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FBC - Q1 2016 Flagstar Bancorp Inc Earnings Call

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CORPORATE PARTICIPANTS

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

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

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

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

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

CONFERENCE CALL PARTICIPANTS

Paul Miller *FBR & Co. - Analyst*

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

Kevin Barker *Piper Jaffray & Co. - Analyst*

Henry Coffey *Sterne Agee CRT - Analyst*

Chas Tyson *Keefe, Bruyette & Woods, Inc. - Analyst*

Jesus Bueno *Compass Point Research & Trading - Analyst*

PRESENTATION

Operator

Good day and welcome to the Flagstar Bank first-quarter 2016 earnings conference call. Today's conference is being recorded.

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

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

Thank you, Chris, and good morning, everyone. Welcome to the Flagstar first-quarter 2016 earnings call.

Before we begin I would like to mention that our first-quarter earnings release and presentation are available on our website at Flagstar.com. I would also like to remind you that any forward-looking statements made during today's call are subject to risks and uncertainty. Factors that could materially change our current forward-looking assumptions are described on slide 2 of today's presentation, in our press release, and in our 2015 Form 10-K and subsequent reports on file with the SEC.

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*

Thank you, 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 Len Israel, our President of Mortgage Banking.

I am going to start the call by providing a high-level view of our performance for the quarter. Then I will turn the call over to Jim for a deep dive into our financial results. Lee will follow with a more detailed review of our business segments and strategic initiatives and I will conclude with guidance for the second quarter before opening up the lines for questions.

We had another successful quarter, further validating our business plan and marking our fifth-straight quarter of putting strong, consistent earnings on the board. Earnings grew 18%, producing a 1.2% return on assets, while capital, liquidity, and credit quality all remained strong. It was a great start to the year.

We took advantage of market opportunities, overcame seasonality, and had a strong rebound in mortgage originations, booking $6.9 billion of fallout-adjusted locks for the quarter. And closings increased 9%, significantly outpacing the market.

On our last call, we talked about our desire to increase our distributed retail and direct-to-consumer originations and we saw the first signs of traction from that initiative. Fallout-adjusted locks were up $152 million, or 62%, for the quarter from these channels. At last count, we had 26 retail mortgage locations in 19 states. These retail channels afford us not only the opportunity for more stable purchase originations, but also for better margins.

Another growth initiative we announced on our last call was builder finance. I am happy to report that we closed our first loan at the end of March and we are building a very impressive pipeline. This business provides another revenue stream and important diversification for our community bank. We are also seeing strong synergies develop between our builder finance clients and our mortgage origination teams.

The rest of our commercial loan business also performed well during the quarter. Average outstandings were up $135 million, or 6%, and we are seeing a stronger pipeline of high-quality loans. We said last quarter that we had completed the derisking of balance sheet and that future loan sales would be opportunistic.

Thus, in the first quarter when we saw the opportunity to execute the sale of lower spread residential mortgage loans at attractive pricing, we seized it, adding $9 million to gain on sale. We will invest the proceeds into higher spread assets, such as commercial loans, providing a boost to our net interest margin without using liquidity or capital.

This action highlights one of the significant strengths of Flagstar: our ability to generate assets quickly. We can rotate assets efficiently when the opportunity presents itself without fear of becoming too liquid.

As part of our pivot to growth and the future, we are refreshing Flagstar's brand. Yesterday, after seven months of intense market research and development, we launched an advertising campaign highlighting the way Flagstar crafts solutions with the financial success of our customers in mind. We believe each customer is unique and each solution is custom fit. That's the Flagstar difference.

Our new brand positioning, which is designed to capture this uniqueness and leverage it to build market share, will be executed throughout all of our businesses.

Finally, we are inching closer to a TARP refinance. Subject to market conditions, regulatory approval, and other conditions, we believe that we will be able to complete the transaction within the next 90 days. I want to be clear that we cannot be certain on the timing of this important transaction, but we are confident that we are making positive progress toward its execution.

And though I can't speculate on timing, we also continue to make positive progress in connection with the listing of our consent order with the OCC. The strong risk and compliance infrastructure we have built is leading us to that end.

Our continuing focus is to outperform the market and we intend to do just that. This call marks my third anniversary as CEO of Flagstar. Lee Smith and I started down the path of building a great company three years ago. We faced many obstacles at that time and we were very transparent about what needed to be done and how we were going to go about getting it done.

I think what we have done best during our tenure is to build an organization whose most important and valuable asset is its people. We have built a great team of people and put them in the right spots. They really care about what they do each and every day. That's the primary reason we have enjoyed some success and what sets us apart from average organizations.

Looking ahead, while we are very pleased with the progress we are making, we are actively looking for strategic opportunities to expand our banking relationships, strengthen our mortgage origination capabilities across all channels, and grow our sub servicing business.

With that, my colleagues will take you through a more detailed discussion of our financials and operations. First up is Jim.

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

Thanks, Sandro. Turning to slide 6, our net income was $39 million, $0.54 per share, this quarter. This compared to net income of $33 million, $0.44 per share, last quarter.

Our earnings this quarter were led by higher net interest income, increased noninterest income, and strong credit metrics. For the quarter we posted an annualized return on assets of 1.2% and returns on equity and common equity of 10.1% and 12.2%, respectively. It was a very good start to the year.

Let's turn to slide 7. Our first-quarter net interest income increased 4% from last quarter to $79 million. This result was led by a 6% increase in our earning assets, partially offset by a slight drop in the net interest margin. Our NIM fell 3 basis points in the quarter to 2.66%, driven mainly by lower relative spreads of the earning asset growth we had at the end of last quarter.

Average earning assets increased $631 million, or 6%, this quarter, led by a $425 million, or 17%, increase in loans held for sale due to higher mortgage originations. Average loans held for investment were largely unchanged from the prior quarter as relationship-based commercial loans increased 6%, while consumer loans declined 3%, largely due to the sale of $787 million of performing mortgage loans during the quarter.

As interest rates dropped, we elected to sell these loans at a $9 million gain to be able to redeploy those funds into higher spread opportunities, such as commercial loans, where our relationship focus continues to deliver good results. We also sold $96 million of higher risk loans during the quarter.

Average total deposits were largely unchanged last quarter as the drop in company-controlled and government deposits was largely offset by higher retail deposits. The Company experienced a provision benefit this quarter of $13 million. This largely resulted from the release of reserves associated with the two sets of loan sales during the quarter. Asset quality continued to be strong and I will provide additional detail on that in a couple of slides.

Noninterest income increased $8 million, or 8%, to $105 million this quarter, led by higher net gain on loan sales, partially offset by a drop in the net return on the mortgage servicing asset and a reduced R&W benefit. So let's dive deeper into each of these items.

First-quarter net gain on loan sales increased $29 million, or 63%. The increase from the prior quarter reflected higher fallout-adjusted locks, an improved gain on sale margin, and also included the $9 million gain from the sale of $787 million of mortgage loans.

Excluding this sale, net gain on loan sales increased $20 million, or 43%. We saw our fallout-adjusted locks increase 37%, led by higher refinance activity due to lower interest rates and stronger correspondent and retail production. The net gain on loan sale margin was 109 basis points this quarter.

Excluding the HFI loan sale, the adjusted margin was 96 basis points, an improvement of 4 basis points over last quarter. The net return on the mortgage servicing asset was a net loss of $6 million this quarter as compared to income of $9 million last quarter, largely due to an increase in prepayments as well as a smaller benefit from the collection of performance incentives on prior-period MSR sales. And the R&W benefit declined $4 million this quarter as the R&W reserve remained unchanged at $40 million.

Moving now to expenses. Noninterest expense increased 6% to $137 million this quarter, as compared to $129 million last quarter, led by higher compensation and benefits expense and commissions, partially offset by lower other noninterest expense. Compensation and benefits increased

$9 million, primarily due to seasonality caused by higher payroll taxes, an anticipated increase attributable to our growth initiatives, and a full quarter's expense related to the ExL TIP plan.

Commissions rose $2 million, mainly due to higher mortgage loan closings, and other noninterest expense fell $3 million, led by lower warrant expense resulting from a decrease in our share price and a decline in the FDIC assessment expense.

On the tax front, the Company's effective tax rate this quarter was 34% as compared to 25% last quarter. Last quarter's 25% effective rate resulted primarily from state income tax benefits. The effective tax rate this quarter is reflective of our long-term rate.

Slide 8 highlights our average balance sheet. Average earning assets increased $631 million, or 6%, led by a 17% rise in loans held for sale, the result of higher mortgage originations. HFI loans were flat and reflected a 3% decline in average consumer loans and a 6% increase in average commercial loans.

The consumer loan decline was the result of HFI sales. Despite these sales, our ending balance of HFI loans was roughly equal to the average balance this quarter and Lee will provide more details on our commercial loan growth. Average retail deposits were flat and the cost of these funds declined slightly despite the increase in the Fed funds rate near the end of the quarter.

Average long-term FHLB borrowings increased $341 million as we lengthened our funding in support of earning asset growth that occurred late last quarter. At March 31, 2016, our common equity to asset ratio remains strong at 9.4% and our book value per share rose an annualized 12% to $22.82.

Let's now turn to asset quality on slide 9. Asset quality remained strong, no matter how you look at it.

Nonperforming loans fell $13 million to $53 million at the end of the quarter, while the nonperforming loan ratio fell below 1%. Early-stage delinquencies remained at a low level. Looking at consumer loans, only $11 million, or 37 basis points, were over 30 days delinquent and still accruing, down $3 million from the prior quarter. There were no commercial loans at March 31, 2016, that were more than 30 days delinquent.

Net charge-offs were $12 million this quarter, including $6 million of net charge-offs associated with the sale of higher risk loans. Excluding loan sales, net charge-offs were $6 million, or 40 basis points, of loans this quarter compared to $7 million, or 51 basis points, last quarter.

At March 31, 2016, our allowance coverage was 2.9% to total loans, down only slightly from the end of last quarter. Coverage was 4.5% of consumer loans, up 24 basis points from last quarter, and 1.3% of commercial loans, reflecting the strong asset quality and continued lack of delinquent loans in this portfolio. Our allowance covered NPLs over 3 times.

Turning now to slide 10, we continued to maintain robust regulatory capital ratios.

On a Basel III partially phased-in basis, at March 31, 2016, our Tier 1 leverage ratio was 11.0% as compared to 11.5% at December 31, 2015. Our Tier 1 common ratio was 14.0% at March 31, 2016. The decrease in the Tier 1 leverage ratio resulted mostly from the 40 basis point negative impact of the higher phase-in requirement in 2016 under Basel III as earnings retention roughly supported earning asset growth during the quarter.

This slide also presents an analysis of our Tier 1 leverage ratio, which is our constraining capital ratio, reflecting the pro forma impact of redeeming our TARP-preferred shares. The pro forma impact also contemplates a reduction in equity in the payment of deferred preferred dividends, which at March 31, 2016, totaled $94 million. As you can see, on a pro forma basis, we still have an 8.2% Tier 1 leverage ratio at March 31, 2016, a healthy stress buffer over the minimum level needed to be considered well-capitalized, particularly considering the composition of our balance sheet now has less risk.

We anticipate that our internal regulatory capital generation rate will continue to be strong for the next few years. Keep in mind, our Tier 1 capital at March 31, 2016, has already been reduced by $212 million, 161 basis points, for our NOL-related DTAs, which should be earned back over the next few years, and further reduced by $133 million, 101 basis points, for MSRs in excess of amounts allowable under Basel III. As we continue to reduce our levels of MSR and grow our Tier 1 capital through earnings retention, these deductions from Tier 1 capital should also shrink significantly, resulting in, at least over the next few years, a higher level of regulatory capital growth.

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

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

Thanks, Jim, and good morning, everyone. We're obviously very pleased with our performance in Q1, but even more satisfied that this represents the fifth consecutive quarter of consistently strong profitability, further validating the business model we've put in place and strategies we are deploying to optimize results.

For the 12 months ended March 31, 2016, we've generated $165 million of after-tax net income. On average, total assets of $12.6 billion, which represents a return on assets of 1.3%. We have also started to invest in new business initiatives, such as the builder finance team, and expand existing business lines, such as our distributed retail and direct-to-consumer mortgage origination businesses. As a result, we believe we are well-positioned in the long run to build on the consistent results you've seen over the last 15 months.

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

Quarterly operating highlights for the community banking segment include: average commercial loans increase $135 million, or 6%, to $2.4 billion during the quarter; led by C&I lending, which increased $99 million, or 21%; and further bolstered with CRE lending, which increased $44 million, or 6%, quarter over quarter.

During the last 12 months we have grown total average commercial loans by nearly $700 million, led by a $345 million, or 56%, increase in warehouse lending, largely due to our strategy change 18 months ago of providing warehouse financing to correspondents who sold to investors other than Flagstar. This is a business line we see opportunities to grow further in the future and it has positive synergies with our mortgage origination business.

CRE lending has grown $188 million over the last 12 months and C&I lending $142 million over the same time period, as we successfully executed on our relationship-based approach with borrowers in many different industries. Under the leadership of Drew Ottaway and the introduction of new business lines such as MSR lending, equipment finance, and builder finance, where we have already approved $200 million in new facilities this year, the first of which just funded, we believe we will continue to see solid, consistent growth as we move forward and are excited about the potential of our non-mortgage lending businesses.

Average consumer loans decreased $109 million, or 3%, in the quarter, as we sold $787 million of performing residential mortgage held-for-investment loans to realize significant gains on our existing portfolio in response to market conditions. We also sold $96 million UPB of NPLs, TDRs, and legacy scratch-and-dent loans as we took advantage of a business opportunity to sell some higher-risk assets and further derisk the balance sheet.

Our NPLs now stand at $53 million, the lowest level in over 15 years. And 30- to 89-day delinquencies totaled $11 million at the end of the quarter, down $3 million from last quarter, which demonstrates both the quality of our overall book following our 2015 derisking program and the effective work of our collections team preventing delinquent loans rolling further past due.

Average total deposits were largely unchanged last quarter as a drop in escrow deposits from fewer MSR subserviced accounts was largely offset by increased retail demand deposits. Over the last 12 months, average retail deposits have grown 6% to $5.8 billion. Government deposits have increased 13% to $1.1 billion and company-controlled deposits have risen 22% to $1.2 billion.

Finally, on the technology front, we completed the project to replace all of our ATMs with state-of-the-art terminals during the quarter. Overall, we are very encouraged by the sustained growth in the community bank, our positioning, and potential for the future.

Please turn to slide 13. First-quarter operating highlights for the mortgage origination business include fallout-adjusted LOC volume increased 37% to $6.9 billion, led by increased refinance volume. Mortgage closings increased 9% to $6.4 billion quarter over quarter as our underwriting and fulfillment teams adjusted to the higher LOC volume, but also maintained consistent turn times and excellent service levels.

We talked about the impact of TRID last quarter, particularly in our broker channel. 90 days on and we can say TRID was a speed bump that we are moving on from. And while our broker business isn't quite back to pre-TRID levels, it has been more than offset by growth in our correspondent and retail channels.

Our adjusted net gain on loan sale margin increased 4 basis points quarter over quarter to 96 basis points, adjusted for HFI loan sales. The higher gain on sale margin was primarily attributable to an increased mix of retail production.

The steps we took during the first quarter toward expanding our distributed and direct-to-consumer retail businesses are beginning to yield positive results with retail originations increasing from 5% to 6% of fallout-adjusted locks, as we hired or have in the recruitment pipeline approximately 100 loan officers and sales assistants. In this highly-regulated environment, and given our comprehensive risk and compliance infrastructure and our cost of funds, we believe we have a compelling business offering which leverages all parts of our business model, including lending and servicing, and are committed to growing the retail origination business.

Finally, we are seeing positive results from our consumer portal, which we launched in December. If you recall, this portal also acts as a document aggregator which drives incremental operational efficiencies and we are pleased with the early returns. We are also continuing to invest in ways that will further enhance the capabilities of this portal in the future.

Moving to servicing, quarterly operating highlights for the mortgage servicing segment on slide 14 include: we were recently notified by Fannie Mae that we had been named a Fannie Mae Servicer Total Achievement and Rewards, or STAR, Performer for 2015 in the general servicing category in recognition of outstanding performance and best practices. This recognition by Fannie Mae, our biggest customer for loan sales, reflects the extraordinary efforts by Flagstar's servicing team to deliver operational excellence and enhance our position as an elite mortgage servicer.

We added another component, default servicer, during the quarter as we continued to build out our best-in-class servicing platform, giving us more optionality when loans become seriously delinquent. Including concurrent flow and bulk sales, we executed on the sale of $5.1 billion in aggregate UPB, or more than 23,000 loans of residential MSRs, during the quarter where we will be the subservicer on over 10,000 of those loans.

We currently service approximately 340,000 loans, of which 192,000 are subserviced for others, making us the seventh-largest subservicer in the nation. The remaining 148,000 are loans where we own the MSR or they are part of our HFI book. Approximately 98% of our servicing book is performing loans and 2%, or approximately 8,000 loans, are 60-plus days delinquent.

Longer term we remain focused on three areas: growing our fee income generating sub servicing business, which has the capacity to service up to 1 million loans; leveraging this platform's cross-selling across our three business line verticals; and executing on an MSR reduction strategy given the requirements of Basel III. Our goal is to reach the fully phased-in MSR limit by the end of Q1 2018 through efficient bulk and flow sale transactions. And we are on track in implementing the early phases of this plan.

Given our capabilities as an originator and a sub servicer, our ability to lend against servicing advances and now directly against the MSR asset and pay interest to MSR owners on custodial and escrow deposits, given we are a bank, we believe we have a compelling business model and proposition for buyers of mortgage servicing rights.

Moving on to expenses on slide 15, our noninterest expense increased $8 million to $137 million in the first quarter. The increase was largely due to higher compensation and benefit expense and commissions, partially offset by lower FDIC premiums and other noninterest expense. Noninterest expense slightly exceeding the high end of our guidance from last quarter because mortgage volumes came in higher than we expected in Q1.

The higher compensation and benefits quarter over quarter was predominantly driven by two things: one, planned increases in headcount for growth initiatives, which accounted for $3 million; and two, higher seasonal payroll taxes which accounted for $4 million of the quarter-over-quarter increased. Commissions increased by $2 million quarter over quarter as a result of higher mortgage closings.

These increases were offset by a reduction of $3 million in other noninterest expense due to the warrant expense decrease given the reduction in stock price and a $2 million reduction in FDIC premiums as a result of our balance sheet derisking program. Our efficiency ratio improved slightly in the quarter to 74.5%, compared to 75.2% in the prior quarter as stronger mortgage revenue was offset by higher seasonal expenses and our investment in growth initiatives.

We've previously stated that our targeted long-term efficiency ratio is in the mid-60%s and our immediate focus in achieving that goal is on growing revenues across all three major business lines, while continuing to build on the cost discipline in management we've instilled throughout the organization. As always, we remain focused on optimizing our cost infrastructure and will continue to look for ways to drive further efficiencies throughout the organization.

We estimate noninterest expense will be between $140 million and $145 million during the second quarter 2016 due to the costs associated with higher mortgage originations and our investment in growth initiatives, including the 100 distributed retail loan officers and sales assistants we have hired or have in the recruitment pipeline. Furthermore, we believe our efficiency ratio will remain in the low to mid 70%s, given the investment period that is needed to ramp up new business opportunities.

However, and as previously mentioned, we are very confident that these initiatives, together with the growth we anticipate in existing channels, combined with our cost and expense discipline, will ultimately see us achieve our long-term goal of a mid-60%s efficiency ratio target.

In summary, we are executing against our strategic plan and are well-positioned to build on the consistently strong results you've seen over the last 15 months. We are pleased with our progress and are committed to delivering strong returns for our shareholders.

With that, I will 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 Q2 and then open the call for questions and answers. Please turn to slide 17.

We expect earning assets and the net interest margin to be relatively stable. We anticipate mortgage locks will increase approximately 15% to 20% as the spring buying season kicks in. We expect a slightly stronger gain on loan sale margins from our adjusted Q1 number fueled by a greater share of retail originations. We anticipate a slight improvement in the net return on the mortgage servicing asset as prepayment speeds subside.

We expect the balance of our MSRs will decline slightly. We anticipate our provision expense will match net charge-offs, which we believe will be consistent with the net charge-off ratio in Q1 adjusted for loan sales and loans with government guarantees, and as Lee noted, noninterest expense will probably be between $140 million and $145 million due to seasonality and investment in growth initiatives.

This concludes our prepared remarks and we will now open the call to questions from our listeners. So I will turn it over to Chris to open up the lines.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Paul Miller, FBR & Company.

Paul Miller - *FBR & Co. - Analyst*

Thank you very much. On the $400 million TARP repayment, could you talk about the mechanics of that? Like, would you have to refinance that completely through debt or can you refinance only a portion of that? Can you also talk about what do you think you can get the deals done at on an interest-rate basis?

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

Unfortunately, Paul, I'm not going to be able to give you much color on any of that. We are still pulling all the information together that we will need in order to be able to be certain of the structure of the transaction. And of course, interest rates -- it all depends on when you go to market and what all the market conditions are at that time, so it's really hard for me to predict that.

Paul Miller - *FBR & Co. - Analyst*

Okay. Then on the adjusted book value basis, how much is in -- how of the TARP accrualed interest rate payments are in the book value? How much do we have to back out?

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

$94 million, Paul. This is Jim.

Paul Miller - *FBR & Co. - Analyst*

$94 million. Thank you. Then lastly, the builder business; that's relatively new to you.

Can you add some more color around that; exactly will this stuff all be sold? Will you put it on your balance sheet? Is it put on your balance sheet and then sold once the houses are complete?

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

These are typically lines of credit are supporting the development of land and/or the construction of homes in relatively large developments. These are typically large developers that are the borrowers and so we are financing the development and construction during that period of time.

We're not talking about the end loans. Now, we do believe that there are synergies, as I noted in my comments, that will allow us to obtain a fair portion of the end loans, but the actual builder finance loans are not for long-term financing.

Paul Miller - *FBR & Co. - Analyst*

What type of yields do you usually get on these lines of credit?

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

We're going to get a spread of somewhere between 300 and 400 basis points, Paul, depending upon the interest rate and the fees that we expect to collect from a draw perspective.

Paul Miller - *FBR & Co. - Analyst*

Okay. Thanks very much. Good quarter.

Operator

Scott Siefers, Sandler O'Neill & Partners.

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

Good morning, guys. How is everybody doing?

First question, Jim, to the extent that there is visibility, when you talk about the net servicing revenue line continuing to be pressured by prepayments, I mean obviously a lot of that is going to be rate based. But I wondered just what do you mean by pressure in that it's been a positive number, swung to a negative this quarter. When you talk about pressure, would you still expect it to revert to a positive number?

Then as we look beyond say the second quarter is there any sense for how that line item might trend? Again, I realize it's kind of a tough one since it's rate based, but just given that it's such a meaningful delta just curious as to your thoughts.

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

Let me take a shot at that and then Jim can add some color to it. First of all, relative to providing you some guidance going forward, past the next quarter I'm not going to go there. That's all a function of what might happen in the markets and interest rates and such and, heck, your guess is as good as mine.

I think over the next quarter we would see the return being a little bit better, but I wouldn't go so far as to assure you that it's going to be positive. We didn't suggest that in our guidance. There's just a lot of uncertainty there.

I do think, if you look at the long term, we've always been able to perform pretty well with the return on our MSR asset over the long term. And you have these situations that occur in the market that provide -- that cause some negative impact, but I'm confident that over the long term we will always have pretty good overall success.

Jim, anything you would like to add on that?

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

I think adding to that, adding to what Sandro said, we are always positioning our MSR to make sure that our net position between our origination business and our MSR that's on balance sheet will yield a positive. So while we saw prepayments accelerate this quarter because of the low level of mortgage rates, we more than made up for it on the mortgage origination side.

The only other thing that I would encourage you to think about as well -- in my prepared remarks, we talk about the negative impact that the MSR balances have on capital and that by the first quarter of 2018, as Basel III is fully phased-in, we will have to bring that balance down so that we're not in a position where we are deducting the MSR balance from capital.

So that is going to necessitate a certain, I would term, a glide path in terms of sales that need to take place in the future. And as you think about future performance, you will have to factor in the cost of those transactions, the sale transactions.

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

Okay. All right, that's helpful. Thank you. Then if we can jump over to expenses for a second.

I guess prior to this quarter you had a really good consistency in sort of the $130 million, $140 million per-quarter range and the guidance for 2Q is, very understandably, a little higher given origination anticipation. I'm just curious, as you look out over the [pole], are we sort of setting up for a higher baseline of expenses going forward or could we bring it back down into that level as we get into sort of, say, pleasingly softer originations in the second half of the year.

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

Scott, a couple of things on this. The noninterest expense, it did slightly exceed the high end of our guidance last quarter because the mortgage volumes came in higher than we expected in Q1. And as you heard, we are guiding towards $140 million to $145 million of NIE run rate expense in Q2.

As you correctly say, this reflects the continued investment we expect to make in growth businesses such as the distributed retail, mortgage, and builder finance businesses, and growth in mortgage production volume from our core business. My view is that growth will ultimately lead to higher revenues as we look forward.

So I think the base probably has shifted up slightly, but it should be more than offset in the longer term with revenue growth. And that's why you heard in my prepared remarks I feel confident that over the longer run we will achieve our mid-60%s efficiency ratio target.

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

Okay, that's perfect. Thank you very much.

Operator

Kevin Barker, Piper Jaffray.

Kevin Barker - *Piper Jaffray & Co. - Analyst*

Just to further discuss some of the sales of the MSRs that you are talking about out to 2018 to reach your -- the deductions on Basel III, do you expect any of the changes in the MSR sales to take --? Do you expect MSR sales to take a different form than what you are doing right now, or to increase the amount of counterparties, or potentially change the way you are selling those assets?

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

The only thing that I would say -- and Lee might want to add something to this -- is, to the extent we can increase the flow agreements, we want to do that and include subservicing arrangements with those. So Lee and the team are working hard to that end.

But, otherwise, you got to see where the market is and where the best opportunity to execute in the market is. That's what we have always done and that's what we will continue to do.

Lee, do you want to anything?

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

I think we've proven that we can execute via bulk sales or concurrent flow sales, and as we mentioned, we sold $5.1 billion of MSRs in the first quarter. I think what is interesting, Kevin, is we feel very good about the quality of our originations and we can provide additional services to buyers of MSRs that complement the transaction such as subservicing recapture, paying interest on the custodial and escrow deposits, and financing solutions around either the MSR asset or servicing advances.

So we believe we have a comprehensive offering that few other sellers can provide, combined with the quality originations underlying the MSRs being sold. In terms of the market, I think it's a pretty common theme. There's often new funds that are coming into the market and we continue to see that.

I think there's still a lot of people that see the MSR asset as a high-yielding, good asset and they're looking to partner with people that can provide them with a very comprehensive operational management around that asset. And as I just described, we can do that.

Kevin Barker - *Piper Jaffray & Co. - Analyst*

So are you saying it's going to be purely flow sales at that point? And you mentioned that it was $5.1 billion of sales this quarter, but you disclosed on slide 14 it was $2.6 billion. So I'm assuming that the delta there is primarily the difference between bulk and flow.

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

That's correct.

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

Yes. $2.6 billion is the bulk and the delta is the flow. We would like to be executing the majority of the sales on a flow basis, because they are much more predictable, but we can complement the flow sales with bulk sales as necessary and as we have done historically.

Kevin Barker - *Piper Jaffray & Co. - Analyst*

Okay. Just to clarify some of the comments you made around TARP, is there a certain premium or discount on top of the amount outstanding, plus deferred dividends? Could you just expand upon that a little bit?

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

I don't think you should assume that.

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

Right. No, if you look at the terms, there is not.

Kevin Barker - *Piper Jaffray & Co. - Analyst*

Okay. So it's straight just principle plus deferred dividends and that's the way we should think about it?

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

Yes.

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

Yes.

Kevin Barker - *Piper Jaffray & Co. - Analyst*

In regards to your deposit base, I noticed that you had a significant increase in non-interest-bearing deposits. Was there any specific driver of that this quarter and do you expect that to continue?

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

The specific driver this particular quarter was the deposits from our custodial arrangements on our servicing book. So Q1 typically has increases relative to income tax payments. And then, of course, because of the large refinance activity in Q1 that builds up the custodial deposits as well. So that's the primary driver of the big increase in Q1.

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

Kevin, I think you are looking at the quarter-end balance there, which is impacted by the P&I payments from the refis that we are seeing.

Kevin Barker - *Piper Jaffray & Co. - Analyst*

Okay. And then you would expect that to be seasonally high in the second quarter, so you would have a little bit more liquidity?

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

Wouldn't necessarily say they would be seasonally higher in the second quarter. Actually, I think it might go the other way. I think it might -- they could drop more because as the prepayments slow down and as tax payments get made --. So I don't see any huge change I guess.

Kevin Barker - *Piper Jaffray & Co. - Analyst*

That's fine. I appreciate you taking my questions.

Operator

Henry Coffey, Sterne Agee.

Henry Coffey - *Sterne Agee CRT - Analyst*

Good morning and thank you for taking my questions. Just for the record, it's Sterne Agee CRT. It's a mouthful.

When we look at your MSRs as a standalone asset and we look at what the investors are buying in the bulk business, what kind of sort of net return do you think they are targeting or realizing, so net of subservicing and amortization to get all the silly fair value stuff? When you talk to them what kind of net return are they realizing from their MSRs?

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

I don't know the answer to that and I wouldn't speculate on that. We are not buying MSRs, so that's not how we look at it. We are a seller of MSRs, so -- Lee or Len, anybody have any thought on that? Or Jim?

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

We don't know what others' expected returns are. That's up to them and their models. We've stated before on calls going back over the last couple of years the way we look at the MSR asset, we target a 6% to 8% ROA. But you got to remember that is net of hedging costs and we have a very comprehensive operational infrastructure around that asset through the servicing business as well.

So that's how we think about it, but how others think about it and their expected returns is their business.

Henry Coffey - *Sterne Agee CRT - Analyst*

If you looked at your own servicing business, excluding any kind of fair value marks on your MSR investment, was that profitable and what did it look like?

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

Yes, I think it is profitable and I think that as we go forward, because it's an economy of scale kind of business, as Lee has said many times, as we -- because we have the infrastructure in place, as we grow the portfolio I think the numbers $5 million to $7 million per 100,000 of loans is added to the pretax profitability of the Company.

We're now at a position where we feel like we can take the next steps to grow. We've got the operation. You heard about the award that the team received. So we've got the quality, we've got the infrastructure; I think we're good to go here.

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

And we have the capacity. We're servicing 340,000 loans and, as I mentioned, we have the capacity to service 1 million. So we have the capacity, and Sandro is right, every 100,000 loans is incremental $5 million to $7 million of operating profit pretax.

Henry Coffey - *Sterne Agee CRT - Analyst*

So what's the governor to getting to $1 million? What's the restraint that --?

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

There's three ways that we add loans. I will let Lee go through the detail. But the thing that we have to be different from what we've done thus far, because thus far the loans have primarily come from Flagstar originations, is we have to obtain third-party contracts to service loans originated by others and MSRs owned by others.

Lee, I will let you take it from there.

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

There's basically three ways we can grow the number of loans that we are subservicing. We can sell the MSRs that we originated and subservice those loans back, and that's what we've been doing successfully over the last two or three years.

We can on-board loans that we haven't originated. And you can imagine, being an MSR seller, we talk to a lot of buyers of MSRs who are buying MSRs not just from us, but others. And we can work directly with the agencies and Ginnie if they ever wanted to direct, [call] the loans to a servicing platform that they felt good about. And so that's another way that we can grow our loan service book.

Henry Coffey - *Sterne Agee CRT - Analyst*

Great, thank you for taking my question.

Operator

Bose George, KBW.

Chas Tyson - *Keefe, Bruyette & Woods, Inc. - Analyst*

Good morning. This is actually Chas Tyson on for Bose. I wanted to ask first on your capital position. Obviously your capital ratios are fairly robust with the TARP redemption hopefully coming up and maybe lifting of the OCC consent order at some point.

How do you think about how you want to use that capital? Do you want to utilize it to continue to grow the balance sheet and grow your asset base, or are there more opportunistic ways you are looking to use it?

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

Well, those are all things that we are considering. We're certainly considering the growth of the balance sheet. We're certainly considering strategic opportunities across all of our lines of businesses. I'm not ready to be specific about that, but those are all things that come into play here as we get this transaction done, get the consent order lifted, and then move forward.

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

First things first, though, and you mentioned the two most important hurdles.

Chas Tyson - *Keefe, Bruyette & Woods, Inc. - Analyst*

Got it. Should we think -- is there any read-through from the TARP redemption to the lifting of the OCC consent order? Those kind of have to happen in tandem or are they not that related?

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

No, they don't. They are independent situations that we are working on separately.

Chas Tyson - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay. And then I just wanted to ask on your mortgage loans as well. It was up quarter over quarter when most of other mortgage participants were down. I just wanted to see if that was something that's kind of more of a trend for you guys taking market share; if it's just you saw an opportunity in the correspondent market this quarter.

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

I will let Len give you some color on that. My quick response is we saw some increase in our retail production, both in our distributed retail as well as our direct to consumer. We did a good job of taking advantage of lower rates in the refinance market.

Len, anything you want to add to that?

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

Yes, I would like to add that during the fourth quarter we took more of an impact adversely due to TRID as a result of our higher TTO concentrations. We talked about that on the last call. So really our rebound is a reflection of the traction in our rebound from -- in our correspondent platform and a return to what we would consider to be a new normal, if you will.

If we look on a year-over-year basis, we are pretty much mirroring what we have seen other participants in the market report in terms of year-over-year changes in their production.

Chas Tyson - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, that makes sense. Thanks, guys.

Operator

Jesus Bueno, Compass Point.

Jesus Bueno - *Compass Point Research & Trading - Analyst*

Thanks for taking my questions. Just a follow-up on the servicing. What was the -- for the servicing that you sold and retained subservicing, what was the retention rate for this past quarter?

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

We sold approximately -- the $5.1 billion is about 23,000 loans. We retained the servicing on 10,000 of those loans.

Jesus Bueno - *Compass Point Research & Trading - Analyst*

Great, thank you. Obviously, you had the benefit of margin expansion during the quarter and it looked, I guess, in part to be actually muted a bit by the heavier shift to correspondent lending. So I guess as you're guiding to a modestly higher margin next quarter, I know you noted that retail would be up.

But I guess are there any reads; how are you seeing margins unfold so far this quarter? On a core basis, are they directionally higher than they were or than you saw in the first quarter?

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

I think in our case, just speaking for Flagstar, then given the fact that we see our mix changing a bit towards the retail, that's really what's driving the increase. I think otherwise we don't see margins changing substantially in the next three months.

Jesus Bueno - *Compass Point Research & Trading - Analyst*

That's great. Just in terms of volumes as well, are there any trends developing in the second quarter? I know you noted that you had refi strength in the first quarter, but I guess the between purchase and refinance are you seeing strength in one versus the other?

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

I think I will let Len give some color on this in the second. But I think we are seeing purchase activity strengthen, but you would normally expect to see that as you get into the second quarter of the year. So I don't think there's anything particularly unusual about that.

We are guiding to another 15% to 20% increase in locks and we're pretty confident that we're going to be able to achieve that. Len, anything you want to add?

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

Just maybe add to it that we are seeing applications for purchase money transactions increasing. Again, as we are seeing the traction in our retail, we expect to see more of that business coming through. And we are doing a good job with our TPO customers as well as we continue to expand that area, so we are opportunistic there.

Jesus Bueno - *Compass Point Research & Trading - Analyst*

Thank you. I will try to slip one last one in. Just on loan growth, obviously you saw balances drop with the sale of the residential mortgage loans. You noted deploying -- redeploying capital into commercial loans.

Just given the level of your originations, I guess how should we think about loan growth going forward in terms of your own originations capabilities? It sounds like you did just over $80 million in commercial loans last quarter. I guess how do you plan on filling that void of the loans that you sold?

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

First of all, relative to the growth of earning assets, we are guiding to relatively flat balance sheet over the next three months. Relative to the cash that we would invest to replace the HFI loans that we sold, our first choice is always going to be relationship-based lending, whether that's in the commercial real estate or C&I, consumer lending, whatever that might be. We're going to first go for those relationship-based situations.

To the extent that we can't fill the hole quick enough, then we will go to retaining some of the high-quality production through our mortgage origination platform. And as I noted in my prepared comments, that's really one of the great advantages that Flagstar has is our ability to generate assets, good quality and good yielding assets pretty quickly. And we can choose the durations that we need in order to keep the interest-rate risk in the right place.

So exactly what is going to happen I can't tell you, because we just don't know. But we do know that we will not have difficulty filling the asset bucket. You want to add anything there, Lee?

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

I would just build off of Sandro's comment. We didn't mention it in the prepared remarks, but we talked about the asset sales. We did add $210 million of loans that we originated ourselves in the first quarter to our balance sheet outside of the commercial growth that we referred to.

Jesus Bueno - *Compass Point Research & Trading - Analyst*

Thank you very much for taking my questions. Congrats on the quarter.

Operator

And with no further questions in the queue, I would like to turn the conference back over to Mr. DiNello for additional or closing remarks.

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

Thanks, Chris, and thanks to everybody for your interest in Flagstar. We feel very good about our prospects for continuing to post strong and consistent earnings going forward. We're working hard at building a less volatile income stream and our results over the last 18 months show great progress in that regard.

We have built a strong bank that is uniquely supported by a powerful, national loan origination platform. The road ahead holds many opportunities for Flagstar and I'm more confident than ever that we will be able to take full advantage of those opportunities and produce a return for our shareholders that they will be very pleased with.

Thanks also to my Flagstar colleagues for all of the contributions they make to our success. I'm very proud to work with all of you. Finally, thanks to everyone for your time this morning. I look forward to reporting Q2 results in July.

Operator

This concludes today's presentation. Thank you all for your participation.
