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PRESENTATION

Operator

Good day, and welcome to the Flagstar Bank Second Quarter 2018 Earnings Call. Today's conference is being recorded.

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

David L. Urban - *Flagstar Bancorp, Inc. - Senior VP & Director of IR*

Thank you, Jonathan, and good morning. Welcome to the Flagstar second quarter 2018 earnings call. 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 2017 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. - President, CEO & Director*

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; Kristy Fercho, our President of Mortgage; and Drew Ottaway, our President of Banking. I'm going to start the call by providing a high level view of our performance for the quarter, and then I'll turn to call over to Jim for details on our financial results. And 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 line for questions.

It was another good quarter for Flagstar. We posted solid results with net income of $50 million, the core operating figure we haven't seen since the third quarter of 2012 when we were much more reliant on gain on sale income. We saw strong earnings growth with net income increasing 43% from the first quarter and 22% from the same quarter a year ago. In fact, we saw improvements across the board. Net interest income was up $9 million, net interest margin increased 10 basis points, mortgage revenues climbed $8 million, average loans held for investment grew $893 million, and average total deposits rose $1 billion.

We realized strong positive operating leverage this quarter, improving our efficiency ratio to 74% from 80% last quarter, as we again showed our ability to quickly adjust expenses in the face of declining mortgage revenue.

Credit quality remained pristine with minimal net charge-offs and no commercial delinquencies. Our community banking business continue to thrive with an 11% increase in average total deposits, and solid growth in average commercial loans, even without the bump we got from acquisitions late in the first quarter.

Deposits rose across the board, and we're pleased to see measurable deposits coming out of our commercial banking relationships. Growth in average total deposits also reflected last quarter's acquisition of the Desert Community Bank branches, but without DCB, we still had a 6% growth in average total deposits.

Our mortgage servicing business continue to prosper, as we added to our book of business and ended the quarter with over 535,000 loans serviced. Fees and deposits from this business continue to grow at a very nice pace, yet the most important development this year has been our ability to onboard loans originated outside of Flagstar. Clearly, we are now a proven leader in the servicing business.

And what is usually a seasonally strong quarter for mortgage originations, our fallout adjusted locks and gain on sale margin came in below expectations. Our GOS margin fell 6 basis points to 0.71%, largely due to lighter spreads on an RMBS securitization late in the quarter. The mortgage industry continues to deal with the double whammy of overcapacity as they transition to a purchase market and the margin pressure that comes with it. Despite all of that, our pretax income remained strong versus the second quarter of last year and the quality of our earnings improved. The power of our banking and servicing businesses have clearly reached a point where we can deliver strong returns in a weak mortgage market. So all in all, it was an excellent quarter where we produced solid diversified earnings, kept credit quality clean and manage expenses.

Next, 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. - Executive VP & CFO*

Thanks, Sandro. Turning to Slide 6. Our net income this quarter was $50 million, $0.85 per share, as compared to net income and $35 million or $0.60 per share last quarter. Our earnings this quarter were led by strong operating leverage as our revenues, both net interest and noninterest revenues, increased 10% while our expenses grew a modest 2% due to effective expense control.

The acquisitions represent a leap forward in the growth of the banking line of business, and this quarter results prove the attractiveness of our strategy to grow the banking business. Not only did it lead to significant quarter-over-quarter operating leverage, it provided a more stable level of core earnings that enabled us to shake off the challenges in the mortgage market and deliver a strong level of earnings.

Fundamentally, the business is solid. Quality earning asset growth was good, deposit growth was very strong and costs were well controlled. Asset quantity remained unblemished and our leverage capital was in the upper half of our target operating range. Our Tier 1 leverage ratio is 8.65%, and we expect our Tier 1 leverage ratio to be 9.14% when the proposed capital simplification regulations are adopted.

So let's turn to Slide 7 and dive deeper into the income statement. Net interest income benefited nicely from the impact of the 2 acquisitions late in the first quarter in the ongoing progress we've made in growing our banking business. Earning assets were up 4% and the net interest margin expanded by 10 basis points to 2.86%, as higher yields on earning assets more than offset a modest increase in deposit costs.

Delving into the margin expansion further, we saw total deposit costs rise only 9 basis points in the quarter, representing a deposit beta of 36%. For comparison, the yield on our loans HFI increased 14 basis points for a loan beta of 56%. But we have noted that the deposit betas across industry are higher this quarter. We believe that the inclusion of the DCB branch deposits helped us manage our deposit costs to this positive outcome. We expect the Wells Fargo deposits will further improve our deposit betas and expand our net interest margin.

Despite a very challenging mortgage market, non-interest income increased 11% as mortgage revenues expanded $8 million. Our gain on sale revenue rose $3 million, while the return on the mortgage servicing assets improved by $5 million. We also experienced a $4 million increase in loan fees and charges from higher mortgage loan closings. The increase in gain on sale revenues reflected higher mortgage volume, partially offset by a lower GOS margin. Fallout adjusted locks rose 17%, reflecting a seasonal increase in mortgage originations driven further by a shift towards purchase mortgages. The percentage of purchase mortgage volume rose to 72% of originations this quarter from 59% last quarter.

The gain on sale margin fell 6 basis points to 71 basis points. Macroeconomic factors late in the quarter pushed spreads wider, impacting our RMBS securitization and resulting in a $5 million reduction in gain on sale revenue. Without this impact, the GOS margin would have been relatively flat at 76 basis points in the quarter.

The net return on mortgage servicing assets improved $5 million, resulting in a net gain of $9 million this quarter as compared to a net gain of $4 million last quarter. The increase from last quarter largely reflected a higher net return from the asset during the period driven primarily by slower prepayment speeds from the challenging mortgage environment; also, improved hedge performance and lower transaction costs related to sales. And expenses remain well-controlled.

Volume-driven expenses increased as a result of higher levels of production in the quarter and from a change in mix towards the retail channel. The remainder of the expense was relatively flat with the prior quarter, demonstrating the scalability of our business. In fact, we have a full quarter of both acquisitions. We saw the efficiency ratio of the community banking line of business improve to 53% from 57% last quarter as this number includes both the direct expenses of the business unit plus the directly allocated overhead expenses. We're pleased with the economies of scale that we are realizing and are confident that we can improve this measure over time as we bring Wells Fargo branches into Flagstar and continue to grow the bank.

Credit costs were negligible again this quarter. The provision benefit reflected a continued decline in loss rates. We reduced the allowance by $2 million to $137 million to reflect the lower risk in the loan portfolio. Net charge-offs were negligible, nonperformers and delinquencies stayed at their very low levels and our allowance coverage at 1.5% of total loans was one of the strongest among our peers.

Finally, the company's effective tax rate this quarter was 20%, consistent with our expectations.

So let's now turn to Slide 8, which highlights our average balance sheet this quarter. Average loans held for investment rose $893 million or 12%. Excluding the impact of recent acquisitions, average loans HFI rose 6%. Commercial loan growth was broad-based with solid gains in warehouse, commercial real estate and C&I loans. We also saw a nice growth in average consumer loans led by higher mortgage loans. If we just look at the ending balances as the Santander loans were included in the March 31 balances, we see loans HFI up $0.8 billion at June 30, or 9%. We ended the quarter with $16.3 billion of earning assets, putting us in a strong position to start the third quarter.

Average deposits rose $1 billion or 11% in the quarter, led by higher retail and custodial deposits. This growth included over $600 million of deposits from the DCB branch acquisition, driving an increase in average retail deposits of $780 million or 12%. Also contributing to this result, commercial demand deposits were up a solid 43% as we expanded our commercial relationships from our mortgage servicing business. Certificates of deposits increased $387 million or 24% on higher customer demand for this product, and the DCB branch acquisition.

Again, if we look at just ending balances, at the DCB deposits were in the March 31 balances, total deposits were up $0.6 billion in June 30, or 6%, with the growth in non-interest-bearing DDA comprising 2/3 of that growth. Point-to-point, non-interest-bearing DDA were up $0.4 billion or 16%. Despite a slight extension of duration in the portfolio from a higher percentage of CDs, the total cost of deposits increased only 9 basis points, and continue to perform better than the deposit pricing betas we've modeled.

At June 30, our tangible common equity to assets ratio remained strong at 7.74%, while our tangible book value per share rose to $24.37, as we continue to compound our earnings to cover regulatory capital levels shortly.

Let's now turn to asset quality on Slide 9. Nonperforming loans were $27 million at the end of the quarter, down $2 million from the prior quarter, while the nonperforming loan ratio dropped to 0.3%. Early stage delinquencies continue to be negligible. Only $3 million of consumer loans were over 30 days delinquent still accruing at June 30, down $2 million from March 31. There were no commercial loans over 30 days delinquent and still accruing, and no commercial nonperformers.

At June 30, our allowance coverage was 1.5% of total HFI loans, coverage remains strong at 1.7% of consumer loans and 1.4% of commercial loans. This commercial loan coverage is even stronger because 35% of that portfolio is in warehouse loans, which are fully secured, and we hold the collateral.

Turning to Slide 10, capital remained robust. Our Tier 1 leverage ratio was 8.65% at June 30, down a modest 7 basis points from last quarter, resulting from average balance sheet growth driven by the 24 basis point impact of the full quarter inclusion of the warehouse business and DCB branch acquisitions largely offset by earnings retention.

At June 30, our Tier 1 leverage ratio had 365 basis points of stress buffer, above the minimum level needed to be considered well capitalized. When the capital simplification proposal is enacted, we would expect to have a capital buffer of 414 basis points of Tier 1 leverage capital in excess of our well-capitalized minimum level.

With the increase in risk weights on both the mortgage servicing rights and the deferred tax assets to 250%, combined with the continued growth in commercial loans, which typically have a risk weighting of 100%, our total risk-based capital now stands at just over 14%, which is over 400 basis points above its well-capitalized minimum level.

When enacted, capital signification regulations would add approximately 13 basis points to this ratio, leaving it roughly in line with the stress buffer for the Tier 1 leverage ratio.

Considering the low level of risk in our business, stellar asset quality with strong allowance coverage, a neutral rate risk position and strong liquidity levels, combined with the robust risk management function, we expect to continue to target a range of 8% to 9% for the Tier 1 leverage ratio over the long term and a range of 13% to 14% for the total risk-based capital ratio.

Given our low-risk profile and strong level of allowance coverage, we would be comfortable operating in the lower end of both of these ranges. If we do become constrained by the total risk-based capital ratio, it would make residential mortgages and other lower risk-weighted assets more viable for the balance sheet. Being allowed to hold a lower level of regulatory capital for these assets, they can more effectively provide an appropriate return on capital, giving us even more options to continue to grow earning assets.

We currently expect a considerable amount of capital build before the end of 2018. In addition to the retention of earnings, we expect that we will continue to build our capital levels for the adoption of the proposed capital simplification regulations and from the utilization of approximately half of our remaining NOL deferred tax assets.

With the pending Wells Fargo branch acquisition, we anticipate that we will use the net proceeds to reduce our longer term FHLB advances. The payout of these obligations will trigger the recognition of approximately $23 million of after-tax net gains from terminated hedges of these advances. This amount is currently deferred and accumulated as other comprehensive income. When recognized, this will provide additional capital to support the acquisition. Should we need, we can also flex the turn times and loans held for sale portfolio down to increase our capital ratios without a significant impact on our earnings.

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

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

Thanks, Jim, and good morning, everyone. We're very pleased with our operating earnings of $0.85 per diluted share for the quarter despite continued challenges in the mortgage sector. Over the last few years, we've diversified our business model and made our earnings more predictable by growing the community bank and our subservicing businesses, and you now have seen the benefit of this strategy play out.

In addition to our solid earnings, we've also executed on some key strategic initiatives, including, we announced that we are acquiring 52 bank branches in Indiana, the Upper Peninsula of Michigan, Wisconsin and Ohio from Wells Fargo. These branches will provide us with approximately $2.3 billion of high quality, low cost deposits, which effectively prefund our balance sheet growth for the next 2 to 3 years. We will be keeping all 52 branches as there is no overlap with our existing branch footprint. This transaction, which brings with it 200,000 new customers, also gives us scale in the Midwest, a market we know well. We expect to close this deal sometime in the fourth quarter. During the first 6 months of 2018, we've grown average deposits $1.3 billion, and this growth has occurred across all deposit categories.

Average retail deposits have increased $889 million in part because of the Desert Community Bank branch acquisition, which closed at the end of the first quarter, but we've also been able to leverage our commercial lending relationships with deposits and seen healthy growth from our Michigan bank branches.

Government deposits have increased to $172 million during the same period with the remaining increase coming from wholesale on custodial deposits as we continue to increase the number of loans subserviced for others. The point being, we have been very successful in 2018, creating liquidity to fund continued balance sheet growth.

Average interest-earning assets increased $639 million in the quarter, largely driven by the acquisition of the Santander warehouse lending business, which also closed towards the end of the first quarter. As a result, net interest income increased $9 million or 8% quarter-over-quarter.

As of July 15, we are currently servicing or subservicing 583,000 loans. This represents an increase of 141,000 loans or 32% from the beginning of this year, and we have on-boarded almost 100,000 of non-Flagstar-originated loans between April and July. We've previously talked about our best-in-class servicing platform and I believe these results have proven that out.

We closed on the sale of $6.4 billion of mortgage servicing rights during the quarter and retained the subservicing on 100% of these sales. It's been another exciting quarter. We're executing on our strategic plan and feel we are well positioned to continue to grow and be successful 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.

Operating highlights for the community banking segment include: Average commercial loans increased $750 million or 19% with average warehouse loans increasing $647 million or 76%; average commercial real estate loans rising $63 million or 3%; and average commercial and industrial loans increasing $40 million or 3%, continuing that transition to a strong community bank. Average consumer loans increased $143 million in the quarter as we added high-quality residential first mortgage loans to our portfolio. Average interest-earning assets have increased $2 billion or 14% over the last 12 months, and we believe we can continue to grow at the same rate over the next 2 to 3 years, given we have the necessary liquidity particularly following the pending Wells Bank branch acquisition, capital and asset-generating capabilities from our unique business model to support its growth.

Of this $2 billion in earning assets growth, $1.5 billion has been driven by high commercial loans with the remaining $500 million being driven by consumer loans held for investment.

Net interest income has increased $9 million or 8% quarter-over-quarter and is $18 million higher than net interest income in Q2 2017. On an annualized basis and using our existing net interest margin of 2.86%, the $2 billion of balance sheet growth I previously referred to is worth $57 million of incremental annualized net interest income.

Average total deposits increased $1 billion or 11% in the quarter, led by an increase in average retail and custodial deposits. This growth included over $600 million of deposits from the Desert Community branches. It should be noted that since we closed the Desert Community Bank branch acquisition, we have seen no deposit attrition. It's actually increased slightly, which is testament to the work of our integration team and excellent customer relationships the Desert Community Bank has have established. We're very encouraged by the performance of the community bank, our positioning and potential for continued future growth.

Please turn to Slide 13. Operating highlights for the mortgage origination business include: Fallout adjusted lock volume increased 17% to $9 billion quarter-over-quarter, primarily due to the seasonal increase in mortgage originations. As a result, gain on sale revenues increased to $63 million in Q2 versus $60 million in Q1, as higher mortgage volume was partially offset by a lower gain on sale margin. And net gain on loan sale margin fell 6 basis points quarter-over-quarter to 71 basis points due to the impact of wider spreads on the outcome of the securitization late in the quarter, and the continued price competition in the market.

The current mortgage environment is challenging, given rising interest rates have significantly reduced refinance volume, which has not been fully replaced with purchase volume. It's further exacerbated by a lack of inventory in certain geographies and is clearly excess operating capacity across the industry, which is putting pressure on margins.

During the quarter, we issued 3 securitizations, 2 jumbo and high balance securitizations and 1 risk retention securitization. It's testament to the scale of our origination business, we were able to issue 3 deals in 1 quarter, and we expect securitizations to be a regular occurrence for us in the future.

Despite the challenging environment, we believe we have one of the best and most diversified mortgage origination platforms in the country and are well positioned to take advantage of any dislocation in the industry, given the smaller and more competitive market.

Moving to servicing. Quarterly operating highlights for the mortgage servicing segment on Slide 14 include: As of July 15, we serviced or subserviced 583,000 loans, of which, 468,000 are subserviced for others, making us the seventh largest subservicer in the country. We've already increased the number of loans serviced by 141,000 so far this year. And given our existing onboarding schedule, we estimate we will be above 700,000 loans serviced or subserviced by the end of this year.

So far, in 2018, we've sold $23 billion in MSRs, including $6.4 billion in the second quarter and retain the subservicing on 100% of these sales. Our unique servicing platform combines quality, operational expertise and complementary ancillary offerings. We've previously discussed MSR lending, servicing advanced lending and recapture services that result in a comprehensive one-stop shop for our customers. This is further enhanced by our robust risk and compliance infrastructure and strong capital position, which means we're seen as a solid and reliable counterparty by owners of MSR assets.

The custodial deposits these loans generate also help us fund our loan growth. We held $1.6 billion of such deposits during the quarter, up $149 million or 10% from the prior quarter. Our MSR to CET1 capital ratio at the end of June was 20% and the capital simplification proposal would allow us to hold up to 25% of MSRs to CET1 capital before it became punitive.

We will continue to grow our subservicing platform through a combination of MSR sales where we subservice the underlying loans and onboarding non-Flagstar-originated loans given the strength of our offering.

Moving on to expenses on Slide 15. Our noninterest expense increased $4 million to $177 million quarter-over-quarter, which was primarily driven by higher commissions and loan processing expenses, given 14.6% increase in mortgage closings quarter-over-quarter. We were prudent in managing our expense base and this resulted in positive operating leverage of 8%, as revenues increased 10% while expenses increased to just 2% quarter-over-quarter. Our efficiency ratio improved 6% to 74% quarter-over-quarter for all the reasons outlined above. We estimate noninterest expense will be between $180 million and $185 million during the third quarter of 2018. We remain focused on improving our efficiency ratio through increasing revenues while maintaining our cost discipline across the organization. We're very pleased with our progress so far this year. We have the necessary liquidity, capital and asset generating capabilities to execute on our strategic plan and continue to deliver significant value for our shareholders.

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

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

Thank you, Lee. Now I'm going to close our prepared remarks with some guidance for Q3, and then open the call for your questions, so please turn to Slide 17.

We expect net interest income will increase approximately 5% on the back of an increase in interest-earning assets, coupled with continued margin expansion. We anticipate gain on loan sale income, gain on sale margin and non-interest income to be flat compared to Q2 and as Lee noted, we expect non-interest expense will rise to between $180 million and $185 million.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll take our first question from Scott Siefers from Sandler O'Neill + Partners.

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

Let's see, a couple of questions on the mortgage business. First, I guess, either Lee or Jim, I appreciate the color on the gain on sale margin expectation for the third quarter. I guess, given all the moving parts that we've got, work issues, inventory issues, et cetera, what's your best guess as to when or how we might see some relief on gain on sale margins? In other words, how would -- your best guess for how the industry, sort of, rationalized itself here over the coming quarters?

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

Scott, I don't know, I'll let Kristy opine on this too, but I wish I had a crystal ball, I wish I could answer that question. I really don't know the answer to that, but here's what we're doing because we don't know the answer to that. We're not assuming it's getting any better. We're assuming that this is what it is, and we'll operate the business that way, and continue to get as much revenue as we can out of the mortgage business. Use that to leverage our balance sheet so that we can continue to grow the banking business, and I think that's how we best increase shareholder value in the face of this difficult mortgage market. Kristy, anything you want to add on that?

Kristy Williams Fercho - *Flagstar Bank, FSB - Executive VP & President of Mortgage*

Yes, I will just say we have expected the overcapacity to come out by now but you've seen some of it, right? So in Q4, you saw Capital One exit the business. In Q1, it was MB Financial, and in this quarter, the big one was Citizens Financial acquiring Franklin American. So it's happening, just not at the speed that I think we would have expected. I think part of that is, with Q2 being a quarter where originations are at their peak, I think people took some cost out and drove some efficiency in the business to create a little breathing room for themselves. But as Sandro said, we expect that rationalization to continue, likely seeing more of it in third and fourth quarter of this year, and I think it's going to continue in the first quarter of next year as well. But we like our chances, I mean, we are very focused on and excited about our business model and really continuing to operate across that diversified mortgage platform in all channels and really looking for opportunities where we could take advantage of what's happening in the market and continue to position ourselves to win.

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

Yes. Scott, it's Lee. I'll just add, this is why you've seen us diversify our business model like we have over the last 3 or 4 years. So we're not relying on any 1 basis line. And you've seen the benefit of that strategy play out. It's a tough mortgage environment, but we've delivered quality earnings.

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

Okay. And then let's see, maybe next question might be best for Jim. Just on the net return on the MSR asset. I think, typically, you guys have offered guidance sort of on the percentage kind of 5% to 7% range, looks like you're suggesting relatively flat net return, which would imply a higher percentage. Just curious if you can sort of walk through the -- that kind of why and how the returns stayed elevated at that percentage vis-à-vis the kind of range you've been asked.

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

Well, I think that as you look at the return this quarter, you're going to find that the core asset return this quarter, prepayments slowed, both actual and expected future prepayments, and actually, our slowest month of the quarter was June. So as we look forward, and we look at everything that we do, typically, we're expecting, in total, that the return on the MSR is about where it ends up for the second quarter.

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

And Scott, again, it's Lee. I'll just jump in. I mean, if you look at the MSR asset and given the rising interest rate environment, I mean, what we've seen in Q2, lower runoff, we had a better hedge performance, there's a higher carry due to lower future forecasted prepayments. I mean, our CPR was 6.22 in Q2, that's the lowest I can ever remember it. And a lot of our MSRs are newly minted, these are loans that have been originated in the last 12 to 18 months. So there's just less chance they're going to pay off.

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

Okay. That all make sense. And actually, just one ticky-tacky question here. Jim, you talked about that $23 million after-tax gain that you guys all recognized. Is that going to occur roughly simultaneously with the branch transaction closure? In other words, would that be sort of a fourth quarter event? Or is that something you're going to do in anticipation that we could see in the third quarter?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

So it would be a fourth quarter event, and just to be clear, we've already terminated the hedges. So we've locked in the gain that we could recognize, those gains are hedges against our long-term FHLB borrowings. And as a consequence of taking the deposit proceeds and redeeming all of our FHLB outstandings, long-term outstandings, the deferred gain will flush through earnings, but it will happen at the time we receive the proceeds from the deposit acquisition.

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

So it's fourth quarter, assuming we close in the fourth quarter, which is our best guess right now.

Operator

Our next question comes from Bose George with KBW.

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

Just wanted to start with question about the net interest margin. It came in, obviously, quite a bit better than your guidance. Just wanted to ask, just what would be the main driver of the upside relative to expectations? And also, just related question on the branch acquisition, the Wells acquisition, you talked about a 21 basis point funding benefit, is that still a good number to go with?

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

So on the first question, I think it's a combination of things. Number one, I think we were able to hold the line on pricing, maybe better than we thought we could in our interest-earning assets. And so as Jim said in his prepared remarks, the beta on our loan yields was very strong. And then on the deposit side, combination of the benefit of the lower beta, DCB deposits and the great job that our people did in the field overall, growing a number of different types of lower-cost deposits like business deposits, helped us keep that deposit beta at a manageable level and consequently, you saw the margin expansion. And we think we will see that develop further as we go through Q3.

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

And -- and then just one the...

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

With respect to the Wells. I'll let -- yes, I'll let Jim comment on the 21 basis points.

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

So what I would say about the Wells is we continue to be convinced of the pricing sensitivity of those deposits. And at this point, our expectations for the benefits on that transaction have not changed in any material respect.

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

Okay, great. And then actually, just on the Wells transaction again, can you remind us what that does on that in terms of operating expenses?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

We said there was roughly about $600,000 net of branch-related noninterest revenues. So the net costs -- our NIE minus the branch-related net interest revenues, and that was about $600,000 per branch.

Operator

Our next question comes from Steve Moss with B. Riley FBR.

Stephen M. Moss - *B. Riley FBR, Inc., Research Division - Analyst*

I want to start on loan growth here. You had good C&I and commercial real estate growth quarter-over-quarter, just wondering what you're seeing in your expectations going forward?

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

I'll let Drew comment on that. And I'll start off by just saying I think what we've been able to do is continue the performance in the past. As you are able to bring good people on board, they gradually bring good relationships onboard, and that's really the secret sauce. Drew, anything you want to add to that?

Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP, MD & Michigan Market President of Flagstar Bank*

No. I think, I mean, that really is the secret sauce. And if you see the growth rates trend mid-single digits from the low teens across both of those in spite of the competition that we've seen out there, we're pretty proud of that. And I think it does go back to the people. I think the only thing I'd add is I think it's really the diversification of our portfolio that's going to allow us to continue to grow the way that we have. So we're not all reliant on CRE or C&I or any other parts of the portfolio.

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

Nor are we reliant in any one geographic area, and that's a little unusual for a midsized bank to have the national presence we have in so many lines of business that allows us to be opportunistic and grow where the right growth is available to us, and that's worked, and it's continuing to work.

Stephen M. Moss - *B. Riley FBR, Inc., Research Division - Analyst*

Okay. And then on deposits here, nice increase in noninterest-bearing on an EOP basis quarter-over-quarter, I'm wondering what's driving that and if you could talk about your expectations, going forward, on interest-bearing deposits?

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

Well, as you grow a commercial book, the hardest thing is bringing the deposits. And I can tell you that Drew, since he's been here, there isn't a loan committee meeting that I've gone to or a loan presentation where if deposits hasn't been brought up by the loan officer, he brings it up. So it's just pounding on it time and time again, and finally, it starts to happen. And people start to believe you that they're not going to get the loan if you don't get the deposits. And so that's coming to fruition, and I can't predict how much more we could do there, but we're going to continue to make that a focus. Drew?

Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP, MD & Michigan Market President of Flagstar Bank*

Yes, I think that's exactly right. I mean, this is about relationship banking. And relationship banking is more than just lending out the balance sheet. So I think the folks that we brought over employ that discipline and they're constantly talking with their clients about how we can expand the relationships that we have them. I think it's a testament, too, that this one of a kind model that we talk about and the synergies that naturally lies all of our different lines of business.

Operator

Our next question comes from Terry McEvoy with Stephens.

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

Just starting with the long-term targets slide. I noticed some changes in the text on the mortgage side going from a kind of 5% to 10% growth trajectory, more to a maintain market share and widen margins. So I'm just trying to get behind the change in the long-term target and whether that impacts really the revenue side going forward, or it's just more of a focus on margin, but with the still -- still with the same revenue trajectory?

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

Yes. Look, I think that as we look at the uncertainty of the mortgage market right now and who knows for how long, I don't think it's prudent for us to try to tell the world that we think we can increase our market share. I don't think that's the right way to look at it. I think the way that we best grow shareholder value here is keeping the mortgage business in the right place, making it better as we get through all of this, taking advantage of the dislocation that will come in the business when it does come, but as we already said, we don't know what that is. And in the meantime, keep growing these other businesses, keep growing mortgage servicing as well as the banking business where we can be more confident about where the revenue is coming from and what level it can be at. And I think as I've already said a couple of times, I think that's the best way to grow shareholder value. How are we going to get a better multiple on these earnings? That's how we're going to do that. And the mortgage business is really, really important because it drives a lot of revenue into this organization that allows us to leverage the balance sheet and grow in a way it doesn't require us to raise capital on. So we've never had to raise capital, we haven't had to dilute our existing shareholders and yet we've gone from a $9 billion company not very long ago to an $18 billion company. So I think what we're doing is making sense, and we'll adjust to the mortgage business as we need to.

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

And then a question for Jim. Thanks for Slide 42 here. On a pro forma basis, the right side of the balance sheet, how much -- maybe just save me from doing some math here after the call, how much FHLB are you replacing within that pro-forma column all the way to the right, assuming that $2.3 billion of deposits comes onto the balance sheet?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

That's going to be around $1.6 billion, $1.7 billion. So it's -- what we're estimating right now is a pretty -- we've taken a pretty conservative view of the -- in modeling the Wells transaction. So we've modeled quite a bit of deposit runoff that we're working hard to make sure it doesn't happen, and we're picking up $130 million worth of loans and paying up net premium over around $160 million. So when you back off the runoff, the loans, the premium and the fixed assets that we're picking up, you'd end up around $1.6 billion. That's when comes through. We'll use all of that to pay down our most expensive wholesale funding, which is going to be the longer term FHLB advances.

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

And Jim, one last question. You mentioned of the call, period end average earning assets 2Q, what was that number again? Do you have that handy? I didn't write that down.

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

Well, so period end is 16.3, average is 16.0.

Operator

Our next question comes from Chris Gamaitoni from Compass Point.

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Assistant Director of Research*

Can we shift over to mortgage servicing? What drove the very large increase in subserviced loans this quarter? And it looks to be future growth given your guidance of $700,000 by the end of the year. Maybe just some color on where those loans are transferring from, from servicing relationship standpoint?

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

Yes. So it's Lee. We -- I mean, I mentioned on the prepared remarks. The big change, we on boarded 100,000 non-Flagstar-originated loans between April and July, and that is what has driven the growth that you've seen, certainly, in Q2. But really, in the first 6 months of this year, we've grown over 140,000 loans, and we expect to continue to do that in the second half of the year, and that's why I've guided to us servicing or subservicing over 700,000 loans by the end of the year. So it's really being driven by these onboarding loans that are non-Flagstar-originated.

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

And I would add that this year, we've been able to maintain subservicing in 100% of the MSR sales. Last year, it was what, 85%?

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

87%.

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

87%. So there's a little bit of a benefit there, too, that we've been able to keep all of the Flagstar-originated loans. And as I've said in my remarks, I think this is -- the real key for this servicing business is the fact that we're onboarding these loans from other parties that own servicing of loans originated by other companies, that's really -- that really tells you how far we've come in terms of the confidence that MSR owners have in our servicing platform.

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

And I would just add. I mean, look, I think the strength of our servicing platform, I mean, we have the quality, you've heard us talk before about us winning the Fannie Mae STAR performer in general servicing 3 years running. We can offer ancillary products, MSR lending, servicing advanced lending, recapture services. The deposits are valuable to us. They help fund the balance sheet, and we're well-capitalized and have a strong risk and compliance infrastructure in place. So we're seeing it as a very, very solid counter party by these owners of MSR assets.

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Assistant Director of Research*

So this is fair that most of the transfers are coming from other sub-servicers?

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

Yes.

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Assistant Director of Research*

Okay. And then another thing I noticed was it's happened in the first quarter as well and continued into the second quarter, is a shift in the composition on your MSR portfolio towards Ginnie Mae's. I was just wondering why that's occurring? Kind of what's the strategic rationale behind that?

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

There's not really a strategy behind it per se. I think we look at where it makes the most sense to hold an MSR versus to sell an MSR and the economics associated with that. And that changes from time to time. If you go back historically, you will see that there were times where we didn't have a lot of Ginnie Mae in the MSR portfolio, and now that's changed. So we're comfortable servicing the Ginnie Mae. The quality of our servicing is outstanding. A lot of companies are afraid of servicing Ginnie Mae, we're not. We're very comfortable, our QC is strong, regulatory oversight is there, that is -- brings a lot of comfort to MSR owners. So it's not particularly a strategy, it's just looking at where the best opportunity is.

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Assistant Director of Research*

Okay. And then the final question is, I saw on your presentation that the spreads for warehouse lending came down quarter-over-quarter, maybe just talk a little bit about the competitive environment and how you'll approach that market if that is occurring?

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

Yes. It's not so much the competitive environment as it is the fact that we purchase the warehouse business portfolio from Santander, and they were focused more on very large originators and larger lines compared to what we've done historically at Flagstar. And as you might expect, the spreads and those relationships are real narrower than they are with the smaller organizations. And so just when you look at the average of the 2 combined, the margin is narrower, it's still very strong. And together with the fees that the business brings, it's still a terrific business, especially considering the strength of the credit that resides in that asset. So it's not that we are conceding on price, it's just a combination of the 2 portfolios.

Operator

Our next question comes from Kevin Barker with Piper Jaffray.

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

In regard -- a follow-up on the servicing, the runoff of the portfolio was extremely low this quarter and some of the comments that were made earlier about June being particularly low, was there anything, any anomaly that occurred within your prepay speeds or any transition on the servicing portfolio that may have caused that decline in amortization expense?

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

No anomalies, Kevin. It's as I said. I mean, the higher interest rate, it's meaning our CPR speeds to the lowest they've been. I mentioned it was 6.22 in the second quarter. And again, I'll just emphasize the other point, most of our MSR portfolio, it's -- these loans have been originated in the last 12 to 18 months, so it's brand new, and there's obviously less chance they will pay up. So I think that's really all you're seeing quite through here.

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

Yes, I mean, that, I think, is the real point, Kevin, is the age of the MSRs compared maybe to the industry as a whole. Unless you're doing the cash-out refinance, there's really not much reason to refinance a loan today and if you got a loan in the last 12, 18 months, you don't have much of an opportunity for a cash-out refinance. So I think we're reaping the benefit of having a very liquid MSR portfolio that we've turned regularly, that we've been able to sell regularly, and so now we're getting an advantage and a pickup in yield there.

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

So what you're trying to say it's a fairly new portfolio that would have relatively lower prepay speeds compared to the rest of the industry?

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

Yes. And you can see the breakdown on Page 41 of the earnings deck, but that is -- that's correct.

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

Okay. And then -- and a follow-up on some of the warehouse lending. How much of the warehouse lending outstanding balance in the second quarter was related to the Santander group that you brought on versus the core Flagstar group today? And then how much attrition was there from what Santander had previously versus what they have today?

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

Yes, there was no attrition. In fact, it's grown quite substantially since the closing of the transaction. And I think -- I'm looking at Jim here, but I think it will be by half-and-half?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

Yes.

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

So you've actually seen an increase in what you would expect typically, given the mortgage market today from...

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

Yes, it's been exactly the opposite of what you would've expected, and I think that tells you a lot about how the customers that came over have embraced the service levels at Flagstar. We believe that we're, if not the best, one of the best warehouse lenders in the country, and I think this is a good evidence that these customers think the same.

Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP, MD & Michigan Market President of Flagstar Bank*

I would just add, Sandro. I mean, I think it's a reflection of the team that we've brought over as well and the deep relationships they have there. Albeit larger customers, but as we brought them on, they just began to use those facilities more and more, and I think it has done a nice job.

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

Not so much -- do correct me if I'm wrong, it's not so much in the new customers coming from the Santander team but higher utilization rates.

Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP, MD & Michigan Market President of Flagstar Bank*

That's right, yes.

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

That's the opposite because you were expecting, I think it was roughly, what, 30% to 40% attrition when they first brought it over? So are you nervous you're going to see that go to the other way? And then -- and follow up on the Wells Fargo transaction, do you have an update on the average cost of deposits today versus December 31?

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

Yes, I think Lee can tell you what that is, yes.

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

Yes. They are basically very similar. So it's about 5 basis points, up from 4 and a change.

Operator

Our next question comes from Henry Coffey with Wedbush.

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

Yes. First, going back to Santander, it's a bigger customer, it's a more robust customer. When you think of dollars lent, do you think ultimately, more servicing transfers over because of that or less?

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

It's hard to say. I don't know if we've -- Lee, have we seen anything in that regard yet?

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

No, we really haven't.

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

And then just jumping to the mortgage business. Most of the transactions that you cited were originators. Maybe, Kristy, you could give us a feeling for what's probably going down, what we'll call then the bottom, the 80 to 100 originator, the 60 to 80 ranked originator, those are the sort of small and obscure people. What's going on down there? Are they in a total panic over what's going on of the market? Are they struggling and hoping? Are they looking to sell? Are they looking to buy? What are your thoughts in terms of the smaller tier of the mortgage market?

Kristy Williams Fercho - *Flagstar Bank, FSB - Executive VP & President of Mortgage*

Yes. Henry, I think it's all of the above, actually. So some of these smaller originators, they don't make the headlines, but we know a number of them have taken the money off the table from the last couple of years. They also, because they're not public, have the ability to kind of operate kind of each loan as a lot, hoping that the market really comes back. I'm on the board of the MBA and at that last board meeting that we have -- that we had, there were a number of, I called it speed dating that was happening at these smaller originators who are looking to be picked up and bought, and really look to do some asset sale so they can take money off the table. So we'll continue to kind of see that fall at the lower levels. And just given where margins are in the business, people won't continue to be able to originate those levels. So we think the overcapacity and that rationalization of it will continue to kind of filter out over the next couple of quarters here.

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

And when you look at your own business, you did a fairly good job on a sequential basis of growing volume, the purchase money that you're bringing in, is that your correspondent channel just delivering more and more purchase loans? Or does that reflect the work of your direct lending effort and the West Coast group?

Kristy Williams Fercho - *Flagstar Bank, FSB - Executive VP & President of Mortgage*

Yes. So the TPO business has been holding strong, but I think it's really the power of our retail business. So both kind of the Opes acquisition really coming on with our historical Flagstar distributed retail group, and then as well as the direct-to-consumer group that we picked up from Capital One last year. So our purchase share for the month of June was 73.6%, which is a high for the year. And I think you'll continue to see as we continue to grow retail, not only margins get better, but us really being able to take advantage of those realtor relationships and referral relationships that are critical in the purchase environment.

Operator

Our next question comes from Daniel Tamayo with Raymond James.

Daniel Tamayo

So first, just on the efficiency ratio of the community bank you mentioned, got that down to 53% in the second quarter. What would be the drivers of -- and you mentioned that you think it can improve over time. What would be the drivers of that improvement? Is that mostly rates? Or would you see, continue to see some scale benefits?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

I think it's both, right? So over time, especially as we bring on the Wells deposits, we'll see margins widen out. So that's -- and the Wells deposits, as we mentioned earlier, are a lot more price-insensitive. So with future rate increases, we'll see the margin widen out and things get more profitable. So yes to that. And yes to the future growth. It was even in my prepared remarks that I think as we continue to grow the business, we've got the right infrastructure and we believe that we can achieve even better levels of efficiency, especially in that business and in other businesses by simply continuing to grow revenues and growing the business.

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

And achieving scale on the cost side as well.

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

Yes. For those of you that have been following us in a long time, when we were under the Consent to Order, we had to build that extremely strong risk and compliance program in order to get that Consent to Order lifted. So now, we'll see the benefit of that because we don't have to invest there like other companies might as they grow. And so I think that's part of it. So it's all these things. It's scale, it's stretching out your support services, it's better margins because of the higher quality deposits, all those things combined will continue to allow us to see improvements in that ratio.

Daniel Tamayo

Okay. Great. And then switching over to credit. You mentioned the reserve ratio of 1.7% of consumer and 1.4% on commercial loans. Still considerably above peers there. How well do you think that can come down, especially considering the mix -- the remix that's happening and then you've added on the Santander warehouse loans. So how low you think you can bring that reserve ratio down to? Maybe by category, if it's easier, by consumer and commercial.

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

I don't know because I don't know what's going to happen in the economy. So we evaluate that every quarter and we look at what's going on in the market, what's happening to our portfolio, run the models, and we come out with a number. And we've admittedly been conservative, but that's our nature in our entire company, to be conservative, smart in terms of what risk we take but generally conservative, and we'll continue to be that way when it comes to our allowance.

Operator

Our next question comes from James Beury with Boenning and Scattergood, Inc.

James Prescott Beury - *Boenning and Scattergood, Inc., Research Division - Analyst of Banks and Thrifts*

So my first question was just generally in terms of the industry, you see a really solid growth here for the last few quarters in the commercial portfolio, particularly. Skipping out homebuilder, it looks like commercial real estate was down a bit. So kind of on that note, I was curious if you're seeing any changes really, just year-to-date in terms of underwriting standards from competitors? And any subsectors or sub-geographies that might be particularly pronounced?

Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP, MD & Michigan Market President of Flagstar Bank*

It's Drew. Listen, it's competitive across the market pricing and structure. So I don't think I'd comment on any one particular part of the portfolio, CRE or otherwise. Homebuilder finance enjoys, I think, some real strength in that market given the dynamics in terms of housing supply as well as the dynamics in terms of funding in that market. And so it's a relatively nascent business for us compared to the legacy or traditional CRE business. So I think you can just see that growth there. But no, I don't think it's confined to CRE nor accentuated there.

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

Drew, what about underwriting guidelines? I think part of his question was have we seen any deterioration? Are people doing things? I know we're not doing anything unusual but...

Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP, MD & Michigan Market President of Flagstar Bank*

Yes. As I started out, I mean, I think the competition, whether that's structure or pricing, is increasing. And truthfully, we pass on a few deals as a result of that and I think over time, that will play out in our favor. Sandro, you just said we are conservative by nature, we're not going to stretch on credit. We haven't stretched on credit, and I think we're just going to stick to our guns.

James Prescott Beury - *Boenning and Scattergood, Inc., Research Division - Analyst of Banks and Thrifts*

Great. That's helpful. And a higher level one kind of for Lee. I know that in past presentations, you guys have referenced capacity to service total of 1 million orders -- or 1 million loans, excuse me, and with the target of around 700,000 per year end, obviously, still ways to go there. At what point do you have to start thinking about incremental investment in the back room to kind of support future growth in that business line?

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

Well, right now, and what I'll tell you today is I'd say our capacity is probably between 1 million and 1.25 million, and we are currently working, and I hope to be able to update you by the end of the year to say that our capacity is 2 million. We are aiming to increase capacity to 2 million loans.

James Prescott Beury - *Boenning and Scattergood, Inc., Research Division - Analyst of Banks and Thrifts*

Okay. That's helpful. And then lastly, just kind of a housekeeping one. Were there any one-time cost during the quarter related to the acquisition?

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

Nothing meaningful.

Operator

At this time, I have no further questions in the queue, and I would like to turn the call over to Sandro DiNello, CEO, for closing remarks.

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

Thanks, Jonathan, and thanks, everyone, for your interest in Flagstar. Our performance in the second quarter underscores how piece by piece, either organically or by acquisition, we have transformed Flagstar into a company that can be profitable in any market. Early last year, we purchased the delegated correspondent business, the Stearns Lending, and that boosted our mortgage origination business. Then we acquired Opes Advisors, which helped lift our retail mortgage lending. Next, came the acquisition of the warehouse loan business from Santander and with it, a nice bump in our commercial loans. Then we bought the branches of Desert Community Bank, which gave us over $600 million in deposits to expand our retail funding sources and reduce our overall cost of funds. Each of these acquisitions has contributed in its own way to make Flagstar a more diversified company, better positioned to deliver strong results to its shareholders, and that's the back story of the second quarter.

Now with the pending acquisition of 52 branches of Wells Fargo, you could see the phase of the new Flagstar, a bonafide bank with 152 branches in the Midwest, 8 in California and a powerful diversified mortgage platform and subservicing business that operates across the country. Well-capitalized with abundant liquidity, pristine credit, a multistate deposit network and diversified revenue streams.

In closing, let me put all of that into context. This is the most profitable quarter that this management team has achieved. Here's what best describes how the company has been transformed. In the third quarter of 2012, when we last achieved this level of profitability, gain on sale income totaled $334 million. In this quarter, gain on sale was only $63 million. If that's not a transformation, I don't know what is.

As I stated last quarter, we have been in full compliance with the Federal Reserve Supervisory Agreement for some time and remain confident it will be lifted in the not too distant future. As I've said in the past, while this agreement has not hampered our operations in any significant way, its lifting is important because it represents the last legacy regulatory issue that we've had to deal with it.

Lastly, we appreciate the loyalty of our shareholders and their support of our business plan, and we thank our employees for their tremendous work on the pending Wells Fargo branch acquisition and all they do every day to make Flagstar a success. Thank you for your attention this morning. I look forward to reporting Q3 results in October.

Operator

Thank you, ladies and gentlemen. This concludes today's teleconference. You may now disconnect.
