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PRESENTATION

Operator

Good day, and welcome to the Flagstar Bank fourth-quarter 2014 earnings call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Mr. David Urban, Director of Investor Relations. Please go ahead, sir.

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

Thank you, Brian, and good morning. Welcome to the Flagstar fourth-quarter 2014 earnings call.

Before we begin, I would like to remind you that the presentation today may contain forward-looking statements, both regarding our financial condition, and our financial and operating results. These statements involve certain risks that may cause actual results in the future to be different from our current expectations. For a non-exhaustive list of such factors, please see our 2013 Form 10-K, and our first-, second-, and third-quarter 2014 Form 10-Qs, as filed with the SEC, as well as the legal disclaimer on slide 1 of our fourth-quarter 2014 earnings call slides that we have posted today on our investor relations site at Flagstar.com.

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

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

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

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

Thanks, Dave, and thank you, everyone, for joining us today. In addition to Dave, I am joined this morning by Jim Ciroli, our Chief Financial Officer; Lee Smith, our Chief Operating Officer; Steve Figliuolo, our Chief Risk Officer; and Mike Flynn, our General Counsel.

I'd like to take a moment to describe the order of the call. First, I'm going to highlight the key items and actions we undertook during the fourth quarter. After my remarks, Jim will review the consolidated quarterly financial performance. Lee will then provide a more detailed review of our business segments and strategic initiatives. Following this, I will conclude with a view of our 2015 first quarter, and then open the call for questions and answers. With that, let's begin.

During the fourth quarter of 2014, we increased core profitability with no unusual adjustments, reflecting our sustained commitment to revenue growth, solid asset quality, and continued expense discipline, all supported by stronger risk management and compliance programs. We reported net income of $11.1 million, or $0.07 per diluted share, as compared to adjusted net income of $7.7 million, or $0.01 per diluted share in the third quarter. Importantly, net income this quarter contained no significant items.

Non-interest income grew by $2.9 million, or 3% on an adjusted basis, to $98.4 million, driven by increased net gain on loan sales, and an improvement in the R&W reserve driven by lower loss experience. Non-interest expense declined. Total non-interest expense fell $1.5 million, or 1% on an adjusted basis, to $139.3 million, led by lower legal and professional fees, and other non-interest expense.

Credit-related costs declined. Total credit costs, including net charge-offs from HFI loans and the R&W reserve, and after resolution expense, totaled $12.3 million in Q4 versus an adjusted $23.9 million in Q3, a decline of $11.6 million.

Capital increased; our Tier 1 leverage ratio rose 9 basis points to 12.6%. The balance sheet also remained very liquid, with cash and agency securities representing 17% of total assets.

We have also continued to add experienced leadership throughout the Organization. Andy Fornarola was hired to run community banking. Andy was most recently EVP and Head of Consumer Finance at First Niagara, and also brings experience from M&T and HSBC.

Mark Landschulz joined our servicing team to lead performing servicing. Mark comes to us from Quicken Loans, where he was their Head of Servicing.

Jim Levites was hired to run specialty servicing. Jim is a veteran of the specialty servicing business, and comes to Flagstar with over 30 years of experience in the business, much of it with CitiMortgage.

More recently, we adjusted our regional management team in the TPO mortgage business to flatten the organization, reduce operating expenses, and better position us for future growth in our mortgage origination franchise. That group is now being led by Brian Vieaux, who most recently was managing our retail mortgage group. Brian came to Flagstar in 2012, with over 20 years experience in the third-party mortgage origination business, primarily with CitiMortgage and IndyMac.

Moving on to our results: While Jim and Lee will provide further detail and analysis in their remarks, I'd like to begin by noting that I'm extremely pleased that this quarter's earnings are the result of core operations. In that regard, I'd like to emphasize a few items. First, we have built a stronger risk management organization, and will continue to improve our compliance infrastructure. Risk management and compliance have been, and will remain, a top priority for this management team.

Second, we will continue to manage risk in order to maintain asset quality and the consistency of credit costs. Third, we remain committed to managing and controlling expenses to support profit growth.

Fourth, we continue to pursue prudent revenue growth, both in net interest income and non-interest income. And lastly, more than ever, we are confident in the future prospects for Flagstar, as we continue to build a company that we believe will produce consistently improving growth in core earnings and shareholder value. As I've said before, we are deeply dedicated to the task at hand.

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

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

Thanks, Sandro. Turning to slide 5, our net income was $11.1 million, or $0.07 per share in the fourth quarter, as compared to an adjusted net income of $7.7 million or $0.01 per share in the third quarter. Driving the overall increase in adjusted net income was the positive operating leverage for the quarter, led by a 1% decline in expenses with stable revenue.

Our fourth-quarter net interest income fell to $61.3 million, as compared to $64.4 million for the third-quarter 2014. The decrease in net interest income was due to lower interest income from loans repurchased with government guarantees, and from lower levels of average consumer loans.

Our NIM dropped 11 basis points in the quarter to 2.80%, mainly due to a lower yield on the Company's Ginnie Mae early buy-out portfolio, and a 21-basis-point reduction of the yield on loans held for sale. The lower yield on Ginnie Mae loans resulted from a combination of lower rates and updated assumptions on the realizability of the interest income claims on these loans, which, while government-guaranteed, are subject to certain performance standards. In prior quarters, the provision for expected losses on this interest income was reported in asset resolution costs. The lower yield on loans held for sale resulted from lower mortgage rates in October.

Earning assets fell 1% last quarter due to the consumer loan portfolio paydowns, and a late third-quarter sale of jumbo mortgage loans. This slight decrease was partially offset by increases in commercial loans, especially in our warehouse lending portfolio, as our success in opportunistically growing our commercial book continued.

Average total deposits increased 1% from the prior quarter, driven by higher retail savings and government deposits, partially offset by lower retail money market accounts and CDs. We had continued success with our promotional campaign to increase retail savings accounts.

The quarterly provision for loan losses fell $3.1 million to $5.0 million for the fourth quarter. During the quarter, we had $9 million of net charge-offs. Excluding $3 million of net charge-offs on loans sold, net charge-offs were $6.0 million. I'll provide additional details on asset quality in a couple of minutes.

Non-interest income increased to $98.4 million in the fourth quarter, as compared to an adjusted $95.6 million during the third quarter, excluding last quarter's $10.4 million of indemnification-related charges. The improvement in non-interest income included an $8.2-million improvement in our representation and warranty activity, excluding last quarter's indemnification charges. We received $2 million in recoveries of prior rep and warranty losses, and a $4-million downward reserve adjustment based upon updated loss rates on Fannie Mae and Freddie Mac claims. A $1.4-million, or 3% increase, in gain on loan sales, we saw higher refinance volume driven by lower rates in October and early December, partially offset by a seasonal decline in purchase volumes. Our gain-on-sale margin of 87 basis points was 4 basis points higher than the third quarter, and a $300,000 improvement in the net return on mortgage servicing assets, which rose modestly to $1.6 million from $1.3 million in the prior quarter.

Our gross return on the MSRs was 7.4%, slightly lower than we experienced in the prior quarter, as a result of higher prepayments. This gross return in Q4 was reduced by transaction costs and losses on sales totaling $3.5 million, as we sold $70 million of MSRs. Additionally, third-quarter results were reduced by updated model changes, which reduced the fair value of MSRs in that quarter by $3.3 million. To help you understand all of this activity better, we've added slide 33 to the appendix.

These positive developments in non-interest income were partially offset by: a $3.1-million decrease in net gain on sale of assets. Gains in Q4 were $1.7 million, as we sold $24 million of lower-performing mortgage loans, whereas Q3 gains included the sale of $48 million of performing jumbo mortgage loans and $33 million of lower-performing mortgage loans; a $2.2-million decrease in other non-interest income due to lower gains on security sales and lower fair value adjustments on mortgage loans; and a $1.9-million or 10% decrease in loan fees and charges primarily due to a drop in mortgage closings for the quarter.

Non-interest expense fell 1% to $139.3 million in the fourth quarter, as compared to an adjusted $140.8 million in the third quarter. This included a $3.2-million decrease in legal and professional fees, excluding the legal costs in Q3 related to the Company's CFPB settlement. The decrease was from lower consulting expenses. A $2.0-million decline in other non-interest expense, excluding the Q3 CFPB settlement, due to lower settlement costs and other losses; and a $300,000 decline in asset resolution costs, which fell slightly to $13.4 million despite a $2.0-million provision related to prior loss recoveries.

The improvement in asset resolution costs was due to process improvements and lower levels of problem assets. These improvements were partially offset by an increase of $5.5 million in compensation and benefits reflecting higher levels of incentive compensation, and $2.6 million of severance costs.

Slide 6 shows our operating metrics. We've already talked about the profitability metrics here, and I would like to focus on our operating leverage, which was positive, as expenses declined 1%, with stable revenue. This performance was a significant improvement from the negative operating leverage in the third quarter. And our capital remains strong, with our Tier 1 leverage ratio improving 9 basis points.

Slide 7 highlights our period-end balance sheet. For the [fifth] consecutive quarter, we remained under $10 billion in assets at period end. While this will provide certain financial benefits, such as lowering our FDIC insurance costs and relief from Durbin, which is assessed based upon the Bank's asset size at December 31, we do not intend to remain under this level. For the past two quarters, our average assets have been higher than the $10-billion level, and we expect to see balance sheet growth throughout 2015.

Turning to slide 8, our allowance covered 7.0% of total loans at the end of the fourth quarter, as compared to 7.6% at the end of the third quarter. The total allowance coverage ratio declined, even though the coverage ratios for both the consumer portfolio and the commercial portfolio remained relatively flat. This is because the commercial portfolio continues to comprise an even larger percentage of our total loan book.

Taking a deeper look, the allowance coverage of consumer loans was flat, as the consumer allowance coverage ratio was 11.0% at December 31, compared to 11.1% at the end of the prior quarter. The commercial loan allowance coverage ratio declined in Q4, reflecting the low level of problem loans in this portfolio, and growth in higher-quality loans, such as warehouse loans during the quarter.

Non-performing loans were $120.5 million at the end of the fourth quarter, as compared to $106.9 million at the end of the third quarter. This $13.6-million increase was driven by higher non-performing TDRs.

There were $9.5 million of loans that were modified in 2009 into five-year balloon loans, which matured during the third quarter, and had not yet been refinanced or modified as of December 31. Of these loans, 93% have been paying since their respective maturity. Despite this increase, non-performing assets remained relatively stable at 1.41% of total assets, as OREO levels declined due to sales. Early-stage delinquencies were down from Q3.

Looking at consumer loans, 1.6% of consumer loans were over 30 days delinquent, and still accruing; an improvement of 28 basis points from last quarter. There were no commercial loans at December 31 that were more than 30 days delinquent. During the quarter, we had $9 million or 91 basis points of net charge-offs, including $3.0 million of charge-offs on loans sold, or 31 basis points. Excluding loans sold, net charge-offs were $6.0 million.

Turning to slide 9, we have details on our representation and warranty reserve. We had favorable experience in this quarter on a few items. First, we had net recoveries this quarter. This was due to favorable results on claims, which were $2.3 million lower than in Q3, as well as recoveries, which were $2.2 million better than in Q3.

Second, as we look at the $7-million reserve we established last quarter, we only had claims of $188,000, which we replenished through additional provision. Third, as a result of having more data points to populate our vintage analyses by virtue of the passage of time, and reflecting upon favorable experience we've had recently, as well as other external factors, we reduced our ending balance of the reserve by $4 million to $53 million from $57 million at the end of last quarter. I would also point out that we add to this reserve continuously by reducing the gain on loan sales, excluding [government] guaranteed loans, by 4 basis points for every loan sold.

Turning to slide 10, we continue to maintain robust regulatory capital ratios. Our Tier 1 leverage ratio was largely unchanged for the quarter at 12.6%. Our Tier 1 common ratio was 12.9% for the fourth quarter, as compared to 12.7% at the end of the third quarter.

Looking at the impact of a fully phased-in implementation of Basel III, our Tier 1 leverage ratio would be 10.2% and our Tier 1 common ratio would be 9.1% at the end of the quarter. This 240-basis-point impact to our Tier 1 leverage ratio is mostly driven by the detrimental treatment that mortgage servicing rights receive under Basel III. Over the long term, we plan to continue to reduce our MSR-to-Tier-1 ratio, taking into consideration market conditions to guide our pace of MSR reduction.

Excluding our preferred stock from Tier 1 capital, our consolidated Bank Corp Tier 1 leverage and Tier 1 common ratios under Basel I would be 9.2% and 11.8%, respectively. As we stated last quarter, we continue to evaluate all of our options with respect to our preferred stock, including the $56 million of preferred dividends that we've deferred to date.

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

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

Thanks, Jim, and good morning, everyone. This quarter we were able to see some of the benefits from the significant efforts over the last 18 months to de-risk the balance sheet and optimize our cost structure. The objective of those efforts was to create a solid foundation that was profitable on a sustainable basis, and one from which we could grow in a prudent and effective manner. As we start to focus more keenly on growth strategies across our three business line verticals, I want to start by outlining some of the key operating metrics from each segment during the quarter.

Please turn to slide 12. Quarterly operating highlights for the community banking segment include: average commercial loans increased 5% to $1.5 billion versus the prior quarter. The portfolio remains balanced among both industry type and collateral, with the majority of our borrowers right here in Michigan. Where the borrower or property is not in Michigan, it is typically because we have followed a strong Michigan-based customer.

New C&I and CRE loan originations in the fourth quarter were $218 million. Commercial loan commitments grew 8% quarter over quarter to $2.9 billion. During 2014, we've grown C&I loan balances by $212 million, CRE loan balances by $211 million, and warehouse loan balances by $345 million, for a net increase in new loan balances of $768 million during the year.

Average consumer loans fell $125 million, or 5%, in Q4, driven primarily by paydowns in consumer HFI loans and a $48-million jumbo loan sale at the end of Q3. The reduction in average consumer loans during 2014 of approximately $500 million has been the result of $560 million UPB jumbo loan sales during the year, and the sale of $93 million UPB scratch-and-dent, NPL and TDR loans. Average interest-bearing deposits increased more than 10% during 2014, driven by higher retail and government savings deposits.

It is our intention to continue to grow our commercial businesses, including warehouse lending, in a controlled, safe and sound manner, as we have been doing to date. We offer warehouse lending on a nationwide basis to our own TPOs, as well as TPOs who sell loans to other investors.

In the C&I and CRE segments, we continue to focus on the Michigan market, and we are also looking at new products that leverage existing skill sets within the Bank. As Sandro noted, during the quarter we brought in Andy Fornarola to head up our community banking business line, and we're excited by the potential of combining our own community banking platform with Andy's experience, particularly in the consumer lending space. We will also look to opportunistically add jumbo, and even conventional, loans to our HFI portfolio throughout 2015, if it makes sense economically to do so.

Please turn to slide 13. Fourth-quarter operating highlights for the mortgage origination business include: fallout adjusted gain on sale margin, which is what we use when reporting gain on loan sale, increased 4 basis points to 87 basis points in the fourth quarter, as compared to 83 basis points in the third quarter. Lock volume remained relatively steady at $6.2 billion.

Purchase mortgages accounted for slightly more than 53% of origination volume in the fourth quarter, as compared to slightly more than 62% of origination volume in the third quarter. We took advantage from the drop in interest rates at the beginning of the quarter, as the 10-year bottomed out to 2.09 on October 15. And although it rallied a little for the remainder of the quarter, we've seen another steep drop at the beginning of 2015, which has been beneficial for our origination business, as refinance activity has picked up. We continue to remain focused on providing service excellence, and monitor our quality metrics and turn times daily, while at the same time implementing strategies to eliminate excess capacity and create a more variable cost structure on the fulfillment side of the Business.

As I mentioned, our origination business is certainly benefiting from the lower interest rates at the beginning of this year. And we've also been working to take advantage of the recently announced FHA mid-production of 50 bps. We see both of these events as having potential upside to our Q1 origination activity.

We continue to look at technology as a way to further improve the top-line performance, and make us more efficient from an operating point of view. And we are also focused on being ready for the new RESPA-TILA disclosure requirements that go into effect later this year. Finally, we are committed to growing our retail origination business on both the retail distribution and direct to consumer sides of this business, and we'll keep you apprised of progress here on future calls.

Moving to servicing: Quarterly operating highlights for the mortgage servicing segment on slide 14 include: we executed on the sale of $6.4 billion in aggregate UPB, or 72,000 loans of residential MSRs during the quarter. And we will act as the sub-servicer on 22,000 of these loans going forward.

We currently service approximately 383,000 loans, of which 238,000 are sub-serviced for others. The remaining 145,000 are loans where we own the MSR or they're part of our HFI book. Approximately 96% of our servicing book is performing loans, which means 4%, or approximately 15,000 loans, are 60-plus days delinquent. We're always looking at ways to reduce the number of default and delinquent loans in our portfolio, given that servicing and working out delinquent loans is not part of our core growth strategy.

Mortgage servicing rights fell $27.6 million, or 10%, to $257.8 million, as a result of the $6.4 billion in MSR sales during the quarter. And our MSR-to-Tier-1 capital ratio decreased from 24.9% at the end of Q3, to 21.8% at the end of Q4. It's important to note that while the low interest rate environment and MIP reduction provide opportunities on the origination side of the Business, it will potentially lead to pressure on the valuation of the MSR asset, given likely higher prepayments.

As previously mentioned, during the quarter we recruited Mark Landschulz to run performing servicing and Jim Levites to run special servicing, which includes default servicing oversight and collections. Given our desire to be a best-in-class player in the mortgage servicing space, we thought it prudent to bifurcate performing and default servicing, given their critical importance. This will allow us to focus maximum attention to both areas at all times, particularly given the heightened regulatory and compliance attention around default servicing.

As we've previously outlined, our focus is on growing our sub-servicing platform, and we believe we can do this in three ways: selling MSRs we create, and sub-servicing those loans; onboarding and sub-servicing loans we did not originate; working directly with the GSEs and Ginnie Mae to offer an alternative servicing platform for their book of loans. We also want to better leverage the cross-selling we are able to do across our three business line verticals, in order to increase share of our mortgage customer's wallet and the number of accounts per household. This initiative is in its infancy, but now that we have the right team in place, we believe there are significant opportunities for us to pursue.

We continue to de-risk the balance sheet by resolving problem assets, including our IO portfolio. If you turn to slide 15, you will see that we have $628 million of interest-only loans on our balance sheet that are yet to reset. Of this, $313 million, or 50%, are due to reset during 2015. The anticipated payment shock associated with these resets versus current payments is approximately 104%.

Slides 15 and 16 of the earnings presentation contain a lot of key data points around this portfolio, in order that you can see how we're handling and tracking the IO book. Rather than reciting the metrics from these slides verbatim, I want to focus on a few key highlights. But before that, I would just say that we continue to be extremely pleased and encouraged with the performance of this portfolio.

Key takeaways include: of the 1,284 IO loans that have reset through December 31, 2014, 25.6% unpaid principal balance have paid in full; 37.2% UPB, or 516 loans, are cash flowing resets, of which 501 have been paying for three months or more; and 363, or 70% of this specific population, have been paying for six months or more. 5.8% UPB, or 92 loans, have been charged off or foreclosed on; and of this, 84 defaulted prior to the reset date, and only 8 defaulted post-reset.

For Q4, we had a right party contact rate of 100%. We're currently at 95.4% for Q1, where we have 412 IOs resetting.

With respect to overall quality, slide 15 shows that 85% of all remaining IOs have FICO scores greater than 660, and 87% of those same loans have LTVs less than 100%. The rolling 12-month average loss severity on the IO portfolio is 37%.

Now moving to our HFI loan book and de-risking efforts here: We sold approximately $24 million UPB of scratch-and-dent loans, NPLs and TDRs during the quarter for a gain of $1.6 million after transaction costs. We've now sold approximately $600 million in UPB of NPLs, TDRs, and scratch-and-dent loans during the last 18 months as part of a concerted effort to de-risk our balance sheet and reduce the costs associated with non-performing assets. It's been a busy quarter, as we continue to reduce risk in the balance sheet, which has been necessary in order to create the platform from which we can push on and grow in our three major business line verticals.

Moving now to expenses on slide 17: Our non-interest expense during the fourth quarter was $139.3 million. This compares to $140.8 million for the third quarter, after adjusting for costs associated with the CFPB settlement. And we believe our current non-interest expense quarterly run rate is approximately $133 million to $138 million. Our Q4 non-interest expense run rate would have been $135 million, after subtracting the $2.6 million of severance costs and $2 million of provision related to prior loss recoveries that Jim mentioned earlier.

During the fourth quarter, we completed a detailed cost review by business unit. This was a bottoms-up approach where we went through every cost line item for our 28 business units. We identified many cost-saving opportunities that we are already working on implementing.

As a result of our expense management, what you should see as we look forward is a cost base that will improve slightly from where we are today, even though we are growing the three major business line verticals. This reflects the increased operating leverage and expense discipline that has been instilled within the Organization, even as we invest some of these savings into our future growth strategies.

Managing our cost structure aggressively will continue to remain a focus. Our goal is to reduce excess capacity, and create a more variable cost structure across the Organization. And we will continue to build on the work we have done to date around vendor management and procurement expenses, asset resolution costs, legal and professional fees, and optimizing our real estate portfolio in particular.

With that, I'll hand it back to Sandro.

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

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

On slide 19 are those itemized guidance parameters. We expect net interest income to increase slightly, led by modest earning asset growth. The net interest margin is expected to be relatively stable, but it could narrow a bit.

Given the current level of interest rate and volatility, mortgage locks are expected to be at least 5% above Q4 levels. We expect a modest improvement in gain on loan sale margin.

We expect loan administration income to be flat to up, while the net return on the mortgage servicing asset will continue to be challenged by volatility in interest rates and transaction costs on any sales we might execute. The ratio of our MSR to Tier 1 capital may rise from year-end levels as we properly react to market conditions.

We expect our provision expense to be at or possibly slightly above Q4, and asset resolution expenses to decline, with no significant change in R&W reserve levels. And, as Lee noted, we expect non-interest expenses to be between $133 million and $138 million.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Scott Siefers, Sandler O'Neill Partners.

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

Lee, I was hoping you could clarify, or I just want to make sure I understand your comments on the expense base correctly. So it sounded like you suggested we could see a little relief even from here despite growth in all the business lines. Should we take that to mean that if refis are total and originations come in better than you might expect throughout the year the cost base is going to be pretty firm still in this sub $140 million level regardless of the origination volume?

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

I'll let Lee answer that more specifically, Scott, but I'll start by saying that at this point the guidance that we're giving is limited to Q1 and that $133 million to $138 million range. But certainly what you're suggesting is what we'd like to see happen. Let me let Lee elaborate on that.

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

I think what I would say, Scott, it obviously depends on the level of refinance activity. Obviously at some point you're going to see some increase, but I think what I would say, and as I mentioned in my prepared remarks, we believe we'll be between $133 million and $138 million for Q1.

And during the fourth quarter we completed a detailed bottoms up cost review by business where we did identify many cost saving opportunities that we're currently working on implementing. But as you mentioned the key here is we're going to invest some of these savings in growing all three of our major business line verticals.

So, as we move forward you should see a cost base that will be more efficient from an operating leverage point of view. I think what you ask is you will see -- you should see what you alluded to, but again it just depends on what sort of volumes we see, because at some point you will see a greater increase.

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

That's helpful. Thank you. And then switching gears a little, Sandro, are you able to update or provide any additional clarity on what you might be able to do with the former TARP preferreds and anything for timing on some flexibility or relief there?

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

I can tell you this. We're certainly aware of the situation and we're investigating all the opportunities that might be out there for us. Jim, anything you want to add to that?

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

Scott, I appreciate the question, but we don't have an update at this time.

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

Okay. And then maybe final question. So you bounce around the $10 billion asset level, and Jim you suggested that we probably won't stay there, stay below $10 million for very long. Which, I guess brings Durbin and FDIC more into focus.

As you look at potentially those kinds of dynamics impacting your numbers or pressuring your numbers once you go above and sustain over $10 billion, what are the plans to counter some of those pressures and are they enough to overwhelm any of the pressures that would come? Or how are you thinking about that dynamic?

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

I think that what I would say is as we got near the end of the quarter what we saw was that we were in measurable distance of still staying under $10 billion. So we decided to limbo under $10 billion. The Durbin pickup alone was about $3 million.

What I would point out is that because we've been under the $10 billion mark all year long, throughout 2015 we're going to be under small bank pricing on FDIC. And the Durbin benefit should persist throughout 2015 into the first half of 2016 as well.

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

So the concern that you expressed relative to what happens on the cost side or how it negatively impacts our operating leverage is more of a 2016 event?

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

No. Now how I'd answer the cost question, Scott, is we've already made the investment. I really don't see much in the way of incremental costs from being over $10 billion. We already have the investment --

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

Well, you have the FDIC costs.

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

Yes. Earliest in 2016.

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

Okay. I guess that's where the thrust of my question was. At some point there's going to be a revenue hit from going and staying above $10 billion. And is that the kind of thing you think you can absorb, or will you have to have additional cost cuts or other pricing changes to counteract any of those in the eventuality of it?

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

No. At that point in time we'll be able to absorb that.

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

Sounds good. Thank you.

Operator

Paul Miller, FBR Investment Bank.

Paul Miller - *FBR & Co. - Analyst*

Thank you very much. Taking a step back a little bit, because I'm not sure if I picked everything up. But on slide 15, Lee, you went through this slide, which I think is very good, but I want to make sure I understand it completely.

You had total resolutions, right, of 1,171? Were they total resolutions out of what? Were they all the loans that reset in 2014 that were in the IO book?

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

The way to look at this, Paul, is from January 1, 2013 through December 31, 2014 we've had 1,284 IOs reset. And the table on the right-hand side shows you exactly what's happened to all 1,284 of those loans.

Paul Miller - *FBR & Co. - Analyst*

So, of the 1,284 loans 300 basically paid in full. And then the cash flow resets -- what exactly is that? Can you explain that to me?

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

Sure. There's a couple of things. One, so you know, Paul, we had about 440 loans reset in Q4. So of that 1,284 about a third of that actually did reset in Q4.

The cash flow in resets of loans where you've hit the reset date, the payment shock has occurred, and these borrowers continue to pay at the higher monthly mortgage payment rate. And then the chart on the left-hand side, it actually -- we're tracking how long after the reset date where you have these cash flow resets of the borrowers continued to pay.

As you can see from the chart a significant amount of these borrowers have been continuing to pay for more than six months following the reset. This is an important metric for us to track because where there is a reset and they are paying the higher monthly rate, we want to make sure that they are comfortable and able to make that payment. As soon as we see any change in payment behavior we're back on the phone to these guys.

Paul Miller - *FBR & Co. - Analyst*

And so if I add -- Jim, that's very clear because I didn't quite understand that. Now if I add charge-off foreclosures as roughly a 6% rate and then default servicing, these are loans that have not made the payments after the reset. Is that accurate, about 9% are running into trouble?

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

Yes. Here's what I would say, though. The loans that are with default servicing, we can still rehabilitate those loans, and we're actively trying to rehabilitate those borrowers where we can. And those will be rehabilitated through a modification. You should look at the ones that are in default servicing and say some portion of those will be modified, and we're actively working on those.

And then you've got the 92 that have charged off to date. And as I mentioned in my prepared remarks, what's interesting is 84 of those defaulted prior to the reset. So the reset wasn't the trigger for them to default. Only 8 of the 92 have defaulted post reset.

Paul Miller - *FBR & Co. - Analyst*

That's what I wanted to get clarification on that. And so, I don't know if you're willing to make this comment, but you in the first-quarter April earnings release put a very big provision out there that kind of surprised people. And I think one of the explanations was that you were concerned about these resets and how these loans would perform.

Looking on our side it looks like these loans are performing better than expected. Is this in line with the expectations for that big provision or better than expected?

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

We'll have Jim take that one.

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

I appreciate the question, but the way we look at this is very cautiously and over time. As Lee pointed out we've got a significant amount of resets yet to come. So, I think it's still too early to tell to be able to answer that question.

Paul Miller - *FBR & Co. - Analyst*

Okay. Correct me if I'm wrong, with the resets what is the reset range?

Was something in the 70% range on average? Or is it lower than that now?

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

The reset -- the payment shock for every loan that's resetting in 2015, and there's approximately $313 million UPB, the payment shock is 104%. It's effectively doubling your monthly mortgage payment.

If you look back at what resetting 2014, it was pretty similar. A little less, probably about a 98% payment shock. It's fairly comparable. 2015 is fairly comparable with what we saw in 2014

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

And the payment shock is against what they're currently paying.

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

Current monthly mortgage payment.

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

If you look at the slide on page 15 it shows you that for those that are resetting in 2015 the payment shock is only 14% against their original payment; what they were qualified for, I should say.

Paul Miller - *FBR & Co. - Analyst*

What they were qualified -- okay, because I was confused by that chart. And then on the mortgage bank, I know the first question they delved into this a little bit, the refi indexes have been up I think 60%, 70% in the first two weeks of the year.

If rates stay at these low levels it sure looks like that 5% increase in locks could be somewhat conservative. I would think that you're seeing a greater than a 50% daily application rate at this point versus December.

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

Yes. Paul, what we've seen is that the refinance activity clearly has picked up. And I think our experience is reasonably consistent with what the MBA has been talking about relative to application increases. We've seen the volume pick up in all of our production channels.

But it's only three weeks into the year here. It doesn't make a trend, but we are on top of it. We're adjusting our capacity on an ongoing basis.

We're trying to keep our costs as variable as possible, but we're ultimately going to make sure that we maximize the revenue opportunity as long as it's there. And as Lee mentioned in his prepared remarks there's also the FHA MIP reduction that's starting any day now, I think within the next couple of days.

And we've already seen activity related to that. So that's another thing that we're all over. And we're going to maximize those opportunities as long as they are there.

It's really early here to get too excited about it. So we're trying to be measured but at the same time very aggressive in our activities to take advantage of the opportunity that has presented itself.

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

Yes, let me add to that. Rates dropped sharply coming into the year, and we just don't know but they could rise sharply, as well.

Paul Miller - *FBR & Co. - Analyst*

Thank you very much.

Operator

Kevin Barker, Compass Point Research.

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

Could you talk about what might be the major impediment to repaying TARP or potentially looking at bringing your dividends current given that they are deferred right now?

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

This is Jim.

When you go to repay TARP you again have to demonstrate your ability to live without that tier 1 capital. And that is entirely dependent upon the level of risk and how well you manage that risk within your balance sheet.

So you've got to go through that regulatory exercise. So that's one impediment.

The other impediment is this is holding company level capital. So we would have to do something at the holding company level, or be able to dividend up from the bank level in order to have the cash funding to be able to either bring those preferreds current or to begin to retire them.

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

What is the major impediment to dividend that money between the bank and the holding company? Because you had close to 20% tier 2 common equity ratio per Basel III at the bank. Correct me if I'm wrong.

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

I think you're right about that. As you look at the rules and regulations, banks are subject to a two-year plus a stub period limitations on the dividends that they can upstream to the parent. So you look at the past two years of net income and that's your dividend paying capacity without getting regulatory approval.

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

Okay. And then when I think about the tier 1 leverage ratio, where it is and some of the stress tests that you're going through right now, you're close to 10% on tier 1 leverage. You have a $4 billion core loan portfolio but your total balance sheet is $9.8 billion, which is constraining you.

Is there any options there to shrink the overall balance sheet in order to deleverage and put yourselves in and de-risk the overall Company in order to put yourself in a better position to repay TARP? Is that an option you're looking at, or is this something where you say it's probably best to out earn -- to earn and increase your retained earnings in order to increase your capital base and be able to repay it a year or two down the road. I'm trying to see how you're thinking about that and how you're positioning the balance sheet.

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

Right Kevin. So I understand all of the logic that you expressed.

What I would say is that in order to be the size of mortgage player that we are, both in the origination and the servicing side, we've made the investment in the risk management and infrastructure systems that we need to really be subject to the over $10 million rules from a regulatory standpoint. We think it's going to be significantly better for us to be over that $10 billion and growing than under the $10 billion and reduce our assets, and therefore our earnings capacity, just simply to retire what admittedly is very high cost capital.

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

Is there any consideration to catch up dividends rather than repay? Or have you considered doing that instead?

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

I'm looking at all options at this point in time.

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

And then quick question on the IO arm portfolio and follow-up on some of Paul's questions. I noticed you had a 15% decline in your IO arm portfolio quarter over quarter. But reserves went up by my estimates roughly $3 million. Do you have further opportunities to make material declines in the IO arm portfolio in the next couple quarters?

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

I'll let Lee handle that more, but what I'd tell you, Kevin, is as we look forward into 2015, half the portfolio resets are over the next year. So, if anything as we look at the IO portfolio, at least from a financial perspective, and I'll let Lee answer from a business perspective, with the long lost development periods that product really has, we're going to be very cautious about taking that reserve down. We're going to take that reserve down when we know that the risk is gone.

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

What I would add from a business perspective, Kevin, is as I said in my prepared remarks when we look at this IO portfolio and how it's performing, we're pleased and encouraged with what we're seeing to date. But, obviously, we want to see a few more quarters here before we start getting some real trends.

But everything we've seen to date is encouraging. If there are opportunities to refinance these loans and the borrower wants to go down that path, then we will obviously look to do that.

If the borrowers are experiencing financial hardship and we need to move them to a modification then we will look to do that. And then, as you know based on sales of MPLs and TDRs and jumbos that we've executed on previously, if there are sale opportunities that make economic sense, then we would look to explore such sales. But I think net/net overall we're encouraged with what we're seeing from this portfolio.

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

Thank you for taking my questions.

Operator

Bose George, Keefe, Bruyette, Woods.

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

One follow-up on that IO portfolio. The 1,284 loans, what was the number of loans that were delinquent when it went into the reset?

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

Bose, we charged off 92 of the 1,284. And of that 92, 84 defaulted prior to the reset. So only 8 of the 92 have defaulted post reset.

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

Great. And then just one, another one on expenses.

Longer term, if revenues don't really grow in line with what you would expect is there room for you to take down expenses a little further? Or is there a targeted expense ratio that you think of in a more normalized basis?

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

Certainly Bose. If we're not able to achieve the revenue targets that we're shooting for internally, then we will take the action that we need to take on the expense side. Make no mistake about that.

But what we'd rather do is continue to find ways to operate more efficiently, support the growth in the businesses going forward without increasing our overall cost of operations. That's really what we're striving to do, and I'm confident we're going to be able to do that. But no question about it, we will take the action we need to take if the revenues aren't where they have to be.

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

And I would just add, Sandro, and I think history has proven that we can do that. As you know, Bose, we've taken $200 million of costs out of the business over the last18 months. So to Sandro's point we'll do whatever is necessary.

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

And just in terms of normalized expense ratios, is there any way to think about that at the moment?

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

This is Jim. As Lee mentioned we're continuing to invest in our businesses for growth. And we could always pull back that investment and just harvest, but we don't think that's the best thing to do.

And as long as we're in that growth mode I think our efficiency ratios are going to be a little bit elevated over where you'd see them trending long term. But to answer your question specifically is going to be hard to do until we really understand what the full potential of each of those three businesses are. I could probably answer it for a community banking business or an origination business, but as you blend the three businesses together they all have different expense loads to them and it's really hard to understand where the potential for those businesses is going to be at any point in the future.

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

Okay, that's fair. Thanks.

Operator

It appears there are no further questions at this time. And I'd like to turn the call back over to Mr. Sandro DiNello for any additional or closing remarks.

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

Thank you, Brian.

Thank you to all of you for your interest in Flagstar. We've been through a tough but necessary journey these last two years, and as you are aware each quarter had significant events outside of core operations. Some of those events were positive, some were not.

But Q4 did not produce any such non-core events. Instead we saw solid core earnings growth, and that solid core earnings growth was based on the strong foundation which this active and positive Management team has been committed to building at Flagstar.

We will continue on that path while remaining mindful that all of our work is based on a commitment to building this Company in a safe and sound manner. Thank you for your time this morning.

I look forward to reporting on Q1 results in April. Have a great day.

Operator

And ladies and gentlemen that concludes today's conference call. We thank you for your participation.
