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FBC - Q3 2017 Flagstar Bancorp Inc Earnings Call

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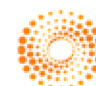

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PRESENTATION

Operator

Good day, everyone, and welcome to the Flagstar Bank Third Quarter 2017 Earnings call. Today's call is being recorded. And 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, Vickie, and good morning, everyone. Welcome to the Flagstar Third Quarter 2017 Earnings Call. Before we begin, I would like to mention that our third 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 with 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, David. And thank you everyone for joining us today. In addition to David, I'm joined this morning by Jim Ciroli, our Chief Financial Officer; Lee Smith, our Chief Operating Officer; Steve Figliuolo, our Chief Risk Officer; Drew Ottaway, our Michigan Market President.

As you know, Kristy Fercho joined our team in September as President of our Mortgage business. Kristy joined Flagstar from Fannie Mae where she held a number of leadership positions during her 15-year tenure. We're thrilled to have Kristy on our Flagstar team. She not only knows the mortgage business top to bottom, but also knows us well and brings many industry relationships with her that will help make our mortgage business even stronger than it already is. While I'm sure she is listening, Kristy is not with us today as she is attending the MBA Annual Convention in Denver.

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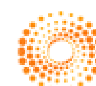

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I am going to start the call by providing a high-level view of our performance for the quarter. Then I'll turn the call over to Jim for details on our financial results. Lee will follow with the review of our business segments and strategic initiatives,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

We're pleased to announce net income of $40 million or $0.70 per diluted share, continuing our record of solid diversified earnings with no surprises. We again demonstrated the power of our banking business to generate earning assets as we notched double-digit growth in all 3 of our commercial loan portfolios. This shows the progress and our success in delivering on our strategic objective of building a more stable and predictable earnings stream. As I said last quarter, and as have been further supported by this quarter's results, Flagstar as a formidable mid-sized bank with one of the best mortgage origination platforms in the nation.

There were many highlights in the quarter. Net interest income increased again this quarter and crossed $100 million for the first time in solid earning asset growth. Mortgage revenue rose 13%, led by a 14% increase in gain on loan sales due to higher retail originations, and credit costs were again negligible while capital remains strong. Expenses rose 11% last quarter, in line with expectations as we realize the first full quarter of expenses from Opes plus some costs from investments in business expansion. The integration of Opes is on track with our initial expectations and while it's still early the financial performance is slightly ahead of expectations. Jim and Lee will both provide more detail on expenses. While we remain [formally] committed to controlling expenses, we will take on extra cost in the short term to build revenue for the long term as long as it doesn't prevent us from hitting our return targets.

The last couple of months have certainly been difficult for many businesses and people due to the hurricanes. Flagstar was no exception as Texas and Florida are our second and third largest mortgage origination states. Although it's difficult to precisely estimate the financial impact, we believe it was as much as $0.03 per share. We continue to do what we can to help our communities recover and are committed to working with our customers to relieve the financial burden.

Finally, as you know, we closed on our first mortgage securitization in July. As you may know, we are back in the market with another offering, which is very similar to the first one, totaling about $576 million. Given the success of our first issue, we believe the ability to go-to-market with this product is an important differentiator for the Flagstar mortgage business that will enhance our origination opportunity and add revenue to the business in a meaningful way going forward.

Looking back at the quarter, I'm very pleased with the results, especially considering the challenging mortgage environment that we continue to operate in. The steady high-quality growth in our commercial lines of business, because of our ability to regularly at high-performing and very experienced lenders, is something we are very proud of.

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 $40 million or $0.70 per share as compared to net income of $41 million or $0.71 per share last quarter. Again, our earnings reflected 3 key things. The growth of the community banking business, the strengthening of the mortgage origination business and a strong discipline of holding the line or expenses. We performed well on each. Earning assets grew 5% supported by deposit growth of 3%. In our mortgage origination business, margins widened while volumes remained relatively constant, reflecting a full quarter of our Opes acquisition. And expenses remained well controlled as we saw positive operating leverage, partially offset by the expense growth from a full quarter of Opes expenses. We also held noninterest expense, as solid growth in deposit balances was achieved while the cost of those deposits remained under control. Credit costs remain virtually nonexistent as net charge-offs were negligible, nonperformers and delinquencies stayed at their very low levels and our allowance coverage of 2.0% of total loans was the strongest among our peers. Finally our capital position is solid. When you consider the results from our DFAST exercise and the outsized benefit that we should experience from the proposed changes in the capital regulations, our capital is among the most robust in our peer group. We'll spend more time reviewing our capital position coming up. But for now let's turn to Slide 7 and dive deeper into the income statement.

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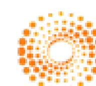

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Net interest income this quarter rose sequentially to $103 million, representing an increase of $6 million or 6%. Two key factors drove this performance. First, average earning assets rose 5% supported by our strong liquidity and capital base. Average commercial loans increased 13%, as we benefited from having a full quarter of the balances [between] last quarter. Importantly, we ended the quarter with $15.2 billion of earning assets, $0.4 billion higher than our third quarter average, giving us a nice start to the fourth quarter. Second, the net interest margin rose 1 basis point to 2.78%, 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 second quarter. And yet, as I mentioned earlier, deposit balances grew 3% while deposit costs rose only modestly. Overall this is the strong performance by the entire community banking team at Flagstar.

Credit costs were negligible this quarter, as we provided for net charge-offs. Also included in noninterest expense is a $0.5 million charge, reflecting a higher allowance for unfunded loan commitments, as we continue to grow our commitments to our commercial customers. Noninterest income increased $14 million or 12% this quarter, led by a $9 million increase in net gain on loan sales. The increase in the gain on sale revenues largely reflected a higher gain on sale margin this quarter. While fallout-adjusted locks remained relatively constant compared to last quarter, the gain on sale margin rose 11 basis points, to 84 basis points, led by a higher distributed retail mix.

The net return on the mortgage servicing asset with an annualized 11%, resulting in a gain of $6 million this quarter, unchanged from last quarter. The performance of both our return expectation resulted from a more stable prepayment environment and improvements in our hedging program made at the end of last year. The increase in the loan fees and charges resulted from a higher level of retail mortgage loan closing to this quarter. Finally, the R&W benefit was $4 million as the R&W reserve fell to $16 million, the result of strong underwriting in servicing which is reflected in the improved risk trends and a repurchase demand pipeline, there was only $5 million at quarter-end.

Moving now to expenses. Noninterest expense rose 11%, to $171 million this quarter, as compared to $154 million last quarter and was in line with our expectations in the guidance we provided on last quarter's call. The increase from last quarter was largely due to a full quarter of operating expense associated with Opes. The remaining increase in expenses reflected the low incremental expense load that we have from growing our community banking revenues. Finally, the company's effective tax rate was 32%, unchanged from last quarter, reflecting our existing business mix and the benefits of tax planning.

Slide 8 highlights the expansion of our average balance sheet this quarter. Average earning assets increased $0.7 billion or 5%, led by growth in commercial loans. Average loans held for investment grows $579 million or 9%, most of which came from commercial loans. The commercial loan growth was noticeable in its breath as each core component, CRE, C&I and Warehouse grew by double digits. We will go into further details on loan growth later.

Average deposits rose $266 million or 3% in the quarter, led by higher company-controlled deposits. Average retail deposits rose $70 million, driven by an increase in retail CDs. Yet, costs remained under control performing better than the deposit pricing betas we had modeled. We continue to maintain strong liquidity in the quarter. Our core banking loan-to-deposit ratio is only 78% at quarter-end. This is important because it shows how much asset growth we can continue to generate and it's also a competitive advantage of Flagstar. We are able to fund our most liquid assets, loans held-for-sale and warehouse loans with company-controlled deposits, the escrow balances from our servicing business that we hold with the bank. When viewed this way, we have the runway to grow assets by another $1.7 billion without any deposit growth before we have a core banking loan-to-deposit ratio of 100%.

At September 30, our common equity to asset ratio remained strong at 8.6% and our tangible book value per share rose to $25.01, as we continue to compound our earnings. We'll cover regulatory capital level shortly.

Let's turn to asset quality on Slide 9. Nonperforming loans rose negligibly and stood at $31 million at the end of the quarter, while the nonperforming loan ratio remained steady at 44 basis points. The absolute level of nonperforming loans at September 30 remained near the lowest we've reported in over 20 years. Early stage delinquencies also remain low. Only $5 million of consumer loans were over 30 days delinquent and still accruing at September 30, unchanged from June 30. There were no commercial loans over 30 days delinquent and still accruing. Net charge-offs were negligible in the quarter, representing a scant 8 basis points of HFI loans.

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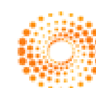

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At September 30, our allowance coverage was 2.0% of total HFI loans, well above the coverage levels of any other mid-size banking peer. Coverage remains strong at 2.3% of consumer loans and 1.7% of commercial loans. We believe that any credit impact from this quarter's hurricanes will be immaterial and in reviewing our allowance coverage ratios at the end of the quarter, [fund] that the levels to be adequate to cover any exposure we might have to that specific risk.

Turning to Slide 10. Capital remained a hallmark. Our Tier 1 leverage ratio was 8.8% at September 30, down only 30 basis points from last quarter. Given the positive signals we saw this quarter on the proposed changes to capital regulations, we allowed our MSRs to grow this quarter, which accounted for most of the decrease in this capital ratio. Looking at what our Tier 1 leverage capital would be -- should the proposed regulations being exactly as they are proposed, we would have a Tier 1 leverage ratio of 9.5% even with this quarter's growth in the MSR portfolio. I would observe that the MSRs return to strong 11% this quarter, because we are a bank, we have the ability to fund this asset efficiently and the ability to hedge its exposure to changes in interest rates, convexity and implied future volatility. So increasing this portfolio makes sense to us. We're also encouraged that having a limit of 25% gives us the flexibility to better manage the uncertainties that may exist within the MSR market at any given time.

At September 30, our Tier 1 leverage ratio had a 380 basis point buffer, a minimum level needed to be considered well capitalized. If you review our capital position in light of the new capital simplification proposal, we would expect to have a capital buffer of approximately 450 basis points, as Tier 1 leverage in excess of our regulatory minimum. Considering our projected level of MSR balances, a recent track record of hedging this portfolio and other factors, we expect to continue to target a range of 8% to 9% for the Tier 1 leverage ratio over the long term.

When you review the strong DFAST results we released last week, our capital levels appear even more robust. Our DFAST results demonstrate that what we have been building is working, that we can generate a superior level of return from a lower level of risk in the balance sheet, from strong asset quality to a relatively neutral market risk position and more than ample liquidity, all supported by a high-quality risk management function.

Nearly lost in all this good news, is that we continue to grow our regulatory capital at a pretax rate, as we utilized our net operating losses. At September 30, our Tier 1 leverage ratio was reduced by 80 basis points for the NOL-related DTAs. We expect that we will recover most of this trapped capital as we utilize our NOLs over the next 9 months. We've also included a summary in the appendix to our earnings call presentation that analyzes the impact of various changes in the tax code on our deferred tax asset position. While we can't predict what might happen or when, we remain positive that meaningful reform and simplification would provide a significant boost to our run rate earnings. But even lacking reform, we will continue to improve the tax efficiency of the company. And I turn to Lee for more insight in 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. It was another solid quarter as we reported earnings of $0.70 per diluted share and continue to execute on our strategic vision for the bank. We were able to grow average earning assets $717 million during the quarter, of which $434 million came from commercial loan growth, as we further build our reputation as a strong community bank. This loan growth enabled us to grow net interest income by $6 million or 6% quarter-over-quarter, to $103 million. We remain focused on continuing to grow earnings from the community bank, smoothing out earnings volatility and creating a sustainable and predictable earnings stream.

The 2 mortgage acquisitions we closed earlier this year have helped us grow gain on loan sale revenue $9 million, to $75 million or 14% quarter-over-quarter. Furthermore, we also saw an increase of 11 basis points or 15% in gain on loan sale margin, due to a mix of retail mortgage business increasing significantly following the Opes transaction. We have been one of the biggest sellers of mortgage servicing rights during 2017 and have sold approximately $29 billion UPB of underlying loans through September 30. We retained the subservicing on 85% of these sales as a result of our best-in-class servicing platform. And now service or subservice approximately 415,000 loans.

Our capital ratios remain strong as we continue to build Tier 1 capital at a pretax earnings run rate given at the deferred tax asset. To put this into perspective, we've grown our ending balance sheet almost $3 billion or 20% since the beginning of this year, and our Tier 1 leverages decreased just 8 basis points to 8.80%. Our capital position is only going to be further enhanced by the capital simplification proposal, which would further increase Tier 1 leverage by approximately 70 basis points as of September 30, and future earnings.

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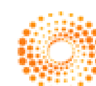

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2017 has been a solid year. We're executing on our strategy and feel we are well positioned to continue to grow and be successful across all 3 business lines in the future.

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 average commercial loans increased $434 million versus the prior quarter to $3.7 billion following strong and balanced growth from all loan categories in the portfolio. [Average] commercial real estate loans grew $169 million or 11%. Commercial and industrial loans grew $137 million or 15%, while average warehouse loans increased $128 million or 15%. We have grown average C&I and CRE balances $1 billion over the last 12 months, as we continue to build a strong commercial presence, and balance earning contributions between the mortgage and commercial businesses. This growth has been facilitated by the introduction of several new business lines over the last year or so, including build the finance lending, MSR lending, equipment finance and leasing, as well as establishing a syndications group. We've also strengthened middle-market lending and business banking teams during the first 9 months of the year, as a result of our successful recruiting efforts.

We're very excited about our commercial lending businesses and the high-quality interest earning assets they are generating, and believe we can continue the growth you've seen, as we leverage the new lending channels while building on our core CRE and C&I businesses. Average consumer loans increased to $145 million, as we added high-quality jumbo and home equity launch of credit to our portfolio, as we look to maintain a diversified approach to asset holdings.

Average total deposits increased $266 million or 3% in the quarter, led by an increase of $121 million in company-controlled deposits. And average retail deposits increased $70 million led by growth in retail certificates of deposit. We continue to be focused on executing on several strategic initiatives to drive further deposit growth, including acquisition opportunities, building out a digital strategy, putting a greater emphasis on bringing in deposits from commercial customers and leveraging our subservicing business for custodial and escrow deposits. We're very encouraged by the sustained growth in the community bank, our positioning and potential for the future.

Please turn to Slide 13. Third quarter operating highlights for the mortgage origination business include fallout-adjusted lock volume declined 1% to $8.9 billion quarter-over-quarter, a slightly lower correspondent and broker volume was offset by stronger retail volume following the fourth quarter of Opes originations. Mortgage closings increased 4% in the quarter, again primarily due to the full quarter of Opes, but also because of the operational excellence of our underwriting and fulfillment teams, who continue to combine both quality and efficiency in that processes.

Our net gain on loan sale margin increased to 11 basis points quarter-over-quarter to 84 basis points, led by a higher distributed retail mix following the Opes acquisition. Although it's difficult to estimate, we believe the impact of the hurricanes was worth anywhere between $0.02 and $0.03 of lost earnings per share through a combination of lost mortgage locks and credit erosion. As we've previously discussed the strategy behind the 2 acquisitions was to preserve mortgage banking revenues in a declining market and also build our retail presence as the market shifts towards the purchase market, I believe that Q3 results validate our original thesis.

We've recently launched our second securitization of the year, which consists of $576 million, a fully amortizing, high-balance conforming and jumbo fixed qualified mortgage loans to borrowers with strong credit profiles and low leverage. We're excited to be able to return to the market just 3 months following (inaudible) securitization, and believe this can become a regular activity for us. As Sandro mentioned, Kristy Fercho was appointed President of Mortgage Banking earlier in the quarter and we're thrilled to have someone with Kristy's talent and experience leading our mortgage business. We believe we've 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.

Moving to servicing. Quarterly operating highlights for the mortgage servicing segment on Slide 14 include, through the first 9 months of this year we have been one of the biggest sellers of MSRs in the country. Of the $29 billion UPB of MSRs sold, we have retained the subservicing on 85% of these sales. I believe this is testaments of the servicing platform we put in place. We've previously spoken about the Fannie Mae STAR awards for 2 consecutive years from a quality point of view. And we also offer MSR lending, servicing advanced lending and recapture services for a comprehensive one-stop shop to owners of MSR assets. If you combine this offering with the robust risk and compliance infrastructure and well capitalized bank, you can see the attractiveness of that proposition and our strength as a solid and reliable counterparty.

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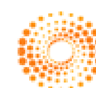

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The escrow and custodial deposits these loans generate also help us fund our balance sheet, and we held [$1.4 billion] of such deposits at the end of the quarter. We currently service or subservice 415,000 loans where almost 300,000 are subserviced for others, making us the eighth largest subservicer in the country. The remaining 115,000 loans are MSRs we own are a part of our HFI book. It should be noted less than 2% of the loans we service or subservice are more than 60 days delinquent. Our MSR to CET1 capital ratio at the end of September was 20% and the recently announced capital simplification proposal would allow us to hold up to 25% of MSRs to CET1 capital before it became punitive. This is obviously a significant and very positive development for Flagstar.

As it related to the hurricanes within FEMA counties in Texas, Florida, Puerto Rico and the U.S. Virgin Islands, we offered homeowners a 90-day forbearance on their mortgage payments in accordance with investor guidelines. It also included working with borrowers on repayment plans in order to allow an extra time for payments so that they could get back on their feet. Going forward, we remain focused on growing up 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.

Moving on to expenses on Slide 15. Our noninterest expense increased $17 million to $171 million quarter-over-quarter, which was in line with the guidance we provided on the last call. Significant increase in expense dollars was predominantly because of the full quarter of Opes expenses. If you recall, we closed this transaction in May, so only we reported a partial quarter of expenses in Q2. Opes also generated revenues in excess of its cost base during the quarter and continues to perform in line with our expectations and be accretive from an earnings per share point of view. As we previously noted, we expect the payback from this investment to be less than 3 years. We also continue to invest in growth initiatives across the bank, particularly in our expanding commercial lending businesses and we should see the revenues from these investments materialize as we move forward.

Expenses across all other areas of the organization were in line with our expectations as we maintained that disciplined approach to expense management. The increase in our efficiency ratio of 1.5%, to 73.5%, from last quarter was again due to a full quarter of Opes results. While the business is profitable in generating earnings in line with our expectations, retail mortgage platform is inherently less efficient than the community bank. We're focused on improving our efficiency ratio through the growth of 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 $167 million and $172 million during the fourth quarter of 2017. We're very pleased with how we performed so far in 2017 with delivering on our strategic plan and believe we will continue to create significant 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 Q4 and then open the call for questions and answers. Please turn to Slide 17. We expect net interest income will be up slightly with average earning assets consistent with period end of Q3 levels and anticipate a relatively stable net interest margin [expect] seasonal decline and gain on loan sale in common. We anticipate a 5% to 10% drop in mortgage locks. We expect a steady gain on sale margin. We anticipate a net return on MSRs will approximate 5% to 7% before transaction costs from the closing of MSR sales.

We expect loan fees and charges will fall moderately and lower mortgage loan closings while all other noninterest income will remain steady with Q3 levels. And as Lee noted, noninterest expense will remain fairly stable between $167 million and $172 million.

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

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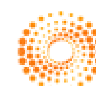

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QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) And we will take our first question today from Jessica Levi-Ribner with FBR . Please go ahead.

Jessica Levi-Ribner

Can you speak a little to kind of the supply dynamics of homes for sale in your markets and then also what kind of competition you're seeing for originations from some of the larger banks?

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

Sure. I think from a supply point of view, it seems pretty clear to me from my interaction with our account executives and loan officers around the country that the supply is tight and particularly in some of our West Coast markets there just doesn't seem to be enough supply out there, and I think that's holding back the size of the mortgage market. Relative to competition from banks, I mean, we don't really look at banks versus nonbanks from a competitive point of view. I mean, what we try to do is position our business so that it makes sense for Flagstar. So we look at what the opportunities are out there and make sure we price the business the right way and make sure that we're balancing our capacity against our production and our revenue targets in the right way and let the rest of it take care of itself, and I think that approach has been working pretty well for us.

Jessica Levi-Ribner

And then in terms of subservicing, you mentioned that you have the capacity to subservice up to 1 million loans. Is that a strategy of yours who go after subservicing or is it more on the basis of MSRs or loans originated and you are selling MSRs retaining the subservicing? And then also how are you thinking about MSR sales versus holding them on the balance sheet given the capital simplification?

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

So, growing sub-ervicing is a strategy, Jessica, and we can grow subservicing always basically. One way is as you articulate, it's selling the MSRs we create through our origination business and then subservice these loans and we've been pretty successful of doing that over the last 3 years. Another strategy is onboarding loans we haven't originated and this year we've already onboarded about 30,000 loans that were not originated by Flagstar and we think that's an opportunity going forward. And then typically coming from the MSR owners that we're selling out MSRs too because they're buying from a number of counterparties. We can work [directly] with Fannie and Freddie and we have capacity agreements in place with both of them.

And then the fourth leg of the stool would be private-label subservicing and this is something we're working on having in place sometime during 2018. So it is a strategy to grow subservicing and we like the fact that it's a fee income business. We've got the quality for the Fannie awards and we can offer a lot of ancillary services such as the lending around the MSR and servicing advances to back that up.

In terms of our strategy, I think with the capital simplification rule, I mean we will hold as much MSR as we can. We like the asset. As you heard Jim say the returns are strong. And I think the increase in what we can hold, it just gives us more options, I think, 10% we were having to sell more. The fact that it's been increased to at least 25%. It means we can hold more and we can -- we only need to sell it if the economics make sense for us.

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

Let me add a couple of things there, Jessica. Number one is, Lee said in this prepared remarks, we're probably the largest seller of MSRs this year in the country and it's important to note that we've been able to keep subservicing in about 85% of those sales and I think that's the -- and we've

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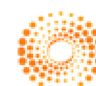

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been able to sell at our marks. So I think that speaks to the fact that we've been capitalizing our MSRs at the right rate. And I think that's important, because if you take risk and the way you capitalize your MSR, it in the short term can help the originations, but in the long term, can put at risk because that MSR asset might not really have the value that you've placed it on the balance sheet at. And I think you can't underestimate the flexibility of piece of this capital simplification plan. At 10% you just don't have flexibility. You pretty much have to sell it when you originate it, when you create it. At 25%, it just gives us ability to make sure that we do it when it's right from an economic point of view. And that just changes week to week depending on what the interest rates outlook is. So, it's a real, real big benefit to be able to have 25% as opposed to 10% . And with respect to the servicing platform, we're really the only full-service bank in the country that's taken this approach to building this business and I think the way it complements the level of MSRs that we create and turns it into a business it really put (technical difficulty) and I think as I said quite unique overall and I think the one thing that we I don't think we mentioned in terms of the benefits, that we provide to those that might onboard with us, the loans we didn't originate is the regulatory discipline that we have as a bank and being the only bank it's really trying to do this, I think that's a big differentiator for us.

Jessica Levi-Ribner

And then one last one from me would be just what the market is right now for MSRs (inaudible) buyers and, yes, and the pricing?

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

So I think what (inaudible) coming back to the election, from a selling point of view, the market was great. And we were able to take advantage of that and that's why we sold $29 billion of underlying loans year-to-date. The pricing is definitely contractive or got tighter in the last 2 or 3 months, but again coming back to the capital simplification rule and moving up to 25%, it gives us more flexibility. We don't have to constantly be selling, and as you've seen in this last quarter, we certainly didn't sell as much as we did in the first 6 months of the year.

Operator

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

Scott Siefers

Just wanted to ask you about, I think if there is one thing I've kind of noticed through out the course of the year, the pace of balance sheet growth has been really quite rapid and it's done a great job of overwhelming just through the sort of that tough mortgage environment. So I guess I'm just curious as you see it, what's kind of the appropriate pace of balance sheet growth going forward. In other words, when does it kind of reach a steady state or begin to kind of plateau in terms of just the overall pace of the loan portfolio growth?

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

I think the pace that we've been at this year is pretty consistent with the last couple of years and consistent with the guidance that we've been talking about going forward. Jim talked about all the capital we have and as long as we've got the capital and as long as we're able to continue to bring new people into the organization, we will be able to continue to generate those earning assets. You used the term rapid. I don't -- wouldn't essentially agree with that term. I think it's been good steady. It's been thoughtful and is solid quality at a price that makes sense. So we're optimistic that we can continue to bring new and high quality people into the organization and if we can do that, then we will continue to grow our earning assets at the pace that we have done.

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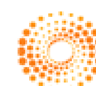

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Scott Siefers

And then just maybe on the the funding side, I guess the only challenge with the overall asset growth is it can be tougher total deposit growth to keep pace. Having said that you've been growing the deposit base pretty rapidly or pretty helpful. So just curious where your thoughts on overall funding strategy where you would see things going from here?

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

So I think similar answer. What we've been doing growing those core deposits pretty steadily going from [$6.2 billion] in the bank to [$6.5 billion], I think we can continue to do that. The brand awareness campaign that we started a couple years ago is taking shape. We've seen our brand awareness scores improved in a very nice fashion based on the information we have. In our prime banking markets, it's grown as much as anybody else's over the last 12 months or so and then we've added this Detroit Pistons relationship with the Jersey's sponsorship and so I think you can see we made a big, big commitment to building our brand, and I think as we build our brand then that allows us to develop our core relationships more and then we have these other ways of building deposits as well through our government banking business, the company-controlled deposits that we talked about and we're working on our online banking opportunities to expand our deposit gathering footprint, if you will. So we're trying to be as creative as we can and then also to get better at the more traditional ways of the bringing funding into the company.

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

Scott, I would also add in the same way that we're adding loans. We're adding deposits by bringing high-quality people from other institutions over to Flagstar and as we bring those high-quality individuals over especially in the commercial arena in the business banking arena they've been really good about bringing over the entire relationship. So it's not just the loan what we're doing, but it's also in a great many of those cases, we're getting the deposits in those relationships.

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

I think -- and Scott, just I didn't mention this in my prepared remarks, it was well sort of building the brand and building core deposits and we've done a nice job of that. I mean, these are the strategies, I mean, this acquisition opportunities Sandro just mentioned building out of a digital strategy, leveraging our commercial customers, as Jim just alluded to, and then leveraging the subservicing business for escrow and custodial deposits. So there's a number of the other strategies outside of building the core deposits that where we're looking at at the moment.

Operator

And we'll now go to Scott Valentin with Compass Point.

Unidentified Analyst

Hi, this is (inaudible) Scott Valentin, how is it going?. Appreciate the color on the impact from the hurricanes and I understand the volume side is difficult to quantify, but did you see any impact on perhaps some loans that you had funded that haven't yet been sold?

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

No, nothing material.

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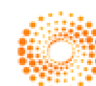

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Lee Matthew Smith - *Flagstar Bancorp, Inc. - COO, Executive VP, COO of Flagstar Bank and Executive VP of Flagstar Bank*

Just -- it's just a timing difference where we need to get a reappraisal on some of those but, yes, nothing material belied as being able to (inaudible) and sell a few days, but nothing material.

Unidentified Analyst

And as it relates to the forbearances, should we also assume that it's not significant exposure there, and I guess, as we look to the fourth quarter, should we expect kind of a short-term uptick in residential delinquencies?

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

Again, we don't think it's a big exposure and we don't expect it to be an uptick in delinquencies in Q4.

Unidentified Analyst

And just on M&A, you mentioned that there was a possibility to grow deposits by acquisitions. You obviously has been focused more recently on nonbank acquisitions, So just in terms of priorities, are you still looking at expanding the mortgage operation, are you comfortable with the size of the unit there or I guess how would you prioritize where you're looking for M&A?

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

Well, I think M&A has always been opportunistic. So I think, let me just address the mortgage side of it first. So I don't think that a mortgage acquisition is high on our priority list. We did the acquisition of Opes that has been a great, great addition to the company and it's allowing us to expand our retail business in the way that we wanted to and it's created a hybrid sort of operation that is very interesting to other loan officers both as individuals and as teams. And so we're seeing the ability to bring people into our retail loan origination program and without having to pay for it, if you well. So if we can do that, if we can continue to expand our retail origination platform because people want to come to Flagstar, because it offers a differentiated choice, then there is no reason to -- pay somebody a premium for that business. That said, if the right economic opportunity presented itself, like we did with the Stearns and the Opes situations, will take advantage of it.

On the banking side, the right [bank] situation is going to be hard to find for us given the fact that we can do what we're doing organically and again similarly (inaudible) premium when we can do what we need to do organically. But again, same if the right economic situation presented itself, we would always consider it, but I don't put M&A at the top end of our priority list right now.

Unidentified Analyst

And If I could just slip one more in on the reps and warrants reserve, the releases you have there been a nice tailwind and it looks like you do have some runway there, I guess, at what level would you expect that reserve to stabilize?

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

Yes, I can't answer that specifically, but what I can tell you, of course, is that we review at every quarter and clearly the trend has been, and from our model has been, [review] the risk for loss in the declining fashion and so right now, it seems like that could continue but to try to predict what the market might bring on forward, I don't want to do that, but certainly I will tell you that we're very comfortable with the quality of originations, the low defect rates we have, we're pleased with some of the changes the agencies that made allow us to be more predictable about their rep and warranty risk and I'm very comfortable with the level that we have and we're pretty conservative, you know that, and so we're going to be careful about taking that down too far.

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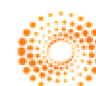

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Operator

And we will now take a question from Kevin Barker with Piper Jaffray.

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

In regards to the MSRs and managing your capital base, you're obviously going to see a lot more spread revenue given now your loan growth has been robust. And then if that continues to grow and you have a more predictable mortgage bank given you have the Opes transaction and you're more retail oriented, would you be comfortable, perhaps bring that Tier 1 leverage ratio below the target range of 8% to 9%?

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

I don't think so, I think in this day and age, 8% to 9% is the right place for a bank like us with the complexity risk levels that we have in our organization, the way we evaluate that, I think 8% to 9% is the right place to be.

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

Given the change in the capital rules, are there any changes in your priorities on deployment of that capital over time? Or do you believe you will continue to grow into your capital?

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

Yes, I think it's the latter. And I think there's no reason to change anything. I think it just strengthens our ability to do what we've been doing for the last 3 years and why we're continuing to do, so I don't think, we change anything.

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

And we continue to [self-fund out] growth that we have, through that capital generation and compounding the earnings.

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

And then in regards to the securitization that you did recently, could you talk about the gain on sale that you got from the most recent securitization versus what you're getting in the conforming or the FHA market?

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

Well, I don't think we provided that kind of detail, Jim?

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

Kevin, what I would say about the deal is there's a lot of different components of the benefits we get from securitizing. Those loans including, really access to a more efficient market, and while we didn't disclose that we are very pleased with the results, and I think this can be a regular activity moving forward.

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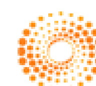

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Alessandro P. DiNello - *Flagstar Bancorp, Inc. - CEO, President & Director and CEO, President & Director of Flagstar Bank*

Yes, and I think in terms of providing guidance to you on what that might mean financially. I think we need a little bit more experience in history here before we can be more specific about it, but certainly just have an ability to generate that product from an origination point of view, that is very helpful for loan officers because there's not a lot of companies that have done it, right. I mean, Chase is the only other company I think that's doing this right now. So it's definitely another arrow in the quiver, if you will, for our loan officers and don't underestimate the benefit of that.

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

And then one that question in regards to your expenses. You've seen quite a bit of tick up in the commission expense and salaries are obviously bumped up following the Opes transaction. Could you talk about run rate for commissions given that Opes is fully integrated at this point, and then how you're thinking about salaries and expenses as well on the next few quarters?

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

Let me give you quick response and maybe Jim may want to add something to that. I hope this is the last time we talked specifically about Opes, right, because this is the first full quarter that we have Opes, and so this now becomes our retail platform. So, going forward when you look at commissions, it's not going to be Opes versus Flagstar, it's just going to be Flagstar basically. So commissions are going to grow based on how our retail originations grow, and we're pretty optimistic about our ability to grow that part of the mortgage business. I think, otherwise with respect to expenses, I think we're pretty satisfied that we've been able to keep the legacy expenses, if you will, under control. And the only other expenses that we've incurred are those, that are allowing us to generate more revenue. In order to get these people, you've got to invest some money in advance and so, but we're doing it very deliberately and very carefully and we're not trying to get the expenses too far ahead of the revenue.

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

Kevin, I will just add that the run rate you've seen in Q3 and what we've guided to in Q4, I think that's pretty consistent. As we mentioned in the prepared remarks, there is a little bit of investment in growth initiatives, but not a ton. And then you've obviously got the mortgage business, the recent seasonality there, and so that can impact quarter-to-quarter, but again not a ton. So I think what you've seen in Q3, where we're guiding you into Q4 is a pretty consistent run rate.

Operator

(Operator Instructions) And we will now go to Bose George with KBW.

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

Just on the new capital simplification proposals, what's the most likely timeline for that to go into effect?

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

Well, this is just my own personal guess, but I've tried -- we've tried to keep pretty close to that, so they still haven't actually issued the proposal, if you will, the final proposal. So there is likely to be a 60-day comment period after that. Now because as everybody knows Basel III rules are fully phased in [J1], I would expect that they're going to issue that pretty soon. So that they can get the new proposal finalized [within] the rules finalize before January 1. That's just my personal opinion. Jim, do you have a different view on that?

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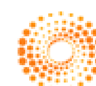

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James K. Ciroli - *Flagstar Bancorp, Inc. - CFO, Executive VP, CFO of Flagstar Bank and Executive VP of Flagstar Bank*

No. As I have mentioned at the (inaudible).

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

Actually one more just on the efficiency, just with the higher retail and the higher efficiency ratio as a result, does this change anything in terms of your longer-term mid-60s target?

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

No, obviously, it does not. Our long-term target is still in the mid-60s and we believe we'll get there through growing revenues across all 3 major business lines.

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

Now I add there with respect to the acquisition, as I think we said previously, we didn't model an expense savings there other than the funding benefits, but certainly as time goes on, we're finding ways to put the 2 organizations together that create a combination that's more efficient. So the efficiency ratio specifically related to that additional retail will get better as time goes on, and so, yes, we remain committed to getting the efficiency ratio down there in the mid-60s eventually.

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

Actually one last big picture question, I know its early in terms of tax reform, but do you have any thoughts about what a doubling of the standard deduction could do to potential homebuyer behavior?

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

Well, if overall tax rates are lower, then I don't think it should be a problem. I think that makes people feel like their paycheck is bigger, and they can afford house just the same. So, I'm the one that believes that it's not an impediment to homeownership.

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

We think it's all driven off of disposable income, Bose, and if you get that disposable income through an interest deduction or through a greater grader standard deduction, there's still money in the pocket of the consumer.

Operator

And I'd now like to turn it back to Sandro DiNello for any additional or closing remarks.

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

Thank you, Vickie, and thanks everyone for your interest in Flagstar. An important story line of the quarter was our power to boost earning assets. We continue to deploy our capital wisely and increased assets almost $1 billion in the quarter. It wasn't that long ago that we talked about putting the past to rest and pivoting to growth in the future, and we're doing that. We have made 2 mortgage acquisitions earlier in the year to offset the impact of what we expected will be a smaller and tighter mortgage market. These acquisitions also help to diversify our mortgage business. We

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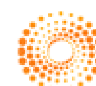

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have posted clean consistent earnings quarter after quarter despite a very challenging mortgage environment over the last year, and our community bank continues to grow, as does the stability of our earnings.

All in all, it was an excellent quarter with important metrics showing impressive results. We also welcome the capital simplification proposal from our regulators as it will accelerate capital formation to support our growth and importantly give us more flexibility in managing our MSR assets. We appreciate the loyalty and support of our shareholders, and we thank our employees for their extraordinary efforts to make Flagstar a success. Finally, thank you for your time this morning. I look forward to reporting Q4 results in January.

Operator

Thank you very much. That does conclude our conference for today. I'd like to thank everyone for your participation and you may now disconnect.

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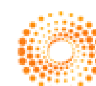

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