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FBC - Q4 2011 FLAGSTAR BANCORP EARNINGS CONFERENCE CALL

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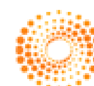

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PRESENTATION

Operator

Good morning. My name is Sara, and I will be your conference operator today. At this time, I would like to welcome everyone to the Q4 earnings conference call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. (Operator Instructions) I would now like to turn the call over to Mr. Paul Borja, Chief Financial Officer. Mr. Borja, you may begin.

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

Thank you. Good morning, everyone. I'd like to welcome you to our fourth-quarter 2011 earnings conference call. My name is Paul Borja, and I'm the chief financial officer of Flagstar Bancorp. Before we begin our comments, I would 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, competitive pressures within the financial services industry and 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 10K and 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 today at flagstar.com.

During the call, we may also discuss non-GAAP measures regarding our financial performance. Our reconciliation of these measures to like or similar GAAP measures is provided in the tables to our press release which we issued last night. With that, I'd like to now turn the call over to Joseph Campanelli, our Chairman and Chief Executive Officer.

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

Thank you, Paul, and good morning, everyone. I'd also like to welcome you to our fourth-quarter 2011 earnings call. Today I will begin with an overview of the fourth quarter and for 2011 and then provide some detail on our legacy balance sheet and associated credit costs, including the strategies we have implemented to address and mitigate the risk imbedded in these portfolios. After I finish my remarks, I will turn it back over to Paul who will help us -- who will take us through a more detailed financial review and our 2012 outlook. Paul and I, along with the rest of the executive team, will then take questions.

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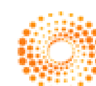

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First off, I would like to say that I am extremely proud of our over 3,000 employees for their efforts and for the passionate commitment they have demonstrated during this challenging economic environment. You will see in a moment that, while we continue to be challenged by legacy credit costs, we've made significant progress in 2011 and achieved many of our established goals and objectives. We believe our core operations and the business strategies we have implemented have positioned us to achieve profitability in 2012.

During the year, we generated over $337 million in pretax, (inaudible) cost income, as you can see on slide 6, and reduced our yearly net loss by 58% from 2010. We've made significant progress in the transition to a more diversified, full-service bank, including converting to a state-of-the-art retail, commercial and mortgage banking systems, providing a competitive suite of products and services, and hiring approximately 100 experienced team members to service and expand small business, middle market, and especially customer base.

We completed the divestitures of our Georgia and Indiana retail banking offices, a strategic move that has allowed us to focus on our core operations and build on the strengths we have in Michigan market. We fortified our balance sheet by adding reserves, maintaining strong capital and liquidity levels, and continuing to derisk through sales, modifications and workouts of nonperforming assets.

We improved our net bank interest margin by 22% from the prior year during a period where the industry in general was faces with significant margin compression. We reduced total non-interest expense by 1.5% from the prior year in spite of significant investments in infrastructure and new business initiatives.

We implemented new policies and procedures and risk management practices to address substantial changes in the regulatory environment arising primarily out of the Dodd Frank legislation and continue to build our expansion function and pursue strategies to put our legacy credit costs behind us.

Turning to the fourth quarter results, we reported net loss to common shareholders of $44.9 million, or $0.08 per share, attributable primarily to elevated level of credit related costs. For the full year of 2011, we reported a net loss to common shareholders of $165.6 million, or $0.30 per share.

During the quarter, we experienced a number of significant improvements in our core business, and we believe the steps we took in the fourth quarter and throughout 2011 have positioned us for a return to profitability in 2012. Before getting into those, I'd like to first discuss credit cost. Our goal today is at that through my comments, along with the additional transparency provided in our earnings release and presentation slides and the 2012 outlook (inaudible) supply will provide you with a meaningful framework to better understanding our credit cost, both for the current quarter and for estimating future amounts.

Our fourth-quarter net loss of $44.9 million includes $71 million in expenses arising from the establishment of additional reserves on our balance sheet which we believe will allow us to be even more proactive in addressing and reducing the overall level of nonperforming loans, of which the vast majority are related to loans originated prior to 2009.

For the quarter, credit cost totaled $173.2 million, as compared to $111.7 million in the prior quarter. This increase was driven by three specific items. First, a $26.9 million increase provision for loan losses. Second, a 33 -- excuse me, a $30.3 million increase in provisions related to representation warranty reserves, which we previously referred to as our secondary market reserve. And finally, a $5.8 million increase in impairment on our available for sale securities.

First, let's discuss provision for loan losses. During the quarter, we implemented a program we referred to as Winning in Banking, which is a comprehensive series of initiatives implemented to encompass best practices across the bank. These initiatives are expected to provide a meaningful financial impact to the bank which we expect to begin seeing in 2012 and will continue thereafter.

As part of the Winning in Banking program, we made significant investments and enhancements in our default servicing and loss mitigation areas, including leasing a new dedicated facility in close proximity to our headquarters in Troy, Michigan, converting to a state-of-the-art servicing platform, increasing loss mitigation staff by over 20% through the addition of approximately 80 full-time employees, and restructuring and enhancing our servicing practices, including establishment of single points of contact for customers who are seeking loss mitigation solutions from the bank.

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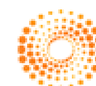

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These investments will be an important factor in reducing the overall level of delinquencies and credit costs, which we will be discussed in more detail later in the call.

Our servicing enhancements provide us with the ability to focus on creative ways to proactively service financially distressed borrowers. This both increases the probability that the homeowner continues to make payments and remain in their home and decreases the bank's overall exposure to a loss. A broader measure of loan modification options, a broader menu of loan up modification options are available to be tailored to individual household characteristics to drive better outcomes.

We have already begun to see a resulting increase in loan modifications and loss mitigation activity, which in the near-term increases the level of a troubled-debt restructurings, or TDRs, on our balance sheets. TDRs require a greater level of allowance for loan losses, and as such, we increased our reserves related to residential first mortgage loans during the quarter, which contributed to the increase of provision expense.

At December 31, 2011, our overall allowance for loan losses was $318 million, or about 65% of nonperforming loans as compared to $282 million, or roughly 63% of nonperforming loans as of September 30, 2011. Overall, nonperforming loans increased by $43.5 million from the prior quarter. However, looking at slide 18, you will see that the pace of increase in the nonperforming loan category continues to slow, while the level of 30 day and 60 day delinquencies declined in the fourth quarter.

Turning to slide 19, you'll see that $32 million, or approximately 75% of the increase in overall nonperforming loans was related to an increase in residential first mortgage performing TDRs, which are modified loans that are current in their payment but must be classified as nonperforming loans until they have performed for six consecutive months after the modification date.

Excluding these performing TDRs which are in the six month seasoning period, the level of nonperforming residential first mortgage loans was essentially flat from the prior quarter. The growth in nonperforming TDRs is consistent with our increased modification efforts which is designed to provide viable solutions for our customers to remain in their homes. We believe that our nonperforming residential mortgage loans have already peaked during the fourth quarter and anticipate quarterly declines throughout 2012.

Nonperforming commercial loans increased by $8.5 million from the prior quarter, driven primarily by four new delinquent commercial real estate loans from the legacy portfolio with an average size of $2.2 million. The balance of our pre-2009 commercial real estate portfolio continues to decline, and we hold a significant level of reserves against it.

At December 31, 2011, reserves related to commercial real estate loans represented 94% of commercial real estate nonperforming assets. Second, we experienced an increase in the provision related to our representation and warranty reserves. This elevated provision level was driven by a $35 million increase in reserve from prior quarter. At December 31, 2011, our representation warranty reserve was $120 million as compared to $85 million as of September 30, 2011.

Turning to slide 21, you'll see at the top left portion of the slide that we received $190 million of repurchased demand this quarter, a decline of $19 million and 9% from last quarter. This slight decrease was entirely due to agency-related demands, most notably from Fannie Mae loans. Overall, the reason for the demand is similar to those in previous quarters, such as borrower misrepresentation or issues with appraisals.

The demands that we received have been more concentrated in loans that have already been through the foreclosure process. However, we recently noted some changes in the pattern of requests relative to the delinquency status. The more recent request for full loan files which are a precursor to future demands have been more skewed toward loans that are delinquent, but not yet in foreclosure. This suggests to us that the agencies that work through the backlog of demands from prior years, which indicates that the continued demand in Q4 could be an acceleration of timing rather than growth in the overall population.

The top right part of slide 21 shows that the aggregate amount of pending demands decreased during the quarter from $352 million to $343 million. This is primarily due to the decline in current quarter demands. The bottom left-hand part of the slide shows charge-offs for the quarter of $38 million, up by $3 million from the third quarter, due to the high level of demand resolution activity. The quarterly provision of $70 million exceeded charge-offs, resulting in an increase in representation warranty reserve of $35 million.

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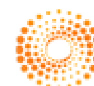

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During the fourth quarter, the Company made refinements to the process of estimating the representation warranty reserve to primarily change in the counterparty activity and our ability to estimate forecasted repurchase demands over the expected period of repurchase exposure. We believe the current reserve level of $120 million is appropriate, in light of the continued elevated level of repurchase activity.

The bottom right-hand portion of the slide 21 provides a broad framework and key model attributes and assumptions for our representation warranty reserve. The four key variables in the framework are the estimated loan file review rate, the repurchase demand rate, the actual repurchase rate based on the bank's win/loss rate and loss severity.

Let's focus on the estimated loan file review and repurchased demand rates first. Repurchase requests received to date have had an inverse correlation in the amount of time between origination and default. The shorter the timeframe between origination and default, the greater the request rate, and the longer the timeframe, the less likely it is that a request will be received.

There's also been a positive correlation between a current loan to value ratio and request rate. The higher the current LTV, the higher the request rate, and vice versa. The preponderance of demands received has come from loans that went delinquent within the first 36 months after origination.

If this pattern continues and the GSE selection criterias do not change, it suggest that the pool of delinquent loans from which we will receive demands should be stabilizing, given that any performing loan from the 2006 to 2008 vintages, our most prevalent repurchase vintage period, is now past its three-year mark. The refinements to the reserve incorporate the expected future demands from this delinquent population of loans.

Current LTV is one predictive variable for a potential magnitude of the loan file pool requested by GSEs. If housing values generally continue to decline, this could indicate the potential for a continuation of elevated request levels. However, we have been witnessing some patterns and demands and full fire requests that suggest the backlog of demand from prior years could be thinning

Factors that point to more modest increases in the request rate are the passage of time, the shift in full fire request from later stage foreclosed loans to earlier stage default status, and the fact that demands can only reasonably be made on that portion of loans that did not meet underwriting guidelines.

With respect to the other variables, our overall repurchase rate has been fairly consistent, in the 40% to 45% range, while the severity rate over the last 12 months has been about 44%. This substantial loss severity rate is due to the impact that declining home values have had on severity, as well as the higher proportion of demands coming from the 2007 vintage, which was the peak of the housing market.

In conclusion, while repurchase demands remained somewhat contingent on third-party behavior, we do expect them to slowly abate in the coming quarters. Moreover, if the assumptions that lead us to believe that we're -- that why we are seeing an acceleration of demands prove correct, and if the GSEs don't otherwise modify their repurchase methodologies, then we would expect that our overall representation warranty reserve of $120 million as of 12/31 2011 is sufficient, we can reasonably absorb the expected losses from such activities in future periods.

Lastly, during in the fourth quarter, we recognized $7.1 million in impairment on our investment securities available for sale. These impairment losses incurred during the quarter relate to expected future credit losses in those the securities act by prime mortgage collateral. The deterioration in collateral performance is a result of continued macroeconomic weakness and is in line with industry expectations for mortgage defaults on prime collateral.

I'd like to talk about some of the significant progress we've experienced in our business. That progress is reflected in the strong revenue we generated in the fourth quarter as evidenced by $131.6 million in pretax, pre-credit cost income, a 28.4% increase from the prior quarter. We continue to leverage our industry position in mortgage banking to originate conforming residential mortgages and generate strong revenues.

Competitors continue to exit the wholesale mortgage business for varying reasons, which we view as an opportunity to selectively gain marketshare. During the fourth quarter, we will take advantage of the strong refinance activity and believe we are well-positioned to gain marketshare in the wholesale market. As a result, fourth-quarter gain on loan sale income increased from the prior quarter to $106.9 million, with a margin of 102 basis points.

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Full-year 2011 gain on sale income was approximately $301 million, as compared to $297 million in 2010. We originated $10.2 billion of residential mortgages in the fourth quarter, a 48% increase from the prior quarter. Full-year 2011 mortgage originations were $26.6 billion, virtually identical to the 2010 level, even as mortgage originations for the industry for the whole a decreased year-over-year.

We are forecasting continued favorable interest rates and strong refinance activity well into 2012. Currently, the mortgage mix is primarily refinance volume, but we are well-positioned for our home lending presence to prudently expand with expectations that there will be an eventual shift towards purchase buying.

We fully intend on participating in enhanced HARP 2 refinance program and plan to capture our proportion of the share of the anticipated volume. Currently, we are awaiting necessary technology changes to the GSE automated underwriting platforms which are expected to be available over the next 60 days.

Since the program became effective, we have done a limited number of manually underwritten HARP 2 loans for previously originated Flagstar loans. We also continue to originate jumbo mortgages on a selective basis. In 2011, we originated almost $300 million in jumbo mortgages, the majority of which were shorter duration ARMs which were originated for our balance sheet.

Our bank net interest margin remains a positive for us, improving to 2.43% for the fourth quarter, a 13 basis point improvement for the prior period and a 25 basis point improvement from the same period a year ago. The improvement from prior quarters is driven by loan growth and a decline in overall cost of funds.

First, turning to loan growth. Average interest earning assets increased from the prior quarter by $1.1 billion, or 9.2%, reflective of our increases in our available for sale, warehouse lending and commercial lending portfolios. The increase in our available for sale and warehouse portfolios are tied to the strong origination market, largely in the second half of 2011. And the increase in our commercial lending portfolios are tied to the success of our commercial banking division which we started in earnest in February of this past year.

Our commercial and specialty groups continue to grow as we acquire new commercial customers consistent with our strategic plan. As you can see on slide 13, we had strong growth in our commercial loan balances during each quarter of 2011. We also continue to cross sell other fee related products and services to our -- for our business banking, middle market and specially lending groups that we expect will provide meaningful fee income generation and growth in 2012.

Turning now to the liability side of the balance sheet, we funded our new loan growth primarily with core deposits and short-term FHLB advances, both of which carry relatively low interest rates. Overall, fourth quarter cost of funds declined to 1.81% from 2.09% in the prior quarter. Debt decline was reflective of the lower cost of deposits which we continue to enjoy success in our efforts to attract new core deposits and a full quarter benefit realized in refinancing of $1 billion in long-term FHLB advances towards of the restructure towards the end of the third quarter of 2011.

During the quarter, we continued to generate low cost to zero cost core deposits, which contributed to a 13-basis-point decline in the average cost of deposits from the prior quarter. Part of the decline in the cost of deposits was attributable to the sale of associated deposits in Georgia and Indiana branches, which carry higher average funding costs than our remaining core deposit franchise.

During December, we closed the previously announced sale of our Indiana and Georgia retail banking offices, which resulted in a combined gain of $21.4 million. These transactions allowed us to focus our resources on the continued execution of our super community banking strategy servicing in Michigan and southern New England markets.

Our retail banking strategy in 2012 is to optimize the bank's branch network and its core markets. We have been successful throughout the years in growing the level of retail core deposits in Michigan, both in dollar and as a percentage of total deposits. In 2012, we will continue our retail strategy of gathering branch banking deposits and commercial business banking deposits, thus reducing our reliance on noncore funding. Our strength in Michigan and our plans to further grow in this important market are essential to our business plans and overall strategy.

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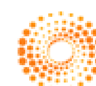

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We like the signs we are seeing in the Michigan economy. The state's unemployment rate recently declined to its lowest level in 28 months, and Michigan added 80,000 private sector jobs over the past year. Further, auto industry employment in the US is projected to increase by over 150,000 jobs by 2015, most of which will be centered in Michigan.

A recent Bloomberg Business Week article also mentioned that Michigan is projected to finish the 2011, 2012 fiscal year with a surplus, it's first in 10 years. New England is also a market that we know and understand well. We believe we are well-positioned to capitalize our new relationships there.

Our commercial lending group continues to experience success, as evidenced by the new commercial loans which we have originated over the past year. We closed the fourth quarter with continued strong capital levels with a tier 1 ratio of 9.19% and total risk-based capital ratio of 17.07%. During the fourth quarter, we invested $18 million in capital from the holding Company to the bank to insure the bank maintains sufficient capital to effectively manage its ongoing business opportunities and to continue to grow market share.

Finally, as part of our earnings release last night, we announced that we would be exercising our contractual right to deferred dividend payments on our preferred stock issued to the US Treasury and interest payments on our trust preferred securities. Under the terms of the TARP preferred stock, we can defer up to six quarters of payments without default or penalty. We can also defer up to 20 consecutive quarters of trust preferred payments without default or penalty.

We believe it is prudent stewardship of capital to defer such dividends and interest payments until our financial conditions improve and restore the Company to profitability, and we'll continue to retain the funds to support our continued execution of our strategic plan. I would like to turn it over -- the presentation to Paul for the detail of the financials side.

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

Thanks Joe. As Joe mentioned, we had a $44.9 million loss during the fourth quarter. This is primarily attributable to a $71 million increase in our reserves for loan losses and for loan repurchases from the GSEs. As quarter, we mentioned that we would focus on four key items during the fourth quarter, improving our net interest margin, leveraging our mortgage banking business, reducing and mitigating credit costs, and controlling expenses. These things focused on the three key areas of our operating results, revenue generation, expenses and credit costs.

In the fourth quarter, the bank's revenue generation capability was reflected in its net interest margin, it's gain on loan sales and its revenue from mortgage servicing rights. The banks net interest margin increased to 2.43% during the fourth quarter, from 2.30% in the third quarter. From a revenue perspective, our net income increased to $75.9 million during the fourth quarter, from $65.6 million during the third quarter. This resulted in both an increase in our interest income and a decline in our interest expense.

Our interest income increased during the quarter, reflecting higher average balances to be carried for our available for sale mortgage loans and our warehouse loans. Yields on these assets were lower than in the third quarter, reflecting a decline in the 10 year treasury rate to near record lows at one point during the fourth quarter. However, the increase in the average earning assets efficiently offset the reduction in yields to generate more interest income than in the prior quarter.

At the same time, we were successful in reducing our funding costs during the fourth quarter. This was attributable to both the restructuring our long-term federal home loan bank advances to lower rates at the end of the third quarter and to a focus on generating lower cost retail deposits.

Despite the sale of our Indiana and Georgia branches, our percentage of retail core deposits to total deposits improved during the fourth quarter, while our retail deposit funding cost actually declined as compared to the cost of those deposits during the third quarter. For the entire year 2011, our bank net interest margin was 2.13% as compared to the 2010 net interest margin of 1.175%.

The improvement over the year primarily reflected the improvements in our funding costs, both on our deposit costs and FHLB advance costs. For the first quarter of 2012, we would expect our net interest income to be between 5% and 10% above our fourth quarter 2011 amounts, with a slight

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increase in average interest earning assets. As such, we would expect our net interest margin to increase, although to a lesser extent than the fourth quarter.

While we do not expect to see the growth in such assets during the first quarter, as was the case during the fourth quarter, we expect that our continuing levels of mortgage production will maintain our current average levels of available for sale mortgage loans and warehouse loans, both of which are higher yielding assets. Further, we expect that our commercial lending operations, which we commenced in February 2011, will continue to build their portfolios and thereby contribute to the reduced volatility in our net interest income.

We also expect to continue the transition of our deposit base towards more core accounts and business accounts, especially as our wholesale CDs continue to run off, and to use lower cost, short-term FHLB advances periodically to fund the growth in the mortgage loans and warehouse loans while our deposit base grows.

Our ability to meet this estimate of net interest income for the first quarter of 2012 depends upon a number of factors, including the continuing robust activity of the residential mortgage market, our ability to meet our lending goals, despite an expected industry wide decline in overall mortgage volume during 2012, a continuation of the current low interest rate environment, and no substantial increase in our nonperforming loans.

The bank's mortgage business during the fourth quarter gave rise to gain on loan sales even larger than the near record amounts of the third quarter, principally from mortgage refinancing activity. We have experienced continued strength for the refinancing activity in the marketplace since the beginning of 2012, and believe we are well-positioned to experience continued increase in our overall industry marketshare during 2012, despite industry estimates that project a slowdown in overall mortgage production for the year.

For the first quarter of 2012, we expect that our production will be similar to that of the fourth quarter. Accordingly, it would be reasonable to expect that our gain on sale income for the first quarter of 2012 will approximate that of the fourth quarter of last year.

Our estimate is based on a number of factors, including that there are no significant increases of a 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 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 mortgage banking.

Our expectation for mortgage loan locks and originations during the first quarter 2012, which would drive our mortgage gain on loan sales, does not include our participation in the recently announced HARP 2 mortgage refinance program. We've underwritten a minimal amount of those loans to date, but are awaiting a launch by the GSEs of the automated underwriting process in April. At that time, we can provide more guidance as to the extent to which we would expect to participate in the HARP 2 program.

Our second biggest driver of mortgage banking revenue is our net servicing revenue, which is a combination of income we earned servicing loans and the net effect of the hedges on a mortgage servicing rights on our balance sheet. In total, our net loan administration income was $29 million for the fourth quarter of 2011, an increase from $16.9 million from the third quarter of 2011.

Our goal is to earn a 6% return on the value of that asset, and we have done a good job of that over the last nine quarters. For the first quarter of 2012, we expect that net servicing revenue will be at a midpoint between the amounts earned in the third quarter and the fourth quarter. This assumption is predicated on the interplay between the 10-year Treasury and mortgage rates, as well as the absence of significant volatility in the mortgage rates and interest rate curbs.

Non-interest expense, excluding asset resolution, was $140.6 million in the fourth quarter 2011, as compared to $116.2 million in the third quarter 2011. The increase from the prior quarter was reflective of increased commissions due to higher loan sales in the fourth quarter, $10.5 billion, than in the third quarter, $6.8 billion. It also reflects increases in salaries as we have increased our staffing to grow the commercial banking business, assist in the underwriting process and enhance our mortgage servicing operations, especially as to those areas that work directly with customers and help mitigate loan losses.

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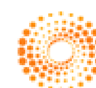

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We anticipate first-quarter 2012 non-interest expense to be flat or slightly below that of the fourth quarter 2011 level. This assumes that the FDIC assessment rate remains unchanged, that mortgage volumes remain at levels experienced in the fourth quarter, and that upcoming regulations or governmental directives do not require changes in service levels or business operations.

Turning to our credit costs, Joe discussed earlier our loan loss provision and our provision for the representation in warranty reserves. Our loan loss provision increased to $63.5 million for the fourth quarter 2011. This increase allowed us to build our loan loss reserves and increased our coverage ratio, that is, the loss reserves divided by our nonperforming loans to approximately 65% and the ratio of our loan loss reserve to our total loans into 4.52%.

The increase in our loan loss reserves generated reflects an increase in our historical loss rates, as well as an increase in the level of our over 90 day consumer loans, including mortgages. Over 90-day consumer loans increased by approximately $35 million as compared to the end of the third quarter.

However, of that amount, approximately $32 million of loans were classified as troubled debt restructurings, or TDRs, in effect an accounting designation for loans we modify to help out homeowners in financial distress.

These types of loans usually have a higher loss rate than non-modified loans. TDRs must be held in the over 90-day category for their first six months after originations, even if they are paying. A key part of our loss mitigation strategy is to modify loans for homeowners, and so we would expect that the overall amount of TDRs in our portfolio would increase.

Note, however, that our 30-day and our 60-day loan balances for consumer loans have declined, reflecting our loss mitigation efforts. This slowing pace of inflows it should help us reduce our over 90-day delinquent residential mortgages during 2012. We expect to continue to enhance our overall loan loss reserve methodology during 2012 by incorporating more granular and segmented data.

At this time, we anticipate that the provision for loan losses for the first quarter of 2012 will be lower than the fourth quarter 2011, and more in line with the midpoint of the provisions recorded in the first and third quarters of 2011. This estimate assumes, among other things, that current trends of unemployment and housing prices remain unchanged, and that the growth rate of TDRs and short sales remain flat. It also assumes that our historical loss rates, which we continually review for validity against current trends and historical experience, do not change significantly.

As Joe mentioned, earlier during the fourth quarter, we made refinements to the process we use for estimating the representation and warranty reserves. These refinements increased the reserves from the prior quarter. A key component in assessing the potential expense arising from this area is the activity of the GSEs.

As discussed earlier by Joe, we are now focused on the loan file request from the GSEs as a more appropriate indicator of the nature and extent of any possible repurchases. To that end, we analyze data on an ongoing basis. Given the uncertainty and taking into account our historical losses, we increased our reserves during the fourth quarter.

We will continue to evaluate our exposure in light of recent GSE activity. Asset resolution expense decreased slightly to $32.4 million during the fourth quarter. We anticipate first-quarter of 2012 to remain close to its current fourth-quarter run rate. Both our estimates for provision and asset resolution expense do not reflect the benefit of the improvements we anticipate receiving from the restructure of our mortgage servicing area that Joe discussed earlier. With that, I would like to turn it back to Joe for questions.

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

Thank you Paul. Sara, if you could open up the line of questions for me, Paul or any member of the executive management team, that would be great.

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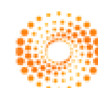

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from the line of Paul Miller from FBR Capital Markets. Your line is open.

Kevin Barker - *FBR & Co. - Analyst*

Good morning, this is Kevin Barker filling in for Paul Miller today.

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

Good morning, Kevin.

Kevin Barker - *FBR & Co. - Analyst*

Good morning. Could you walk us through some of the thought process of deferring TARP? You're going to have to pay it again in six quarters when it comes to that. I understand keeping capital in place and bringing some of the capital down to the bank to keep capital ratios stable, but could you just walk us through that thought process and why you did it?

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

Yes, Kevin, we believe we'll see 2012 continue to be a flatter growing balance sheet, given the business activity in commercial banking, the growth we are experiencing there and in mortgage banking. And the best use of capital is to support our growth in transition to profitability, which we see coming in 2012. There wasn't a lot of upside in the continued payment in the sense that there's no penalty, the step up in interest rate doesn't occur until early 2014. So, the prudent use of capital allocation would be to support activities that will help us transform the bank into a more full-service, along our ongoing strategies.

Kevin Barker - *FBR & Co. - Analyst*

So, this would help you with mortgage originations and possibly going into HARP 2.0 and so forth?

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

Yes, we see -- as you saw in the fourth quarter, a lot of activity with our warehouse lending business, our available for sale to support the residential mortgage business. And if you look at one of the charts, I believe it was 6, we're seeing very nice development of our commercial banking practices, building relationships there. So, not only the size of the balance sheet, but most importantly, the composition of the balance sheet continues to improve, and we believe that's the best allocation of capital.

Kevin Barker - *FBR & Co. - Analyst*

I believe you touched on it, but as far as the revised HARP program, do you see -- why can't you mind your own servicing portfolio right now as opposed to waiting until April?

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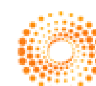

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Matt Kerin - *FLAGSTAR BANCORP INC - EVP, Managing Dir., Mortgage Banking and Warehouse*

Kevin, this is Matt Kerin. We actually are rolling out for our manual underwritten loans, the HARP 2.0. The primary driver for waiting until the automated tool sets get put in place, because that's the vast majority of how people do business today, through the automated underwriting. And there's also an added benefit of -- with respect to the rep and warranty issue associated with the manual versus the automated underwriting. And we had to make some changes to our own systems in order to do the manual underwriting as well because of the changes in the program. So, there are multiple factors that influenced that decision.

Kevin Barker - *FBR & Co. - Analyst*

Is there a risk in April of other originators mining your servicing portfolio as part of HARP? Or do you see that -- you're defensive enough -- (multiple speakers)

Matt Kerin - *FLAGSTAR BANCORP INC - EVP, Managing Dir., Mortgage Banking and Warehouse*

Quite frankly, given our position in the industry and our pretty broad distribution base, I'm not overly worried about others mining our portfolio. There's a lot of business out there that people are trying to figure what they're going to do. I think we have a pretty good strategy around it right now.

Kevin Barker - *FBR & Co. - Analyst*

Okay, and I've got one final question on the TDRs. As you transfer your classification of those TDRs, are you seeing -- what level of re-default rates are you seeing on the restructured loans?

Mike Maher - *FLAGSTAR BANCORP INC - EVP, Director of Mortgage Servicing and Operations*

Hey, Kevin, good morning, this is Mike Maher. I would tell you that our re-default rate on modifications over the last year or so has been in the mid to upper teens. Essentially, our target in 2012 would expect that re-default rates that would kind of center around 20%. I think that is in line with industry experience and certainly is part of our disclosure from our third quarter Q. Our volume of modification have ramped up substantially in the fourth quarter, so we are talking about a relatively unseasoned portfolio, but we would expect that the overall re-default rate would be along the lines of the industry averages in the upper teens.

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

Yes, while TDRs are unique in the sense that they are not all created equal, and we spent a lot of time with Mike and his team looking at what caused the re-defaults and looked at ways that's more efficient, you have more tools to help increase the probability of success of keeping the homeowner in the house and reducing the net loss impact to the bank. So, there's been a lot of effort and work getting a better understanding of those strategies that become effective and those that's really a classified as TDRs, but don't have a meaningful modification of results and a change of performance.

Kevin Barker - *FBR & Co. - Analyst*

Have you seen borrowers to be very receptive to those modifications? Does that include some principal write-down, or is it more extending the length of the loan, bringing down the interest rate? Can you just provide a little bit color around that?

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Mike Maher - *FLAGSTAR BANCORP INC - EVP, Director of Mortgage Servicing and Operations*

Certainly, certainly. The vast majority of our loan modification solutions and the primary acceptance by the customers has been in the form of term extension first and then interest rate reduction on top of that. To date, we have done very little principal reduction, principal forgiveness in response to modifications on firsts. We have begun to look at -- we have a relatively inconsequential second mortgage portfolio on the balance sheet, and we've begun to look at forgiving some level of principal, especially on delinquent HELOCs and second mortgages in an attempt to mitigate losses. The vast majority of those assets in the second mortgage portfolio would've already been charged off due to delinquency. But to date, the customer acceptance of our term extension and rate reduction has been quite positive.

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

I think half of that is attributable to the terms of the modification. The other part of that I think is equally attributable to the single point of contact, Winning in Banking strategy, where the decision making process is much more fluid, quicker turnaround times.

Kevin Barker - *FBR & Co. - Analyst*

Okay. Thank you for taking my questions.

Mike Maher - *FLAGSTAR BANCORP INC - EVP, Director of Mortgage Servicing and Operations*

Certainly.

Operator

Your next question comes from the line of Bose George from KBW. Your line is open.

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

Good morning. Actually, the first question, I just wanted to follow-up on the TDR issue, just to understand the reserving. Are some loans going straight from current into TDRs? Is that what's creating the need for the additional reserving there?

Mike Maher - *FLAGSTAR BANCORP INC - EVP, Director of Mortgage Servicing and Operations*

Certainly, some of the modifications that we have done have gone from either 30 or 60 day delinquencies into TDR. The majority of our modifications in the fourth quarter were actually of the delinquent -- the more delinquent, more seriously delinquent population, 90 plus, into TDRs. The additional reserves that we put aside was a combination of the 30 and 60s that we indeed did modify, as well as just the overall loss -- historical loss rate increase on our overall first mortgage portfolio.

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

Okay, good. Then just switching over to the -- I just wanted to revisit the rep and warranty issue again. You noted that there was some sort -- an acceleration of the GSE, or the GSEs are looking more at pre-foreclosure loans, but your claims are down quarter over quarter. So, I was just wondering, does this suggest that they -- we could see an increase in the first quarter? How is the change in the GSE behavior going to play out in the numbers, do you think?

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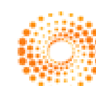

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Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

This is Paul Borja. We took a look at the GSEs and we take a look at that particular slide, what we are trying to do is make sure we've captured on a predictive loss basis the activity of the GSEs as we know them to be now. So, from a 12/31/2011 perspective, we are comfortable that based upon the activities of the GSEs and what we expect to them to pull and using the assumptions on the bottom right-hand side, that we have the reserve appropriate to absorb the kinds of losses we are talking about.

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

And just to clarify that, you have the reserves appropriate for the claims to date, basically?

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

Well, no, I think it is more that we start with the universe of those loans that we sold in the marketplace. We take a look at what is left, and we apply our ratios against those.

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

Okay. So, really, if those are right, then there should be a pretty meaningful decline and the rep and warranty reserve mix going forward.

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

That would be a correct assumption.

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

Great. And then just lastly, on the gain on sale margin, I'm always just a little confused about how to calculate that number. Should we look at the denominator as being interest rate locks or loans sold? Because looking at loans sold, your gain on sale margin went down this quarter quite a bit. But if you are looking at rate locks, it looks kind of different. So, what would you suggest to look at?

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

What you have in front of you is a bit of a hybrid. When we first had that calculation, we looked at loans sold. We switched to a fair value method for our available for sale loans, it then it became appropriate to look at the derivatives on the fair value basis. Interest rate locks, forwards and the fair value of our available for sale mortgages. You see the fair value portion of the top part of that chart. You see the sale of loans, the actual income and expenses from sale loans on the bottom part. The reason the second part is important is because certain expenses such as commissions are triggered upon the sale of the loan rather than just the locking of the loan. So, in combination then, we've got both of those which suggests a much lower margin for Q4 than Q3, although we can tell you that from a Q4 versus Q3 perspective, Matt Kerin and his team have done a great job of protecting and bringing in pretty strong margins overall.

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

Okay, so it's fair to say that if you look at loans sold in isolation, it kind of exaggerates the decline, and we really should look at both those numbers

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Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

Correct, that's right. That's the way to look at it.

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

Okay great, thanks.

Operator

(Operator Instructions) And your next question comes from the line of Mark Steinberg from Dawson James. Your line is open.

Mark Steinberg - *Dawson James Securities - Analyst*

Yes, good morning. I was wondering if someone could address what measures are being taken or considered to help avoid the stock from being de-listed?

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

Yes, our Board and Management is looking at a multiple of opportunities that we have available to us. We've had [dialogues] and NYSEs, to put together these strategies, and over the coming quarters, we would expect to bring something to NYSE in a shareholder vote to avoid a de-listing. We haven't come to a final resolution on what specific actions would be taken, but we clearly have a couple of different variables available to us.

Mark Steinberg - *Dawson James Securities - Analyst*

Could you elaborate a little bit on what some of these variables are?

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

Well, it's a whole -- I mean, one thing is execute on our plan to restore the Company to profitability. I think that there's -- as you become more profitable, the valuations will be close to our book value, which is well in excess of benchmark trading levels, in addition to traditional sources of any potential reverse stock split and a couple of other opportunities. But right now, we're not prepared to get down to the details. We still have a period of time that gives us sufficient planning and a more detailed approach to talk to NYSE and others on.

Mark Steinberg - *Dawson James Securities - Analyst*

What is the timeframe, sir? How much time do you have?

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

This is Paul Borja. We initially have (inaudible) incurred from the date that we (inaudible) --

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Mark Steinberg - *Dawson James Securities - Analyst*

I'm sorry sir, could you repeat it? I couldn't hear you.

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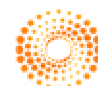

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Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

Sure, pardon us. We initially had a six-month period following the time period when we first received the notice from the New York Stock Exchange. We've since contacted the exchange to discuss with them some of the different strategies from the initial discussion and what we plan to do, and we are still formulating that strategy. They are working with us, and so we don't anticipate any sort of de-listing activity in the near term. At a minimum, we would expect we would have enough time through our annual meeting in order to either execute on the strategies to which Joe Campanelli was referring or be able to propose action for a shareholder meeting.

Mark Steinberg - *Dawson James Securities - Analyst*

Are they giving you an extension?

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

There is an extension that is allowed and that they have allowed us to take advantage of through the annual meeting.

Mark Steinberg - *Dawson James Securities - Analyst*

I see. Okay, well, thank you.

Operator

Your next question comes from the line of [John Lux] from IMS. Your line is open.

John Lux - *IMS - Analyst*

Thank you. Good morning from Europe. We are monitoring some regional banks as canaries in the American coal mines. And as a matter of fact, in relation to the previous quarter results, I am missing the taxes ratio on your slide number 4. It was mentioned there as nonperforming assets over tier 1 capital per general reserves, and that figure I am missing. It was rising in quarter two it was 34%, in quarter three it's 28%, and now I have no clue what it should be. But considering the rise of the nonperforming residential mortgages of 90 plus days of almost 10% to something like $44 million or $45 million, which oddly enough, coincides also with the total net loss of about $44 million. Well, I'm a bit worried concerning the taxes ratio continuing to increase? But I don't know how much it is right now.

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

Yes, sir, this is Paul Borja. We had normally included that calculation. We omitted it this time, but we will go ahead and include it and we will find a way to include it in our later filing today. The taxes ratio that we computed based upon our calculations, this is the [seat] that you're used to seeing, would have based upon, we calculated it as 38.5% ratio from the SNL's financial perspective, the way they calculated it, it's about 92.18%. And then from our regulatory perspective, the way the OCC classifies it, is 61.84%.

John Lux - *IMS - Analyst*

Did I understand it good that it now rose from the last quarter 38% to 51% now?

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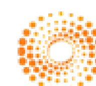

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Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

From -- our prior quarter was 35.9%, the way we had calculated it to now 38.5%, and then from the SNL perspective --

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John Lux - *IMS - Analyst*

You see, on the previous quarter results, it was mentioned that in quarter three you had nonperforming assets over tier 1 capital per general reserves had a ratio of 38.58%.

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

Yes sir. And that is in comparison to 35.9% up from quarter three.

John Lux - *IMS - Analyst*

And now, how much is it now?

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

38.5%, the way we calculated it as of the end of Q4 versus the 35.9% at the end of Q3.

John Lux - *IMS - Analyst*

Okay. And then you mentioned -- not you, the CEO, on the slide 19 which is based on the figures on the slide 17 that you saw some kind of a flattening of the 90 plus day residential first mortgages which are turning delinquent. I am very sorry, but I continue to see there a increase quarter after quarter of between $40 million and $45 million in that class of assets. Especially when I look closer to the figures of the 60 to 90 days past due, that remains some of [that latter] of $45 million -- $40 million, $45 million, and that continues quarter after quarter. So, I assume that the 60 to 90 days past due are the ones who will come into the 90 plus day residential first mortgages which turned delinquent.

Mike Maher - *FLAGSTAR BANCORP INC - EVP, Director of Mortgage Servicing and Operations*

John, this is Mike Maher. The activities that we undertook throughout the fourth quarter and continue to ramp up as we go into 2012 in terms of loan modifications are activities that will reduce the overall level of a nonperforming residential mortgage loans on a quarter-over-quarter basis beginning in 2012. Indeed, we did have an overall increase in nonperformers in the fourth quarter, but it was driven primarily by the onset of our increased loan modification efforts with residential borrowers here in the states. So, as we enter into 2012, I think you can look to see a -- while there has been already an abatement of both 30 and 60 day delinquencies, as shown on slide 18. You will see as we begin the first quarter of 2012 and thereafter a downward trend in the overall level of delinquencies. Assuming that our efforts continue as successfully as they have in the fourth quarter of 2011.

John Lux - *IMS - Analyst*

But the 90 plus days will continue to rise.

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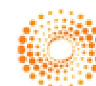

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Mike Maher - *FLAGSTAR BANCORP INC - EVP, Director of Mortgage Servicing and Operations*

No, the 90 days, in our opinion, will not, as 30s and 60s have abated, the inflow into 90s, as well as our efforts to modify those customers that are in 90 or otherwise find loss mitigation solutions, which includes deed in lieu or short sales, our projections are that the overall 90 day level of residential mortgage loans will show improvements in each of the quarters, beginning in 2012.

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

Both from a lower roll rate coming out of 30s, 60s and accelerated mitigation.

Mike Maher - *FLAGSTAR BANCORP INC - EVP, Director of Mortgage Servicing and Operations*

Exactly.

John Lux - *IMS - Analyst*

Okay. And something that is not mentioned in this report, but I -- after the falling off of the published -- of the publication of the Company concerning shareholders and [sales] and something, I estimate that's about 5% to maybe 8% each year new shares are issued to staff, and I see that they, well, practically all they continue to dump those received shares immediately on the stock markets. What -- which gives to outsiders an impression of that, well, the employees, they do not trust that much evolution in the Company. What -- can I ask your comments on that, because 5% to -- each year 5% to 10% of additional shares which are practically immediately dumped on the stock markets, well, that comes to the issue which my colleague has already touched, that is the matter of the de-listing.

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

Right. This is Paul Borja. The share transactions to which you are referring are most likely the ones that were being reported on Form 4 for the SEC. Those reflect for the different officers the shares that they receive as part of their salaries. The shares that they receive as part of their salaries must, for tax purposes, be provided to them net. So, that is that a number of shares equal to the tax they would otherwise pay to the IRS has to be withheld. In prior filings we would show that the total amount of shares that were granted, and then we would show that the amounts that were withheld. No shares are actually sold into the open market by the employer by the Company.

This question was raised by some other investors because of potentially confusing disclosure. Because of that, about a month ago we began reporting the shares net, that is the amount that actually goes to the individual. So that now, for instance, as recently as these past filings, you can clearly see that there are shares going to the employees as salary and that no shares are being disposed of. And that has been the case the whole time, it's been more a matter of disclosure within our sales. I have not sold, our CEO has not sold, key members of management aren't selling. We are instead aligning ourselves with shareholders, and we have shares as well as everyone else. But there is not a dumping of shares or selling the shares by executive management.

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

And the magnitude of those shares don't represent 5% to 8% of the bank at all. It's a much, much lower percentage of outstanding shares.

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

Right, and I would say to the opposite, in 2010 we raised capital, and many members of the executive team actually contributed and purchased shares in those offerings as well. So, we are holders -- we are acquirers and holders of the stock. And we've worked to correct the form disclosure

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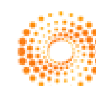

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that has created confusion among a number of investors, and rightly so. So, we believe we have taken the appropriate action, talking with our outside securities counsel in how best to reflect that, and we believe we are doing so now.

John Lux - *IMS - Analyst*

Okay, thank you. Continue the good work.

Paul Borja - *FLAGSTAR BANCORP INC - EVP, CFO*

Thank you. I appreciate your call.

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

And good afternoon. Good evening, rather.

Operator

And you next question comes from the line of [Chaigo Hill] from Market Group. Your line is open.

Chaigo Hill - *Market Group - Analyst*

Thanks for taking my question. Just a clarification on the TDRs. Once they start -- they are performing, once they clear the six month hurdle, they would right away go into the loans category and go out of the whole delinquent margin that you have here?

Mike Maher - *FLAGSTAR BANCORP INC - EVP, Director of Mortgage Servicing and Operations*

That is correct. That is correct. They would become essentially current loans. As the vast majority of our modifications today that are less than six months are performing and paying as agreed.

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

Correct me, they will become -- they will come out of the nonperforming category, but they will stay -- once they are TDR, they're always a TDR and will stay in the classified under the SNL taxes ratio. So, when you look at earlier in our conversation, we talked about the difference in our perspective. Once these have seasoned into performing and show that there's desire and capability to continue to perform, they are still part of that classification.

Mike Maher - *FLAGSTAR BANCORP INC - EVP, Director of Mortgage Servicing and Operations*

Always a troubled debt restructuring, but they will not be reflected in 90 plus, which is where you're seeing the increase. They will be reflected in the appropriate delinquency bucket, most likely in the current bucket, given that the vast majority are paying as agreed.

Chaigo Hill - *Market Group - Analyst*

Okay, so in that case, the $22.7 million from Q3, assuming the 20% re-default rate on that, they should be expected to go out by end of Q1? Is that correct? The remaining performing ones.

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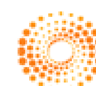

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Mike Maher - *FLAGSTAR BANCORP INC - EVP, Director of Mortgage Servicing and Operations*

That's it exactly.

Chaigo Hill - *Market Group - Analyst*

Okay, and just wanted to pick your thoughts on the fed's proposal of converting the foreclosed homes or the delinquent homes to some extent on the real -- rental markets, how it's going to affect you, or how do you see your markets being affected by that?

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

We really don't expect any direct, or for that matter, a significant indirect impact. I think overall, anything that stabilizes or improves of the national housing market is good for Flagstar and good for every bank and good for, I think, all of us taxpayers, because we do need stability in housing to really get some traction under an economic recovery. But we don't have any -- it won't be a direct impact one way or the other, but I think a good housing agenda that is well thought out and transparent will allow everyone to be making decisions in a better environment. I don't know if you have anything other --

Matt Kerin - *FLAGSTAR BANCORP INC - EVP, Managing Dir., Mortgage Banking and Warehouse*

No, I would concur, Joe. I think that as you look at the level of the other inventories are coming, they are continue to come down. You've seen the number of foreclosures that picked up after the moratorium began then come back down. It's really recently driven in terms of the impact it's going to be, and rental prices versus the ability to purchase in this rate environment are pretty much at a breakeven point right now. So, it's going to depend on the housing policies that will hopefully stabilize the values of housing and give people a better outlook about home ownership.

Chaigo Hill - *Market Group - Analyst*

All right, and finally, on the HARP 2 plan, if -- even though it's too early right now, but just comparing how it has performed overall for the markets compared to the recent HARP program, what kind of signs are you seeing there?

Matt Kerin - *FLAGSTAR BANCORP INC - EVP, Managing Dir., Mortgage Banking and Warehouse*

This is Matt Kerin. We are seeing a lot of interest in the program. I think the benefits to HARP 2 that didn't exist with respect to the original HARP program were the cost to the homeowners in terms of their ability to get the mortgage on more affordable terms, as well as the lessening of the underwriting. We have been a significant modifier of loans under the initial program, and I would expect that we will continue to do so. We will be less impacted than many because we actually have been an active seller of our servicing over the years, and many of the loans that we have sold would be those that are better candidates for the higher LTV thresholds that have been built into the HARP 2.0 versus the original HARP.

Chaigo Hill - *Market Group - Analyst*

Okay, thank you.

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

Sara, if we have another question, we have time for one more.

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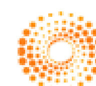

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Operator

There are no further questions in queue.

Joseph Campanelli - *FLAGSTAR BANCORP INC - CEO*

All right, well, great. Thank you everyone for joining us this afternoon. We look forward to continuing our dialogs. Have a great day

Operator

And this concludes today's conference call. May now disconnect.

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