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FBC - Q3 2013 Flagstar Bancorp Earnings Conference Call

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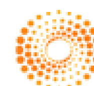

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PRESENTATION

Operator

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

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

Thank you. Good morning, everyone. I'd like to welcome you to our third-quarter 2013 earnings call. My name is Paul Borja. I am 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 to be different from our current expectations. These factors include among other things, changes in economic conditions; changes in interest rates; the outcome of pending litigation; competitive pressures within the financial services industry; and legislative or regulatory requirements that may affect our businesses. For additional factors, we urge you to review the press release 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 third-quarter 2013 earnings call slides that we have 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, we have several members of our team here including Lee Smith, Chief Operating Officer; Mike Flynn, General Counsel; and Matt Kerin, who previously was our Mortgage Banking President and is now an Advisor to the CEO.

Let me first layout the order of the call. I am going to began by talking about our long-term strategies and how they are tied to our third-quarter performance. After that, Lee will discuss some of the initiatives that he is working on. Paul will then take us through the financial results, including our outlook for next quarter. Finally, our executive team will be available to answer your questions.

Last quarter, we laid out three high-level strategies we are working towards, which we believe will allow us to achieve our goal of sustainable profitability and drive increased shareholder value. First, we need to increase revenues in each of our segments both by continuing to leverage and grow our mortgage business and by increasing the revenue contributions of other businesses.

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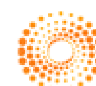

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Second, we need to enhance efficiency and optimize expenses throughout the organization.

And third, we need to continue to address risk and reduce the remaining legacy assets on our balance sheet, which will lead to lower credit costs and clear room for the growth of profitable core businesses.

Before I get into my remarks about the quarter, I'd like to update you on where we stand with each of these three strategies.

During our second-quarter call, we spent a significant amount of time discussing how we think about risk within the organization and outlining the credit characteristics of each of our key portfolios. This quarter, I want to spend more time articulating the revenue and cost optimization story. Now let me be clear, addressing and mitigating risk is still an emphasis for Flagstar but as we continue to reduce our risk, we can begin to devote more attention to increasing and diversifying revenues and prudently growing the Company.

Let's begin with revenues. Mortgage banking has contributed significantly to the revenue stream of this Company for some time with the low interest rate refinance-driven market helping to fuel this revenue. However, our goal is to make money in any mortgage cycle, be it refinance driven or purchase, and to do that we need to streamline the business and structure it appropriately so that our expenses are more variable and we can quickly expand and contract as needed.

We intend to build the fixed portion of our mortgage origination business around what we believe is our minimal, sustainable level of originations in the foreseeable future. We plan to then design a system where we can quickly upsize capacity and opportunities when higher levels of originations present themselves. We believe we can also build a service proposition that is best in class, which should differentiate us from our competition and provide us with opportunities to gradually grow our market share in a profitable fashion. I know this is what many companies say, so we have to prove ourselves. And we plan to. We have won J.D. Power awards in our banking business; we will bring that same level of quality and service commitment to our mortgage business.

At the same time, we also need to grow the other lines of businesses so that they are more steady contributors to the overall profitability of Flagstar. In that regard, we are working to add profitable core businesses and increase the revenue contribution from other areas. We think we can be a significant sub-servicer of performing mortgages, and as we said last quarter, we intend to grow the servicing business. Lee will talk more about that opportunity during his remarks.

We intend to continue to grow our community banking business, which should generate both treasury management fees and spread income and the loans we had to the balance sheet. While the revenue contribution is relatively small now, that business is growing at a very steady pace. Like most banks, we're sitting on excess liquidity. During the quarter, we purchased over $400 million in pass-throughs and agency mortgage-back securities with an average yield of 2.4% and average duration of just over four years. These assets have good credit characteristics and yield significantly more than cash. We are also beginning to add high-quality jumbo, adjustable-rate mortgages to our balance sheet. We have originated about $57 million in jumbo ARMs year to date through September 2013, and we have an additional $266 million in the locked pipeline. We are also looking at other assets strategies which we believe can generate additional net interest income going forward.

Further, we are making good progress on our organization-wide efficiency and cost optimization initiatives. As you will see from our financial results, total noninterest expense decreased by $15.9 million from the prior quarter. This was due to both fixed cost savings from the corporate-wide initiatives we put in place last quarter, as well as a reduction in expenses associated with lower mortgage origination activity.

Turning to credit, we continue to make further progress in reducing the overall risk profile the Company, improving credit performance, and disposing of legacy assets. In addition to the two sales last quarter, we completed a third-quarter sale of nonperforming loans and troubled debts restructurings, disposing of $167.2 million in unpaid principal balance or UPB, for a net gain of $1.6 million. We said last quarter that we would continue to review further opportunities to de-risk our balance sheet and would seek transactions that make economic and operational sense. By completing this sale, we significantly improved asset quality ratios and helped contribute to lower credit costs on our consumer loan portfolio. As a result of all of these actions, our consumer allowance coverage now stands at 143% of nonperforming loans.

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At the same time, the size of our commercial nonperforming loan portfolio, which is predominantly comprised of loans originated in 2009 and prior, has continued to decline as we aggressively work our way through it. Commercial nonperforming loans declined to just under $16 million at September 30 from a high of over $400 million in 2009. Notably, our commercial allowance coverage now stands at 194% of nonperforming loans.

Loans repurchased with government guarantees decreased to $1.2 billion at September 30 as compared to $1.5 billion at June 30 and $1.9 billion at September 30 of 2012. This portfolio represents delinquent loans which have been repurchased from Ginnie Mae pools that are insured or guaranteed by the Federal Housing Administration. The balance of this portfolio has continued to decrease, driven primarily by normal pay downs, resales, and accelerated dispositions. The continued reduction in this portfolio should help contribute to lower asset resolution costs.

As I am sure you are aware, one of the most significant risks we face is the size of our mortgage servicing rights portfolio in relation to the size of the capital. If we fast-forward to slide 28, we provide our MSR to Tier 1 capital trends. We feel we have done a good job managing that ratio over the last year, but we believe that our concentration is still too high, especially as we transition to Basel III. To that end, we want to let you know that we are in advanced negotiations with potential purchasers of a significant portion of our MSR portfolio. The demand for this asset is high, and we believe that our valuation is in line with the market. We do need to caution you, however, that this transaction is still a work in progress and is subject to a number of factors including due diligence, regulatory and agency approvals, and finalization of certain terms and customary closing conditions. So there is a lot that still needs to happen. And it is important to point out that we intend to reduce MSR concentration as a result of these transactions but still intend to protect servicing revenue as we have discussed in the past and as Lee will explain in more detail.

So let's now turn to our results. Please turn to slide 3 of the earnings presentation.

For the third quarter, we reported net income of $12.8 million, or $0.16 per diluted share, as compared to $65.8 million, or $1.10 per diluted share, in the prior quarter. If you recall, second-quarter net income included $44.1 million in income arising from our settlements with Assured and MBIA.

If you back out those one-time items, net income was down by about $9 million quarter over quarter as declines in revenue as a result of the mortgage slowdown were largely offset by a decreased credit costs and noninterest expense. Our book value increased to $17.96 per share at September 30 as compared to $17.66 per share at June 30. Also at September 30, our DTA stood around $300 million which would translate to an additional $5.35 per share in book value assuming we are able to reverse the valuation allowance.

On slides 4 through 7, we have prepared some additional highlights on our income statement and balance sheet. On slide 8, we have highlighted our gain on loan sale income and margin, which was $75.1 million in the third quarter, down from $144.8 million in the prior quarter. This decline was driven by lower refinance volumes and reduced margin. Gain on loan sale margin based on fallout-adjusted locks decreased by 33 basis points from the second quarter principally due to increased hedge costs. The decline in gain on loan sale income was also driven by reduce level of mortgage rate lock commitments during the third quarter, which are outlined on slide 9. As expected, we saw a significant decline in refinance volume during the third quarter, driven by a higher interest rate environment.

As outlined on slide 10, overall mortgage volume declined by 29% from the prior quarter, driven by a 48% decline in refinance originations. This decrease was partially offset by a 17% increase in purchase originations. HARP volume has come down and was 7.5% of total originations in the third quarter.

Now let me take a step back and talk about the mortgage industry as a whole. On slide 11, we show total mortgage industry origination trends dating back to 2000. As you know, 2012 was a strong refinance year for the industry, reflecting historically low mortgage rates and significantly higher gain-on-sale spreads. During 2013, the mortgage industry began to shift from a predominantly refinance-driven market to a purchase market. Industry sources, including Fannie Mae, Freddie Mac, and the Mortgage Bankers Association, project that overall volume will decline from $1.9 trillion in 2012 to $1.7 trillion in 2013, then down to $1.2 trillion in 2014. At the same time, those sources indicate that the percentage of refinance volume is expected to decline from 72% in 2012 to 60% in 2013 and then to 36% in 2014.

Historically, Flagstar has tracked to the refinance purchase mix of the industry, both in the aggregate and for each channel. You can see this outlined on slide 12.

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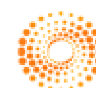

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On slide 13, you can see that we have been successful in growing our share of the purchase business. In 2006, we had a purchase share of 0.6%, which we have grown to over 2% in 2012. For the third quarter, we estimate that we held a purchase share at 2%.

On the right side of the chart on slide 13, you can see that we have increased the level of purchase mortgage originations during each quarter in 2013.

Turning to slide 14, you can see that home purchase affordability remains at a historically high level. We believe there is a lot of pent-up demand, and there are still many buyers who are sitting on the sidelines, which could translate into potential upside to the mortgage volume estimates for 2014.

While we will enhance our focus on the purchase side of the business, we still believe that the refinance market opportunities remain meaningful in the current interest rate environment. On the top half of slide 15, you can see that at the current level of 30-year mortgage rates the amount of refinance eligible mortgages is $1.3 trillion. On the bottom half of the chart, you can see there is significant sensitivity of refinance eligible loans to mortgage rates. While there remain some addressable markets, we certainly are not counting on a decline in rates to drive another refinance boom.

Now please turn to slide 16. Net interest income decreased by $4.4 million from the prior quarter driven largely by lower average balances in our mortgage-related portfolios. Another reason for the decrease is the continued amount of liquidity we currently have on the balance sheet. As we have highlighted in our public materials, we a completed transactions to de-risk the balance sheet over the past few quarters, in particular, the northeast-based commercial loan sales, several bulk MSR sales, and now the MPL and TDR sales. As we have executed on these, our liquidity has grown and as I mentioned, we are currently exploring ways to deploy this liquidity. We believe that net interest income may have bottomed out and that it should began moving upward quarter by quarter going forward.

The decrease in interest income was partially offset by improvements on the funding side. Looking at slide 17, you can see that we have continued to do a good job of gathering core accounts and improving our deposit mix. The overall need for deposit funding declined in the third quarter consistent with the slowdown in mortgage originations. This has allowed us to run off higher costing deposits as we continue to have success in bringing in core checking, savings, and money market accounts. Our core deposit ratio, calculated as a percentage of retail deposits, improved to 73% at September 30, 2013, as compared to 46.1% at September 30, 2012. Our funding costs are also highlighted on slide 18, which are driven largely by the leveling mix of our deposits.

So let's talk about what we're doing to further grow core accounts. About a month ago, we signed an agreement with the Detroit Red Wings. We are exclusively offering Red Wings-themed debit cards, checking accounts, and credit cards. We are excited about this partnership and believe it can strengthen account growth opportunities as well as increase the stickiness of our core deposits. We now have partnerships with the Red Wings and University of Michigan Athletics, two names that everybody knows well in Michigan.

We also rolled out a new state-of-the-art account opening system which we believe will help facilitate cross sales and improve customer service.

Our commercial lending team continues to add solid core relationships both in commercial real estate and traditional C&I lending. These are local Michigan customers who have strong ties to the state. We have a strong team of experienced lenders which we continue to add upon. And we know we can compete on service and responsiveness. We are doing business the old-fashioned way. The fact that we are the largest Michigan-based bank and that decisions are made right here in southeast Michigan is a huge competitive differentiator and an advantage for us. This enables us to win business when we are not the price leader.

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. While the overall commercial portfolio has declined as we work out and dispose of legacy commercial loans, it is important to look at the growth in new core commercial loans. As you can see on slide 19, through the first three quarters of 2013, that portfolio has grown at an annualized rate of about 85%. And we're not just a credit shop. We are beginning to see proportionate growth in treasury management fees and commercial deposit balances tied to those commercial loans, as well.

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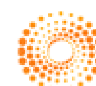

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Turning to credit, we continue to demonstrate solid progress in reducing overall risk, improving credit performance, and disposing of risk-year legacy assets during the third quarter, which was reflected in our financial results.

On slide 20, overall credit-related cost decreased by $50.8 million from the prior quarter driven by reduce ALLL provision expense and reduced provisions associated with the representation and warranty reserve. As I mentioned earlier, we sold $167.2 million in UPB of nonperforming loans and TDRs during the quarter for a small gain. This was third such sale this year, which helps significantly improve asset quality ratios and contributed to a lower provision for loan losses in the third quarter.

Turning to slide 21, you can see that the level of nonperforming loans significantly declined from the second quarter. As of September 30, we had total nonperforming loans, which are 90 days or more past due, around $139 million, a 46% decline from the prior quarter and a 65% decline from the same period year ago. As you can see from the slide, the third quarter nonperforming loan amount included about $23 million of TDRs, which are currently performing but have yet to season for six months.

It is important to note that while overall loan loss reserves and provisions declined from the prior quarter, this was driven largely by releases of reserves associated with the loans we sold. This is evidenced by the fact that our overall allowance coverage ratio actually increased substantially to 153% at September 30 from 94% at June 30.

On slide 22, we show our allowance coverage for both consumer and commercial nonperforming loans. Consumer nonperforming loans comprise about 89% of our overall nonperforming loans and are predominantly residential first mortgages. Commercial nonperforming loans totaled $15.5 million at September 30, down from $63.8 million at June 30, as we continue to aggressively work through that portfolio. As noted, the allowance coverage for each portfolio is significantly over 100%.

Slide 23 breaks out our TDR portfolio, which represents the portion of a balance sheet loans that have been modified as part of a loss mitigation efforts. We generally seek to modify loans when it is economically beneficial for Flagstar, which we believe is a favorable method as compared to the alternative of allowing the loans to go to nonperforming status and then pursuing a drawn-out foreclosure process. And you can see on the slide, total TDRs declined to $433 million at September 30 as compared to $547 million at June 30. The decrease was driven primarily by the loan sale we completed, which reduced the overall balance of TDRs by approximately $113 million. It is important to note that about 90% of this portfolio was performing and our redefault rates have not materially deteriorated. And with an average yield north of 3.5%, we are pretty comfortable with this portfolio. So overall, we are very pleased with the results from the TDR strategy we have followed.

On slide 24, we highlight details on the representation and warranty reserve. The level of the representation and warranty reserve remains above the current repurchase pipeline. At the same time, we continue to explore a potential repurchase settlement with Fannie Mae. As in any negotiation, unless and until the deal is completed, no assurances can be given. But we are hopeful we will soon reach a positive resolution with respect to representation and warranty put back exposure.

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

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

Thanks, Sandro, and good morning, everyone. As Sandro mentioned, it's been a busy quarter as we moved to further derisk the balance sheet, optimize the cost structure of the organization, and set the bank up for future growth and success. Please turn to slide 26.

The top chart shows our efficiency trends over the last five quarters. As you can see, our efficiency ratio was 89.5% in Q3 as compared to 65.3% in Q2. However, if you adjust for the one-time net gains in Q2 from the resolution of the Assured and MBIA litigation matters, our efficiency ratio was 77.1%. The worsening of our efficiency ratio this quarter has been driven by a decrease in revenues, particularly gain on loan sale income which decreased approximately $70 million quarter over quarter.

On the expense side, we continue to execute on our cost optimization plan. Specifically, our noninterest expense decreased approximately $16 million from the previous quarter. To put that into context and if you refer to the chart at the bottom of slide 26, noninterest expense was averaging

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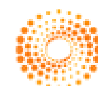

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$65.5 million per month in Q1 of this year, $58.1 million per month in Q2, and $52.8 million per month in Q3. Our precise and aggressive initiatives are beginning to have a positive impact. We expect this run rate to continue to decrease in Q4 and beyond, which I will talk about shortly. If you take it a layer deeper and break our efficiency ratio down between mortgage banking and community banking in Q3, we found that mortgage banking was around 69% versus 59% in Q2 because of the decrease in production volume and margin. This decrease was somewhat offset by a $14.4 million reduction in mortgage-related NIE. As we stated on the last earnings call, our goal is to create a truly scalable infrastructure so that we can flex our cost base up and down in line with our mortgage revenues.

The community banking efficiency ratio was 113% for Q3 versus 108% for Q2. Community banking NIE decrease $1.5 million quarter over quarter, but this was offset by a $3 million quarter-over-quarter decrease in revenues as a result of reduced interest income. As Sandro noted, our goal is to make all business units profitable on a standalone basis and to provide our business unit leaders and managers with the right tools to focus on the real value drivers, productivity and efficiency measures, and cost controls within their spans of control.

If you recall from the last earnings call, we talked about our intent to reduce noninterest expense across the organization by $80 million to $100 million on an annualized basis. Slide 27 breaks down how we intend to achieve those savings. Overall, comp and benefits are a large piece of the jigsaw puzzle and if you look at our headcount at June 30, it was 3759 on an FTE basis. At September 30, 2013, that declined to 3428 for an overall decrease of 331. This was driven by execution of the outsourcing of our default servicing business, which I will talk more about shortly; reductions in our mortgage fulfillment area; and optimizing other areas within the organization as we look to drive productivity efficiencies.

We also reduced the number of long-term subcontractors this quarter by 155, which resulted in an overall stack reduction of 486 during Q3. Overall, I believe we can reduce comp and benefits by $30 million to $40 million on an annualized basis, which excludes the headcount savings related to our decision to outsource default servicing.

We also launched a new centralized vendor management and procurements initiative this quarter and achieved some quick wins. As an organization, we were on track to spend in excess of $300 million on third-party vendors for the full year in 2013. The fact that this process was decentralized led to a number of inefficiencies. But we have now organized it around one central team that works directly and collaboratively with the various business units. Overall, I expect this initiative to generate significant savings, perhaps as much as $40 million to $60 million on an annualized basis.

Following the outsourcing of default servicing together with other opportunities we are currently exploring, we believe we can reduce asset resolution costs by as much as another $10 million to $15 million on an annualized basis. And this excludes savings associated with the outsourcing of default servicing.

Finally, given the reduction in headcount, we are also working with an outside commercial real estate agency to optimize our real estate portfolio. We believe that a rationalization and realignment plan could generate further cost savings. As noted earlier, from a balance sheet de-risking point of view, we sold $167.2 million UPB of NPLs and TDRs during the quarter and achieved a small gain on the sale after transaction costs. This that presented our third bulk NPL and TDR sale this year and means in 2013 we have sold $508.4 million UPB of NPLs and TDRs, up virtually 100% of net book value. This not only gives us confidence in our marks but means that we now have an ALLL to NPL coverage ratio of 152.6% at September 30, which is higher than many of our peers.

As we mentioned last quarter, we made the decision to outsource our default servicing business, given that it was less than 4% of our overall servicing book and our performance in default servicing was less than satisfactory. This decision was not made lightly and even though we estimate it could generate up to $15 million to $25 million of annual savings, we really did it because we were looking to create a single servicing platform that could offer servicing excellence in both the performing and default areas.

We also wanted to create a platform that could achieve this in the seamless way for the borrower, the MSR owner, and the GSEs and Ginnie Mae. As a result, we decided to team up with the specialized sub-servicer of defaulted loans, Selene Finance, who could complement our performing servicing unit. We have set it up as a private label structure whereby Flagstar remains the master servicer and the transition is seamless to the borrower so they still see Flagstar as the servicer. Furthermore, Selene uses the same MSP system as we do so we continue to have visibility on loans that becomes 60-plus days delinquent in our system and are being serviced by Selene. This is advantageous when you remain the master servicer.

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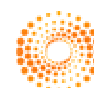

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The private label structure also means that we don't have to split loan pools and gives any investor a one-stop option if they are looking to place a book of servicing business that contains both performing and defaulted loans.

Finally, given that there is an active market for MSRs at the moment and a lot of financial buyers, this platform could be easily utilized by such buyers of MSRs. We currently service approximately 390,000 loans, and I believe we could have the capacity to take this up to 1 million loans in time. A lot of the infrastructure investment in the MSP platform has already been made, so such a ramp up would predominate involve an increase in headcount done in a controlled and efficient manner that adapts to variable market conditions. We're obviously excited about the platform we have created and see it as a way to diversify our future earnings away from just the origination business.

This platform also provides an opportunity for us in terms of our own MSR book. We recognize the concentration risk inherent in our existing model and believe we may be able to utilize what we've created to reduce our MSR concentration while retaining the servicing revenue and customer relationship.

As you can see, it's been a busy quarter, but I believe we have made excellent progress in our goals to de-risk the balance sheet and right-size the organization. The sequencing has created the foundation from which we can grow and be successful, 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 and CFO*

Thank you, Lee. Both Sandro and Lee have spent significant time this morning discussing our key strategies that we believe will drive long-term shareholder value. I am going to now review the key components of our overall third-quarter 2013 results and update you on our Q4 2013 outlook for the key drivers of our financial performance. In that regard, please turn to slide 4, which provides summaries of key financial results grouped by financial operations, balance sheet, credit quality, and capital ratios. This slide, together with the summary income statement on slide 6 and a balance sheet summary on slide 7, provide more details of our third quarter performance.

We have also prepared an income statement bridge on slide 5 which highlights the key items that changed during the third quarter as compared to the second quarter.

On slide 4 in the first group, we earned $12.8 million for the third quarter 2013, or $0.16 per share on a fully diluted basis. This compares to net earnings in the second quarter $65.8 million, or $1.10 per diluted share. Keep in mind that the second-quarter results included $44.1 million in income related to the resolution of the Assured and MBIA litigation.

Our net interest income declined to $42.7 million for the third quarter as compared to $47.1 million for the second quarter, a decline of $4.4 million. This resulted in a reduction in net interest margin at the bank level from 1.72% during the second quarter to 1.68% during the third quarter. From a rate volume perspective, the net interest income decline of $4.4 million was primarily attributable to declines in the volume of interest-earning assets, as mortgage production declined, thereby reducing loans available for sale and warehouse loans, and as we continue to de-risk the balance sheet through sales of TDRs and nonperforming loans.

For the third quarter, declines in the average balances of those interest earning assets offset in part by the decline in higher yield certificates of deposits, reduce net interest income by $7.5 million. The decline due to volume was offset in part by $3.1 million improvement in net interest income due to rates including an increase in the average yield earned on loans available for sale and a decline in the average rates paid on savings deposits.

For the fourth quarter, we expect that our net interest income will be at or slightly above the levels of the third quarter. This would reflect the full effects of our investment during the third quarter of excess cash into agency securities and our investment of another $500 million of cash into such securities during the fourth quarter. It would also reflect the investment of our cash into originations of jumbo residential mortgage loans for

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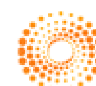

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our portfolio, although we would expect only an initial nominal effect to the bottom line as we would also provide loan loss reserves for this class of loans.

This outlook could be affected by factors such as the general softening of demand for jumbo residential mortgage loans or by significant volatility in the marketplace that could cause us to reduce our agency security purchases.

Looking at slide 6, noninterest income during the third quarter declined to $134.3 million from $220 million during the second quarter. The income statement bridge on slide 5 highlights key changes for components of that category. For instance, gain on loan sale income decreased by $69.7 million or 48% from the prior quarter as our fallout-adjusted mortgage locks declined by 33% during the quarter and our gain on loan sale margin on such locks declined by 22%. The decline in locks reflected the overall volume declined in the industry June quarter. And the margin decline reflected a number of factors, principally increased hedge costs due to rate volatility during August and September.

Loan fees decreased by $9 million, or 30%, from the prior quarter, consistent with the decline in mortgage production quarter over quarter from $10.9 billion in the second quarter to $7.7 billion in the third quarter. Net loan administration income, also referred to as our net servicing revenues, decreased by $5.7 million from the prior quarter. If you recall, second-quarter net loan administration income included one-time gains related to bulk sales of MSRs we completed. Excluding that, net loan administration income would have improved modestly from the prior quarter, reflecting improved hedge performance.

Finally, our other noninterest income category on slide 6 decreased by $36.2 million, which reflects the income we earned in the second quarter from the litigation settlements. We had no such settlement during the third quarter. Similarly, our category for impairment of investment securities improved by $8.8 million. This was because of the third quarter we did not have an investment security write-down as was the case in the second quarter as part of the litigation settlement activity.

Looking to the fourth quarter, gain on loan sale income and loan administration income are two of the key drivers of our mortgage banking business. With respect to gain on loan sales, we earlier discuss the evolving trend of declining originations throughout the industry and into 2014. We experienced this in the third quarter with a 30% reduction of originations and continued pressure on gain on loan sale margins. And we would expect this impact to continue although at a slower pace, as the transition to the purchase market continues and we maintain and improve our market share.

For the fourth quarter we would expect that production would decline by approximately 10% from the third quarter, principally from declines in refinancings that offset in part by purchase-driven originations. At the same time, we would expect that our gain on loan sale margin would be at or slightly above third-quarter levels assuming an absence of rate volatility as was the case during the third quarter.

With respect to loan administration income, we had discussed in prior quarters a target return of 4.5% on our mortgage servicing rights. We account for our MSRs under the fair value method and we hedge our MSRs to manage interest rate volatility. Our income from this asset depends on our ability to successfully hedge as well as the overall size of the asset base. For the fourth quarter, we would expect that our loan administration income would be at or just slightly below that of the third quarter. If we dispose of mortgage servicing rights during the fourth quarter, however, this outlook could be affected by the reduced earnings base. Also, our outlook could be adversely affected if we experience sudden and significant interest rate volatility similar to that seen in the marketplace during the second quarter.

Turning to credit costs, we focus on three key areas, loan-loss provisions for our loans held in our investment portfolio; rep and warranties provision expense, which relates to potential put back losses from loans we've sold over the years into the secondary market; and asset resolution expenses, which primarily relate to our foreclosure expenses from our held-for-investment loan portfolio and the expenses associated with managing down our insured government loan portfolios.

As to our loan-loss provisions, we continue to see improvement in the credit quality of our overall portfolio. Our past-due loans, both commercial and residential, have declined quarter over quarter. The volume of nonperforming loans has declined due to the sale of nonperforming residential mortgage loans and TDRs during the second and third quarters and due to the workout of commercial loans. At the same time, we've continued

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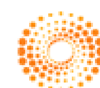

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to focus on nontraditional residential mortgage loans in our portfolio and have increased our allowance for loan losses to reflect probable losses embedded in the portfolio.

For instance, during the third quarter, we increased our allowance by $24 million to reflect the risks associated with the interest-only portfolio. At the same time, we were able to reverse a portion of the allowance associated with the nonperforming loans and TDRs that we sold during the quarter. As such, and with the improved risk profile of the remaining portfolio, we did not require a significant provision overall during the third quarter to achieve the desired level of the allowance.

For the fourth quarter, we would expect a provision would increase above that of the third quarter but would be well below that of the first quarter.

Our provision for rep and warranties expense by which we reserve for possible losses from loan put backs, declined to $5.2 million in the third quarter as compared to $28.9 million in the second quarter. This decline reflects the reduction on our rep and warranties reserve to $174 million at September 30, 2013, versus the reserve of $185 million at June 30, 2013. Our lower reserve reflects our analysis of probable losses based on file pools and put back demand as well as our assessment for future losses.

We will continue to include those data points in our analysis as well as our assessment of future activity in the repurchase base.

With respect to our asset resolution expenses, we announced during our last earnings call that we would be outsourcing our default servicing operations. Given the time needed to affect the outsourcing, we did not expect any immediate savings last quarter. However, that outsourcing process was completed during the third quarter, and we're also working to improve aspects of our performing servicing that should allow us to work more efficiently.

We have also reduced the level of nonperforming loans overall in our portfolio and thus our foreclosure levels.

Taken together, we would expect that our asset resolution expense for the fourth quarter would be lower than that of the third quarter. Total noninterest expense decreased by $15.9 million from the prior quarter reflecting lower variable expense, which is tied to mortgage origination volume, as well as to a decrease in fixed costs associated with our ongoing, Company-wide expense management initiatives. We expect to continue to focus on cost optimization, as Lee discussed in detail earlier.

With that, will turn it back to Sandro for the questions and answers.

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

Thank you very much, Paul and Lee. Let's go ahead and open the line up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Paul Miller.

Paul Miller - *FBR & Co. - Analyst*

Thank you very much, guys. Great quarter. I want to go back to slide 24 and talk about this a little bit because I think this is most of my calls today have been on this slide. Can you fill us in a little bit about the process of when you get a file pool to when it becomes a repurchase demand and then when it becomes part of your pipeline. And then what has been the level of repurchase demand that turns into the pipeline? What percentage of that, if you have that data? And then what is your loss rate on that pipeline over the last quarter or two?

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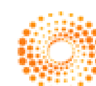

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Sandro DiNello - *Flagstar Bancorp, Inc. - President and CEO*

Thanks, Paul. Well, with respect to the representation and warranty reserve, I'm afraid that we're not going to be able to answer those specific questions that you just asked. As said in our prepared comments, we are in advanced discussions with Fannie Mae. There's not much more I can say about the reserve. We believe that the lower reserve reflects our analysis of the probable losses based on the file pools and the pullback demands as Paul said as well as our assessment for future losses. And we're comfortable, very comfortable with the level of the reserve as we always are at the end of any quarter.

So at this point, Paul, the kind of information you are looking for there, we haven't provided in the past, and we are not at this point looking to provide that today.

Paul Miller - *FBR & Co. - Analyst*

Okay. And then moving on to your -- you said you're net interest income line, this might be the bottom of it. Your margin has been hit by the large cash reserves. And you're going to start putting some of that money to work in your securities portfolio. Is there anything else that you can do to speed up the allocation or speed up that cash -- to speed up -- to redeploy the cash into earning assets?

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

As we said in the prepared comments and you just noted, we are looking and we have already made investments in the securities portfolio, and there could be additional investments in that regard. And we've also started to put some jumbo product on our books, good high-quality jumbo product. And so I would expect that we would do a little bit more of that.

And then we are looking for other opportunities. Ultimately we are a bank and we're going to look for bank-like assets to put on the books. So while I can't be specific, Paul, certainly the level of cash flow that we have, it's more than we need to have. And we're going to continue to prudently in a very safe and sound fashion redeploy that cash into a good solid earning assets going forward.

Paul Miller - *FBR & Co. - Analyst*

And one last on the jumbo products, are they mostly ARMs, 5/1s, 7/1s, or are you just doing any jumbo that you can profitably get a hold of?

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

Yes, they are totally 5/1s, 7/1s. It's all adjustable-rate product.

Paul Miller - *FBR & Co. - Analyst*

Okay. Thank you, guys.

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

You're welcome.

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Operator

Kevin Barker.

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

Thank you for the very thorough comments earlier. Could you provide us with a little bit more specifics around what point in time the GSEs are looking to settle any claims that they have outstanding?

And are you seeing different patterns between Fannie Mae and Freddie Mac?

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

Well, to the first question, no, I can't really give you any specificity on the timing. We are working on it aggressively. It's something we'd like to get done sooner rather than later. But I really can't be very specific on the timing.

With respect to the second question, most of our exposure is in the Fannie Mae area. So with respect to Freddie Mac, we haven't had any extensive discussions with Freddie Mac at this point, so I don't have the intelligence relative to Freddie to be able to answer that.

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

Okay. And then related to the expense base, you provided a lot of detail. But are you seeing any restructuring charges associated with that that we would back out or is there any other expense reduction initiatives that would be one-time in nature?

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

Yes. So in terms of one-time items, we've spent $2.2 million in Q3, which was severance cost and costs associated with the reduction in the headcount.

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

So I think what you are getting at is whether there's any potential future charges. And there is nothing significant on the horizon. That would be one-time charges associated with any reductions that we have already made.

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

Okay and finally, do you have any update on the potential to pay off the Series C preferred stock before the dividend rate moves up to 9%?

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

We have no plans to do that at this point, so I can't give you any more than that. But we're comfortable with the shares. As you know, the TARP shares were sold to private individuals, and as you noted, the rate is going to go to 9%. But we have no near-term plans to make any changes in that.

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

Okay. Thank you.

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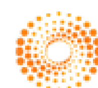

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Sandro DiNello - *Flagstar Bancorp, Inc. - President and CEO*

You're welcome.

Operator

Bose George.

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

Going back to your guidance on the gain on sale margin in 4Q, did you guys say that it goes up relative to 3Q? And is that driven primarily by lower hedge costs?

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

Yes, this is Paul. That is the guidance. If you take a look at Q3, gain-on-sale margin, we believe it was impacted in part by hedge performance, and we believe that gain-on-sale margin for Q4 would be therefore slightly increased in the absence of that.

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

And then in terms of -- when you talk about the margin you are referring to the margin based on rate locks, right?

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

Right. We tend to favor reporting gain-on-sale margin based on locks, although in our slide and in our 10-Q, we provide margin based on both locks and on sales.

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

Great. Actually, going forward just as things converge or become more stable in the mortgage markets, will those two margins become pretty close? It looks like they were very close a year ago.

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

Well, I think it's good to be a matter of volatility because of the timing. The time between locks and closings tend to be about 30 days, and so, it depends on interest rate volatility, the time, and the related effect on mortgage rates. And so that is also a function of the primary, secondary spreads. So it's really a timing issue on rate differentials between them.

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

All right, great. And then actually in terms of calculating your EPS, I was curious about the share count. Because I just look at the $12.8 million and the $0.16, I get a higher diluted share count. So just wonder what number was being used.

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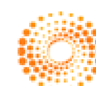

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Paul Borja - *Flagstar Bancorp, Inc. - EVP and CFO*

Within the tables we should have a different share piece that would be necessary to compute the EPS. We will also have it as part of the 10-Q, which we intend to file shortly. What I will do is go back and just double check that, and I can get back to you off-line.

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

Okay, great. Thanks.

Operator

(Operator Instructions) Okay, at this time we have no further questions. I would like to turn it back over to our speakers for any closing comments.

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

Well, I just want to thank everybody for taking the time to listen to our call. I know they have gotten a little bit long, but I hope you appreciate that we're trying to be very transparent with all of you. And we want you to know everything we know about what is going on at the Company.

As Lee said, we are quite optimistic and energized about what's going on at Flagstar, and I look forward to reporting even better things to you going forward. Thank you.

Operator

Thank you for your participation in today's teleconference. You may disconnect at any time. And have a wonderful afternoon.

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