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EDITED TRANSCRIPT

FBC - Q2 2015 Flagstar Bancorp Inc Earnings Call

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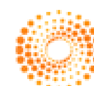

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CORPORATE PARTICIPANTS

David Urban *Flagstar Bancorp, Inc. - IR*

Sandro DiNello *Flagstar Bancorp, Inc. - CEO*

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

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

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

CONFERENCE CALL PARTICIPANTS

Bose George *Keefe, Bruyette & Woods - Analyst*

Paul Miller *FBR & Co. - Analyst*

Kevin Barker *Compass Point Research & Trading - Analyst*

PRESENTATION

Operator

Good day and welcome to the Flagstar Bank second-quarter 2015 earnings call. As a reminder, 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, Robert, and good morning. Welcome to the Flagstar second-quarter 2015 earnings call. This is David Urban, Director of Investor Relations.

Before we begin, I would like to remind you that the presentation today may contain forward-looking statements regarding both our financial condition and our financial and operating results. These statements involve certain risks that may cause actual results in the future to be different from our current expectations. For a non-exhaustive list of such factors, please see our 2014 Form 10-K as well as the legal disclaimer on slide 2 of our second-quarter 2015 earnings call slides that we have posted today on our Investor Relations site at Flagstar.com.

During the call we may also discuss non-GAAP financial measures regarding our financial performance. A non-GAAP financial measure is a metric that is not presented in accordance with US GAAP. We believe that our use of these non-GAAP financial measures in addition to the GAAP results can provide investors with additional information that is useful in assessing the results of Flagstar's operations on a run rate basis.

In today's presentation, in the press release we issued this morning, and in our subsequent SEC filings, we identify these non-GAAP financial measures as adjusted measures which are modified for significant items. We are providing a reconciliation of these measures to similar GAAP measures in the tables to the press release that we issued this morning or in the appendix to our earnings call slides.

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. - CEO*

Thank you, Dave, and thank you, everyone, for joining us today. In addition to Dave, I'm joined this morning by Jim Ciroli, our Chief Financial Officer; Lee Smith, our Chief Operating officer; and Steve Figliuolo, our Chief Risk Officer.

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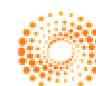

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Also with us for the first time is Len Israel, our new President of Mortgage Banking. Len brings a wealth of industry knowledge to Flagstar and we are thrilled to have him on the team. With Len in place, I will now be spending more time working directly with our community bank team.

I would like to take a moment to describe the order of the call. First, I'm going to highlight the key items and actions we undertook during the second quarter.

After my remarks, Jim will review the consolidated quarterly financial performance. Lee will then provide a more detailed review of our business segments and strategic initiatives. Following this, I will conclude with a view of our 2015 third quarter and then open the call for questions and answers.

We reported net income of $46.4 million, or $0.68 per diluted share, for the second quarter 2015 as compared to $31.5 million, or $0.43 per diluted share, in the first quarter. During the period, we significantly boosted profitability, carefully grew the balance sheet, and materially improved asset quality. Once again, we generated positive operating leverage as we held the line on expenses and improved our efficiency ratio.

Let's take a closer look at a quarter that was mostly highlights. Net income rose 47%. Net interest income climbed 12%. Earning assets, interest-earning assets grew 10%. Non-interest income advanced 7%, despite lower gain on sale revenue. Our non-performing loan ratio fell to 1.22% with adjusted charge-offs declining to 0.26% and early-stage delinquencies fell 71 basis points to 0.50% of consumer loans.

Let's talk about our interest-only portfolio for a moment. In my first earnings call two years ago, I spent a lot of time on IOs because of the uncertainty about the portfolio's risk. Our approach was to have Lee lead a highly-proactive, highly-focused plan of attack. We did that and every quarter we produced results that were better than most expected.

Now, with the sale of almost $400 million of these loans during Q2, I think we've demonstrated our determination and ability to effectively manage this risk. What was not long ago a $1.6 billion portfolio with uncertain risk is now a $369 million portfolio with a much clearer risk profile.

The sale of half our remaining IO portfolio, together with the $70 million of lower performing loans, represents another giant step forward in derisking our balance sheet. It dramatically improved our credit profile and triggered a $10 million after-tax net allowance release.

In the first six months of this year, we have sold almost $800 million in higher risk assets. We now feel more comfortable with the risk in our balance sheet and, therefore, will be more opportunistic about future do risking.

Importantly, as lower performing loans come off the balance sheet, we are replacing them with higher quality assets generated by our community bank. This is key to diversifying our company by making Flagstar less dependent on mortgage production, thus smoothing out the volatility of our earnings.

And thanks to our strong capital base, we are in a position to deploy excess capital to support growth in our community bank. In fact, in the second quarter, community banking posted a 15% increase in loans held for investment.

On the regulatory front, while I can't be specific, we continue to make progress with those items under our OCC consent order. And given our recent performance, we are increasingly confident we should be able to redeem our TARP preferred securities no later than the second half of 2016.

To sum up our performance for the quarter, we believe we have proved our ability to deliver as promised. We have demonstrated our focus on derisking the balance sheet. We've generated solid earnings from mortgage originations despite lower gain on sale and we made progress in building our community bank in order to diversify earnings. Compliance, risk management, and expense control are watchwords that will be with us always as we continue the path of growing profitability.

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.

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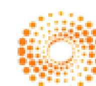

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Jim Ciroli *- Flagstar Bancorp, Inc. - EVP & CFO*

Thanks, Sondra. Turning to slide 6, our net income was $46.4 million, $0.68 per share, in the second quarter, as compared to net income of $31.5 million, $0.43 per share, in the first quarter. Our earnings this quarter were shaped by positive operating leverage and lower credit costs.

Total revenues increased 9%, while expenses increased only 1%. For the quarter, we posted an annualized return on assets of 1.6% and returns on equity and common equity of 12.7% and 13.1%, respectively. On the basis of our revenue growth, our efficiency ratio improved to 69.6%, which Lee will provide additional color on in a few minutes.

Our second-quarter net interest income rose 12% to $72.5 million. The increase in net interest income was led by solid earning asset growth and net interest margin expansion. Our NIM improved 4 basis points in the quarter to 2.79% as we had growth in relatively higher-yielding assets and maintained a relatively stable funding costs.

Average earning assets rose 10% last quarter due to growth in loans held for sale and loans held for investment. Our success in opportunistically growing our loan book continued with a 56% rise in warehouse lending and a 10% increase in residential mortgage loans. Average deposits increased $368 million from the prior quarter, driven by 19% growth in company-controlled deposits and 5% growth in retail savings.

The increase in company-controlled deposits was attributable to a higher number of mortgage loan payoffs in the second quarter, driven by industry-wide refinance activity from the first quarter's lower mortgage rates. The quarterly provision for loan loss was a benefit of $13.3 million for the second quarter versus a benefit of $3.5 million in the first quarter as we realized a $16.4 million net allowance release, primarily related to the sale of $456 million of interest-only and lower performing loans late in the quarter.

Our net charge-offs of $17.7 million for the second quarter included $14.6 million of net charge-offs associated with the aforementioned loan sale. Excluding this amount, net charge-offs were $3.1 million, or 26 basis points, of applicable loans. I will provide additional detail on asset quality in a few slides.

Net interest income increased $8.7 million, or 7%, to $127.0 million in the second quarter. The main improvement in non-interest income was an $11.7 million increase in the return on the mortgage servicing asset, a result of lower volatility, increased servicing fee income, and a decrease in anticipated prepayment speeds due to higher mortgage rates.

This positive development in non-interest income was partially offset by a $9.1 million drop in net gain on loan sales reflecting lower fallout-adjusted locks and a slight drop in the gain on sale margin. Fallout adjusted locks fell 5%, led by a decline in refinance activity due to higher mortgage interest rates. The net gain on loan sale margin decreased 6 basis points, driven by tighter pricing on conventional business, partially offset by a higher mix of government production.

Moving to expenses, non-interest expense increased only 1% to $138.9 million in the second quarter as compared to $137.0 million in the first quarter. During the second quarter, commissions and loan processing expense increased $3.2 million as a result of higher mortgage closings and warrant expense rose $2.5 million related to the improved stock price at the end of the quarter.

These were partially offset by a $3.1 million decline in asset resolution costs, reflecting both the Company's ongoing progress in derisking the balance sheet and a benefit of a $2.1 million FHA indemnification release; a $1.7 million drop in compensation and benefits primarily due to lower payroll taxes; and a $1.2 million decrease in legal and professional fees.

Turning to slide 7, we wanted to cut through the more significant noise this quarter to discuss the core performance improvement. If we normalize for the allowance release and the reduction in the R&W reserve, as well as the swings in gain on sale of revenue and return on mortgage servicing rights, which are more variable but naturally offsetting, we can see a quarter-over-quarter improvement of $7.4 million. As we delve deeper into this core performance improvement, we see it as primarily driven by higher net interest income from our community banking segment, led by higher balances on our national warehouse lending business, where we continue to grow our market share.

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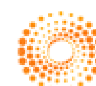

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Slide 8 highlights our average balance sheet. Average total assets increased 9% to $11.8 billion in the second quarter, led by growth in loans held for sale and loans held for investment. Average deposits increased 5%, led by growth in company-controlled deposits and a 5% increase in retail savings deposits. We maintained a strong balance sheet with a stable funding base. Our common equity to asset ratio remained solid at 10%, with deposits equaling 75% of average liabilities.

Turning to asset quality on slide 9, our allowance coverage was 4.3% of total loans at the end of the second quarter as compared to 5.7% at the end of the first quarter. Coverage dropped 138 basis points as a result of the sale of lower-quality loans and the continued growth of higher-quality assets, such as our warehouse loans where credit risks are low. At quarter-end we had a 6.5% allowance coverage of our consumer loan book, down 3 percentage points from the prior quarter-end, consistent with the sizable drop in consumer delinquencies and fewer lower-quality assets.

The commercial loan allowance coverage ratio remained fairly stable at 1.4% in Q2, reflecting the high quality of this portfolio and growth in warehouse loans during the quarter. Non-performing loans were only $65 million at the end of the second quarter, down $19 million from the first quarter. This decrease was driven by the sale of lower performing loans late in the quarter. Performing TVRs also fell to $108 million in the second quarter, reflecting this loan sale.

Early-stage delinquencies were down dramatically from Q1. Looking at consumer loans, only 0.5% of consumer loans were over 30 days delinquent and still accruing, an improvement of 71 basis points from the first quarter. The improvement in the delinquency ratio was driven by better asset quality, the sale of lower performing loans, and growth in higher-quality residential mortgage loans. There continued to be no commercial loans at June 30 that were more than 30 days delinquent.

Turning to slide 10, we continued to maintain robust regulatory capital ratios in the second quarter with a partial phase in of Basel III. On a partially phased-in basis at June 30, 2015, our Tier 1 leverage ratio was 11.5%. This compared to 12.0% at March 31, 2015. The decline in this ratio resulted from the deployment of capital for balance sheet growth, partially offset by earnings retention. Our Tier 1 common ratio was 14.6% at June 30, 2015.

Looking at the impact of a fully phased-in implementation of Basel III, our Tier 1 leverage ratio would have been 9.4% and our Tier 1 common ratio would've been 8.4% at the end of the quarter. The 207 basis point average impact to our Tier 1 leverage ratio is mostly driven by the detrimental treatment that mortgage servicing rights receive under Basel III.

Over the long term, we plan to continue to reduce our MSR to Tier 1 ratio, taking into consideration market conditions to guide our pace of MSR reduction. Excluding our preferred stock and now $71 million of deferred preferred dividends from Tier 1 capital, our consolidated Tier 1 leverage and Tier 1 common ratios under Basel III fully phased-in would be 5.7% and 7.5%, respectively.

At June 30, 2015, we had $317 million of MSRs, representing 24.2% of Tier 1 capital. The value of the MSR asset rose last quarter due to higher interest rates, slower prepayment speeds, and lower volatility boosting the MSR to Tier 1 ratio. We will continue to look for opportunities to reduce our MSR exposure over time.

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

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

Thanks, Jim, and good morning, everyone. We are obviously very pleased and encouraged with our results during the first six months of 2015. As you will recall, we've worked tirelessly to derisk the balance sheet and optimize the cost structure of the bank in order to create a solid foundation from which to grow in our three major business lines of mortgage originations, mortgage servicing, and community banking.

About nine months ago we started to pivot toward executing on our growth initiatives and we are now beginning to see all the hard work come to fruition. Our goal is to generate consistent and sustainable earnings that grow over time and we believe we are well on the way to doing that given the model we've created.

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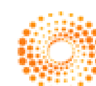

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I will now outline some of the key operating metrics from each segment during the quarter. Please turn to slide 12.

Quarterly operating highlights for the community banking segment include average total commercial loans increased 21% to $2 billion versus the prior quarter, primarily due to growth in our warehouse lending business. Warehouse loans increased $349 million, or 56%, due to increased mortgage origination activity on overall market share gains driven predominantly by an increase in the funding of loans purchased by other investors.

During the last 12 months, we have grown total commercial loans by nearly $700 million, led by $520 million in warehouse lending, $106 million in CRE lending, and $72 million in C&I lending. Average consumer loans increased $298 million, or 11%, in the quarter. This is a net increase, even after accounting for the sale of $456 million of interest-only and lower-performing loans.

We funded $964 million of jumbo and conventional product during the quarter that we added to our HFI portfolio as we swapped out lower performing and riskier assets for higher-quality, interest-earning assets. Average total deposits increased 5% during the second quarter and nearly 20% over the last 12 months, primarily due to increases in retail savings and company-controlled deposits.

It is our intention to continue to grow our commercial businesses, including warehouse lending, in a controlled, safe, and sound manner, as we have been doing to date. We are encouraged by the growth we've seen in the warehouse business during the second quarter and will look to build on that further as we move forward and continue to expand our market share of this business by growing the book with borrowers who don't sell to Flagstar.

In the C&I and CRE segments, we continue to focus on the Michigan market and we are also looking to expand our consumer and business banking offerings. We have made significant progress in derisking the balance sheet of lower quality loans and will continue to replace them and grow the balance sheet with higher quality loans in order to maximize net interest income.

Finally, we are in the process of replacing our entire fleet of ATMs with state-of-the-art terminals and expect this transition to be completed by the end of the year.

Please turn to slide 13. Second-quarter operating highlights for the mortgage origination business include fallout-adjusted lock volume decreased 5% to $6.8 billion as higher mortgage rates reduced refinance activity. Refinance mortgages accounted for 46% of locks in the second quarter, down from 63% of locks in the first quarter.

All-out adjusted gain on sale margin decreased 6 basis points to 121 basis points in the second quarter as compared to 127 basis points in the first quarter. The decrease in margin was driven by increased competition in the conventional market, partially offset by a stronger mix of government-insured loans.

We are pleased that much of the improvement in gain on sale margin reported during the first quarter held during Q2. We continue to believe that a portion of the year-to-date margin improvement is permanent and attributable to operational enhancements we have implemented over the last six or seven months. 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.

As Sandro mentioned, we have recently hired Len Israel as the President of Mortgage Banking and are excited to have Len on board, given his extensive experience and knowledge of the industry. We are investing in technology as a way to further improve the top-line performance and make us more efficient from an operating point of view.

We recently launched Phase 1 of our consumer portal and expect to launch Phase 2 in Q4 of this year. This portal will allow our customers to start the application process through our website and also acts as a document aggregator, driving further efficiencies. We continue to be ready for the new RESPA-TILA disclosure requirements that go into effect on October 3.

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Finally, we are committed to growing our retail origination business on both the retail distribution and direct-to-consumer side and we will keep you apprised of progress on these fronts on future calls.

Moving to servicing, quarterly operating highlights for the mortgage servicing segment on slide 14 include we executed on the sale of $4.6 billion in aggregate UPB, or 24,300 loans of residential MSRs, during the quarter. We currently service approximately 378,000 loans, of which 225,000 are subserviced for others, making us the sixth-largest subservicer in the nation. The remaining 153,000 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 3.3%, or approximately 12,500 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 cost associated with servicing such loans and because servicing and working out delinquent loans is not part of our core growth strategy.

We remain focused on growing our fee-income-generating, sub-servicing portfolio, which has the capacity to service up to 1 million loans, and we continue to improve our servicing platform. We went live with a second component default servicer on July 1.

This means we have two component default servicers where we can send seriously delinquent loans, thus giving us more optionality. We have structured this 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. 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 accounts per household.

Moving to asset quality, we continued with our sustained efforts to derisk the balance sheet. We sold approximately $456 million of interest-only and lower-performing loans during the quarter. We've now sold almost $1.5 billion in UPB of IO and lower-performing loans over the past two years as part of a concerted effort to derisk our balance sheet and reduce the costs associated with non-performing and higher risk assets.

Please turn to slide 15. As of June 30, we have approximately $369 million of IO loans on our balance sheet, of which $263 million have yet to reset. Of this $263 million, $155 million, or 59%, are due to reset during the remainder of 2015. Slides 42 and 43 in the appendix to the earnings presentation contain a lot of key data points around this portfolio, so you can see how we are handling and tracking the remaining IO book.

The team has done an outstanding job and we continue to be extremely pleased and encouraged with the performance of this portfolio, and believe we will successfully manage the remaining loans through their reset dates as we have previously demonstrated. These loan sales, which have also reduced our NPLs to $65 million, the lowest level they have been in over 10 years, should lead to a continued reduction in asset resolution expenses in future periods as well as lower FDIC premiums in 2016.

In addition to derisking the balance sheet, we are also seeing a marked improvement in consumer loan delinquencies as we add high-quality loans to the balance sheet and improve our collection strategies. Using data from the MBA, our 30 to 60 and 60 to 90 day roll rates are significantly better than industry averages.

In summary, it has been one of our most productive quarters as we continue to reduce risk and strengthen the balance sheet.

Moving now to expenses on slide 16, our non-interest expense was up $2 million, or 1%, to $138.9 million in the second quarter. Non-interest expenses have consistently been between $137 million and $141 million for the last four quarters. However, that doesn't tell the entire story.

In Q3 2014, gain on loan sale was $52 million versus $82 million this quarter, an increase of 58%. During the same period, variable cost increased 22% and fixed cost decreased by 5%. We have continued to take excess capacity out of the model and optimize our variable cost structure at a time when revenues have been increasing significantly.

Given this success, we believe non-interest expense will improve slightly and be in the $133 million to $138 million range in the third quarter. Despite the modest increase in expenses in the quarter, we saw continued improvement in the Company's efficiency ratio to 69.6% from 74.8% the previous quarter. The improvement was driven by increases in revenues from net interest income and non-interest income.

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Given our unique business model, our efficiency ratio target is around the mid-60%s and, as revenues continue to grow, you can now begin to see the benefit of our cost optimization efforts over the last two years to make our cost structure more variable, eliminate excess capacity, and improve our operational effectiveness in many areas. We continue to work tirelessly to further optimize our cost structure and drive greater efficiencies.

As a result of our expense management and discipline, what we expect you should see as we look further forward is a cost base that increases at a lower rate than revenues as we continue to grow the three major business line verticals. And it is this positive operating leverage that will drive the improvement in our efficiency ratio.

With that, I will hand it back to Sandro.

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

Thanks, Lee. I'm not going to close our prepared remarks with some guidance (technical difficulty) third quarter of 2015 and then open the call for questions and answers. On slide 18 are those itemized guidance parameters.

We expect a slight increase in net interest income, principally fueled by a modest increase in earning assets. The net interest margin will most likely contract slightly, given the likely addition of a modest amount of lower-yielding assets. Mortgage loans will likely decline -- mortgage locks will likely decline 5% to 10% on lower projected mortgage industry closings.

We expect a slight decline in gain on loan sale margin on increased price competitiveness in the mortgage market. We expect loan administration income to be flat. We expect that the net return on the mortgage servicing asset should average 4% to 6%.

The ratio of our MSRP to Tier 1 capital should decline from June 30, 2015, levels. 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 decline to $133 million to $138 million, led by lower variable expenses on decreased mortgage closings. And, lastly, we expect an effective tax rate equal to 34% for fiscal year 2015.

This concludes our prepared remarks and we will now open the call to questions from our listeners. So, Robert, can you get us going on that?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Bose George, KBW.

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

Good morning. The first question is just on the loss reserve on the IO portfolio. You had given it last quarter; it was $88 million. I didn't see the same number for this quarter.

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

Yes, so let me let Jim take that one, Bose.

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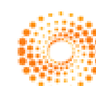

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Jim Ciroli - *Flagstar Bancorp, Inc. - EVP & CFO*

Right. Bose, we don't separately disclose what that number is. What I would point you to is that we have $222 million of allowance at the end of the quarter, about two-thirds of that allowance is available -- is designated to the residential mortgage portfolio and the IO book is in the resi mortgage portfolio.

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

Great, thanks. And actually a couple more. In terms of the loans you are retaining, Lee noted that there's some conforming in there as well. Can you break that out? Is that a meaningful component of the loans that are being retained now?

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

So I mentioned, Bose, that we had funded approximately $960 million during the second quarter and I would say about $300 million of that was jumbos. The remainder was conventional products, so the vast majority was conventional products.

As we move forward here it's not the intention to put more conventional products on the balance sheet, but I think we will continue to put jumbos on the balance sheet at a similar rate to what we put them on in the second quarter.

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

Largely 5-1 and 7-1 type ARMs.

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

Correct.

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

Okay, great. And then actually just one more on the warehouse. Actually what percentage of the warehouse lines that you are doing are now with lenders who are selling to others?

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

Bose, I don't have that right in front of me but it's in the 60%, 65% range.

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

Okay, great. Thanks and good job this quarter.

Operator

Scott Siefers, Sandler O'Neill & Partners.

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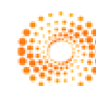

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Unidentified Participant

Good morning, guys. This is actually Brendan on the line from Scott's team. Just to start off I was hoping you could maybe expand little more on the circumstances surrounding the sale of part of your IO portfolio this quarter.

Is there a commonality to the group of loans you sold this quarter with regards to things like credit and reset characteristics? And then how do the sold loans look relative to what you retained with regards to those same characteristics?

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

Yes, that's a great question. What we sold was predominantly those loans that had already reset and were cash flowing, so it was the resets that we've seen predominantly through 2014 and the early part of 2015 that were cash flowing resets and those IOs that were due to reset in 2017 and beyond. So the almost $400 million that we sold came from those two buckets.

The ones that we are retaining are those IOs that are resetting this year and then there's a few that are resetting in 2016 and even fewer that are 2017 and beyond. The characteristics in terms of credit, so FICOs, LTVs, geography are all the same. It was just a matter of the timing of the resets.

The reason that we are happy to hold on to the loans that are resetting this year and 2016, as you know, the [right party] contact team that we've got in place dealing with this portfolio has done a tremendous job getting ahead of the resets. And we're going to continue to do that.

Unidentified Participant

That's great. That's definitely very useful. And then I guess you answered part of my follow-up question in that would you guys be open to selling the remaining part of the IO portfolio? If so, what would the circumstances be if you go down that avenue?

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

As you know, we've sold almost $800 million of non-performing and riskier assets during the first six months of this year, so we are under no pressure at this point to sell any further assets. We've done a lot of derisking over the last two years, culminating in that $800 million during the first half of this year.

If the economics make sense to do another sale, we will look at it, but we are certainly not planning on any further large sales in the future.

Unidentified Participant

No, that's great. It definitely makes sense. And then hopefully I can sneak one more in there on the gain on sale margin. It came down a few basis points this quarter, kind of similar to what we've seen from other banks that have reported so far, but I would say that yours held in a little better than we had expected. And you have offered some guidance in the prepared remarks for this third quarter, which is definitely helpful, but it leaves the range of where it could end up a little bit wide.

Could you maybe discuss what you see as the main puts and takes in the gain on sale margin as we go forward?

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

Sure, let me take a crack at that and then maybe Jim or Len might want to add.

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There's a lot of factors that obviously impact gain on sale: the activity in the marketplace impacts it, the capacity that we have impacts it, the overall economic environment impacts it. And we have made some fundamental changes in the way we price to our third parties so, in our case, it's really difficult to know where it's going to go. We expect that because of capacity in the business, that it will decline a bit, but how much is really uncertain.

But I can tell you this: we're going to continue to look, as we have, at ways that we can increase our margin on new business that we bring into the Company.

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

I would like to add to that -- this is Len -- we have a focus on expanding our retail channels, both distributed and direct to consumer, and typically those channels have higher margins. We have plenty of opportunity in the retail sector and to continue to evolve our correspondent and wholesale business lines with relationships that we haven't even yet touched. So there's additional opportunity there as well.

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

This is Jim. Let me just add that we manage that, Brendan, for revenue so we are focused on revenue and not just volume for the sake of volume. We are very conscious of what the channel mix is and we will manage the revenue number and not the volume number.

Unidentified Participant

That's great. Thank you for taking my questions, guys.

Operator

Paul Miller, FBR.

Paul Miller - *FBR & Co. - Analyst*

On the sale of the 300 -- or was it the $389 million and you still grew your portfolio, did you portfolio more than $200 million of resi loans in the quarter?

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

Yes, Paul, this is Lee. As I mentioned in the prepared remarks, we funded $960 million of loans, residential loans in the second quarter. $300 million of those were jumbo and the rest was conventional product.

Paul Miller - *FBR & Co. - Analyst*

Was that just --? I know George was asking that same question. In the convention -- you're not planning on portfolio-ing a more conventional product but you will portfolio the jumbos?

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

Yes, we will continue to portfolio the jumbos at a similar rate to what you saw in the second quarter and I would say there will be a very small amount of conventional that will bleed into Q3, but we are pretty much done in terms of adding conventional product.

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And, again, it all ties into the asset sales. We've sold $800 million of higher -- of riskier assets and NPLs and we are replacing that with better quality assets as we seek to maximize interest income.

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

Paul, this is Jim. We have a variety of different ways to grow the balance sheet and portfolio-ing production is only one of those. We also are continuing to grow warehouse loans and commercial and CRE loans, so our preference to be to continue growing relationship-type loans over the non-relationship stuff. So it could come in a variety of different ways.

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

We guided to a small increase in interest-earning assets for Q3. And it's really one of the great advantages of the Flagstar platform is if we're not getting the growth where we have targeted the growth, we can always add our residential production because we have such a strong production engine.

Paul Miller - *FBR & Co. - Analyst*

Then on the warehouse lines, it's an area that's doing very well. How should we look at that for volatility?

Even though we are probably going to go somewhat of a slowdown, but I don't think it's going to be as bad as people think in the second half of the year. Do you think that by adding new relationships this earning asset will be somewhat stable in the second half of the year?

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

Well, look, mortgage business is volatile, so unless you take other actions you will see some volatility in the outstanding balances. So what we are going to work at very hard is moving out those ebbs and flows in the business by bringing on the right kind of customers. We think there's a great opportunity to do that. And I think we can be very selective about the customers we bring on so that we bring those that have the right credit and quality characteristics and so that we can keep the risk in that portfolio on the low end.

Paul Miller - *FBR & Co. - Analyst*

Then talking about your commercial loans that are not warehouse-related, can you add some color there? I know that's -- Sandro, talking to you that's one of the things you really want to push going forward to make you guys less exposed to the mortgage market.

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

Yes, so it's a slower growth rate for our commercial lending, the Michigan-based commercial lending opportunities. First of all, let me break it up between C&I and CRE.

C&I takes a little longer to come out of a recession than CRE does and so the growth that we are seeing right now in C&I is a little lower than it is for CRE. And that is because businesses just aren't quite confident in the economy. They're not ready to expand their investment in equipment and inventory as much as we all would like to see them feel confident to do. So consequently, though we are seeing nice, steady growth in C&I, it's a little bit less than it is -- has been in the CRE portfolio.

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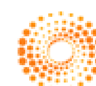

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We've got a great CRE team here and we've got relationships with some of the most long-standing and reputable developers in Michigan. And they are doing a great job of bringing new opportunities to us. There's a lot of real estate expansion, commercial real estate expansion that is taking place in Michigan right now and we're getting certainly our fair share of that.

And so the CRE business for us is growing at a very nice pace and I think you're going to see some strong growth in that throughout the rest of this year as we go through the construction season.

Paul Miller - *FBR & Co. - Analyst*

Okay, guys. Thank you very much.

Operator

Kevin Barker, Compass Point.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Thanks for taking my questions. In regards to the comments you made about TARP earlier and repayment before the second half of 2016, could you help us understand the thinking behind not catching up on your TARP preferred dividends, given that they are compounding at 9% rate? Is it possible that you may catch up on those dividends?

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

I'm not going to say too much more than what I said in my prepared comments, Kevin. And to be specific relative to the catch up on the dividends, I don't see that happening before the entire TARP matter is addressed.

Kevin Barker - *Compass Point Research & Trading - Analyst*

So you wouldn't --? Okay. So you wouldn't look to --?

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

No, we're not looking (multiple speakers).

Kevin Barker - *Compass Point Research & Trading - Analyst*

You would keep the deferral until it's all gone is the way you're looking at it?

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

Correct, that's most likely how that will happen, yes.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Is that due to regulators stating that or is that a business decision by Flagstar?

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

Well, there's a lot of factors that go into the TARP situation and so let me leave it at this point. The best I can tell you is that we are very confident, given our current performance, that we will be able to take care of that in the second half of 2016.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Okay. And then your MSR is marked up to 115 basis points this quarter and rates are significantly higher. I'm assuming that the bid on MSRs in the market right now are a lot more attractive. Are you looking to test the market, given where bids are today?

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

Well, I'll let Jim answer that, but just an intro comment. We mark the MSR to market obviously and we hedge the portfolio, so we have had good success in selling at our marks and so we are comfortable that that opportunity will continue to exist going forward.

Jim, you want to add to that?

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

The only thing I would add is, Kevin, is that there has been recent success at demonstrating that our marks are valid so we are quite comfortable.

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

And I would just add to what Jim said. Kevin, as you know and you can see, we're selling MSRs pretty much every quarter so we know the market. We mark the book daily. We hedge the asset and we have independent valuations, two, every quarter. So we feel very confident about the way we manage that MSR asset.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Okay. And then, sorry if I missed it, but did you give an update on the fair value of the FHA liability this quarter?

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

No, we didn't. I think that will be in our 10-Q when it comes out in a couple of weeks.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Okay. And then you guided to a 34% tax rate through the rest of this -- for the fiscal year 2015. That's quite a bit lower or a few points lower than what you have been running. Is there any particular moving parts around the tax rate or something we should take into account?

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

Yes, Kevin, I think as you think about that; when we do our tax return, we typically would do our tax return in the third quarter and that gives us the opportunity to discreetly claim some credits that we might have available to us.

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Kevin Barker - *Compass Point Research & Trading - Analyst*

So primarily in the third quarter or fourth quarter probably revert back to your normalized rate?

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

I would say in the fourth quarter we would probably normalize back to the rate we guided for the full year.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Okay. And then just back on the -- putting residential loans on your balance sheet, they tend to have longer duration. Could you us an update on where you would estimate your asset sensitivity or even liability sensitivity on 100 or a 200 basis point move in the yield curve?

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

Let me take it first and then Jim can be more specific. We are very, very focused on making sure that we've got the right balance in our asset liability management process. We are not doing anything that would put us in a situation where a change in interest rates would have significant detrimental effect to the Company, so we're very, very, very focused on that.

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

Kevin, to add to that, I think just take a look at our disclosures that we made periodically in our Qs and you will see that from a net interest income simulation we are asset sensitive. And then, from an EVE perspective, we are liability sensitive. And I think that is consistent with a lot of our peers that would show the same character.

We really -- and we mentioned this in the last call -- have gone out and lengthened our liability duration in anticipation of continuing to grow our balance sheet. And so we continue to manage the interest rate risk that we have back to that neutral to slightly asset-sensitive perspective that we have been reflecting in our Qs.

Kevin Barker - *Compass Point Research & Trading - Analyst*

Okay, thank you for taking my questions.

Operator

There are no further questions at this time. I will turn the call back to Sandro for closing remarks.

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

Thanks to Robert for his assistance and to all of you for your interest in Flagstar. If there are two words that sum up our performance in the quarter, I would say they are good execution.

Good execution by our mortgage and community banking teams in growing earning assets. Good execution in derisking the balance sheet through the sale of our interest-only and lower-performing loans and good execution in holding the line and expenses, thus setting the stage for positive operating leverage. My compliments to the entire Flagstar team for pulling off such an outstanding quarter.

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Looking ahead, our company remains focused on improving profitability in a safe and sound manner, and we are committed to making Flagstar one of the great companies. Thank you for your time this morning. I look forward to reporting on Q3 results in October.

Operator

This does conclude today's conference call. Thank you again for your participation and have a wonderful day.

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