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PRESENTATION

Operator

Good day, everyone, and welcome to the Flagstar Bank fourth-quarter Investor Relations conference call. Today's call is being recorded and 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, everyone. I would like to welcome you to our fourth-quarter 2013 earnings call. My name is Paul Borja and I'm the Chief Financial Officer Flagstar Bank.

Before we begin, I would like to remind you that the presentation today may contain forward-looking statements regarding both our financial conditions 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 and Form 10-Q, as well as the legal disclaimer on page 2 of our fourth-quarter 2013 earnings call slide that we have posted today in 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 is in the appendix to our earnings call slides.

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

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

Thank you, Paul. Thank you, everyone, for joining us today. In addition to Paul, Lee Smith, our Chief Operating Officer, and Mike Lynn, our General Counsel, are here with me today.

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

After our prepared comments, we are happy to answer any questions you may have.

So let me begin. Over the past year, we addressed declining levels of revenue by aggressively managing noninterest expense, by being proactive in completing transactions to improve asset quality, and decrease credit-related costs by capitalizing on an improving market for mortgage servicing and by continuing to improve our funding profile and lower our interest expense. I want to emphasize that all of these actions we took were guided by our commitment to becoming a highly efficient and best-in-class operator in each of our businesses while generating value for our shareholders. This management team has demonstrated that it moves quickly and aggressively to implement the initiatives that we determine will enhance shareholder value.

In 2013, we worked tirelessly to address risks, dispose of legacy assets, optimize the cost structure, and eliminate valuation overhangs. We made important strategic and operational progress that have helped position our Company for sustainable growth over the long term.

I would like to walk you through our 2013 accomplishments and initiatives, understanding that the narrative of this progress will help frame our strategy for 2014 and beyond.

Let's start with the fourth quarter. We previously announced during the quarter that we had reached a settlement agreement with both Fannie Mae and Freddie Mac over pre-2009 mortgage repurchased obligations. In December, we also announced that we entered into an agreement with Matrix Financial Services Corporation, a wholly-owned subsidiary of Two Harbors Investment Corporation, to sell mortgage servicing rights with underlying loans that have a UPB of $40.7 billion while remaining a subservicer on these loans. Combined with other bulk sales, we sold $53.4 billion in total servicing rights this quarter which reduced our MSR to Tier 1 ratio from 56% at the end of Q3 to 23% at the end of Q4.

After careful analysis with our finance and accounting team as well as with our auditors and independent accounting advisors, we reversed the valuation allowance on 100% of our federal deferred tax assets and a portion of our state deferred tax assets. This contributed to a substantial increase in the Company's book value per share.

We also prepaid all of the long-term Federal Home Loan Bank advances on our balance sheet, creating a much cleaner and more flexible funding profile, which should be significantly -- which should significantly improve net interest income going forward.

In addition, the estimated fair value liability for our February 2012 Department of Justice settlement was increased from $28.5 million to $93 million. This amount represents the present value of future cash flows based on the current projected contingent payment schedule. This estimated liability could increase or decrease going forward depending on various factors that influence the projected contingent payment schedule.

Turning back to the first quarter, we completed the sale of our Northeast-based commercial loan portfolio, thus exiting that business so we could focus on our mortgage banking franchise and Michigan community banking operations. Then in the second quarter, we resolved the two outstanding legacy litigation matters, Assured and MBIA, and we completed the bulk sale of $341 million in UPB of nonperforming loans and troubled debt restructuring.

We also began to implement a series of initiatives to optimize our cost structure and better manage efficiency. As part of those efforts, we announced the decision to outsource our default servicing business.

During the third quarter, we completed an additional sale of nonperforming loans and TDRs disposing of $167 million in UPBs. As part of our cost optimization effort, we reduced full-time equivalent by about 330 and noninterest expense declined by $16 million from the prior quarter level. All these actions taken together and coupled with the workforce reductions and organizational restructuring we announced last week aimed at further reducing cost provide for a much less volatile and choppy P&L going forward and support the long-term sustainability of earnings while simultaneously reducing risks, strengthening the balance sheet, and removing many of our valuation overhangs.

With these larger one-time items mostly behind us and with the continued commitment to building our culture of compliance, our focus in 2014 has shifted to prudently redeploying excess capital, leveraging the balance sheet within our core competencies, specifically our mortgage origination franchise, our newly broadened servicing business, and our community bank and increase in our share of wallet and providing best-in-class service to our mortgage and community banking customers.

So let's now turn to our financial performance. During the fourth quarter, we reported net income to common stockholders of $160.5 million or $2.77 per diluted share. For 2013, we reported net income to common stockholders of $261.2 million or $4.37 per diluted share. Our book value per common share increased from $16.12 per share at year-end 2012 to $20.56 per share at year-end 2013.

Now let's look at some of the key drivers. Like others in the mortgage industry, we were not immune to volume declines caused by steadily increasing interest rates during 2013. As a result, this past year was a challenging one for mortgage-related revenues. We experienced reductions in gain on loan sale income, interest income and loan fees, all of which are primarily driven by mortgage originations.

In 2013, we originated $37.5 billion of residential mortgages as compared to $53.6 billion in 2012. The margin we earned also declined. For 2013, our gain on sale margin based on fallout adjusted lock declined to 107 -- 127 basis points from the 196 basis points we had in 2012. As a result, net gain on loan sales decreased from $991 million in 2012 to $402 million in 2013. Loan fees also decreased by almost $40 million from the 2012 level and our interest income, which in 2013 was largely tied to mortgage production, decreased by $150 million in 2012.

In the fourth quarter, we continued to experience lower gain on sale income as the rise in mortgage interest rates and slower home purchase activity due to seasonality created a difficult mortgage origination environment. Fourth-quarter net gain on sales decreased to $45 million as compared to $75 million in the prior quarter. The margin we earned on our fallout adjusted rate locks also declined to 85 basis points from 114 basis points in the third quarter.

Based on recently issued industry estimates for mortgage originations, we anticipate that 2014 will be a challenging year. As you know, total mortgage originations for the industry were $1.8 trillion in 2013 and for 2014, Fannie has lowered its mortgage origination estimate to $1.3 trillion while Freddie and the MBA have revised their estimates downwards to $1.1 trillion.

These estimates underscore the importance of all the transactions we completed during 2013 which have prepared us for the reality of the 2014 mortgage market.

Turning to commercial banking, we had an outstanding year of adding solid core commercial relationships. Our new commercial loan portfolio, which consists of commercial loans originated in 2009 and after, increased by 83% from the end of 2012 and while still a small portion of overall revenue, we are seeing similar growth in treasury products and commercial deposits.

We also experience outstanding growth in core deposits and saw nice traction from our partnerships with the University of Michigan Athletics and the Detroit Red Wings. Our core deposit ratio calculated as a percentage of retail deposits improved from 50% at year-end 2012 to 79% at year-end 2013.

Now let's take a look at why the initiatives we completed in the fourth quarter put us in a position to be consistently profitable going forward.

Please turn to slide 21. As I noted earlier, interest expense will be lower in 2014 as a result of the prepayment of our Federal Home Loan Bank advances. At the end of the fourth quarter, we prepaid $2.9 billion in long-term fixed advances, which had an average coupon of about 3.3%. Though we have replaced and will likely continue to replace some of these borrowings going forward, the average coupon is expected to be significantly less. As a result, we believe that net interest income will be higher by between $15 million and $20 million per quarter versus the Q4 level. Beginning in 2014, we plan to fund growth in our lending and investment portfolios with increased deposits. Keep in mind this does not include any benefit from the deployment of excess capital, which I will discuss shortly.

As I mentioned, we sold a significant portion of our mortgage servicing rights during the quarter. We did retain the sub servicing rights on a good portion of those and Lee will discuss how to think about the impact of that to the P&L during his comments.

Turning to noninterest expense, we believe there is a potential for further saving from our fourth-quarter 2013 run rate. Lee will discuss this in more detail. But beginning in Q2 2014, we believe overall noninterest expense should average less than $140 million per quarter, assuming no significant deviation from the mortgage industry estimate I discussed earlier.

Given the settlements with Fannie and Freddie during the quarter, we believe our current reserve is adequate and any incremental representation and warranty provision or repurchases going forward will be negligible, assuming no change in our current environment. Finally, we believe we will see lower provision for loan losses going forward.

So let's now talk about where we see in parental opportunities for earnings per share growth from our fourth-quarter revenue level in each of our three core businesses.

Please turn to slide 23. First, we think there is an opportunity to leverage the balance sheet and redeploy excess capital to grow interest-earning assets, generating additional net interest income assuming the same yield on our commercial loan portfolio and a similar cost of funds as compared to the fourth quarter 2013 levels, we could expect to generate an additional $0.27 in annualized earnings per share for every $2 billion in commercial loans deployed. This would be incremental to the fourth quarter 2013 run rate.

Second, our goal is to remain profitable from the origination and sale of mortgage loans no matter what the market size is. We believe we are now staffed appropriately to deal with the volatility of the business.

Assuming gain on sale margin returns to the third-quarter 2013 level and assuming our current market share, we could expect to generate an additional $2.24 in annualized earnings per share in a $2 trillion mortgage market. This again would be incremental to the fourth-quarter 2013 run rate.

Third, we believe we can add significant income from our mortgage servicing business. As Lee mentioned on previous calls, our goal is to take this business up to 1 million loans serviced from the 356,000 or so loans currently serviced. Assuming we get to 1 million loans served, we believe we could earn an incremental [$0.47] (corrected by company after the call) of additional annualized earnings per share from the fourth quarter 2013 run rate.

To summarize, we believe that the actions we took in 2013 should allow us to remain profitable in 2014 even given the current forecast of lower levels of mortgage originations. As you can see, we believe there is significant further upside to our earnings per share as we redeploy capital within our existing mortgage and community banking businesses and add a recurring stream of revenue from the less capital-intensive servicing business we set up.

Before I turn the call over to Lee, I want to highlight a few metrics that I think encapsulate our progress in 2013.

As you can see on slide 4, we are working hard to improve the financial condition of this bank and increase shareholder value. As I mentioned earlier, our book value per share increased by over 28% from the prior year. All of our asset quality and allowance coverage ratios improved dramatically from 2012 levels as you can see highlighted on the bottom half of slide 4.

As an example, nonperforming loans to total loans declined from 7.4% to 3.6% and our allowance coverage of nonperforming loans improved from 76% to 146%. We cut our MSR to Tier 1 concentration in half from 56% in Q3 2013 to 23% in Q4 2013. We significantly improved our regulatory capital ratios which provide us with the balance sheet flexibility going forward. Finally, we managed through a difficult mortgage environment in 2013 and were able to remain profitable.

In conclusion, I want to take a moment to thank all of our employees for their hard work and dedication. Our achievements over the last year are very satisfying and they are a testament to the ongoing commitments of this team.

With that, I will turn the call over to Lee to discuss operations.

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

Thanks, Sandro, and good morning, everyone. As Sandro mentioned, it has been another busy quarter as we continued to build the foundations for future growth and success. The sequencing of our actions has been pivotal in laying such foundations as we continue to optimize the cost structure of the organization and further de-risk the balance sheet.

Please turn to slide 5. Our total noninterest expense during the fourth quarter was $388.7 million. After you normalize the run rate by subtracting the prepayment adjustment of $177.6 million on the FHLB advances and the additional Department of Justice estimated liability of $61 million, which represents the incremental amount based on the DTA reversal, you get a normalized run rate of $150 million for the fourth quarter 2013. This compares to $158 million in Q3 and $174 million in Q2.

If you remember from our last earnings call, we provided guidance for noninterest expense to range from $552 million to $597 million on an annualized basis. Our fourth-quarter run rate of $150 million puts us at the lower end of the expense savings range. However, the recently announced workforce reductions which we estimate will lead to approximately $40 million of annualized cost savings have not been factored into our fourth-quarter run rate. If you include those, that would give us an annualized noninterest expense run rate of $560 million for the year, which is at the high end of the expense saving guidance we provided last quarter.

And remember, this run rate is based on actions already effectuated. To put this into context, for the first six months of 2013, our annualized noninterest expense run rate was $742 million, so in eight months we have been able to reduce noninterest expense costs by $180 million or 24% on an annualized basis of which $125 million have been fixed cost reductions and $55 million have been variable cost reductions because of reduced mortgage origination volumes.

Last week we announced that we had implemented a companywide organizational restructuring, which resulted in approximately 600 full-time equivalents being eliminated from our September 30 level. These reductions, which will be completed by the end of the first quarter, will result in $40 million of annualized savings, for which the bank will incur a pretax charge of approximately $5.2 million. $1.4 million of this amount was incurred in the fourth quarter.

The decision to restructure the organization and eliminate these positions was not taken lightly but was necessary given the significantly reduced mortgage origination market and the need to properly align overall corporate support expenses to our revenue projections. Together with the 331 reductions in Q3 and natural attrition in the second half of 2013, total full-time equivalents have been reduced by approximately 1000 or 26% since June 30, 2013. Over the same period, we have also reduced the number of permanent subcontractors by 187 for a total reduction of almost 1200 in eight months.

Please turn to slide 6. As a result of our actions, we are increasing our 2014 guidance on compensation and benefit savings unrelated to the outsourcing of default servicing from $30 million to $40 million to $45 million to $50 million on an annualized basis.

The new vendor management and procurement initiative is now in full swing and the team has already been able to achieve some meaningful wins. We continue to believe the annualized savings from this initiative 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 over $300 million annualized on third-party vendors.

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

With the headcount reductions, we continue to look at our real estate portfolio of 181 properties, both owned and leased and rationalize and realign our portfolio accordingly.

When you account for the FHLB prepayment adjustment and the incremental expense for the Department of Justice estimated liability, our consolidated efficiency ratio for the quarter was 97.3% versus 89.5% in the prior quarter. The increase in our efficiency ratio was driven entirely by a reduction in pretax revenues. Gain on loan sale down $31 million from the previous quarter and is down $100 million from the second quarter or $400 million on an annualized basis, which emphasizes how important it has been for us to act quickly and decisively with our cost reduction actions.

As a result of the reduction in gain on loan sale, the mortgage efficiency ratio was 80.5% in the fourth quarter versus 68.9% in the previous quarter. Community banking increased slightly in the quarter to 115.7% versus 113.1% in the third quarter. This change was driven by lower warehouse loan interest as a result of the reduced mortgage origination volumes.

What is interesting to note here, if you factor in the one-time items identified on slide 21, which includes the quarterly cost savings associated with the recent reduction in force of $10 million per quarter together with the savings on interest expense of approximately $18 million as the result of our restructuring of the FHLB funding, our consolidated fourth-quarter efficiency ratio would have been 87.1%. We believe that shows we have rightsized the cost structure of the organization to the point where we can be profitable at any time during the mortgage banking cycle. Actions we have taken to derisk the balance sheet over the last six months and which I will talk about in more detail shortly, have also helped in this regard and we will continue to look at ways to make ourselves more efficient across the entire organization.

Just because we have hit the targets we set for ourselves does not mean we're going to stop focusing on being as efficient as we can whilst also becoming a best-in-class provider for all of our products and services.

We continued to be extremely active during the quarter in terms of further de-risking the balance sheet. As Sandro mentioned, we entered into agreements with both Fannie Mae and Freddie Mac to resolve substantially all of the repurchase requests and obligations associated with the loans originated between January 1, 2000 and December 31, 2008 and sold to those GSEs. When you combine the two agreements, the total settlement amount was $132.3 million and after paid claim credits and other adjustments, we paid $102.4 million to the GSEs.

The R&W reserves specific to the loans covered by the agreements exceeded the payments by almost $25 million. When you consider that we incurred $256 million in 2012 and $36 million in 2013 after accounting for the $25 million release in R&W provision expense, these settlements should lead to a significantly reduced R&W provision expense in 2014 and beyond.

During the fourth quarter, we saw $40.7 billion in aggregate UPB of residential MSRs to Matrix Financial Services Corporation. This represented 55% of our mortgage loans serviced for this portfolio as of September 30, 2013. Essential component of this transaction is that Flagstar will act as a subservicer on all of the mortgage loans underlying the MSRs being sold and as a result, we will receive subservicing income and retain a portion of the ancillary fees.

This transaction was significant on two levels. One, it significantly reduced our MSR concentration risk and, two, we were able to utilize our newly reconfigured servicing business to generate ongoing servicing revenue and diversify the Company's operations.

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 servicing excellence 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. This structure is beginning to be noticed in the market, as can be seen from the recent transaction with Matrix.

We also sold $12.7 billion of MSRs during the quarter where we did not retain the subservicing including a $1.8 billion forward flow deal. As of December 31, 2013, we had $285 million of MSR assets or $25.7 billion of underlying loans on our balance sheet and an MSR Tier 1 ratio 22.6%, which was down from 56.8% at September 30, 2013. 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 on the loans from such sales.

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 cost. 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, we would not want to ever entirely eliminate the MSR asset we carry on our balance sheet.

In terms of the $53 billion of MSRs we sold during the fourth quarter and assuming a return on asset of 6%, the amount of net income foregone on this asset is approximately $19 million to $22 million annualized after factoring in what we will recapture from subservicing the loans to Matrix. However, our mark-to-market and hedging risks have been significantly reduced as a result of the MSR sales.

We are currently servicing approximately 356,000 loans of which 198,000 are subserviced for others 158,000 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. We would therefore need incremental 270,000 to 300,000 loans to replace the loss of income from the MSR asset sales during the fourth quarter. 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 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.

In terms of other balance sheet activities, we have a team dedicated to mining our interest-only and HELOC books before the respective loans reset or mature. We want to make our borrowers aware of the upcoming event and lay out the various options available to them allowing us to get ahead of the IO reset and HELOC maturity dates and be proactive in refinancing such loans if that's something that our borrowers are interested in doing.

As you can see, it's not just been a busy quarter but it's been a busy eight months since Sandro and I assumed our positions and I firmly believe we have made excellent progress in our goals to derisk the balance sheet and rightsize the organization. This sequencing has created the foundation from which we can grow existing and new lines of business and we continue to be excited and energized by the opportunity 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 fourth-quarter 2013 financial results and update you on our Q1 2014 outlook for the key drivers of our financial performance.

On slide 22 we have prepared an outlook for the full year 2014, but I will focus on the first quarter during my comments. Please turn to slide seven, which provides an income statement bridge and highlights the key items that change during the fourth quarter as compared to the third quarter. We have also prepared a summary income statement on slide eight and balance sheet highlights on slide nine.

We reported $160.5 million of net income for the fourth quarter 2013, or $2.77 per share, on a fully diluted basis. This compares to net income in the third quarter of $12.8 million, or $0.16 per diluted share.

It is important to note that our fourth-quarter financial results were impacted by four key items. First, we reversed the entire valuation allowance of our deferred tax asset related to federal taxes and a substantial portion of the allowance that relates to state taxes. Your overall effect was a fourth-quarter 2013 tax benefit to our bottom line of $410.4 million.

If you recall, we established a full valuation allowance against our deferred tax asset in the third quarter of 2009. During the fourth quarter of 2013, we evaluated our ability to earn enough to use the net operating losses that underlie the DTA. After a lot of work analyzing the key accounting factors that affect our decision, we concluded that Flagstar would like to be able to realize the benefits of the deferred tax assets.

Second, we prepaid all of our $2.9 billion in long-term FHLB advances, which resulted in a prepayment adjustment that we were charged and which totaled $177.6 million. These advances carried an average coupon of 3.3% so we expect to see a significant benefit in the form of lower funding costs and a more flexible funding structure beginning in the first quarter of 2014.

Third, we incurred an incremental $61 million in noninterest expense, above our normal estimated liability and related to the settlement with the Department of Justice we entered into February 2012. We recorded that settlement as a fair value liability and have been adjusting for it in accordance with accounting standards. That brought the total estimated liability to $93 million as of December 31, 2013.

Fourth, we had a benefit of $24.9 million during the quarter associated with the previously announced settlements with Fannie Mae and Freddie Mac regarding pre-2009 loan originations that we sold to them.

Please turn to slide 10. Our net interest income declined slightly to $41.2 million for the fourth quarter as compared to $42.7 million for the third quarter. As you can see on the bottom left chart on that slide, interest income declined by $7 million in the third quarter. This was partially offset by a $5.5 million decline in interest expense as shown in the bottom right chart.

From a rate volume perspective, the decline in interest income was primarily attributable to declines in the balances of loans available for sale and warehouse loans, as well as a lower average yield earned on loans repurchased with government guarantees. These decreases were partially offset by increased income from investments as we invested excess liquidity into higher-yielding agency investment securities as opposed to lower-yielding cash.

In addition, we benefited from a decline in deposit expense as higher-costing retail CDs continued to roll off. As a result of the lower cost of funds, our net interest margin at the bank level improved from 1.68% during the third quarter to 1.8% during the fourth quarter.

Turning to slide 11, you can see that we continued 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 to almost 80% in the fourth quarter from about 73% in the third quarter. On the bottom half of slide 11 you can see that our need for overall deposit funding has declined along with decreased mortgage production.

On slide 12 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. The overall commercial portfolio has declined over the last year as we work out and dispose of legacy commercial loans.

However, you can see we have been able to grow the portfolio of new commercial loans over the course of 2013. As shown on the slide, that portfolio has increased by 83% from the end of 2012. As Sandro discussed, this is a major component of our balance sheet growth strategy and we have been seeing good results thus far.

For Q1 2014, we expect that net interest income before provision for loan losses will increase by approximately 40% as compared to net interest income in Q4 2013. Our view of such improvement in net interest income arises primarily from our Q4 2013 pay down of the long-term fixed rate FHLB advances. We also expect that this will result in a net interest margin at the bank level by year-end 2014 of between 2.75% and 3%, assuming overall asset growth during 2014 of between 8% and 10%.

Also, while we expect to continue to obtain FHLB advances as our needs require, we expect that such borrowings will be at much lower rates and with short- and medium-term maturities.

Turning to slide 13, net gain on loan sales decreased to $44.8 million for the fourth quarter as compared to $75.1 million for the third quarter. This decline was attributable to a 20% decline in fallout adjusted mortgage locks and a 25% decline in the gain on loan sale margin on such locks.

The decline in locks was consistent with the overall industry decline in mortgage production during the quarter, reflecting both the interest rate environment and homebuying seasonality. The reduction in margin reflected mortgage rate lock volatility in the fourth quarter.

On slide 14, we provide some additional details of 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 Q1 2014, we expect that the volume of mortgage locks will decline by about 20% as compared to Q4 2013, consistent with industry expectations.

However, we would expect that the gain on sale margin will return to the levels experienced in Q3 2013 absent any intervening matters as occurred during Q4 2013. Net loan administration income, also referred to as our net servicing revenue, was $28.9 million, relatively flat from the third-quarter level. Our noninterest income also included $8.9 million in net transaction costs related to the NSR bulk sales of $53.4 million in aggregate UPB which we sold during the quarter as Lee mentioned earlier.

For Q1 2014, we expect to continue to realize a 6% return on the MSR assets. We also intend to continue to seek opportunities for disposition of the asset from time to time so that we maintain levels appropriate for regulatory compliance. 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 Q1 2014 will be within our targeted range of 15% to 20%.

Please turn to slide 15. With respect to credit costs we focus on three key areas: loan-loss provisions for our loans held in our investment portfolios; rep and warranty provision expense, which relates to potential putback losses from loans we sold over the years in the secondary market; and asset resolution expenses, which primarily relates 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 the slide, these three credit costs for the fourth quarter totaled $2.1 million as compared to $25.6 million for the third quarter. Loan-loss provision increased to $14.1 million during the fourth quarter as compared to $4.1 million in the third quarter, primarily reflecting increased residential first mortgage reserves as we continue to refine our allowance methodologies to reflect probable losses embedded in the portfolio.

Turning to slide 16, you can see that our nonperforming loans have come down significantly from levels a year ago. At the same time we continue to maintain strong allowance coverage on both our residential and commercial loan portfolios as outlined on slide 17.

Our overall allowance coverage of nonperforming loans was 145.9% as of December 31, 2013. For Q1 2014 we expect to see a continuation of improved credit quality metrics. We do not expect that a significant amount of net loans will be added to the held-for-investment portfolio. Accordingly, we would not anticipate that the provision expense for Q1 2014 would exceed the level in Q3 2013.

Our provision for rep and warranty expense by which we reserve for possible losses from loan putbacks was actually income of $15.4 million for the fourth quarter as compared to an expense of $5.2 million in the third quarter. This was driven primarily by a $24.9 million release of reserves in the fourth quarter associated with the Fannie Mae and Freddie Mac settlements which we signed during Q4 2013.

On slide 18 we provide further details of our rep and warranty reserve. For Q1 2014, we would not expect further provision, other than through our normal loan sales process, as we believe the reserve is appropriate based on our view of the remaining potential exposure.

Fourth-quarter asset resolution expense of $3.4 million as compared to $16.3 million during the third quarter, driven by gains from the sales of commercial real estate-owned properties and a decrease in foreclosure costs associated with loans the Company services for others.

For Q1 2014 we expect that the structure for servicing loans, whereby defaulted loans will be transferred to a specialty servicer, should lead to lower asset resolution expense. Thus, we would expect that asset resolution expense would for Q1 2014 be 40% to 60% less than such expense as was incurred in Q3 2013.

Noninterest expense is also a critical part of our overall analysis. Lee has already discussed noninterest expense in detail and provided a revised range.

Finally, turning to slide 19, 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 will turn this back to Sandro.

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

Thanks, Paul. I think we would now like to go and take your questions. So, Vicki, I will turn it back to you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Bose George, KBW.

Bose George - *KBW - Analyst*

Good morning. Just to start with a question on capital. What is the best way to think about how much excess capital you have? Should we focus on level for your TCE or just curious how to think about that?

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

This is Paul Borja. I think the very first thing to do is take a look at our Tier 1 leverage capital, because that Tier 1 leverage capital is how we have guided over the past years. As we talked about it, we have talked in the past about looking at 9% to 10% Tier 1 capital is something the Board has considered to be an appropriate minimum level.

As we continue to expand and look at various risks as we grow the balance sheet, I think the Board and the management will continue to look at the composition and the quality of capital going forward in addition to focusing on Basel III. So we manage both Basel I and Basel III in parallel to look at those, but I think that the ranges that we are looking at provide us with the opportunity to stay as we said in the speech, that we are looking for opportunities to invest excess capacity.

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

This is Sandro. The only thing I would add to that is obviously we have to keep in mind the stress testing requirements, but given the fact we have derisked the balance sheet so significantly this year, the impact of that going forward should be less than what maybe it was the previous way.

Bose George - *KBW - Analyst*

Okay, great. And if you also -- so presumably it's probably early to start thinking about share buybacks or TARP repayment or anything along those lines?

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

It's certainly something that we are going to be thinking about, but a little early for us to comment on it certainly.

Bose George - *KBW - Analyst*

Okay, great. Then switching to gain on sale margin, the trends that you guys showed were different. Most of the banks that have reported so far have showed an increase. I was just curious; do you have any thoughts on why your numbers are kind of different from what we have seen from some of the others?

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

If you look at it from our point of view and our situation, it's a combination of both the volume decline and some hedging challenges. So the volume decline I think was consistent with what the industry experienced and I think we've appropriately dealt with the hedging challenges. We've addressed them and so that's why we are giving guidance that we believe that going forward that the margin will be more close to the Q3 levels. I think that's what Paul had in his comments.

Bose George - *KBW - Analyst*

Okay, great. Let me throw in one small one. Just the effective tax rate going forward.

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

So going forward, now that we reversed the valuation allowance we are looking at effective tax rate of 35% for modeling.

Bose George - *KBW - Analyst*

Great, thanks a lot.

Operator

Scott Siefers, Sandler O'Neill Partners.

Scott Siefers - *Sandler O'Neill - Analyst*

Good morning, guys. I appreciate all the information on the outlook. It's good color, so thank you for that.

Paul, I was wondering if you could -- you have a lot of information so I wanted to make sure I got it right. And then was hoping for a little more color, specifically on the margin and NII outlook.

So if I heard you correctly it sounded like you said 40% increase in the first quarter net interest income versus the fourth quarter. One, was that right?

Then, two, can you kind of just sort of the succinctly go through how you are think about margin progression throughout the year? For example, if most of it -- most of that 2.75% to 3% bank margin outlook is based on the FHLB prepayment then it would come in very quickly. But if a portion of it is based on utilizing some of that excess cash that you guys have with maybe flowthroughs throughout the year, so how should we be thinking about that?

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

Scott, so you're right. I did say 40% for Q1 2014. When we think in terms of the math, we look at the FHLB prepayments, and although we would be -- we may be re-borrowing FHLB advances it would be at a much lower rate.

We did indicate that it was a 3.3% coupon that we were able to take off, so the delta between what we were able to take off into Q4 and what we would be re-borrowing using given a smaller balance sheet is going to be substantial. So that's where we are going to get the 40%.

As we think in terms of the 2.75% to 3%, we think the terms of the margin; it is a combination of those factors. There's actually three things going on. One is the reduced borrowing expense since we no longer have the FHLB advances at the 3.3% coupon.

It's also growing the asset base, both on the total assets as well as the interest-earning asset base. And, thirdly, it's taking some of the excess cash as we generate through a growth in the balance sheet and looking at opportunities beyond the 25 basis point cash savings. So thinking in terms of both investments and loans, and we did mention that we were looking for loan growth.

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

Scott, it's Sandro. I will just add one thing to that. When you look at the earning assets that we project that we will add to the balance sheet in 2014, I think what our expectation is is that the margin we would earn on those additional earning assets would be in that 2.75% to 3% range.

Scott Siefers - *Sandler O'Neill - Analyst*

Okay, perfect. Then just one final point of clarification on that, so the 2.75% to 3%, that's an average margin for the year or it's kind of a by the end of 2014 we hope to get there?

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

It's for the year.

Scott Siefers - *Sandler O'Neill - Analyst*

For the year, perfect. Then just one technical question. I think you reversed everything except a portion of the date DGA. One, is that correct? And then, two, what else would have to happen to reverse that? How meaningful is it, if at all?

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

This is Paul. First of all, that's correct; we only reversed a portion of it. Second, the reason we didn't reverse all of it is because the states have differing requirements for NOLs as far as time periods and offsets on deferred tax assets and liabilities. So we are continuing to evaluate that at this time.

Scott Siefers - *Sandler O'Neill - Analyst*

Okay. And, I'm sorry, how substantial is that number?

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

From a sizing perspective, I believe we are looking at about $12 million to $14 million more.

Scott Siefers - *Sandler O'Neill - Analyst*

Okay, so quite small relative to what you've done already, basically. Okay. All right, great. I think that does it for me, so I appreciate all the color.

Operator

Paul Miller, FBR.

Paul Miller - *FBR & Co. - Analyst*

Thank you very much. On the -- you guys have done a lot and I will give you guys -- I think the Street is given you guys a lot of credit. You are selling TDR, selling MSRs, moving those NPAs down.

Are we done selling assets? Are we now just going to work on internally driving down the nonperformers or could we see some more asset sales on that front, both on the MSRs and the nonperforming assets?

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

I think, with respect to the nonperforming assets, Paul, it's just a matter of execution. We are certainly going to be working very hard at drawing them down ourselves and Lee will be very focused on that.

With respect to would we do any further sale, it's certainly a possibility. Just depends on whether the right opportunity presents itself.

I think with respect to the MSR we give you a lot of guidance on what our expectation is for the sale of MSRs in both Paul and Lee's comments. I don't have anything more to add to that.

Paul Miller - *FBR & Co. - Analyst*

You talked about the NIM; there was a question about the NIM. So the big question about you guys is where is your core earnings power? I think it's still difficult for us to -- and you've given us a lot of guidance, guys. I know that. I don't know if you want to take that one step further.

But where do you -- are you shooting for a 15% return on equity through the cycle? Are you shooting for return on assets of 1% to 1.5% through the cycle? What are your major goals from here? Because you have done a lot; I know this TARP probably gets taken care of at some point. But what is your goal that you are setting up for this?

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

Well, our goal is sustainable profitability while at the same time meeting all of our regulatory expectations, so we are looking at improving them. We are looking at lower credit costs, predictable noninterest income, lower operating expenses. We are going to keep improving in each and every one of those areas.

We have not given guidance specific to ROA or ROE, but we've given a lot of guidance. So I think at this point I'm not prepared to comment specifically about what our goals are in the short term for either ROA or ROE. But I think that you can that from an earnings power point of view we think it's very significant in all three lines of our businesses.

If we've got this mortgage thing figured out right with our expenses, and we will make money regardless of what's going on in the market, and we are confident that we can do that. The banking business is growing very, very steadily and there's a lot of good things happening on our banking side, both in the way of new loans, good, solid, high-quality loans and also in the way of improving our mix of core deposits. Now that we are in a position to grow those deposits a little bit you will see us go after that little bit more aggressively.

Then, finally, this mortgage or this servicing thing has got tremendous earnings power. You are going to see that come and we are going to work very hard at that. We have layed out exactly what we have got planned there and now we know that we have to execute.

But I think you can see that we've done a pretty good job of executing on the things we told you we've done and we are going to do in the past. We aim to have that same kind of success going forward.

Paul Miller - *FBR & Co. - Analyst*

Then one last question. And if it's in the data, I apologize, and maybe you can -- but the rate lock issue. How much of a negative was the rate lock issue this quarter, the lower rate locks?

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

You mean as far as impacting our gain on sale?

Paul Miller - *FBR & Co. - Analyst*

Yes.

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

Well, I think it was both the gain on sale -- I think we provided some of the data on slide 13, so I think it's a combination of both the decline, which we indicated in the speech was consistent with the rest of the industry. And I think the issue more so became on margin and whether or not we think that was out of sync, and if it was, how we fixed it.

What we talked about was that if you identified the gain on sale margin Q4 issue and resolved it, so we expect to return in Q3.

Paul Miller - *FBR & Co. - Analyst*

When you say resolve and fix the issue, you know that there's a quirk in the accounting because of the rate lock issue. Is that -- when you say fix it, is that the main reason why it was down?

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

I think what we talked about the speech was that there was some hedging volatility that impacted our gain-on-sale margin and that we have -- we believe that based upon the process that we have in place that we should be able to return to our gain-on-sale margin from Q3 2013.

Paul Miller - *FBR & Co. - Analyst*

Okay, thanks a lot, guys.

Operator

(Operator Instructions) Kevin Barker, Compass Point.

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

You still have $54 million of reps and warrants reserve following the GSE settlements. How much do you expect to incur over the normal course of business? Or are you expecting to release some of those reserves over 2014? Could you just give us some color as to the puts and takes on the reps and warrants reserve?

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

This is Paul. I guess between Lee and Paul we will talk about this. I think as a starting matter we continued to add to the reserves, to our normal loan sale process. As we sell we put aside some amounts that go into the rep and warranty, which we believe is the appropriate estimate of potential losses based upon sales. And that's just based on the current losses.

Then from that perspective the comment we had was whether we think that on a post-sale basis that we have enough reserves to cover anticipated further put backs. And I think what we referred to in part was the Fannie and Freddie settlements and how putting a pre-2009 originations behind us really affects substantially our view of the reserve.

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

Kevin, I think we believe we are adequately reserved today, particularly following what we were able to release after the settlements. As Paul alluded to, we take a reserve for every loan that we originate and we think that we are adequately reserved. We are not planning on releasing anything further as we move forward here.

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

So would you have no reserve build, even though you are originating new loans? And essentially just -- how should we think about that?

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

The mechanics are that if you take a look at our rep and warranty reserve we have beginning balance plus provision minus charge-offs equals our ending balance net charge-offs. And so the provision part of that map is coming from our loan sales. So as we sell a loan we take a certain portion and put that in the reserve as we have done over the years. I think we have described that in the K and Q.

And so you are going to have a reserve that is going to be added to and then you're going to have it be depleted to through normal charge-offs net of recoveries.

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

Okay. Then do you have an estimate for what your Tier 1 common equity ratio would be per Basel III standards following the sale of MSRs?

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

We haven't publicly released our Basel III, especially since we don't -- it doesn't apply to us except on a phase-in basis beginning January 1, 2015. It's something that we are looking at, but I do think that the guidance we gave, which was where we expect our MSR to Tier 1 ratio to be, from that perspective should be helpful and instructive as we look at that.

We are below 20%. We are currently at 22.8% or 23% and we are anticipating by the end of Q1 2014 to between 15% and 20%. So thinking in terms of the transition period, when we only phase in 20% per year anyway beginning January in 2013, I think we are well ahead of schedule.

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

Okay. Then could you help us understand the earnings power from subservicing versus servicing? How to think about the fees you are getting from that and associate costs with the subservicing relationships?

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

Yes, and what I would do, Kevin, is I would refer you back to my prepared comments where -- and I said there for every 100,000 loans we grow that we believe or we expect to generate between $5 million and $7 million of incremental operating profit.

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

Kevin, you may also look at slide 23 where we give some guidance there as well on mortgage servicing and on the earnings per share opportunity.

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

Okay. Then you are currently operating under -- working with a capital plan with the OCC and that consent order. Are there particular ratios beside the Tier 1 leverage ratio that they are looking at before you could potentially prepay the Series B preferred stock?

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

Yes, so I'm not -- we are not able to give you that kind of information. So I would just tell you, like I have in the past with respect to the consent order, that we are pleased with the progress we've made in connection with that and I'm comfortable with where we stand.

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

Okay, thank you for taking my questions.

Operator

Bose George.

Bose George - *KBW - Analyst*

Just a couple follow-ups. In terms of that DOJ liability, is the remaining marks that you can take just the difference between the $93 million and the $118 million that is sort of the upside amount?

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

Yes, that's it.

Bose George - *KBW - Analyst*

Okay, great. Then one last one on the MSRs again, on the subservicing. Is the main focus there on purchases of prime MSRs that will use you as a subservicer or people, institutions that currently own MSRs? I'm just curious how the marketing of this will develop.

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

It's a good question. I think what we have done, and we, as you know, Bose, spent several months putting this platforms together. And as I alluded to, the start of that was outsourcing default servicing to Selene Finance, a specialty default servicer.

So we believe you have got -- with our platform you've got the best of both worlds. You've got us on the performing side and then you've got Selene on the default side, and we are both excellent at what we do.

We set it up as a private-label deal so we are still the master servicer and basically some other advantages of the set up is that Selene is on the same MSP system as we are, so we keep and retain full visibility of all loans when they move over to Selene at 60-plus days delinquent.

In terms of where the business can come from, I think it's threefold. One, it's obviously this transaction similar to what we did with Matrix. So MSRs we own, we sell, and we subservice those loans back.

You've then got, as you know, at the moment a very active market for MSR assets. There's a lot of financial buyers out there and I think what we have now provided then is optionality, so they could be buying MSR assets from anybody and we can actually be the subservicer of those loans. It doesn't have to be, or they don't have to be serviced by the institution that originates them. So we are giving them that option.

I think the other thing that I would say, and I've had these conversations with the GSEs -- the GSEs are often looking to place servicing books of business quickly, particularly if they are moving them from distressed situations or troubled situations.

And what they've told me is what you've created here is a one-stop shop so we can bring a book of business to you, whether it has got performing or default loans within the portfolio and you will take care of it. It's not as if we have to think about splitting it up between the performing and the default side.

So there's actually numerous ways that we can bring business in here. And as I mentioned in my speech, we do intend to leverage that's because there's also a lot of good things we are doing on the reporting side to make it as transparent as we possibly can to the people that we are servicing for.

Bose George - *KBW - Analyst*

Great, thanks a lot for the color.

Operator

There are no other questions. I would like to turn it back to Sandro DiNello for any additional or closing remarks.

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

Thanks, Vickie. To conclude, 2013 was an important year of strategic and operational progress and we did what we said we were going to do. We reduced risk, strengthened the balance sheet, built capital, eliminated valuation overhangs, and optimized our cost structure.

With all we have done it's time to put the past behind us and focus on the Company's long-term earnings power. That's exactly what we will now be laser focused on. We intend to grow this company in a safe, sound, and profitable fashion.

I'm proud of our team for executing these initiatives and I believe Flagstar is positioned for growth and success in the coming years. Thank you all and have a good day.

Operator

Thanks very much and that does conclude our conference for today. I would like to thank everyone for your participation.
