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PRESENTATION

Operator

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

Paul Borja - *Flagstar Bancorp - EVP, CFO*

Thank you. Good morning everyone. I'd like to welcome you to our second-quarter 2013 earnings call. My name is Paul Borja. I'm the Chief Financial Officer of Flagstar Bank.

Before we begin our comments, I'd like to remind you that the presentation today may contain forward-looking statements regarding both our financial condition and our financial and operating results. These statements involve certain risks that may cause actual results in the future to be different from our current expectations. These factors include, among other things, changes in economic conditions, changes in interest rates, the outcome of pending litigation, competitive pressures within the financial services industry, and legislative or regulatory requirements that may affect our business. For additional factors, we urge you to review the press release we issued last night, our SEC documents such as the most recent Form 10-K and Form 10-Q, as well as the legal disclaimer on Page 2 of our second-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 tables to our press release which we issued last night as well as in the appendix to our earnings call slides.

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

Sandro DiNello - *Flagstar Bancorp - President, CEO*

Thank you Paul, and thank you, everyone, for joining the call this morning. In addition to Paul, with me today are Lee Smith, our chief operating officer, and Matt Kerin, our head of Mortgage Banking. I'm very pleased to get a chance to talk with you this morning, and I'm excited about my new role as CEO of Flagstar. I've been with this Company for over 30 years, so my roots in Michigan run deep and my understanding of our markets and consumers is thorough. I'm confident in our team and I believe that, together, we will build an even stronger future for Flagstar. And I know these are just use words to you right now. I get that. So my job is to tell you how we are going to get there. It's very simple.

There are three things we need to accomplish to achieve our long-term vision of this company. We need to increase revenues in all of our segments. We need to enhance efficiency and control expenses throughout the organization. And we need to continue to work through legacy issues which will lead to lower credit costs.

We understand that revenues are meaningless if they are consumed by credit costs, which has been the case for us over the last few years. So we have dedicated significant resources to cleaning up our balance sheet. And while we are not ready to call bottom, we believe we have a good handle on these and we have a firm strategy to resolve the remaining legacy issues.

With that said, our number one goal is to grow revenue. We plan to accomplish this in a few ways, first and foremost to continue to grow our national mortgage presence, not just status quo either. We believe we can get much more out of this business. We are not just a refinance shop. We've always earned our fair share of the purchase market, and we intend to grow that business even further. Matt will discuss specific strategies on how we plan to do this.

Second, we intend to grow our performing servicing platform without increasing our mortgage servicing asset concentration. We are a very good servicer of mortgage performing loans and we can expand that into a meaningfully profitable sub servicing business. Lee will discuss this more.

Third, we are looking to grow our Michigan Community Bank. I've been a Michigan banker for over 34 years. I know the market and I know the bankers. We have a tremendous opportunity to grow this business so that it can become profitable on a standalone basis. There is no bank of size in Michigan that cares as much about this market as we do and I believe we can leverage that bank. That's the revenue piece of the pie.

In addition, we know that we have to continue to focus on reducing our credit costs and we have to become a much more efficient operator. Lee and I will talk more about these strategies during the call.

But before launching into my further remarks, I want to be very direct in reiterating our strategy which is to deliver improving performance by leveraging our national mortgage banking business and our community banking operations in Michigan, all with a continued eye on risk management and compliance. In the last quarter, we made numerous accomplishments aligned with this strategy. We were opportunistic in closing out our remaining legacy litigation errors, entering into settlement agreements with Assured and MBIA which together resulted in a gain of approximately $44 million. We also sold $341 million in UPB of nonperforming loans and TDRs for a small loss which significantly improved our asset quality ratios. And we grew our tier 1 capital ratio to 11% at the end of the second quarter.

Our focus on risk management and putting legacy issues behind us helps us clear the way for Flagstar's next phase of growth and development. We have dedicated a significant amount of time and resources over the last several years to cleaning up some of Flagstar's legacy issues, and we are in a much stronger position today thanks to our efforts.

We now need to turn our attention to improving operational performance across the organization by reducing credit costs, driving improvements in efficiency, and growing underutilized lines of business while managing expenses and creating a more variable cost structure. And we are starting to do that.

Let me be clear here. This organization will be built on a culture of accountability and accomplishing and our objectives. If we tell you that we are going to undertake a strategy or initiative, we will accomplish it as fast as reasonably possible.

For example, we recently announced a decision to outsource our non-core default servicing business to a third-party provider that specializes in this area. By focusing our mortgage servicing business on core performing mortgages, we believe that we will be able to save potentially as much as $20 million per year while better positioning ourselves for long-term growth. Lee will talk more about this initiative later in the call.

As we continue to execute on our strategy to further improve our financial performance and create shareholder value, a key area of focus for me is to continue enhancing our transparency. We appreciate the feedback we have received from analysts and investors and look forward to sharing additional information to demonstrate our continued progress.

Looking to the future, Flagstar will remain committed to enhancing our culture of compliance as we create new growth opportunities and pursue sustainable profitability. Thanks to our successful efforts to reduce risk and fortify the balance sheet, combined with a gradually improving economy and increasing home prices, we are well-positioned to further reduce costs, diversify revenue, and deliver value-enhancing growth for shareholders. I am confident that together we will build a best-in-class mortgage business at Michigan Community Bank.

With that, I would now like to turn my remarks to the quarter. Let me begin by laying out the order of the call. I will start by talking about how we view risk in the organization, and more importantly what we are doing to mitigate and address it. Then Lee and I will discuss the strategy in more detail, including some of the initiatives we have completed or plan to undertake. After that, Matt is going to discuss the Mortgage Banking business and then Paul will take us through the financial results, including our outlook for next quarter. Finally, we will be available to answer your questions.

Now, please turn to Slide 3. For the second quarter, we reported net income of $65.8 million, or $1.10 per diluted share, as compared to $22.2 million or $0.33 per diluted share in the prior quarter.

On Slide 4, you can see that this translated into a return on assets of 2.03% and a return on equity of 21.23%. Our book value also increased to $17.66 per share at June 30, 2013 as compared to $16.46 per share at March 31, 2013. At the end of the second quarter 2013, our DTA was $208 million, which translates to an additional $5.49 per share in book value once we reversed the valuation allowance.

The $65.8 million in net income during the second quarter included several significant nonrecurring items which I will highlight. First, the settlement agreements we signed with Assured and MBIA resulted in a net gain of $44.2 million. Second, we recorded an $18.2 million gain from the sale of MSRs completed during the quarter. And third, these were partially offset by a loss of $3 million related to the NPL and TDRs sales. In total, this represents $59.4 million in nonrecurring income for the quarter. When you back that out of our net income, it translates to a run rate of $6.4 million. This amount included gain on sale loan income of $144.8 million. So what that means is assuming everything else in our P&L is a run rate, we needed to generate at least $138.4 million in gain on sale income during the second quarter to break even. That does not mean you should assume everything else in our P&L is a run rate.

We believe we have upside in other revenue lines and expense base. On the revenue side, as I mentioned earlier, we believe we can grow other lines of business such as performing servicing and commercial and consumer lending. We also think we can right-size the cost structure and achieve significant expense savings. Further, there is the potential for reduced credit costs, especially as we continue to derisk the balance sheet and work through legacy issues.

Our second-quarter performance reflects two overarching themes which are both consistent with unlocking the potential upside to our P&L that I just mentioned -- first, an emphasis on resolving legacy issues and addressing any remaining risk in the organization; second, segmenting the business lines and developing strategies, including efficiency optimization and right-sizing the cost structure to ensure that each is profitable on a standalone basis.

Let me first discuss how we view our key risks and then discuss what we are going to do to address and mitigate each. These risks translate into real dollars. While levels have come down from their peak, we are still experiencing significant credit costs each quarter which are offsetting, in part, of our overall results. It is important to me that our shareholders or any stakeholder for that matter fully understand what risks are embedded in the Company and how we plan to mitigate and address those risks. To do that, we have to do a better job of articulating them so that you understand that we have a good handle on the remaining risks and that there is potential upside to our P&L.

We view risk in two categories, on and off balance sheet. On-balance sheet risk is grouped into four main buckets -- nonperforming loans, troubled debt restructurings, or TDRs, interest solving mortgages, and our second mortgage and HELOC portfolio. Let's start with the nonperforming loans.

I'm going to skip ahead now to Slide 17. As of June 30, 2013, we had total nonperforming loans which are 90 or more days past due of around $258 million. a 30% decline from the prior quarter and a 40% decline from the same period a year ago. As you can see from this slide, the second quarter amount includes about $72 million of TDRs which are currently performing but have yet to season for six months. While the chance of re-default is higher on TDRs and they carry a larger reserve, these are loans that are currently paying as agreed and carry less risk than a normal nonperforming loan.

Nonperforming loans are broken into two types, consumer and commercial. Consumer loans comprise about 75% of our overall nonperforming loans and are predominantly residential first mortgages. These loans are backed by the underlying property, making the severity of loss obviously better than a commercial loan. This is one reason we believe our portfolio of nonperforming loans is comprised of better quality loans relative to those of our peers.

Another reason is geographic diversification. Looking at Slide 18, you can see the one quarter and one year HPI growth rates for California, Florida and Michigan, which are the top three states in our first mortgage loan portfolio. These three states make up 45% of the total nonperforming mortgage loans in our portfolio. As you can see from the chart, these states have performed significantly better, averaging a growth rate of 12.2% over the last year, which is almost double the average of the United States over the same period.

On Slide 19 you can see the trend in consumer nonperforming loans and the consumer reserves over the last several quarters. Consumer nonperforming loans declined significantly from the prior quarter, decreasing by $109 million, or 36%. This decline was driven by our sale during the second quarter of $167 million in UPB of residential first mortgage nonperforming loans, which had a carrying value of $110 million. The driving force behind these sales was to significantly improve our asset-quality ratios. Now that we have done that, going forward, we can seek to opportunistically dispose of these assets, exploring all of our alternatives, including modifications, workouts, and sales. As you can see, at June 30, 2013, the total level of consumer nonperforming loans was at approximately $194 million with reserves of $214 million, which translates to a consumer coverage ratio of about 110%.

Now let's discuss TDRs. TDRs represent the portfolio on balance sheet of loans that have been modified as part of our loss mitigation efforts. Under the accounting rules, after modification, the loan is not considered a performing loan until the borrower has made six consecutive on-time payments under the new loan terms. Given the high propensity to default associated with those loans, we take a large upfront reserve against that. We seek to modify these loans generally when it is economically beneficial for us as compared to the alternative of allowing the loans to go into nonperforming status and then pursuing a drawn-out portfolio process.

Turning to Slide 20, total TDRs declined to $547 million at June 30, 2013 as compared to $744 million at March 31, 2013. On the bottom half of the slide, we prepared a roll-forward of our TDRs for both the performing and nonperforming portfolios. As you can see, around $33 million of additions came into the performing TDR bucket from the prior quarter.

For the first six months of 2013, the inflows of performing TDRs have decreased by about 43% when compared to the first six months of 2012. This decrease is consistent with the decrease in the level of total delinquent loans in our portfolio over the same period.

We also saw an increase in transfers out driven by sales of $157 million of performing TDRs completed during the quarter. This significantly brought down the total balance of these loans which are viewed as inherently more risky than true performing loans.

We generally review the TDRs as an attractive alternative to a drawn-out foreclosure process. On average, we earn around a 3% yield on TDRs, and our percentage mix of TDRs is mostly performing. At June 30, 2013, you can see that 95.6% of the total TDR portfolio was currently paying as agreed.

In addition, the geographic concentration of our TDR portfolio is more heavily weighted in markets we like. Similar to the mix of our nonperforming loans, about 45% of the overall portfolio is in California, Michigan and Florida. As I mentioned earlier, these states were among the highest in home price appreciation over the last year, averaging about 12% HPI growth.

Now let's turn to interest-only loans, which are one of our primary areas of focus. We have about $1.1 billion in interest-only loans on our balance sheet, which are broken out by reset year on Slide 21. As you know, once borrowers hit their reset date, both the principal and interest payments become due and the payments will rise, some more significantly than others. This is commonly referred to as payment shock.

The blue line in the chart on Slide 21 represents the average borrower payment shock, which is 138% in 2014. Although we have not experienced issues with this portfolio so far, these payment shocks could potentially represent a higher chance of default, so we are using this year to get out ahead of this. We have assembled a dedicated team which is responsible for mitigating the risk in this portfolio. This will be accomplished in a number of ways, including through sales and through modifications and refinances using both calling campaigns and direct mailings.

Let's dig a little deeper. The majority of those loans were underwritten on a fully amortizing basis and were originated prior to 2008, which was a significantly higher interest rate environment. This means that the borrower had the benefit of lower payments over the last few years. Therefore, when you compare the re-casted monthly payments versus the original payment, which is the green line on the chart, the payment shock is not quite as severe, for example decreasing from 138% to 58% for 2014.

Another mitigating factor in this portfolio is the borrower credit quality. On Slide 22, you can see that the credit statistics of this portfolio are pretty good with an average current cycle of 731 and an average HPI adjusted LTV of 90%. This is evidenced in the performance of the portfolio where the majority of these loans continue to perform.

While the average LTVs in our interest-only loans have declined since origination, they remain above water, which we believe could mitigate some of the severity of loss in the portfolio. We have also established reserves for this portfolio and will continue to evaluate as more information becomes available.

The last major bucket of on-balance sheet risk is our second mortgage and HELOC portfolios which were originated prior to 2009. As you can see on Slide 23, at June 30, 2013, we had about $482 million in second mortgage and HELOC loans that were originated prior to 2009. Although the average note rate is higher than our first mortgage, the loans carry significantly smaller balances so the monthly payment may not be overly burdensome. There were a number of underwriting guidelines for these loans at the time, including FICO floors in the range of 620 to 720, CLTV ceilings of 100% or 90%, depending on whether Flagstar originated the first lien, and debt to income caps of 50% if we did not own the first lien. The majority of these loans were closing connection with us closing on the first lien. As you can see, the average original FICOs for these loans were pretty strong.

Similar to the interest-only loans, these portfolios are currently performing pretty well. The delinquency rates on our second mortgage and HELOC portfolios at June 30, 2013 were 1.63% and 2.50% respectively. While we know the LTVs on these loans have increased over time, we are aware of what we have on the balance sheet and we believe we are ahead of this issue. We've also assembled a core team who will be focusing on mitigating risk in the second mortgage and HELOC portfolios. We are first focusing on loans that have matured or are maturing in 2013. Again, we plan to use a number of strategies, including calling campaigns and direct mailings, to seek modifications and refinances.

Now let's turn to off-balance-sheet risk which includes the litigation with MBIA and Assured who recently settled, and the agency repurchases. First, the litigation portion, as I mentioned earlier, we settled both MBIA and Assured during the first quarter, which were the two key material litigation issues that were pending against Flagstar. Paul will discuss the financial impact of these during his comments.

Slide 24 shows further detail on our representation and warranty reserve. As you can see on the top left chart, the representation and warranty reserve remains flat from the prior quarter at $185 million and now stands significantly above the level of the active pipeline.

The chart on the top right shows the total repurchase pipeline which declined to $115 million at June 30, 2013 as we continue to aggressively work through the existing population of repurchase requests. The chart on the bottom right shows our audit file pulls from the GSEs which increased by 34% from the prior quarter. Audit file pulls have been a leading indicator of new demands for repurchases, and as you can see, they have remained heightened since the fourth quarter of 2012. This trend has not translated into material increases and repurchase demands or an increase in the open pipeline. However, we continue to monitor this closely.

Now I want to turn to our second overarching theme, which is individual business line profitability. Though we're just beginning our efforts, our goal is to have each of our core business lines profitable on a standalone basis. We are beginning to segment each as an individual unit and then we'll look at ways to maximize efficiency and right-size the cost structure to be more variable with the revenue drivers. We are beginning to look at strategies and plan to elaborate more in future quarters.

The way we view the business internally, and I think this provides a good framework for how you can view it, is by looking at the three primary revenue generating areas -- mortgage originations, mortgage servicing, and the retail commercial bank. I'm going to discuss the retail and commercial bank strategy. Lee will talk about the mortgage servicing strategy, which ties into expense management. And Matt will then discuss the mortgage origination strategy.

Our net interest income and margin has continued to decline over the last few quarters, which is outlined on Slide 10. This is really driven by two items, the slowdown in the mortgage business and the amount of liquidity we currently have on the balance sheet. As we have completed transactions to derisk the balance sheet over the past few quarters, in particular the Northeast-based commercial loan sale, several book MSR sales and now the NPL and TDRs sales, our liquidity has grown.

In addition, the mortgage business has slowed down and we have not needed cash to fund the mortgage production to the extent we originally had anticipated. Although we have been successful in significantly reducing wholesale deposits and since we are reluctant to reduce core deposits, we have a limited ability to shrink the liability side of the balance sheet, given our long-term FHLB advances. That is evidenced by the flattening of our cost of funds this quarter as outlined on Slide 11.

While our liquidity has negatively impacted our NIM, we believe this is a good time to be cash rich. We are proactively looking at opportunities to invest some of the excess cash we are holding on the balance sheet. With the yield curve steepening, we have the opportunity to deploy the cash prudently by adding well underwritten high-yielding assets and we expect to do so once we have had a chance to properly evaluate alternatives with our board.

As I mentioned, we are limited in our ability to strengthen the liability side of balance sheet, so our focus will has been on improving the mix of deposits. This will continue to be driven by our ability to bring in core deposits, which we classify as demand, savings and money market.

You can see the positive trends we have been able to accomplish highlighted on Slide 12. We have grown core deposits by over $800 million since June 30, 2012, and our percentage of core deposits to retail deposits has increased from 49% to 64% over the same period.

Core deposits will continue to be a significant part of our strategy, especially as we look to prudently grow the balance sheet. One of the key ways we plan to accomplish the strategy is through the completion of a new account system which we believe will reduce the time to open new accounts improved across our opportunities and enhance overall relationship management. We have completed installation and are currently in the process of rolling it out to five branches.

We have also seen good traction from our partnership with the University of Michigan Athletics. About 10% to 20% of our new checking account growth has been from this partnership. We are also currently in the process of evaluating other partnerships which we think we can also leverage to grow core deposits.

With that, I would like to now turn the call over to Lee.

Lee Smith - *Flagstar Bancorp - EVP, COO*

Thanks Sandro. Good morning everyone. I want to echo Sandro's enthusiasm and excitement about the vision, strategy and future prospects for Flagstar.

Please turn to Slide 25. The top chart shows our efficiency ratio trends over the last five quarters. As you can see, our efficiency ratio was in the mid-60s% during the peak of the mortgage cycle and then began to increase as origination volume and gain on sale margin declined. When you normalize our efficiency ratio and adjust for the Assured and MBIA settlements, we would be around 77% for the second quarter 2013. Year to date 2013 we are averaging about 79%.

When you dig deeper into the numbers, it is not hard to see that revenues have come down and expenses have remained relatively flat, meaning we added fixed costs during 2012 to deal with the increased production volumes. And this is something I've started to look out more closely during my time at Flagstar.

My number one priority has to be to look for opportunities to maximize productivity efficiencies and optimize the cost structure of the organization. Now, that doesn't mean we are going to cut costs to the bone and forego future growth opportunities or be the lowest cost producer. But we do need to get leaner and ensure our cost structure is scalable with mortgage production volumes in particular. As such, we need to make our expense base more variable so that it attracts revenues and ensures we can be profitable at any stage of the mortgage cycle.

We also need to ensure all business lines are profitable on a standalone basis. To do this, we are implementing detailed KPI reporting that focuses on the real value drivers, productivity and efficiency measures and cost controls across every major business unit.

We are going to challenge the status quo. Undertaking a process because it's always been done a particular way is not the right answer. We're going to look to improve our existing thought processes and efforts to better differentiate ourselves from the competition.

Assuming income remains relatively constant, our immediate goal would be to get our efficiency ratio back to somewhere in the 65% to 67% range. This would equate to achieving approximately $80 million to $100 million of cost savings on an annualized basis.

When we break down our efficiency ratio between the Mortgage business and Community Banking in Q2, we found that Mortgage Banking was around 60% and Community Banking was around 108% on a fully loaded basis. For Community Banking to be profitable on a standalone basis, we would need to take out approximately $12 million in costs on an annualized run rate basis. The remaining $68 million to $88 million that we've targeted would come out of Mortgage Banking and the various support functions. We believe we can get to this run rate by mid-2014.

So how have we started to address this in the second quarter of 2013? You heard Sandro mention that we recently announced the decision to outsource our non-core default servicing businesses to a third-party provider that specializes in this area. During the second quarter of 2013, we did a deep dive analysis into the cost to service between performing everything current through 59 days delinquent and defaulted loans, which is everything 60-plus days delinquent. And we found that we were much more efficient at servicing performing loans.

In July, we made the decision to outsource or sub-service the default servicing book which is everything 60-plus days delinquent and represents less than 4% of our overall servicing book. We expect that this move should generate approximately $20 million in annualized cost savings.

This transaction would also allow us to focus more on the performing servicing platform, which we believe will help diversify revenues without materially increasing our concentration levels. Flagstar currently services approximately 350,000 performing loans. And we are optimistic that we could, given time and investment, get that to 1 million loans. We believe we can be a sub-servicer of performing loans for other organizations as well as the loans we originate ourselves.

We've also been busy in a number of other areas. During the quarter, we sold approximately $341 million of unpaid principal balance in NPLs and TDRs with a carrying value of $278 million for 99.5% of book. Not only did this give us confidence in our marks, but it also helped us de-risk the balance sheet and bring our asset-quality coverage ratios more in line with our peers. We will continue to review opportunities to further de-risk our balance sheet as we move forward, provided such transactions make economic and operational sense for the Bank.

Going forward, incentive plans will be appropriately aligned with the Company's goals and objectives. Previously, we had as many as 22 separate incentive plans in place at any one time, which was confusing and didn't lead to a common approach throughout the organization. We have now fixed this and are excited about the new program that we are about to roll out, as I'm sure our employees will be.

We're also working on a vendor management and procurement initiative that should centralize the process, eliminate inefficiencies, and streamline the way we deal with third-party vendors. When you consider we've spent in excess of $400 million over the last 18 months on third-party vendors, we believe this is a significant opportunity in this area.

We are also looking at ways to maximize our existing real estate portfolio. We currently have 186 real estate properties owned and leased, and we are exploring ways and opportunities to unlock value. As you can see, we are currently working through a lot of initiatives and we are excited about the opportunities and future potential for Flagstar.

I'll now turn it over to Matt to talk about the mortgage business.

Matt Kerin - *Flagstar Bancorp - EVP Mortgage Banking*

Thank you Lee, and good morning everyone. I'm looking forward to the opportunity to speak with you today. I think I'd start by saying we had a pretty good quarter from an originations and gain on sale margin perspective.

If you look at Slide 13, you can see that our net gain on loan sales increased from the previous quarter, but trails on a year-over-year basis. The increase from the prior quarter was driven primarily through an improvement in our capitalization rates supported by our recent MSA transaction, as well as secondary marketing and hedge performance combined with a flat level of locks.

As you can see from the bottom chart on Slide 13, the level of locks remained flat from the prior quarter. The gain on sale margin increased over the same period. Nonetheless, we are experiencing competitive pressures in the marketplace from new entrants focusing on the emerging correspondent segment of the business as we and other competitors compete for business in a shrinking market.

As you likely have heard on other calls, industry mortgage originations were strong in April but then declined in May and June as interest rates increased around 100 basis points. You can see this highlighted on Slide 14. While treasury experienced a slight rally since rates peaked, we may well be at a new normal for production as refinance activities are expected to contract throughout the remainder of this year. Consistent with our production activity, we are continuously assessing our staffing and noninterest expenses while being mindful of the production swings inherent in the mortgage business, especially during periods like this of great volatility.

Please turn to Slide 15. You'll see some additional stratifications on our residential first mortgage originations. As you can see, they are all very high quality loans with an average LTV of 75% and an average FICO of around 750.

If you look at the chart on the bottom of Slide 15, I'd also like to point out that we increased -- we experienced a 34% increase in purchase volume which was offset by a 23% decline in refinance activity.

We mention on our last call that we expected purchase activity to grow significantly during 2013 and that we expected to continue to be a major player in that space. As such, we've been working various strategies as we prepare for the anticipated return to a more traditional purchase driven market.

While the refinance market will continue to be a meaningful part of our overall originations, growing our share of the purchase side of the business is a key component of our mortgage strategy. And that strategy is for growth. We aim to continue to deliver strong product offerings. We have a renewed focus on an excellent technology platform, which we will continue to combine with our reputation for service. That service level includes access to knowledgeable underwriters, which is unique to the industry, we believe, and this provides us a heightened level of ability to deliver certainty of closing to our TPOs, our realtors, our homebuilders and our borrowers alike.

According to recently published data from Inside Mortgage Finance, we were the fifth largest seller of purchase money mortgages to the GSEs so far in 2013. It's important to note that, unlike many of our peers, we originate through our PPO network largely and do not rely upon a large retail distribution network to get purchase business. In fact, if you look at the chart on the bottom left, you can see that our home lending center retail originations comprised only 5% of our total.

Our GPO dominant distribution market continues to generate purchase mortgage business and we believe that will continue. We have proven that from a historical effective as well.

Looking at the top chart on Slide 16, you can see that we have tracked historically to the industry mix of purchase originations. Looking closer, this has been true for each of our channels as well as evidenced by the bottom chart.

Flagstar's mortgage strategies have been built around service and salable products at a fair price. And we're going to continue with that strategy. Going back to late 2009, we did begin to develop and execute on a long-term strategy to better focus on the purchase market in anticipation of rising rates and then return to a traditional purchase refi mix.

We have enjoyed a slightly higher than normal share of the home purchase business market historically, but we recognized then the need to be ahead of the pack so that we can earn more business from those who are proactively building relationships with realtors, homebuilders, and other purchase money mortgage referral sources.

More specifically, steps we have been taking to generate a greater share of the purchase market include the following. We are continuing to improve and maintain superior service, underwriting turn times, speed to closing and reliability, all key factors impacting our ability to land home purchase business. We are focusing on generating more mortgage through referrals from real estate agents in the homebuilder market. Work is underway to develop builder and purchase bundles based on best practices we have experienced across the country.

We are increasing our marketing efforts and training to those forward-looking TPOs actively making contact with traditional referral sources of realtors and builders in an effort to gain a larger share of a smaller market. This would include previous customers.

We prioritize purchase applications for timeliness of review and approval, something we think is critical in today's environment when so many people are chasing such few inventory for purchases. Further, while not a large part of our business today, we continue our controlled expansion of our home lending centers with a focus on purchase money mortgage originators in those markets, markets we deem to be attractive and where we believe were underrepresented in the TPO space.

Appropriate product expansion and refinement of underwriting overlays consistent with an improving economy are also contribute and to our value proposition. These include construction products, jumbo hybrid and combination second loans.

As well, we are creating broader awareness amongst the TPOs and our loan officers of our loan down payment options, including private mortgage insurance, FHA, VA, and USDA GRH programs where we have a very strong presence today.

Further, we've also recently reintroduced our TBD loan reviews on properties which will allow brokers and non-delegated correspondents to better compete against local large lenders offering preapproval prior to home purchase contract signings. These are just a number of the many strategies we are executing on today.

The focus of many of the new entrants in the TPO arena has been a replication of the Flagstar emerging correspondent offerings. We have set the market and we given our long-standing investment in technology, people and our strong distribution network, we can expect to continue to earn our customers' business.

To summarize, the key to our long-term success is as it has always been -- service delivery.

I'd now like to turn the presentation over to Paul Borja.

Paul Borja - *Flagstar Bancorp - EVP, CFO*

Thank you Matt. This morning, we've discussed key strategic issues and specific operational opportunities as a result of our 2013 second-quarter results and also based upon our view of the near-term outlook of Flagstar.

At this time, I'll review components of our overall second-quarter 2013 results and touch on key areas that affect our outlook for financial performance during the third quarter of 2013. Please turn to Slide 5 which provides a condensed income statement of our second- and first-quarter results as well as results for the same period last year. This slide and Slide 6 together provide more details on our income statement and balance sheet, along with our regulatory capital ratios on Slide 7. We've also prepared an income statement bridge on Slide 8 which highlights the key items that changed during the second quarter as compared to the first quarter.

In total, we earned $65.8 million for the second quarter 2013 or $1.10 per share on a fully diluted basis. This compares to our earnings in the first quarter of 2013 of $22.2 million or $0.33 per diluted share.

As you can see on Slide 5, our net interest income for the second quarter 2013 declined by 18% as compared to the first quarter. This was due primarily to the decline in interest income as the average balances declined for both our mortgage loans held available-for-sale, and the warehouse loans we originate as part of our Mortgage Banking business.

We discussed earlier that our locks during the second quarter were approximately the same as in the first quarter. However, our level of originations declined from $12.4 billion in the first quarter to $10.9 billion in the second quarter. This decline reduced the average balance of our available-for-sale mortgage loans, and because of their linkage, reduced the balances of our warehouse lines.

For the third quarter, we expect that our overall earnings on our loan portfolio will not differ materially from that of the second quarter. We expect that any declines in average balances will be more than offset by the overall rate improvement, given the higher interest rate environment that arose during the middle of the second quarter and that we expect will continue during the entire period of the third quarter.

Also on Slide 5, noninterest income increased by 19%. As noted in more detail in our earnings release today, this increase reflects a number of different items -- an increase in our gain on loan sales as the level of our loan locks remains steady and our margin increased by 7 basis points. An increase in our loan administration income, as we realized an $18 million gain on the sale of recent vintage mortgage servicing rights which was offset in part by the challenges we experienced during the quarter in hedging the significant and sudden increases in market rates at the end of May and again at the end of June. And increases in our other category also reflecting our settling of the Assured and MBIA litigation.

We settled the Assured and MBIA litigation items during the quarter, and I'd like to take a few minutes to discuss them because the financial impact to us is contained in different parts of the income statement.

As to Assured, we paid $105 million and so reversed the remaining $5 million of litigation reserve that had been set aside for this litigation. As such, that $5 million was a benefit to us and was treated during the quarter as a credit against our legal and professional expenses.

We also recognized a $44 million gain at the time of the Assured settlement. This is because the settlement agreement allowed us to control the servicing of the loans contained in the two securitization trusts at the heart of this litigation. Under accounting rules, that control requires us to bring the assets of the trusts back onto our balance sheet at fair value.

At the same time, we also brought back the related liabilities also at fair value. The excess in fair values of the assets over the liabilities created this $44 million gain. Overall, we recognized a $49 million gain from settling this litigation.

As to MBIA, we paid $110 million and similarly reversed a further $5 million of litigation reserves we had set aside for this litigation. Just as with the Assured settlement, this reversal was applied as a credit against legal and professional expenses.

So for the quarter, legal and professional expenses decreased by $10 million from the prior quarter due to these two sets of reversals. Because the terms of the settlement lifted the MBIA insurance from the securitization trust that we already held in our balance sheet under the available-for-sale securities category, we had to recognize a credit loss that had previously been covered by it. That created the $8.8 million OTTI expense you see on the income statement.

Finally, after reaching the MBIA settlement and because we already owned that securitization, we took steps to effectively dissolve the trust and bring those loans back onto our balance sheet. With this final step, we were able to recognize a $6.1 million tax benefit which you see on our income statement under the income tax line.

But we also had to recognize a $7.2 million loss related to a reversal of another comprehensive income or OCI entry in equity section of our balance sheet. Overall these different pieces which are in different parts of our income statement resulted in a loss of $4.9 million for the MBIA litigation settlement. Taken together, our efforts to resolve these two key legacy litigation matters during the second quarter led to a $44 million gain.

The noninterest income category also reflected declines in several items, including the following -- loan fees and charges which typically decline as loan closings decline. Note, though, this is offset in part by a decline in our commission expense. Also OTTI which we just discussed and which is the expense associated with the credit risk of a security. As noted, this particular expense arose as part of our overall MBIA litigation settlement.

So as you can see, several of these items are nonrecurring. However, gain on loan sales and loan administration income are key parts of our Mortgage Banking business.

With respect to gain on loan sales, we are mindful of the current view by industry analysts that mortgage loan production volumes may decline by 10% to 15% or more during the third quarter and fourth quarter of this year. We believe this level of decline is reasonable given the recent and significant increase in interest rates that has caused a rapid drop off in loan refinancing activity.

Further, based on our experience over the years in the mortgage business, we are aware that the period of transition from a refinance market to a purchase market can result in lower overall volumes during that time. However, the financial effect of this volume decline might be offset in part by the reduced price sensitivity or purchase oriented borrowers whose focus is generally on monthly payments rather than merely rate comparisons to an existing loan.

For the third quarter, we would expect that production volume would decline and that such decline would be directionally consistent with the general movement of the overall industry. However, we would expect the rate of decline would be less than the industry decline due to the initiatives previously discussed by Matt. We would also expect that our margin on these loans would be slightly compressed as a result.

With respect to loan administration income, we would expect our earnings for the third quarter would reflect our target return of 4.5%, as discussed in last quarter's call. We target this as we hedge the MSR to manage interest-rate volatility, which is required of all regulated depository institutions. As such, we would expect that our earnings would be similar to that of the first quarter 2013, but adjusted for a higher balance of mortgage servicing rights as we continue to originate and sell mortgage loans during the third quarter. In that regard, if we dispose of mortgage servicing rights during the third quarter, this outlook would be affected by any gain or loss associated with that disposition and a lower income stream thereafter because of a reduced earnings base.

Our credit costs are comprised of three items -- loan-loss provisions for our loans held for investment, representation of warranty expense, which relates to potential put-back losses from loans we sold over the years into the secondary market, and asset resolution expenses which relate to our foreclosure expenses from our held for investment and ensured government loan portfolios, as well as expenses associated with GSE loans.

As noted earlier, we have seen improvements in the credit quality of our held for investment portfolio. As our credit delinquencies have declined, also the potential loss severities of those loans are expected to diminish to the extent that home prices rise and thus increase the value of our collateral.

We did during the second quarter increase our provision by $11 million, most of which was to reflect the emerging risks associated with defaults by borrowers with interest-only loans once their loan payments reset, and they then have to pay both principal and interest. As noted earlier, we are continuing to monitor this portfolio closely and will include consideration of any further developments into our overall analysis of the allowance for loan losses.

Our provisions for the representation and warranty reserve by which we reserve potential losses from loan put-backs, increased by $11 million in the second quarter. This resulted in a provision of approximately $29 million for the second quarter and allowed for a reserve of $185 million at June 30. We evaluate this reserve every quarter and based on our reviews to date would expect a similar lower provision for the third quarter and could expect a decline thereafter.

With respect to our asset resolution expenses, we are monitoring our foreclosure expenses carefully, especially in light of our recently announced outsourcing of our default servicing. Once such outsourcing is complete, we would expect significant savings in this area. However, given the transition time necessary to fully affect the outsourcing process, we do not expect any significant declines in this expense for the third quarter.

Asset resolution expenses are part of our overall noninterest expense category, and total noninterest expense decreased by $22.2 million from the prior quarter, primarily reflecting lower compensation and benefits, lower commissions and lower legal and professional expense. The decline in compensation was related to the timing of payroll taxes in the prior quarter. The decline in commissions was tied to the decrease in mortgage production volume we experienced during the second quarter, and so this expense decline was offset by the decline in loan fee income. And the decrease in legal and professional expense was driven by the $10 million credit arising from the release of reserves from pending and threatened litigation that we discussed earlier relating to settlements with Assured and MBIA.

For the third quarter, we would expect that our efficiency ratio would be similar to that of the second quarter. While we would not expect that noninterest expense would be reduced by the reversal of litigation reserves as was the case during the second quarter, we expect that similar benefit could be achieved by the lower legal and professional fees post-litigation as well as by the enhanced cost reductions discussed earlier by Lee.

With that, I'll turn it back to Sandro DiNello for the question-and-answer session.

Sandro DiNello - *Flagstar Bancorp - President, CEO*

Thanks very much Paul. I guess we'll get Rufus back on the line to do questions that are in the queue.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Paul Miller, FBR.

Paul Miller - *FBR & Co. - Analyst*

Thank you very much. On selling the NPAs, is there any thoughts of it continuing to sell into the third and fourth quarter just to clear them out?

Sandro DiNello - *Flagstar Bancorp - President, CEO*

I'm sorry, we had a little trouble with our speaker here. Yes, that is something we are considering and it could be a possibility. We're going to continue to evaluate those opportunities. And if something that makes sense comes along, we won't be afraid to pull the trigger.

Paul Miller - *FBR & Co. - Analyst*

And then with the MSR sales, there's a lot of rumors out there. I don't want you to comment on rumors, but can give me -- you say you want to be a primary servicer, but we keep on hearing that you want to sell a big chunk of these MSRs away. But on the performing -- on the nonperforming servicing, by our calculation, that's only roughly $4 billion or $5 billion of UPB. Am I correct?

Lee Smith - *Flagstar Bancorp - EVP, COO*

Yes. So look, Paul, there have been a lot of rumors. All I can say right now is we are still evaluating our options when it comes to the MSR strategy. But I do want to make it clear that have no intention of exiting the performance servicing business. As I mentioned earlier, that's a business that we feel we are good at and we want to grow.

Paul Miller - *FBR & Co. - Analyst*

And then can you talk a little bit about your mortgage originations? I think a lot of people -- I think one of the reasons why the stock is down and the negative commentary, yes, we know refis are down 50%. Yes, we know the gain on sale margins and whatnot is going to decline. But I think a lot of people in the industry feel that, in the second half of the year, a lot of these mortgage banks like you will not be able to make money and the gain on sale margins will get annihilated to a point where it would be -- you won't make any money. On top of that, can you talk a little bit about your variable costs associated with the origination business that will probably be taken out also?

Matt Kerin - *Flagstar Bancorp - EVP Mortgage Banking*

This is Matt. I think that obviously with the rate moving at the current in the April, May, early June timeframe, we saw a lot of volatility and we saw a pretty precipitous decline in the refinance activity.

I guess the good news or the silver lining there was that we had the opportunity to experience a pretty good uptick in the purchase business. And in particular with Flagstar, I think there was a recent publication that showed us as the number five purchase originator in the first six months of the year to the GSE.

So clearly there is going to be an expectation. I think Fannie just came out with some new estimates for the second half that show roughly, I don't know, somewhere between a 10% and 15% decline over their previous estimates for the second half.

We have seen some stabilization or leveling off with rates over the last month. And we've seen the refinance activity kind of pick up as people on the fence have come back into the market. We think there's ample room to grow.

Obviously, when you have an overcapacity situation, margins do get stressed. But I think what you have to do is be well positioned as we've tried to be in the purchase market with the product offerings and the credibility from a service level and ease of doing business perspective to leverage our footprint and our network to increase our share. So, I would say that we are guardedly optimistic, if I can use a phrase without making a forward-looking comment, that we are doing all the right things to generate growth in the production activities.

From a variability of cost perspective, obviously there's always room for refinement in your efficiency. We have always been a utilizer of third-party providers. We have use that to manage our overflows. We've also been fairly diligent in using over time and weekend work. We are one of the few shops that does provide direct access to our underwriters, which on the one hand may seem to be inefficient but on the other hand it adds heightened degree of certainty at closing and you can talk to the people and get conditions understood there. So, I think we will continue to manage through that.

We have actually reduced the number of contractors over the course of the last several weeks, whether they are MIA underwriters or internal reviewers or the like. And we still have room -- opportunity to do that further should the situation warrant. We are very efficient in terms of our production on mortgages from a number of units internally. Always room for improvement. We are looking at IT and other methods and with the help of Lee and some of the other resources, we will continue to look at our workflows and processes to maintain our diligent and regimented expense base.

Sandro DiNello - *Flagstar Bancorp - President, CEO*

This is Sandro. Let me just add, and I think I said this in the comments but I want to reiterate this. We are going to be aggressive about gaining greater share in the purchase market. We've got the capacity to do that. I personally have been out to three of our markets, Washington, California, Texas. I can tell you that customers love doing business with Flagstar. So if we provide the service that they need to be able to close their deals, we will get their business. And I can tell you too there's nobody out there that's knocking the ball out of the part, so we think we can take advantage of that position and all the things that Matt just talked about. So we're going to be after it hard and fast, and I know it's just talk, but we are going to get there.

Paul Miller - *FBR & Co. - Analyst*

Okay. Thank you very much. Great quarter.

Operator

Kevin Barker, Compass Point.

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

Good morning everyone. During the quarter, you reported an unadjusted increase on the gain on sale margin from 107 to roughly 130. Could you talk about how much of this gain was related to MSR capitalization versus cash gain on sale? And could you break out the different gain on sale margins that you're seeing between the correspondent wholesale and retail channels?

Paul Borja - *Flagstar Bancorp - EVP, CFO*

It's Paul Borja. How are you? When we take a look at our gain on sale -- first of all, I appreciate what you're saying with respect to channel profitability. That's something we look at internally but we haven't yet publicly disclosed. We are working on that, and we'd be happy to include that down the road. But at this point, we are not looking at gain on sale channel profitability disclosures, but it is something we monitor.

With respect to the MSR capitalization rate, our MSR capitalization as part of our overall gain on sale is we believe reflective of the overall marketplace. I think if you take a look at the earnings, take a look the earnings release, we do have within there our basis points and also our cap value. From there you can see our current cap rate is 3.7% which compares to 3.3% in the prior quarter. Really, 3.7% is very -- on a blended basis is competitive and consistent with the marketplace inasmuch as we do fair value all of our mortgage servicing rights. So we don't break out the cash versus non-cash value but we certainly consider that as additional disclosure.

I will tell you that, overall and when we take a look at gain on sale, what we do look at is the value proposition that comes in the door and then our value proposition on the secondary marketing desk as we protect our profit. I'll tell you that our secondary marketing group has done a tremendous job in a very turbulent time during Q2 to protect and add to the profitability.

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

And then shifting to some of the MSR sales that you had and following up with some of the questions Paul had, did I hear you right where you had an $18 million gain on the sale of the $12.7 billion portfolio during the quarter?

Paul Borja - *Flagstar Bancorp - EVP, CFO*

Yes, that's correct. What we wanted to do was make sure that when you take a look at the loan administration income on the income statement and compare it against Q1, that you are aware of that particular amount so as to be able to properly model from a run rate perspective Q3. So as we talked about during the course of the call, our Q3 outlook really relates back to Q1 rather than Q2, so that you take that properly into account.

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

Okay. Then related to the sale, the 4% of your servicing -- sub-servicing of 4% of your total servicing portfolio, could you talk about the lost fee revenue given that you're having roughly $20 million of expense saves related to that portfolio? Could you talk about the other side of it?

Lee Smith - *Flagstar Bancorp - EVP, COO*

Sure, yes. This is Lee. So the lost revenue is pretty small. So it's -- so the $20 million is net savings. And to be totally candid with you, in 2012, we were losing in excess of $30 million on the default servicing side. So the revenue associated with that is actually less than $10 million.

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

Okay. And then finally, concerning your -- the sales of your NPLs, is there specific buyers that are bidding for these assets, and are you seeing a significant amount of competition for the sale of nonperformers in the market right now?

Lee Smith - *Flagstar Bancorp - EVP, COO*

Sure. This is Lee again. Yes, there is significant competition. And we work through an investment banker to action the two sales that we referenced in the second quarter. And as Sandro said, we will be opportunistic if a future transaction makes sense for us, both from a profitability and from an operational point of view, then we will look to execute on that. But the market is strong at the moment and there's a lot of competition.

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

Are you selling particularly to one counterparty, or is it several counterparties you're looking to sell NPAs and TDRs?

Lee Smith - *Flagstar Bancorp - EVP, COO*

We are open. I mean we are not just looking to sell to one particular counterparty. We are looking to -- we are open to the best bidder, basically.

Sandro DiNello - *Flagstar Bancorp - President, CEO*

Let me be quite clear. This is Sandro. We may not sell anything. We may determine the best way to move ahead here is to work through these ourselves. We've been able to move our asset quality ratios to a level that we are pretty comfortable with right now, so we don't feel pressure to do anything. If the right opportunity exists, as I said earlier, we will pull the trigger on it, but we are certainly not particularly anxious about doing another transaction. We don't feel we need to. We will do it only if it makes sense.

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

All right, thank you for taking my questions.

Operator

(Operator Instructions). Bose George, KBW.

Bose George - *Keefe Bruyette & Woods - Analyst*

Good afternoon. First just a question on gain of sale margin trends. Can you comment on trends over the course of the quarter, and since the end of the quarter how they looked?

Paul Borja - *Flagstar Bancorp - EVP, CFO*

It's Paul Borja. How are you? We've looked, as we've been going through and as we talked about in the speech, we looked at an inflection point during the course of the quarter as everyone else did from the refi to the purchase market. And consistent with that, what we did see were changes in the overall margins, which is why you've seen us be able to take advantage of some opportunities in the inflection point but we don't expect those opportunities will continue to Q3.

We do see, if you take a look at the primary secondary spread, you do see some consistency in the primary secondary spread but just at a higher level as we've seen because of the May and the June run-ups at month end, respective months end, on the 10-year treasury and related mortgage. So we do see, with that inflection point, with the increases, a shift to the purchase and our ability because of folks in late May and in June to enter into refi arrangements prior to higher rates, we do see that we are able to protect some of the margins in that context. However, for Q3, Bose, we don't foresee that same opportunity rising in mid-quarter, so that's why our outlook was styled way it was.

Matt Kerin - *Flagstar Bancorp - EVP Mortgage Banking*

This is Matt too. I think we had a lot of volatility in rates in the last quarter. And Paul referenced the outstanding job the secondary folks did. But our base margin, if you will, is fairly consistent right now.

Bose George - *Keefe Bruyette & Woods - Analyst*

The base margin meaning the spread at which you execute?

Matt Kerin - *Flagstar Bancorp - EVP Mortgage Banking*

Our primary infraction model, yes.

Paul Borja - *Flagstar Bancorp - EVP, CFO*

Correct.

Bose George - *Keefe Bruyette & Woods - Analyst*

Okay, great. And then I just wanted to follow up on the servicing questions. In terms of growing that business, is that just going to come from your own originations, or are there sub-servicing opportunities you're exploring as well?

Lee Smith - *Flagstar Bancorp - EVP, COO*

Yes. So on the default side, are you referencing, or on the --

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Bose George - *Keefe Bruyette & Woods - Analyst*

No, actually on the performing side.

Lee Smith - *Flagstar Bancorp - EVP, COO*

Yes, on the performing side, yes, it would be both from -- we are looking at opportunities both from our own originations and sub-servicing loans for other organizations as I mentioned earlier in the call.

Bose George - *Keefe Bruyette & Woods - Analyst*

Actually, going back to the question on the product mix, do you guys break out just the HARP mix quarter-over-quarter? Did that change much at all?

Matt Kerin - *Flagstar Bancorp - EVP Mortgage Banking*

Break it out? This is Matt Kerin. On Slide 15 there is a mix. It's been fairly consistent. We are running in the 8.5%, 9% range. We peaked early on when the product first came out like everyone did with the pent-up demand, and then that kind of eroded a little bit. And then when the program was reinvigorated, we stepped up a little bit. But it has been a nice, pleasant, steady piece of business for us and we would expect that to continue.

Bose George - *Keefe Bruyette & Woods - Analyst*

Okay, great. Thank you.

Operator

[Ken Basil], [Elemental] Management.

Ken Basil - *Elemental Management - Analyst*

Thank you for taking my question. My question is regarding normalized legal and professional expenses. So we are coming out of this period which I would say is clearly some extraordinary legal cost, hopefully coming out of it. So without asking for guidance as to when you think we will get there, how would you think of legal and professional expenses once we are through this period of the downturn in 2008, 2009?

Paul Borja - *Flagstar Bancorp - EVP, CFO*

It's Paul Borja. With respect to legal and professional expenses, you're correct, and we talked about it in the speech, that we do expect, with respect to the MBIA and Assured litigation significant, downtick in expenses led to those. It's clear that, over the prior periods, we've had some significant expenses and as we talked about, it's been very -- we did result in some favorable -- it came to some favorable results in Q2.

In Q3 and Q4 and going forward, as we are shifting our focus from the legacy litigation matters, we do want to make sure everyone understands there are still litigation matters out there. In fact, we expect to file our 10-Q later this month, and a key part of that overall disclosure is going to be pending and threatened litigation matters.

At this time though, as Sandro noted and others have noted, from a remaining legacy litigation perspective, we believe we've put those behind us. So as such, we would expect that you would see a downtick in the gross amount of legal and professional fees.

Just a reminder though, as you to take a look at the breakdown both in the earnings call as well as the more detail in the 10-Q, that the legal and professional expense line item does reflect the $10 million credit from the reversal of those reserves that we'd previously put through there.

Mike Flynn - *Flagstar Bancorp - General Counsel*

This is Mike Flynn, General Counsel. I should also add that when we complete our efforts to outsource our default servicing, depending upon the terms of the arrangement we make with the sub-servicer, some of our current litigation costs in that area would likely be transferred to that servicer. We can't quantify that amount right now, but that's a benefit that could well happen.

Ken Basil - *Elemental Management - Analyst*

What do you think, using this quarter as an example, how much would you estimate you spent this quarter on professional and legal expenses that were not related to the real estate downturn in 2008, 2009?

Paul Borja - *Flagstar Bancorp - EVP, CFO*

It's Paul Borja. I'm sorry, I just don't have that off the top of my head. We can take a look at that and chat with the off-line, and certainly think about putting it in the 10-Q because that is an important question from the perspective of moving past the legacy side. So why don't we do that, and we'll look at the 10-Q if that's okay.

Ken Basil - *Elemental Management - Analyst*

Great, thank you very much.

Operator

Henry Coffey, Sterne Agee.

Henry Coffey - *Sterne Agee & Leach Inc. - Analyst*

Good morning everyone. And I've listened to these calls before and wanted to complement you on the quality of what you're doing here. It's quite impressive.

Help me out here. I may be making a mistake. You said the gain on the servicing sale was $18 million on $12.7 billion? That's 14 BPS or half X. Is that because it was -- am I doing my sums wrong here or is that because it was delinquent servicing, or -- I'm either making a mistake or maybe need a little --

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Paul Borja - *Flagstar Bancorp - EVP, CFO*

This is Paul Borja. First of all, we wanted to make sure that we highlighted the $18 million so that from a run rate perspective that wasn't taken into account going forward in Q3.

Henry Coffey - *Sterne Agee & Leach Inc. - Analyst*

Right, I'm not worried about it. I'm just trying to focus in on the MSR valuation on the sale.

Paul Borja - *Flagstar Bancorp - EVP, CFO*

Sure. Secondly, it was a significant amount. As you know, over the course of the last few years, we've sold MSRs on an occasional basis. Generally, what we do in conference calls as we indicate the amount of the MSRs so that investors can reconcile the pluses and minuses. In this particular case, there was a rather significant gain with respect to this MSR portfolio. This was not older vintage; this was not old vintage or legacy vintages. These were recent vintages. And so what it reflects, if you will, was an inflection point in MSR valuations. As folks took a look at both, we believe funding on the sidelines as well as a rising interest rate scenario. So in that context, we were able to move forward and close that transaction. I'm not saying --

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Henry Coffey - *Sterne Agee & Leach Inc. - Analyst*

No, you're missing my question.

Paul Borja - *Flagstar Bancorp - EVP, CFO*

I must be, yes.

Henry Coffey - *Sterne Agee & Leach Inc. - Analyst*

$18 million gain divided by $12.7 billion in servicing is 14 basis points. Most people value servicing at about 100 basis points. So that -- or am I just doing my math wrong? Which is totally possible at my advanced age.

You said the gain -- I'm just trying to get the right set of numbers and numerators and denominators. So sorry, but just trying to get the numbers right. I understand the sale process.

Paul Borja - *Flagstar Bancorp - EVP, CFO*

I understand it. So I apologize. So I understand what your question is. MSRs are carried at fair value on a daily basis. And so we mark those to fair value.

Henry Coffey - *Sterne Agee & Leach Inc. - Analyst*

Thank you.

Sandro DiNello - *Flagstar Bancorp - President, CEO*

(multiple speakers) there's an inflection in the marketplace that causes the value to go well above previously established valuations. And as such, they'd accrete this gain.

Henry Coffey - *Sterne Agee & Leach Inc. - Analyst*

So it's an $18 million gain over the carrying value of the MSR?

Sandro DiNello - *Flagstar Bancorp - President, CEO*

Over the fair value of the MSR which we carry --

Henry Coffey - *Sterne Agee & Leach Inc. - Analyst*

Can you tell us what the gross sale was?

Paul Borja - *Flagstar Bancorp - EVP, CFO*

Not sure if we have that much detail on that. Let me think about it.

Henry Coffey - *Sterne Agee & Leach Inc. - Analyst*

We were told it was sold at north of 100 basis points. Can you put that into context for us?

Sandro DiNello - *Flagstar Bancorp - President, CEO*

No, I think that what we can do, what we normally do is we'll talk about movements within the MSR portfolio so you can (multiple speakers) --

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Henry Coffey - *Sterne Agee & Leach Inc. - Analyst*

Right.

Sandro DiNello - *Flagstar Bancorp - President, CEO*

-- overall balances. And then we will highlight significant changes to the extent there is a P&L affect that is material so it's not to affect run rate analyses.

Henry Coffey - *Sterne Agee & Leach Inc. - Analyst*

Right, no, but we're just looking at a lot of us have been asking questions about the MSR sales. You didn't sell it for 14 basis points. You obviously sold it for something better than that. So thank you. Thank you very much.

Operator

Kevin Barker, Compass Point.

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

I just had a follow-up on your capital. Given that the Fed recently finalized the rules concerning Basel III, could you give an update on where your Basel III ratio would stand, and how much of your MSR portfolio would potentially be for sale in order to get it to roughly the 7% Tier 1 common equity ratio that's required?

Sandro DiNello - *Flagstar Bancorp - President, CEO*

Yes, Kevin. I'm just thinking about your question. So as you know, the new rules were released just a few weeks ago. So we are evaluating the impact that they will have both on the Bank as well as the consolidated holding company. One of the largest impacts from the proposed (inaudible) for us would be the permanent grandfathering of the trust preferred. This will be a big benefit for our consolidated ratios. But there's really no impact on the Bank ratios. We don't hold the preferred stock at the Bank level.

The change in risk weighting on the residential mortgages that came in the final will help given the size of our residential portfolio of course. And then obviously MSR deductions are key for us. But we think that will be able to solve for this through our earnings growth and by disclosing our MSRs as we've always done. So while we are not ready to release any pro forma ratios yet, our initial estimates show that we are in compliance with -- that we will be in compliance with all of the required ratios on a fully nascent basis as of June 30, 2013. Does that answer your question?

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

Yes, it does. And then concerning the OCC consent order and the capital plan that you're working with the OCC, are they taking into account the Fed stress test that you have to go through? And is that a main item that they are looking at, concerning how your capital plan is going to lay out over the next several quarters, even several years?

Sandro DiNello - *Flagstar Bancorp - President, CEO*

This won't surprise you that I can't get into too much detail about that. We have been working closely with the OCC and devoted significant attention and resources to addressing all of the matters identified in the consent order. We have delivered a capital plan that includes all the required stress testing. And along with everything else in the consent order we are waiting for a complete review by the OCC. And we're pretty confident we will be able to achieve full compliance with the entire order as soon as possible. And although I can't say anything more about that, I can tell you that I am very pleased with the progress we've made on everything on the regulatory front.

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

Are the regulators concentrating more on how you are looking from a Basel III perspective or a Basel I perspective?

Sandro DiNello - *Flagstar Bancorp - President, CEO*

They're concerned about both of course. They're concerned about where we are at today from a Basel I perspective, and where we will be on a projected basis on Basel III. So I'm very comfortable that we will be able to meet all of the requirements of Basel III, and I think that the regulators will have to review that and time will tell whether we are able to do it or not.

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

Thank you for taking my questions.

Operator

With that, ladies and gentlemen, we have no further questions on our roster. Therefore, Mr. DiNello, I will turn the conference back over to you for any closing remarks.

Sandro DiNello - *Flagstar Bancorp - President, CEO*

Thanks everyone. I hope you thought that our presentation today was helpful to you. We obviously were much more transparent than we have been historically. We're going to continue to be that way going forward. And we look forward to delivering better results for you going forward. That's our goal as management. The management team is very committed to getting things right, growing revenues, controlling expenses, remaining compliant, and we look forward to doing that. Thanks for taking the time to listen to us today.

Operator

And ladies and gentlemen, this will conclude today's conference. Thank you for your participation.
