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FBC - Q1 2013 Flagstar Bancorp Earnings Conference Call

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PRESENTATION

Operator

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

Paul Borja - *Flagstar Bancorp - EVP, CFO*

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

Before we begin our comments today, I'd like to remind you that the presentation today may contain forward-looking statements regarding both our financial condition and our financial results. These statements involve certain risks that may cause actual results in the future to be different from our current expectations.

These factors include, among other things, changes in economic conditions, changes in interest rates, the outcome of pending litigation, competitive pressures within the financial services industry and legislative or regulatory requirements that may affect our business.

For additional factors, we urge you to review the press release we issued last night, our SEC documents, such as our most recent Form 10-K and our Form 10-Q, as well as the legal disclaimer on page two of our first-quarter 2013 earnings call slides that we posted today on our Investor Relations page at Flagstar.com.

During the call, we may also discuss non-GAAP measures regarding our financial performance. A reconciliation of these measures to similar GAAP measures is provided in the tables to our press release, which we issued last night, as well as in the appendix to our earnings call slides. With that, I'd like to now turn the call over to Mike Tierney, our Chief Executive Officer.

Mike Tierney - *Flagstar Bancorp - President, CEO*

Thank you, Paul, and good morning, everyone. Thank you for joining us. I'd also like to welcome you to our first-quarter 2013 earnings call.

On the last conference call, we told you that we were going to be refocusing our strategy on our national mortgage banking business and our Michigan-based Community Bank model. We also mentioned that we'll continue to be improved risk management, strengthen compliance and quality control and strengthen the balance sheet. Our results for the first quarter reflect the positive impact from these efforts, which are highlighted by the strong improvements in many aspects of our business this quarter.

Total credit costs declined significantly, to the lowest quarterly level since 2008. Total nonperforming loans decreased by approximately 8% from the prior quarter and have now decreased by $785 million, or approximately 70%, from their peak level during the second quarter of 2010.

Our allowance coverage ratio increased to 78% of nonperforming loans, and our active repurchase pipeline decreased by about 17% from the prior quarter. Our representation and warranty reserve is now almost equal to our active repurchase pipeline.

We also continue to add deposit customers in Michigan, where we experienced a 13% increase in core deposits from the prior quarter. We are experiencing solid commercial and consumer loan growth. At the same time, we significantly strengthened our capital and liquidity ratios and continued our efforts to reduce MSR concentrations as we prepare to meet the requirements of Basel 3 and the regulatory prescribed stress tests.

Along with the rest of the industry, we experienced a significant reduction in mortgage banking activity in the first quarter. Flagstar's business model is heavily dependent on mortgage production, and our top-line revenue was negatively impacted by decreases in gain on loan sales, reduced interest income from mortgage and warehouse loans and lower loan fees from new mortgage originations.

We saw reduced demand due to the upward movement of rates during the quarter. Margins also compressed due to the increased competition with excess capacity in the mortgage space. As a result, we lost some market share in the first quarter. In response to that, we have taken steps to gain market share back and improve our margins. We feel positive about our national footprint and core penetration levels in our key markets, and continue to believe we are well positioned to grow market share.

In addition, we saw positive signs during the end of the first quarter which have continued into April.

I'd now like to discuss some of the key drivers of our first-quarter results. Matt Kerin, our Mortgage Banking President, will then talk about the mortgage business. After Matt, Sandro DiNello, our Bank President, will provide an update on our community banking areas. Paul Borja will then take us through the financial outlook, and finally, we'll be available to answer your questions.

Let's begin on slide five. As you can see, we reported first-quarter net income of $22.2 million, or $0.33 per share. On an annualized basis, this represented a return on average assets of 0.65% and a return on average equity of 7.55%.

Turning to slide six, we've provided a bridge from the fourth-quarter 2012 net loss to our first-quarter 2013 net income. As you can see on the slide, our first-quarter results were impacted by four key items. First, legal and professional expense decreased by nearly $184.6 million, primarily driven by having increased reserves for pending and threatened litigation during the fourth quarter.

Second, total credit related costs decreased by about $43.2 million, including a $29.9 million decrease in provision for loan losses, a $7.8 million decline in representation and warranty reserve change in estimate expense and a $4.8 million reduction in asset resolution expenses.

Third, gain on loan sales decreased by $101.4 million. From a rate volume perspective, this decrease was driven equally by a decrease in the volume of mortgage rate lock commitments and a lower gain on sale margin. Matt will discuss this later in the call.

Lastly, interest income decreased by $20.4 million, driven primarily by lower average balances of residential first mortgage loans held for sale and warehouse loans, both attributable to the reduced mortgage banking activity during the quarter. It also reflects the impact of the sale of our New England-based C&I and commercial real estate loans originated by our former lending group during the last quarter.

On slide seven, we've broken down select items from our balance sheet. As you can see, total assets decreased by almost $1 billion from the prior quarter. This decrease was driven largely by an $859 million reduction in commercial loans held for sale, attributable to the closing of our two sales of Northeast-based lending group's commercial loans referenced earlier. In addition, our mortgage loans held for sale and warehouse loans decreased during the quarter.

These decreases were partially offset by an increase in cash and interest-earning deposits resulting from both the proceeds of the commercial loan sales and a reduced level of funding needed for the mortgage business. We expect the excess liquidity to decline through the remainder of the year as mortgage funding needs increase and we experience further reductions in high-cost liabilities.

Please turn to slide eight. Like a majority of the banks in the industry, we continue to significantly increase regulatory capital ratios. At March 31, 2013, the Tier 1 leverage capital ratio was 10.14%, the highest level in recent history and an 88 basis point increase from the prior quarter.

Turning to slide nine, you can see a breakout of our non-interest expense. In total, non-interest expense decreased by $196.6 million from the prior quarter. As I mentioned, the majority of this decrease was related to us increasing the reserves for pending and threatened litigation during the fourth quarter of 2012. Nonetheless, we are actively evaluating our cost structure, seeking opportunities to reduce expenses while implementing initiatives to improve our operating efficiency, consistent with what I'm sure you're hearing from others in the financial services industry.

As we noted in our earnings release, during the first quarter, the US Treasury announced it had sold our TARP preferred stock to private investors. This amount will continue to qualify as Tier 1 capital and we will continue to accrue cumulative dividends quarterly at a rate of 5% per annum.

We continue to emphasize a culture built around exceptional customer service. In April, JD Power & Associates ranked Flagstar Bank second highest in customer satisfaction for the North Central region, which includes Michigan, Indiana, Ohio, Kentucky and West Virginia. The JD Power survey measures retail customer satisfaction based on account activities, account information, banking facilities, fees, problem resolution and product offerings. Our overall score of 807 ranked 44 points above the national average.

With that, I'd like to turn the presentation over to Matt Kerin for more detail on our mortgage banking operations.

Matt Kerin - *Flagstar Bancorp - EVP, President of Mortgage Banking Division*

Thank you, Mike. Good morning, everyone. As Mike mentioned, both the industry and Flagstar experienced a slowdown in mortgage banking activity during the quarter, which reduced demand and created tighter margins due to increased competition and the result in excess capacity.

If you turn to slide 10, you can see that net gain on loan sales decreased significantly from both the prior quarter and from the same quarter in 2012. This was driven by a decrease in both rate lock commitments and margin, both of which we highlight on the bottom chart on page 10.

For the first quarter of 2013, fallout adjusted locks came in at $9.8 billion as compared to $12.6 billion in the prior quarter. This decrease as compared to the prior quarter was driven by a number of factors, including seasonality, an upward movement in rates and increased competition for mortgage lending with new entrants to the top 30 and several of the top lenders buying up market share.

Gain on sale margin, which we measure based on fallout adjusted rate locks, decreased to 140 basis points in the first quarter as compared to 190 basis points in the fourth quarter of 2012. As we know, gain on sale margin stayed at historically high levels throughout much of 2012, and we, along with the industry, had anticipated it would come down. Our gain on sale margin declined due to a number of factors, including the impact of G-fee increases, seasonality, increases in the buyup and buydown fees and the conservative approach we took to capitalizing our new mortgage servicing rights that were generated in the quarter.

If you look at where the quarter ended, with the increase in registrations we are seeing, the G-fee increases now being well incorporated into our pricing, and changes in the primary secondary spread, together with recent information suggesting increased MSR valuations, we believe we'll be seeing improved margins in the second quarter.

As we look at the business today, and while we clearly have come down from the peak of 2012, we believe we are now back to a level that is not far away from the longer-term run rate, and we are optimistic for the future.

Please turn to slide 11, which provides additional stratifications on our residential first mortgage originations. As you can see from the chart on the bottom right, both purchase and refinance originations declined from the prior quarter levels, but increased as compared to the same period a year ago. We continue to expect refinance activity to remain strong during 2013, and we expect to continue to be a major player in that space.

However, growing the purchase business continues to be a key component of our strategy going forward, as all of the industry estimates contemplate the percentage of purchase share to more than double by the end of 2013 and continue that increase through 2014 as a percentage of the total production.

In addition, during the quarter, we added 10 retail home lending centers as part of our purchase acquisition strategy on the home lending side of the business.

If you turn to the chart on the top of slide 11, you can see our HARP 2.0 originations decreased in total, but continue to hang around the 9% level of total production. We've been successful in refinancing HARP-eligible loans, especially our originations relative to the size of our overall servicing [book].

With the recently announced extension of the HARP 2.0 program and with the recent rally in the 10-year, we see a greater opportunity for a stronger refinance market. Coupling that with the fact that as housing values go up, there will be more customers that could take advantage of a refinance, we see a good opportunity for continued success in the HARP space.

Further, HARP opportunities are not limited to our own servicing book, and we've routinely [HARPed] loans last year and prior from other servicing books. We would expect that to continue.

If you turn to slide 12, please, the net servicing revenue, which is a combination of our net loan admin income, including the off-balance-sheet hedges of the MSRs, or mortgage servicing rights, and the gain on trading securities, which in this case is the on-balance-sheet hedges of mortgage servicing rights, decreased to $20.4 million as compared to $25 million in the prior quarter. This decrease from the prior quarter was primarily attributable to challenging hedges, or hedging challenges, I'd say, associated with the interest-rate volatility we experienced during the quarter.

I'd now like to turn to credit quality. If you look at slide 13, you can see our total credit costs -- credit-related costs declined by about $43 million from the prior quarter, which represents the lowest level since 2008. This decrease was driven by significant reduction in each of our three major categories of credit costs, representation and warranty reserve, our change in estimate expense, provision for loan losses and asset resolution.

On slide 14, expenses related to the rep and warranty reserve decreased by $7.8 million from the prior quarter. This decrease was largely driven by two factors. First, as you can see on the chart on the top right of the page, there was a $37 million reduction in the total active repurchase pipeline, as we continued to work through the existing population of repurchase requests.

Second, loss rates improved from the prior quarter, resulting from two consecutive quarters of declining levels of net chargeoffs from loan repurchases.

As you look at the bottom two charts on the page, both new audit file review requests and repurchase demands increase from the prior quarter, yet continue to remain below peak levels. We believe this is a reflection of heightened scrutiny from the GSEs as they transition to their new review process, focusing away from the pre-2009 vintages toward more current originations. While both the level of file pools and new demands increased, we anticipate continuing improvement.

Turning to slide 15, our allowance for loan losses decreased from the prior quarter, largely driven by a release of reserves associated with the commercial loans we sold in the Northeast, but also due to an improvement in the overall loss rate associated with the consumer loan portfolio. Despite the decrease in reserves, our ratio of allowance to nonperforming loan improved to 78.5% as compared to 76.3% in the prior quarter.

If you turn to slide 16, you'll see that our net charge-offs on consumer loans decreased by about $15 million from the previous quarter, as we continue to work diligently through nonperforming loans associated with our HFI residential first loan portfolio. As a result of the decrease in net charge-offs, we saw a decrease in provision for loan losses from the prior quarter.

Slides 17 through 19 provide a breakout of our nonperforming loan and TDR portfolios. As you can see on slide 17, total nonperforming loans decreased by 7.6% from the prior quarter. While the absolute level of nonperforming loans declined, the ratio of nonperforming loans to total loans actually increased from the prior quarter. It is important to note that this occurred primarily because there was a $700 million decrease in the investment loan portfolio at the same time, which negated much of the effect of the lower level of nonperforming loans.

Loans past-due 30 to 59 days, which are a leading indicator for us of nonperforming loans, also decreased about $14 million or roughly 19% from the prior quarter.

Finally, asset resolution expense, which includes expenses associated with foreclosed properties, decreased to $16.4 million in the first quarter as compared to $21.2 million for the fourth quarter of 2012. This decrease was primarily attributable to the realization of gains on the sales of repossessed assets due to an improvement in home prices.

I would now like to turn the presentation over to our Bank President, Sandro DiNello.

Sandro DiNello - *Flagstar Bancorp - EVP, Chief Administrative Office and President of Flagstar Bank*

Thanks, Matthew. Good morning, everyone. Please turn to slide 20. As Mike mentioned, our net interest income and margins decreased significantly from the prior quarter. Net interest income decreased from $75.6 million in the fourth quarter 2012 to $57.3 million in the first quarter 2013. Net interest margin at the Bank also decreased to 1.89% as compared to 2.26% in the prior quarter. These declines were primarily attributable to lower average balances of our mortgage-related portfolios, both residential first mortgage loans held for sale and warehouse loans. Both of these lower balances were attributed to a slowdown in mortgage volumes during the quarter.

The decrease was also related to a decline in commercial and commercial real estate loans related to loans we sold in the Northeast. Both of these contributed to a $20.4 million decrease in net interest income.

Looking at slide 21, you can see our overall balance sheet shrunk, driven by conversion of higher-yielding assets to cash. The decrease in interest income was partially offset by a $2.2 million decrease in interest expense as compared to the prior quarter. This was primarily due to lower average balances of retail certificates of deposit and wholesale deposits, as well as the lower average cost of deposits.

As you can see on slide 22, our average cost of funds improved by six basis points from the prior quarter. This improvement was driven primarily by two factors. One, our mix of funding sources continued to improve as we reduced the balance of higher-costing liabilities. And two, the average cost of our retail deposits also fell by six basis points versus the fourth quarter, driven primarily by a 12 basis point decline in the average rate paid on retail certificates of deposit.

Turning to slide 23, which presents point-in-time balances at quarter-end, you can see that total deposits decreased by about $500 million from the level at December 31, 2012. The decrease from the prior quarter was primarily driven by decreases in Company-controlled custodial deposits and certificates of deposit, as we continue our efforts to reduce the level of wholesale funding sources. These reductions were partially offset by increases in demand in savings deposits, as we continue to add core customers in Michigan.

In that regard, on slide 24, you can see that we continue to add core deposits and improve the ratio of core deposits, which we define as checking, savings and money market accounts, to retail deposits. We added approximately $400 million in core deposits during the quarter, a 13% increase from the same period last quarter. As a result, our percentage of core deposits improved from 50.1% at December 31, 2011 to 58% at March 31, 2013.

With that, I will turn it back to Paul Borja.

Paul Borja - *Flagstar Bancorp - EVP, CFO*

Thank you, Sandro. Good morning again, everyone. As we've talked about on prior calls, we focus on three key areas of our operating results -- revenue generation, expense management and credit costs. Starting with revenue generation, as Mike mentioned, the majority of our revenues are tied to the mortgage business. Gain on loan sale income is reflective of the volume of fallout-adjusted mortgage rate lock commitments, which we now provide for you. It is also impacted by gain on sale margin, which is calculated based on the level of fallout-adjusted locks. Loan fees are primarily based on the level of residential mortgage originations.

The majority of our interest income is also based on the mortgage business, with mortgage loans held for sale and warehouse loans being driven by the level of residential mortgage originations. Within the remainder of our investment loan portfolio, we expect the residential first mortgage portfolio to continue to run off. We will try to offset a portion of that runoff with growth in the commercial and industrial, as well as commercial real estate portfolios and, to a lesser extent, consumer loans.

The most current industry projections from Fannie May, Freddie Mac and the Mortgage Bankers Association estimate that total mortgage production industrywide for the second quarter of 2013 will be between $400 billion and $500 billion. The percentage of total mortgage originations which are refinances are estimated to remain between 60% and 70%.

As we've discussed earlier, for a number of reasons we discussed, we lost market share during the first quarter. As the quarter progressed, however, we saw a healthy increase in registrations and strong pullthrough, and we believe that we can gain back mortgage market share going forward. We've seen a pickup in our purchase volume, and expect that to actively increase over the course of the year. Our mix of refinancing versus purchase mortgages that we originate during the second quarter of 2013 should mirror that of the industry estimates, as has historically been the case with us.

Also, as Matt indicated, we believe that our base margin declined in the quarter due to the factors Matt outlined earlier. At the same time, we are experiencing a number of positive trends, including an improving marketplace for more profitable servicing transactions as the approximately $2.1 trillion in mortgage servicing rights in the banking industry moves from the regulated banking space to the nonregulated space during this year.

Recent information suggests that MSR valuations are increasing, and as a result, we believe that we will see improved margins in the second quarter.

Net servicing revenue is a function of interest rates, our hedge effectiveness and the impact of mortgage servicing rights as well. We expect hedging challenges that occurred with respect to our MSR during the first quarter to continue, although to a much lesser extent. However, we expect to maintain at least our minimum 3% target level for total return on net asset.

At the same time, we are working to increase our warehouse loan balances for the first-quarter 2013 level, although, like the rest of the industry, we do not expect to return to fourth-quarter 2012 levels. We also plan to redeploy the excess cash we currently have to add interest-earning assets and reduce higher-costing liabilities.

These actions are consistent with our short-term goal of increasing our NIM over first-quarter levels, as we target gradually moving back toward levels experienced in 2012, by the end of 2013.

Turning to non-interest expense, we are working towards managing quarterly expenses at or below first-quarter 2013 levels for the rest of the year, and we are optimistic we can reduce the overall quarterly level of non-interest expense by about 5% by the end of this year.

In looking at credit costs, we identify the primary three as our provision for loan losses, our rep and warranty expense and our asset resolution expense. We remain cautious about regarding losses embedded in our loan portfolio as we continue evaluating loans with potential payment shock and characteristics. As such, taken together, we expect credit costs for the next quarter to remain a key challenge at current or just slightly higher levels.

With that, I will turn it back to Mike Tierney, our CEO, for the question-and-answer session.

Mike Tierney - *Flagstar Bancorp - President, CEO*

Great. We are happy to entertain questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Paul Miller, FBR.

Paul Miller - *FBR - Analyst*

Thank you very much. Paul, on the expense side, that is one of the areas I think we were a little under relatively speaking, and I think it was mainly [due] to legal costs. You talk about the expenses being down 5%. Can you give some color to where you think the legal costs shake out over the next couple quarters?

Paul Borja - *Flagstar Bancorp - EVP, CFO*

This is Paul. Thanks, Paul Miller. With respect to the overall legal costs, we are continuing to evaluate the litigation. I think that in the context of legal expenses, I think folks are aware that we had a higher level of legal expenses in Q4 and Q1 of 2011 and 2012, respectively, with respect to the Department of Justice analysis. We have also experienced higher-level legal costs we discussed earlier in Q4 of 2012, as well as Q1, based upon publicly-available information regarding our ongoing litigation.

At this point, we are modeling -- we are looking towards legal expenses as I presume the same level. We are not in a position now to discuss the level extent either in total or by type of litigation, although we do acknowledge that we have incurred quite a bit in the past and it might seem a little outsized.

Paul Miller - *FBR - Analyst*

So I mean, not to put words in your mouth -- so expect the same level for the next couple quarters until things kind of calm down?

Mike Flynn - *Flagstar Bancorp - EVP, General Counsel*

This is Mike Flynn, the General Counsel. We cannot project out to the future all legal fees involved in the litigation, which is the biggest driver of our legal fees at the present time. We are presently involved in several large pieces of litigation, which have been publicly reported and are ongoing. And we are incurring the expenses in those cases, but those expenses obviously vary from month to month depending upon the activity in the case.

Paul Miller - *FBR - Analyst*

Okay. And then moving on -- I missed the first 5, 10 minutes of the call. I was in a meeting. Can you talk a little bit about your gain on sale margins and where things are improving? The 10-year is down like 30 bps over the last month, which usually means that is beneficial for gain on sale. Can you talk a little bit about your gain on sale this quarter?

Matt Kerin - *Flagstar Bancorp - EVP, President of Mortgage Banking Division*

As you know, the industry was down overall, and we were down probably a little bit more than the industry, in part because of the seasonality, in part, because of the upward movement in the 10-year, which caused a slowdown, which further compresses margin, especially when there are ones that were increasing their buying into the market share, which we chose not to do.

But with the recent improvement in the 10-year, we've seen a significant uptick in registrations, which we've been experiencing over the course of the quarter, as well as our ability to price through some of the anomalies that took place in the first quarter with respect to some of the secondary activities and the implementation of the G-fee.

So I think that it is -- we are very optimistic, while not -- we're pleased with necessarily the performance in the first quarter, we see a number of positive trends as we enter into the second quarter, including increased registration, strong margins, that we believe will put us back on track to where I think people will be comfortable.

Paul Miller - *FBR - Analyst*

Thank you very much, gentlemen.

Operator

Kevin Barker, Compass Point.

Kevin Barker - *Compass Point - Analyst*

Your provisions for reps and warrants came down to $17 million from $25 million and you released $8 million worth of reserves, while the pipeline has come down. However, repurchase demands have increased roughly 20%. Could you help us understand why there would be a reserve release as demands are increasing?

And you mentioned a change in that GSE review process the last couple quarters. Can you help us understand how the review process has changed and what your expectation for losses are going forward?

Paul Borja - *Flagstar Bancorp - EVP, CFO*

Sure. This is Paul Borja. You know, with respect to the second part, we have had increased demands in file pulls, as we've indicated on the chart. I believe it was one of the earlier charts within the slides -- 14.

And with respect to that, we see that the increase -- we talked about heightened scrutiny from the GSEs as they transition to the recent process. You may recall back in September of 2012, the GSEs announced that they would be implementing a new review process effective January of 2013. That continues to be a process that they are implementing at the same time. We understand, as others do who deal with the GSEs, that there are going to be increased demands as they go through that process.

So we are working through our existing population of repurchase requests. We've had a $37 million decline, Kevin, as you see in the chart, in total repurchase pipeline. We think we've put good process improvements in place, as we've indicated in our earlier conversations or earlier conference calls. And with the process improvements, we think we can work through these influx of new demands on a timely basis and we'll remain in compliance with the agreements.

As far as overall mortgage putbacks, we've seen -- as far as overall mortgage putbacks, we've seen audit file pulls at an elevated level -- that is what you were looking at -- for the past two quarters. But that has yet, in our view, to systematically translate into higher demands.

We did see a surge in demands in mid-March, but however, since then, at least through mid-April, the rate of demand putbacks has normalized back to levels seen prior to March. In addition, the demands from Fannie in March were 56% of make-wholes versus a low of 20% that we typically see. We experienced a higher loss on make-whole demands versus repurchase demands. So in the interim, we are expecting slightly higher net charge-offs, where we are working through this mix in our current pipeline.

April, so far, has trended back to normal levels, with make-whole demands making up roughly 23% of total demands, so a significant drop-off. So we are expecting net charge-offs to stabilize a few months out as we clear out our existing pipeline.

Kevin Barker - *Compass Point - Analyst*

But do you see an endpoint eventually down the road? Do you see the light at the end of the tunnel for reps and warrants? (multiple speakers) some color around that.

Paul Borja - *Flagstar Bancorp - EVP, CFO*

Well, I think that what we are not prepared to do is sort of a first horizon statement said that says we've got everything in there. I think that, as pretty much everybody else has said during the course of their calls this season, we are carefully monitoring the progress and addressing it. And what we want to do in the meantime is be as transparent as possible, which is why we've increased the amount of information within our slides and within these calls.

Kevin Barker - *Compass Point - Analyst*

Okay, thank you. And concerning capital, you submitted a capital plan to the OCC this past quarter. Can you just give us some color around that, and when you expect to hear back from the OCC and what that process entails? And just some color around the OCC capital plan.

Sandro DiNello - *Flagstar Bancorp - EVP, Chief Administrative Office and President of Flagstar Bank*

This is Sandra DiNello. Yes, we submitted the capital plan, kind of a first version of it, and at this point, we are working through discussions with the OCC and getting their feedback. But we are very, very satisfied with what we've been able to accomplish there with our discussions with the regulators, and we think we're in good shape on that front.

Kevin Barker - *Compass Point - Analyst*

Do you expect to hear back soon, or is that something that is like a work in process (multiple speakers)?

Sandro DiNello - *Flagstar Bancorp - EVP, Chief Administrative Office and President of Flagstar Bank*

It is clearly a work in process. There is no timetables for these things. But there is ongoing dialogue with the regulators and we feel very positive about the relationship that the new management team has put together with the OCC, the [CFPBM], the Fed and the FDIC. We've worked very hard at making sure that they are partners with us and we feel real good about that relationship.

Kevin Barker - *Compass Point - Analyst*

Okay. And do you have any thoughts or plans around TARP repayment, given the coupon stepup in the beginning of next year? Is there anything you could provide there on what your plans are for TARP?

Paul Borja - *Flagstar Bancorp - EVP, CFO*

As you know, the preferred stock that was previously held by the US Treasury as part of the TARP program was successfully auctioned off in the course of March. And that was -- as you know, the Treasury issued a press release announcing all of that.

And so going forward, the preferred stock is now in the hands of private investors, and therefore out of the TARP program. We do still have that preferred stock and we do consider that -- we are considering that, Kevin, as part of our overall capital plan, to which Sandro was referring. So we are still looking at that, and we will probably have some more information down the road.

Kevin Barker - *Compass Point - Analyst*

Okay. Thank you very much.

Operator

Marc Steinberg, Dawson James Securities.

Marc Steinberg - *Dawson James Securities - Analyst*

Good morning. I heard a few times mentioned about trying to pick up market share, but I don't really think I heard anything specific as to how the Company expects to pick up market share. And if you can go into a little bit of detail about that, I would appreciate it.

Matt Kerin - *Flagstar Bancorp - EVP, President of Mortgage Banking Division*

Absolutely. This is Matt Kerin. We have obviously been fairly successful in increasing our market share over the last several years. And while we had a downturn in the first quarter, there were a number of factors that we referenced earlier.

But we have taken a number of steps throughout the quarter that are starting to demonstrate some results, at least based on the early indications of April.

We have continued to improve our customer service levels and retain current staffing levels, unlike some of our peers, so that our turn times were competitive or supercompetitive, because that is one of our value-added propositions.

We continue to focus on our core markets, like California, which are areas that are strong HPI growth regions that will help us as we migrate to more a purchase-focused environment.

We have held a consistent pricing strategy, and we believe that will help us regain shares. Others eased their pricing from the approach that they took in the first quarter.

In addition, we continue to open up -- expand our -- prudently expand our home lending business activities, which is heavily purchase-market focused. And in the first quarter, we opened up 10 new home lending centers in nondominant wholesale markets for us.

Marc Steinberg - *Dawson James Securities - Analyst*

And do you expect to see the California market make a significant difference for you?

Matt Kerin - *Flagstar Bancorp - EVP, President of Mortgage Banking Division*

We've always had a strong presence in California, in part because of our seasoned sales force and our long-standing customer base. And we believe that will continue to be a significant part of our efforts.

Marc Steinberg - *Dawson James Securities - Analyst*

Thank you.

Operator

(Operator Instructions) Robert Drenk, Optimum First Mortgage.

Robert Drenk - *Optimum First Mortgage - VP*

Hello, guys. This is Robert Drenk. I'm with Optimum First, as she said, which I believe we are the top broker in relationship to Flagstar Bank, and we are based out of California.

This was more a response to the gentleman's last question you just had, in the California market. In regards to purchases, with Flagstar, what are you guys doing -- A, of course, what are you guys doing to increase the mortgage trade here in California in purchases? That seems to be a really big opportunity for Flagstar. And then I'll go on with my comment.

Matt Kerin - *Flagstar Bancorp - EVP, President of Mortgage Banking Division*

I think what we are doing is really trying to put a forward-looking attitude in the entire Company, so that we are, one, streamlining the turn times on our purchase activity. We've always prioritized our purchase business. We are putting more of a focus on prioritizing our purchase business.

We are ensuring that we have AMCs and appraisers that are in tune with the markets, so they can be responsive to the needs of the customers. And we are constantly looking at the strengths in particular markets and working with our underwriting and processing teams to eliminate some of the inefficiencies that developed over time as we were processing a significant amount of refinance volume.

So I think it's a combination of processing efficiencies, good, strong customer service, problem resolution in terms of areas where a loan may get off the tracks, if you will, so that we can restore confidence in the marketplace that there is a certainty of execution when they come to Flagstar.

Robert Drenk - *Optimum First Mortgage - VP*

Got you. And (inaudible) the refinance arena, obviously, the rates ticking up had a (inaudible) even in our business, which seem to have about a 30%, 40% falloff.

But in regards to you guys, Flagstar as a bank does a great job. It's definitely our go-to bank. You guys do a great job of making sure you are leading, the best interest rates out there, the best systems, the best customer service. We are, as you guys are, seeing a big uptick in volume right now compared to last quarter as well. So keep up the good work and thank you.

Unidentified Company Representative

Thank you. We are going to continue to invest, and thank you for your business.

Operator

Jim Fowler, Harvest Capital.

Jim Fowler - *Harvest Capital - Analyst*

Good morning. Thank you for taking the question. One clarification, I guess, just ironing out my understanding. With your reference to the impact on guaranty fees, my understanding is that increases in guaranty fee announcements are made and go in effect 90 days hence, and a lender is protected on their current pipeline. So I guess I am a little lacking in understanding why the increase to guarantee fee would have an impact on sale margins, unless you were not able to push that through in price 90 days forward, and given the protection you have on your pipeline.

The reason why I ask the question is to get some view on what the impact might be in the impending 20 basis point guarantee fee that we continue to hear about that -- my understanding is that is being discussed with lenders right now, that it will be announced at some point in the near term and will have, again, a lagged impact.

But if the last one caused a disruption in your margin, as you've stated, I'm wondering if it might similarly -- if the next one might have an equal impact in the linked second-quarter, early third-quarter to margins. Just any thoughts there would be helpful. And then I have one more question.

Matt Kerin - *Flagstar Bancorp - EVP, President of Mortgage Banking Division*

This is Matt Kerin again. One, we are not in a position to talk about discussions with the GSEs on potential future G-fee increases. But relative to your question on the first quarter, we did not have the price protection in place at the time. We are since in the process of looking at that as an option so that we can avoid what I would call the one-time interest-rate impact on our pipeline.

Nonetheless, because -- we introduced our G-fee increases sooner than others that had the protection, and so therefore, we were early on and that impacted our margin and our production. So we were kind of hit twice with that. We do not anticipate that happening going forward.

Jim Fowler - *Harvest Capital - Analyst*

Okay. And then one question on your building out your home lending center infrastructure. How do you -- assuming now that refis at some point will wane a bit and everybody -- the larger lenders, the more efficient lenders and also the smaller lenders that would like to kind of remain at some level of vibrancy -- become more competitive in terms of pricing. Why do you think this is the right time to be putting in place a broad infrastructure to originate purchase mortgages, if some of the larger, lower cost of capital originators will start to focus on that and some of the smaller guys that want to just stay in business and will cut pricing to the bare bones to do so, will also?

I mean, how does a midsize lender compete with competition coming from both ends, and how long are you willing to maintain the fixed cost structure in that environment?

Matt Kerin - *Flagstar Bancorp - EVP, President of Mortgage Banking Division*

Sure. This is Matt Kerin again. Let me offer a couple of comments. One, respectfully, I wouldn't suggest that we are a mid-size lender. We are a major lender in the industry from a share perspective, and that is a function of our capacity to produce loans.

With respect to the home-lending initiative, this is something we embarked on close to -- almost four years ago, when I first arrived, to strategically expand upon our existing home lending centers in areas of strong -- in today's environment, strong employment prospects and good HPI indicators, in markets where we are underrepresented in the wholesale TPO space.

The difference for us is that we do not have a brick-and-mortar expense associated that others may see in terms of branch banking and organization. So for us, it is really a very quick return on investment. In fact, it is as good a return on investment as probably anything you could probably put your money into from a capital investment.

The cost of entry for us is de minimis. We have the platforms. We have the technology. It is a function of bringing people on that want to come to Flagstar because we are known in the marketplace, we have a good reputation for being nimble and for basically providing certainty of execution, which really drives the purchase business. And we see the purchase opportunity as something that's going to continue to grow as the refinance activity begins to slow, whether it is this year or next year.

Jim Fowler - *Harvest Capital - Analyst*

Thanks, Matt. Appreciate it.

Operator

Bose George, KBW.

Bose George - *KBW - Analyst*

Good morning. When I look at that slide 14 again on the rep and warranty, was the increase there driven by new loans, as the GSEs are auditing kind of on the front end? Or is it still kind of the older books that are driving that?

Paul Borja - *Flagstar Bancorp - EVP, CFO*

This is Paul Borja. When we take a look at the pulls that we -- are we taking a look on 14 at the --?.

Bose George - *KBW - Analyst*

At the pulls, yes.

Paul Borja - *Flagstar Bancorp - EVP, CFO*

So the file pulls we are looking at are going to prior vintages, not the most recent vintages, as they continue to go through the older books. So a lot of these are -- and I know Matt Kerin is also working directly with this, so he'll comment as well -- but a lot of these are going to be files that we are seeing that we already looked at in the past.

Matt Kerin - *Flagstar Bancorp - EVP, President of Mortgage Banking Division*

This is Matt. We are seeing a combination. The vast majority of the increase in the pulls are, for lack of a better way to describe it, I think a bona fide effort from the GSEs to take one final look at a legacy book or a more comprehensive look, largely focusing in the modified loan space.

But we still continue to see a review of the current book or post-2009 book, if you will, on a regular basis, although it is not a meaningful part of the percentage.

I think if you read the verbiage that has been published out there through the FHFA and from the GSEs themselves, the intent is to move forward at some point, probably towards the end of this year or early next year, towards the new model, which would be a heavy focus on the current originations, so that the industry doesn't get stuck in the quagmire that we've experienced the last couple years about looking at loans that are seven years old. So we are still seeing a heightened level of pre-2009 books, but we would expect that to continue to move in the opposite direction as they implement the new model.

Bose George - *KBW - Analyst*

Okay. And then actually, did you say that sort of the conversion rate from a pull to a repurchase demand is kind of lower on the recent ones?

Matt Kerin - *Flagstar Bancorp - EVP, President of Mortgage Banking Division*

Clearly, you have more success with the more current vintages in terms of where you are going. So we think that should continue as a trend. The other issue is your severity of loss should come down as well, as the economy is improving and your make-wholes are less and your actual losses on repurchases.

From a perspective of the performing books, we've had -- if you look at our 2010 post vintages, it is a really significant number of repurchases. And other than a miscoding in a program, it is largely -- they are performing loans.

Bose George - *KBW - Analyst*

Okay, and then on the servicing revenue, the comment you made about the hedging challenges, I was just curious if you could quantify the impact there.

Matt Kerin - *Flagstar Bancorp - EVP, President of Mortgage Banking Division*

I think it was about a $5 million quarter-over-quarter delta in the actual return on the hedge. And obviously, that -- or return on the hedging activity from the servicing asset. I think it just had to do with some of the volatility that we experienced. We did have a pretty rapid uptick in the 10-year, I think probably in the middle of February or early February, that happened pretty quickly -- overnight.

Bose George - *KBW - Analyst*

Okay, great. Thanks a lot.

Operator

(Operator Instructions) Kevin Barker, Compass Point.

Kevin Barker - *Compass Point - Analyst*

In your third quarter 10-Q, you mentioned wholesale relationships were about 1800 brokers and then you had about 1400 correspondent lenders. And then those numbers came down by about 100 brokers and about 100 correspondent relationships in the 10-K. Has that number changed, or are you growing or shrinking the amount of relationships you have with brokers and correspondent lenders?

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Matt Kerin - *Flagstar Bancorp - EVP, President of Mortgage Banking Division*

We are constantly evaluating our correspondent broker relationships, both from an efficiency perspective, the quality of loans we get and there is just a natural attrition. There is also a pruning based on performance and loan characteristics. So we consistently and have done so are adding new brokers and correspondents and eliminating others, in part for production reasons, in part for quality reasons. It could be any number of factors. But I think you will continue to see a gradual reduction in our overall number of customers.

Kevin Barker - *Compass Point - Analyst*

Paul, you mentioned that credit costs will be elevated in the second quarter due to payment acceleration. Could you just give some color on that, and how that's going to play out over the next couple quarters?

Paul Borja - *Flagstar Bancorp - EVP, CFO*

I'm sorry, Kevin -- payment acceleration, you are saying?

Kevin Barker - *Compass Point - Analyst*

You said -- I missed that comment at the end of your prepared remarks.

Paul Borja - *Flagstar Bancorp - EVP, CFO*

With respect to credit costs for Q2, what I mentioned was that we expect there to be continuing challenges with respect to our portfolios. And what we talked about was that we are continuing to look at loans that have potential payment shock characteristics, such as our interest-only loans. So as we continue to look at that and as we continue to work through our portfolio, what I mentioned was that we expect our credit costs for Q2 to remain a key challenge, and so we would expect it to be at current or just slightly higher levels.

Kevin Barker - *Compass Point - Analyst*

Okay. Are most of the IOs having payment shock in the next few quarters, or is that -- is that mostly a 2013 event or a 2014 event?

Paul Borja - *Flagstar Bancorp - EVP, CFO*

Just to make sure we have all that kind of information out -- because your question is a good one; it is asked by a number of folks -- we actually broke it out by vintage in the 10-K. And then we expect to in the 10-Q that we are filing soon to break it out again. So it will be a quarterly presentation, and we may want to start doing it during the earnings call, where also it is readily available. So we do see, as a lot of others do, 2014, 2015, 2016 shocks based upon that disclosure.

Kevin Barker - *Compass Point - Analyst*

Okay. I appreciate it. Thank you.

Operator

(Operator Instructions) We have no further questions in the queue, and I will turn the call back over our presenters for any additional or closing remarks.

Mike Tierney - *Flagstar Bancorp - President, CEO*

All right. Thank you all for joining us today, and we'll look forward to talking to you in another quarter.

Operator

That does conclude our conference for today. Thank you for your participation. You may now disconnect.
