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FBC - Q2 2017 Flagstar Bancorp Inc Earnings Call

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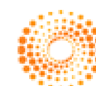

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PRESENTATION

Operator

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

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

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

Thank you, Mindy, and good morning. Well, before we begin, I would like to mention that our second 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 materially change our current forward-looking assumptions are described on Slide 2 of today's presentation, in our press release and in 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 and CEO, President & 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 also want to welcome Drew Ottaway to his first call. Drew was recently named our Michigan Market President and included in his responsibilities is the day-to-day management of our community banking business.

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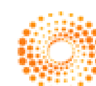

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I'm going to start the call by providing a high-level view of our performance for the quarter, then I'll turn the call over to Jim for details on our financial results. Lee will follow with a review of our business segments and strategic initiatives,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

We're pleased to announce net income of $41 million or $0.71 per diluted share in a quarter of many high points, including strong growth in commercial loans and net interest income, solid mortgage revenues and strong asset quality. Our community bank continues to produce outstanding results with good growth in all lines of business: commercial real estate, commercial and industrial and warehouse loans.

Once again, we achieved a new all-time high in net interest income totaling $97 million for the quarter, a 17% increase over the prior quarter. We saw a 14% increase in average earning assets, largely commercial loans and loans held-for-sale. We also saw a significant margin expansion in the quarter.

I could not be more pleased with the way we have been able to expand our margin and grow interest-earning assets. The steady progress we have made in these objectives has led to a more predictable earnings performance with less volatility, and in turn, a more valuable earnings stream.

Turning to servicing during the quarter. We closed on the previously announced bulk sales of more than $190 million of mortgage servicing rights, successfully executing our MSR reduction strategy and releasing capital to support further balance sheet growth. Lee will provide more color later, but it's noteworthy from a strategic perspective that we retain subservicing on approximately 85% of the servicing we sold and we've crossed the threshold of 400,000 accounts serviced or subserviced. We've said all along that we have expertise and capacity in servicing and want to build our subservicing business. We're executing on this strategy, sometimes in big steps, sometimes in small steps, but steadily and thoughtfully moving the ball forward.

Our mortgage business also had an outstanding quarter. Fallout-adjusted locks rose 50% to $9 billion. As expected, we closed on the acquisition of Opes Advisors during the quarter. The on-boarding of Opes in mid-May, coupled with the purchase of the delegated correspondent business of Stearns Lending in the first quarter, was a key driver of mortgage originations in Q2. Both acquisitions helped us maintain revenue in a softer mortgage origination market and Opes, in particular, positions us well in the attractive purchase mortgage market, which is where the industry is trending.

Both acquisitions are going well with minimal attrition of customers or employees. There's been good acceptance of Flagstar by the former Stearns corresponding customers and good synergies with both Stearns and Opes from a product perspective. Salespeople that have joined Flagstar from both Stearns and Opes have more products to sell, which is a win for everyone.

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

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

Thanks, Sandro. Turning to Slide 6. Our net income this quarter was $41 million, $0.71 per share as compared to net income of $27 million, $0.46 per share last quarter. Our earnings this quarter reflected continued transformation into a full service commercial bank as the performance our community banking businesses continued to contribute even more to the earnings stream.

The expansion of revenue from these banking businesses outpaced the growth in our mortgage businesses, even with the impact of a full quarter of our acquired delegated correspondent business and half a quarter of contribution from the Opes acquisition. Yet, as we've continued to message, the additional revenues from our community banking businesses came at a relatively low incremental cost as our expenses for the quarter came in about $5 million below the expectations that we provided on last quarter's call.

So let's turn to Slide 7 and dive deeper into the income statement. Net interest income this quarter rose sequentially to $97 million, representing an increase of $14 million or 17%. Two key factors drove this performance. First, average earning assets rose 14%, as capital generated by the MSR sales facilitated a 17% increase in average total commercial loans and 30% growth in our loans held-for-sale. Most encouraging was to see the contributions this quarter from our 2016 lending initiatives. Homebuilder, equipment finance and MSR lending all contributed meaningfully to

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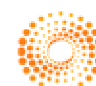

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this growth. A portion of the increase in loans held-for-sale was to support the RMBS securitization we launched yesterday, representing our entry into this activity and opening up for us a more efficient outlet market for our jumbo mortgage loan offering. Second, the net interest margin rose 10 basis points to 2.77% as we grew higher spread loan portfolios and enjoyed the full quarter benefits of the increase in short-term rates that occurred at the end of the first quarter. And yet, deposit balance

(technical difficulty)

I'll provide additional detail on a few slides. Noninterest income increased $16 million or 16% this quarter. Total mortgage revenue increased $10 million as an improvement of $18 million in net gain on loan sales was partially offset by a lower net return on the mortgage servicing asset. This improved performance was enhanced by an increase in loan fees and charges. The increase of $18 million in gain on sale revenues largely reflected a $3 billion or 50% increase in fallout-adjusted locks. The combined impact of 2 factors drove this volume increase. First, our acquisitions having, a, a full quarter of a delegated correspondent business we acquired from Stearns; and b, a half quarter of the distributed retail business from Opes, both of which together contributed $2.0 billion of this volume increase.

Second, we believe our legacy volumes outperformed the normal seasonal increase we saw in this year's second quarter as growth in our correspondent business and the expansion of our distributed retail business continued. Partially offsetting the benefit of this higher volume, a shift in mix and what we believe to be shorter-term market forces, drove the decline in the net gain on loan sale margin to 73 basis points.

The net return on the mortgage servicing asset was an annualized 11%, resulting in a gain of $6 million this quarter, despite approximately $2 million of transaction costs tied to the second quarter's MSR sales. Last quarter, we reported a gain of $14 million, which included a $5 million benefit from improvements in macroeconomic conditions.

Comparisons between the total amounts of net return in the 2 quarters were also impacted by the lower levels of MSRs in the current quarter, resulting from sales that we announced on last quarter's call. The performance above our anticipated 4% to 6% annualized return expectation resulted from a more stable prepayment environment and improvements in our hedging program despite continued surprises in the 10-year yield. The increase in loan fees and charges resulted from a higher level of mortgage closings this quarter. As a greater percentage of closings this quarter were from our delegated correspondent channels, the 33% increase in loan fees and charges was not quite as large as the 56% increase in closing volume.

Finally, the $1 million increase in other noninterest income included an R&W benefit of $3 million this quarter as the R&W reserve fell to $20 million, the result of continued improvement in risk trends and a repurchase demand pipeline that was only $4 million at quarter end.

Moving now to expenses. Noninterest expense rose 10% to $154 million this quarter as compared to $140 million last quarter. Excluding $11 million of operating expenses and $1 million of transaction costs attributable to the acquisitions, noninterest expense was $142 million, reflecting a greater degree of expense control and the low level of incremental costs from expanding our community banking revenues. The slight increase from the prior quarter, excluding the impact of the acquisitions, was primarily due to an increase in volume-driven expenses such as commissions and loan processing expense from higher mortgage closings. The company's efficiency ratio improved to 72% this quarter, reflecting positive operating leverage.

Finally, and despite the higher level of pretax income, the company's effective tax rate this quarter was 32% as compared to 33% last quarter, consistent with our projected long-term effective tax rate of 32% to 33%.

Slide 8 highlights the expansion of our average balance sheet this quarter. Average earning assets increased $1.7 billion or 14%, led by growth in loans held-for-sale and total commercial loans. Average loans held-for-sale increased $983 million or 30% in the quarter, the result of, a, higher mortgage activity; b, the warehousing of loans and support of the RMBS securitization we launched yesterday; and c, taking advantage of the ability to quickly deploy our capital into a portfolio that, this quarter, yielded 4%, directly funded by short-term FHLB advances at less than 1%, providing a spread that contributed to the expansion of our net interest margin.

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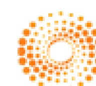

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Just as remarkable, average loans held for investment rose $585 million or 10%, over 80% of which came from commercial loans. The commercial loan growth was noticeable in its breadth, as each core component, CRE, C&I and warehouse, contributed plus or minus $160 million of the total increase. Diving deeper into CRE and C&I, the breadth of the increase continues and shows the dividends of the initiatives that we launched in 2016 of homebuilder finance, equipment finance and MSR lending.

The core Michigan-based middle-market CRE and C&I lending also continued their growth trajectories. Finally, we saw green shoots with regard to our Michigan-based smaller business initiatives. Our community bank continues to grow in a well-balanced, disciplined fashion. Average deposits remained virtually unchanged in the quarter. Higher company-controlled and retail deposits largely offset lower government deposits. Average retail deposits rose $32 million, led by a 4% increase in demand deposits. Importantly, this stability was in an environment where our retail bankers have met the challenges of increases in rates during each of the last 3 quarters. We continue to maintain strong liquidity in the quarter. We look to the company-controlled deposits, the escrow balances we hold at the bank, to fund our most liquid assets, 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.

So as you look at the remaining non-warehouse loan portfolio, it is only 73% of our non-escrow deposit base, providing a substantial runway for continued growth. This also gives additional 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 June 30, our common equity to assets ratio remained strong at 8.8%, and our tangible book value per share rose to $24.29 as we continue to compound our earnings.

We'll cover regulatory capital levels shortly. We had $0.75 of net tangible book value growth from 1 year ago, which is remarkable considering we spent $1.84 of book value to bring dividends current on our now redeemed TARP preferred stock. We also used $0.35 of book value in our 2 acquisitions this year. We believe that the rate of $2.94 in annual gross book value growth should bring an even greater amount of net book value increase in the future without these 2 factors present.

Now let's turn to asset quality on Slide 9. Nonperforming loans rose negligibly and stood at only $30 million at the end of the quarter, while the nonperforming loan ratio fell to only 44 basis points. Absolute level of nonperforming loans at June 30 remained near the lowest we've reported in over 20 years. Again, there were no commercial nonperforming loans at the end of the quarter. Early-stage delinquencies also remained low. Only $5 million of consumer loans were over 30 days delinquent and still accruing at June 30, unchanged from March 31. We ended up with a single commercial loan of less than $1 million that was more than 30 days delinquent.

Net charge-offs were negligible in the quarter, representing a scant 4 basis points of HFI loans. At June 30, our allowance coverage was 2.1% of total HFI loans, well above the coverage levels of any other midsize banking peer. Coverage remained strong at 2.5% of consumer loans and 1.7% of commercial loans. And our rep and warranty reserve remained robust, declining to $20 million as the metrics we use to measure our exposure in this area look great across the board.

Turning to Slide 10. Capital also remained a hallmark. Our Tier 1 leverage ratio was 9.1% at June 30, the second quarter in a row that Tier 1 leverage was above 9% despite the significant balance sheet growth during the quarter. In fact, balance sheet growth used 130 basis points of Tier 1 leverage capital. Achievable because earnings retention, including NOL utilization, supported 44 basis points of this growth and MSR reductions provided another 65 basis points. At this level, our Tier 1 leverage ratio has a 410 basis point buffer above the minimum level needed to be considered well capitalized. We would expect to target this ratio as our constraining capital ratio to be in the 8% to 9% range over the long term. When you review our other regulatory capital ratios, they're even stronger. Our CET1 ratio was 12.5%, a 595 basis point buffer above its well-capitalized minimum level. And our Tier 1 and total risk-based capital ratios have over 590 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 June 30, our Tier 1 leverage ratio was reduced by 100 -- by 91 basis points for the NOL-related DTAs. Other than NOLs, whose utilization is constrained by Section 382 of the tax code, we expect to fully utilize our NOLs within the next 12 months.

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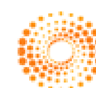

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At June 30, MSRs in excess of the amounts allowable under Basel III reduced Tier 1 leverage by 58 basis points. Thus, through MSR sales and the utilization of NOL-related DTAs from continued profitability, we believe we have 149 basis points of capital that could come back in the regulatory capital over the near-term horizon, providing an outsized level of internal regulatory capital generation. The combination begins to give us even greater capital flexibility as the reduction of NOLs in the sin bucket makes more room for MSRs, allowing us to be more economically practical when selling our MSRs.

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

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

Thanks, Jim, and good morning, everyone. We're very pleased with our solid earnings of $0.71 per diluted share in the second quarter and $1.16 per diluted share through the first 6 months of this year. We believe these results further demonstrate the successful implementation of our strategy to balance earnings between the community bank and mortgage businesses.

Despite experiencing margin pressures in mortgage banking, which limited gain on sale to $66 million during the quarter, we were still able to grow average interest-earning assets by $1.7 billion, including $481 million of commercial loan growth to $14 billion and generate almost $100 million of net interest income.

We remain focused on continuing to grow earnings from the community bank, smoothing out earnings volatility and creating a sustainable and predictable earnings stream. That isn't to say we aren't planning on further growing our mortgage business, we are, and the 2 acquisitions prove that. But we expect we can grow earnings from the community bank at an even faster cadence.

We also continued to execute on some key strategic initiatives that position us very well for the future, including we have made tremendous progress integrating the delegated correspondent business that we purchased from Stearns Lending in the first quarter. During the second quarter, we have seen volumes approach the levels of last year when this business unit produced approximately $7 billion of originations from 250 correspondents. Furthermore, we have also closed and funded our first warehouse lines during the quarter with correspondents that were acquired as part of this transaction.

On May 15, we closed on the transaction 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 acquisition was part of our strategic goal to expand our distributed retail mortgage business with a strong purchase market originator. At the time of the acquisition, Opes had 39 branches in California, Oregon and Washington, and there is virtually no overlap with our existing distributed retail footprint. We always felt the cultures of both organizations were very similar, and as a result, the integration of Opes is going extremely smoothly. Furthermore, early financial results are strong. We sold in bulk $191 million fair value of MSRs in the quarter and have sold $256 million during the first half of the year. Additionally, we have sold another $16 million in flow sales during the quarter and $36 million during the first half of this year. These sales represent approximately $27 billion UPB in underlying mortgage loans during the first half of the year, and we will be the subservicer of the underlying loans for the significant majority of these sales.

As a result of these transactions, we have reduced our MSR to CET1 ratio to 15% as of June 30. We've previously talked about executing on an MSR reduction strategy, given the requirements of Basel III, and we are delivering on that plan. We executed subservicing agreements with 3 new counterparties during the quarter and believe that through these and existing agreements, you will begin to see an increase in loans subserviced for others as we look forward. We also on-boarded approximately 20,000 of non-Flagstar originated loans during the quarter and crossed the 400,000 loans serviced or subserviced for others threshold as we continue to build out our servicing business.

We closed on the sale of approximately $70 million of HELOCs early in the quarter that were part of the legacy securitized trust, and we continue to be extremely pleased with both the quality of our held for investment portfolio and asset quality coverage ratios. We believe our balance sheet provides a strong and clean foundation from which we will continue to build.

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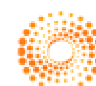

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It's been a solid first half of 2017, and we feel we are well positioned to continue to grow and be successful across all 3 business lines in the future. I will now outline some of the key operating metrics from each of our major business segments during the quarter.

Please turn to Slide 12. Quarterly operating highlights for the community banking segment include: in the second quarter, average commercial loans increased $481 million versus the prior quarter to $3.3 billion following strong growth in all loan categories in the portfolio; average commercial and industrial loans grew $162 million or 21%, while average warehouse loans increased $160 million or 23%; and average commercial real estate loans grew $159 million or 12%. We have grown average C&I and CRE balances $907 million over the last 12 months as we look to balance earning contributions between the mortgage and commercial businesses. We've introduced several new lending business lines over the last year or so, including builder finance lending, MSR lending, equipment finance and leasing as well as establishing a syndications group. We have also strengthened our middle-market lending and business banking teams during the first 6 months of the year as a result of our successful recruiting efforts.

We're very excited about our lending businesses and the high-quality interest-earning assets they will generate. We also 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 $174 million of high-quality jumbo and conventional mortgage originations to our held for investment portfolio during the quarter as we look to maintain a diversified approach to asset holdings.

Average total deposits were unchanged in the quarter as higher company controlled and retail deposits largely offset lower government deposits. Average retail deposits increased $32 million, led by a 4% increase in demand deposits. We remain focused on executing on several strategic initiatives to drive deposit growth, including building out a digital strategy, 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 the growth 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.

Please turn to Slide 13. First quarter operating highlights for the mortgage origination business include: fallout-adjusted lock volume increased 50% to $9 billion quarter-over-quarter, driven primarily by the impact of the Stearns-delegated and Opes Advisors acquisitions. Even excluding recent acquisitions, fallout-adjusted locks increased 23% to $7 billion. Mortgage closings increased 56% in the quarter, again, primarily due to the acquisitions but also because of the operational excellence of our underwriting and fulfillment teams who continue to combine both quality and efficiency in their processes. Our net gain on loan sale margin fell 7 basis points quarter-over-quarter to 73 basis points. We believe this is partly driven by a smaller and more competitive market and originator's pricing to fill up operating capacity. We're 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're already seeing the benefits of the 2 acquisitions we have executed on during the first 6 months of this year from the $2 billion in fallout-adjusted locks that have been generated just in the second quarter. And remember, we only closed the Opes Advisors transaction on May 15, so we've yet to see a full quarter's benefit following this acquisition.

Given the year-over-year reduction in the mortgage market that was being forecast last year, our strategy was to execute on these 2 transactions in order to preserve our mortgage revenues in a much smaller market, and that theory is playing out as we expected. We believe we have one of the best mortgage origination platforms in the country and are primed to take advantage of any dislocation in the industry given the smaller and more competitive market, further consolidating our position as the fifth largest bank originator in the nation.

Finally, we recently launched our inaugural $440 million securitization trust of 30-year and 15-year fully amortizing, high balance conforming and jumbo fixed qualified mortgage loans to borrowers with strong credit profiles and low leverage. Given the scale of our mortgage operation, we're excited to be able to offer our own securitizations.

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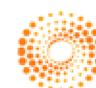

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Moving to servicing. Quarterly operating highlights for the mortgage servicing segment on Slide 14 include: we closed on the previously announced bulk sales of $191 million fair value of MSRs in the quarter. Our MSRs now stand at 15% of our CET1 capital at the end of June as a result of these sales, positioning us well for the full phase in a Basel III. We are executing on our MSR reduction strategy, which is capital accretive and generates noninterest fee income through the loans we subsequently subservice. We executed subservicing agreements with 3 new counterparties during the quarter as more customers experience the value of our one-stop shop business model. What I mean by this is that MSR investors cannot only acquire our MSR assets from Flagstar but have confidence in our subservicing capabilities. Furthermore, we are also able to provide recapture services and MSR and servicing advance financing. This is all from a well-capitalized counterparty that has a robust risk and compliance infrastructure.

Following the loan transfer just at the quarter end of one of the larger bulk MSR sales in Q2, we currently service approximately 400,000 loans, of which approximately 300,000 are subserviced for others, making us the eighth largest subservicer in the nation. The remaining 100,000 are loans where we own the MSR or they're 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 leveraging other business opportunities as a result of this offering 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 increased $14 million to $154 million quarter-over-quarter. It should be noted that when you exclude $11 million of operating expenses and $1 million of transaction cost related to the 2 acquisitions and noninterest expense was $142 million, which is comparable to previous quarters. The slight increase in noninterest expense, including -- excluding acquisition operating expenses and transaction cost was a result of increased commissions and loan processing expenses because of higher mortgage closings.

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, excluding recent acquisition cost. This is something we're very focused on as an organization. Our efficiency ratio improved to 72% in the quarter versus the previous quarter as a $30 million increase in revenues was partially offset by a $14 million increase in expenses. 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 $168 million and $173 million during the third quarter of 2017. The increase in forecasted expenses quarter-over-quarter is in large part due to the following factors: estimating a full quarter of expenses for the Opes Advisors division; increases in commissions and loan processing expense, excluding Opes, given the increasing expected mortgage closings in the third quarter; and increased compensation and benefits as we continue to invest in growth initiatives across the bank and particularly our new commercial lending businesses.

We're very pleased with how we started 2017. We're delivering on our strategic plan and believe we have the right team in place that will enable us to create further value for our shareholders.

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

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

Thank you, Lee. I'm now going to close our prepared remarks with some guidance for Q3, and then open the call for questions and answers.

Please turn to Slide 17. We expect net interest income will [increase] (corrected by company after the call) moderately with average earning assets consistent with period-end Q2 levels. We anticipate a steady net interest margin. We expect a significant increase in gain on loan sale income led by a full quarter of Opes Advisors. We anticipate mortgage locks will increase moderately. We expect an increased gain on sale margin on a higher distributed retail mix. We anticipate the net return on MSRs will approximate 5% to 7% on an annualized basis on stable prepayments and lower transaction costs. We expect loan fees and charges will rise on higher mortgage closings, while all other noninterest income will remain steady with Q2 levels with a modest decrease in the R&W benefit. And as Lee noted, noninterest expense will increase to $168 million to $173 million.

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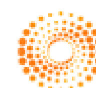

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This concludes our prepared remarks, and we'll now open the call to questions from our listeners. Mindy?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll take our first question from Jessica Levi-Ribner from Friedman, Billings, Ramsey.

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

One on the lending platform, where are you seeing the most traction? And how do we think about that on a go forward, on the non-mortgage lending platform?

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

Non-mortgage? Okay. Well, as I've said in my opening remarks, we've got Drew Ottaway with us today, who's President of our Michigan market and he oversees this line of business, so I'll let him take this question.

Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP, MD of Lending, Executive VP of Flagstar Bank and MD of Lending of Flagstar Bank*

Yes. Thanks, Sandro. I think we're really well positioned to continue to grow our loan portfolio. As we described in the prepared remarks, we've really seen broad-based growth across all the different lending lines of business, including our core lines of business, key initiatives like homebuilder finance, equipment finance and MSR lending. And then we'll continue to add on new teams opportunistically. So to answer your question, I really think across the board, we have good opportunities. It's relationship banking and so we'll continue to add lenders with deep relationships.

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

And one thing I would add, Jessica, is that, and this is really important, some companies focus on CRE, some focus on auto, some focus on warehouse. We don't focus on any one thing, we focus on a bunch of things. So we keep it very diversified. We keep our concentration limits such that no one problem could be really devastating to the company. So that's why we've got CRE and we've got warehouse and we've got C&I and we've got specialty mortgage lending like MSR financing and builder finance and equipment finance. And then lastly, the ability to fill any gaps we have with high-quality mortgage loans from our mortgage origination platform. So it's maybe a bit unique, but I think from a risk point of view, it's keeps us in a very manageable position.

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

And what kind of competition are you seeing on the lending front? And I guess that, that's a broad question given the breadth of your platform, but are you seeing the super-regionals or community banks and can you talk a little bit about that?

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

Yes. There's competition in every line of business. This is not an easy business. I think if you get the right people, you can compete very effectively and maybe Drew has got something he'd like to add to that.

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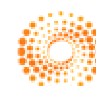

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Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP, MD of Lending, Executive VP of Flagstar Bank and MD of Lending of Flagstar Bank*

I think that's exactly right. It really does comes down to the people. And it does vary. We have the majority of the business here in Michigan, but we do have national lines of business as well such as warehouse lending, homebuilder finance. And so you'll see a little bit different mix of competitors in some of the different lines of business, but as Sandro said, it's competitive across the board and we really believe the relationship model that we have in place, adding true value to our client relationships, is how we compete.

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

We've been able to add a good number of very, very experienced commercial lenders in both the C&I and CRE space, even in builder finance, even a person in your warehouse. So as long as we can keep adding those kind of people, I think we can still provide growth in a very meaningful way like we have here in the recent past.

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

Okay. And then just one on the subservicing and the MSR sales. What can we expect for the pace of the MSR sales? And then on the subservicing side, your subservicing partners where you didn't originate the loan, do you expect to get more of that business? Or is your focus really on Flagstar-originated loans that you then sell the MSRs?

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

Yes. So let me take the first part of your question and answer that. So I mean, if you look at Q2, the level of MSR sales versus prior quarters was significantly higher, and we've got a chart in the deck that illustrates that. And we were very successful with bulk sales, in particular. And that's building off of Q1. I think we saw an opportunity post the election to execute on MSR sales at favorable economic implications and we took that opportunity. And throughout that period, the level of flow sales has been fairly consistent. I think what I would tell you is as we look forward, I mean, we are going to work to be in compliance with Basel III by the end of Q1. We will do it through a combination of bulk and flow sales, but we're only going to execute on sales if it makes economic sense for us to do so. And the bulk sales are a little bit more unpredictable. So it's tough for me to say we're going to continue at the same cadence. We're going to try to, but we're only going to do it if it makes sense for us economically. In terms of the loans that we're subservicing, what -- ideally, as we build up to -- I mentioned in my prepared remarks we have the capacity to service or subservice 1 million loans and we're currently servicing or subservicing 400,000 loans, so we have a lot of capacity. Ideally, we'll build up to that predominantly with loans that we onboard that we haven't originated. That's where you're going to see real increases in revenue because they weren't loans we originated. We created the MSR and subsequently sold and are now subservicing those loans. We put ourselves in a position through the quality of our servicing operation, that we won the STAR award as it relates to Fannie Mae for the second year running. We talked about that on the last call. So we feel we've got the quality in place. We've got the platform and we've got all the ancillary products such as MSR lending recapture in place to begin to build that out. Again, it's very unpredictable. Things don't happen at a steady rate. They come -- it can be bulky or they can come in sort of small amounts, but we feel we've got the platform to build that out as we look forward.

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

I think an important thing to note here, and I think Lee said it in his remarks or maybe Jim did, but 85% of the MSRs that we sold here this year, we've been able to keep that servicing -- the subservicing, and that percentage has gradually increased over time as we've been able to prove out this model and the buyers of the servicing, the MSRs, get more and more comfortable with Flagstar. So I think that's really important to see that we've been able to do that because, previously, when we did a bulk sale, they were almost always servicing release and that's not the case anymore. Additionally, as a bank, as a public company, we've got to make sure we capitalize MSRs at the right rate so that the number is accurate and that allows us then to be opportunistic when the market provides that opportunity to sell the assets. So you got to have a lot of patience when managing an MSR asset. I think our team here has done a really nice job with that. Remember, we're already 80% phased in to this Basel III requirement so there's not much more to go, and we've got enough capital that we can be patient and execute advantageously when it comes to MSR retention or sales.

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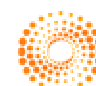

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Operator

And we'll take our next question from Bose George with KBW.

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

First, just on the gain on sale margin, I just wanted to ask about the differential between the gain on sale margin on the distributed retail, the Opes stuff that's coming on versus your more traditional correspondent.

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

So as you know, we don't get very detailed in that regard. But obviously, as the share of retail in the organization grows, you'll see the benefit of that coming to the overall gain on sale margin. So I mean, if you look in the second quarter, I think we had almost 8% or 9% of our originations came from retail. That's almost double what it was not that long ago. And then as we have Opes for a full quarter, you'll see that continuing to increase. So I think that's why the guidance is as it is. Anything, Jim, you want to add there?

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

Yes. Bose, I would think about retail at around plus or minus 300 bps. And you can see from historically where we've been with just a very small, say, 5% retail contribution, historically, that's where Flagstar has been and think about the marginal business coming on 300-ish, at least when you're talking about the margin of Opes.

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

Okay. Great. That's very helpful. And then actually, I just wanted to ask also about this jumbo securitization, just from a sort of the broader reasoning for doing it. Is it helpful from the funding standpoint? Are there other benefits to using securitization versus just funding it on your own balance sheet?

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

Yes. So it gives us a more efficient way of selling those into the marketplace, Bose. And that's going to give us a competitive advantage in the jumbo loan pricing, which will help us garner more volume at better spreads, as well as better performing mortgage loan producers.

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

And in terms of the accounting for those, is that just going to be consolidated on your balance sheet? Or how is the accounting going to work?

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

It's a sale.

Operator

And we'll go to our next question with Scott Valentin with Compass Point.

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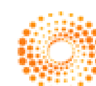

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Scott Jean Valentin - *Compass Point Research & Trading, LLC, Research Division - MD and Research Analyst*

Just with regard to capital, clearly, the growth rate was strong this quarter. I think, if I look at average growth for held for investment, it would be about 11% next quarter based on end of period, if that's kind of the guidepost. Just wondering how fast -- you mentioned the, I think it was the MSR and NOL ability to creep into capital. I'm just wondering the tradeoffs there. As you grow fairly rapidly, how fast can you accrete those 2 arms into capital to benefit the ratio?

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

Well, I think -- Scott, this is Jim. The way I would model the NOL is that we're really growing capital of pretax and not an after-tax rate. So look at the pretax income and take that into capital instead of an after-tax net income in trying to figure out the NOL side. As far as MSR, as I'd harken back to Lee's comments, which are that how close we are to being in compliant -- in full compliance with the B3 limits. It gave us a lot of flexibility there to be patient and practical. So we're going to be more opportunistic and not have to sell into an adverse markets, if that's what we encounter. And then finally, just look at what I said in terms of the sin bucket. And as we utilize more NOLs, the capacity for MSRs and the sin bucket gets larger. So you've got a benefit there that many people overlook.

Scott Jean Valentin - *Compass Point Research & Trading, LLC, Research Division - MD and Research Analyst*

Okay, that's helpful. And then on deposit funding, there was no deposit growth. I guess, on an average basis, it was a pretty flat-linked quarter. I know these have short-term funding for the warehouse and AFSs, that makes perfect sense. But just wondering, looking forward as you grow held for investment, do you anticipate growing deposits? And if so, what's that going to require? It is it going to require lifting the rates? Or do you see treasury management or any combination of those 2?

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

Yes, I think it is a combination of a number of different things. So we're very pleased with the way deposits have behaved on our balance sheet the first half of this year. It's worked very favorably for us. And the way we've managed against the competition has allowed us to increase yields on the loan and investment side without increasing the cost on the deposit side. How long we can continue to do that is a question I can't answer, but we're going to keep working towards that end. I think long-term funding from the retail side will be an area that we'll have to address, and we want to get more and more funding from there. But I think in the near horizon, I think the way we've been managing deposit growth and other sources of funding, I think it's worked pretty well for us.

Operator

We're going to take our next question from Kevin Barker with Piper Jaffray.

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

Are you there, Kevin? Mindy, we are not hearing Kevin.

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

Do you hear me?

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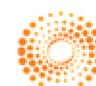

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Lee Matthew Smith - *Flagstar Bancorp, Inc. - COO, Executive VP, COO of Flagstar Bank and Executive VP of Flagstar Bank*

Yes.

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

Yes, now. Go ahead, Kevin. Sorry about that.

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

So in regards to the mix in the third quarter of between retail correspondent and broker channel and with the Opes fully onboard, we saw your retail go from $400 million in the first quarter up to $800 million in the second quarter. When you think about that full run rate, are you expecting that $1.2 billion in the third quarter? And could you help quantify what that impact will be, given you guided to a significant increase in margins for the third quarter?

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

Well, Kevin, I couldn't give you that much specificity, but I think if you look at where we think the market is going to be the rest of -- or in Q3, I think we guided to a bit of an increase in locks. And I think that -- you can assume that's going to come kind of generally across the board, and then try to interpolate what the -- we gave you the benefit from Opes and the Stearns business for Q2. So that should help you look at what you think it might be for Q3. So again, we're going to look at where the best opportunity is and judge the competition appropriately and put forth the pricing that makes sense where the business makes sense. Jim, anything?

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

Yes, Kevin. Some of that $400 million to $800 million lift is seasonal, and that seasonality is even more pronounced as you have a purchase mortgage market.

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

Right. And you should have more loans closing in the third quarter, right, because of the seasonality associated with that purchase market. Is that the way to think about it?

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

It is and we book revenue at lock.

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

Okay, okay. And then in regards to your long-term efficiency ratio in the mid-60s and it's running at 72% right now, if economic conditions were to remain where they -- as they just right now, you don't see much change in interest rates or the mortgage market in general. How long do you think it would take for you to hit some of these longer-term targets for an efficiency ratio nearer 65%?

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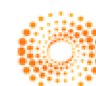

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Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President & Director and CEO, President & Director of Flagstar Bank*

Yes, I can't -- I really can't answer that. What I can tell you is that we're going to balance the efficiency ratio against the returns on equity and assets and make sure that we're growing the company at the right rate that makes sense from an investor point of view. So if we need to do something dramatic on efficiency, on the cost side, we will. But as Lee has said many times in the past in his remarks, the goal here is to keep growing revenue, and that's what will get us to the right efficiency level.

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

Yes. I would just -- I mean, the macroeconomic factors, no one can predict. What we're creating is a platform that puts us in a position to be as successful as we can be across all 3 business lines. You've heard us talk about the growth on the commercial side of the business and what we're doing there. We've done the 2 acquisitions on the mortgage side of the business to protect mortgage revenues there and one of those was Opes Advisors as we move into this purchase market, we feel we'll get a lift from that. And then we built what we believe is one of the best servicing platforms in the country, and we have capacity to grow there. So we positioned ourselves to achieve that growth and the revenue should come from that growth. But who knows what will happen from a macroeconomic point of view.

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

And I want to remind you, Kevin, back in 2012, we cut operating expenses on an annualized basis by $200 million when we saw the economic conditions going in a direction that concerned us. And we reduced our employee count from about 4,000 to 3,000. So we will take the action we have to take should it be necessary. But of course, our hope is that we can solve to the 65% efficiency ratio by growing revenue, not by cutting expenses.

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

Okay. And when you think about the mix in the efficiency ratio on a go-forward basis and each individual growth in -- I mean, considering the growth that you're seeing in revenue, can you see what's the incremental efficiency that you're generating off of the new revenue that you're generating right now?

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

Yes. So Kevin, this is Jim. What we've always said is the efficiency ratio that we target is an output and not an input. So harkening back to Sandro's comments, we're not going to -- we're not saying, look, we're going to achieve an efficiency ratio and that's our strategy. We have a variety of different strategies that we plan to employ. And as we look at what we think the impact of those strategies are, when they're fully ramped into our business model and they're in our portfolio of businesses, we believe we'll be at a mid-60s efficiency ratio. But an efficiency ratio of 65% in and of itself is not -- it's an output, not an input. So yes, we're going to be opportunistic with what we do, and we've always expected that the mortgage businesses will be less efficient than the banking business.

Operator

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

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

Could we go through some housecleaning stuff here? What were the gains reported in the quarter? I know you had a write-up of the MSR, but you also had the bulk sales. I kind of lost track of what the numbers were.

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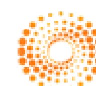

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Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President & Director and CEO, President & Director of Flagstar Bank*

The bulk sales were pretty much at book. Is that right, Jim?

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

They're at book because they're at fair value. Henry, there's -- in our appendix that we provided in the slide deck, there is a breakdown of the MSR roll forward and the -- and an attribution model breaking down the components of the return that we generated in both quarters.

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

And then sort of looking -- there've been a lot of questions about this but the simplistic way to think about your acquisitions is that they're profitable now and the incremental boost and overhead that you've put out there is going to be covered by an equal or greater amount of revenue in the mortgage business?

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

Yes, absolutely. I think last quarter, we gave some guidance on the payback periods for both of the businesses. And I think we said with the Stearns acquisition, it was less than a year, and with the Opes, it was less than 3 years on a crossover basis, right? So yes.

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

Correct.

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

And then just kind of -- so yes, so we've got the overhead being covered and then some -- the margin goes up of provision, obviously, and rep and warranty cost a little higher. Is the stage set for a near-equivalent version of the second quarter in the third quarter or should we be a little more cautious?

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

Well, we're always optimistic about our ability to execute, but that's why we give you all this guidance, so you can figure it out.

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

And then -- yes, but I'm lazy. And then looking at the mortgage business going into -- that was a great quarter and the guidance is extremely helpful. But looking at the fourth quarter, as the retail component grows, should we expect a sort of a slowdown there as closings and locks probably decline going into Christmas and then a pickup again in March, so maybe a slightly more amplified level of seasonality?

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

I don't know the answer to that. I mean we, in the appendix, I think we show you that our estimate is $1.7 billion for the entire market this year, and there's no reason for me to believe that it's going to be different than any other year from a seasonality point of view. But who knows, economic conditions change. So I can't -- I really can't say much past the third quarter.

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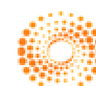

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Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

All right. And then, of course, loan quality has been really solid. Anything on the horizon that concerns you there?

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

No, all the trends are solid, so I think the comments we've made are in line with our expectations. We're very, very pleased with the overall asset quality.

Operator

And we'll take our next question from [Paul Miller], private investor.

Unidentified Shareholder

Can you talk a little bit about the purchase market versus the refi market? We know the refi market's down, but I think there's expectations that the purchase market will start to recover given the better economic outlook out there.

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

Yes, well, you can see in our numbers that the share from purchase is growing so -- and I would expect that to continue. I mean, the economy is a wild card. It's hard to figure out what's going on. The rates go up, they go down. The tenure's back up a little bit now. So duty of our origination platform and having the correspondence that we have, and you know this because you followed us a long time, we will adjust to whatever is going on in the market. So it doesn't matter if it's a purchase market or a refinance market. We will follow what the market does. But clearly, we positioned ourselves here with the Opes acquisition because we think that the trend is towards a greater purchase market, and we think that puts us in a better position than we would otherwise be to take advantage of that.

Unidentified Shareholder

And I've been reading some articles where some of the problems of the purchase market is just not a lot of supply. Are you seeing the same type of stuff out across the country?

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

We have. We had our salespeople in from all over the country not that long ago and we were hearing that from everybody from every corner of our origination platform. So that certainly does, anecdotally, based on information we have, seem to be the case.

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

I think, Paul, actually, I'll just add. As well as the supply, home prices have continued to increase. And so that's just kept some people on the sidelines who maybe can't quite afford the price point where that happens to be at the moment. So I think it's a supply and a home price issue that you've seen in certain areas.

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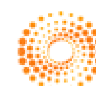

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Operator

And we'll take our next question from Scott Siefers with Sandler O'Neill and Partners.

Robert Scott Siefers - *Sandler O'Neill + Partners, L.P., Research Division - MD, Equity Research*

Just wanted to follow up on some of these expense questions. So the guidance now is for $168 million to $173 million for the third quarter. I guess I'm just curious. Now that we got the 2 acquisitions sort of fully baked into the run rate in the third quarter and beyond, what kind of additional flex is there once the origination environment kind of subsides? In other words, before we were to get into any like special cost savings measures, how much of the expense base at this point is kind of volume related and what's left up or down, depending on what happens with origination?

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

Yes. So I think the 2 line items to look at are commissions and loan processing expenses. Those really are your variable line items in the P&L. And when -- just going back to my prepared remarks and giving you guidance of the $168 million to $173 million and what's driving that, we obviously -- we have the full quarter of Opes, not a partial quarter. I talk about the increases in commissions and loan processing expense outside of Opes, given we're saying that there's going to be increased closings in the third quarter versus the second quarter. And then we've got some increased comp and benefits as we continue to invest in the growth initiatives we've discussed, particularly on the commercial lending side of the business.

Robert Scott Siefers - *Sandler O'Neill + Partners, L.P., Research Division - MD, Equity Research*

Okay. And then just sort of back on that efficiency question. So do you guys expect to see any improvement in the efficiency ratio in the second half? Or because we've got sort of some of these investments taking place, are we going to sort of take a step back on efficiency in the near term before it starts to improve again, say, at some point in 2018? Or how are you guys thinking about that dynamic?

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

Well, Scott, this is Jim. We only give guidance 1 quarter out. So all we can talk about is Q3. And I think when you -- just the pure aspect of having a full quarter of Opes in Q3 will be negative to the efficiency ratio, but strongly positive to something like ROE.

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

I mean, the only thing I would add, Scott, is we continue to invest in these growth initiatives. Again, you've heard us talk about what we're doing on the commercial lending side, the servicing side. And so you've always got that investment in those growth initiatives. So we expect improvement, but we don't expect that you see a big improvement while we're still investing in the growth initiatives because, obviously, there's a cost involved in doing that.

Operator

We'll take our next question from Terry McEvoy with Stephens.

Terence James McEvoy - *Stephens Inc., Research Division - MD and Research Analyst*

First question, the homebuilder finance portfolio outstandings are up 35%, about $0.5 billion now. In terms of just concentration and just risk in that portfolio, are you going to continue to focus on growth? And how do you think about concentration? And then it looks like you've highlighted some secondary markets. How much of the recent growth is then transitioning from your original primary markets into those secondary ones?

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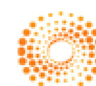

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Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President & Director and CEO, President & Director of Flagstar Bank*

Let me make a general comment, then I'll have Drew answer your question more specifically. So we're being very, very disciplined on the growth in all of our portfolios and so builder finance is no exception to that. We're making sure that from a geographic point of view, that the loans are very dispersed across the country. We're making sure that whole levels are at sensible numbers. We're making sure that when we have larger opportunities, that we're using our syndication team to take those out and reduce our exposure here but still gain some fee income from that process. And we're limiting ourselves pretty much to the top builders in the country. So there's some publics and there's some non-publics, but largely we're dealing with the top 100 builders in the country and the credit underwriting is very, very strong. But let me see if Drew wants to add anything to that. Did I steak all your thoughts?

Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP, MD of Lending, Executive VP of Flagstar Bank and MD of Lending of Flagstar Bank*

Honestly, Sandro -- yes, you did. You covered it very well. I would just echo this. The homebuilder finance industry has been underserved. You can see that in the home stock that Lee referred to earlier and the pricing pressure that's put on existing homes. So that really is an industry that's been underserved. What we love about that platform are the people that we brought over. They've all been in the business a long time. They've all worked together for a long time and they have all worked with clients for a long time. So when we talk about the large regional and national builders that we've targeted there, Sandro's spot on. We really feel like we have been very selective, very disciplined. We have a great concentration, a vision in place for that, whether that's with respect to geography or size or product type, and we're just going to continue to manage it very carefully.

Terence James McEvoy - *Stephens Inc., Research Division - MD and Research Analyst*

And then just a follow-up. So it doesn't sound like the revenue generated from the retail channel coming from Opes, which is at that 300 kind of basis point level, that, that incremental revenue will not be enough to offset that $14 million to $17 million quarter-over-quarter increase in expenses that you noted on Slide 17. As I put this whole call together, Jim, is that what you said in response to Scott's question?

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

I had a hard time following the double negatives there, Terry. So what I would tell you is that we found that both acquisitions were highly profitable and one has a payback period of months and not years and the second one, Opes, is less than 3 years. So you should take from that, that the revenue is significantly more than the expenses.

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

Terry, I'll just add. I think you're looking at the $154 million and looking at the $168 million, the lower end of the guidance, and you're coming up with your $14 million. So I would just say exactly what Jim said in terms of the profitability, the acquisitions. Not all of that increase is because of Opes. Part of it is because you're now looking at a full quarter versus a partial quarter, but we've got increases in commissions and loan processing expenses for increased closings outside of Opes. And then you've got increased cost as it relates to the growth initiatives on the commercial lending side of the business and the servicing side of the business. So that -- you got to think about the big picture, it's not all related to just one thing.

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

It would take a special situation for us to make a significant investment that would cause expenses to exceed the revenue that we think would come from that investment.

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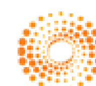

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Operator

And we'll take our final question from Steve Stein with FSI.

Steven Neal Stein - *FSI Group, LLC - Chairman and CEO*

I had a similar question on expenses, just trying to think about it. If most of the increase in the $14 million is from additional closings, should I think of that as in terms of, say, $1.50 of revenue for every $1 expenses, $2? Is there a range, at least, that you could help kind of narrow this down to for modeling purposes?

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

We don't -- we really don't get that specific, Steve. But I'll tell you that...

Steven Neal Stein - *FSI Group, LLC - Chairman and CEO*

I mean, you've told us it's more than $1 of revenue for the $1 of expenses, but I was wonder if you could ballpark a little bit more tightly than that.

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

Yes, I'm afraid we can't.

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

Yes, we can't. And again, I just want to -- it's not all -- you sort of you made the comment at the beginning of your question that it was all coming from increased closings and it's that $14 million, and it's not. It's the partial Opes quarter versus a full quarter and as well as production volume, there's other expenses in there. And then there's the increased expenses on the community bank and the servicing side as we invest in growth initiatives. So that's the only caution I would give you. You refer to it all coming from closings, which is not accurate even.

Operator

And there are no further phone questions.

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

Okay. Thanks to Mindy, and thanks to everyone for your interest in Flagstar. To put the quarter in perspective, it was a performance just like many previous quarters, strong loan growth in our community bank, solid results for our mortgage business regardless of the strength of the market, skillful management of our MSR asset and pristine asset quality, all in the context of no surprises and smoothly integrating the Stearns and Opes acquisitions. It's the kind of consistency our business model will produce. Whether it was created in a strong community bank, strengthening our mortgage business, derisking our balance sheet, building a culture of compliance or other strategic initiatives, we have delivered quarter in and quarter out. Importantly, we have delivered profits consistently in a relatively soft mortgage market. We are optimistic about the future and confident in our one-of-a-kind business model. With numerous profitable quarters under our belt, I think it's safe to say that we have validated our model. We have a formidable banking business, an industry-leading mortgage origination platform and a young but growing subservicing operation.

Looking ahead, we are committed to expanding our balance sheet carefully and thoughtfully with high-quality, relationship-focused assets and to providing ever-increasing value to our shareholders. We believe we are well equipped to deliver on both. 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.

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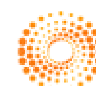

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Finally, thank you for your time this morning. I look forward to reporting Q3 results in October.

Operator

This concludes today's call. Thank you for your participation. You may now disconnect.

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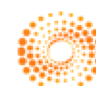

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