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FBC - Q3 2015 Flagstar Bancorp Inc Earnings Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Flagstar Bank third-quarter 2015 earnings conference 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.

David Urban - *Flagstar Bancorp, Inc. - IR*

Thank you, Nikki, and good morning, everyone. Welcome to the Flagstar third-quarter 2015 earnings call.

Before we begin, I would like to mention that our third-quarter earnings release and presentation are available on our website at flagstar.com. I would also like to remind you that any forward-looking statements made during today's call are subject to risks and uncertainties. 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 2014 Form 10-K and subsequent reports on file with the SEC.

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

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

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

I will start with the order of the call. First, I'm going to provide a high-level view of how the quarter fits into our overall strategy. Then I will turn the call over to Jim for a deep dive into our financial results. Lee will follow with a more detailed review of our business segments and strategic initiatives, and I will conclude with guidance for the fourth-quarter 2015 before opening up the lines for questions.

First, it's great to have another great, clean, profitable quarter under our belt. That's four solid quarters in a row, and with each one we put distance between the Flagstar of the past and the Flagstar of the future.

We have accomplished a lot. We've put to rest key credit concerns, created a culture of risk management, and made expense control a way of life. We have strength in both our balance sheet and our capital and delivered on our promise to restore profitability and derisk our balance sheet, which we have done by systematically replacing lower-quality loans with higher-quality assets.

As reported in our earnings release, we executed on another large sale of interest-only loans during the quarter, which now leaves us with a very small, manageable portfolio. Any future sales will be driven not by credit or concentration issues, but by the opportunity to execute an attractive transaction.

We are now in a post-crisis mode where the key words are growth and diversification and the watchwords are expense management and compliance. We have seen a steady improvement in our efficiency ratio the past four quarters and are pleased to have posted our third straight quarter of positive operating leverage. Boosting that leverage by improving efficiencies and getting topline growth is front and center with this management team.

Earlier this year, we had good success retooling our third-party mortgage origination business to widen margins, reduce operating expenses, and better position Flagstar for future growth. We are continuing to look for ways to optimize fulfillment, all while analyzing our footprint to see where it makes sense for us to expand. We are targeting growth in our retail distribution channel as a way to diversify originations, and because the purchase business is less rate driven than refies, we're making purchases a priority.

We see lots of upside opportunity in the direct-to-consumer business and recently hired an experienced executive, [Greg Carlton], to lead this origination channel. He comes well credentialed to make Flagstar a front runner in this important space.

And we have made other additions to staff to support our planned growth. Matt Allen joined us last week as Chief Marketing Officer and he, too, brings a strong background in his field. One of his first assignments is an important one, refreshing Flagstar's brand to jumpstart consumer awareness. We feel that Flagstar has a unique persona and a compelling story. We want to package that uniqueness and wrap it in a messaging that will help us grow our three lines of business.

The common thread here is that piece by piece we are putting together a team that is focused on growth and the future. As you would expect with any important personnel additions, though, we don't expect to see an immediate impact as a result of their work because it will take time to integrate them into Flagstar.

We also continue to be encouraged with the progress we're making toward the lifting of our OCC consent order and we're holding to our target of resolving TARP no later than the second half of 2016.

With that, my colleagues will take you through a more detailed discussion of our financials and operations, so let me now turn the call over to Jim.

Jim Ciroli - *Flagstar Bancorp, Inc. - EVP, CFO*

Thanks, Sandro. Turning now to slide 7, our net income was $47 million, $0.69 per share, in the third quarter as compared to net income of $46 million, $0.68 per share, in the second quarter. Our earnings in the third quarter were again shaped by positive operating leverage. Total revenues increased 1%, while expenses dropped 5%.

For the quarter, we posted an annualized return on assets of 1.5% and returns on equity and common equity of 12.4% and 12.7%, respectively. On the basis of our revenue growth, our efficiency ratio improved to 65%, which Lee will provide additional color on in a few minutes.

Our third-quarter net interest income was unchanged at $73 million. The results were led by modest earning asset growth, offset by a slight drop in the net interest margin. Our NIM fell 4 basis points in the third quarter to 2.75%, due to a shift in the mix of the portfolio toward lower-spread, but higher-quality, residential mortgage loans as we portfolioed these loans ahead of our early Q4 interest-only loan sale.

Average interest-earning assets rose 3% in the third quarter, led by a 10% increase in loans held for investment. We grew our loan book 16% in resi first mortgage loans and 16% in other consumer loans, predominantly home equity.

Average total deposits increased 7% from the prior quarter, driven by a $359 million or 32% increase in Company-controlled deposits and a 13% gain in government deposits. The increase in Company-controlled deposits was driven by the return of mortgage escrow deposits, partially offset by seasonal factors.

The Company experienced a provision benefit in the third quarter of 2015 from the sale of lower-performing loans. The quarterly provision for loan losses was a benefit of $1 million for the third quarter versus a benefit of $13 million in the second quarter as we realized a $9 million net allowance release primarily related to the sale of $233 million of interest-only and lower-performing loans.

Our net charge-offs of $24 million for the third quarter included $16 million of net charge-offs associated with the aforementioned loan sale. Excluding this amount, net charge-offs were $8 million, 61 basis points of loans. The increase from the prior quarter was primarily due to $3 million of commercial loan charge-offs and $1 million of consumer loan charge-offs related to a one-time adjustment as we began recording charge-offs on certain loans before 180 days and we have evidence of an inability to repay.

I will provide additional detail on asset quality in a couple of slides.

Non-interest income increased $2 million or 2% to $128 million in the third quarter, led by, A, an increase in the net return on mortgage servicing asset; B, higher net gains on sales of assets; and C, more other non-interest income.

The $10 million improvement in other non-interest income resulted from $3 million of positive fair-value adjustments this quarter, compared to $6 million of negative fair-value adjustments last quarter. These adjustments were driven by three factors.

First, the change in fair value of the Company's commitments to purchase residential mortgage loans that are designated for HFI improved $5 million, due to a drop in interest rates at the end of the quarter, as compared to an increase in rates at the end of the prior quarter.

Second, the change in fair value of HFI residential mortgages carried under a fair value election was $3 million better, due to the impact of the same change in rates.

And finally, the fair value of HELOCs improved $2 million, due to a $2 million charge in the prior quarter when certain of these loans were serviced externally. At the end of the second quarter, we exercised our cleanup call on part of this portfolio and its performance in the third quarter has been consistent with our expectations.

These positive developments in non-interest income were partially offset by a $15 million decline in net gain on loan sales, reflecting a drop in the gain on sale margin and lower fallout-adjusted locks. The net gain on loan sale margin decreased 16 basis points, led by a return to more normalized government margins, increased price competitiveness on conforming conventional, and lower spreads on refinance business.

Fallout-adjusted locks fell 5%. The Company increased government and jumbo production to partially offset a drop in conventional volumes.

Moving now to expenses, non-interest expense decreased 5% to $131 million in the third quarter as compared to $138 million in the second quarter. During the third quarter, asset resolution expense declined $5 million, largely reflecting the positive impacts of building a stronger balance sheet. Lee will provide additional details on asset resolution expense later.

We also experienced a $2 million drop in other non-interest expense, due to lower advertising costs and regulatory-related expenses. These decreases were partially offset by a $2 million increase in legal and professional fees, due to higher legal expense related to the execution of various nonagency loan sales and consulting fees on various projects aimed to further improve operational efficiency and further strengthen risk management.

On the tax front, the Company's effective tax rate in the third quarter fell to 34%, resulting from the recognition of R&D tax credits and higher tax-exempt income. We anticipate that the tax rate in Q4 will be unusually low as a result of state tax benefits that we anticipate recognizing.

Our full-year tax rate is expected to be 34%, a rate that we would consider normal, given our business and geography mix.

Turning now to slide 8, we wanted to cut through the more significant noise this quarter to discuss core performance improvement. When we normalized for the allowance release and the changes in fair value, which cannot be counted on to recur, as well as swings in gain on loan sale, return on mortgage servicing rights, and asset resolution expense, we can see a core quarter-over-quarter improvement of $3 million.

This core improvement, while small, was broad based. We saw good performance improvement across many different lines as we grew existing businesses, added new revenue streams in small ways, and were able to pare back expenses slightly.

Slide number 9 highlights our average balance sheet. Average total assets increased 4% to $12 billion in the third quarter, led by growth in loans held for investment as we continued to deploy capital with residential mortgage loans. We maintained a strong balance sheet with a stable funding base. Our common equity to assets ratio remained solid at 9.9%, with deposits equaling 77% of average liabilities.

Turning to asset quality on slide 10, our allowance coverage was 3.7% of total loans at the end of the third quarter as compared to 4.3% at the end of the second quarter. Coverage dropped 65 basis points as a result of the sale of lower-quality loans and the continued growth of higher-quality assets.

At quarter-end, we had a 5.2% allowance coverage of our consumer loan book, down 134 basis points from the prior quarter-end, consistent with fewer lower-quality assets. The commercial loan allowance coverage ratio remained at 1.4% in Q3, reflecting the high quality of this portfolio.

Nonperforming loans were relatively stable at $63 million at the end of the third quarter, while the ratio of nonperforming loans to loans held for investment fell 7 basis points to 1.15%. Performing TDRs fell $11 million to $97 million in the third quarter, reflecting the sale of lower-performing loans.

Early-stage delinquencies remained at a low level in Q3. Looking at consumer loans, only 0.64% were over 30 days delinquent and still accruing, up modestly from the second quarter of 2015, but down 131 basis points from the same quarter last year.

The quarterly rise in consumer delinquencies was led by the HELOC loans on which we exercised our cleanup call in late Q2. The Company wrote down the fair value of this portfolio earlier this year, in anticipation of these non-renewals, and is working to resolve the issue. The loans are performing in line with expectations. There continued to be no commercial loans at September 30 that were more than 30 days delinquent.

Turning now to slide 11, we continued to maintain robust regulatory capital ratios in the third quarter with the partial phase-in of Basel III. On a partially phased-in basis at September 30, 2015, our Tier 1 leverage ratio was 11.7% as compared to 11.5% at June 30, 2015. The increase in the ratio resulted from earnings retention and the lower deduction for NOL-related deferred tax assets, partially offset by earning asset growth.

We continued to use our excess capital to support balance-sheet growth. Our Tier 1 common ratio was 14.9% at September 30, 2015.

Looking at the impact of a fully phased-in implementation of Basel III, our Tier 1 leverage ratio would have been 9.9% and our Tier 1 common ratio would have been 9.6% at the end of the quarter. Due to the detrimental treatment, the mortgage servicing rights in the DTA receive under Basel III.

Looking ahead, we should be able to grow regulatory capital at a strong pace as we utilize our NOL-related DTAs and scale back our concentration of MSRs. As we achieve a higher level of Tier 1 capital from earnings and NOL use, there will be a positive multiplier effect that also reduces the deductions for excess DTAs and MSRs. At September 30, 2015, we had $294 million of MSRs, representing 21.1% of Tier 1 capital.

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

Lee Smith - *Flagstar Bancorp, Inc. - COO*

Thanks, Jim, and good morning, everyone.

We are very pleased with our Q3 results, but even more encouraged when you look back at the last 12 months, where we have generated $136 million of after-tax net income. Furthermore, and starting with Q4 2014, our performance has continued to improve every quarter through Q3 2015. We have worked diligently to derisk the balance sheet, optimize the cost structure, and strengthen the risk management practices of the bank in order to create a solid and efficient foundation from which to grow in our three major business lines and generate sustainable earnings.

I will now outline some of the key operating metrics from each segment during the quarter. Please turn to slide 13.

Quarterly operating highlights for the community banking segment include average consumer loans increased $454 million, or 16%, in the quarter. We funded $651 million of jumbo and conventional product during the quarter that we added to our HFI portfolio, as we continued to execute on our strategy of swapping out lower-performing and riskier assets for higher-quality interest-earning assets.

Average total commercial loans increased 1% to $2 billion versus the prior quarter, primarily due to growth in our C&I and CRE businesses. During the last 12 months, we have grown total commercial loans by nearly $700 million, led by $416 million in warehouse lending, $140 million in CRE lending, and $142 million in C&I lending.

Average total deposits increased 7% during the third quarter and 17% over the last 12 months, primarily due to increases in retail savings and Company-controlled deposits.

During the quarter, we also sold one of our branches as we look to further optimize our branch footprint. We recognized the gain on this sale of approximately $2 million.

We intend to continue to grow our consumer loan balances, both from our own originations, as well as being opportunistic with asset purchases that fit our credit and risk profile. Of the $651 million, we grew our HFI book in Q3. $454 million was from jumbo originations and $197 million was from conventional product. This balance-sheet growth contributed to the $1 million quarter-over-quarter interest income improvement.

We continue to look for opportunities to grow our C&I and CRE businesses, as well as expand in our consumer and business banking offerings. We are encouraged by the sustained growth we have seen in the warehouse business over the past 12 months and we will look to build on that further as we move forward by growing business with existing customers, as well as adding new customers, including those that don't sell directly to Flagstaff.

On the technology front, we're about to launch a new and improved online banking platform that will enhance our overall service offering to our customers and we are in the process of replacing our entire fleet of ATMs with state-of-the-art terminals. We have swapped out around 30% of our machines to date and hope to swap out the remaining 70% by the end of this year.

Please turn to slide 14. Third-quarter operating highlights for the mortgage origination business include fallout-adjusted gain on sale margin decreased 16 basis points to 1.05% in the third quarter, as compared to 1.21% in the second quarter. The decrease was primarily a result of increased capacity in the industry leading to lower margins on government products and refinance business, in particular. Fallout-adjusted lock volume decreased 5% to $6.5 billion, led by a decrease in conventional volume, partially offset by increased government and jumbo production. Purchased mortgages remained at 54% of locks during the third quarter.

We continue to remain focused on providing service excellence, while at the same time implementing strategies to refine and optimize our variable-cost model on the fulfillment side of the business.

We are continuing to invest in technology as a way to further improve the topline performance and make us more efficient from an operating point of view. We expect to launch phase two of our consumer portal before the end of the year. This portal will allow our customers to shop for a mortgage and start the application process online and it will also act as a document aggregator, driving further operating efficiencies.

We are now processing loans under the new RESPA/TILA Integrated Disclosure requirements that went into effect on October 3 and have been extremely pleased with how smoothly this has gone.

Finally, we are committed to growing our retail origination business on both the retail distribution and direct-to-consumer side as we transition to a purchased market. As Sandro mentioned, we hired Greg Carlton during the quarter to head up our direct-to-consumer business and are excited about the knowledge and experience he brings to this role.

Moving to servicing, quarterly operating highlights for the mortgage servicing segment on slide 15 include we executed on the sale of $6.7 billion in aggregate UPB or 28,600 loans of residential MSRs during the quarter. We currently service approximately 369,000 loans, of which 221,000 are subservice for others, making us the seventh-largest subservicer in the nation. The remaining 148,000 are loans where we own the MSR or they are part of our HFI book. Approximately 97% of our servicing book is performing loans and 3%, or approximately 10,000 loans, are 60-plus days delinquent.

Over the last 12 months, we have successfully reduced the number of seriously delinquent loans in our portfolio, given the significant costs associated with servicing such loans and because servicing and working out delinquent loans is not part of our core growth strategy.

As part of our continued efforts to improve our servicing platform, we went live with the second component to full servicer on July 1. This means we have two component to full servicers where we can send seriously delinquent loans, thus giving us more optionality. We have structured the second relationship similar to the first relationship, meaning the component servicer plugs into our MSP system, making it seamless for the borrower when any loan becomes 60-plus days delinquent.

Longer term, we remain focused on growing our fee income-generating subservicing portfolio, which has the capacity to servicer to 1 million loans, and recently hired Rodney Moss as head of business development to lead this effort.

We also want to better leverage the cross-selling we are able to do across our three business line verticals in order to increase share of our mortgage customers' wallet and the number of active accounts per household.

Moving to asset quality, we continue with our ongoing efforts to derisk the balance sheet. We sold approximately $233 million unpaid principal balance of interest-only and lower-performing loans during the quarter, albeit the interest-only trade for $214 million officially closed after the quarter-end in October.

We have now sold over $1 billion in UPB of interest-only and lower-performing loans in 2015 as part of a concerted effort to derisk our balance sheet and reduce the costs associated with nonperforming and higher-risk assets.

Please turn to slide 16. As a result of this recent interest-only trade, we have materially eliminated the risk associated with interest-only loans. Since the end of 2011, this portfolio has decreased more than 90% or $1.4 billion. As of September 30, 2015, we have approximately $124 million of IO loans remaining on our balance sheet, of which $97 million have yet to reset.

I would like to compliment the Flagstar team for their outstanding efforts in successfully dealing with this interest-only loan portfolio. These loan sales, which have also reduced our NPLs to $63 million, the lowest level they have been in nearly 10 years, should lead to reduced asset-resolution expenses in future periods, as well as lower FDIC premiums in 2016.

Moving now to expenses on slide 17, our non-interest expenses decreased $7 million or 5.1% to $131 million in the third quarter. The reduction in expenses is in large part due to the continued decline in asset resolution costs quarter over quarter as a result of our balance-sheet derisking program. However, we also benefited from some one-time reimbursements in this line item during the quarter that amounted to approximately $2.5 million.

We have also experienced lower cost on the mortgage origination side of the business, given the variable-cost model we have implemented in this business line tracking the reduced mortgage origination revenues during the quarter. As always, we remain focused on optimizing our cost infrastructure and looking at ways to drive further efficiencies throughout the organization.

We estimate non-interest expense will be between $130 million and $135 million in the fourth quarter of 2015.

Despite the modest increase in revenues in the quarter, we saw continued improvement in the Company's efficiency ratio to 65% from 69.6% the previous quarter. The improvement was primarily driven by decreases in non-interest expenses.

We mentioned last quarter that our efficiency ratio target is around the mid-60%s, so we're pleased to have hit our target in Q3. The key for us is to maintain this efficiency ratio going forward. Given our quarterly non-interest expense run rate, it means revenues need to be approximately $200 million every quarter.

Looking forward, the efficiency ratio will remain more sensitive to changes in revenue, given how consistent our expenses have been over the last 15 months.

We continue to work tirelessly to develop and implement revenue-generating initiatives, further optimize our cost structure, and drive greater efficiencies throughout the organization. It is this focus and drive that will enable us to consistently achieve our efficiency ratio target.

With that, I will hand it back to Sandro.

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Thank you, Lee. I am now going to close our prepared remarks with some guidance for the fourth quarter of 2015 and then open the call for questions and answers.

I have been very pleased with our results so far this year. We have exceeded the Street's expectations on profitability, while further strengthening the balance sheet.

Now, as we look to the fourth quarter, I'm cautiously optimistic because I do believe we will experience some headwinds from seasonality and lower revenue from mortgage refinance activity. Please turn to slide 19 where we have itemized our guidance parameters.

We expect a slight drop in net interest income and a slight contraction of the net interest margin, primarily due to a modest decline in earning assets as our mortgage pipeline shrinks a bit due to seasonality. Mortgage locks will likely decline in line with mortgage industry activity as we don't expect any notable change in market share. We expect a slightly lower gain on loan sale margin. We expect the number of loans serviced to decline a bit, which will cause loan administration income to decline.

We expect to return to a normalized net return on the mortgage servicing asset of 4% to 6%. The ratio of our MSR to Tier 1 capital will likely remain steady. We expect our provision expense to match net charge-offs, which we expect to be consistent with the net charge-off ratio in Q2, adjusted for loan sales. As Lee noted, non-interest expenses should remain stable between $130 million and $135 million, and lastly, we expect an effective tax rate in the mid-20%s in the fourth quarter.

This concludes our prepared remarks and we will now open the call to questions from our listeners. Nikki?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Bose George, KBW.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Good quarter. Just to clarify, on the IO sale that happened in October, is there going to be any impact in the fourth quarter or they already put it into HFS last quarter so that's what we saw in [3Q] earnings?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Yes, no fourth-quarter impact. It's all in Q3.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, great, thanks. And then, switching to the mortgage banking, in your commentary you had noted lower margins in the government business this quarter. Can you just discuss some of the dynamics driving that trend?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

I will let Lee answer that. It is principally competitive factors, Bose, that caused us to narrow the margin a bit in that business. Anything to add to that, Len?

Len Israel - *Flagstar Bancorp, Inc. - President Mortgage Banking*

Yes, this is Len. What we have seen is more of a return to normalized margins the first quarter going into the second quarter because of the FHA MIP reduction. We did see a huge swell in volume industrywide as well.

As a result of that, we were able to enjoy abnormally high margins, and again, we are seeing that normalize.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, great, thanks. And then, finally, any updates you can provide on TARP?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Not anymore than what we said in the prepared comments.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, great. Thanks very much.

Operator

Paul Miller, FBR & Co.

Paul Miller - *FBR & Co. - Analyst*

Can you talk a little bit about your thoughts or strategy behind the MSR sales? I know this is done -- you do this on a regular basis. Do you market these on a consistent basis? Do you want to run your servicing portfolio at a certain level? Can you just talk about your theories behind that?

Lee Smith - *Flagstar Bancorp, Inc. - COO*

Paul, it is Lee. As you know, we have been a regular seller of MSRs over the last two years and we will continue to do so.

Given we're the 10th largest originator of mortgages in the country and the advent of Basel III, we have done a nice job of reducing our concentration in MSRs from the high point in September 2013, I believe, and we will be where we need to be by the end of Q1 2018, which is when Basel III will be fully phased in.

The way we intend to get there is through a combination of bulk and flow sales. And the good news here is we can use the sale of MSRs to benefit our subservicing business whereby we retain the subservicing on the underlying loans being sold.

Paul Miller - *FBR & Co. - Analyst*

Yes, that was my next question. You're going to be -- do you subservice some of these loans? So what percentage do you subservice? Is it the bulk of them or just half of them?

Lee Smith - *Flagstar Bancorp, Inc. - COO*

Yes, we would like to subservice all of them. The transaction we executed on in Q3, the $6.7 billion, that was a release deal, and so I would say so far this year it has probably been about -- we have retained about 60% of what we have sold, 40% we have sold on a release basis.

Paul Miller - *FBR & Co. - Analyst*

And then, you talked about the online origination platform because most of your stuff comes through brokers or correspondent, am I correct? And you do have some branches. Can you talk a little bit about -- because this is a little bit of a change in strategy for you. What percentage originations is your goal on this online origination strategy?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Paul, I don't have a percentage to target for you, but what I will say is that given the fact that on the direct-to-consumer, it has been a relatively low amount of production for us, it is an opportunity we think that can incrementally improve our retail business, which is where our focus is. Maybe Len would like to expand on that.

Len Israel - *Flagstar Bancorp, Inc. - President Mortgage Banking*

Yes, we see a tremendous amount of opportunity. As Sandro and Lee both mentioned, we did hire Greg Carlton who has a tremendous amount of experience in leading direct-to-consumer channels.

And we are finding that with the opportunity to link to various service providers, we have an opportunity to engage in more aggressive outbound solicitations, and that's opportunity for us.

Paul Miller - *FBR & Co. - Analyst*

Okay, thank you very much.

Lee Smith - *Flagstar Bancorp, Inc. - COO*

Paul, I will just add to that. I think with the way the market is going and the millennials who are doing more things online, this gives us an opportunity to reach out to that customer base.

And as I mentioned in the prepared remarks, so it's not only a sales tool; it actually acts us a document aggregator as well. So we can drive further efficiencies throughout the business because, in theory, it will mean our LOs are not chasing missing documents, and when a package gets delivered to our fulfillment business, it is a full package, so they are not opening it and finding that there is a document missing, either. So it is going to help us both on the sales side, but it is also going to help us from an efficiency point of view as well.

Paul Miller - *FBR & Co. - Analyst*

Okay, guys. Thank you very much.

Operator

Scott Siefers, Sandler O'Neill & Partners.

Scott Siefers - *Sandler O'Neill & Partners - Analyst*

A couple of questions here. First, I was hoping you could touch on the reserves. You guys have done such an enormous amount of derisking, particularly this year, and I guess I'm just curious where you see the overall reserve level going since it is still quite elevated relative to some of your peers and maybe over -- how and over what period of time you might hope to get it down to a more normalized level.

Jim Ciroli - *Flagstar Bancorp, Inc. - EVP, CFO*

Yes, Scott, this is Jim. As we look at -- we look at the reserve every quarter. We set it to the level we think we feel appropriate and I would tell you that we take a very -- considering where we have been -- a very conservative view on the level of future losses because we just -- we don't want to get over our skis there, taking that down prematurely and have to take it back up. So we are very cautious about the level we set it at, but we look at that every quarter.

Scott Siefers - *Sandler O'Neill & Partners - Analyst*

Okay, all right. And then maybe, Jim, the next one is for you. You gave a lot of good color on the nuance within other income this quarter and all the deltas relative to the 2Q.

I guess as you look at things, and understanding that with all that nuance, it can be tough to pinpoint, but what is your best guess as to where that other income number goes? And I guess maybe a more appropriate way to ask it would be, what would have to happen to keep that level elevated up near this $10 million number versus the closer to zero it had been running just the last couple quarters?

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Jim Ciroli - *Flagstar Bancorp, Inc. - EVP, CFO*

Yes, Scott, as you look at our other non-interest income, we have about $3 million of fair-value benefits this quarter, so I wouldn't project -- I can't project where the market is going to be in terms of fair value in the future, but I would take a zero line, so I would take $3 million out of that line and that would probably be your best plot.

Lee Smith - *Flagstar Bancorp, Inc. - COO*

I think -- just to add to that, Scott, I think I mentioned in my prepared remarks, it was a $2 million gain on the sale of a branch and that is also in that line item, so you can add that $2 million to the $3 million Jim just referenced.

Scott Siefers - *Sandler O'Neill & Partners - Analyst*

Perfect. Okay, good. Thank you.

And then maybe Lee, was hoping you could expand upon some of your comments on the subservicing business. You had given some good color a question or two ago, which I appreciate. But just given that the capacity for what you could subservice is just so much in excess of what you are actually doing, I'm curious if you can talk a little bit about the ongoing strategy there.

And then if I heard correctly, it sounded like you might have some new management in that area, so, I guess, did I hear that correctly and what is your current thinking there?

Lee Smith - *Flagstar Bancorp, Inc. - COO*

Yes, so the subservicing business, this is something we have talked about a lot over the last 12, 18 months. As you correctly say, we are currently servicing 369,000 loans. We have the capacity to service 1 million loans, so we have plenty of capacity.

If you go back to the end of last year, we hired Mark Landschulz to run performing servicing. Mark brings a ton of experience in that role. And then, this last quarter we brought in Rodney Moss as the head of business development and so that's what you heard in the prepared remarks this time. And so, he is going to help in conjunction with Mark to grow that business.

The way we can grow that business is threefold. One would be selling MSRs that we've originated and then we subservice the loans after the sale. Onboarding loans that we haven't originated, and given that we're an active seller of MSRs, we are very close to a lot of buyers who are buying not just from us, but from other organizations. And then, we can work directly with the GSEs and Ginnie Mae to subservice their books of business as well.

And then, the other thing that I would point out, and again, this is something that we have mentioned publicly before, for every 100,000 loans we add to our platform, we estimate it generates between $5 million and $7 million of incremental operating profit before tax.

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Scott, Sandro here, so just one additional comment. Relative to Mark coming aboard a year or so ago and Rodney more recently, this is the right kind of sequencing. You bring the operator in first, let him get the operation in the right place, build the infrastructure, and then bring your salespeople in to go find the business.

So that's what you have seen us do here. You have seen us build this thing, get it ready to go, and now we will opportunistically look for situations where we can bring other portfolios onto our platform.

Scott Siefers - *Sandler O'Neill & Partners - Analyst*

Okay, that's perfect. Thank you.

And I think maybe the final question, Sandro, either for you or for Jim, but was hoping you could speak in a bit more detail on the anticipated pace of loan growth. I feel like the last couple quarters have been a little colored in that you had a balance-sheet hole to fill with the IO sale. So looking ahead, would you anticipate -- if you X out the noise, would you anticipate this kind of pace of core loan growth to sustain itself or would you maybe take your foot off the pedal just a little bit, now that you no longer have that pressure to refill the IO bucket, so to speak, or the bucket created by IOs leaving?

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Yes, so I think in terms of the next quarter, which is as far as we have provided that guidance, we're not expecting any significant growth. And, in fact, I think we even guided to a little bit lower number in earning assets.

More long term, we will look for where the opportunities are to grow the balance sheet because we think that growing our net interest income in our community bank is where the opportunity is to continue to diversify the revenue and smooth out the seasonality of the mortgage business. So certainly that's what we want to do, but we need to make sure that we do it the right way, that we do it with the right quality and everything in a safe and sound fashion.

Scott Siefers - *Sandler O'Neill & Partners - Analyst*

All right, that's perfect. Thank you guys very much.

Operator

(Operator Instructions). Jesus Bueno, Compass Point.

Jesus Bueno - *Compass Point Research & Trading - Analyst*

Thanks for taking my questions. My first question is just we have heard a lot of news about the TRID implementation, so I was hoping you could offer some color about how it has gone for you and if there has been any impact on closing timelines as a result.

Len Israel - *Flagstar Bancorp, Inc. - President Mortgage Banking*

That's a great question. What appears to be the replacement of four disclosures brought about by federal law from 1974 is really -- it is a fundamental change in the workflows and timing involved in the production of the disclosures, and this really has shifted the roles and responsibilities of our lenders, our brokers, settlement agencies, all parties in transaction, and that includes the consumer.

We have seen choppy action and the industry has as well. First, there was a swell in volume coming up prior to the October 3 date; then it died down as everybody was trying to absorb and identify any issues and processes, and then to fix on the technology side any systems-related issues, as well as the communications with the settlement agency, making sure those were straight.

From our perspective, we spent over 50,000 hours just in IT-related configuration, testing, and retesting alone, and another 20,000 hours in training with both our correspondent customers or broker customers and throughout retail. So, 70,000 hours in total, so the impact to us has been minimal.

Lee Smith - *Flagstar Bancorp, Inc. - COO*

I think the only thing I would add, Len, as well, if you actually look at locks around the October 3 date, it was definitely a pull forward of locks into the week before October 3 and then there was a reduction in the week post October 3. But if you average the two weeks out, it was on track.

That's the sort of phenomenon that you saw occur around the October 3 date, and as Len mentioned, just the phenomenal effort from the team. It was 47,000 IT man hours and another 20,000 non-IT man hours to put this into place.

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

And bottom line, everything is working smoothly at Flagstar. We are not delaying any closings. Everything is working the way it did before TRID. As these guys said, it was a hell of a lift to get to this point, but, as usual, our team did a great job and now it is business as usual.

Jesus Bueno - *Compass Point Research & Trading - Analyst*

Great, that sounds like quite the undertaking. I appreciate the color.

And I guess back on the TARP repayment, just to double check and I know we have discussed this before, but the OCC consent order, I guess, do the two go hand in hand? Is it something that you can -- can you go and repay TARP without having the consent order lifted? Are regulators, are they taking into account the OCC consent order? If you could add any color around that, that would be great.

Lee Smith - *Flagstar Bancorp, Inc. - COO*

All I would say, Jesus, is that one does not necessarily connect to the other and the timing of what we have set forth is what we expect to happen, and there is really nothing more that I could add to that.

Jesus Bueno - *Compass Point Research & Trading - Analyst*

Great, and if I can get in one more on the primary servicing, I guess as you sell off primary servicing and as you retain subservicing, I was looking back and it looks like you're doing about 28 basis points on the primary and I guess made about 8 basis points on the subservicing. So, I guess going forward as you think about servicing income in the context of non-interest income, are you looking for ways to bolster the lost income from the switch to subservicing? Are you looking to do that primarily through expanding your subservicing operation or are there other ways that you're looking at growing on interest income to (multiple speakers)

Lee Smith - *Flagstar Bancorp, Inc. - COO*

I think, yes, we have an MSR asset today that is around $290 million and it is a little over 20% concentration MSR to Tier 1. And again, with the advent of Basel III, we need to get that down to 10%, so you're going to see us reduce that over time.

And you're right. Look, it is an asset that generates income, and so as a result we need to replace that income, and the way we're going to do that is threefold. We have got the subservicing business and so subservicing the loans that we sell, that will allow us to build income, fee income, from the subservicing business.

As Sandro just alluded to, we want to grow the balance sheet and that will help generate interest income, and then we are looking at ways, and we talked about the consumer portal, to further grow our origination business, particularly on the retail side.

So there isn't just one area it is going to come from. It's a combination of the three business lines that we have always spoken about.

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Yes, and I would add with respect to the servicing business, as we are able to grow the subservicing business and increase the number of loans that we service, along with that comes great funding because of the story of the process, and if we do end up seeing interest rates increase, that will be a great advantage to us to have growth in that funding source.

Jesus Bueno - *Compass Point Research & Trading - Analyst*

Great, thank you for the color. I appreciate you taking my questions. Thank you.

Operator

There appears there are no further questions.

Sandro DiNello - *Flagstar Bancorp, Inc. - President, CEO*

Okay, thanks, Nikki, I appreciate your assistance and thanks to all of you for your interest in Flagstar.

It was a quarter for putting to rest post-crisis issues, executing on our business plan to drive operating leverage, and laying the foundation for the future. I am pleased that we were able to achieve higher total revenue on a linked-quarter basis, despite lower mortgage originations, proof that the diversification strategy we embarked on in 2013 is working.

I am also pleased with the rigor we applied to derisking our balance sheet. As Lee noted, nearly $1 billion in lower-performing loans in the first three quarters of this year were replaced with higher-quality assets. That's a significant accomplishment.

Further, as you can clearly see, we have been unwavering in our commitment to control costs. At this point, our quarters are starting to look a lot like each other, but that's okay. We like the steady progress, the consistency, and the solid performance. Going forward, our focus is on growing and diversifying earnings, all within the framework of a robust and empowered risk management system.

Finally, thanks to all my Flagstar colleagues for their hard work and commitment to build a truly great Company. Thank you for your time this morning. I look forward to reporting on Q4 results in January.

Operator

Thank you and that does conclude today's conference. Thank you for your participation.

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