THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

FBC - Q1 2014 Flagstar Bancorp Earnings Conference Call

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

THOMSON REUTERS

CORPORATE PARTICIPANTS

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

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

Lee Smith *Flagstar Bancorp, Inc. - COO*

CONFERENCE CALL PARTICIPANTS

Bose George *Keefe, Bruyette & Woods - Analyst*

Paul Miller *FBR & Co. - Analyst*

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

Kevin Barker *Compass Point Research & Trading - Analyst*

PRESENTATION

Operator

Good day, and welcome to the Flagstar Bank first-quarter investor relations conference call. Today's conference is being recorded. At this time, I would like to turn the conference over to the chairperson. Please go ahead.

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

Hi. Good morning, everyone. I'd like to welcome you to the Flagstar Bancorp Inc. first-quarter 2014 earnings call. My name is Paul Borja, and I'm the Chief Financial Officer of Flagstar Bank. Before we begin, I'd 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 business.

For additional factors, we urge you to review the press release we issued last night, our SEC documents such as our most recent Form 10-K, as well as the legal disclaimer on page 2 of our first-quarter 2014 earnings call slides that we've 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 table 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 and 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; and Mike Flynn, our General Counsel.

Let me first lay out the order of the call. I'm going to begin by reviewing the initiatives we undertook during 2013 and especially during the fourth quarter of 2013, which I continue to believe positions our Company for growth and success during 2014 and beyond. I then want to go into the key drivers of our first-quarter financial performance. After my comments, Lee will update you on our operations areas including the servicing business and non-interest expense initiatives. Paul will then take a deeper dive into the financial results for the first quarter and provide our outlook for the second quarter of 2014.

After our prepared comments, we are happy to answer any questions you may have. With that, let's begin.

During 2013 and especially during the fourth quarter, we took specific actions that we discussed during our last earnings call to further reduce risk, strengthen our balance sheet to develop quality revenue diversification alternatives, and enhance operating efficiencies. These actions included reducing our reliance on wholesale funds by paying down high-cost borrowings from the federal loan bank and by increasing our core deposit base to replace other wholesale funds. Reducing our non-performing and modified loan portfolios by selling groups of these loans during the year. Improving the flexibility of our mortgage operations by tightening our oversight of costs to better manage variable costs with our variable revenue stream while managing down the fixed expense base. Building our commercial loan business through continued growth in originations. Diversifying our revenue potential by establishing a sub-servicing platform through the initial bulk sale of mortgage servicing rights, in which we remained a sub-servicer of the underlying loans. And reducing our overall risk profile by settling outstanding litigations, entering into settlement agreements with Fannie and Freddie, and reducing the interest rate risk associated with our then-current levels of MSR concentration.

We believe these actions set the stage for improved top-line revenue and increased stability in our mortgage operations while reducing the risk of our balance sheet. Despite significant mortgage headwinds during the first quarter and our continuing focus on asset quality, we believe that our first-quarter performance demonstrates that we've made good progress towards these goals.

For the first quarter of 2014, we continue to take actions to address regulatory matters and requirements, improve profitability, improve the amounts and composition of earning assets on our balance sheet, and provide additional reserves against future losses.

These included completing our DFCS stress test results and submitting them to our regulators by the March 31 due date for their view, which is ongoing; deploying our excess cash to our investment securities portfolio; and eliminating the negative carry while maintaining our strong liquidity structure. Continuing to grow our commercial real estate and C&I portfolio with both growing balances and increased origination. Improving our borrowing profile with both reduced levels of borrowing and substantially reduced borrowing rates. Continuing to grow core deposits and improve the mix of our deposits. And significantly bolstering our loan-loss reserves.

Let's now turn to our financial performance. Please turn to slide 3. We've reported a net loss of $78.9 million for the first quarter of 2014, as compared to net income of $160.5 million in the prior quarter. As I will discuss further in a minute, the loss was caused by an increase in the loan-loss reserves and a one-time adjustment to our repurchase loans.

Keep in mind that the prior quarter, our fourth quarter of 2013, contained multiple significant one-time items that dramatically distort the bottom line comparison. But as we've discussed, that positioned the organization for future sustainable profitability. These fourth-quarter 2013 items included a $410 million tax benefit tied to the reversal of the valuation allowance and our deferred tax asset, the $178 million expense associated with the prepayment of approximately $2.9 billion in long-term fixed-rate Federal Home Loan Bank advances, and other items associated with legacy legal settlements that we have discussed in great detail on past calls.

We are obviously disappointed with the loss that we reported in Q1. The primary cause of the loss is a $100 million increase in the allowance for loan losses for residential mortgage loans that we don't expect to repeat. This increase was based on our evaluation of emerging credit data including the performance of interest-only loans following a repayment recess.

Accordingly, we have determined that it is appropriate to increase our loss estimation period from a 12-month to 18-month loss coverage and increase our reserve related to the reset risk. This is consistent with everything we have done since I became CEO to properly de-risk the Company. Taking this action significantly increases the coverage that we now have for losses as compared to the end of 2013.

It's important to note that this action was not driven by charge-offs. In fact, net charge-offs declined quarter over quarter. This point is worth repeating. Net charge-offs declined quarter over quarter.

Further contributing to the loss was a $21 million adjustment to non-interest income, decreasing the originally recorded fair value of performing repurchase loans.

Other than those items, the quarter was positive, as reflected on slide 4. Our net interest margin grew in line with our expectations. Our gain on sale income remained level despite a drop in production, as we were able to increase our margin in the face of a very competitive market. Our non-interest expenses were in line with our expectations.

Our banking business continues to grow, and we made a lot of progress setting up our servicing business to begin adding more loans through sub-servicing arrangements. And obviously, our non-performing loan coverage ratio increased significantly from 146% at the end of 2013 to 287% at the end of Q1.

With this first-quarter loss, our book value per share decreased since year end to $19.29. And despite the loss, our Tier 1 capital ratio measured a solid 12.44%.

In a challenging mortgage environment, our strategic initiatives remain designed to enhance our core net interest margin, better manager our gain on sale production margin, and deliver improved operating efficiencies systemwide. Our continuing focus on these broad guiding themes should serve to further develop a consistent, sustainable earnings platform that we have discussed on prior calls.

With regard to our net interest margin as shown on slide 5, net interest income increased significantly from $41.2 million recorded last quarter to $58.2 million reported in the current period. This was despite a contraction from year end in average-earning assets as we used excess liquidity in December 2013 to pay off the Federal Home Loan Bank advances outstanding at that time.

The opportunity to optimize the balance sheet by eliminating higher-cost funding enabled us to improve our top-line revenue during a lower mortgage origination market and effectively fund our operations primarily with traditional core deposits.

This significantly improved funding mix helped drive the core margin enhancement we are focused on achieving. To that point, the bank's net interest margin improved dramatically to 3.05% versus 1.80% in the fourth quarter of 2013.

As I mentioned earlier and as noted in trade publications, origination volumes industrywide continue to decline, and they declined at Flagstar proportionately as well.

Please turn to slide 6. In the first quarter of 2014, we reported mortgage originations of approximately $4.9 billion as compared to last quarter's level of $6.4 billion, while industry forces and competitive dynamics have served to compress gain on sale margins in recent quarters. And Flagstar has not been immune to this pressure. We are encouraged by our ability in the most recent quarter to maintain pricing and execution discipline while retaining market share objectives.

Please see slide 7. During the second half of 2013, we experienced a continuing trend of gain on sale margin compression, moving from nearly 200 basis points in 2012 to 85 basis points in last year's fourth quarter. Given that competitive pressures were greater than anticipated, with softness in the market, we are pleased that we are able to increase our margin in the first quarter of 2014. This increase, although smaller than we had hoped, was a reflection of the execution discipline and service quality pricing flexibility we are reinforcing in this very competitive environment.

Consequently, even with origination volumes that decline significantly and in the case of overcapacity in the industry, we were able to report a modest increase in net gain on loan sales. Our gain on sale increased from $44.8 million in the fourth quarter to $45.3 million in the first quarter of 2014, and we were able to accomplish this while maintaining market share. We were the fifth largest seller of purchased mortgages and the seventh in overall sales to the GSEs in Q1.

While we were able to stabilize the gain on sale margin in a continuing difficult environment, we were not immune to the attendant decline in loan fee revenues that mirror a drop in mortgage origination activity. In the first quarter of 2014, loan fees and charges decreased to $12.3 million, as compared to $19.3 million in the last quarter.

Moving to servicing, net servicing revenues fell from $28.9 million in the fourth quarter of 2013 to $19.6 million in the first quarter of 2014.

In this regard, please recall that, in proactively managing our MSR concentration as it relates to our capital levels, we sold more than $53 billion of MSRs through bulk sales in the fourth quarter of 2013. As such, the decline relates primarily to lower MSR balances.

We have been able to prudently manage our ratio of MSRs to Tier 1 capital from a level exceeding 55% a year ago to approximately 28% today. This is slightly above our target level, and therefore we will continue to work to execute on additional MSR sales in Q2. On that front, we will continue to manage our MSR balances while ideally retaining the ability to augment our sub-servicing platform in the process.

While Lee will delve into this dynamic a little later and the operating efficiencies it entails, I wanted to touch on the cost control initiatives we have implemented in recent quarters and which we continue to focus on as we move forward. Last quarter, we discussed our operating expense run rate and the opportunity to potentially corral additional efficiencies systemwide. Efforts to rightsize the organization and better align costs with revenues served to strengthen our operating leverage during the course of 2013.

Please turn to slide 8. In the first quarter of 2014, we announced a reduction in force designed to better align the realities of a declining mortgage origination environment with an operating cost structure able to sustain core profitability for our organization.

Last quarter, we told you that we believe our overall non-interest expense could average less than $140 million per quarter beginning in the second quarter of this year, assuming no material deviation in our expectations concerning mortgage industry origination levels. In fact, we met our goal in the first quarter, as Lee will discuss further.

We expect that as our first-quarter staffing reduction takes full effect in coming quarters, coupled with additional cost optimization efforts, we should be able to demonstrate further prudent reductions in total non-interest expenses.

Now turn to slide 9. On the asset quality front, we continue to aggressively seek to lower our non-performing loan balances. NPLs declined to $110.7 million, down from $145.7 million at the end of the prior period.

As reflected in slide 10 and was noted earlier, even with these positive trends regarding problem assets, we have made a decision to increase our allowance for loan losses by $100 million to $307 million. As a result, our ratios of allowance for loan losses to non-performing loans has expanded in the past 12 months from 78.5% to 286.9% today.

Before turning the call over to Lee, there are a few more items of like to discuss briefly. First, we recognize that aligning our cost structure with the realities of this market best positions our Company to deliver the consistent sustainable performance that is expected of us.

Second, we have been and will continue to pragmatically redeploy cash resources while maintaining sound liquidity levels. This should enable us to reap the benefits of excess cash being put to work without extending far out on the yield curve in order to retain redeployment flexibility as traditional lending opportunities develop in an improving economic environment.

Third, we remain committed to being Michigan's leading bank, and we will continue to nurture profitable consumer and business relationships.

And lastly, we continue to be optimistic about the future prospects for Flagstar as we consider how to grow and optimize our position as one of the top 10 mortgage originators in the country. I assure you 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, after which we will be available to answer your questions. I'd like to now turn the call over to Lee.

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

Thanks, Sandro, and good morning, everyone. It's been another busy quarter as we moved to transition from laying the foundations for future growth and success through de-risking the balance sheet and optimizing our cost structure to executing on our growth and revenue enhancement strategies.

Please turn to slide 8. Our total non-interest expense during the first quarter was $139.3 million. This compares to $150.1 million for the fourth quarter after normalizing for the prepayment adjustment with respect to the FHLB advances and the additional Department of Justice estimated liability, and $158.4 million in the third quarter.

During our last earnings call, we provided guidance for non-interest expense to range from $535 million to $575 million on an annualized basis, and our first-quarter run rate puts us in the middle of this range at approximately $557 million.

We announced and implemented a companywide organizational restructuring during the quarter, which has resulted in the elimination of approximately 600 full-time equivalent positions from our September 30, 2013 headcount levels. Of these 600, approximately 350 were eliminated during the first quarter, and we incurred severance and outplacement expenses of $3.6 million. If you subtract this amount, you get a normalized, non-interest expense amount of $135.7 million, or $542.8 million on an annualized basis, which is at the top end of our previously provided guidance.

To put this into context, for the first six months of 2013 our annualized non-interest expense run rate was $742 million. So in 10 months, we have been able to reduce non-interest expense costs by $200 million, or 27% on an annualized basis. Of these costs, approximately $130 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, centralizing vendor management and procurement, outsourcing non-core operations, containing asset resolution costs, and realigning our real estate footprint.

At the end of the first quarter, our total FTE headcount was just under $2800, which means that over the course of the last 12 months, we've reduced the number of FTEs by a little more than 1000. During the same period, we've also reduce the number of permanent subcontractors by 185 for a total headcount reduction of almost 1200. We expect annualized savings to be in the range of $50 million to $60 million as a result of these reductions.

We continue to believe the annualized savings from our initiative to centralize the vendor management and procurement function will be in the $40 million to $60 million range from the first half of 2013 run rate, when we were on track to spend ever $300 million annualized on third-party vendors.

Following the outsourcing of default servicing in 2013 and the sale of the significant part of our MSRs during the fourth quarter, we continue to believe the savings in asset resolution costs will be in the $17 million to $32 million range on an annualized basis.

We continue to look at our real estate portfolio of 170 properties, both owned and leased, and realign that portfolio accordingly, particularly following the reduction in headcount. During the quarter, we sold two facilities in Georgia at book value and exited 14 leases. We also purchased one property and entered into four new leases as we looked to maximize our real estate footprint and grow our home lending retail business.

When you factor in our actions to date, we expect quarterly non-interest expenses to be in the $130 million to $140 million range, or $520 million to $540 million range on an annualized basis. The significant cost reductions were necessary given the reduction in mortgage origination volumes and margins over the last 12 months.

We generated approximately $45 million of gain-on-loan sales during the first quarter, which was consistent with the amount we generated in the fourth quarter. However, this is significantly less than the $75 million generated in the third quarter and $145 million generated in the second quarter of 2013. As such, 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 consolidated efficiency ratio for the quarter was 104.6% versus 251.8% last quarter. However, after adjusting for various one-time items including the FHLB prepayments adjustment, Department of Justice estimated liability, rep and warranty leases, and the fair-value adjustment on our repurchase loans, we get an efficiency ratio of 91.3% this quarter versus 108.1% in the fourth quarter.

The improvement in efficiency is predominantly the result of $22 million of quarter-over-quarter FHLB interest expense savings following the prepayments of the FHLB advances and the $11 million quarter-over-quarter improvement in non-interest expense as I've previously discussed.

We believe we have now rightsized the cost structure of the organization to the point where we can generate positive free credit cost earnings at any time during the mortgage origination cycle. Actions we've taken to de-risk the balance sheet have also helped in this regard, and we will continue to look at ways to make ourselves more efficient across the entire organization.

We continue to be active in terms of de-risking of positioning the balance sheet for future growth during the quarter. We sold $278 million unpaid principal balance of non-agency jumbo loans for a gain after transaction costs. There is a lot of private capital that's interested in buying these type of products, and we have set up the same flow process we have with the GSEs in conforming loans.

As a result, in the future we may originate jumbo loans as available for sale instead of holding these loans in our portfolio. Not only does this keep our capital turning, it enables us to establish key relationships with private buyers.

We also sold $35.1 million unpaid principal balance of non-performing loans and triple-debt restructurings during the quarter for a very small gain after transaction costs. This not only gives us confidence in our marks, but it's reduced the amount of non-performing loans on our books to $110.7 million at the end of the first quarter, down from $145.7 million at December 31, 2013, and $369.3 million at the end of Q1 2013.

It also meant our ALLL to MPL coverage ratio was 286.9% at the end of the first quarter, versus 145.9% at the end of the fourth quarter.

Please turn to slide 19. Following the agreements we ended into with both Fannie Mae and Freddie Mac in Q4 2013 to resolve the bulk of the repurchase requests and obligations associated with loans originated between January 1, 2000 and December 31, 2008 and sold to the GSEs, our R&W pipeline has declined to $69.4 million unpaid principal balance at the end of the first quarter, down from $97.2 million at the end of the fourth quarter on $187 million 12 months ago. As a result, our R&W reserve was $48 million at the end of the first quarter, down from $54 million at the end of the fourth quarter.

Our MSR for Tier 1 ratio at the end of the first quarter was 28.1% versus 22.6% at the end of the fourth quarter. As I mentioned on the last earnings call, 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 sub-servicing of the loans from such sales.

We are engaged in negotiations on further bulk sales. And while there is never certainty unless and until a deal is done, we hope that we can successfully conclude those transactions in the second quarter.

If you turn to slide 11, you will see that we have $967.7 million of interest-only loans on our balance sheet, of which $266.2 million are due to reset during the remainder of this year. The payment shock associated with these resets versus current mortgage payments is approximately 69%. We also have approximately $28 million of HELOCs maturing throughout the remainder of 2014.

As I mentioned on our last earnings call, we've put a team together to get ahead of these resets and maturities. We want to make our borrowers aware of the upcoming event and lay out the various options available to them. It's allowing us to reach out to borrowers ahead of the I/O reset and HELOC maturity dates and be proactive in refinancing or modifying such loans, if that is something our borrowers are interested in doing.

Now I'd like to briefly touch on some new opportunities that we're exploring in addition to the jumbo flow initiative that I previously mentioned. If you refer to slide 12, you will see a schematic that represents our structure which we believe provides a leading-edge solution to the ever-evolving MSR and servicing markets. Flagstar is somewhat unique in that we originate loans, we service loans, we sell MSR assets, and we are also a bank.

As you know, we made the decision in 2013 to outsource our default servicing unit to Selene Finance in order to create a single servicing platform that could offer customized servicing in both the performing and default areas. We set it up as a private-label structure whereby Flagstar remains the master servicer and the transition is seamless to the borrower.

We also executed on the sale of $40.7 billion in aggregate UPB of residential MSRs to Matrix Financial Services Corporation, a wholly owned subsidiary of Two Harbors corporation, in the fourth quarter where we act as sub-servicer on all of the mortgage loans underlying the MSRs sold.

We are currently servicing approximately 370,000 loans, of which 195,000 is sub-serviced for others and 175,000 are either owned by us or we own the mortgage servicing asset. 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. Our goal is to grow that to where we service 1 million loans, as we have previously stated. And at the same time, we will also remain focused on driving further cost efficiencies in servicing and the rest of the organization.

As we reported, we had total assets of approximately $9.6 billion at the end of the first quarter, which is a decrease of approximately $3.5 billion from a year ago. This is largely due to our de-risking activities over the last 12 months.

However, and as I stated at the beginning of my remarks, we are now looking at growing existing and new lines of business in a controlled and safe manner. We would look to do this at least initially through leveraging our core strengths of mortgages and our Michigan community banking platform.

Finally, we are also looking to enhance our technology options from both an efficiency and revenue-generation point of view. We are exploring several avenues in this regard, and I expect to be able to update you further in future earnings calls.

As you can see, it's been another busy quarter, but I firmly believe we have created a platform from which we can push on and grow existing and new lines of business. And we continue to be excited and energized by the progress being made here in Flagstar.

With that, I'll hand it over to Paul.

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

Thank you, Lee. I'm going to now review the key components of our overall first-quarter 2014 financial results and update you on our Q2 2014 outlook for the key drivers of our financial performance. In that regard, please refer to slide 13, which provides an income statement bridge and highlights the key items that changed during the first quarter as compared to the fourth quarter. We've also prepared a summary income statement on slide 14 and balance sheet highlights on slide 15.

We recorded a loss of $78.9 million for the first quarter of 2014. This compares to net income in the fourth quarter 2013 of $160.5 million. It's important to note that our fourth-quarter financial results were impacted by four key items. We reversed our valuation allowance on our deferred tax asset. We prepaid all of our $2.9 billion in long-term FHLB advances. We incurred an incremental $61 million in non-interest expense above our normal estimated liability related to the settlement with the Department of Justice. And we had a benefit of $24.9 million during the quarter associated with the previously announced settlement agreements with Fannie Mae and Freddie Mac.

Please turn back to slide 5. Our net interest income increased to $58.2 million for the first quarter 2014, as compared to $41.2 million for the fourth quarter 2013. As you can see on the bottom-left chart, interest income declined by $5.5 million from the fourth quarter. This was offset by a $22.5 million declining interest expense, as shown on the bottom-right chart.

From a rate volume perspective, the decline in interest income was primarily attributable to declines in the average balances of loans available for sale and warehouse loans. The decline in interest income was offset by the reduced funding costs resulting from the prepayment of FHLB advances in the fourth quarter 2013.

As a result of the lower cost of funds, our net interest margin for the bank improved from 1.8% during the fourth quarter to 3.05% during the first quarter.

Turning to slide 16. You can see that we continue to do a good job of gathering core accounts and improving our deposit mix. While overall core deposits remained relatively flat, the percentage of core deposits to retail deposits increased slightly to 80% in the first quarter from 79% in the fourth quarter.

On the bottom half of slide 16, you can see that our overall deposit funding has increased during the quarter. 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 17, 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 continue to work out and dispose of legacy commercial loans. However, you can see we've been able to grow the portfolio of new or core commercial loans over the past quarter by 26%. As Sandro discussed, this is a major component of our balance sheet growth strategy, and we've been seeing good results thus far.

For Q2 2014, we expect that net interest income before provision for loan losses will increase by approximately 10%, as compared to net interest income in Q1 2014. Our view of such improving and net interest income arises primarily from expected growth in mortgage origination volume and our commercial loan portfolio over the second quarter.

Turning back to slide 7. Net gain-on-loan sales increased slightly to $45.3 million for the first quarter, as compared to $44.8 million for the fourth quarter. This increase was attributable to an increase in gain on sale loan sale margin on our mortgage locks. This stronger margin allowed us to increase our gain on sale revenue, even though mortgage locks decreased consistent with the overall industry mortgage production during the quarter. The increase in margin reflected an improvement in our hedge execution during the first quarter.

Turning back to slide 6, we provide some additional details on our first mortgage originations including by channel and by product. As you can see, purchase originations continue to become a bigger percentage of our overall mortgage production as we transition with the industry given the current rate environment.

For Q2 2014, we expect that the volume of mortgage locks will increase by 25% or more, as compared to Q1 2014, as we enter the busy spring season. However, we would expect that the gain on sale margin will remain consistent with rates experienced in Q1 2014, absent any intervening events.

Net loan administration income, also referred to as our net servicing revenue, was $19.6 million, a decrease from the $28.9 million recorded in the fourth quarter. This decrease primarily reflects a reduction in our MSR balance due to the fourth-quarter MSR sales transaction.

For Q2 2014, we expect to continue to realize an approximate 6% return on the MSR asset. We also intend to continue to seek opportunities for disposition of the 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 plan transactions, Flagstar's MSR to Tier 1 ratio at the end of Q2 2014 will be at or slightly below the ratio at the end of Q4 2013.

Please turn to slide 18. With respect to credit costs, we focus on three key areas -- loan-loss provisions for loans held in our investment portfolio; rep and warranty provision expense, which relates to potential put-back losses and loans we sold over the years in 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 portfolios.

As you see on this slide, these three credit costs for the first quarter reflected an expense of $122.1 million, as compared to $2.1 million for the fourth quarter. Loan-loss provision increased to $112.3 million, as compared to a provision of $14.1 million in the fourth quarter.

Turning back to slide 9, you can see that non-performing loans have come down significantly from levels a year ago. As outlined on slide 10, our overall allowance coverage of non-performing loans was 286.9% as of March 31, 2014.

For Q2 2014, we do not expect a significant amount of net loans will be added to the HFI portfolios. Also, we expect a slight decline in net charge-offs and do not expect any meaningful change in our reserve level.

Our provision for rep and warranty expense, by which we reserve for possible losses from loan put-backs, was actually income of $1.7 million for the first quarter, as compared to income of $15.4 million for the fourth quarter. The fourth-quarter income was driven primarily by a $24.9 million release of reserves associated with the Fannie Mae and Freddie Mac settlements. The first-quarter income reflects a release of holdback reserves from prior MSR sales. On slide 19, we provide further details on our rep and warranty reserve.

During the first quarter, we began to see a trend in repurchase loans that initially had mortgage insurance, but the insurance had been revoked years earlier without the loan records being updated to reflect this. As such, loans that had been considered to have a lower severity of loss were now giving rise to a higher loss rate. While we do not expect this to have a significant impact on our overall repurchase credit trends at this time trends, we are monitoring this situation closely. For Q2 2014, we would expect a slight provision of less than $5 million in addition to the provision that arises to our normal loan sales process.

First-quarter asset resolution expense was $11.5 million, as compared to $3.1 million in the fourth quarter, driven by lower gains in the first quarter from the sale of REO properties and an increase in foreclosure costs associated with loans that we service for others.

For Q2 2014, we expect that the structure for servicing loans, whereby defaulted loans will be transferred to a specialty servicer, should lead to slightly lower asset resolution expense.

Lee has already discussed non-interest expense in detail. And, consistent with the guidance he provided last quarter, our expectation is that total non-interest expense should not exceed $540 million for 2014.

Finally, turning to slide 20, you can see that we continue to maintain capital and balance sheet flexibility to fund the initiatives to drive future earnings that Sandro highlighted earlier.

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

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

Thanks, Paul. So why don't we go to questions now? So I'll give it to the operator.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Mr. Miller, FBR.

Paul Miller - *FBR & Co. - Analyst*

(technical difficulty)

Operator

Mr. George, KBW.

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

I had a couple of questions. First just on the ARM resets on the charge you guys took. Actually, could you give us a little more color just about the product? Are these [10-1s], and are they hitting their first resets? Also, just given how large your reserve risk relative to your NPLs, is it fair to say that (technical difficulty)?

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

Bose, these are not ARMS; these are interest-only mortgages that had originally seven- and 10-year maturities. So they are beginning to mature in larger numbers in 2014. They'll be a relatively significant number in 2015, relatively small number in 2016, and then it picks up again in 2017. I think we give you the detail on that in one of the slides. It's slide number 11.

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

Bose, this is Lee, just to add on that. If you look at that slide, so you'll see the payment shock associated with those resets for the remainder of this year is 69%. That's versus existing payments that those borrowers are making.

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

Okay, great. Just in terms of the timing of the charge, were the trends that you guys are seeing on that product somewhat worse than expected in terms of what caused the charge to be taken now versus (technical difficulty) in the quarter?

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

Well, based on the information we have now, we have taken a look at the -- where we should be from an allowance point of view. And I think you've got to look at this thing wider than just this piece of the loan portfolio.

So as we mentioned in the prepared comments, the increase in the allowance that we made was all relative to the residential mortgage portfolio. So I could kind of expand a little bit on the answer or -- and not be as specific as you've asked it because it's hard to be that specific.

What we've looked at -- as we look at the information that we now have and we believe that as we look at other institutions that have loan portfolios with characteristics similar to ours, many of them are considering loss-estimation periods or other reserve changes like we have. And we think that moving the loss-estimation period from 12 to 18 months is the right thing to do.

And so we've completed our analysis. We've consulted with our primary regulator, with our auditors. And we think this is the right thing to do at this time and that this change in estimate is prudent, safe, and sound. So my answer is a little broader than maybe your question, but it's hard to be that specific in terms of any particular part of the residential mortgage portfolio.

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

Okay. Thanks. That makes sense. And then a couple of other things. Just on the net interest margin, it went up pretty nicely. Just curious, the outlook there over the next year or so. Is there anything that should change that margin much, or is that kind of a good range for it?

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

Oh, I think right now that's a good range. We are continuing to focus on the funding -- this is Paul Borja -- we're continuing to focus on the funding for the core deposits. And based upon that, we would expect that the margin would be at or above -- I believe we targeted that amount towards year end, and we are actually hitting it much earlier. And so we're going to continue to improve that. What will drive it also is going to be the composition of the interest-earning assets that we're putting on board the balance sheet as the year progresses.

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

Great. Actually let me just throw in one more just on the non-interest expense. If mortgage volumes are flat next year, do you think there's more room to take costs down there?

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

I think what I would say, Bose, is we've already taken $200 million of costs out of the business in the last 10 months, as you know. Of that, $70 million has been variable cost reductions because of the reduced mortgage volumes; $130 million have been fixed cost reductions. I think while reducing expenses further will be more challenging because we've taken a lot of the low-hanging fruits out, we will do whatever is necessary to align expenses with revenue.

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

Great. Thanks a lot.

Operator

Mr. Miller, FBR.

Paul Miller - *FBR & Co. - Analyst*

On the $21 million of reserves you set aside with reps and warrants, was that product that you had the buy back from Fannie and Freddie but was performing and then defaulted in the quarter?

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

No. Go ahead, Paul.

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

You are referring to the fair-value adjustment for the $21 million?

Paul Miller - *FBR & Co. - Analyst*

Yes.

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

These are loans that we repurchased in the secondary market place. And as we take a look for the different loans, we looked at the overall valuation of them -- some were e performing, some more non-performing -- and we took a look at the fair value and made the adjustments.

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

So they are loans that were repurchased from the GSEs, but they are outside of the R&W reserve.

Paul Miller - *FBR & Co. - Analyst*

So I'm just wondering, could we have further fair-value adjustments against this book going forward? Is this something that's going to add noise to the earnings going forward?

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

This is Paul. No, this is a one-time adjustment. And on repurchase loans, we wouldn't have this problem going forward. We wouldn't have this issue going forward.

Paul Miller - *FBR & Co. - Analyst*

And then the other question I had is you were -- we've seen the application indexes came out this morning for MBA, and they are down and they've been relatively flat, up maybe slightly. The spring buying season has been a big disappointment relative to the purchase market. And we have seen refis starting to burn themselves out. But you talked -- are you seeing something different? Because you talked about you expect originations to increase in the second quarter, but we're just not seeing it in any of the data out there.

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

We are seeing a pickup in our activity here early in April. So we expect normal seasonal benefit from a strong purchase market in the second-quarter, and we think that will drive improved origination growth for us. We think the housing recovery remains on track. The affordable index is very attractive. Consumer debt is coming down. Employment continues to increase.

So we think that when it's all and said and done, then housing will benefit from the spring buying season, and we are ready to take advantage of that. And I know it's very early in Q2, but we have seen a nice increase in productions thus far this month and we've been able to hold our margins. So we're not out there buying the volume; we're sticking firm with our pricing philosophies. And yet we have seen a little bit of improvement this month.

And with respect to purchase, we did see towards the end of Q1 that our activity has been increasing. We had, I think, a 25.7% increase in purchase activity for rate locks in March versus February, and we think that the trend is going to continue.

Paul Miller - *FBR & Co. - Analyst*

Okay. Thank you very much. I'll get back in the queue.

Operator

Mr. Siefers, Sandler O'Neill and Partner.

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

Sandro, you kind alluded to it but I was hoping you could expand on what specifically drove the need for the provisions this quarter. I guess the reason I have [gotten] that the number of times this morning was just something that was driven specifically by regulators. Or Lee, you had alluded to an analysis that you were going through last quarter where you were reaching out to borrowers in the [IO] portfolio. Maybe if you could just be -- give a little more color on the exactly what drove the need to relook at the reserve on the IO piece?

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

Well, Scott, it's hard to be exact because this isn't an exact science. This is an art. And so what we're trying to do is look at all the information we have available and do what we think is the right thing. And that's exactly what we've done. We've taken a look at all the information that we have available and looked at what's going on out there in the industry and with our portfolio in particular, and we decided that moving to this longer loss-estimation period, given all the information we have, is the right thing to do.

So, yes, have we consulted with our regulators? Have we consulted with our auditors? Of course. We do that all the time relative to important financial matters. And as we've looked at everything as a whole, we think in order to be prudent, safe, and sound, this is the right thing for us to do right now.

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

That's perfect. Okay. I appreciate that color. And then just along the lines of what the $100 million kind of covers you for, so to speak. So if the lookout is roughly in the next 18 months or so, I guess that would specifically cover the recess of 2014 and 2015, which is about 2/3 thirds of the entire IO book.

Do you think, however, that the $100 million that you took this quarter -- does that, in your estimation, kind of cover you for the full book? Or as we go forward and kind of creep into the point where 2016, 2017, et cetera, come into that look window, would there be additional costs in your best judgment? Or how are you thinking about that dynamic?

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

Well, all we can do right now, Scott, is look at what we think we know today. So based on what we know today, or at least what -- best we can analyze today, we think that the $307 million allowance and that portion of it which is attributable to the residential portfolio does cover us for our anticipated losses. Now, as time goes on, as you know, with an allowance you get more information, you get more knowledge, and then you adjust accordingly. So am I hopeful that there will be improvement in this as time goes on? Certainly. But as I said a moment ago, this thing isn't a science, it's an art; and we are doing our best to figure it out in the right way right now.

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

Okay. And then just along the lines of what the specific allowance for the IO book, have you guys disclosed or would you disclose what the percent -- or I guess the dollar value of the allowance just for the IO book specifically was, and I guess it's now, $100 million higher than what it was. But you have that starting point, by any chance?

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

We have -- this is Paul -- we have not in the past because IOs are part of our overall residential portfolio. Both for the tables and in the 10-Q, we generally disclose our allowance for all of our residential portfolio given the similar risks that are based there. We can, though, break it out in the 10-Q later on, and we'll be talking about that internally.

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

We'll take that into consideration, Scott.

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

Okay, perfect. I appreciate that. And then just to get I guess the last question, you guys had recaptured the DTA last quarter. Does a loss this quarter -- I guess what I'm asking is there any risk to the DTA that you recaptured last quarter? Are you kind of completely in the clear, or is there a tail risk or anything we should be thinking about there?

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

Hi. This is Paul. We've taken a look at this loss relative to the DTA analysis. We analyze it every quarter. And based upon our analysis, we're comfortable that this quarter's result doesn't impact our decision in the prior quarter to reverse the reserves. So we are comfortable as we are sitting here now.

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

Okay, perfect. Thank you. And then final ticky-tack question. Paul, did you give or update provision guidance specifically? I think I got most of your guidance, but I think I might've missed part of it. Did you offer any provision guidance either for the second quarter or the full year?

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

We offered some provision guidance for the next quarter that we expect that a slight -- we would expect that there is not going to be a meaningful change in the reserve for Q2 for the coming quarter and that our charge-offs would be about the same as the next quarter.

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

Okay. All right, that's perfect. Great. Thank you guys very much.

Operator

Mr. Barker, Compass Point.

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

Outside of making borrowers aware that payments are going to change as they start amortizing on interest-only portfolio, what sort of programs do have in place in order to prevent foreclosure or default from these borrowers? And what percentage of these borrowers have you actually been able to contact when you do reach out to them?

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

We've got a great program in place, Kevin, and I'll let Lee explain it to you.

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

Yes, what we've got in place, Kevin, what we have set up is the [right-party] contact program. And so what that means is we are reaching out to these borrowers ahead of time. So we're doing it on both the IO and the HELOC side. But obviously the IOs is where we have a lot more exposure to billion dollars.

Now, what -- we have got a team of people, and they're contacting these borrowers and actually making them aware of the upcoming event and laying out the various options to them. So whether that be a refinancing opportunity or we may have to do a modification, they're laying all this out and the economic impact of the reset.

What we are typically finding is the sweet spot for actually really getting these borrowers engaged is typically 90 to 120 days before the actual event. If you get too far ahead of this, people just don't want to deal with it. They're pushing it out.

But what I would tell you as it relates to the right-party contact, in terms of resets that are occurring in Q2, we've actually made contact with 99% of all borrowers. So that's 440 IOs that will be resetting in Q2.

As it relates to Q3 already, we've already got a right-party contact percentage of 92%. So you can see that we're -- I mean, we're working extremely hard to get ahead of the game. And as a result of that, it's allowing us to be proactive in managing that reset exposure.

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

Okay. And then if you were to look at those, what -- how many have you actually modified to date that are going into amortization during 2014? And if so, what type of modification programs do you have in place for those type of program -- for those type of borrowers?

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

Here's what I can tell you, Kevin, rather than getting into the detail of the specific modification program; we can discuss that off-line. Here's what I'll tell you in terms of some general stats. So if you go back to January 1, 2013 through the end of the first quarter 2014, 255 IO loans have reset. And what I can tell you is 49 of those have paid in full, 35 have been sold or modified, 18 have been charged off or foreclosed upon, 10 are in a 30 plus day -- some sort of 30-plus-day delinquent status, and 101 are cash-flowing resets at this point in time. And then there's 42 that we're in the process of resolving, most of which will move to the cash-flowing reset bucket; although some of those are actually refinance referrals, and we are working them through that process as well.

We have that data for -- we're looking at this on loan-by-loan basis. So we have that granular data for what's going on in Q2 and beyond as well. We're tracking every loan through the refinance program. We know exactly where it is in the system, and it's the same with all loans that have been modified as well.

So we have a very comprehensive and robust program in place, and I'd be happy to talk to you further off-line about the specific programs. I don't think I need to go into detail on this call.

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

Okay. Thank you. And then on the -- your Tier 1 common equity ratio for Basel III is up quite a bit and is well above the minimum ratios you're going to need to maintain. With that level, does it put the potential -- the payoff (inaudible) -- the preferred stock that reset to 9%, is that in the near term, is this something you are looking at right now, or do you see that as being further out?

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

Well, obviously, the -- as you know, everybody knows the coupon rate increased to 9% recently. So we have been looking at all the options available to us in connection with the former term but at this point have not come to a conclusion as to what actually we might take. But I can assure you it's something where we're thinking through very carefully.

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

Okay. I'll get back in the queue. Thank you.

Operator

(Operator Instructions) Mr. Fowler, [Arvis Capital].

Unidentified Participant

My question was related to the 255, and you gave excellent detail there. So just one follow-up question to that and then one more question. On the 18 loans that went to foreclosure, what was your loss severity on those loans, please?

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

Again, I won't get into the specifics. What I can tell you is the loss severity on those is less than the loss severity that we experienced in the rest of the first lien HFI book. And we -- the data you are requesting, we have. And as I say, the loss severity is less on these loans than it is on the rest of the book.

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

Great. Thank you. And then on your gain on sale in the first quarter versus the fourth quarter, was there any material change in your MSR capitalization factor quarter over quarter?

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

I'll refer that the Paul, but I don't think so.

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

No, there was not.

Unidentified Participant

Your handful of basis-points improvement, then, was related to hedge efficiency (technical difficulty) non-cash accounting?

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

That's right.

Unidentified Participant

Okay, great. Thank you very much.

Operator

(Operator Instructions) There are no further questions at this time. Please continue.

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

Thank you, Charles. I appreciate that. So I'd like to close with just a few comments.

Despite the Q1 loss, we remain pleased with the progress we are making to strengthen the foundation for future profitability in a safe and sound fashion. We realize we are in a challenging mortgage environment and believe we are taking the steps necessary to position ourselves to grow long-term shareholder value.

Finally, I'd like to thank all of my Flagstar associates for their hard work this past quarter and also thank our shareholders for their support. Thank you, and have a good day.

Operator

Ladies and gentlemen this concludes the conference call for today. We thank you for your participation. You may now disconnect your line and have a great day.