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FBC - Q1 2019 Flagstar Bancorp Inc Earnings Call

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PRESENTATION

Operator

Good day, and welcome to the Flagstar Bank First Quarter 2019 Earnings Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Ken Schellenberg, Vice President, Investor Relations. Please go ahead.

Kenneth Schellenberg

Thank you, Quena, and good morning. Welcome to the Flagstar First Quarter 2019 Earnings Call.

Before we begin, I'd like to mention that our first quarter earnings release and presentation are available on our website at flagstar.com.

I would also like to remind you that any forward-looking statements made during today's call are subject to risks and uncertainty. Factors that could materially change our current forward-looking assumptions are described on Slide 2 of today's presentation, in our press release and in our 2018 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, Ken, and welcome to your first quarterly earnings call. Good morning to everyone listening in. I appreciate you taking the time to join us today.

In addition to Ken, I'm joined this morning by Jim Ciroli, our Chief Financial Officer; Lee Smith, our Chief Operating Officer; Kristy Fercho, our President of Mortgage; Drew Ottaway, our President of Banking; and Steve Figliuolo, our Chief Risk Officer.

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

It was another solid quarter for Flagstar, highlighted by our announcement of a quarterly dividend and the initiation of a $50 million share buyback. Actions that underscore our progress in diversifying our franchise and delivering value to our shareholders.

For the quarter, we posted adjusted net income of $37 million or $0.64 per diluted share, up 7% from the same quarter last year with the adjustment attributable to acquisition-related expenses from the Wells Fargo branch transaction.

We have solid operating results, where we proved once again that we can deliver positive results and drive shareholder value.

In our banking business, we saw the benefit of the Wells Fargo transaction in deposit costs that were 3 basis points lower, reflecting a full quarter of attractively priced deposits from our new branches.

We are also pleased that 4 months after conversion, we have experienced overall deposit attrition of only 4.9%. It's significant that most of that attrition came from customers who don't reside in the actual branch footprint. Attrition from customers within the branch footprint was only 2.7%. Deposits were also helped by our government banking team, which we deployed in Indiana to bring their expertise and high-touch brand of service to the market. These lower cost deposits helped us expand net interest margin for the fifth consecutive quarter.

The continued growth in our commercial and industrial, commercial real estate and consumer lending portfolios, 5% versus the prior quarter, is a testament to our success in building a resilient earnings stream.

As we've said before, we will not compromise on credit quality to achieve loan growth and the proof is in our track record of 0 nonperforming loans in our commercial portfolio. Should the economy slump, we believe our strong credit discipline will serve us well.

Our servicing segment continued its march toward 1 million loans as our servicing book grew 13% during the quarter to 962,000. Our year-over-year growth in this portfolio was an outstanding 102%. We are pleased with the continued growth in this business as it provides both a stable source of fee income and liquidity.

We also saw an uptick in mortgage, all of which occurred in March, with fallout-adjusted locks reaching $6.6 billion for the quarter, a 25% increase from the fourth quarter 2018.

As we've said in the past, we have managed our mortgage business for the long term, building deep customer relationships all while maintaining profitability in the business.

Despite downsizing capacity significantly last year, our ops team reacted quickly and ramped up to meet the opportunity the market presented us in March. This is further evidence of the variable capacity mile that our team has built.

Looking ahead, we don't see the year shaping up any differently than we saw a quarter ago in terms of the overall size of the origination market but we do believe that capacity is starting to adjust and that some of the irrational pricing has subsided a bit.

The result is that the strength of our customer relationships, our commitment to service and the consistency of that service are returning to the top as a competitive advantage.

In closing, it was a quarter where we achieved a milestone in our transformation with the announcements of a quarterly dividend and a share repurchase.

We also successfully completed the integration of 52 new retail branches, further expanding our footprint and product offerings. All of our business lines, community banking, servicing and mortgage turned in solid performances. And finally, we kept credit quality near-perfect and capital strong.

That concludes my comments. Now let me turn it over to Jim.

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

Thanks, Sandro. Turning to Slide 6. Our adjusted operating net income this quarter was $37 million or $0.64 per diluted share compared to the $42 million or $0.72 per diluted share of adjusted operating net income last quarter.

When you adjust for last quarter's provision benefit and the seasonal increase in compensation and benefits expenses, approximately $4 million, you'll note improved performance in several areas. The first has been the trend for many years now. Operating results were driven by a stronger level of net interest income. Each quarter, as we grow loans and deposits, we stabilize the level of net interest income, which this quarter increased $3 million or 2% despite a slight decline in earning assets. This was more than driven by having a full quarter of the acquired deposits.

Noninterest income improved on a linked-quarter basis as we saw strong levels of fallout-adjusted locks in the last weeks of the quarter. This drove an $11 million increase in our mortgage banking revenues as net gain on sale revenues increased, offset only slightly by a lower net return on the MSR asset.

Asset quality continued to be strong as net charge-offs were only 5 basis points, our nonperforming loan ratio was flat and our allowance coverage of the loan portfolio remained solid at 1.3%, still among the strongest in the industry.

We're now less than a year away from CECL adoption and while we're not going to specifically discuss its impact on Flagstar, we feel our coverage level positions us as well as any midsized bank for whatever CECL's impact might be.

Capital also remained solid. While our total risk-based capital ratio is lower, its level represents $329 million of capital protection above the well-capitalized threshold.

Nearly 2/3 of our balance sheet is invested in assets with the low level of credit risk, assets such as cash, securities, mortgage loans, warehouse loans and FHLB stock. We'll also note that capital simplification regulations will improve this ratio by 26 basis points.

I'll take us through a more extensive analysis of our capital later so let's turn to Slide 7 and dive deeper into the income statement.

Net interest income grew $3 million as net interest margin expansion was largely driven by a $6 million increase due to the full quarter benefit of lower cost deposits from our Q4 branch acquisition. This more than offset the $3 million impact of 2 fewer days in the quarter.

The adjusted net interest margin expanded by 10 basis points to 3.09%. The net interest margin was negatively impacted by seasonally lower levels of warehouse and home builder loans during the quarter, which we addressed by holding the mortgage loans held for sale a little longer on the balance sheet. We'll discuss earning asset growth on the next slide.

Noninterest income increased 11% as mortgage revenues increased $11 million. Our gain on sale revenue of $49 million represented an increase of $15 million or 44% from the prior quarter.

The improved level of gain on sale revenue was driven by a 12 basis point increase in our gain on sale margin, which was achieved despite no RMBS transactions in the quarter.

Additionally, fallout-adjusted locks improved 25% as we saw higher volumes in all our sales channels. We saw a purchase mix decline to 63% of our volume driven by a lower mortgage rate environment, especially at the end of the quarter. As you'd expect, the return on the mortgage servicing asset decreased by $4 million due to lower quarter end rates.

We also saw improved levels of deposit fees and charges, attributable to having a full quarter of the acquired branches. We continued to waive fees for customers early in the quarter in order to smooth their transition to Flagstar, and we estimate that these January and early February fee waivers approximate to $2 million.

Loan administration income increased $3 million or 38% due to the continued growth in our sub-servicing business.

Adjusted noninterest expense was $190 million, up $15 million from the prior quarter. This reflected the full quarter impact of operating expenses from the newly acquired branches and approximately $4 million of seasonally higher payroll taxes and employee benefits.

The higher costs were partially offset by lower mortgage expenses as we recognize these expenses at origination, that is funding, whereas gain on sale revenues are recognized at rate lock.

Credit costs were negligible again this quarter. We experienced only 5 basis points of net charge-offs, nonperforming loans were $2 million higher at $24 million or 24 basis points of the portfolio while the commercial loan portfolio remained clean.

Let's now turn to Slide 8, which highlights our average balance sheet this quarter. Average loans held for investment grew $248 million even as average warehouse loans seasonally declined by $162 million.

Loan growth continue to be well balanced by type and channel. Commercial loan growth was led by C&I, which continue to have nice traction across our Michigan footprint and had a full quarter of the small business loans that we acquired in last quarter's branch acquisition.

Our CRE portfolio saw good growth as well albeit late in the quarter. We also saw higher balances in consumer loans driven by our non-auto indirect portfolio, which averaged $185 million during the quarter and continue to demonstrate good traction among dealers.

Our mortgage loans held for investment declined slightly, the result of 1 small sale at the end of last quarter and a small sale again this quarter.

Average deposits increased $964 million or 8% in the quarter driven by the benefits of a full quarter from the Wells Fargo branch deposits and higher custodial deposits. Excluding the impact of the acquired deposits, average retail deposits were relatively flat, and we held this category to only a 10 basis point increase in the face of a full quarter impact of the mid-December rate hike and the carry-on effects of all the rate hikes in 2018.

Average custodial deposits rose $402 million or 19% driven by a 13% increase in serviced accounts.

Our performance in managing deposit cost this quarter is consistent with how we've managed deposit costs throughout the last cycle of rate increases.

We saw our total deposit costs rise 30 basis points compared to the first quarter of 2018 and excluding deposits acquired last quarter, representing a deposit beta of 30%.

For comparison, over the same time period, yield on our loans held for investment increased 53 basis points. And since the beginning of the rate cycle, our total deposit costs have risen only 49 basis points excluding the Wells Fargo deposits, representing a cycle to date deposit beta of only 22% while the yield on our loans held for investment has increased 125 basis points over the same period for a loan beta of 56%.

At March 31, our capital position remained solid. Tangible equity to assets ratio fell 29 basis points to 7.16% while our tangible book value per share increased $0.75 to $24.65.

We'll cover regulatory capital level shortly. So let's now turn to asset quality on Slide 9.

Early-stage delinquencies continue to be negligible. Only $8 million of consumer loans were over 30 days delinquent and still accruing at March 31, and we currently have no commercial loans over 30 days delinquent still accruing and no commercial nonperformers.

At March 31, our allowance coverage was 1.3% total HFI loans. Average remained strong for both consumer and commercial loans. This commercial loan coverage was even stronger because 29% of that portfolio is in warehouse loans, which are fully secured and we hold the collateral.

Turning to Slide 10, capital remained solid. Our total risk-based capital ratio was 12.5% at March 31. Assuming final capital simplification regulations are enacted as proposed, this ratio should be 26 basis points higher.

At quarter end, we saw some nice commercial loan growth opportunities while at the same time, we were allowing period end loans held for sale to stay a bit higher, knowing that absent the proposed capital simplification regulation being enacted, this would move us into our strategic flexibility buffer, which is the 100 basis point cushion that we maintain above our capital stress buffer.

Our target operating range is the size of the strategic flexibility buffer and the stress buffer we maintain above well-capitalized status are all informed by our stress tests.

Having such a large component of the balance sheet and loans held for sale gives us the ability to be flexible and agile in the event capital becomes constrained.

Our Tier 1 leverage ratio was 8.4% at March 31, up 8 basis points from last quarter. Capital simplification will benefit this ratio by 55 basis points and when capital simplification regulations are enacted, we should be at the upper end of our target operating range of 89% for this ratio.

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

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

Thanks, Jim, and good morning, everyone.

We're very pleased with our adjusted operating net income of $0.64 per diluted share for the quarter and believe we have the necessary levels of capital, liquidity and asset-generating capabilities to continue to grow at our targeted profitability threshold going forward.

We're off to a positive start in 2019. The highlights of which include: we instituted a quarterly dividend for the first time since December 2007 and initiated a $50 million share repurchase during the quarter; we grew average consumer and commercial loans held for investment $410 million or 5% and expanded our net interest margin by 10 basis points quarter-over-quarter.

As of March 31, 4 months after we closed the transaction, net attrition for the acquired Wells Fargo bank branches was 4.9% versus 8.7% when we reported our Q4 results in January and the 17% we had modeled.

Following the acquisition, we saw deposit attrition start to normalize and flatten out in the early part of 2019, and we've been successful in adding new customers and higher deposit balances from existing customers, particularly in the 4 states where the branches are located.

Given the current level of attrition, the expected payback on this transaction is estimated to be 4.4 years.

Overall, average deposits increased $964 million or 8% quarter-over-quarter due to the benefit of a full quarter of the acquired deposits and an increase of $402 million in custodial deposits, given the increase in the number of loans subserviced.

As of March 31, we were servicing or subservicing 962,000 loans, which is an increase of 111,000 loans or 13% quarter-over-quarter.

We are now the fifth largest subservicer of loans in the country according to Inside Mortgage Finance, and we also won the Fannie Mae STAR performer award in the General Servicing category for the fourth year running.

Finally, we saw increased production volume in our mortgage origination business following the reduction in the 10-year treasury note rate later in the quarter.

Financial impact on Q1 was minimal, but we're encouraged about its potential impact on the remainder of the year for our origination business.

I will now outline some of the key operating metrics from each of our major business segments during the first quarter.

Please turn to Slide 12. Operating highlights for the community banking segment include average commercial and industrial and commercial real estate loans increased $328 million or 9% in the quarter, led predominantly by a $249 million increase in commercial and industrial loans.

Average consumer loans held for investment increased $82 million or 2% in the quarter as we added high-quality non-auto indirect loans and HELOCs to our portfolio.

Average warehouse lending loans decreased $162 million or 12% in the quarter due to the expected seasonal slowdown in the mortgage origination business.

Given our relationship-based approach and expanding footprint, we believe we can continue to grow consumer and commercial loans at the same levels and believe you will see a healthy increase in outstanding warehouse lending loans during the second quarter, given the improved mortgage origination environment right now.

Total deposits increased $964 million and our net interest margin expanded 10 basis points in the quarter, a result of both expanding yields on interest-earning assets and the benefit of a full quarter of the acquired branch deposits.

We're very pleased with the performance of our community bank as it continues to grow and contribute the most significant portion of earnings to net income from any of our business lines.

Please turn to Slide 13. Operating highlights for the mortgage origination business include: fallout-adjusted lock volume increased 25% to $6.6 billion quarter-over-quarter while the net gain on loan sale margin rose 12 basis points or 20% to 72 basis points. As a result, gain on sale revenues increased $15 million to $49 million in Q1 versus $34 million in Q4. The increase in fallout-adjusted lock volume quarter-over-quarter was predominantly due to both the anticipated increase from the spring buying season and reduction late in the quarter of the 10-year treasury note rates.

As we've mentioned in previous reports, we're disciplined with our pricing in terms of optimizing production from the most profitable channels and using it as a mechanism to manage capacity. It's this continued focus that enabled us to increase our gain on sale margins 12 basis points to 72 basis points quarter-over-quarter.

While there is still excess capacity within the industry, it has started to correct itself over the last few quarters and given our scale across all origination channels, we believe we're well positioned to benefit from the lower interest rate environment.

We will also continue to be disciplined in our pricing and expense management in order to maximize earnings from the mortgage business line.

Moving to servicing. Quarterly operating highlights for the mortgage servicing segment on Slide 14 include: we serviced or subserviced approximately 962,000 loans, of which over 800,000 or 85% are subserviced for others. We've increased the number of loans serviced or subserviced by 485,000 or 102% in the last 12 months, another fastest growing subservicer in the industry during that period according to Inside Mortgage Finance.

Furthermore, our growth over the last 12 months has predominantly come from non-Flagstar-originated loans that we've onboarded, rather than Flagstar-originated loans where we've sold the MSRs and retained the subservicing.

Today, we have the capacity to service or subservice 2 million loans and therefore, have sufficient runway to keep growing.

I think our growth is testament to the one-stop shop we offer to our customers but is also backed by a quality team and platform as the recent Fannie Mae STAR award for the fourth consecutive year indicates. As well as subservicing the loans, we offer financing solutions and recapture services all behind a bank that is well capitalized.

The custodial deposits these loans generate also help us fund our loan growth. We held $2.5 billion of average custodial deposits throughout the quarter, an increase of $402 million or 19% quarter-over-quarter.

We couldn't be more pleased with the progress of our subservicing business and believe you will continue to see grow and be successful as we move forward.

Moving on to expenses on Slide 15. Our noninterest expense increased $15 million to $190 million quarter-over-quarter after adjusting for $1 million of onetime integration costs associated with the bank branch acquisition. The majority of the increase in noninterest expense was due to a full quarter of expenses associated with this acquisition, which closed at the beginning of December, together with seasonally higher payroll taxes and employee benefits.

We also saw an increase of $1 million in loan processing expenses, given the increase in the number of loans subserviced, and we continue to invest in further growth opportunities across all of our business lines.

Our efficiency ratio was 81% for the first quarter, which was a worsening of 2% from the prior quarter for the reasons I just outlined. However, if you dig deeper and compare this quarter's noninterest expense to Q1 2018, as the seasonally higher compensation and benefits costs are included in both, you will see an increase of $70 million. Of this, $60 million is because of the Wells Fargo bank branch acquisition, $3 million is due to higher loan processing expenses given the significant increase in loans being subserviced, partially offset by lower mortgage expenses.

The point being, we have maintained our expense discipline throughout with the increases in noninterest expense being acquisition or volume related.

We estimate noninterest expense will be between $205 million and $210 million during the second quarter. The full cash increase in expenses is all related to increased mortgage production volume and revenues. It's been a solid 3 months. We've benefited from a full quarter of low-cost deposits from the bank branch acquisition and have seen better-than-targeted attrition.

We continue to grow high-quality assets from our core commercial and consumer lending businesses. Our subservicing business continues to grow and go from strength to strength, adding inconsistent noninterest fee income to our earnings, and we feel positive about the outlook for our mortgage origination business, given where interest rates are.

Given our diversified business model and robust risk and compliance infrastructure, all complemented by our strong capital and liquidity positions, we believe we're well positioned to continue to grow across all 3 of our major business lines and continue to add value for shareholders.

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

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

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

Please turn to Slide 17. We expect net interest income will increase 5% to 10% driven by seasonally higher interest-earning assets while net interest margin will increase 5 to 10 basis points.

We anticipate gain on loan sale income will increase 30% to 40% attributable to the seasonally increasing mortgage locks and a slight increase in gain on sale margin. All other noninterest income is expected to increase 5% to 10% as loan fees will grow in concert with loan closings. We expect the return on the MSR to decline slightly.

As Lee noted, we anticipate noninterest expenses to be between $205 million and $210 million, and we expect the effective tax rate to be 18%.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). We will now take our first question from Bose George from KBW.

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

Just a follow-up on the expense guidance. The increase quarter-over-quarter, is that being driven almost entirely by the variable piece on the mortgage increasing or is there anything else to sort of think about there?

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

Yes. Bose, it's Lee. It's predominantly being driven by the variable piece on the increased mortgage volume.

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

Okay. Great. And then actually, in terms of the increase in the NIM that you've guided for the second quarter, can you talk about the drivers there and also just how should we think about the net interest margin just going forward, assuming rates are fairly stable?

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

Yes. So Bose, this is Jim. So it was kind of there in the prepared remarks when I talked about the first quarter was a little bit lower because of lower warehouse and home builder and as we get into the summer months as warehouse inflates and home builder inflates and we pull back on mortgage loans held for sale, you'll see that margin expand back up into where you'd expect it to be.

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

Okay. And then just in terms of the outlook, any commentary there?

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

With respect to the margin itself?

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

Guiding to...

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

Yes. Well, we're guiding to a little wider, because as we look at the assets that we'll grow on the first quarter versus the funding, we think that we'll see 5 to 10 basis point increase. I'm not going to give you any view farther than that, but we're pretty confident about the next -- about Q2.

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

Okay. Just one on mortgage servicing. When you guys -- in terms of the incremental servicing that you've put on, is there an operating margin that you target on that?

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

Yes. If you -- it's Lee again, Bose. I mean we -- for every 100,000 loans we add, it adds an incremental $4 million to $6 million of operating profit. We've said that consistently and it's in the deck.

Operator

Our next question comes from Scott Siefers from Sandler O'Neill + Partners.

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

Sandro, you guys have alluded to in your prepared remarks a couple of times, kind of the rationalization in pricing that seems to be sort of finally taking place in the industry. I just, at a top level, was hoping you could maybe expand a little upon those dots and sort of give us a sense for where are we in that process? And sort of in a perfect world, how much more is there to go?

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

I'll let Kristy jump on here in a second. It's really hard to say, Scott, and it's too soon to suggest that it's a trend but it certainly welcomed to see that some of the rationality has subsided. But there's still some out there and so I think we need another quarter to really give better vision on that but let me say what Kristy might have to add on that.

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

Yes. I'd add two things, Scott. I'd say the first is kind of initially when the rate rallied, we actually saw some of the pricing subside a little bit because I think people were just trying to deal with the volumes that they've had. But as that has stabilized a little bit, we're still seeing some kind of aggressive competitive pricing, especially on the production note rates so that's continuing. And if you think about it, those 2 had started to come out of the market when you look at January and February, we actually had some of that rationalization continue. But I think the rally gave, some of people who were going to exit, it gave them a little bit of breathing room and so we're still seeing a competitive pricing, which is why we are conservative about our expectations for the remainder of '19 but we believe that we're positioned well as the market continues to rally here at lower rates.

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

Okay. Perfect. And then maybe sort of continuing on the theme of the improving mortgage market. What kind of sustainability do you guys think there is to this rally. I guess I ask because while rates have dropped quite a bit at the long end of the curve obviously, you look over the last couple of years, there have been plenty of times when rates have been at or below this level. So just as you guys look at your own book and the housing market as a whole in the country, could this rally driven by refinance, could that continue beyond sort of a finite period or what kind of longevity do you think the rally would have?

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

Well, like I said in my comments, Scott, I don't think the market this year is going to be any different than we thought it was going to 3 months ago, despite this rally, January and February were absolutely awful. So March was a lot better. But to have a lot of optimism that somehow this market is going to be a lot bigger than everybody thought or at least we thought at the end of the year, I don't see that. So with respect to volume, I do not see a big change. I'm hopeful that we'll continue to see the opportunity to find places in the market where we can get a better margin and that's why we're guiding to a little bit of a better margin in Q2. But no, I don't see any big, big change. Kristy, any difference on that?

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

No. And I would just remind you guys, Scott, that for us, the discipline that we've shown not only last quarter but this quarter and then the scale of our diversified mortgage platform really positions us well to be able to take advantage of those pockets in the market as Sandro described, where we can either by product or in certain market or in certain channels, we can really look to see strategically where we can compete and take advantage of the market that way. So that variable cost model and diversified platform really serves us well in a market like this. And if the rally continues then we can scale up and take advantage of it with the rest of them.

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

Okay. Perfect. And then if I can slip in one last question just to return to the notion of expenses. I appreciate the comments that basically all the -- predominantly, the 2Q rise is going to be a function of variable rate cost associated with higher volumes but I guess I'm wondering, where we'd be able to return to as those volumes begin to subside. So I guess there would be maybe some natural pressure on expenses from things like costs associated with servicing more subservicing more, so I guess I'm just trying to get a sense for what is the steady state of the quarterly expense base. So maybe any additional thoughts you could provide will we appreciated.

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

Well, I don't think there is a steady state, if you're a growing organization. I think the pure dollar amount of your expenses will continue to grow as you grow the organization and so if you look at who we are this year versus who we are last year, there's a lot of differences and so you're going to have an increase in the dollar amount of expenses. Our efficiency ratio has been pretty flat, it's up a little bit this last quarter because we continue to be focused on making sure that we're very diversified in our lines of business and not just having 3 lines of business but within each line of business having diversification. So that's a little bit more expenses. Now I'm not going to tell you that I don't think there is ways for us to get more efficient that, as I said in my prepared remarks, that it is front and center for us to see where we can gain more efficiencies. But we're -- to compare us now to a year ago and wonder what steady state is, I don't know that there is a steady state. Lee, do you want to add anything to that?

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

No. I think you're absolutely right. I mean as you know, Scott, we've been an acquisitive bank and we've been growing in all of our business lines, particularly on the community bank and the subservicing business and that's why I sort of gave you that bridge of Q1 of '19 versus Q1 of '18. But to Sandro's point, I don't think there is a steady state when you're a growing organization and that's something that we have been and we want to continue to be.

Operator

Your next question comes from Steve Moss from B. Riley FBR.

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

Lee, I believe you mentioned loan growth for C&I and commercial real estate expect a similar pace relative to the first quarter -- relative to this quarter. Just kind of wondering what you're seeing for the underlying drivers there?

Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP & President of Banking*

It's Drew. So a number of drivers and I think where I'd start is to echo what you heard from Kristy as well is from Lee and Sandro, which is really diversification. So if you think about the loan portfolio that we have, if you look at the platforms that we have in place, the diversification that we have across those platforms, that's really what's sustaining the growth. So this quarter, we saw really good growth out of C&I. Last quarter, there was less growth out of C&I. So you're going to see some movement quarter-to-quarter, but you're going to see balanced steady growth going forward because of the investments that we've made.

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

And I'll just add, given our expanding footprint as well, you're going to see growth across both the commercial loans and the consumer loans as well and that's why we break the 2 up when we talk about loan growth. But we believe that given the relationship-based approach that we always talk about, the ever-expanding footprint, we can continue at that pace and also for the reasons Drew just articulated.

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

Okay. And then in terms of just on capital here going forward, wondering if we can get any updated thoughts around both potential for additional share repurchases and M&A activity?

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

Well, with respect to share repurchases, no comment on that. We don't have anything to tell you in terms of any additional plans in that regard. In terms of M&A, our situation if you remember, we've got these TruPS and the TruPS create a little bit of problem for us with purchasing a bank because we would lose the Tier 1 treatment of the TruPS. So it's not to say that a transaction couldn't come along that would make sense but we really have to have the right situation in order to lose that Tier 1 treatment of the TruPS. With respect to bank -- our branch purchases, we've done 2 of those now in the last year. We're really pleased with the low-attrition rates we've had there, given our ability to generate assets at a pretty steady rate and very good assets with the right quality and the right returns. Funding is more important to us than buying assets. So if we can buy branches, if the right opportunity presents itself, that's something that's more interesting to us but you just never know when those opportunities are there. I don't see us doing anything on the mortgage side of the house relative to M&A. Kristy's team's been very successful in lifting out some very high-producing teams from other organizations and so if you can expand your business by bringing new people in without buying the business and the infrastructure associated with it, there is no reason to do that. So that's overall how I view our M&A position.

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

I guess maybe following up on that, Sandro, just wondering on the branch acquisition front, are you seeing still continue good opportunities or has that abated, perhaps a little color that way?

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

Well, there certainly still are opportunities. I think there was one announced this morning as a matter of fact where Santander sold some branches to a bank in Pennsylvania I think it was. So they're happening every now and then, and we haven't seriously looked at anything since we put together the deal with Wells Fargo. Because we needed to get that one behind us. But our ear is to the ground and when the next opportunity presents itself, we'll see if we could find a way there.

Operator

The next question comes from Kevin Barker from Piper Jaffray.

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

Just to follow-up on some of the Wells deal. What changed in attrition between the January and your latest update and why the attrition declined? And then also, could you give us an update on what the average deposit costs were for the Wells Fargo deposits as of the first quarter?

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

I'll take the first part, and I'll let Jim take the second. I'm not sure if we've disclosed that or plan to but with respect to what changed. So I think the first 30 days was pretty rough and so we saw early attrition, I think we reported back in January 8% or 9%, something like that. What we saw happening after that was things settled down pretty quickly, frankly, and that's a good testament to our team and their ability to rally around a tough situation and get it back in a good place and then go forward. I visited Ohio, Indiana a couple of weeks ago, visited 15 branches myself, had an opportunity to talk all of the branch managers in that market as well as a lot of the employees. There is a very, very positive vibe there. They're happy to be part of Flagstar. They're long-tenured people that have really strong relationships with their customers and even some customers that got upset initially or were attracted by a $300 or $400 offer by a competitor to move their accounts are trickling back and so now we're seeing growth. And so we did see the attrition get north of 10% at one point but then we started seeing it go the other way and have leveled out and then in the last 30 days, we actually saw growth and so I think that's a really good sign that we're in a good place.

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

Yes. Kevin, this is Jim. I'd also point out that when you have a portfolio of kind of small balanced checking accounts like we've picked up in that acquisition, the trough is -- throughout the whole year is probably in that January time period when the bills for the holidays come in, you pay those bills off. The trough is probably mid-January to later in January. Regarding your cost question, I would say that the costs have, in that portfolio, have held pretty steady. The only thing I would note, as Sandro said, we've not disclosed anything, the only thing I would note is that of course, you'd expect us to take a small amount of purchase accounting mark on the CD portfolio.

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

Right. And then the cost to operate the branches that you disclosed last quarter has remained stable, is that correct?

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

Yes. Other than the incremental 2 months that you have, you have a full quarter versus 1 quarter but the costs have remained relatively stable.

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

Okay. And then turning back to mortgage. I understand you're not expecting much change in the overall market, given where rates are and obviously we're kind of at this point where you guys will pick up and refi but not big pickup because like what's mentioned earlier, right, rates were lower for last few years. But are you seeing any differences between the retail channel versus wholesale and correspondent and the competitive dynamics within each of those?

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

I'll let Kristy answer that. I don't think so, but I'll let her answer that.

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

No. I would just say retail and interestingly, we saw the first 2 weeks of that rally, retail spiked pretty significantly in refinances and normally retail is pretty consistent, Opes, for example, our Opes branches, that first week, they went over 80% refinanced. They settled back down into kind of their normal 35% refinance volume and so I think people just got hot in terms of the market and what was happening with rates. In terms of pricing and the competition there, our third-party space just tends to be a little more competitive as the culprits that we've seen getting aggressive on pricing is they are really active, especially in that broker and non-del correspondent space and so that has continued regardless of the refinance market and so that's why we'll continue to just watch it and be measured in terms of where we can compete their and maximize our revenue as a result.

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

Okay. And I would assume that maybe some of the financing for the nonbank competitors is one of the main causes for the third-party channel being much more aggressive, is that fair to say?

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

Are you referring to the warehouse lines of financing?

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

Yes, or some of the FHA financing that we're seeing out there for some of the nonbank lenders and yes, and the warehouse lines that they're receiving. Are you seeing some of that cause the nonbanks to be a little more competitive or one of the underlying...

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

No -- yes. Kevin, I wouldn't say that's the driver of it. Again, I think the pressure that we saw in January and February and it was the story really all throughout 2018 is people figuring out where they could compete and really just staying competitive in the market, waiting for the buying season to kind of come back and so I think it was just more a function of just competitiveness for each loan and really wanting to make sure that they could keep staff busy and focused. And so we saw in January and February, as Sondra already said, the continued pricing pressure that we saw there in the third-party space continued and now that the rally we're still operating at lower rates but if the rally subsided a little, we are still seeing aggressive competition on some of the main production note rates. And so I think individual strategy is really -- depend on what the individual company is looking to do but I think people are just trying to sustain their business getting to this peak buying season.

Operator

(Operator Instructions) Our next question comes from Chris Gamaitoni from Compass Point.

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

I just wanted to follow-up on the comment about consistent C&I and consumer loan growth. It looked like a lot of the loan growth based on period end was back-end loaded. Are you saying for on a average basis or for kind of period end basis consistency?

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

I always refer on an average basis, Chris.

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

Okay. And then is most of the other consumer growth coming from your recent GreenSky relationship?

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

No. It's actually -- it's coming from a number of factors but some of it is GreenSky, a big piece of it is HELOCs that we're originating ourselves and we're utilizing our mortgage channels to originate HELOCs as well. And then there's unsecured loans, some of those we acquired as part of the Wells Fargo branch acquisition but there's other unsecured loans that we're originating and then you've got the non-auto indirect loans as well and that channel, that team is going very strong indeed, so we're seeing good growth as it relates to the non-auto indirect lending channel.

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

All right. And do you have any update on kind of deposit competition in your local markets following lower forward curve?

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

Nothing really different, Chris. There is always deposit competition, there's always somebody that's trying to be aggressive. The good thing that we have now going for us after this last acquisition, so together with the DCB and the most recent branch acquisition, we just have more markets to go to and so we can -- we have more flexibility in deciding where we're going to be more competitive and where the better opportunity is for us to bring deposits in. I think Jim's prepared remarks on betas are really compelling to see how well this team has managed deposit costs and still been able to grow organically and we slowed that up a little bit more recently because we knew we had those wells deposits coming. But overall through this cycle, we've done a really good job and we've got even better analytics today that can help us identify the opportunities. So I don't think it's any different than it's ever been. It's always competitive and just a matter of finding the right opportunities, given your situation in your markets.

Operator

The next question comes from Henry Coffey from Wedbush.

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

On the competitive front, we just hear a scattering of news and I think someplace in the ramblings of life, even Jamie Dimon said he thinks you got to get out of the mortgage business because of -- unless rates go lower. I'm not quite confident he has any idea what he's talking about but that's an editorial for another day. We also have some regional banks that have been complaining about MSR volatility. You've got Ditech, which is still in the question mark camp and these are all things that you manage well and have over time. So I get it, it's bleak, it's dark, there's a lot of competition out there but there are also a lot of large bodies that may topple off the edge and there's some interesting MSR acquisition opportunities. What would cause you to kind of brighten up your view?

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

Well, I don't think my view is dark. I think I'm pretty optimistic actually about things and overall. I think the mortgage business has got some -- a little bit of a hint of a tailwind, as I said. So look, I don't...

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

That's what I meant. It will brighten up your view on mortgage. The banking stuff is just great, the banking stuff is not going to stop. It's in fabulous shape.

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

Compared to a year ago, Henry, I'm thrilled about the mortgage business. So look, it's come a long way and I feel that there's some light at the end of the tunnel but it isn't going to -- that light isn't going to come, I don't believe, from a $2 trillion market. We're in this $1.6 trillion, $1.7 trillion market, I just don't see anything that's going to drive that to a higher level. But I do think that adjustments in the market will continue. I do think capacity will continue to adjust and that will cause pricing to become more, let's put it this way, smarter and that will allow us to gradually increase our margin going forward. But it's hard in the mortgage business to look farther than 3 months, I mean it's just so volatile. If you would have asked me in February, if we were going to see that rally in March, I would've said no way but it came. And so those of us that have been in this business a long time know that it can change quickly. I think what's different about Flagstar against almost any other originators, especially nonbank originators is, we cut the cost quickly and we adjust to increases in volume quickly. And so you saw us cut the cost last year and now you're seeing the cost come back into our projection this year because we see activity increasing. So it's just what the business is. And we're not in an economy that -- where housing is driving and so how can you be any more positive than we are being about the mortgage business. I just don't see it.

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

You don't see the -- I'm sorry, go on.

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

Sorry, Henry. I just want to jump in. I mean if you think of our model, I mean exactly what Sandro said, on the mortgage side, we're disciplined, we have scale in all 6 origination channels, we won't chase the prize, we wanted a profitable business and we've got a variable cost model. So we always maintain that discipline on the origination side and you've heard Kristy say that. In terms of the MSR asset, we protect that like you wouldn't believe. We hedge it, we understand it operationally, if you look at our track record, we generate good returns on it, we generated a 9.1% return in Q1. And then we've created the subservicing business, which allows us to sell the MSR and retain the subservicing. So we've created a model and a discipline that can be successful in any mortgage environment and I think that's what's different about our model versus the nonbank model.

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

No. I agree completely. I mean I'm watching some of these independent but not public operators to self-implode and I'm watching a bunch of regional banks that don't really know how to manage their MSR risk, so I think -- they're complaining about it now because rates are going down. Speaking of your subservicing and servicing business in your GAAP -- your public filings, you have started disclosing details on the servicing business as kind of a standalone unit. Does that disclosure include both the MSR revenues as well as the subservicing revenues or are those 2 still reported separately?

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

So Henry, this is Jim. The MSR, we carry in our mortgage segment and then the servicing segment is treated as a servicer whether that's for the portfolio of MSRs that's held by the mortgage segment or whether that's a portfolio of MSRs that's held by a third-party unrelated to Flagstar. But when you look at the servicing segment financials, it's treating everything outside of itself and it holds no MSRs itself, it's treating everything as basically being subserviced by them. It's kind of like just an independent servicing company that services both for Flagstar and for others. And so there are some intersegment revenues there but that's the best way. So if Flagstar decides to sell some MSRs, the impact to the servicing business is unaffected because that MSR is no longer held by Flagstar's mortgage business, it's held by somebody else.

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

As long as we retain subservicing on those loans.

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

Yes. Right, right. Can you give us some sense of what you think the profitability of that business will look like over time? I know you mentioned that XYZ gain in units equals so much to the bottom line, maybe you could talk about that in terms of likely basis points of revenue and servicing cost?

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

Yes. It's something we can think about. We haven't looked or disclosed it that way but maybe that's something, Jim, we can think about.

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

Let me think about it.

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

No. It's a very strong business and the number of banks that don't have your capacity to manage hedging risk were notable this quarter. So great quarter, thanks for all your comments.

Operator

We will now take a follow-up question from Kevin Barker from Piper Jaffray.

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

I actually had a quick question on capital front. Obviously, you're returning more capital to shareholders but do you consider the TCE ratio as a constraining factor or something to manage to or you're primarily focused on most of your regulatory capital ratios when planning out your capital planning?

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

Kevin, it's something we watch. The regulatory capital ratios are what we manage to though. And so when we look at the TCE, we're cognizant of it where it is relative to the risks in our balance sheet but we're really managing, I'd say, to the regulatory capital ratios. I think CET1 is a much better measure for that purpose than the TCE, although TCE I think shortcuts CET1 and may be it's easier to follow.

Operator

As there are no further question signals, I will now turn the call back to Mr. DiNello for any additional or closing remarks.

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

Thank you, Quena, and thanks to everyone for your interest in Flagstar. This was another good quarter for our company. We continue to produce consistent earnings and growth while maintaining strong credit quality and capital. And we are doing this regardless of economic conditions, interest rate fluctuations and mortgage market volatility, as evidenced by our solid return on tangible equity over the last 12 months. I feel good about our current position and I'm optimistic we can improve our performance going forward. We have the hint of a tailwind in mortgage for the first time in a long time, earnings from servicing are becoming almost annuity like and we have a lot of confidence in the ability of our banking business to continue to deliver strong results. Going forward, identifying ways to get more efficient will be front and center. Thanks, again, to the Flagstar families for your outstanding performance and thanks to our shareholders for your support.

Operator

That will conclude today's call. Thank you for your participation, ladies and gentlemen. You may now disconnect.
