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FBC - Q2 2012 Flagstar Bancorp Earnings Conference Call

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## CONFERENCE CALL PARTICIPANTS

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

**Sito Weisberg** *Caspian - Analyst*

**Chai Gohil** *Market Group - Analyst*

## PRESENTATION

**Operator**

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

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

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

Before we begin our comments I'd like to remind you that the presentation today may contain forward-looking statements 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 and competitive pressures within the financial services industry as well as legislative or regulatory requirements that may affect our businesses.

For additional factors, we urge you to review the press release we issued last night, our SEC documents, such as our most recently filed Form 10-K and Form 10-Q, as well as the legal disclaimer on page 2 of our earnings call slides that we have posted on our investor relations page at Flagstar.com this morning.

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 release, 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 Chairman and Chief Executive Officer.

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

Thank you, Paul, and good morning, everyone. I'd also like to welcome everyone to our second quarter 2012 earnings call. As usual, I would like to begin today with some general comments on the second quarter. After I finish my comments, I'll turn it back over to Paul, who will take us through a more detailed financial review, including our outlook for the third quarter. Afterwards, Paul and I, along with the rest of the executive team, will be available to answer any questions you may have.

I am extremely pleased to report that Flagstar Bank has returned to profitability both for the second quarter and on a year-to-date basis, consistent with the guidance we provided early in the year. This is a significant milestone along the path of our transformation, so it's important that I take a moment to thank our leadership team and all of the more than 3000 employees whose hard work and dedication have helped us achieve this important accomplishment. I would also like to thank all of our customers, business partners and investors that continue to support us.

Our results this quarter, which I will get into in a moment, reflect significant time, effort and commitment over the past several years. But I want to stress we recognize we still have a lot of work ahead of us. In fact, in many ways, we are still in the early phase of our transformation. Now that we have returned to profitability, we will continue to execute on our business plan, becoming a more diversified super community bank focused on key markets and businesses that we know and understand while continuing as a national leader in the residential mortgage business.

We have identified opportunities within our core businesses and markets to drive sustainable profitability and continued investment in product development and risk and compliance infrastructure. A relentless focus on eliminating inefficiencies and redundancies is a necessary part of our daily activities, given the industry-wide pressure on margins, lower consumer transaction fees and higher regulatory costs as Dodd-Frank becomes fully implemented.

We fully believe the strong risk management and compliance functions are a core competency necessary for any successful company. And finally, we continue to implement lasting, innovative ways to better serve our customers, all with the overriding goal of generating value for our shareholders.

Last night, we reported second-quarter net income of $86 million or $0.15 per share. Through the first six months of [2002] (sic -- see press release "2012"), we have earned $77.3 million or $0.13 per share. Our second-quarter net income was one of the most profitable quarters in the history of our 25 years.

Our quarterly net income also contributed to an increase in our tier 1 capital ratio to 9.07% and total risk-based capital ratio is in excess of 17%. On an annualized basis, second-quarter return on average assets was 2.37%, and return on average equity was in excess of 31%. Book value also increased by nearly 11% to $1.65 per share as compared to $1.49 per share in the prior quarter. We continue to maintain a deferred tax asset allowance of approximately $348.7 million or $0.62 per share, which, consistent with GAAP, is not included in the $1.65 book value per share.

Our second-quarter results reflect the strong earnings power of our mortgage banking business with second-quarter gain on loan sale income of $212 million or 166 basis points. Second quarter residential first mortgage originations were $12.5 billion and residential first mortgage rate locks remain strong at $17.5 billion.

If you would turn to slide 7 of our earnings presentation, second-quarter residential first mortgage originations increased by 12% from the strong first-quarter level and by 170% from the same period a year ago. Similarly, gain on loan sale income increased by 4% from the prior quarter and by more than fourfold from the same period a year ago. The increase in gain on loan sale income reflected wider gross margins and higher volumes, principally due to a favorable refinancing environment including the early success of the HARP 2 program. Major initiatives implemented over the past year to align our origination strategy and channels and reengineer our underwriting and servicing platforms have begun to drive significant returns and gains.

Looking forward, we see a significant opportunity to selectively expand our customer relationships and increase our mortgage market share as well as position ourselves for a future return to a larger purchase market. We continue to participate in the HARP 2.0 program, actively working to help keep borrowers in their homes throughout the country. Through the first six months of 2012, we have helped more than 4200 borrowers to reduce their mortgage rates by an average of approximately 195 basis points. Refinancing under the HARP program comprised approximately 15% of our total residential first mortgage originations during the second quarter, which we expect to maintain throughout the duration of the program.

Even as we take advantage of the current mortgage refinance wave, we continue to position ourselves for diversified revenue growth and diversification through our commercial banking and specialty teams and the new commercial relationships they bring to Flagstar Bank, increased treasury and cash management fee revenues, the growth of core retail deposits and loans generated out of our 111 community banking offices and the addition of new home lending centers and lenders to capitalize on the inevitable shift to a more robust purchase market.

Turning to commercial banking, our commercial and specialty teams are steadily adding new business relationships. Consistent with our strategic plan, during the second quarter we originated approximately $197 million in new commercial relationships and continue to build a meaningful commercial deposit base and recurring stream of fee income. We remain focused on continuing to build a high quality, diversified business portfolio of small businesses and commercial customers. Our commercial customer acquisition strategy is to find creative financial solutions and assisting companies' growth opportunities in Michigan and in new England markets.

Turning to personal financial services, we were consistent in our goal of growing core deposits and shifting our funding mix away from more expensive and less sticky funding sources. During the quarter, retail core deposits increased by 2.7% from the prior quarter, and the retail core deposit ratio improved to 48.6% at June 30, 2012. Wholesale brokered deposits are being intentionally run off as immature and are being replaced with retail core deposits.

During the quarter we closed two underperforming banking centers, bringing our total to 111 at June 30. We plan to open three new banking centers, two of which are planned for the city of Detroit. As the largest financial institution headquartered in Michigan, we are committed to helping foster the economic revitalization of the city.

This improvement in core deposits led to a reduction in the overall cost of funds. Second-quarter cost of funds was 1.72% compared to 1.76% in the prior quarter. Overall cost of funds has improved for a number of consecutive quarters; however, we believe that the current level is close to hitting its trough. Most of our efforts to widen our net interest margin going forward will be focused on changes in our asset mix.

Second-quarter bank net interest margin was 2.37% compared to 2.41% in the prior quarter, a very slight compression of the margin and one that was less expensive than many of our peers'. We are currently asset sensitive and, consistent with a declining interest rate environment, yields on our interest-earning assets decreased at a marginally greater rate than the improvement in our cost of funds.

Turning to slide 17, our second-quarter results were also reflective of a 40% reduction in total credit related costs from the prior quarter. This reduction was driven by a linked-quarter decrease in each of the bank's three primary credit costs -- the provision for loan losses, representation/warranty reserve change in estimate, and the asset resolution expense. While credit costs declined, reserve levels for the allowance for loan losses and representation and warranty reserve were increased quarter over quarter.

Second-quarter provision for loan losses was $58.4 million as compared to $114.7 million in the prior quarter. The decrease was driven by two key items. First, turning to slide 18, the allowance for loan losses increased to $287 million or approximately 67% of nonperforming loans at June 30, 2012, as compared to $280 million or approximately 69% of nonperforming loans at March 31, 2012. This increase was driven primarily by an increase in TDRs and an increase in historical loss rates, which are updated quarterly, partially offset by a decrease in allowance related to our commercial loan portfolio reflecting continued success in reducing the legacy commercial real estate portfolio.

Since the beginning of the year, the commercial real estate legacy portfolio was reduced from approximately $970 million to $747 million, a $223 million or 23% reduction year to date. As I've discussed in the last two calls, we continue to experience increased TDRs or troubled debt restructurings as a result of our aggressive efforts to increase the number of loan modifications and other loss mitigation activities.

As shown on slide 19, the overall level of TDRs has increased significantly over the last two quarters. As you can see from the chart, nearly 81% of total TDRs are classified as performing loans. Although they continue to perform, we hold a higher reserve against them, which is what drove the increase in allowance from prior quarter. In the long-term, we believe that helping borrowers who have the desire and capacity to remain in their homes provides a win-win solution for the homeowner and investor and supports the stabilization of the overall housing market.

Second, looking at slide 20, provision for loan losses in the second quarter reflect net charge-offs of $52.4 million as it compares to $151.7 million for the first quarter of 2012. The decline from prior quarter related primarily to a reduction of residential first mortgage charge-offs, reflecting the heightened level taken in the first quarter of 2012, and from the write-offs of the related specific valuation allowances.

Our loan modification efforts, combined with selected portfolio sales, loan principal repayments and non-retention strategies such as short sales and deed-in-lieus, have contributed to a meaningful decline in the balance of our two largest legacy assets, which we consider internally to be the residential first and second mortgage held for investment portfolios and the legacy portion of our commercial real estate held for investment portfolio. Both of these portfolios were, for the most part, originated prior to the end of 2008.

Looking at slide 21 you can see that these two -- that those two loan portfolios have decreased substantially since 2009. At the same time, we continue to see improvements in our consumer credit quality with overall delinquent residential first mortgage loans decreasing for the third consecutive quarter. Since their peak levels after the bulk sale in late 2010, total delinquent residential first mortgage loans have decreased by 27%.

Total nonperforming residential first mortgage loans, which are 90 or more days past due, also decreased by 6.5% from the prior quarter. Residential first mortgage loans past due 30 to 59 days and 60 to 89 days also decreased by 5.5% and 37.3%, respectively.

Nonperforming commercial real estate loans in the legacy portfolio increased by $45.8 million from the prior quarter. Approximately half the increase is related to a letter of credit which we converted to a loan and are in the process of working out. The remainder of the increase was attributable to several fully reserved larger loans. These are loans that are current on their payments but were downgraded to nonaccrual status and therefore categorized as nonperforming loans and have been individually evaluated for impairment in accordance with generally accepted accounting principles.

The ratio of nonperforming assets to tier 1 capital and allowance for loan losses, commonly referred to as the Texas ratio, also improved slightly to approximately 34% at June 30, 2012. Efforts are focused to reduce the level of classified assets.

Second quarter representation and warranty reserve and change in estimate also decreased by $14.5 million from the prior quarter.

If I could point you to slide 23, you see that our representation and warranty reserve increase to $161 million as compared to $142 million in the prior quarter. This increase is attributable to an increase in loan repurchase demand from the GSEs as you can see from the top left portion of the slide, partially offset by an improvement in the demand repurchase rates, as you can see from the bottom right-hand portion of the slide.

Lastly, second-quarter asset resolution expense decreased from the prior quarter by $15.9 million. This decrease was primarily attributable to a reduction in anticipated claims-related expenses, a reduction in foreclosure cost and in increased recoveries due to stabilizing real estate values. Servicing enhancements implemented over the past year along with investments in technology and human resources are beginning to drive a material reduction in asset quality expenses.

To recap, I'd like to emphasize two points before handing it over to Paul. First, we continue to capitalize on a strong mortgage banking presence and prudently grow our commercial and personal banking businesses, driving growth in our pre-provision net revenues. Second, investment in loss mitigation and strategies employed to reduce credit costs are now delivering significant results. I'd like to now turn it over to Paul.

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

Thank you, Joe. Good morning, everyone. Our net income for the second quarter of $86 million, or $0.15 per share, reflects the continued strong core revenue generation capability of the Company and the substantial reduction during the quarter in credit costs. 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 second-quarter results arose from increases and the gain on sales of residential mortgage loans and on our net interest income before provision for loan losses. At the same time, we continued to earn income from our mortgage servicing rights at a level above our internal target, although at a slightly lower level than in prior quarter.

The first component, net interest income, increased to $75.5 million from $74.7 million in the first quarter. At the same time, the bank's net interest margin declined slightly to 2.37% from 2.41% in the first quarter. On a Company-wide basis, the yield of our interest-earning assets declined by 9 basis points, primarily on our mortgage loans held for sale, which are short-term assets and thus more sensitive to interest rate movements. Also during the second quarter, the cost of our liabilities declined by 4 basis points, and so the spread earned on our assets declined to 2.08%.

The overall decline in yields and rates reflects the lower interest rate environment during the second quarter. For instance, the 10-year U.S. Treasury rate declined 55 basis points from the end of the first quarter to the end of the second quarter. The overall average balance of our interest earning assets, however, increased during the second quarter, offsetting the effect of the lower spread on net interest income. This increase was primarily in mortgage loans available for sale, reflecting the higher level of closings during the quarter. The increase was offset in part by the decline in the average balance of mortgage loans held for investment as loans refinanced, contributing to the decline in interest income for that asset. With these and other changes in average balances in yields, the bank's interest income remained unchanged for the second quarter at $123 million.

As in the first quarter, we were successful during the second quarter in continuing to reduce our funding costs. Our retail funding cost declined to 98 basis points from 1.06% in the first quarter and down from 1.34% in the second quarter of last year as we continue to focus on the growth of our core deposit base. The decline in our retail funding cost during the second quarter of 2012 was attributable primarily to the lower rate structure for our retail certificates of deposit, which we place to maturing higher cost retail certificates of deposit, and the wholesale certificates of deposit in our funding structure.

Overall, total funding cost for the second quarter declined to 1.72% from 1.76% in the first quarter and from 2.21% in the second quarter of last year. As such, our funding costs for the second quarter of 2012 declined to $47.4 million from $48.2 million in the first quarter.

For the third quarter of 2012, we would expect our net interest income to be slightly below the level of the second quarter with net interest rates lower but with a slight increase in average interest earning assets. We expect such increase to arise from the continued growth in mortgage production during the quarter, thereby increasing the level of available-for-sale residential mortgage loans and warehouse loans. We would expect this increase in average balances to only partially offset the decline in net interest rates, thereby slightly lowering our net interest margin for the third quarter.

Our ability to meet this estimate of net interest income for the third quarter 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 continued ability to invest excess funds in assets of similar yields, the absence of a sudden and significant increase in the general interest rate environment during the quarter and no substantial increases in nonperforming or nonaccrual loans.

The bank's mortgage business during the second quarter generated $213 million in gain-on-loan sales, which was higher than that of the first quarter as the bank continued to originate loans through refinancings of residential mortgage loans, including participation in the HARP 2 program. For the first two quarters of 2012, the bank's total gain on loan sales was $418 million, exceeding the gain on loan sales for all of 2011. The gain on loan sales for the second quarter 2012 reflects the strong growth in overall production volume arising from both overall industry volume as well as increase in market share.

During the second quarter, we experienced growth in both our loan locks and our sales. Based on recent reports of competitors exiting certain channels of the mortgage business, we continue to believe that we will remain well-positioned to maintain and perhaps increase our overall industry market share during 2012.

For the third quarter 2012, we expect that our loan locks and our loan originations will be slightly above that of second quarter and that we will sell substantially all of our loan originations. However, depending upon the seasonal market conditions and types of loans that we lock and originate, we believe that our margin levels could be slightly below that of our second-quarter margin, more than offsetting the gain on loan sale benefit of the increased production. Accordingly and based on preliminary July results, it would be reasonable to expect that our gain on loan sale income for the third quarter 2012 could be at or slightly below that of the first quarter 2012.

Our estimate is based on a number of factors, including that there are no significant increases or volatile movement 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 relationships with its investors, primarily the GSEs, remains consistent with past practices involving loan sales, escrow accounts on loan servicing; that the expected trend in mortgage originations industrywide for the third quarter does not decline beyond current industry projections and that there are no regulatory or other legal impediments to our full participation in mortgage banking.

Another driver of mortgage banking revenue is our net servicing revenue, which is a combination of income we earn from servicing loans and the net effect of the hedges on the mortgage servicing rights on our balance sheet. In total, our net loan administration income was $29 million for the second quarter of 2012, a decrease from $33 million in the first quarter of 2012.

Our mortgage servicing asset increased during the second quarter to $639 million from $597 million at the end of the first quarter, due in large part to our high levels of loan production during the second quarter.

At June 30, 2012, the asset reflected approximately $76 billion of underlying loans we are servicing for others, primarily the GSEs. Our goal has been to earn a 6% annualized return on the value of that asset. For the third quarter 2012, we expect that net servicing revenue will be approximately three-fourths of the amount earned during the second quarter. Our estimate assumes there remains a close and positive correlation between rate movements of the ten-year treasury and residential mortgage rates as well as the absence of significant volatility in mortgage rates and interest rate curves.

Noninterest expense excluding asset resolution was $149 million in the second quarter of 2012 as compared to $152 million in the first quarter of 2012. For the second quarter, noninterest expense reflected slightly lower compensation expense but also included higher commission expense due to the higher level of loan originations during the quarter. Our general and administrative expenses also decreased, reflecting lower fees for professional consulting firms.

For the third quarter 2012, we expect that our non-interest expense will be flat or slightly below that of the second-quarter level. This assumes that the FDIC assessment rate remains unchanged, that our mortgage volumes remain at levels experienced during the first quarter, that upcoming regulations or governmental directors do not require changes in service levels or business operations and that our legal, consulting and professional expenses remain constant.

Turning to our credit costs, Joe briefly discussed our loan-loss provision and our provision for the representation warranty reserves as well as asset resolution. Loan-loss provision expense declined to $58 million for the second quarter as compared to $115 million for the first quarter. At the same time, we continued to build our reserve, increasing it to $287 million at June 30, 2012, from $281 million at March 31, 2012. You may recall that during the first quarter, we undertook several enhancements to our loan-loss methodology. We also eliminated our specific valuation allowance for 180-day and over loans by charging it off during the first quarter.

During the second quarter, these enhancements were already in place, so there were no further specific valuation allowance charge-offs for those types of loans.

Also during the second quarter, we continued our loss mitigation activities to keep borrowers in their homes by modifying their loans or by allowing them to sell their homes for less than the loan value, which is a process referred to as short sales. For those modified loans which are referred to as troubled debt restructurings or TDRs, the loss rate in our model is higher than loans which are performing because of the perceived increase in the default rate of already modified loans that would eventually lead to a loss.

Similarly, short sales, while beneficial to consumers, are generally affected at a loss to the bank. We include this loss experience in the overall loss rate applied to our total performing loan portfolio. During the second quarter, our TDR balance increased, and we would expect that trend to continue for the foreseeable future. This change in the composition of the loan portfolio from non-modified loans to modified loans increases the overall risk to the portfolio and thus increases the amount we reserve against the total portfolio.

At the same time, we note that our loan balances in the 30-day, 60-day and 90-day past-due categories for residential mortgage loans have all declined and that the 30-day and 60-day past-due loan category for commercial loans has also declined. We continue to expect that the loss mitigation efforts we are undertaking should reduce over time our over 90-day delinquent residential mortgages during 2012.

At this time, we anticipate that the provision for loan losses for the third quarter of 2012 should be approximately equal to that of the amount in the second quarter. This estimate assumes, among other things, that current trends of unemployment and housing prices remain unchanged and that the growth rates of TDRs and short sales remain constant. 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 macroeconomic or other factors.

We refined our methodology for estimating the representation and warranty reserve as well during the first quarter. This included incorporating more recent data to loan file requests from the GSEs, which we believe is a more appropriate indicator of the nature and extent of any possible repurchases. For the second quarter, we increased our reserve to $161 million to reflect, among other things, an increase in the pending loan file request, an increase in severity rate and decline in recovery rate. Our provision for the quarter related to the changes in estimate for our reserve was $46 million and reflected the lower level of net charge-offs during the second quarter as compared to that for the first quarter.

For the third quarter of 2012, we would anticipate that our provision expense in this area would be 10% to 20% above that of the second quarter, which would still be well below the level of the first quarter as we continue to work through the loan demand pipeline. Our estimate assumes there are no significant changes in the current practices or patterns of the GSEs and that the levels of loan file requests, loss severity rate and recovery rate remained unchanged.

Asset resolution expense declined to $21 million from $37 million in the first quarter. For the third quarter of 2012, we anticipate that the level of 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 repurchased government-insured loans.

With that, I'll turn it back to Joe.

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

Thank you, Paul. We'd like to now open to any questions that people may have on the phone.

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## QUESTIONS AND ANSWERS

**Operator**

(Operator instructions) Bose George, KBW.

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

Good morning and congratulations on getting back to profitability. I just had a couple of questions. First, I just wanted to clarify -- when you guided to 3Q mortgage banking income being closer to 1Q, are you referring to the dollar amount of gain on sale income?

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

Yes.

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

Okay, great. And then switching to mortgage capacity, obviously applications keep increasing. I'm wondering, do you have capacity to increase volumes, or do you feel like the industry stretches out this refi wave as opposed to seeing pickups in volumes from here?

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

Yes. Over the past several years, we've invested significantly in a lot of reengineering and processes relative to the underwriting and turn times in the mortgage business and our servicing capacity, to really position ourselves to [worry] our current run rates. We are monitoring turn times and those types of things to keep volume at a steady flow. Maybe, Matt, you handle the originations, so you can add a little color to that.

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**Matt Kerin** - *Flagstar Bancorp, Inc. - EVP*

Obviously, to Joe's point, we have invested pretty significantly in the infrastructure and we've got a pretty broad distribution network, as I'm sure you're aware, with roughly 1000 active correspondents and probably 1600 active brokers. So I do believe we are well-positioned. We have invested in the infrastructure and technology, and I think we're pretty well positioned with even the stress on term times in today's environment because of the high volumes, especially with some of the volatility as the 10-year moves around and it's not necessarily correlating to MBS like it has historically.

But we're pretty optimistic for the future in terms of how we're positioned, and we'll continue to seek solutions for staffing and making sure that the quality of the portfolios that are being brought in on an unusual loan basis are where we want them to be from a touchiness and a risk perspective.

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

And in terms of the turn time, what's the time line to close now versus a couple of months ago?

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**Matt Kerin** - *Flagstar Bancorp, Inc. - EVP*

Well, they're up slightly. We have different turn time targets, depending on whether it's purchase or a cash-out refi or the like. But we are consistently -- we get it down, and then we get spikes in volume, and you go to that. We're running probably about, on average, 20 days.

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

Okay, great. And then actually a quick question on the [rep in] warranty. There was some increase in the newer vintage stuff, the 2008 and 2009 to 2012. I was wondering what was driving that. Has there been any change in the GSE behavior on that, on the newer stuff?

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**Mike Maher** - *Flagstar Bancorp, Inc. - CAO*

Yes, there was a spike in the second quarter in terms of 2009 to 2012 vintages that has not translated into increased actual repurchase demands. They've pulled files and are reviewing them. I wouldn't describe that, however, as a meaningful change in practice. I would -- we have more transparency, much greater transparency with the GSEs, and they continue to focus their primary efforts on the older, more problematic vintages of 2008 and prior.

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

Okay, great, thanks.

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**Operator**

(Operator instructions) [Sito Weisberg], [Caspian].

**Sito Weisberg** - *Caspian - Analyst*

I had a question on your valuation allowances. Now that you've hit profitability, what are your plans or potential actions regarding gradually unwinding that valuation allowance, if you're planning on doing that?

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

You are referring, I think, to the valuation allowance associated with our deferred tax asset?

**Sito Weisberg** - *Caspian - Analyst*

Yes, the DTAs, yes, sure.

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

Right; this is our first quarter of profitability. We expect, as we've discussed in prior conference calls, once we reach this, to be in discussions with our different -- with our auditors to talk about how many quarters of profitability are appropriate before we would think about reversing that. So we're looking down the pike, and we haven't come to a conclusion on that yet. Generally, it would be (multiple speakers) --

**Sito Weisberg** - *Caspian - Analyst*

Sorry; would that be like a gradual unwinding, or you're thinking of hitting X number of quarters and then fully unwinding (multiple speakers)?

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

Generally, from a time line perspective, generally what we've seen is anywhere between four and 12 quarters. And when we've seen it, generally that's been a one-time unwinding, similar to what some non-bank companies have done in the past. There has been some discussion of gradual, but generally it's a one-time unwinding into book equity, and then a gradual unwinding into regulatory capital.

**Sito Weisberg** - *Caspian - Analyst*

Okay, thank you.

**Operator**

(Operator instructions) [Chai Gohil], [Market Group].

**Chai Gohil** - *Market Group - Analyst*

A question on Basel III capital ratio, if you have it handy? Would you guys have the number for Basel?

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

No -- I think, from our perspective, we've taken a look at the NCRs, as others are, and we're continuing to go through it. I think that we've certainly done an informal analysis of that, but we're still going through a very detailed analysis to see how it affects the different pieces, especially as it affects our business. But we're not at that point yet where we are ready to publish different numbers or different estimates.

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**Chai Gohil** - *Market Group - Analyst*

Got you. And just a follow-up question to Bose regarding the 2009 to 2012 vintages -- like Mike said, GSEs are reviewing them. In terms of reserve that you are building up, is it a similar level as 2006 to 2008 vintages?

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**Mike Maher** - *Flagstar Bancorp, Inc. - CAO*

By no means are they in line with the 2005 to 2008 vintages. The vast, vast majority of file pull requests by the GSEs and ultimately demand for repurchases have been virtually confined to that 2005 and 2008 vintages. And importantly, the vast majority of the 2009 to 2012 demands that represents the spike in the chart essentially are a review of performing loans by the GSEs and, in our opinion, would result in a very insignificant amount of repurchase demands, ultimately.

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**Chai Gohil** - *Market Group - Analyst*

Right. So should I read it as you are reserving very small amount or minimal for the 2009 to 2012 vintages right now?

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**Mike Maher** - *Flagstar Bancorp, Inc. - CAO*

Well, we continued to reserve an appropriate amount on vintages from 2009 through 2012 as a -- in relation to the volume of loans sold to the GSEs, essentially about 8 basis points on loans sold to Fannie or Freddie. The vast majority of our reserves, therefore, are still aligned with the 2005 to 2008 vintages.

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**Chai Gohil** - *Market Group - Analyst*

Got it. And just a follow-up to the DTA question -- so in terms of re-starting the dividends under the TARP program, would it also follow when you start taking DTAs? Or can you start repaying dividends earlier?

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

I think, from the perspective of the DTA valuation allowance and dividends, those are going to be disconnected items -- or, those are going to be two separate items. We're going to, certainly, take a look at our profitability as we go forward and make decisions at that time.

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**Chai Gohil** - *Market Group - Analyst*

So could you start repaying dividends before the rate goes higher, to 9%?

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

I think it's one of those where it's possible to do, but we would want to make sure that we have discussions with the Board and with our regulators before doing so.

**Chai Gohil** - *Market Group - Analyst*

Got it. And just a final question in terms of the recent press release on Mr. Patterson -- so, should I read it as things are fine, and that's the reason he has switched out of the Board position?

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

Yes. We view it as, while we totally appreciate and reflects Mark's contributions, and I have not only a strong personal view of Mark and a professional relationship. He was part of the recruiting effort to bring myself and many of my team members here. We look at it as an orderly transition. Peter Schoels, the recommended director to replace Mark, has been with MatlinPatterson since 2002. He's been actively involved in their investment with Flagstar and provides for a very orderly, smooth transition. So, as much as I'll miss meeting Mark on our monthly Board meetings, I'm sure I'll stay in close contact with him, given his role at MatlinPatterson.

So from a management perspective, we kind of view it as a nonevent. Any other, further comment, I guess you'd have to ask him or their firm personally or directly.

**Chai Gohil** - *Market Group - Analyst*

Thank you, and congrats on a great quarter.

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

Thank you very much; it's been awhile coming.

**Operator**

(Operator instructions). It appears we have no further questions at this time.

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

Well, I'd like to thank everyone that joined us on today's call for their support of the Company through this transition period and look forward to talking about our third quarter call in a couple of months. So thank you all, have a great day.

**Operator**

This concludes today's teleconference. You may now disconnect, and enjoy your day.