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FBC - Q3 2012 Flagstar Bancorp Earnings Conference Call

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CORPORATE PARTICIPANTS

Paul Borja *Flagstar Bancorp, Inc. - EVP & CFO*

Joseph Campanelli *Flagstar Bancorp, Inc. - Chairman & CEO*

Mike Tierney *Flagstar Bancorp, Inc. - President*

Matt Kerin *Flagstar Bancorp, Inc. - Mortgage Banking*

CONFERENCE CALL PARTICIPANTS

Paul Miller *FBR & Co. - Analyst*

Bose George *KBW - Analyst*

Andrew Luke *[Jersey Mike's] - Analyst*

Eric Goldsmith *DSG Capital - Analyst*

Vlad Artamonov *Coastal Investment - Analyst*

PRESENTATION

Operator

Good day and welcome to the Flagstar Bank third-quarter earnings conference call. Today's conference is being recorded. At this time, I would like to turn your conference over to Mr. Paul Borja. Please go ahead, sir.

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Thank you. Good morning, everyone. I'd like to welcome you to our third-quarter 2012 earnings call. My name is Paul Borja, and I'm the Chief Financial Officer of Flagstar Bancorp.

Before we begin our comments, I'd like to remind you that the presentation today may contain forward-looking information regarding both our financial condition and our financial results. These statements involve certain risks that may cause actual results in the future to be different from our current expectations. These factors include, among other things, changes in economic conditions; changes in interest rates; competitive pressures within the financial services industry; and legislative or regulatory requirements that may affect our business. For additional factors, we urge you to review the press release we issued last night and the Form 8-K we also issued last night, which was filed this morning with the SEC containing the press release; our SEC documents such as our most recent Form 10-K and Form 10-Q; as well as the legal disclaimer on page two of our earnings call slides that we have posted on our Investor Relations page at Flagstar.com.

During the call, we may also discuss non-GAAP measures regarding our financial performance. A reconciliation of these measures to like GAAP measures is provided in the tables to our press releases, which was issued last night, as well as in the appendix to our earnings call slides.

With that, I'd like to now turn the call over to Joseph Campanelli, our Chief Executive Officer.

Joseph Campanelli - *Flagstar Bancorp, Inc. - Chairman & CEO*

Thank you, Paul, and good morning, everyone. I'd also like to welcome everyone to our third-quarter 2012 earnings call. I'd like to begin today with some general comments on the third quarter, specifically around credit costs and asset quality. I will then turn the call over to Mike Tierney, who will discuss some of the key drivers during the quarter. After Mike finishes his remarks, Paul Borja will take us through a more detailed financial review, including our outlook for the fourth quarter. Afterwards, our executive team will be available to answer any questions you may have.

We reported another strong quarter and our second consecutive quarter of profitability with third quarter net income to common shareholders of $79.7 million or $1.36 per diluted share. On an annualized basis, third-quarter return on average assets was 2.1%, and return on average equity was 25.8%. Our quarterly net income contributed to our Tier 1 capital ratio to 9.31%, which you can see on slide nine. Book value also increased to $17.76 per share as compared to $16.50 per share in the prior quarter, a quarter-over-quarter improvement of approximately 8%.

Our third-quarter performance was driven primarily by record levels of residential mortgage originations and gain on loan sale revenue, which we attribute largely to initiatives we have implemented over the last several years. These initiatives, combined with record low interest rates and the ongoing dislocation in the mortgage marketplace, have allowed us to leverage our vast distribution channels and long-standing customer relationships, thus prudently increasing our market share of our customer's share of wallet and mortgage market share.

Based on the most current industry data, Flagstar has grown its total mortgage market share from 2% and ninth in the country in 2011 to 3% and the eight in the country through the first six months of 2012. We anticipate this trend will continue as we remain focused on leveraging our core competencies as a top-tier mortgage lender in a super community bank in Michigan, emphasizing all three lines of business -- mortgage banking, personal financial services, and commercial banking.

Slides 10 through 13 highlights some of our key mortgage banking drivers, including gain on loan sale revenue and margin, mortgage originations, mortgage rate locks, and revenues from our mortgage servicing rights.

As you can see, with the exception of the MSR income, we experienced significant improvement in each of the key drivers. MSR income was down from previous quarters due to rate volatility; however, it still remains positive.

At the same time, we continue to incur substantial credit costs associated with our legacy portfolios and representation warranty exposure. However, turning to slide 14, you can see that the 2012 revenues for our mortgage banking business have more than fully offset credit-related costs.

Slide 15 shows a breakdown of our three primary credit costs -- provision for loan losses, representation of warranty reserve change in estimate and asset resolution expense.

I want to spend some time and provide further color on each of these components. Please note that in addition to the slides I'm going to cover, we have prepared a number of slides in the appendix that relate to credit quality and additional stratifications of the legacy loan portfolios, which you may find helpful.

During the third quarter, we added significant reserves and strengthened the balance sheet against various legacy exposures, including residential mortgage loans and loan repurchases primarily related to loans sold for the GSEs prior to 2009 and claims arising out of our 2005 and 2006 securitizations.

Slide 16 shows we have increased our representation warranty reserve by approximately 26% from the prior quarter to $202 million at September 30, 2012.

This increase has two major components. First, we increased reserve based on updated forecast of demands, primarily related to pre-2009 vintages, as a result of the recent change in behavior by and enhanced transparency from the GSEs.

Second, we made a number of enhancements to our repurchase operations to increase the processing capacity and to allow for the heightened focus on resolving the aged loan repurchase demands. Part of those efforts included aggressively resolving loans aged over 180 days in the pipeline. Slide 17 shows the positive results of those efforts with both the overall repurchase pipeline and percentage of demands over 180 days improving significantly from the prior quarter. As a result, we experienced a significant increase in net charge-offs in the third quarter. This increase in net charge-offs produced an adverse impact on the loss rates used in our reserve model and resulted in an increase in rep and warranty reserve.

We experienced several additional encouraging repurchase trends during the third quarter as well. For example, on slide 18, you will see that audit and file review requests, which are a leading indicator of repurchase demands, decreased by approximately 35% from the prior quarter.

Turning to slide 19, it shows new repurchase demands decreasing by approximately 26% from the prior quarter, again driven by significant declines in demands from our primary investor, Fannie Mae.

On slides 20 and 21, new demands for the 2009 to 2012 vintages decreased by approximately 20% from the prior quarter, and we believe losses associated with those vintages will be relatively insignificant.

It is important to keep in mind that on average approximately 66% of the new demands for the 2009 to 2012 vintage are performing loans with a significant portion related to curable documentation issues. Paul will discuss further our outlook on the repurchase division during his comments.

Please turn to slide 20 where we note that our allowance for loan losses increased to $305 million, or approximately 77% of nonperforming loans at September 30, 2012, as compared to $287 million, or about 67% of nonperforming loans at June 30, 2012. This increase in allowance was attributable to two components.

First, our allowance associated with residential first mortgage loans increased, reflecting management's view of probable losses in the existing portfolio of interest-only and adjustable-rate mortgages. Although the interest rates on a significant portion of these residential mortgage loans do not reset until 2014 and beyond. We are currently looking into potential sales, modifications and refinancing programs to address these risks.

Second, on slide 23, we continue to actively serve our distressed borrowers, providing loan modifications to such customers, which are characterized as TDRs, or total debt restructurings. We believe it is important to help borrowers remain in their homes, and we are dedicated to supporting the stabilization of the housing market. Although many of our TDRs continue to perform, we hold a relatively high reserve against this portfolio, which resulted in an increasing allowance for loan losses from the prior quarter.

During the third quarter, we also increased reserve to reflect management's view of probable losses within that portfolio of modified loans.

On slide 24, net charge-offs decreased in total by approximately 15% from the prior quarter, even though we continue to focus aggressively on loss mitigation strategies and working through legacy assets. Overall credit metrics improved from the prior quarter.

Slide 25 shows total delinquent loans 30 days or more past due decreased by about 6% from the prior quarter. This is driven primarily by consumer nonperforming loans, 90 days or more past due, which improved for the third consecutive quarter with almost 6% decline from the prior quarter.

Slide 26 highlights a continued reduction in the balance of the legacy commercial real estate portfolio, which we define as loans originated prior to 2010. This portfolio has now declined by over 36% since 2011. We have been replacing those assets, along with a substantial run-off of the residential held for investment portfolio with new commercial loans underwritten to more rigorous standards.

I would now like to take a moment to highlight some key steps we took during the quarter to strengthen the Company. First, we increased our litigation reserves based on the assessment of overall legal exposure from pending and threatened lawsuits by $40 million.

Second, we recognized a $19.9 million tax benefit as a result of the sale of the remainder of our $200 million-plus non-agency CMO portfolio.

Third, during the quarter, we participated in a HUD-coordinated market auction of loans repurchased with government guarantees. In connection with that transaction, we agreed to convey over $300 million in such loans in an accelerated fashion at par value. This resulted in a reduction in otherwise-expected curtailment of the venture interest income, thus decreasing asset resolution expense by $7.8 million during the third quarter.

Our third-quarter results also include a $15.2 million charge from when we pre-paid $500 million in long-term FHLB advances with a weighted average cost of 1.97%. This not only reduces our future funding costs, but also reflects our strong growth in funding from deposits during the quarter and provides us with room for further deposit growth as we continue to shift our funding structure toward a retail deposit emphasis.

I would now like to turn our presentation over to our President, Mike Tierney.

Mike Tierney - *Flagstar Bancorp, Inc. - President*

Thanks, Joe, and thank you for all you've done for Flagstar Bank, most importantly, leading us back to profitability.

Good morning, everyone. If you'd please turn your attention to slide 27. During the quarter, we experienced a decline in our net interest income and margin from the prior quarter as we experienced NIM compression from declines in our variable yields, predominately in our adjustable-rate mortgages and commercial loans. In previous quarters, we had experienced lower funding costs, which helped offset declines in the interest yields.

However, on slide 28, you can see that our third-quarter average cost of funds was essentially unchanged from the prior quarter, although our cost of deposits continues to decline.

Turning to slide 29, we increased total deposits by over $500 million from the prior quarter, replacing more than what we prepaid in FHLB advances. This is consistent with our strategy to grow branch deposits to fund our growth.

On slide 30, our core deposits declined slightly from the prior quarter as clients moved to higher-yielding CDs and reacted to a prolonged low-interest-rate environment.

Please turn to slide 31. Recognizing the importance of strong brand recognition and active community involvement, during the third quarter, we entered into a three-year agreement with the University of Michigan to become an official sponsor of the University's athletic program. This partnership meshes perfectly with our marketing message that, as the largest bank headquartered in Michigan, Flagstar is Michigan-based and Michigan-focused.

It also pairs us with one of the top academic and athletic collegiate brands in the nation. We expect that this agreement will increase our brand awareness with 540,000 U of M alumni, thus helping us to generate additional core deposits in Michigan.

Please turn to slide 32 and slides 32 and 33. Over the last year, we've been successful in raising deposits in Michigan and reducing our overall cost of funds. Based on the FDIC's latest deposit statistics for the 12 months ended June 30, 2012, Flagstar was the fastest-growing bank in Michigan among banks with at least five branches and the fastest growing bank in the United States among all banks with at least 30 branches, and our average branch size has increased by $20 million, which is a 33% increase.

As of June 30, 2012, the latest available data, we had the sixth largest deposit share in Michigan, moving up one spot from last year. Over that period, we had deposit growth of approximately 30% as compared to an average of about 6% for all of Michigan.

The power ratio is a measure of a Company's fair share of its deposits related to the number of branches it has. For example, a power ratio of 100% means that you are taking your fair share of the amount of deposits in your market relative to the number of branches you have. If you are over 100%, you're doing well. If you are under 100%, not so good.

In Michigan, Flagstar's current power ratio is 145%. And unlike some of our leading competitors, we've never done an in-market consolidation, which leads to a higher power ratio.

We remain dedicated to our super community banking strategy in Michigan and believe that the unparalleled customer service, strong rates, and everyday convenience of our Michigan branch franchise allows us to continue to fund new mortgage and commercial loan growth going forward.

As we grow our bank presence, we also continue to emphasize prudence growth in our commercial loan portfolio, which is illustrated on slides 34 and 35.

And now I'd like to turn the presentation back over to Joe.

Joseph Campanelli - *Flagstar Bancorp, Inc. - Chairman & CEO*

Thanks, Mike. I am sure most of you are already aware that I'll be stepping down as CEO and Chairman effective November 1, 2012.

Before I turn our presentation over to Paul, I'd like to thank all of our employees for their extraordinary efforts to help turn Flagstar around. I deeply appreciate all of your hard work and long hours in my tenure to my Flagstar a success. It wasn't always easy, but we accomplished a great deal, and I'm confident Mike Tierney is the right man to lead Flagstar going forward.

With that, I will turn the presentation over to Paul.

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Thank you, Joe. Good morning, again, everyone. As mentioned, our net income for the third quarter was $79.7 million or $1.36 per share on a fully-diluted basis. This follows our profitable second quarter in which we earned $86 million or $1.47 per share fully diluted.

Our third-quarter earnings were due in large part to the increase in our gain on sales, offset by the increases we made to our loan loss reserves and our representation of warranty reserves, reflecting our cautious view about the near-term outlook.

We have in prior calls focused on three key areas of our operating results -- revenue generation, expense management and credit costs. From a revenue generation perspective, our third-quarter results arose from mortgage banking revenue, including the highest level of gain on loan sales in a single quarter in the bank's history and the continued strong levels of net interest income before the provision for loan losses.

With respect to net interest income, it declined slightly to $73.1 million from $75.5 million in the second quarter. At the same time, the bank's net interest margin declined to 2.21% from 2.37%.

On a Company-wide basis, the yield on our interest earning assets declined by 26 basis points due to lower yields on our mortgage loans held for sale, which are short-term assets and thus more sensitive to interest rate movement; on our loans repurchased with government guarantees, the portfolio of which has a 12-month to 18-month life and earns varying yields based on debenture rates outstanding at the time of delinquency; due to lower yields in our residential mortgage loans as higher rate loans have refinanced; and on our commercial real estate loans as our legacy loans have paid off or refinanced away from us.

The cost of our liabilities during the third quarter was relatively flat, and so the spread earned on our assets declined to 1.81% from 2.10% during the second quarter.

The overall decline in yields reflects the continuing low interest rate environment during the third quarter, and its effect on our shorter-term and medium-term assets is also reflective of the inter-period volatility of these rate.

During the third quarter, for instance, the 10-year US treasury rate remained at historic lows beginning and ending the quarter at a rate of 1.65%. This facilitated continuation of the current refinancing environment and higher-yielding residential mortgage loans that we held for investment refinanced to lower rates were paid off, in both cases reducing the yields we earn on those asset classes.

At the same time during the quarter, the 10-year Treasury rate fluctuated from a low of 1.04% to a high of 1.87%. Reducing the overall yield, we were able to earn on our residential mortgage loans that we hold for sale for periods of 25 to 45 days.

The overall average balance of our interest-earning assets increased slightly during the third quarter, but only partially offsetting the effect of these lower yields on net interest income. This increase was primarily mortgage loans available for sale, reflecting the higher level of closings during the quarter and warehouse loans which tend to increase as our originations of loans held for sale increase.

We also had an increase in our average balance of cash levels reflecting the increase in mortgage loan sales during the third quarter and also our focus on managing liquidity to levels consistent with our funding needs.

However, such balance is only earned at a 25 basis point level, thereby reducing the overall yield of our interest earning asset base. At the same time, these increases were partially offset by the decline in the average balance of mortgage loans held for investment as loans refinanced and the average balance of our commercial real estate portfolio. With these and other changes in average balances and yields, the bank's interest income for the third quarter declined slightly to $119.7 million from $123 million during the second quarter.

During the third quarter, we were able to reduce our funding costs, although not to the same extent as in the prior quarter, as we saw less elasticity with deposit rates than in the past. However, we see opportunities for potential reductions as we continue to execute on our strategy for a liability structure comprised substantially of retail deposit products.

For the third quarter, the average cost of our retail deposits declined to 92 basis points from 98 basis points in the second quarter. We continue to see declines in the cost of our certificates of deposit with the lower rate structure of our retail certificates of deposits continuing to replace maturing, higher-cost retail certificates of deposit and wholesale CDs in our funding structure. At the same time, our repayment during the third quarter of $500 million in FHLB advances with an average cost of 1.97% allows for replacement funding with lower-cost deposits.

Because the advances we paid off with the lower-costing tranche of outstanding FHLB advances on our books however, their payoff actually increased the average funding costs of the remaining FHLB advances. As such, during the third quarter, our overall funding expense declined to $46.7 million from $47.4 million in the second quarter. However, the cost of such funding increased slightly to 1.73% from 1.72% during the second quarter.

For the fourth quarter of 2012, we would expect our net interest income to be slightly higher than the level of the third quarter with net interest rates approximately equal to that in the third quarter but with a slight increase in the average interest-earning assets. As with the third quarter, we expect such net interest income increase to arise from the continued growth in mortgage production during the quarter, thereby increasing the average levels of the portfolios of available for sale residential mortgage loans and warehouse loans.

We would also expect the replacement of the FHLB pre-paid advances with lower costing deposits to offset in part the lower yields experienced during the third quarter. With higher net interest income and a higher average base of interest earning assets expected in the fourth quarter, we would expect this to result in a lower net interest margin for the fourth quarter.

Our ability to meet this estimate of net interest income for the fourth quarter of 2012 depends upon a number of factors including the continuing ability to generate and maintain higher average balances of available-for-sale mortgage loans; our ability to invest the excess funds and assets of similar yield; the absence of a sudden and significant increase in the general interest rate environment during the quarter that could significantly curtail our production of available-for-sale residential mortgage loans; and no substantial increases in nonperforming or nonaccrual loans.

Turning to gain on loan sales, the bank's mortgage business during the third quarter generated $334 million in gain on loan sales as compared to $213 million during the second quarter.

To put that in perspective, the third-quarter gain-on-loan sales was higher than such gain-on-loan sales for all of 2011, and the combined gain-on-loan sales for the second quarter and the third quarter is higher than the bank's previous record for gain-on-loan sales for the entire year of 2009.

During the third quarter, the bank continued to originate loans through refinancing of residential mortgage loans, including participation in the HARP II program in originations of FHA and VA loans. The gain-on-loan sales for the third quarter of 2012 reflects the strong growth in overall loan lock volume arising from both overall industry volume increases, as well as the increase in market share.

During the third quarter, we again experienced growth in both our loan locks and our sales with a combination of competitors exiting certain channels of the mortgage business and our increase in market share, as discussed earlier. We believe we remain well positioned to participate meaningfully in the current mortgage market, and we expect to continue our efforts in building market share.

For the fourth-quarter 2012, we expect that our loan locks and our loan sales will be higher than those levels experienced during the second quarter, but not as high as we experienced in the third quarter. Our view is based upon the continued strength we see in the refinancing demand, tempered in part by our expectation of seasonal decline generally experienced in the year-end holiday season.

We also expect that during the fourth quarter we will continue to sell substantially all of our loan originations -- residential mortgage loan originations. Based upon our experience in the interplay of margin and volume levels to manage our capacity and depending upon the types of loans that we lock and originate, we believe that our margin levels could be slightly below that of our third-quarter margin.

Accordingly, and based on preliminary October results, it would be reasonable to expect that our gain-on-loan sales income for the fourth-quarter 2012 could be approximately 20% to 25% below that experienced in the third quarter of 2012.

Note that even with such reduction, we would expect our gain-on-loan sale income for the fourth quarter to still be well above that of the second-quarter 2012.

Our estimate of the fourth-quarter gain-on-loan sale income is based on a number of factors, including that there are no significant increases or volatile movements in the current interest rate environment that could affect consumer demand or hedging costs; that the operating environment for mortgage banking activity does not significantly change; that the bank's ongoing relationship with its investor, primarily the GSEs, remains consistent with past practices involving loan sales, escrow accounts, and loan servicing; that the expected trend in mortgage originations industry-wide for the fourth quarter does not decline beyond current industry projections; and that there are no regulatory or other legal impediments to our full participation in the mortgage banking industry.

Another driver of mortgage banking revenue is our net servicing revenue, which is a combination of incoming we earn from servicing loans and the net effect of the hedges on the mortgage servicing rights on our balance sheet.

During the third quarter, we continue to earn income from our mortgage servicing rights during a quarter in which, as we discussed earlier, there was significant interest rate volatility in the marketplace.

In total, our net servicing revenue was $11 million for the third-quarter 2012, a decrease from $29 million in the second quarter of 2012. This reflects the refinancing experienced during the third quarter, as well as the hedging challenges experienced during that time with the volatile interest rate environment given the federal reserve QE3 announcement and the European marketplace impact on the US treasury market.

Our mortgage servicing asset increased during the third-quarter 2012 to $687 million from $639 million at the end of the second quarter due in large part to our continued high levels of loan production during the third quarter. At September 30, 2012, the asset reflected approximately $82 billion of loans we are servicing for others, primarily to GSEs.

For the fourth-quarter 2012, we expect that net servicing revenue will be at or slightly above the amount earned during the second quarter, which was $29 million.

Our estimate assumes that there remains a close and positive correlation between rate movements of a 10-year treasury and residential mortgage rates, as well as the absence of significant volatility in mortgage rates and interest rate curves, especially such volatility as was experienced in the third quarter.

Noninterest expense, excluding asset resolution, was $221 million in the third quarter of 2012 as compared to $149 million in the second quarter of 2012. For the third quarter, noninterest expense also included a $15 million loss for pre-paying the FHLB advances and a $40 million litigation reserve expense.

Excluding those items as well and asset resolution for comparability to the second quarter, the third-quarter 2012 noninterest expense would have been $166 million. This reflected slightly higher compensation expense and higher commission expense due to the higher levels of loan originations during the quarter, as well as higher general and administrative expense associated with our use of professional and consulting firms.

For the fourth-quarter 2012, we expect that our noninterest expense would be approximately equal to that of the third quarter without the effect of the FHLB pre-payment expense or the litigation reserve expense. This assumes that the FDIC assessment rate remains unchanged; that mortgage volumes are at levels consistent with that reflected in our earlier discussion of gain-on-loan sales income; that upcoming regulations or governmental directives do not require changes in service levels or business operations; and that our legal, consulting, and professional expenses remain constant with that of the third quarter.

Turning to our credit costs, loan loss provision expense declined to $53 million for the third quarter as compared to $58 million for the second quarter. At the same time, we continue to build our reserves, increasing it to $305 million as of September 30, 2012 from $287 million at June 30, 2012 for the reasons discussed earlier.

Going forward, we expect to continue to engage in modification of residential mortgage loans, which then become troubled debt restructurings, or TDRs, as part of our loss mitigation efforts.

Also, we have worked this past year improving our loan servicing process so that we may efficiently assist our loan customers. We believe our diligent efforts in this area have contributed to the improvements we are experiencing in two of our credit quality metrics -- the ratio of nonperforming loans to total loans and the ratio of nonperforming assets to total assets.

At the same time, we note that our loan balances in the 30-day and 90-day past due categories for loans have declined with the 60-day category substantially flat. We believe that our loss mitigation efforts should further reduce over time our over 90-day delinquent residential mortgages. At this time, we anticipate that the provision for loan losses for the fourth-quarter 2012 should be approximately equal to that of the amount in the third quarter.

This estimate assumes among other things that current trends of unemployment and housing prices remain unchanged and the growth rates of TDRs and short sales remain flat.

It also assumes that the loss rates we apply against our different portfolios do not change significantly based on our experience with our own portfolio, different segmentation, or due to the effect of various macro economic or other factors.

Turning to our representation and warranty expense, net expense increased for the third quarter significantly as compared to the second quarter. For the third quarter, we increased our reserves from $161 million at June 30, 2012 to $202 million to reflect among other things the increases in our losses that we would expect could arise from increases in forecasted demands by the GSEs.

In particular, we experienced increases in GSE demands in the 2005 and 2006 loan vintages, well after we had assumed such vintages would not be as actively reviewed.

We also experienced GSE demand for the 2007 and 2008 vintages at a level beyond that normally expected to loans seasoned to that degree.

Our reserve level also reflects the higher charge-off levels during the quarter as we remediated loans in our pipeline, causing the pipeline to decline meaningfully.

For the fourth-quarter 2012, we would expect that our provision expense in this area would be approximately half that of the expense in the third quarter, and this would be above that of the second quarter and at a level that we believe would allow us to prudently address further changes in GSE demand during the fourth quarter.

Our estimate assumes that there are no significant changes in the current practices or patterns of the GSEs and that the levels of loan fall request, loss severity rate, and recovery rate remain unchanged.

Turning to asset resolution expense, it declined to $12 million from $21 million in the second quarter. This decline reflected the $7.8 million benefit we realized from the HUD-coordinated market auction of our loans during the third quarter as we discussed earlier.

For the fourth-quarter 2012, we anticipate the asset resolution expense will be approximately 20% to 30% higher than the second quarter, but still well below the level of the first quarter as we continue to engage in loss mitigation activities and also continue our processing of the balance of repurchased government-insured loans.

With that, I'll turn it back to Joe Campanelli for the question-and-answer session.

PRESENTATION

Joseph Campanelli - *Flagstar Bancorp, Inc. - Chairman & CEO*

Thank you, Paul. I'd like to ask Donna, our operator, to open the lines up for questions and answers.

Operator

(Operator Instructions). Paul Miller, FBR.

Paul Miller - *FBR & Co. - Analyst*

Paul, can you back up a little bit on your credit cost guidance for your reps and warranties? I'm not sure I heard you cleanly or correctly. Are you expecting to slow down the reserve build or to continue to grow the reserve build at the current level?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

This is Paul Borja. We expect that -- first of all, we believe that we're properly reserved at the end of Q3, but that we expect that during the course of Q4 that we would have additional provision expenses which may be charge-offs or reserve build.

Paul Miller - *FBR & Co. - Analyst*

But did you say would it be at the same levels as the third quarter or would it be lower? You're not giving that guidance?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Our provision expense for the fourth quarter, we believe, was even lower than that of the third quarter.

Paul Miller - *FBR & Co. - Analyst*

Okay. And then the litigation expense of $40 million, I mean everybody knows I think out there that you are right now currently in a court case, and we're not going to make an assessment of what that's going to be. But I guess they are suing for $110 million. Can you tell me what you have reserved against that, or is that something that you don't release?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Well, as a general matter, as you know, we provide disclosure based on our overall litigation exposure. So we don't provide individual amounts, and we also don't comment on any litigation.

Paul Miller - *FBR & Co. - Analyst*

Okay. And then your guidance for your charge-offs -- I just want to make sure I have this all right -- the charge-offs relative to own portfolio, not off portfolio, including TDRs, you're saying those trends still remain in a favorable manner and that the charge-offs -- tell me if I'm wrong -- and the charge-offs are going to go down in the fourth quarter, most likely?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

With respect to our loans on our books?

Paul Miller - *FBR & Co. - Analyst*

Yes.

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Yes. What we expect -- with respect to our loans on our books, the charge-offs are going to impact the provisions, which is the expense to the extent that we see that there are additional reserves necessary. At this point, we expect that the provision expense to be at or slightly higher than what we had in Q3. We don't -- we expect there to continue to be charge-offs. I don't believe that we provide the charge-off amount on a separate basis because that really feeds into our provision expense, which is what is going to affect our overall bottom line.

Paul Miller - *FBR & Co. - Analyst*

Now talking -- your gain on sale, now your gain on sale really, really jumped. Now you know we've got to increase production, but your gain on sale from [1.6 to 2.4], and you highlighted in some of your discussion is that some of that was due to change of processes. Can you elaborate on that a little bit?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Why don't I turn it to Matt Kerin, from our Mortgage Banking Group.

Matt Kerin - *Flagstar Bancorp, Inc. - Mortgage Banking*

I mean, we -- amongst the management team, management has been a business going back a year and a half, and we continue to invest in people, modification of processes. There's been dislocation in the market. We've obviously been managing to our capacities as we continue to expand our capacity to produce, which is certainly has had an impact on increasing the margin. As you can see, we've increased our market share gradually, but I would say prudently or in a controlled manner and that we would look at that to continue.

We've obviously been blessed by the -- the FBR's accommodative monetary policy, and we're probably looking at historically low mortgage rates certainly in my lifetime. It is probably dating back to pre-World War II.

So I think we are continuing to look at the unprecedented margin levels today associated with many companies, ours included, that are managing our margins to stay in sync with our capacity while we continue to increase capacity. So it's really a multi-functional dynamic here that's going on to generate these margins that we've had. And --

Paul Miller - *FBR & Co. - Analyst*

We know that low interest rates and we know that this is probably one of the most profitable time periods for mortgage banking, but nobody else out there is really seeing this type of jump in the gain on sales. So that's what we are trying to say -- what did Flagstar do differently than everybody else?

Matt Kerin - *Flagstar Bancorp, Inc. - Mortgage Banking*

I would say there's a couple of things. One, if you look at our product mix, about 12% of our production has come in the HARP space, the HARP II.0. And that has commanded premiums in the execution marketplace that investors use on the pre-payment potential for those loans versus what's going on with some of the heavier prepayment speeds in the industry today from a bonds perspective.

But I think the biggest thing is we've become more efficient in terms of our processes. We have committed to more resources, and a leverage potential from a resource of expense to dollar revenue is fairly dramatic in the business.

So I think it's a combination of us increasing share of wallet, which doesn't necessarily have an attendantly higher cost of doing business because customers are already doing business with us today. It's the fact that we have improved our processes and workflows to make us more efficient in getting our loans out.

It's the rate environment, and it's also just us increasing our share of the overall market.

Paul Miller - *FBR & Co. - Analyst*

Okay. Thank you very much, gentlemen.

Joseph Campanelli - *Flagstar Bancorp, Inc. - Chairman & CEO*

Thank you, Paul.

Operator

Bose George, KBW.

Bose George - *KBW - Analyst*

Just wanted to follow up on the gain on sale issue. Did the HARP percentage change quarter over quarter?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Modestly. Not anything relevant. It's been fairly consistent.

Bose George - *KBW - Analyst*

Okay. So that wasn't really the driver.

And then secondly, just in terms of the dynamics of the decline that you guys are forecasting for next quarter, that 25%, can you just walk through that again because was there anything one time in this quarter that's going away in next quarter -- just any way to think about what's happening there?

Matt Kerin - *Flagstar Bancorp, Inc. - Mortgage Banking*

No, this is Matt Kerin again. Paul can certainly jump in. But I think it's largely driven by the fact that we look at the margins and we look at the demand that was made, if you think about the last quarter, rates went as low as 1.31% on the 10-year. And that drove unprecedented refinance boom.

We also had a fairly strong focus on the purchase market with many of our customers so as we look at that. So I think we're just taking a conservative and appropriately so approach to as others build up their capacity, margin will certainly have some compression. And that's really the large driver there, I would guess.

Bose George - *KBW - Analyst*

Okay, great. That makes sense. And then switching to the litigation issue, I know you can't say anything about the existing litigation, but I was curious, are there other bonds that you guys have done with bond insurance where there might be risks that we should think about?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

This is Paul. We did back in the mid-2000s when folks were doing two to three or four securitizations, we did four securitizations over the course of two years, and we disclose them in the footnotes to the financials. Those are the only ones we've done -- two HELOC -- two home equity securitizations and two second-mortgage securitizations.

Bose George - *KBW - Analyst*

Okay, great. And actually then one last one, in terms of your DDA valuation allowance, when do conversations occur about potentially reversing that?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Well, our DTA right now, at September 30, $309 million against which there is 100% valuation allowance. In discussions that we've had with our auditors and with our accounting consultants, we view that as a reversal point between -- after four to 12 quarters of profitability and also based upon our ability to reasonably forecast profits going forward and being able to track that. So at this point, after two quarters of profitability, it's a bit premature to have those discussions. We are aware of institutions that have reversed it as soon as five quarters and institutions that have reversed it as late as 12 quarters.

Bose George - *KBW - Analyst*

Okay. Great. Thanks a lot.

Operator

[Andrew Luke], [Jersey Mike's].

Andrew Luke - *[Jersey Mike's] - Analyst*

I was just wondering if the selloff of some of the banks outside of Michigan were possibly one of the good reasons for the restructuring and turnaround of the bank in general?

Joseph Campanelli - *Flagstar Bancorp, Inc. - Chairman & CEO*

I'm not quite sure I understand this what is driven by the selloff.

Andrew Luke - *[Jersey Mike's] - Analyst*

Well, there was a couple of banks were sold outside Michigan, like in Georgia.

Joseph Campanelli - *Flagstar Bancorp, Inc. - Chairman & CEO*

Sure. I think that it's fair to say that the most efficient return on capital is right here in Michigan, and you can see the great job Mike and his team have done in increasing our power ratio and replacing deposit growth and things.

So I think it's a better allocation of capital and, hence, better returns, in combination with the focus on building a strong mortgage origination platform, servicing platform. So I think those things are all coming together over the last couple of years.

Andrew Luke - *[Jersey Mike's] - Analyst*

Great. So they weren't doing necessarily poorly, but we just think they are going to do better in Michigan. Is that part of the reason they were sold off or more just getting more offense?

Joseph Campanelli - *Flagstar Bancorp, Inc. - Chairman & CEO*

I think if you look back at strategically our discussion when we announced the sale, it was a much more efficient reinvestment in the Michigan market.

Andrew Luke - *[Jersey Mike's] - Analyst*

Okay. I was curious, is there any future target price for the next 12 months or 24 months or anything like that?

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

No, we have not -- normally don't provide target prices. But we normally do is we'll provide, we believe, sufficient drivers for models for each of the analysts. Each investors tend to have different types of models, so it's difficult for us to do apples to apples comparisons.

So we believe we have provided the most meaningful drivers in our existing operational structure and hopefully have provided enough background as to why we think that's an appropriate estimate.

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Andrew Luke - *[Jersey Mike's] - Analyst*

Okay. I understand. All right. Thank you. Appreciate it.

Operator

Eric Goldsmith, DSG Capital.

Eric Goldsmith - *DSG Capital - Analyst*

Terrific quarter. Are there any current restrictions on declaring a dividend? And if that's the case, when do you think you guys can start?

Joseph Campanelli - *Flagstar Bancorp, Inc. - Chairman & CEO*

Yes. The fact that we still have TARP outstanding in addition to the regulatory orders precludes us from paying a dividend currently.

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

We've also, if I could, we deferred trust preferred and we deferred the TARP, and under the terms of the trust preferred of the TARP, we need to resume those two dividend payments before we can resume dividend payments elsewhere.

Eric Goldsmith - *DSG Capital - Analyst*

Okay. Thanks very much.

Operator

Vlad Artamonov, Coastal Investment.

Vlad Artamonov - *Coastal Investment - Analyst*

Great quarter. A question for you regarding the new consent order that has been signed. Can you walk us through how it is going to affect you particularly, you feel like you have a large mortgage origination platform?

Joseph Campanelli - *Flagstar Bancorp, Inc. - Chairman & CEO*

Yes, with respect to the Consent Order we recently entered into with the OCC, if you recall back in January of 2010, we had a similar order, a surprise agreement under the OTS, and with the OTS merged in that, obviously transition is over.

There are a variety of issues that are outlined in the agreement, the vast majority of which we have actions and initiatives underway to modify and correct and enhance the underlying processes to work through.

I'm not sure -- there's a second part of your question?

Vlad Artamonov - *Coastal Investment - Analyst*

Right. I don't know if there's been discussions or understandings of how your business practices will be changed or the sizes of the your mortgage origination and other kinds of lending is going to be modified given the new regime.

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Like I said, I believe in the press release that we issued separately last evening regarding the consent order, I believe we indicated that we do not think that our current business operations will be impacted adversely by the consent order. It requires us to address the fundamental issues -- certain issues that all bankers address on a regular basis -- liquidity, capital planning, asset management. And so we expect to do so in due course in partnership with our regulators.

Vlad Artamonov - *Coastal Investment - Analyst*

Got it. And the second question is on the new rules that are coming in effect early next year. Can you talk about how it's going to affect your business on balance? I know there's a lots of regulations coming down the pike.

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Are you referring to Basel III, the capital regulations or some other regulations? (multiple speakers)

Vlad Artamonov - *Coastal Investment - Analyst*

More and more with regards towards mortgages.

Matt Kerin - *Flagstar Bancorp, Inc. - Mortgage Banking*

This is Matt Kerin. I'm presuming you're asking about the QRM and the qualified mortgages. Obviously, we're very actively engaged with the MBA and in conversations with the appropriate parties in Washington. And we believe that we're going to be largely exculpated from much of this because we are predominantly a GSE seller for now and into the foreseeable future. That is our selling point of our Company.

So we don't really think that barring any adverse changes, we're mindful of what's going on in the industry from a regulatory perspective. Compliance is right up there with production. And Production is second to making sure that we have good quality control of our products so that we're going to be in compliance with the regulatory standards as they allow.

So I think we're well positioned, and we don't see that as an obstacle to our doing business going forward.

Vlad Artamonov - *Coastal Investment - Analyst*

Great. Well, fantastic quarter. Good luck, guys. And hopefully the one-off expenses and deductions will abate at some point.

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Thank you.

Matt Kerin - *Flagstar Bancorp, Inc. - Mortgage Banking*

Thanks.

Operator

And I am showing no further questions in queue at this time.

Joseph Campanelli - *Flagstar Bancorp, Inc. - Chairman & CEO*

Well, thank you all for participating in this quarter's conference call. Thank you, Donna.

Paul Borja - *Flagstar Bancorp, Inc. - EVP & CFO*

Thank you very much, guys.

Operator

And this concludes today's teleconference. You may disconnect at this time. Thank you and have a great day.
