we carry on our balance sheet. Our asset quality ratios remain strong relative to peers with our ALLL to NPL coverage ratio being 263.1% versus 94.2% 12 months ago. The improvement is a result of selling approximately $540 million in UPB of NPLs and TDRs during the last 12 months and the increase in the ALLL reserve last quarter.

If you turn to page 10, our R&W pipeline has declined to UPB $53.7 million at the end of the second quarter, down from $69.4 million at the end of the first quarter and $115 million 12 months ago. As you can see, we continue to work aggressively and diligently to eliminate legacy risks from the balance sheet and to provide transparency and visibility into where the remaining risks are and how we are working to resolve and mitigate those risks.

I'd now like to talk briefly about some of our strategic growth initiatives. When we think about the bank, we break it down into three business line verticals -- the mortgage origination business, which comprises our wholesale and retail origination platforms; our servicing platform; and the community bank that includes both commercial lending and the retail branches. As everyone is aware, the origination market has decreased significantly from the highs of the refinance boom in 2012 when the market was estimated to be $2 trillion in size. In 2014, the Mortgage Bankers Association, Fannie Mae and Freddie Mac are estimating a market size of approximately $1.1 trillion. This reduction in size has led to market dislocation that we believe we can benefit from. We are the eighth largest mortgage lender in the country and we have already done a lot of heavy lifting around cost optimization and derisking the balance sheet so we can focus on growing our current 2% marketshare.

We have recently introduced some new products and processes such as a construction to permanent loan, a piggyback second loan, flexible jumbo loan and a pipeline advocate program. We also sold approximately $234 million in unpaid principal balance of jumbo loans during the quarter for a gain of $3.7 million after transactions costs. This is something that fits in with our core competency of originating mortgage loans and selling them. There is a lot of private capital that is interested in buying this type of product and we've set up the same flow process we have with the GSEs on conforming loans. As a result, such loans stay on our balance sheet for a short period of time before we sell them. Not only does this keep our capital turning, it enables us to establish key relationships with private buyers. We also have the capacity to portfolio such loans if the economics associated with any transaction do not make financial sense.

We continue to be excited about what we are doing on the servicing side of the business and during the quarter, we signed a contingent subservicing agreement with Fannie Mae for loans that are current and performing up through 59 days delinquent. As mentioned earlier and during the quarter, we executed on the sale of $5 billion in aggregate UPB of residential MSRs where we will act as subservicer. We are currently serving approximately 367,000 loans of which 213,000 are subserviced for others and 154,000 are either owned by us or we own the mortgage servicing asset.

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As we have discussed before, for every 100,000 loans we grow our servicing book, we expect to generate between $5 million and $7 million of incremental operating profit before any allocation of indirect expense. To that end, we intend to leverage our unique servicing platform as quickly and effectively as possible. The servicing industry landscape is changing as private capital continues to enter the market looking for yield opportunities together with the ever-increasing regulatory scrutiny and oversight. Operationally, costs are increasing, particularly as it relates to risk management compliance and regulatory oversight and as a result, organizations are leveraging existing infrastructure through the developments of strategic partnerships. We believe we are well-positioned to prosper in this rapidly changing landscape given our retooled servicing platform, the fact we are a bank and already have a large infrastructure in place that is focused on risk management and regulatory matters and as an originator of mortgages and seller of MSRs, we know the market.

With respect to the community bank, during the first six months of this year, we've grown C&I lending by $123 million, CRE lending by $114 million and warehouse lending by $260 million for a net increase in new loans of almost $500 million. It is our intention to continue to grow this side of the business in a controlled, safe and sound manner as we've been doing to date. We continue to focus on the Michigan market and are looking at new products that leverage existing skill sets within the bank.

As you can see, it has been another busy quarter, but I firmly believe we've created the platform from which we can push to grow existing and new lines of business and we continue to be excited and energized by the progress being made here at Flagstar. With that, I will hand it over to Paul.

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Thank you, Lee. I'm going to now review the key components of our overall second-quarter financial results and update you on our third-quarter outlook for the key drivers of our financial performance. In that regard, please refer to slide 11, which provides an income statement bridge and highlights the key items that changed during the second quarter as compared to the first quarter. We've also prepared a summary income statement on slide 12 and balance sheet highlights on slide 13.

We reported earnings of $25.5 million for the second quarter. This compares to a net loss in the first quarter of $78.9 million. Please turn back to slide 5. Our net interest income increased to $62.4 million for the second quarter as compared to $58.2 million for the first quarter. As you can see on the bottom left chart, interest income increased by $5.6 million from the first quarter. This was offset by a $1.3 million increase in interest expense as shown on the bottom right chart.

From a rate volume perspective, the increase in interest income was primarily attributable to increases in average interest earning balances of investment securities, mortgage loans available for sale and warehouse loans offset by a decrease in first mortgage loans held for investment. The increase in interest expense was primarily attributable to a 7 basis point increase in the average rate of deposits. As a result of an improved asset mix into higher-yielding assets, particularly warehouse, commercial real estate and C&I loans offsetting slightly higher rates for deposits, our net interest margin for the bank improved to 3.06% during the quarter from 3.05% during the first quarter.

Turning to slide 14, you can see that we continued to do a good job of gathering core accounts and improving our deposit mix. Overall core deposits increased 4.6% and the percentage of core deposits was steady at 81% in the second quarter compared to 80% in the first quarter. On the bottom half of slide 14, our overall deposit funding increased $334 million, or 5.3%. We will continue to focus on growing our core deposit base to maintain a strong net interest margin as our need for funding increases.

On slide 15, we highlight some of the trends in commercial loans. Our commercial loan portfolio contains both legacy commercial loans, which were originated in 2009 and prior and newly originated commercial loans, which we consider core. We have been able to grow the portfolio of new commercial loans during the second quarter by 17%. As noted by Lee, this remains a major component of our balance sheet growth strategy and we continue to see good results.

For the third quarter, we expect that net interest income before provision for loan losses will increase between 2% to 4% as compared to net interest income in the second quarter. Our view of such improvement in net interest income arises primarily from an expected seasonal growth in mortgage origination volume and growth in our commercial loan portfolio.

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Turning back to slide 7, net gain on loan sales increased to $54.8 million for the second quarter as compared to $45.3 million for the first quarter. This increase was attributable to an increase in volume of our mortgage locks offset by a decline in gain-on-loan sale margin. Flagstar has been committed to maintaining rigorous price discipline and will continue to do so going forward.

Turning back to slide 6, we provide some additional details on our first mortgage originations, including by channel and product. As you can see, purchase originations continue to become a bigger percentage of our overall mortgage production. For the third quarter, we expect that the volume of mortgage locks will increase by 5% or more as compared to the second quarter as we conclude the summer season. However, we would expect that the gain-on-sale margin will decrease slightly compared to the second quarter resulting from continued market pressure on margins. We expect that this decline will be offset by the projected increase in volume of mortgage locks.

Loan administration income was $13.9 million, a decrease from the $19.6 million recorded in the first quarter. For the third quarter, we intend to continue to seek opportunities for the disposition of the MSR asset from time to time so that we maintain concentration levels appropriate for risk management. We expect that the amount of MSRs will continue to fluctuate, but that through planned transactions Flagstar's MSR to Tier 1 ratio at the end of the third quarter should be at or slightly above the ratio at the end of the fourth quarter of last year.

Please turn to slide 16. With respect to credit costs, we focus on three key areas -- loan loss provisions for our loans held in our investment portfolio, rep and warranty provision expense, which relates to potential putback losses from loans we sold over the years into the secondary market and asset resolution expenses, which primarily relate to our foreclosure expenses from our held-for-investment loan portfolio and the expenses associated with managing down our insured government loan portfolio. As you can see on the slide, these three credit costs for the second quarter reflected an expense of $29.3 million as compared to $122.1 million for the first quarter. Loan loss provision decreased to $6.2 million as compared to a provision of $112.3 million in the first quarter.

Turning back to slide 9, you can see that nonperforming loans have come down significantly from levels a year ago. Our overall allowance coverage of nonperforming loans was 263.1% as of June 30, 2014. For the third quarter, we do not expect that a significant amount of net loans will be added to or decreased from the HFI portfolios. We expect a stable performance with respect to net charge-offs and do not expect any meaningful change in our reserve level from the second quarter.

Our provision for rep and warranty expense by which we reserve for possible losses from loan putbacks was $5.2 million for the second quarter as compared to income of $1.7 million for the first quarter. The first quarter reflects a release of holdback reserves from prior MSR sales. On slide 10, we provide further details on our rep and warranty reserve.

During Q2, we updated our analysis to reflect loss rates from our repurchase loans, which are affected when loans are repurchased in a higher interest rate environment than when originated. This impact has been offset somewhat by our declining trend of repurchase demands and our lower repurchase pipeline. For the third quarter, we would expect a provision that is slightly lower than the second quarter.

Second-quarter asset resolution expense was $17.9 million as compared to $11.5 million in the first quarter. For the third quarter, we expect asset resolution expense to be more consistent with the level we experienced in the first quarter of this year. Lee has already discussed noninterest expense in detail and consistent with the guidance he provided last quarter, our expectation is that total noninterest expense should be between $520 million and $540 million for 2014.

Finally, turning to slide 17, you can see that we continue to maintain capital and balance sheet flexibility so that we can fund the initiatives necessary to drive future earnings as Sandro highlighted earlier. With that, I'll turn it back to Sandro.

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

Thanks, Paul. So now we are ready to take some questions and I'll turn it over to Erica to get that started.

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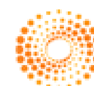

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Scott Siefers, Sandler Neil.

Scott Siefers - *Flagstar Bancorp, Inc. - Sandler O'Neill*

Good morning, guys. Lee, I think first question is probably best for you. I appreciate the detail on the IO portfolio and just on the numbers you gave on slide 21, so it looks like about 65% of what's already reset through the end of the second quarter, it looks like it's basically fine, either has paid in full or has reset presumably as expected. For that remaining roughly 35% or so, what has been the loss as a percent of the unpaid principal balance?

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

Yes, I think -- so what I would say, Scott, is without getting into detail, when you look at slide 21, I think the numbers that I've focused on are the number of loans that have been charged off or foreclosed on and then the ones that are with the default servicing team at the moment and we are obviously working those hard. The losses on the IO portfolio, as I mentioned in my speech, are less than the losses on the non-IO portfolio and that was one of the big reasons we were able to release $10 million of ALLL reserve as it relates to the IO portfolio during the second quarter.

Scott Siefers - *Flagstar Bancorp, Inc. - Sandler O'Neill*

Okay, all right, thanks. And then, let's see, Paul, I was just hoping you could help me with the size of the negative MSR fair value adjustment that hit loan administration income in the second quarter.

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

During the second quarter, you saw some differential and really it's a combination of just overall transactions. So when you look at the delta, I think the entire portion that we are talking about there is what we look as a negative fair value, Scott. That includes hedging costs, that includes some transaction, that includes mark-to-market movements. So we view all of those pieces, which we see in the normal course, as negative fair value adjustments.

Scott Siefers - *Flagstar Bancorp, Inc. - Sandler O'Neill*

Okay, all right. And then let's see, Sandro, you had made the comment about the three options for the former TARP capital and it sounds like you are more focused on refinancing or redeploying. One, are you able to provide any more detail on the kinds of tactics you'd be looking at more specifically? And then as a follow-on to that, given that you are focused on the first two as opposed to repaying, I mean does that say anything about when you would hope the regulatory restrictions, the consent order specifically would come off and what else do you feel like you guys have to do given all the changes you've made to get rid of that?

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

Okay, so I think you've asked three different things. So first of all, there was no signal intended relative to the comments on our TARP analysis related to regulatory aspects in any particular way and with respect to further detail on what we might do in connection with those first two options, I think at this point we are going to leave it at what was in the speech and over the next few months, we will be looking at those options more specifically and may be in a position to report further on that after Q3.

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With respect to just the whole regulatory situation in general, I think we are pretty satisfied with the way things are going. We are making progress in addressing all of the issues in the consent order. It's one of those things that we can't be very specific on, but I can say that I'm comfortable with the progress that we've made and I'm optimistic that in due course we'll get in a position where the regulators will consider lifting the orders.

Scott Siefers - *Flagstar Bancorp, Inc. - Sandler O'Neill*

Okay, all right. I think that's it for me. Thank you, guys.

Operator

Paul Miller, FBR.

Paul Miller - *Friedman, Billings, Ramsey - Analyst*

Yes, thanks a lot, guys. On really slide 15, but overall on your balance sheet, the commercial loan originations, I know it's one of the focuses and I know you guys don't want to be a major player in the mortgage banking world, but I also know with conversations that you want to increase your commercial exposure. Can you talk a little bit how you have been able to grow originations? Have you brought on more teams in the area and what are some of the areas you are focused on?

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

Yes, hi, Paul. So sure, I think the success is not that complicated. Number one is you have got to hire the right people and we've been able to do just that. And in the commercial business, we've been really focused on developing full relationships with clients. And so when they look at the interest that we have in Michigan and the quality of people that we brought aboard, the relationships that they have with sponsors, I think that we just have seen a really good result there. It's basically blocking and tackling in the commercial arena here in Michigan. I mean it is originating, maintaining, growing those relationships, getting experienced bankers that can capitalize on the fact that we make our decisions locally. So there isn't anything really special about it except that when you look at who Flagstar is in Michigan as compared to who the other players are, there are some things we bring to the table just because we are here located in Michigan that are of interest to both strong commercial borrowers and strong commercial lenders.

Paul Miller - *Friedman, Billings, Ramsey - Analyst*

And I mean what are some of the businesses and issues that you are focused on and is it mainly all Michigan? Is anything outside of Michigan?

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

It is mainly Michigan or Michigan-sponsored in some fashion, Paul. So we have successful businesses that are anchored here in Michigan but that end up doing business in other parts of the country. So we will venture outside of the Michigan world for that sort of thing. In terms of business that has no Michigan connection, it is a relatively small amount of the business that we do.

Paul Miller - *Friedman, Billings, Ramsey - Analyst*

And then your warehouse line, it grew very nicely, probably more so than the origination market in general and you said that that is an area that you have been focused on. Can you just talk about that a little bit?

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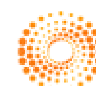

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Sandro DiNello - *Flagstar Bancorp, Inc. - President & CEO*

Yes, a couple things there. So I think we are getting the normal share of Flagstar-based business or the loans that we are buying. We are continuing to provide warehouse lines at historic levels there, but the two things that are different, one I mentioned in my speech, which is that our team over the last year has been working really hard on developing relationships with larger originators that don't sell to Flagstar. We had not really played in that space before and so we've had some very, very good success in that arena.

And then, secondly, we are much more open these days than we used to be to those lines that are financing loans that are not coming to Flagstar from our own customer base. So those customers, they do sell to us, but now we are financing some of the business that they sell to others at a level that is much more significant than we used to do.

Paul Miller - *Friedman, Billings, Ramsey - Analyst*

And then on your reps and warrant stuff, it looked like there was an uptick in losses and also an uptick in file requests a little bit. I know you've hopefully put this to bed a couple quarters ago, but is that anything to be concerned about at this point or is that just expected given where we are today?

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

Yes, I don't think it is anything to be concerned about, but let me let Lee get into the detail a little bit more.

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

Yes, I think the slight uptick you saw, Paul, it reflects the estimated impact of changes in the fair value of repurchased loans at the time of repurchase. But if you see -- if you look at the pipeline and what has happened to that, it came down again in Q2. So it was $53.7 million versus $69.4 million last quarter and $115 million twelve months ago. So I don't believe it's anything to be concerned about at all and I think as Paul alluded to in his guidance, we actually expect it to come down slightly as well next quarter.

Paul Miller - *Friedman, Billings, Ramsey - Analyst*

Okay, guys, thank you very much.

Operator

Kevin Barker, Compass Point.

Kevin Barker - *Compass Point - Analyst*

Thank you.

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

Hi, Kevin.

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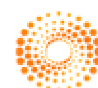

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Kevin Barker - *Compass Point - Analyst*

Hi, thank you. How do you -- given that you are not going to address TARP right now, how do you plan to handle the accrued dividend given it's compounding at a 9% rate right now? And even if you don't repay TARP, are you planning to catch up on the accrued dividend or continue to let it be deferred?

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

Well, Kevin, this is Sandro. I think that is all part of the whole strategy related to what we do with TARP, with the TARP repayment. So to have a specific strategy that addresses just the dividend, we are not at that point right now. So what we are going to do is evaluate the three options and more specifically those two that we are focused on that I mentioned in the speech and I think together with that will come to rest relative to how we want to handle the deferred dividends or the accrued dividends.

Kevin Barker - *Compass Point - Analyst*

Okay. And then correct me if I am wrong, but you have roughly about $0.78 per share of deferred dividends that are not recognized as a liability on the balance sheet, is that right?

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

I don't know that number off the top of my head. Paul, does that sound right?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

That's about right, yes.

Kevin Barker - *Compass Point - Analyst*

Okay. And then you made a $10 million adjustment to your DOJ settlement this quarter. What is the net liability not recognized on the balance sheet regarding that settlement right now. Does it go up by another $10 million to $38 million, is that correct?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

So this is Paul. So our net liability on the balance sheet is $78 million as of June 30.

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

That is what we have accrued.

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

That's what we've accrued so far.

Kevin Barker - *Compass Point - Analyst*

And you still owe $118 million, right?

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Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

That's right. And it's a fair value accounting concept and so as we run the model and as we look at the timing of the cash flow payments that will eventually accrue towards that.

Kevin Barker - *Compass Point - Analyst*

Okay. And then the $5 billion servicing that you are planning to transfer through Fannie Mae, can you talk about the mechanics of that relationship that you've set up going forward? If there is another counterparty involved -- and if there is another counterparty involved, how does negotiation happen between those $5 billion of MSRs that you are selling?

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

So let me talk about that, Kevin. So the $5 billion that we sold during the quarter and subserviced back, that wasn't a sale to Fannie Mae. That was a sale to a REIT basically and we are subservicing those loans back, approximately 22,000 loans. What we've actually engaged with Fannie Mae, which I referred to in my speech, we've signed a contingent subservicing agreement with Fannie Mae. So what that means is if Fannie Mae chooses to use our servicing platform and have us subservice loans for them directly, we are now able to do that and we have a contract in place.

Kevin Barker - *Compass Point - Analyst*

So Fannie Mae is essentially buying the MSRs from you?

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

No.

Kevin Barker - *Compass Point - Analyst*

No?

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

It's totally separate. This would be loans that Fannie Mae either already owns or has control over and they are looking to have those loans serviced. It has got nothing to do with the MSRs that we sell to other buyers. It separate -- it's a separate relationship.

Kevin Barker - *Compass Point - Analyst*

So it's purely a subservicing contract that Fannie Mae set up with Flagstar?

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

Correct. That's exactly what it is. Purely a subservicing contract with Fannie Mae.

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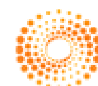

Sandro DiNello - *Flagstar Bancorp, Inc. - President & CEO*

Basically, Kevin, it puts us in a position to take on subservicing from Fannie Mae if they have say somebody they'd pull servicing from for some reason or they purchased loans back or whatever reason that Fannie Mae might need a servicer, we are now in a position to take that business from them if we can win the contract.

Kevin Barker - *Compass Point - Analyst*

Okay. And then just one last question. With the gain on sale coming down slightly this quarter, was that primarily pressure from the correspondent channel or was that something else that played a part with the gain on sale coming down this quarter?

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

Well, given the fact that 95% of our business comes from the correspondent channel, there is obviously a lot more pressure that comes there to the gain on sale. So the reasons that I articulated in the speech for the reduction in the margin are consistent with the 95%/5% split between our correspondent and broker versus our retail business level. So it isn't in particular one or the other. Just because of volume though, there is more that comes from the correspondent and broker channel.

Kevin Barker - *Compass Point - Analyst*

Were you seeing margins better in the correspondent or in the broker channel? Basically were they moving in a similar direction?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Well, generally speaking, in the industry, broker margins are better than correspondent margins. What I'm saying is that, in terms of positioning the pricing and determining what margin we accept, what we did was we accepted a lower margin and balanced that against the additional production in revenue that that would bring. So it isn't any particular channel that had more pressure than another if that makes sense.

Kevin Barker - *Compass Point - Analyst*

It does, yes. Thank you for taking my questions.

Operator

Bose George, Keefe, Bruyette & Woods.

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

Good morning. I just wanted to follow up on the Fannie Mae contract. Is that focused primarily on performing servicing?

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

Yes, it's focused on performing servicing through loans that are 59 days delinquent.

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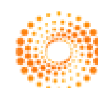

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Bose George - *Keefe, Bruyette & Woods - Analyst*

Okay, great. And then actually just on the MSR again, just Paul's comments earlier on the size of the MSR, as we sort of model it out into 2015, is the MSR to equity, that ratio just going to slowly trend down a little more over time?

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

So I think the guidance we gave is that we were going to shoot for a level that was similar to where we were in Q4 and that was at 22.6%. So that's basically what we are looking at. I think you gave some guidance as well, one of you did, right? Lee?

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

Yes, I think we've previously provided guidance, this is going back to January, of sort of being in the 18% to 22% MSR to Tier 1 range and I think we still feel pretty good with that. I think I would probably extend it slightly and say we are probably going to aim to be in the 18% to 23% MSR to Tier 1 range, Bose.

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

Okay, great. Thanks. Then actually switching to the exhibit, exhibit 21, the 695 loans, so is it safe to say all of those were current as they went into the reset?

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

So let me have Lee take a look at that. Go ahead, Lee.

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

Well, no, they weren't all current going into the reset. That is the issue. Some of these -- so some of the ones that were charged off or foreclosed on, the reset didn't have necessarily anything to do with that. So they could have already gone delinquent and been charged off prior to the reset. This just identifies the entire population of IOs that we had from January 1, 2013 through June 30, 2014. But it is not necessarily reflective of what happened at or after the reset date.

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

Okay, thanks. I guess is there a way to think about how much of a catalyst the reset has been for delinquencies because it looks like some of these loans are delinquent already?

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

Yes, that's right and the reset catalyst, it's actually not been -- it has not had that much of an impact and you can infer that from the number of loans that are cash flowing following the reset and the strong percentages that have been paying for more than three months and six months. But maybe we can actually include that metric in the next earnings report. I can understand why you would want to see that. What I can tell you is the reset date has not been the reason -- of the 47 that you see that have been charged off or foreclosed on, the reset date was not the reason for that happening in a large number of those.

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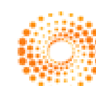

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Bose George - *Keefe, Bruyette & Woods - Analyst*

Okay, great. That is very helpful. Thanks.

Operator

Scott Siefers.

Scott Siefers - *Flagstar Bancorp, Inc. - Sandler O'Neill*

Thanks, guys. Let's see, Paul, I think someone might have alluded to this earlier, but I was just hoping you could spend a second offering some color just on what specifically drives or drove the change in the fair value of the liability, just that $10 million favorable change with the DOJ settlement? Can you go into a bit of detail about that, please?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

We can touch on it just a bit. We take a look at the DOJ liability every quarter because it is a fair value accounting measure. Part of the components there include the timing of the payments, the discount rates and as we look at that, every quarter, we reevaluate the timing of the scheduled payments according to the contract and in the quarter, as we looked at it and reevaluated it, we determined that the scheduled payments differed from -- had changed from what we had looked at earlier just in the normal course and so when we run the fair value model, we move the scheduled payments and then just from a present value perspective, Scott, the valuation changes. And so you'd expect over the course of any fair value liability or asset that you would have increases and decreases as the underlying assumptions change from quarter to quarter.

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

But the reason we pointed it out, Scott, as sort of an unusual item is because that much of a change in a quarter is a bit unusual. So we don't want to send a message that that should be something that can be relied upon going forward.

Scott Siefers - *Flagstar Bancorp, Inc. - Sandler O'Neill*

Yes, I definitely get that and I appreciate the transparency there. And then I guess just a final question, Sandro, maybe best for you, wanted to ask sort of an M&A-related top-level question. You had a large thrift sold yesterday for I guess a pretty significant premium to where -- you guys are trading on a price tangible book basis. It has generated at least some discussion. So I was just curious to hear your updated thoughts, if any, on how you are thinking about strategically and options, things like that.

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

Well, sure, I saw that transaction yesterday and as I read more about it, I guess you can understand from both sides why there might have been some motivation to do what they did. But from Flagstar's point of view, we are in the middle of building this Company and I think, for us, our focus is just that, is building this Company, growing our shareholder value and doing the best job we can with that and those sorts of things will take care of themselves. Our focus here of this management team is continuing to grow our net interest income, continuing to improve on our noninterest income sources, keep those expenses disciplined and just build shareholder value. And that is what we are going to keep doing.

Scott Siefers - *Flagstar Bancorp, Inc. - Sandler O'Neill*

All right, that's perfect. I appreciate the time.

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Operator

It appears we have no further questions at this time. So I would like to turn it back over to our speakers for any closing remarks they might have.

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

Thank you, Erica. I appreciate everyone's time listening to us this morning and the good questions. So thanks to everyone for your continued interest in Flagstar. This management team and the Board are together working very hard to build a great company. We've made a lot of good progress in Q2, took us a little closer to where we need to be, but there is still a lot of work ahead and we look forward to reporting further progress to you in the future. Thank you and have a great day.

Operator

We'd like to thank everybody for their participation in today's conference call. Please feel free to disconnect at any time.

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