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FBC - Q1 2017 Flagstar Bancorp Inc Earnings Call

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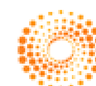

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Flagstar Bank First Quarter 2017 Earnings Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Mr. David Urban, Director of Investor Relations. Please go ahead, sir.

David L. Urban - *Flagstar Bank, FSB - SVP and Director of IR*

Thank you, and good morning. Before we begin, I would like to mention that our first quarter earnings release and presentation are available on our website at flagstar.com.

I would also like to remind you that any forward-looking statements made during today's call are subject to risks and uncertainty. Factors that could material -- materially change our current forward-looking assumptions are described on Slide 2 of today's presentation, in our press release and on our 2016 Form 10-K and subsequent reports on file with the SEC.

We are also discussing GAAP and non-GAAP financial measures, which are described in our earnings release and in the presentation we made available for this earnings call. You should refer to these documents as part of this call.

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

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

Thank you, Dave, and thank you, everyone, for joining us today. In addition to Dave, I am joined this morning by: Jim Ciroli, our Chief Financial Officer; Lee Smith, our Chief Operating Officer; and Steve Figliuolo, our Chief Risk Officer.

I'm going to start the call by providing a high-level view of our performance for the quarter, then I'll turn the call over to Jim for details on our financial results. Lee will follow with a review of our business segments and strategic initiatives, and I will conclude with guidance for the second quarter before opening up the lines for questions.

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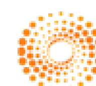

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We were pleased to turn in another good quarter. The combination of seasonality and rising interest rates made for not just a challenging first quarter but maybe the most challenging 6-month run for mortgage revenue that I can recall in our history. This type of volatility in the mortgage business and the associated revenue risk is what caused us 4 years ago to start to change Flagstar's business model. That's why we built a strong banking business. That's why we made a commitment to the servicing business, and that's why we had a very successful quarter, solidly beating almost everyone's estimate of what our earnings would be.

I've been saying that we are no longer just a mortgage company for a long time. I believe that our results for the last 6 months, given the volatility in interest rates and mortgage volumes, is proof of that. Make no mistake, we are a mid-sized bank, operating on a national basis with an incredibly strong mortgage business. This business model has produced an adjusted ROA in excess of 1% over the last 12 months, not because of mortgage revenue but despite relatively low mortgage revenue.

Our community bank continues to produce solid earnings growth, especially in commercial and mortgage loans held for investment. C&I and CRE growth has been very strong, increasing 11% from the prior quarter and 58% from the same quarter end last year. While some other large warehouse lenders struggle to overcome balance declines, the loan growth we were able to achieve through the many asset acquisition options we have, allowed us to almost completely offset a very tough quarter for warehouse loans, which was significantly impacted by the drop in line usage and reductions in days online.

We also took advantage of a stronger market for mortgage servicing rights by selling over $250 million of MSRs already this year, $65 million closed in Q1 and the rest will close in Q2. These sales have significantly reduced the MSR risk on our balance sheet and freed up capital for other investments in the franchise. I couldn't be more pleased with the way we've navigated through what was a very difficult MSR environment last year and how we have quickly taken advantage of a more favorable market this year. This [plan] is a hallmark of the way we have rebuilt and managed this bank, and the benefit of that discipline is clearly reflected here.

The big strategic news of the quarter was our 2 acquisitions. First was the purchase of a delegated correspondent business from Stearns Lending, which closed on February 28. This was an opportunistic acquisition with a payback of less than 1 year that allows us to become a leader in the mandatory bulk correspondent business, which was our weakest TPO channel, and more importantly, supports our goal of protecting mortgage revenue. Second is the pending acquisition of Opes Advisors, which we expect to close in Q2. For some time, we have signaled our interest in acquiring a high-quality retail mortgage originator and Opes fits the bill perfectly. This combination of 2 strong companies provides benefits to both sides. Opes will have the backing of a highly capitalized parent that can help expand to the entire country what it has done so well in California, Oregon and Washington. Flagstar will have a best-in-class retail origination platform on which to build that should pay for itself in 3 years or less.

Further, Opes will help us make headway on our goal of achieving a better balance between retail and third-party originations. It will add about 160 experienced loan advisors and 39 retail locations in very attractive markets. And because Opes has a wealth management arm that works closely with its mortgage business, its customers tend to be affluent, high balance with high FICO scores. Plus, it has an attractive product mix with jumbos making up about 40% of its production. This will provide us with an outstanding source of high yield, high-quality loans for portfolio and an excellent base from which to begin building a high quality non-QM portfolio.

I started my comments today by saying that this was a good quarter. Actually, it was a terrific quarter. We produced strong earnings, reduced our MSR exposure significantly, agreed to buy 2 complementary businesses that don't rely on cost-cutting to make sense, continue to grow reliable community bank revenue and increase total mortgage revenue.

Let's put this in perspective. In 2012, we averaged $250 million in gain on loan sale per quarter. This quarter, gain on loan sale was $48 million, and we were much more profitable. So it's pretty clear that we have firmly planted our flag in the future. We are profitable, we are well capitalized, and we are growing, albeit carefully, thoughtfully and strategically, within a disciplined and compliant structure.

With that, my colleagues will take you through a more detailed discussion of our financials and operations. First up is Jim.

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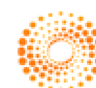

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James K. Ciroli - *Flagstar Bancorp, Inc. - CFO, EVP, CFO of Flagstar Bank and EVP of Flagstar Bank*

Thanks, Sandro. Turning to Slide 6. Our net income this quarter was $27 million, $0.46 per share as compared to net income of $28 million, $0.49 per share last quarter. Our earnings this quarter were led by relatively stable net interest income, increased mortgage revenue and good expense control.

Our return on assets was 0.8% and we returned 7.9% on common equity. These metrics were impacted by the seasonality of the mortgage business. If we look back at the last 12 months, adjusted for Q3's DOJ gain, we had an adjusted ROA of 1.0% and an adjusted ROCE of 10.7%. We continue to make good progress on reaching our long-term financial targets.

Let's turn to Slide 7 and dive deeper into the income statement. Net interest income this quarter fell $4 million compared to last quarter. Two factors drove this decline: first, we had a benefit of $2 million last quarter when we terminated certain FHLB borrowings, which did not recur; and second, there were 2 fewer days in Q1 compared to Q4, which was worth $2 million.

Otherwise, net interest income was flat as a contraction in earning assets was offset by a slight expansion of our net interest margin, net of last quarter's FHLB termination benefit.

Anticipating a contraction in warehouse loans, we grew all other remaining loan categories by 6%. Further, we extended turn times on our loans held-for-sale, boosting net interest income. We have the balance sheet flexibility and ample liquidity to hold these loans in order to fully invest our capital as other parts of our earning assets seasonally wane.

Despite the partial offset in gain-on-sale revenues, we actually net a positive amount of income with this tactic due to the arbitrage between the benefits of holding the loan in the short-term cost of funding and the cost of hedging.

As I mentioned, excluding last quarter's FHLB termination benefit, our NIM increased 6 basis points, attributable to the rate hikes at the end of 2016 and to a lesser extent, March 2017.

The provision for loan loss totaled $3 million this quarter, matching our nonsale related net charge-offs. Asset quality continues to be strong, and I'll provide additional detail in a couple of slides.

Non-interest income increased $2 million or 2% to $100 million this quarter. Total mortgage revenue increased $10 million as an improvement of $19 million in the net return on our mortgage servicing asset was partially offset by lower net gain on loan sales. This improved performance was partially offset by a decline in loan fees and charges.

The net return on the mortgage servicing asset was a gain of $14 million this quarter as compared to a loss of $5 million last quarter. We saw positive results from our decision to hedge market implied volatility more fully.

Market conditions continued to strengthen this quarter, benefiting the valuation of this asset by $5 million. This result was further corroborated by the sale of a significant portion of our remaining MSR at a breakeven price.

First quarter net gain-on-loan sales fell $9 million or 16%. The decrease largely reflected the incremental hedging costs of the tactic I mentioned before of holding loans held-for-sale a few days longer and a slight decline in volumes, excluding the $0.3 billion contributed from the delegated correspondent acquisition, albeit with a lower margin.

The R&W benefit was $4 million this quarter as the R&W reserve fell to $23 million. The results of continued improvement in risk trends and the repurchase demand pipeline that was only $6 million at quarter end.

Moving now to expenses. Noninterest expense decreased 1% to $140 million this quarter compared to $142 million last quarter. Overall, an $8 million drop in mortgage volume-driven expenses was largely offset by a $6 million increase in seasonally higher benefits expense and $1 million of acquisition-related costs.

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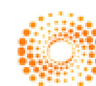

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Reflecting these costs, the company's efficiency ratio was unchanged at 77%. The company's effective tax rate this quarter was 33%. We don't anticipate that either of the acquisitions will impact our overall effective tax rate.

Slide 8 highlights our average balance sheet. Average earning assets decreased $0.5 billion or 4%, as a decline in warehouse loans was partially offset by growth in other parts of our loans held for investment portfolio. The results of how we acted can best be seen by looking at our quarter-end balance sheet and comparing it to our year-end balance sheet. While our warehouse loan portfolio contracted approximately $400 million point to point, we grew other commercial loans as we had nice growth opportunities in both the CRE and C&I portfolios. We grew residential first mortgages by adding higher-quality jumbos to our portfolio. And finally, we pulled forward investment securities purchases we plan to make in mid-2017.

At the end of the first quarter, we find that loans held for investment are approximately $300 million higher than they averaged during the quarter, setting us up well for net interest income growth in Q2.

Average deposits decreased $438 million or 5%, led by lower company-controlled deposits. This decline was partially offset by a 2% rise in retail deposits, where we were able to grow consumer savings accounts and keep the cost of resale deposits flat, despite rate hikes by the Fed at the end of Q4, and again at the end of Q1.

We continue to maintain strong liquidity in the quarter. As we look to the company-controlled deposits, the escrow balances that we hold at the bank to fund our most liquid assets, that is loans held-for-sale on warehouse loans, we also use short-term FHLB borrowings to fund these assets as they match well with the very short turnover times of these assets.

As you look at the remaining non-warehouse loan portfolio then, it is only 66% of our non-escrow deposit base. This gives insight into how we manage our liquidity position and also how much liquidity we truly have, because not all asset categories require the same liquidity. It's just another example of how much agility we have in our balance sheet due to our business model.

At March 31, our common equity-to-asset ratio remained strong at 8.9% and our book value per share rose to $24.03 as we continued to compound our earnings. We'll cover regulatory capital level shortly.

We had $3.05 of real book value growth from 1 year ago, considering that $1.84 of that growth was used to bring dividends current on our now-redeemed TARP preferred stock.

Let's now turn to asset quality on Slide 9. Nonperforming loans declined $12 million to $28 million at the end of the quarter, reducing the nonperforming loan ratio to only 47 basis points. We sold $17 million of nonperforming loans during the quarter, and the absolute level of nonperforming loans at March 31 is the lowest we've reported in over 20 years.

Again, there were no commercial nonperforming loans.

Early-stage delinquencies also remained low. Only $5 million of consumer loans were over 30 days delinquent and still accruing, and there were no commercial loans at March 31 that were more than 30 days delinquent. Net charge-offs were $4 million this quarter, representing 27 basis points of loans compared to $2 million in the prior quarter or 13 basis points of loans. Net charge-offs this quarter included $2 million related to our loans of government guarantees.

At March 31, our allowance coverage remained at 2.4% of total HFI loans. Coverage remained strong at 2.9% of consumer loans and 1.9% of commercial loans.

Turning to Slide 10, capital also remained strong. Our Tier 1 leverage ratio was 9.3% at March 31, up 43 basis points from December 31 despite a 33 basis point cost from a higher phase-in requirement under Basel III. At this level, our Tier 1 leverage ratio has a 430 basis point buffer above the minimum level needed to be considered well-capitalized. We would expect to target this ratio as our constraining regulatory capital ratio to be in the 8% to 9% range over the long term.

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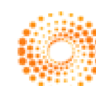

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When you review the other regulatory capital ratios, they're even stronger. Our CET1 ratio was 12.3%, a 580 basis point buffer above its respective well-capitalized minimum level. And our Tier 1 and total risk-based capital ratios have over 600 basis points of buffer to their respective well-capitalized minimums, well above peer averages.

These ratios are even stronger when reflecting upon the lower level of risk in the balance sheet, strong asset quality, relatively neutral market risk and robust liquidity and the high-quality risk management function we've built.

We continued to grow our regulatory capital at a pretax rate as we utilized our net operating losses.

At March 31, our Tier 1 leverage ratio was reduced by 122 basis points for the NOL related DTAs, now reflecting 80% of the deduction we would have under Basel III. We anticipate the elimination of this deduction over the next 2 years, given our level of profitability.

At March 31, MSRs in excess of the amounts allowable under Basel III reduced Tier 1 leverage by 123 basis points. On a pro forma basis at March 31, if we were to include all pending bulk sales, totaling $195 million of mortgage servicing rates, our MSR deduction would have dropped only 9 basis points, bringing 114 basis points back to capital. Thus, through MSR sales and continued profitability, we believe 245 basis points of capital could come back into regulatory capital over the next 1 to 2 years, providing an outsized level of internal regulatory capital growth during that period.

I'll now turn to Lee for more insight into each of our businesses.

Lee Matthew Smith - *Flagstar Bancorp, Inc. - COO, EVP, COO of Flagstar Bank and EVP of Flagstar Bank*

Thanks, Jim, and good morning, everyone. We're very pleased with our first quarter financial results as we again demonstrated the ability of our one-of-a-kind a model that generates solid earnings of $0.46 per diluted share, despite the typical seasonal slowdown in the mortgage business on higher interest rates environment suppressing both the amount of refinance originations and outstanding warehouse balances.

Interest income remained relatively flat quarter-over-quarter as we continue to add high-quality CRE, C&I and mortgage loans to our held for investment portfolio as well as extend turn times on our available-for-sale mortgage pipeline in order to offset the decline in interest income because of low warehouse balances.

Our business model, which enables us to generate high-quality interest-earning assets in multiple ways, strong capital position, robust liquidity and solid balance sheet, allow us these opportunities and levers.

Furthermore, we continue to execute on some key strategic initiatives that position us very well for the future, including we announced and closed on the acquisition of the Stearns delegated correspondent business during the quarter. This business produced approximately $7 billion of originations in 2016 from 250 correspondents. This was an opportunistic acquisition that strengthens an existing channel and introduces us to new correspondent partners that we may also be able to provide warehouse lending and other lending lines too. We can fund this business at a lower rate than a non-bank given our lower cost of funds, and given these are delegated or closed loans, the operational risk is more manageable as you are not underwriting and fulfilling the loans in-house.

We announced the signing of a definitive agreement just after quarter end to acquire the operating assets of Opes Advisors, a distributed retail mortgage originator based in the San Francisco Bay Area that originated approximately $3 billion in 2016. This pending acquisition fits our strategic goal of expanding our distributed retail mortgage business with a strong purchase market originator. Opes has 39 branches in California, Oregon and Washington, and we're excited about the high credit quality originations they produce. There is virtually no overlap with our existing distributed retail footprint, and we also believe this is a strong cultural fit for the bank.

We sold in bulk $65 million fair value of MSRs in the quarter, and have agreed in principle to sell a further $195 million in Q2 for a total of $260 million during the first half of the year. These actual or pending sales represent approximately $24 billion UPB in underlying mortgage loans. We will be the subservicer of the underlying loans for the significant majority of these sales.

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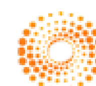

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We have previously talked about executing on an MSR reduction strategy, given the requirements of Basel III, and we are delivering on that plan. We executed on a $24 million UPB, NPL and scratch-and-dent sale just prior to quarter end, and a sale of approximately $70 million UPB of HELOCs just after the quarter end that were part of the legacy securitized trust.

As a result of these sales, our NPLs now stand at $28 million and we have no nonperforming commercial loans.

Our nonperforming assets -- total assets ratio is just 27 basis points as of March 31, and all other asset quality ratios are extremely favorable when comparing to peers. We believe our balance sheet provides a strong and clean foundation from which we will continue to grow.

As Jim noted, for the last 12 months, we've continued to make progress on our long-term financial targets, posting on adjusted return on assets of 1% and an adjusted return on common equity of 10.7%. We're off to a strong start in 2017 and feel we are well positioned to continue to grow and be successful across all 3 business lines in the future.

I will now outline some of the key operating metrics from each of our major business segments during the quarter. Please turn to Slide 12. Quarterly operating highlights for the community banking segment include in the first quarter, average commercial loans fell $690 million versus the prior quarter to $2.8 billion, led by an $852 million drop in warehouse loans from anticipated seasonal factors and lower refinance activity because of higher interest rates. The drop in warehouse loans was largely offset by continued solid gains in other asset classes.

Average commercial real estate loans increased $109 million or 9% while commercial and industrial loans grew $53 million or 7%. One of our strategic objectives is to continue to grow average commercial loans held for investment in order to balance earning contributions between the mortgage and commercial businesses, smoothing out earnings volatility.

We've introduced several new commercial lending business lines over the last year, including builder finance lending, MSR lending and equipment finance and leasing. We currently have $271 million in outstandings of builder finance loans, $91 million in equipment finance and leasing outstandings and continue to fund MSR facilities with further potential deals in the pipeline.

We also launched the syndications team during the fourth quarter of 2016 and are seeing good deal traction in this area.

During the first part of this year, we have also introduced the dedicated non-auto indirect lending channel and further built out our business banking capabilities as we introduce more commercial lending lines that can originate high-quality, interest-earning assets.

We believe these new business lines will complement our existing C&I and CRE lending channels, and we will continue to see solid, consistent growth as we move forward.

Furthermore, we can leverage these lending relationships to generate other synergies such as deposit growth, correspondent relationships through the warehouse business and subservicing opportunities. We added $249 million of high quality jumbo and conventional mortgage originations to our held for investment portfolio during the quarter, as we look to balance earning asset growth between various asset classes to reduce risk. And we also extended turn times on assets available for sale to further grow interest income.

Average total deposits fell $438 million or 5% in the quarter, led by lower company-controlled deposits given the higher interest rate environment reducing the amount in refinance activity.

Average retail deposits increased $98 million or 2% due to growth in consumer savings accounts. We remain focused on executing on several strategic initiatives to drive deposit growth, including our rebranding strategy that went into effect last year. Putting greater emphasis on bringing in deposits from commercial customers and leveraging our subservicing business for custodial and escrow deposits.

Looking forward, we believe we can continue to grow, as you've seen in our commercial businesses as we leverage the new lending channels while building on our core CRE and C&I businesses. We're very encouraged by the sustained growth in the community bank, our positioning and potential for the future.

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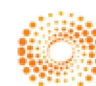

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Please turn to Slide 13. First quarter operating highlights for the mortgage origination business include: Fallout adjusted lock volume remained relatively flat quarter-over-quarter at $6 billion, as a reduction in refinance volume was offset by an increase in purchase volume. Mortgage closings declined 31% in the quarter as a result of the slowdown in production volume towards the end of last year, which also continued into the beginning of 2017 as a result of seasonality on the higher interest rate environment. Our net gain-on-loan sale margin fell 13 basis points quarter-over-quarter to 80 basis points. The decrease in margin was primarily driven by extending turn times and averaging in delegated volume from the Stearns acquisition for the month of March. We're encouraged by the quality of our originations and the work of our fulfillment and underwriting teams. Because of this quality, our repurchase pipeline is less than $6 million, the lowest it's been in many years.

We are also leveraging our direct-to-consumer business to provide recapture or retention services for clients we subservice loans for. This provides significant value to the owners of MSRs or the underlying loans, and is another way our business lines complement one another.

We believe the acquisitions of the Stearns delegated business and Opes Advisors are going to enable us to maintain and ultimately grow our market share in positioning in a mortgage market that's declining from approximately $2 trillion in 2016 to $1.6 trillion in 2017.

Furthermore, we believe our enhanced mortgage platform will also enable us to take advantage of further dislocation in the market as the refinance wave fades away. We're thrilled with our positioning as the fifth largest bank originator in the nation and are excited about what we can accomplish going forward, particularly given these 2 acquisitions.

Moving to servicing. Quarterly operating highlights for the mortgage servicing segment on Slide 14 include: For the second year in a row, we were named a Fannie Mae servicer, total achievement and rewards or star performer for 2016 in the General Servicing category, in recognition of outstanding performance and best practices. This recognition by Fannie Mae, our biggest customer for loan sales, reflects the extraordinary efforts by Flagstar servicing and customer engagement teams to deliver operational excellence for our customers.

We executed on the sale of $65 million fair value of residential MSRs during the quarter, and we have pending bulk sales of $195 million of residential MSRs under contract, with servicing retained at a breakeven price. We estimate our MSR to common equity Tier 1 ratio will be approximately 14% at the end of June as a result of these sales. We are executing on our MSR reduction strategy, which is capital accretive and generates noninterest fee income through the loans we subsequently subservice.

We currently service approximately 393,000 loans, of which 242,000 are subserviced for others, making us the eighth largest subservicer in the nation. The remaining 151,000 are loans where we own the MSR or that part of our HFI book. We remain focused on growing our fee income generating subservicing business, which has the capacity to service up to 1 million loans and executing on our MSR reduction strategy through efficient bulk and flow sales given the requirements of Basel III.

Moving on to expenses on Slide 15, our noninterest expense declined $2 million to $140 million quarter-over-quarter. Lower commissions and loan process in expenses of $8 million, which are tied to mortgage closings, were offset by higher compensation and benefits of $6 million. The higher compensation and benefits related almost exclusively to higher seasonal payroll taxes.

Slide 15 illustrates our cost discipline and how we've operated within a fairly tight range when it comes to expenses over the last 5 quarters. This is something we're very focused on as an organization.

Our efficiency ratio remained constant at 77% in the quarter versus the previous quarter as a $2 million decline in revenues was counteracted by a $1.5 million decline in expenses. However, we should be mindful of the following factors.

This quarter contained approximately $6 million of seasonal payroll taxes and $1 million of legal and professional fees related to our acquisition activities. If you were to adjust for these nonrecurring amounts, our adjusted efficiency ratio would be 73% for the quarter.

We continue to invest in growth initiatives across all of our major business lines, both organic and inorganic. And the revenues for organic initiatives, in particular, typically lag the cost investment.

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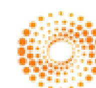

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Q4 and Q1 are the 2 quarters that were most impacted by seasonality in the mortgage industry. The seasonality this time has been further compounded by a rise in interest rates at the end of last year, which has reduced refinance origination volumes.

In fact, gain-on-loan sale at $48 million for the quarter is the lowest it's been since Q4 2015. Despite this, we've been able to grow interest income and flex our mortgage expenses appropriately to keep our efficiency ratio in the mid-70s.

When you consider these factors, we believe you are seeing the strength of our business model and how the growth of our commercial businesses over the last 2 years increased interest-earning assets, and variable cost model allows us to be profitable even in a challenging mortgage environment.

We previously stated that our targeted long-term efficiency ratio is in the mid-60s, and that remains our goal. Our immediate focus in achieving that goal is on growing revenues across all 3 major business lines while continuing to build on the cost discipline and risk management we've instilled throughout the organization.

We estimate noninterest expense will be between $147 million and $152 million during the second quarter of 2017. We're pleased with how we started 2017 and are excited for the future. We're delivering on our strategic plan and believe we have the right team in place that will enable us to generate continued strong returns for our shareholders.

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

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

Thank you, Lee. I'm now going to close our prepared remarks with some guidance for Q2 and then open the call for questions and answers.

We expect net interest income will increase 10% to 15% led by a 5% to 10% rise in period end earning assets, primarily warehouse and other commercial loans.

We anticipate a steady net interest margin with an upward bias resulting from the recent Fed rate hike. We expect a significant increase in gain-on-loan sale income on a seasonal rise in the mortgage market led by higher purchase originations.

We anticipate mortgage locks will increase 25% to 30%, excluding the impact of the Stearns acquisition. That acquisition should add $1 billion to $1.5 billion to our production total in Q2.

We expect a relatively stable gain-on-sale margin, excluding the acquisition-related volume. We anticipate the net return on MSRs will decline due to a significantly lower MSR balance and will approximate 4% to 6% on an annualized basis.

We expect loan administration income will increase slightly on higher subservice volume. We anticipate loan fees and charges will rise on higher mortgage closings while all other noninterest income will decrease slightly from Q1 levels. And as Lee noted, noninterest expense will increase to $147 million to $152 million.

This concludes our prepared remarks, and we'll now open the call to questions from our listeners.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll take our first question from Bose George with Keefe, Bruyette & Woods.

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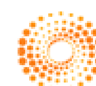

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Bose T. George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

The first one, just in terms of the capital that's going to be released from the MSR sale and the, I guess, the upcoming MSR sale, is that all going to be deployed immediately? Is it -- is some of that going to be used for Opes or is it just balance sheet growth?

James K. Ciroli - *Flagstar Bancorp, Inc. - CFO, EVP, CFO of Flagstar Bank and EVP of Flagstar Bank*

Bose, this is Jim. That's a good question. What I would tell you is that my numbers were, as of March 31, and trying to give you a sense of the potential capital release. We're going to continue to book more MSRs as we continue with production, and we'll sell those through the flow sales we have in place and opportunistically through bulk sales. The -- just to answer the other question, Opes is not going to be a significant drag to capital here.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

So Bose, we're going to continue the balance sheet growth as we had planned. This activity with the MSR sales does not -- was not done because we needed to release capital at this point. It was an opportunity to take advantage of the market situation, and we're not in the business of taking risks on MSRs. So when the opportunity was there to transact, we did.

Bose T. George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay, great, that makes sense. And if you just -- sticking to the acquisitions, are you still looking to grow on the mortgage side? Or does the focus shift a little more to what you can do in terms of the bank -- community banking side?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

Well, I think it's what all about what opportunities present themselves to us, Bose. We're not specifically looking to try to grow the mortgage business. But if the right situation presents itself, where we can bolt something on that helps us stabilize that revenue stream, we'll certainly do that. And on the banking side, we feel like we have a path to steady shareholder value growth. And so we're not feeling any pressure to do something on the bank side. That said, we're keeping our eyes and ears open. And if the right opportunity presents itself, one where we can actually add to our company and see accretion come from new revenue streams as opposed to cutting costs, we'll certainly take a look at that very closely.

Bose T. George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay, and just one clarification from Lee's comments. On the expenses, did you say that the $7 million of it was really driven by the acquisition, so ex -- if it wasn't for that expense, it will be $7 million lower?

Lee Matthew Smith - *Flagstar Bancorp, Inc. - COO, EVP, COO of Flagstar Bank and EVP of Flagstar Bank*

No, only $1 million was driven by legal cost around the acquisition, $6 million was seasonal payroll taxes.

Operator

We'll take our next question from Kevin Barker with Piper Jaffray.

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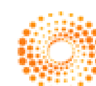

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Kevin James Barker - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

In regards to the Opes transaction, do you expect that to be accretive or dilutive to book value in the second quarter?

James K. Ciroli - *Flagstar Bancorp, Inc. - CFO, EVP, CFO of Flagstar Bank and EVP of Flagstar Bank*

It's dilutive. There is going to be a small amount of goodwill that we will book. So it will be dilutive to book value, but accretive to EPS.

Kevin James Barker - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

Okay, and then when you think about the, that acquisition, what is your expected payback period given the dilution to book value and the earnings accretion?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

I think I mentioned it in my prepared remarks. So we expect it to be 3 years or less.

Kevin James Barker - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

Okay. And then, in regards to the net results on the MSR this quarter, you mentioned a $5 million markup, and obviously, part of that was due to slower prepayments due to less voluntary prepayments this quarter. Could you give us the details on the shift from a negative $5 million up to a positive $14 million and then your expectations for MSR returns going forward?

James K. Ciroli - *Flagstar Bancorp, Inc. - CFO, EVP, CFO of Flagstar Bank and EVP of Flagstar Bank*

Yes. So great, Kevin, there is a page in the appendix that we normally put out, and it's there again this quarter. It's $38 million, and that gives you a pretty good detailed attribution of what the return was this quarter versus last quarter. And you can see down in the model changes, which really reflected this quarter, just market sourced inputs, the $5 million that I referenced in my speech. Other than that, I think what we saw this quarter was more of a return to normalcy versus last quarter, where I think, not only us but a lot of other people in the industry were fighting volatility.

Kevin James Barker - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

Right, so the main thing you're probably looking at is the runoff line that would have most of the volatility around that and everything else should be constant, is that a good assessment there?

James K. Ciroli - *Flagstar Bancorp, Inc. - CFO, EVP, CFO of Flagstar Bank and EVP of Flagstar Bank*

I wouldn't over focus on any single one of those lines. We gave them all to you for your benefit. I think the return that we would expect quarter in and quarter out, assuming that we've -- as we have, hedged up the exposure to the market implied volatility, is going to really be that gross return, and what's going to provide just more of a period-to-period discontinuity are the other 2 lines, the sales transactions and any model changes. But that being said, quarter-to-quarter, absent any -- anything unusual to that quarter, I'm looking at a 4% to 6% type of net return from those 3 lines. They're going to move some of those lines up above that gross return line, are going to move contrary to each other. So it's hard to focus on one line. But overall, you should get a 4% to 6% -- 4% to 6% return.

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Kevin James Barker - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

And then in regard to the warehouse lines, they've come down quite a bit. Obviously, that has a lot to do with the decline in origination volumes and closings in the first quarter. I was hoping you could just give us a little bit of color on the competitive dynamics in the warehouse market at this point?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

Well, Kevin, we've been in that business for 20 years. So we can do a pretty good job of predicting what we think is going to happen, given the fact that we've got 250 consumers that we do business with. And what we saw in the fourth quarter and end of first quarter was pretty consistent among all of those customers across the board. And what we think is that it bottomed out in February, we started to see the balances come up in March. So we think as the year progresses, and then originations continue to grow, we'll see balances get back to where we'd like to see them be. With respect to competition, sure, it is competitive, but I don't think it's any more competitive than any other asset class that we're involved with. And as you know, I always talk about service. And I think Flagstar offers one of the shortest [days] online in the industry. And so I think, over time, that's going to carry us and allow us to continue to grow our -- position, excuse me, in that important asset class.

Lee Matthew Smith - *Flagstar Bancorp, Inc. - COO, EVP, COO of Flagstar Bank and EVP of Flagstar Bank*

If I could just add, Kevin. I mean one of the synergies I mentioned in my prepared remarks of the Stearns acquisition, is they were doing business with approximately 250 correspondents. And so that gives us an opportunity to sell warehouse lending lines and other lending lines into those new correspondent partners.

Operator

We'll take our next question from Henry Coffey with Wedbush.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD for Specialty Finance*

In terms of looking at the sale of MSRs, greater than 50% is a good starting point. But when you sell an MSR, what -- basically, what percentage or retention are you seeing, losing the servicing versus keeping it in the subservicing business?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

As -- the results here, it's really good, and I'll let Lee give you the details.

Lee Matthew Smith - *Flagstar Bancorp, Inc. - COO, EVP, COO of Flagstar Bank and EVP of Flagstar Bank*

Yes, I mean, I think the numbers that we articulated, Henry, so $65 million in Q1, we've got $195 million or so of pending sales in Q2. We're going to be retaining the servicing on about 80% of both sales. It's a really high percentage where we're retaining the subservicing. So we're really pleased with that out.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD for Specialty Finance*

And you used the word breakeven. Is your subservicing business working towards profitability? Is it struggling? Is it profitable? Can you give us some insight into what the subservicing business looks like today?

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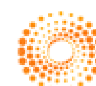

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Lee Matthew Smith - *Flagstar Bancorp, Inc. - COO, EVP, COO of Flagstar Bank and EVP of Flagstar Bank*

Yes, so that -- I think there's 2 parts to your question. When we referenced breakeven, that's in terms of where we've got the MSR marked on our balance sheet. So that's what we mean when we say breakeven. In terms of the profitability of servicing or subservicing, every increment or loan is profitable given our existing scale and each loan we add to our platform is at a low -- very low marginal cost.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD for Specialty Finance*

And then, focusing in on the bank -- as the bank sees a brighter future, what are the product areas that are -- that you're really interested in, in either -- adding either through sales efforts or through acquisitions?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

So I think Lee did a pretty good job in his portion of the speech in articulating those areas that we've already expanded to and then some of the newer ones that are coming online, such as the non-auto consumer and direct. So I think what he has outlined there is -- as far as I'm prepared to go today, in terms of what new lines we would consider, you might have also noticed that I mentioned non-QM mortgages, so that's another area that we would look to grow balance sheets. So we're looking at where the opportunity is in the marketplace, and where the right people are available to us. And then we're taking advantage of those opportunities to expand. And we do want to continue to be very disciplined in our level of asset exposure, capital exposure in each one of these asset classes. So we're going to continue to look for those, the right people to bring into the organization.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD for Specialty Finance*

Just a last follow up on that. Non-auto, indirect, is that loaning to major parties or regional parties? Or are you going out into the community and finding locally -- family-owned, furniture retailers, et cetera? How does that business actually work for you?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

Yes, it probably starts with bigger-ticket items like RV and Marine, and then maybe over time, segues into other things. But yes, this is going direct to the consumer through the dealer.

Operator

We'll take our next question from Scott Valentin with Compass Point.

Manuel Jesus Bueno - *Compass Point Research & Trading, LLC, Research Division - VP and Research Analyst*

It's Jesus Bueno for Scott. Just quickly on the gain-on-sale margin, I appreciate the color around the added Stearns business and the impact on margin. I guess as we factor in the Opes acquisition going forward, what should we expect as kind of the impact on margin? And I guess in terms of volumes, should we kind of expect similar production to last year? I think it was around $3 billion that they had in volume?

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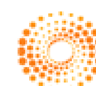

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Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

So we haven't provided any guidance relative to the Opes transaction. That hasn't closed yet, and so we've chosen not to provide any specificity there. You had noted likely that -- and accurately that last year, their originations totaled $3 billion, and they were largely purchase money mortgages. So you can take a shot at what you think it's going to be this year, given what's going on in that market. But at this point, we're not prepared to provide any specific guidance on the Opes acquisition.

Manuel Jesus Bueno - *Compass Point Research & Trading, LLC, Research Division - VP and Research Analyst*

Appreciate that. And just back to the question on capital return. Obviously, you've made a lot of headway with the MSR sales and recapturing some of the disallowed capital. Going forward, you still have the 100% phase-in on Basel III to look forward to, but given that you've put up this kind of long-term target on capital, it seems like you have a pretty healthy buffer there. I guess when do you start -- I guess when are you comfortable thinking about the potential for capital return, applying capital towards the, perhaps dividends and share repurchases and beyond, just [loan growth and] acquisitions?

James K. Ciroli - *Flagstar Bancorp, Inc. - CFO, EVP, CFO of Flagstar Bank and EVP of Flagstar Bank*

I think that it's something that we're aware many people would be interested in. And it's something that we're open to. What I would tell you is that we feel like we have some really nice capital investment options on the table right now. And in the future, we'll be considering whether there is an appropriate return that we should make to our shareholders of some of that capital as we continue to kind of compound that book value.

Manuel Jesus Bueno - *Compass Point Research & Trading, LLC, Research Division - VP and Research Analyst*

And regarding MSR sales, should we expect in terms of kind of the flow agreements you have in place, that, that should remain somewhat similar to what we've seen over the previous few quarters?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

Well, I mean, I think the last few quarters have been a bit different because of the market conditions, so we do have flow agreements and their shown, I think, on Slide 14, you can see how much comes from flow. And so that I think is something you can interpolate going forward what those numbers might be. But the bulk sales are opportunistic, and it's just really hard to protect what that might bring.

Manuel Jesus Bueno - *Compass Point Research & Trading, LLC, Research Division - VP and Research Analyst*

I'll just slip in one last one. Just on, kind of where you're targeting, where you'd like your UPB to be, as it relates to MSR. Do you have a target in mind? Or is it just -- you're going to be opportunistic about being able to do bulk sales along the way to kind of whittle that MSR down?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

Well, obviously, Basel III sets a bar that you want to be around, right? So you want it to be at 10% of capital, if you can be, but we're not going to focus so much on that, that we transact in an inefficient way. So that would be the ideal situation, to be able to create MSRs, dispose of MSRs, stay around that Basel III limit all the time. The truth is, it's very difficult to manage it that tightly. So it's just really hard for me to be specific about where we're going to be.

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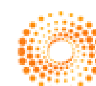

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Operator

And our final question will be from Jessica Levi-Ribner with FBR.

Jessica Sara Levi-Ribner - *FBR Capital Markets & Co., Research Division - Research Analyst*

A question around the M&A, you just noted that there's -- you see some good capital investments on the table. And I know some of that is through your lending channels, your different lending channels. But would some of that also be through more M&A?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

Well, I think that acquiring other companies, whether it's a mortgage originator, a bank, an asset based lender or any multitude of other opportunities, they're all out there and investment bankers are making us aware of opportunities all the time. But as I said in the past, we feel like we've got a path to steady and significant shareholder growth without M&A. So M&A has just got to make sense. And if it's not the right situation, not one that enhances our strategic objectives, we're just going to keep doing what we've been doing. And so far, that's worked pretty good, so I don't see any reason to change course.

Jessica Sara Levi-Ribner - *FBR Capital Markets & Co., Research Division - Research Analyst*

Okay. And if you were to do M&A, would you be more focused on the commercial side of the business versus mortgage, given the acquisitions you've done in the quarter? Or you're just kind of open to all options?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

Yes, I wouldn't say that there's a bias one way or the other. It's all dependent on what the opportunity is.

Jessica Sara Levi-Ribner - *FBR Capital Markets & Co., Research Division - Research Analyst*

And then one last one, the commercial loan growth. I know you gave little bit of guidance on the loan balance growth, but how do we think about, maybe the level of loan growth in the commercial side going forward? And which channels or which segment do you see the most promise in?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

Well, if you look at where the loan growth has been over the last, let's call it, 6 quarters, I think that, that's a pace that we think we can continue in a pretty comfortable fashion. And like we've done over that same period of time, it's been pretty balanced growth across various lines within C&I, CRE. And though we've had the decline in warehouse over the last quarter because of market situations, if you look past that, you'll see that there's been a steady growth in our warehouse business as well. So I would expect all of those different asset classes to grow in a fairly steady fashion. It's going to be lumpy within each one, but again, depending on where the best opportunity is. But I think the past is pretty good indication of what the future might look like.

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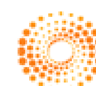

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Operator

Ladies and gentlemen, this concludes today's question-and-answer session. For final remarks, I would like to turn the conference over to Sandro DiNello, President and Chief Executive Officer.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President, Director, CEO of Flagstar Bank, President of Flagstar Bank and Director of Flagstar Bank*

Thanks, Keith, and thanks to everyone for your interest in Flagstar. Looking back at the quarter, I think an important storyline is how our business model operates to create options for us to succeed in virtually any economic scenario. The levers we have to adjust to a changing environment are arguably unmatched in a bank of our asset base.

As an example, which was front and center in this quarter, regardless of the environment for mortgage originations, we still generate billions of dollars of mortgage production every quarter, much of which we can unlock for net interest income or for portfolio growth. It's a value embedded in our business model that we can tap to mitigate seasonality or lower demand in other parts of the bank.

And while rising rates hurt us on the mortgage originations, they help the servicing business as was evidenced by the improved MSR return we experienced in Q1. Rising rates are also generally a sign of a better economy, which helps our banking business.

As an example this quarter, a stronger housing market, together with low housing inventory, helps boost our builder finance business.

Looking ahead, we will continue to increase revenue generated by our banking business. We will diversify the sources of mortgage originations. We will protect the revenue in our mortgage business, and we'll continue our path toward a high level of profitability and increase shareholder value.

As always, we remain ever mindful of risk management, vigilant on costs and conservative in our practices.

We appreciate the loyalty of our shareholders and their support for our business plan, and we thank our employees for all they do every day to make Flagstar a success.

Finally, thank you for your time this morning. I look forward to reporting Q2 results in July.

Operator

And ladies and gentlemen, that concludes today's conference. We appreciate your participation.

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