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EDITED TRANSCRIPT

FBC - Q2 2016 Flagstar Bancorp Inc Earnings Call

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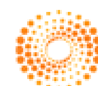

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PRESENTATION

Operator

Good day, and welcome to the Flagstar Bank second quarter of 2016 earnings conference call. Today's conference is being recorded. At this time, I'd like to turn the conference over to David Urban, Director, Investor Relations. Please go ahead.

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

Thank you, and good morning. Welcome to the Flagstar second-quarter 2016 earnings call. Before we begin, I would like to mention that our second-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'd 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'm 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'm going to start the call by providing a high-level view of our performance for the quarter, then I'll 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'll conclude with guidance for the third quarter before opening up the lines for questions.

It was another outstanding quarter of solid, consistent earnings and of doing what we said we would do. And there were a lot of continuing positive trends, strong revenue growth, impeccable credit quality, impressive operating leverage, and improving efficiency ratio, and ample capital, all capped by the resolution of TARP. Net income was $47 million on an 11% increase in revenue, which was powered by strong mortgage banking results. This strong revenue growth was met with an increase in expenses of only 2% thus again generating positive operating leverage. The net effect was an efficiency ratio that improved to 68%. This is one of the advantages of our business model that we've been talking about.

We can produce solid returns when mortgage activity is normal and outstanding returns when mortgage activity is strong. The power of our national mortgage platform and the advantages of our variable cost model were front and center this quarter. At the same time, our community

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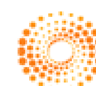

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banking business continues to flourish. In fact, for the first time, average commercial loans exceeded consumer loans. We experienced strong growth in warehouse loans as well as in C&I and CRE. Further, our new builder finance team continued to find success, and we booked our first MSR lending relationship and our first significant lease deal. The diversity demonstrated in this loan growth is the foundation of our community banking business.

Diversity is also important for our mortgage business. We've spoken in the past about our plan to increase both our distributed retail and direct to consumer originations. And over the last three quarters, we've made steady progress ratcheting up from 6% to total gross rate locks in Q4 2015 to 8% this quarter. And in fact in June, this number was closer to 8.5%. Our goal is to build these channels and take advantage of the economics of the purchase mortgage market while at the same time diversifying our mortgage originations. As you can see, the foundation that we have been building is now pivoting to real growth, growth in our community bank relationships via warehouse lending, C&I and CRE loans, growth in relationships through our distributed retail mortgage channel, and growth in average retail deposits, which I might add, increased 4% during the quarter.

Credit quality is now a non-story for Flagstar. For starters, we continue to have no commercial delinquencies and no commercial nonperforming loans. Overall, nonperforming loans fell again this quarter, and our reserve coverage remains strong. It has been a long-term goal of this management team to position Flagstar to succeed in any business environment. We've now turned a profit every quarter since Q4 2014. Our returns on assets and common equity both came in within our range this quarter.

One more thing before I turn it over to Jim. As you know, we went to market with $250 million of senior notes earlier this month and a market demand for the offering was very satisfying. With TARP behind us, we now have more freedom to pursue strategic alternatives and add value to our Company. While we continue to operate under an OCC consent order, I'm comfortable saying the old Flagstar is no more. We have sharpened the best part of the old Flagstar and combined it with the broader, more stable and less risky business model. The new Flagstar is set up to take advantage of whatever the market gives us. We don't need interest rates to rise, and we don't need them to fall. We can generate targeted returns in either environment. With respect to the OCC consent order, I believe we are in the stretch run, and I'm confident it will be behind us in the not too distant future. 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. - CFO*

Thanks, Sandro. Turning now to slide 6, our net income this quarter was $47 million, $0.66 per share. This compared to net income of $39 million or $0.54 per share last quarter. Our earnings this quarter were led by higher non-interest income and strong credit metrics. For the quarter, we posted a return on assets of 1.4% and a return on common equity of 13.8%, both within our long-term targeted range. It was a very good quarter. Let's now turn to slide 7. Our second-quarter net interest income remained relatively stable at $77 million. This reflected a 2% decline in earning assets.

Our NIM also fell slightly in the quarter to 2.63% driven by a lower yield on loans held for sale from the drop in mortgage rates and prepayments of higher yielding consumer loans. These negative impacts were partially offset by increased net interest income from a rotation of lower spread residential mortgages into higher spread commercial loans. Average earning assets fell $232 million or 2% mostly from a decline in average loans held for investment. While commercial loans increased 20%, consumer loans declined 17% largely from the sales of performing mortgages in Q1 and again this quarter. Average total deposits rose $581 million or 7% this quarter led by higher Company-controlled deposits and retail deposits, partially offset by a drop in government deposits. Company-controlled deposits rose $403 million or 35%, the result of seasonal factors, higher refinance volume, and growth in the number of loans serviced.

The Company experienced a provision benefit this quarter of $3 million. This resulted from the release of reserves associated with the loan sales during the quarter. Asset quality continues to be strong, and I'll provide additional detail in a couple of slides. Noninterest income increased $23 million or 22% to $128 million this quarter led by higher net gain in loan sales and loan fees and charges. Let's dive deeper into these items. Second-quarter net gain on loan sales increased $15 million or 20%. The increase from the prior quarter reflected higher fallout adjusted locks, an improved gain on sale margin, and also included $5 million of gain from the sale of $408 million of mortgage loans that were transferred from the HFI portfolio this quarter.

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Excluding gains from the sales of mortgage loans held for investment in both the current and prior quarters, gain on loan sales increased $19 million or 29%. We saw fallout-adjusted locks increase 18% led by higher seasonal purchase volumes, which accounted for over 75% of the increase in the quarter's rate lock activity. Excluding the HFI loan sales, the net gain on loan sale margin was 104 basis points, an improvement of 8 basis points over last quarter. The increase in loan fees and charges reflected higher mortgage originations. The net return on the mortgage servicing asset was a loss of $4 million this quarter resulting from higher prepayment than expected as compared to a loss of $6 million last quarter. The return improved primarily as result of higher servicing fee income and lower MSR disposition costs from fewer bulk sales. And the R&W benefit rose $2 million this quarter as the R&W reserve fell to $36 million, the result of continued improvement in our exposure.

Moving now to expenses. Noninterest expense increased 2% to $139 million this quarter as compared to $137 million last quarter. The Company's efficiency ratio improved to 68.2% this quarter as revenues grew without the addition of significant incremental expenses. Overall, higher mortgage volumes drove the quarter's increase in noninterest expense. Commissions increased $4 million, and loan processing expense rose $3 million. Warrant expense driven by a higher stock price also increased $3 million. These increases were partially offset by decreased levels of expense in a number of other categories including legal and professional fees, asset resolution expense, and compensation and benefits which were seasonally lower.

The Company's effective tax rate this quarter was 33% as compared to 34% last quarter, largely from the benefit of a state tax settlement in the quarter. Slide 8 highlights our average balance sheet. Average earning assets decreased $232 million or 2% primarily from the sale of performing residential mortgage loans late in Q1 and again this quarter. While HFI loans were relatively flat, we grew commercial loans and sold residential mortgages at a gain. Despite these sales, our ending balance of HFI loans was 5% higher than the average balance this quarter providing a good start to the third quarter. Lee will provide more details on our commercial loan growth.

Average deposits rose $581 million or 7% of higher Company-controlled and retail deposits partially offset by seasonally lower government deposits. At June 30, 2016, our common equity to assets ratio remained strong at 9.7%, and our book value per share rose at annualized 12% to $23.48. When we adjust these numbers for the pending TARP redemption on a pro forma basis, our common equity to assets ratio was 8.9% and our book value per share was $21.67. Let's now turn to asset quality on slide 9. Nonperforming loans fell $9 million to $44 million at the end of the quarter, while nonperforming loan ratio of 76 basis points represented an improvement of 19 basis points over last quarter. There were no commercial nonperforming loans. Early stage delinquencies remained at a low level.

Looking at consumer loans, only $7 million or 27 basis points were over 30 days delinquent and still accruing, down $4 million from the prior quarter. There were no commercial loans at June 30, 2016, that were more than 30 days delinquent. Net charge-offs were $9 million this quarter including $2 million of net charge-offs associated with the sale of lower performing loans and $4 million for loans with government guarantees.

Excluding these charge-offs, net charge-offs were only 18 basis points of loans this quarter compared to 20 basis points last quarter. At June 30, 2016, our allowance coverage was 2.6% of total HFI loans, down slightly from the end of last quarter. Coverage was 4.5% of consumer loans, unchanged from the prior quarter and will pay 2% of commercial loans reflecting the increase in warehouse loans and continued lack of delinquent loans in the commercial portfolio.

Turning to slide 10, capital remains strong. This quarter, our Tier 1 leverage ratio grew to 11.6% from 11% last quarter, nearly all of which was from earnings retention. Our CET-1 ratio was 13.6%, and our Tier 1 and total risk-based capital ratios remained near 20%. These ratios are even stronger when reflecting upon the now low level of risk in the balance sheet and the strong risk management function we've built. Given our pending TARP redemption, we wanted to present its impact our capital ratios. As you can see on a pro forma basis, reflecting this redemption, our capital ratios remain strong.

Our Tier 1 Leverage ratio of 8.6% compares well to the median midsize bank leverage ratio of 9.1% at March 31, 2016. The CET-1, Tier 1, and total risk-based capital ratios remain well above the median for other midsize banks after this TARP redemption. The pro forma Tier 1 and total risk-based capital ratios would put us in the top quartile of midsize banks. We continue to grow our regulatory capital at a pre-tax rate as we utilize our net operating losses. Our Tier 1 leverage ratio is reduced by 150 basis points for our NOL related DTAs, and we anticipate the elimination of this deduction over the next two to three years given our profitability.

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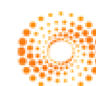

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MSRs in excess of the amounts allowable under Basel III also reduced Tier 1 leverage by 110 basis points. We anticipate that this deduction will be eliminated over the next seven quarters through both flow and bulk sales. The combination of these two deductions reveals 260 basis points of capital deductions that we believe will be eliminated over the next two to three years providing an outsized level of internal regulatory capital growth. 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. We're very pleased with our performance in Q2. But even more satisfied, this represents the sixth consecutive quarter of consistently strong profitability further affirming the business model we put in place and strategies we're deploying to optimize results. For the 12 months ended June 30, 2016, we generated $166 million of after-tax net income on average total assets of $13 billion, which represents a return on assets of 1.3%.

Before I get into the results of our major business segments, I do want to outline our business model, how the different business lines complement each other and why we believe we are well positioned to continue to build on the strong results of the last 18 months. As you know, Flagstar has three main business lines. The community bank, which comprises our branches or non-mortgage lending businesses, the mortgage origination business, and the mortgage servicing business. These three business lines are interconnecting units and give us the ability to generate assets for our own balance sheet. What we mean by this is as follows.

We can grow assets and therefore interest income through mortgage originations that we decide to portfolio as well as through our commercial originations. We do not have to sell everything we originate, particularly on the mortgage side, which gives us flexibility and options that maximize returns for the bank. In terms of the business lines being complementary, we originate mortgages that we can either portfolio or pool and sell. These mortgages create MSRs that we can also hold or sell. Given our unique servicing platform, we can service our own loans or sub-service loans for the buyers of the MSRs for a fee. Being a bank, the [extra] custodial deposits these loans generate are valuable to us as they help fund our balance sheet.

We can also offer financing solutions around the MSR asset or servicing advances through our commercial lending businesses. On the origination side, we also offer warehouse lending facilities to our third-party originators, and of the 260 or so relationships we currently have, approximately 92% sell some portion of their loans to Flagstar. And with our commercial clients, we can leverage borrowing facilities into deposit relationships. This is all done under the watching guidance of a comprehensive risk and compliance infrastructure. The points I'm demonstrating is our business lines feed each other and give us flexibility and optionality to generate assets for sale and our own portfolio as well as providing a first-class service and multiple solutions for our customers.

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 increased $469 million or 20% to $2.8 billion led by warehouse lending which increased $351 million or 36%, and further bolstered by growth in C&I in CRE lending. Average commercial loans held for investment exceeded consumer loans held for investment at the end of the quarter as we continue to balance earning contributions between the mortgage and commercial businesses, smoothing out earnings volatility and allowing us to accelerate earnings in a favorable mortgage environment.

During the last 12 months, we've grown total average commercial loans by nearly $800 million led by a $347 million or 36% increase in warehouse lending. Of the $1.3 billion in average outstanding warehouse balances during the quarter, 58% of loans funded were sold to investors other than Flagstar with the remaining 42% of loans funded being sold to Flagstar. CRE lending has grown $266 million over the last 12 months, and C&I lending $186 million over the same time period as we continue to execute on our relationship-based approach with borrowers in many different industries. As you know, we introduced several new commercial lending business lines at the beginning of this year, including builder finance lending, MSR lending, and equipment finance lending.

We currently have $90 million in outstandings of builder finance loans and have approved $60 million of MSR lending facilities which we expect to fund in the next few weeks. We believe these new business lines will complement our existing C&I and CRE lending channels, and we will continue to see solid consistent growth as we move forward. Furthermore, we can leverage these lending relationships to generate other synergies such as

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deposit growth and sub-servicing opportunities. Average consumer loans decreased $568 million or 17% in the quarter, as we sold $408 million of performing residential mortgage held for investment loans to realize significant gains on our existing portfolio in response to market conditions.

During the quarter, we also added approximately $220 million of non-agency and agency product to our portfolio from our own originations. Our NPLs now stand at $44 million, the lowest level in over 15 years, and 30 to 89 day delinquencies total $7 million at the end of the quarter, down $4 million from last quarter, which demonstrates both the quality of our overall book following that de-risking program last year and the effective work of our collections team preventing delinquent loans rolling further past due. Average total deposits grew $581 million or 7%, led by higher Company-controlled and retail deposits. The higher Company-controlled deposits are driven in part by a higher servicing loan count this quarter, and the growth in retail deposits has been driven by leveraging commercial relationships, as well as our new branding campaign. 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 lock volume increased 18% to $8.1 billion led by higher seasonal purchase volumes. Mortgage closings increased 31% to $8.3 billion quarter over quarter as our underwriting and fulfillment teams were able to flex up and adjust to the higher lock volume while also maintaining consistent turn times and excellent service levels. Our net gain on loan sale margin increased 8 basis points quarter over quarter to 104 basis points excluding the HFI loan sales. The higher gain on sale margin was primarily attributable to a higher correspondent margin and an increased mix of retail production.

The steps we've taken during the first six months of this year to expand our distributed and direct to consumer retail businesses are beginning to yield positive results. With gross rate locks increasing from 6% in Q4 2015 to 8% of overall production this quarter. Finally, we are continuing to see positive results from our consumer portal, which we launched last December. During the first six months of this year, the portal has generated over 3,000 inquiries which has led to approximately 1,600 full applications. 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 mortgaging servicing segment on slide 14 include we executed on the sale of $2.2 billion in aggregate UPB of concurrent flow sales or more than 9,100 loans of residential MSRs during the quarter where we will be the sub-servicer on these loans. We currently service approximately 358,000 loans of which 194,000 are sub-service for others making us the seventh largest sub-servicer in the nation. The remaining 164,000 are loans where we own the MSR or they're part of our HFI book. Approximately 98% of our servicing book is performing loans and 2% or approximately 7,600 are 60 plus days delinquent. Average Company-controlled deposits, which are directly correlated to our servicing loan count, increased $403 million during the quarter to $1.6 billion.

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 to cross selling to cross out 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. Moving on to expenses on slide 15. Our noninterest expense increased $2 million to $139 million in the second quarter. The increase was largely driven by higher commissions and loan processing expense due to higher mortgage volume. The other noninterest expense categories remained relatively stable.

Our efficiency ratio improved to 68% in the quarter compared to 75% in the prior quarter as revenues grew by 11% and costs only increased 2%, further demonstrating the strong operating leverage we've built within our business model. We previously stated that our targeted long-term efficiency ratio is in the mid-60%s, which equates to approximately $0.75 earnings per share per quarter or $3 earnings per share annualized. 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 and risk management we've instilled throughout the organization.

We estimate noninterest expense will be between $142 million and $147 million during the third quarter of 2016 due to the cost associated with higher mortgage originations and our investment in growth initiatives including our mortgage retail channels and various commercial lending businesses that I spoke about earlier. Furthermore, we believe our efficiency ratio will remain in the high 60%s to low 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-60s efficiency ratio.

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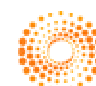

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We are pleased with our progress and are committed to delivering strong returns for our shareholders and believe we have built a model that will enable us to continue to deliver on the strong and consistent results you've seen over the last 18 months. 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 Q3 and then open the call for questions and answers. Please turn to slide 17. We expect average earning assets will increase 5% to 8% led by higher loans held for sale and commercial loans. We anticipate a slight contraction in the net interest margin due to the impact of senior notes related to our TARP redemption. We expect mortgage locks will increase approximately 5% on a slightly stronger mortgage market.

We anticipate a moderately stronger gain on loan sale margin from our adjusted Q2 number. We expect the net return on the mortgage servicing asset will be negatively impacted by continued prepayments. We anticipate the balance of our MSRs will be relatively flat. We expect our provision expense will match net charge-offs which we believe will be consistent with the net charge-off ratio in Q2 adjusted for loan sales and loans with government guarantees.

And as Lee noted, noninterest expense will probably be between $142 million and $147 million due to higher mortgage originations and increases in asset resolution and other noninterest expense. This concludes our prepared remarks, and we'll now open the call to questions from our listeners. Roxanne, I'll turn it over to you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

And we'll take our first question from Scott Siefers.

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

Hi, Scott.

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

I just had a quick question, so a couple ones. First on the expense outlook, Lee, it sounds like from your comments, the $142 million to $147 million, that's going to be perhaps a new steady state given that you've got some investments pending that you'll do. Just curious, one, if that's indeed correct or if two, there might be some element of transitory nature to it given that it's also a function of origination volumes and then I think you guys had suggested some asset resolution expense as well. In other words, while it goes up in the 3Q, is there any chance we'd see some moderation thereafter?

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

I think you've hit the nail on the head, Scott. So what you saw in Q2, a lot of that increase was driven by the increase in mortgage volume. And you can see that in the commissions and loan processing expense lines particularly. And the guidance that I'm giving for Q3, the $142 million to $147 million, that's driven again by we're guiding to slightly higher mortgage activity in Q3 versus Q2. I think what I would tell you as well in Q2 that we benefited from, not much, but there was probably $2 million to $3 million of sort of one-time events.

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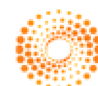

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We got some reimbursements on asset resolution. There was about $1.5 million and we also came in a little lower on consulting fees which you see on the legal and professional line. There was some lower repairs and maintenance costs in Q2. That probably had sort of as I say $2.5 million benefit. That is why we came in at $139 million. Otherwise it would have come in right in the middle of what we guided to for Q2 if you call which was $142 million to $145 million.

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

Okay. That's perfect. Thank you. And then maybe switching gears just a bit. Sandro and Jim, now that TARP is almost officially behind us, wonder if you could just kind of remind us of capital priorities as you would see them whether it's reinstating a dividend, stock fund buyback. I know you've talked about M&A a little this year but you also have a very strong growth dynamic. The other emerging piece of the story is you have gotten nearly 300 basis points of capital that feels like naturally become available here over the next couple of years. Just any updated thoughts on capital you could give. I'd appreciate it.

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

Let me have Jim talk to about capital generally. What I'll tell you is you've made a good point relative to recognizing the rapid capital growth opportunity that we've got. And so given that, that will support the bigger balance sheet and that has been our strategy here over the last three years is to grow the balance sheet and as noted in Lee's prepared remarks, about the importance of continuing to grow the community banking business and the net interest income associated with that. I think we believe that the best use of our capital going forward in order to be able to smooth out earnings and take away some of the market concern about the volatility of the mortgage business is to continue to improve the net interest income line. And so that's how I see the use of our capital. Let me let Jim comment as well.

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

Right, so directly answer your question, Scott. There are no plans at this time to do anything like a dividend or any buyback programs. And I think our best -- our highest and best use of capital is to continue to grow the balance sheet, like Sandro said, as long as we can continue to find the great investment opportunities in markets where we think we can provide a unique and strategic advantage over other players in those markets.

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

Okay. That's perfect. Thank you, guys, very much.

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

Thank you, Scott.

Operator

And will take our next question from Bose George. Please go ahead.

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

One question on the guidance first. The 2Q to 3Q provision you said will be in line with the 2Q charge-offs which was around $9 million. Is there an offset in there for the Ginnie Mae losses or is it the $9 million we should use?

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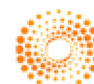

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Jim Ciroli - *Flagstar Bancorp, Inc. - CFO*

Hello, Bose. This is Jim. We're trying to guide you, in my speech we talked about a net charge-off run rate. And that's what we tried to guide you. The $9 million includes charge-offs related to loan sales, which I don't know that those are going to repeat as well as to some EVO charge-offs. And so we're trying to guide you to what is kind of residual after those two components.

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

Okay. Okay, great. And then actually just switching to the earlier question also referred to, potential M&A activity that you guys have talked about in the past. Is there a way to kind of think about what it could be, what areas it could be in, potential of scale, et cetera?

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

Well, Bose, I think that now that we have TARP behind us, the main thing that we need to focus on is moving through the consent order. As I think you probably know, when you are under a consent order, a bank acquisition is not possible. So I think we'll wait until the consent order is lifted to talk about that as a real opportunity in the future. On the mortgage side, I think that if we can find a way to accelerate to the growth that we would like to see in our retail originations, I think we would do that. But it's got to be the right deal. And frankly, it's hard to find the right deal. The right deal at the right price that has the right quality and what were looking for is not easy to find. So that's certainly a possibility and we'll keep our eyes open in that regard. But it's not something we feel like we have to do in order to execute on our business plan.

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

Okay, great. Thanks. Just one more on the normalized tax rate going forward. Is that 34%?

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

Yes. That's what we've said consistently. So it's just a small little benefit this quarter. But it should normalize back to 34%.

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

Okay, great. Thanks.

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

Thank you, Bose.

Operator

And will take our next question from Paul Miller. Please go ahead.

Paul Miller - *FBR & Co. - Analyst*

Thank you very much, guys. On the loan sales, can you talk a little bit about what type of loans you did sell? If you mentioned it before, I missed it. And are you planning on more loan sales? I guess they were mostly residential consumer loans. It is that just -- not de-risking the balance sheet but switching the balance sheet to more of a commercial flavor than a consumer flavor?

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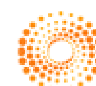

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Sandro DiNello - *Flagstar Bancorp, Inc. - President & CEO*

Let me start, Paul, and then I'll let the other guys here pipe in they like to. It's really taking advantage of market opportunities. So if there's an opportunity to sell an asset at a gain and replace it with an asset that has a better spread and not significantly create a risk profile, we're going to do that. So if it fits from a duration point of view, then we're going to take advantage of that opportunity. And this is one of the great advantages that we have. We can generate assets without a tremendous amount of difficulty. And so we're not afraid to sell assets, take a gain, and then replace them when that opportunity presents itself.

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

Yes, so Paul, it's Lee. Just building up what Sandro said. So $408 million over the sales that we executed on in the second quarter were exactly that. And they were performing residential mortgage held for investment loans. And we did that because the market conditions that allowed us to take gains on those sales. And we started to cycle some of that balance sheet capacity into the commercial loans. As we discussed, we've grown commercial loans -- average commercial loans $800 million over the last 12 months. There was another smaller sale of $14 million of NPLs, TDRs, and scratch and dent loans. An opportunity presented itself that made economic sense and it just gave us a chance to further de-risk the balance sheet.

Paul Miller - *FBR & Co. - Analyst*

Now on the loan sales, did you sell them through -- did the gain on those things flow through the mortgage banking side? Because I didn't see any gains on the income statement from the loan sales.

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

They are included in the overall GOS and so if you look at the detail, you would see that we do break out how much of the gain on sale came from the HFI sales. And we also provided an adjusted margin so you can see what the overall margin was and you can also see what the margin was net of the gains associated with those HFI sales.

Paul Miller - *FBR & Co. - Analyst*

And were these mostly 30 year fixed-rate mortgages then?

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

No, they were not. They were probably mostly jumbo ARMs.

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

Yes, all at seven.

Paul Miller - *FBR & Co. - Analyst*

You said they were sevens, seven ones?

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

Yes, five and seven ARMs.

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

We [definitely] recent origination. I think we had originated relatively recently.

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

Yes, within last 12 months. And just generally, Paul, we're very, very seldom do we put any 30-year fixed paper on the books.

Paul Miller - *FBR & Co. - Analyst*

Yes, that's what I thought. I was just wondering why it was such a big sale. I know you guys take advantage of the market opportunities. You guys have always done that. The other question is, how should we look at the preferred dividend? You have about $8 million that flowed through the income statement. I guess when you get done paying down TARP, did that whole $8 million disappear?

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

Yes, Paul. This is Jim. In Q3, you'll see still one month of that because we'll redeem that in full on Friday, this Friday. But you know, on quarters thereafter, that $8 million will completely go away. It will be replaced by the funding that we raised up in the interest expense section.

Paul Miller - *FBR & Co. - Analyst*

So your NIM comes down but that preferred dividend goes away.

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

Correct. Actually, net income will come down but EPS should go up.

Paul Miller - *FBR & Co. - Analyst*

Yes. And then what was the adjustment? So when all this clears out, is it about $1.50 on the accrued? What's the total number on the accrued interest expense on those preferred that go out the door?

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

So the back dividend is $104 million.

Paul Miller - *FBR & Co. - Analyst*

$104 million. Thanks a lot, guys.

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

Sure. Thank you, Paul.

Operator

And we'll take our next question from Kevin Barker.

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

Morning, Kevin.

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

Good morning. Thank you for taking my question. In regards to the retail mortgage originations you did this quarter, it's roughly $0.5 billion. You've made quite a few hires over the last few months. Given that backdrop, what's you're trajectory for the amount of retail originations into the third quarter and maybe going forward from there?

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

Hello, Paul. We haven't been specific, Kevin, about targets. But I think the growth that we noted in the speech comments which was related to the gross locks kind of give you a sense for the growth that we are experiencing. I think that rate of growth can continue. So market conditions always are going to have an impact on what the business levels are going to be. But I think that kind of steady growth in retail originations is what we would expect to see.

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

What percentage of your retail originations would you assign to the recent hires that you've done in that channel?

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

I don't know that I have that information at hand. But remember that it takes time for people to come in and get their pipelines going and so forth. So I think that will better reveal itself over the next couple of quarters as opposed to this quarter.

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

Okay. And then the incremental impact that you expect on NIM over the next quarter, obviously the senior debt rate as well will have an impact. But you know, from reinvestment yields that you're seeing on your not only warehouse lines but other commercial real estate, I mean other commercial loans, where do you see the most pressure outside of the recent senior debt rates?

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

I think that relative to the banking business, it's being very disciplined on the asset generation side and making sure that the assets we put on the books not only have the right credit profile, but give us the returns that meet our minimum thresholds. And so I think when we look the net interest margin, the guidance we gave you is that the change in the next quarter will be related to the impact of the senior notes. And so what that tells you is, we don't think there's going to be an impact relative to the business generally. And so what I like to think is that we're at a point where that

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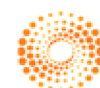

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has bottomed out and now that we've got all of this balance sheet restructuring behind us, as we continue to grow the banking assets that you'll see that margin over time widen. That certainly will be our objective.

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

Given your loan to deposit ratio is below 80%, you probably have some flexibility on the deposit side.

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

Absolutely.

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

And then in regards to the MSR sales, it looks like you paused this quarter outside of flow agreements. Was there any shift in strategy in this quarter, just given the repayment of TARP or do you expect to accelerate the sales on a go forward basis?

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

I wouldn't call it a shift in strategy. Again, you try to do things when the market gives it to you, and sometimes the market gives it to you and sometimes it doesn't. And we have been very focused on increasing the level of gross sales that we have but the bulk sales are going to happen when they make sense to happen. And this wasn't the right transaction to trigger in Q2. Lee, anything you want add to that?

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

No. I think you've hit the nail on the head. We will be responsive to the market when it makes sense just to the flow sales in Q2.

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

Thank you for taking my questions.

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

You're welcome.

Operator

And we'll take our next question from Jesus Bueno. Please go ahead.

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

Good morning, Jesus.

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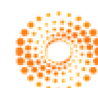

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Jesus Bueno - *Compass Point Research & Trading - Analyst*

Good morning, and thanks for taking my questions. I apologize if this may have asked before but in terms of the gain on sale guidance going forward, is it relative to what you're seeing in terms of margins or is it more associated with mix? Of course, your retail margin or retail originations as a percentage of your mix seemed to have picked up a bit.

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

Yes, I think it's a combination. I think certainly as the retail originations pick up, you are going to see the margin widen and as you well know, that comes along with some additional expenses. So it's a little deceiving when you see the margin increase because of retail expansion. But it's also a function of demand in the market and if -- we always are going to default to service quality and service excellence and so at times, that will mean that we'll take a little more bit margin and control the volume of the business. We are much more interested in revenue and income as compared to market share. And so when the market gives us that opportunity, then we're going to take a little bit more margin. So I don't see that it's going change significantly, Jesus, in the next quarter. But I think it's a little weighted to the upside for us in the gain on sale margin.

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

That's great. Thank you. And just as a longer term, I guess I'm thinking about your retail operations. I know you were able to pick up some talent from a competitor. How has that integration gone? I guess, longer term what are your expectations for that? And perhaps even where would you expect retail as a percentage of overall originations to go ideally?

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

Well, as I said earlier, we haven't set forth a target for that. We want to see steady growth in our retail originations. We've seen that over the first six months as reflected in those gross lock figures that I shared with you. And so we think that that is going to continue. And again, will take what the market gives us. We're not going to force it if the right business isn't there. But I'm pretty optimistic that the opportunity to grow that business steadily over time will be there.

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

Thank you. And just one last question. As it relates to the OCC consent order, I know you can't comment too much on these things. Of course there's the phase where you're actually trying to correct things and then there's kind of a monitoring phase to ensure that you're compliant. I take it, in terms of where you are in the consent order, I take it -- I would assume it's the latter that it's essentially a monitoring phase you're in.

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

Unfortunately, I would love to be able to answer that question very specifically but I can't. But you know, like I said in the prepared comments, I'm very confident we're in the stretch run here. So I don't think it will be a long period of time before that will be behind us.

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

I completely understand. Thank you very much for taking my questions.

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

You're welcome.

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Operator

And it appears we have no further questions at this time. I would like to turn the call back over to our speakers for any additional or closing remarks.

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

Thanks, Roxanne, and thanks, everyone, for your interest in Flagstar. Looking back at the quarter, we are pleased with the consistency of our earnings. With our unique relationship driven business model, we have demonstrated that we are positioned to succeed. In fact, we have performed through volatility in interest rates, landmark regulatory changes, and the ups and downs of mortgage originations. The power of our mortgage business combined with the versatility of our community banking business gives us unique flexibility.

Looking ahead, we are committed to hitting our long-term financial targets by growing our business, especially our community bank. And thanks to the resolution of TARP, we now have more options. We appreciate the loyalty of our shareholders and their support for our business plan and we thank our employees for all they do every day to make Flagstar a success. Finally, thank you for your time this morning. I look forward to reporting Q3 results in October.

Operator

And this does conclude today's call. We thank you for your precipitation. You may disconnect at any time. And have a wonderful day.

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