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FBC - Q3 2016 Flagstar Bancorp Inc Earnings Call

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CORPORATE PARTICIPANTS

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

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

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

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

CONFERENCE CALL PARTICIPANTS

Paul Miller *FBR & Co. - Analyst*

Brendan Nosal *Sandler O'Neill & Partners - Analyst*

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

Kevin Barker *Piper Jaffray & Co. - Analyst*

Henry Coffey *Wedbush Securities - Analyst*

PRESENTATION

Operator

Good day and welcome to the Flagstar Bank third-quarter 2016 earnings conference call today's conference is being recorded. At this time I'd like to turn the conference over to Mr. David Urban, director of investor relations please go ahead sir.

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

Thank you and good morning welcome to the Flagstar third-quarter 2016 earnings call. This is David Urban, director of investor relations. Before we begin, I would like to mention that our third-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 uncertainties. Factors that could materially change our current forward looking assumptions are described on slide two of today's presentation, in our press release, and in our 2015 form 10K and subsequent reports on file with the SEC. We are also discussing GAAP and non-GAAP financial measures, which are described in our earnings release and in the presentation we made available for this earnings call. You should refer to these documents as part of this call. With that I 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 think 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, and Steve Figliuolo our chief risk officer. I'm going to start the call by providing a high level view of our performance for the quarter, and then I'll turn the call over to Jim, for a deep dive into our financial results. We will follow with a more detailed review of our business segments and strategic initiatives and I'll conclude with guidance for the fourth quarter, before opening up the lines for questions.

As you know we've posted a solid quarter this morning. Net income totaled $57 million, or $0.96 per share. Our largest quarterly profit in nearly 3 years. With the completion of our TARP repayment, at the beginning of the quarter, together with the eighth consecutive quarter of profitability, I think it's safe to say Flagstar has turned itself around. The final I will be dotted when we exit our consent order, and I am hopeful that will happen in the not-too-distant future.

Our business model is clearly proving to be successful. The underlying power of our core business is to provide consistent, diversified earnings regardless of the financial dynamics of the quarter, is being demonstrated, quarter after quarter. Deploying our capital is important to growing our earnings, and we saw strong growth in earning assets this quarter, led by our community bank where commercial real estate was up 20%, and warehouse loans were up 18%. Expense discipline is also very important to our strategy, and I'm pleased to report that topline growth drove positive operating leverage and improved efficiency ratio. The modest expense growth we experienced during the quarter, was due entirely to performance driven items. We also benefited from a lower cost of capital, due to the repayment of our TARP preferred as a result of the dividend the bank paid to the holding company, in connection with the TARP repayment our expectation as to the timing of payments to the DOJ has changed, resulting in a reduction in the liabilities fair value. Jim will provide a deeper dive on this matter when he discusses our financial results.

On the mortgage side, low rates continued to fuel refinances which produced positive results in our mortgage business during the quarter. Net gain on loan sales rose 11% to $94 million unadjusted results from the prior quarter, with the increase largely attributable to our success at managing margins. We continue to take advantage of today's low rate environment, and we are well positioned to capitalize on the favorable economics of the purchase market, when the time comes.

Solid credit quality was another hallmark of the quarter. Both our nonperforming loans, and our net charge up ratio were lower. And we continue to have no commercial delinquencies or commercial nonperforming loans. With TARP now behind us, we are in the position to reap the benefit of lower capital costs and that gives us the luxury of having more options. Options to invest internally in our businesses, or to invest externally and businesses that will accelerate our growth, and add value to our company. We believe we have a one-of-a-kind business model, focused on growing our community banking business, expanding our mortgage business, and building our servicing business. All this is aimed at delivering industry-leading returns for our shareholders, within a strong risk compliance framework. 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 six, our net income this quarter was $57 million, $0.96 per share, as compared to net income of $47 million or $0.66 per share last quarter. This quarter benefited from a drop in the fair value of the DOJ settlement liability, totaling $24 million. Excluding this benefit, third-quarter net income was $41 million or $0.69 per share and EPS increase of 5% from last quarter.

Our earnings this quarter were led by strong commercial loan growth, better gain on sale margins on higher volume, and positive operating leverage. The quarter also benefited from two months of our post TARP redemption capital structure. For the quarter, we posted, on an adjusted basis, a return on assets of 1.2% and a return on common equity of 12.6%. Both enviable measures. It was a solid quarter with high-quality earnings.

Let's turn to slide seven. Our third-quarter net interest income rose 4% to $80 million. This reflected a $679 million, or 6% increase in earning assets. Led by increases in both loans held for sale, and loans held for investment. As expected, our NIM also fell slightly in the quarter, to 2.58%, driven by a partial quarter of interest expense on the senior debt issued for TARP redemption. This negative impact was partially offset by increased net interest income, from a rotation into higher spread commercial loans. The quarterly provision for loan losses totaled $7 million for the quarter, as compared to a provision benefit of $3 million in the prior quarter. Asset quality continues to be strong, and I'll provide additional detail in a couple of slides.

Noninterest income increased $28 million, to $156 million this quarter. This included a benefit from the drop in the fair value of the DOJ settlement liability totaling $24 million. The fair value of the company's DOJ settlement liability was $60 million, at September 30 down from the $84 million fair value at June 30. The lower value resulted from a change in the estimate as to the timing of payments to the DOJ. Payments to the DOJ will occur when the bank's tier 1 leverage ratio is 11% or greater, at the end of any quarter. Subject to OCC approval. This quarter, the bank paid a dividend to the Bancorp of $200 million, to support the redemption of our TARP preferred. This, combined with an expectation for additional dividends in the future, from the bank to the Bancorp, resulted in a projection of a longer time period before this remaining criterion, that is tier 1 leverage of 11% or greater, is met.

So, excluding the DOJ benefit, noninterest income rose $4 million or 3%, primarily to higher net gain on loan sales and loan fees and charges. This positive impact was partially offset by a wider loss on the mortgage servicing asset. So let's dive deeper into each of these items. Third-quarter net gain on loan sales increased 4 million or 4%, the increase from the prior quarter primarily reflected an improved gain on sale margin. Net gains on loan sales increased $9 million or 11%, when excluding the $5 million of gains last quarter, that were previously designated as HFI. The net gain on loan sale margin was 113 basis points, an improvement of nine basis points over last quarter, when we saw our fallout adjusted locks increase 2%, led by an 80% increase in refinance activity. The net return on the mortgage servicing asset was a loss of $11 million this quarter, resulting from higher prepayments and a charge of $7 million this quarter for MSR sales that will close next quarter. Those MSRs had a carrying value of $50 million at quarter end. The R and W benefit rose $2 million this quarter as the R and W reserve fell to $32 million, the result of continued improvement in risk trends and a repurchase demand pipeline that is now only $11 million. In other noninterest income, excluding the DOJ benefit, was $12 million in the third quarter, as compared to $9 million in the prior quarter. This increase was led by a combination of several categories, including securities gains, customer derivative revenue, and improved fair value adjustment.

Moving out to expenses. Noninterest expense increased 2% to $142 million this quarter, as a compared to $139 million last quarter, overall higher performance-based compensation, and increased business activity drove this quarter's increase. Compensation and benefits increased $3 million, and commissions rose $2 million. The company's efficiency ratio excluding the DOJ benefit, still improved to 67.0% this quarter, as revenues grew without the addition of significant incremental expenses.

Slide eight highlights our average balance sheet. Average earning assets increased $679 million, or 6% led by solid growth in loans held for sale and loans held for investment. Loans held for investment grew 5% as average commercial loans grew 16%. Lee will discuss commercial loan growth in a few minutes. Average deposits rose $495 million, or 6%, led by a 19% rise in company controlled deposits. At September 30, are common equity to assets ratio remained strong at 9.0%, and our book value per share fell to $22.72 reflecting the impact of paying the deferred TARP dividends at redemption.

Let's now turn to asset quality on slide nine. Nonperforming loans fell to $40 million at the end of the quarter, down $4 million from the nonperforming loan ratio of 63 basis points, represented an improvement of 13 basis points over last quarter. There were no commercial nonperforming loans. Early stage to link with these also remains low. Only $8 million of consumer loans were over 30 days delinquent, and still accruing. And there were no commercial loans at September 30 there were more than 30 days to delinquent. Net charge-offs were $7 million this quarter, representing 51 basis points of loans compared to $9 million in the prior quarter, or 622 basis points of loans, most of the charge-offs related to our loans with government guarantees were prerecorded a charge of $5 million. At September 30, our allowance coverage was 2.3% of total HFI loans, down slightly from the end of last quarter. Coverage remains strong at 3.8% of consumer loans, and 1.3% of commercial loans.

Turning to slide 10, capital remains strong. As expected our tier 1 leverage ratio fell to 8.9%, largely due to the TARP redemption. Our tier 1 leverage ratio was 30 basis points higher than at June 30, pro forma for this TARP redemption. Our CET 1 ratio was 12.0% and our tier 1 and total risk-based capital ratios remained well above peer averages. These ratios are even stronger when reflecting upon the lower level of risk in the balance sheet and the strong risk management function we've built. This strength is also reflected in the good D fast results we disclosed yesterday, which show the benefits of our de-risking efforts over the last few years, and validate the strength of our capital position post TARP.

We continue to grow our regulatory capital at a pre tax rate as we utilize our net operating losses. At September 30, our tier 1 leverage ratio was reduced by 127 basis points for the NOL related DTAs and we anticipate the elimination of this deduction, over the next 2 to 3 years, given our profitability. MSR is in excess of the amounts allowable under BASLE 3 also reduce tier 1 leverage by 105 basis points. The sales of MSRs under contract at September 30, which are expected to close in Q4, will benefit tier 1 leverage by 19 basis points. We anticipate that this excess MSR deduction will be eliminated over the next six quarters, through both flow and bulk sales. The combination of these two reveals more than 230 basis points of capital deductions, that we believe will be eliminated over the next 2 to 3 years, providing an outsized level of internal regulatory capital growth, during that period. I will now turn to Lee into more insight into our businesses.

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

Thanks Jim, good morning everyone. We're very pleased with our performance in Q3 and believe it further validates the profitability, and sustainability, of our one-of-a-kind business model. If you remember from our last earnings call, we spoke about how our three major business lines, the Community Bank, mortgage originations, and mortgage servicing, feed each other and enable us to generate high-quality, interest-earning assets in multiple ways, and yet provide complementary hedges, so we can operate successfully in any interest rate environment.

During the quarter, we've seen a most $500 million of growth in our warehouse, CRE, and C&I lending channels. And these were supported by another strong quarter for our mortgage operation. This has enabled us to grow interest-earning assets by approximately $700 million during the quarter, which resulted in an increase to total interest income of $7 million quarter over quarter. Adjusted noninterest income increased $4 million quarter over quarter, despite a negative return on our MSR asset of $11 million. We believe this quarter's performance demonstrates that the investment in our growth initiatives is paying off and that our scale across businesses gives us operating leverage which the improvement in efficiency supports.

Q3 represents the eighth consecutive quarter of consistently strong profitability. After the 12 months ended September 30, 2016, we generated $160 million of adjusted after-tax net income or $2.33 earnings per diluted share, excluding this quarter's DOJ benefits. Remember, these earnings-per-share number includes 10 months of top dividends, which has now gone away, so if you adjust for that pro forma EPS is $2.63 per diluted share, over the last 12 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 increased $445 million, or 16% to $3.3 billion, led by warehouse lending which increased $236 million or 18%, and further bolstered by CRE, lending which grew $183 million or 20%. Average commercial loans held for investment exceeded consumer loans held for investment 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 over $1.2 billion, led by a $616 million, or 66% increase in warehouse lending. Of the $1.6 billion in average outstanding warehouse balances during the quarter, approximately 60% of the underlying loans were sold to investors other than Flagstar, with the remaining 40% being sold to Flagstar.

Average CRE lending has grown $417 million or 63% over the last 12 months, and C&I lending has grown $190 million or 43% over the same time period, as we continue to execute on our relationship-based approach, with borrows in many different industries.

As you know, we introduced several new commercial lending business lines at the beginning of this year. Including build-a-finance lending, MSR lending, and a equipment finance lending. We currently have $100 million in outstandings of builder finance loans, $27 million in equipment finance outstandings, and funded our first MSR facility during the quarter, where we are also the sub servicer of the underlying loans, with further potential fields in the pipeline. 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 deposit growth and sub servicing opportunities.

We added $187 million of high-quality jumbo and conventional originations to our health reinvestment portfolio, during the quarter, as we look to balance earning asset growth between various asset classes, to reduce risk. Overall, average consumer loans decreased $166 million, or 6% in the quarter, led by a drop in mortgage loans due to prepayments, and the impact of loan sales that closed towards the end of the second quarter, and reduced average balances at the beginning of Q3. Our NPLs now stand at $40 million the lowest level in over 15 years. And 30 to 89 day delicacies totaled a modest $8 million at the end of the quarter, which demonstrates both the quality of our overall book and attributes of our unique servicing platform. It should be noted we have no delinquent or nonperforming commercial loans on our books at this time.

Average total deposits grew $495 million or 6% in the quarter, led by higher company control deposits. Over the last 12 months, we've grown retail deposits by $305 million, government deposits by $78 million, and company control deposits by $483 million, for total deposit growth of $866 million. This growth is been achieved through executing on several strategic initiatives, including our rebranding strategy that went into effect earlier this year, putting greater emphasis on bringing in deposits from commercial customers, and leveraging our sub servicing business for custodial and escrow deposits.

Looking forward, we believe we can continue the growth you've seen in our commercial businesses, as we leverage the new lending channels, while building in our core CRE and C&I businesses. We are also looking to enhance these by introducing syndications and middle-market teams in early 2017. Furthermore, and as we have mentioned, we can complement our commercial growth through portfolio growth, of high-quality mortgage loans from our mortgage origination business. Overall, we are very encouraged by the sustained growth in the community bank, our positioning and potential for the future.

Please turn to slide 30. Third-quarter operating highlights for the mortgage origination business include, all out adjusted lot volume increased 2% to $8.3 billion, led by higher refinance volumes, particularly in our correspondence channel. Mortgage closings increased 10% to $9.2 billion quarter over quarter, as our underwriting and fulfillment teams were able to flex up and adjust to the higher lot volume, while also maintaining consistent turn times. Our net gain on loan sale margin increased nine basis points quarter over quarter, to 113 basis points, excluding the HFI loan sales in the second quarter. The increase in margin was driven by stronger market pricing power, as we priced to balance volumes and capacity in order to maintain first-class service levels.

The steps we've taken during the first nine months of this year to expand our distributed and direct to consumer retail businesses are yielding positive results. With retail, all out adjusted rate locks increasing nearly $250 million, or 77% from the same period last year, and $400 million or 36% on a year-to-date basis.

We're also leveraging our direct to consumer business to provide recapture and retention services for those clients we subservice loans for. This provides significant value to the owners of MSRs or the underlying loans, and is another way our business loans complement one another. Looking forward, we will continue to pursue the growth of our retail footprint, via organic and inorganic strategies. As well as to expand our third-party originations business, via new customer activations. As you know, we're the sixth largest bank originator in the nation and are well-positioned to benefit from any market dislocation, were interest rates to rise in the refinance boom goes away. We're also looking at launching our own securitized loan pools levels, given we're an originator of scale, we already have a lot of the infrastructure in place to be able to offer securitized pools, and it will provide us more optionality in terms of what we can do with loans we originate.

Moving to servicing, quarterly operating highlights for the mortgage servicing segment on slide 14 include, we executed on the sale of $5.3 billion in aggregate UPB of bulk and concurrent flow sales of residential MSRs during the quarter. We also incurred disposition costs of approximately $7 million on a bulk Ginnie Mae MSR sale of approximately $4 billion in aggregate UPB that will close in Q4. This bulk sale is not reflected on slide 14, and represents nearly all of our remaining Ginnie Mae MSRs. We currently service approximately 366,000 loans, of which 198,000 are subservice for others making us the seventh largest sub servicer in the nation. The remaining 168,000 our loans were 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 7,400 loans are 60 plus days delinquent. Average company control deposits, which are directly correlated to our servicing loan count, increased 292 million during the quarter, to $1.9 billion, as a result of growth in the number of loan serviced, and higher prepayments during the quarter, given the low interest rates environment.

We remain focused on growing our fee income generating subservicing business which has the capacity to service up to 1 million loans and during the quarter we hired Don Klein to head up all servicing and sub servicing new business development. Don brings with him a strong track record, and we're thrilled to have him on board, and executing on or MSR reduction strategy, given the requirements of BASEL 3. 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 rose a modest $3 million to $142 million in the third quarter, due entirely to performance driven items. Compensation of benefits increased on higher performance-based compensation, and commissions rose on increased business activity particularly within the mortgage business. Slide 15 illustrates how we've operated within a fairly tight range when it comes to expenses over the last five quarters. This isn't something that just happens, it requires a tremendous amount of discipline and my compliments go to the team who are always looking at ways we can improve and become more efficient.

Our adjusted efficiency ratio improved for 67% in the quarter, compared to 68.2% in the prior quarter, as adjusted revenues grew by $7 million or 3%, and costs only increase $3 million or 2% further demonstrating the operating leverage we've built within our business model. We previously stated that our targeted long term efficiency ratio is in the mid-60s which equates to approximately $0.75 earning per share per quarter, or $3.0 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 instilled throughout the organization.

We estimate noninterest expense will be between $140 million and $145 million during the fourth quarter of 2016, due to the seasonal slowdown in the mortgage business, being offset by our investment and 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 60s to low 70s given the investment period that is needed to ramp up new business opportunities. However, and as previously mentioned, we're very confident that these initiatives together with the growth we anticipate an existing channels, combined with our cost and expense discipline, will ultimately see us achieve our long-term goal of a mid-60s efficiency ratio.

We're please with our progress and believe we have the right team, business model, and strategies in place that will enable us to deliver continued strong returns for our shareholders. With that all headed back to Sandro.

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

Thanks, Lee. I'm now going to close our prepared room is with some guidance for Q4 and then open the call for questions and answers.

Please turn to slide 17. We expect to grow average earning assets slightly, led by increases and C&I, CRE and jumbo mortgage loans, partially offset by a seasonal decline in warehouse loans. We anticipate a modest rise in the net interest margin, as we rotated to higher spread loans. We expect mortgage locks will drop approximately 15% on a seasonal decline in the mortgage market. We anticipate a moderate drop in the gain on sale margin, also on lower mortgage demand. We expect the mortgage servicing asset will realize an annualized loss of approximately 5% on a net return basis. We anticipate the balance of our MSRs will remain relatively flat through the end of year. We expect our provision expense will be slightly lower on continued strong asset quality, and as Lee noted noninterest expense will remain fairly stable between $140 million and $145 million. This concludes our prepared remarks, and we'll now open the call to questions from our listeners.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

We will take our first questions from Paul Miller, with FBR & Company.

Paul Miller - *FBR & Co. - Analyst*

Hi guys, good quarter.

Can you add a little more color about the Ginnie Mae sales. Backing into that, I guess you're planning to sell between $20 billion and $25 billion of Ginnie Maes. Are you expecting to take a gain on that, or selling it at the price where you have it marked?

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

I'm not sure what you're referring to at this point.

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

We are selling Ginnie Mae MSRs, Paul, that's what we're -

Paul Miller - *FBR & Co. - Analyst*

Yes, Ginnie Mae MSRs, that's what I was talking about.

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

Yes so basically, we have a flow dealing in place for the majority of our Ginnie MSRs, that we just renewed, but we were left with a, call it a legacy, amount that we just agreed to sell. It was a fair value adjustment on that, that's why we took the $7 million hit in the P&L and that's shown in the return on the MSR line. But once we close that sale, which should be in the next two or three weeks, we will have no more Ginnie MSRs left.

Paul Miller - *FBR & Co. - Analyst*

So all your Ginnie Maes are gone?

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

Yes. (multiple speakers) On the MSRs, yes on the MSRs.

Paul Miller - *FBR & Co. - Analyst*

And then you a flow agreement, so if you originate anymore Ginnie Maes, that flow, those Ginnie Mae MSRs just flow, I mean flow to whoever you have that arrangement with?

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

Correct.

Paul Miller - *FBR & Co. - Analyst*

And then on the origination side, you're growing your correspondent originations at a pretty good clip. Where do you guys see that as averaging out as a, on a, like you did $9 billion settlement, was corresponded, about 80%. I guess 80% back of the envelope type stuff. Is that what you want corresponded? Are you going to try to do more retail down the line?

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

Okay so let me start with the corresponded piece. I think that we are now in a position with our TCO channel where there's an opportunity to increase the number of TPO's that we have. Now, that's because I think we've got a very good system in place to rate our TPO's make sure they meet the high quality standards that we have in place at Flagstar. So this year, we've seen a little bit of growth in the number of correspondence that are selling loans to us, and I am hopeful that we'll see that continual increase as we go forward.

With respect to the retail business, we have seen nice growth this year in our retail business. We did slow that a bit, if you will, in the third quarter because there was so much refinance activity, we wanted to make sure that the capacity that we had was taking care of that refinance activity, keeping our service levels high, and the opportunity to expand and widen our margins presented itself. So overall, I think when you look at both the correspondent as well as the retail businesses, they're both good news stories.

Paul Miller - *FBR & Co. - Analyst*

Okay hey guys thank you very much.

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

Thank you Paul.

Operator

We will now take our next question form Scott Siefers, with Sandler O'Neill.

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

Good morning Scott.

Brendan Nosal - *Sandler O'Neill & Partners - Analyst*

This is actually Brendan on the line from Scott's team. I just wanted to start with your the recent balance sheet growth. And the pace has been pretty extraordinarily strong in recent periods. I was wondering how much runway you guys think you have to keep up such a pace, and if your loans up 14% year-over-year, 8% linked quarter, any thoughts there would be helpful.

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

Yes so I think this is one of the, a real positive things about our unique business model is that we have a lot of alternatives that are available to us to grow our assets. So in the most recent quarter, you saw the opportunity was there in the commercial businesses. And so we were able to grow particularly in our commercial real estate, in our warehouse business is very nicely.

In the past you've seen where we've taken advantage of the access we have to high quality adjustable rate jumbo loans, and we've added those to the balance sheet where the opportunity was there, and then when the opportunity was there to rotate out of those into higher yielding commercial assets, we took advantage of that. So, I think, to answer your question very specifically, I think our confidence in being able to grow at the same pace we've been growing is pretty high, and given the strong capital position that we're in, I think that the runway is there for us to be able to continue to do that.

Brendan Nosal - *Sandler O'Neill & Partners - Analyst*

That's great color. Thank you. And then one other one; I want to switch over to the net return of the MSR. One, just want to make sure I have the guidance for the fourth quarter correct, and then two, want to take a little bit of a longer term outlook here.

So I believe you guys said a negative 5% return annualized for the fourth quarter, which I believe comes to a roughly $4 million negative for that line, which would be roughly in line with this quarter. Outside of the $7 million negative impact. So, one, is that correct, and then two, how do you think about the return on the MSR as we look further out into 2017.

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

I'll look over to Jim to make sure that, you're --

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

Yes, Brendan, I think you're thinking about the right way.

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

I think you're right. Perfect, so with respect to returns going forward, it's largely a function of what's going on in the mortgage business. I mean when you have the high levels of prepayments that we have today, you know you're going to have challenge with respect to the MSR return.

The good news at Flagstar is, we've been able to overcome that with increased revenues in the mortgage business. So your guess is as good as mine as to what might happen with interest rates going forward, but if interest rates start to rise and if prepayments slow down as the MBA Freddie Mae and Freddie Mac think are going to happen, then I think you'll see on the return on MSR improve.

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

The other thing you need to consider, Brendan is that as we continue our sell down strategy over the next six quarters, we're going to continue to see transaction costs from that, from those bulk sales in, the flow sales shouldn't produce much in the way of transaction costs. But from the flow sales we're going to have transaction costs, flow through that net return line, and that's going to depress the return.

Brendan Nosal - *Sandler O'Neill & Partners - Analyst*

Understood. Thanks for the color guys.

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

Good. You're welcome.

Operator

We will now take our next question from Bose George, with KBW.

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

Good morning Bose.

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

Yes, good morning. Can you give us an update on the opportunities in the mortgage subservicing area.

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

Sure. This is Lee, Bose.

So I think what I would say is this sort of fits into our MSR strategy, in terms of us wanting to be fully aligned with BASEL 3 when it's fully phased in by Q1 2018 and given that we're able to subservice loans, we can also offer recapture and retention services, the escrow and custodial deposits are helpful to us, and we can offer financing solutions.

You're finding that there's a lot of people approaching us in terms of buying our MSRs because they know we can offer all of those services so we see that as definitely a way we can grow the amount of loans that we're subservicing. Just through the originations that we're doing day in and day out and then turning around and selling those MSRs.

What we're also finding now though is there's a lot of funds that are out there buying MSRs from others, and because they like the quality of the subservicing that we're doing, they're talking to us about putting loans on our platform that we haven't originated, and I think we mentioned earlier this year that we won an award from Fannie Mae, in the category of general servicing, that shows some of the, just our strengths from a servicing and subservicing point of view, and people are beginning to see that and are recognizing that.

And then we can work directly with the agencies in Ginny Mae, to subservice their books of loans as well, and so we've been in dialogue with those guys constantly over the last several months and that opportunity's there. And there's a fourth leg of the stall that we're actually thinking about launching in Q2 of 2017. And that's private label subservicing.

And so we're working on putting the technology in place that would enable us to do private label subservicing. So we feel very good about the opportunity. We feel very good about the quality, and we feel very good that just given the rest of our business model, we can complement and help grow that subservicing opportunity, Bose.

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

I would just add Bose, that I think we're the only full-service financial institution in the nation that offers this comprehensive subservicing platform. And I think that there are benefits that we have, being as highly regulated as we are, that can provide comfort to third parties that need someone to service their loans. So I think, you know the next year is important. We built this infrastructure that Lee talked about, hiring Don to lead the marketing efforts and so we look to increase the number of loans that we service on a steady basis going forward.

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

Okay great. And then actually, on a related note, the MSR financing opportunity, can you talk about how meaningful that is, is that just, the landscape there, how competitive, etc.

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

It's another arrow in the quiver, Bose. Individually it isn't the needle mover, but when you take a lot of these kind of niche businesses you put them together they do move the needle. This is a lending area where not a lot of banks are involved in and so from a competitive point of view, I don't think that's the issue.

It's finding the right counterparty that you're comfortable with lending to that meet all of our high standards relative to operations and capital and so forth. So it's been a nice addition for us, and one that I think has some growth opportunities going forward.

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

I think I would just add, Bose, the way we look at MSR lending it's a product that we want to leverage into a much deeper relationship with the counterparty, so we don't look at it just an one transaction and you're done. I mean we want to use that to then bring in subservice, loans that we subservice or deposits, all those other things that we can sell MSRs to the person that we're providing the financing to. So we look at it more as helping us establish a much deeper relationship with a particular counterparty.

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

Yes and that term, relationship, is important, that's where all of our business kind of tie together. So clearly we don't want to be making just an MSR loan to someone. We want that to be one of the services that they use Flagstar for.

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

Okay thanks and just one last one.

On the rep and warranty board, you said yesterday, Fannie Mae announced that the one day certain fee, which I guess should be a step towards more clarity on the rep and warranty side, can you just talk about how you feel on what's happened to the GSPs but also with the FHA. Is the FHA doing more? Do you see any signs there to help lenders with that issue?

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

Well I think the news on the R and W are certainly good, I haven't had much chance to dig into it or read anybody's opinions. But it certainly sounds like it's another step in the right direction. I think we've already seen some benefit from some of the changes Fannie Mae and Freddie Mac have made, and as a result at Flagstar, we've enjoyed a reduced liability in connection with rep and warranty.

On the government side you know that's still an open question Bose. I think lenders are still looking for more and more clarity, from the FHA in particular, relative to those issues that could cause indemnifications or other false claims app issues. But I'm happy to tell you at Flagstar compare ratios are very strong. There in the lower-level hundreds and so we are maintaining high-quality. And I think that if you as an originator, if you maintain high-quality if you keep your compare ratios at a low level, that you're less likely to have a problem in that business.

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

Okay great. Thank you.

Operator

We will now take our final questions from Kevin Barker, with Piper Jaffray.

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

Hi Kevin.

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

Hi, good morning, I just wanted to follow-up on the FHA, DOJ settlement fair value mark. Your tier 1 comment obviously came down and that affected your projection. But obviously you're going to be selling a bunch of MSRs going forward, which should benefit your regulatory capital ratios. So would you expect that liability to mark back up in the future?

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

No. I think we've projected what we think the capital ratios are going to be at the bank level. Contemplating exactly the things that you've talked about: our glide path to selling the MSR down, and the capital benefit that that's going to provide. So that's already incorporated in the numbers we've disclosed today.

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

Okay, so you have a little flexibility to kick the can down the road on paying that liability, is that right?

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

I wouldn't put it that way, not at all. No. This is a function of our business model, so as we run our projections for what we think will happen relative to the earnings of the company and the growth of our assets, we determine where we think capital is going to be, and what the big difference here, between a quarter ago as Jim said in his prepared remarks, is that we paid a $200 million dividend from the bank to the holding company, and that alone just changes the projections for when your payments are going to take place. You add to that the consideration of future dividends to the holding company to support the debt service, you know that further impacts what you think the projection for payments will be. So this is just math, and coming back to what the current fair value is, and it's as simple as that.

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

Okay. That makes sense. That makes sense. And then when I think about you made some comments around the consent order, and hoping that that would be lifted --

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

I didn't say much about that Kevin.

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

I know, I know. Hopefully it will be lifted sometime in the future. But when I think about that consent order, and your capability to-- could you just remind us, your capacity to either make bank or non-bank acquisitions, and your capacity to either buy back stock or not buy back stock, while operating under a consent order, and what flexibility you have around utilizing your capital base.

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

So certainly when, you know that, when you're under a consent order, you cannot file a licensing application. So anything, any business transaction that would require a licensing application is not available when you're under a consent order. So when the consent order is lifted, that opens the door to us thinking about those things.

Otherwise everything else is still available to us. I mean, look, $200 million dividend from the bank to the holding company, that required regulatory approval. When we get new lines of business for the most part, that regulatory non-objection. So we've navigated through all of that, and it's not hampered us in terms of improving shareholder value and earnings-per-share and so forth, and so I don't think in the short-term there's anything that really is going to be constraining for us, because of the consent order. And as I said in my comments, this isn't going to be around forever, and before you know it will be lifted and then we'll see how that changes our business strategies going forward.

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

That's helpful. Very helpful. Thank you Sandro.

Operator

We will now take our next question from Henry Coffey, with Wedbush.

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

Good morning Henry.

Henry Coffey - *Wedbush Securities - Analyst*

Good morning. Thanks for taking my question. Kind of continuing down the same line, is it an overly simplistic view that if you paid off the DOJ on day X, because you had accrued for the liability, that the impact on capital would be zero or minimal?

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

Oh yes. If you're paying something out of liabilities, I think that's correct. What we had at market - -

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

And then the gross liability there is $118 million and have it on the balance sheet at $60 million at the end of September.

Henry Coffey - *Wedbush Securities - Analyst*

So is that a gating factor for when you can declare a dividend and buy back stock, paying off that $118 million?

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

We wouldn't think about it that way Henry. So if we would take any action, like what you've mentioned and we have no plan to take any buyback or dividend action at this point time, that would affect the holding company. The capital trigger for payments to the DOJ is at the bank level.

Henry Coffey - *Wedbush Securities - Analyst*

But there's nothing in the agreement with the DOJ that says you can't up dividend capital to the holding company is there?

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

No. We just did it, when we --

Henry Coffey - *Wedbush Securities - Analyst*

Right. That's why I'm asking.

You could, it's not a gating factor. You could move forward. The consent order is obviously more of an issue. Regulatory non-objection is an issue. But this in and of itself is not a, isn't what would prevent you? Is that the way to think about this?

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

I think that's right.

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

That's right, and you probably know this, but just in case you don't the DOJ settlement agreement is a public document, so you can read it if you would like to.

Henry Coffey - *Wedbush Securities - Analyst*

And then in terms of business development, are there any one of these new initiatives whether, it's home lending, or MSR lending, that could open up some larger volumes? I know we haven't really see big numbers on MSR lending yet. But maybe you could give us some sense of, as to where those two business lines are going.

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

So Henry, with respect to all or different lines of business, we, our strategy is to be very disciplined in the growth rates of any one type of business. So we have in place what probably in the industry would be relatively conservative concentration limits internally, so we work very hard at keeping very very strong diversification amongst all of our business lines.

So it allows us to take advantage of whatever the market opportunity is, and we do that within these conservative concentration limits, that we've established. So I think all of these different lines of business including the two you mention, have nice opportunities for growth going forward, but you won't see any one of them get huge, because we don't want to be exposed to any one line of business that could have a negative impact on our operation in the short term.

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

And then I will just add to what Sandro said.

We also look at these business lines and see where they are complementary to one another, so when we look at these new commercial businesses, if there's ways to bring in deposits, as a result that's interesting. We brought on board to build-a-finance team at the beginning of this year, and we've looked at synergies with our origination business, because they're dealing with predominantly tier 1 and tier 2 homebuilders. And then we talked about MSR lending and how that can help from a subservicing point of view, so a lot of these niche businesses, they bring a lot of synergies with other parts of the bank, and again, you hear us talk about our one-of-a-kind business model and that's what we mean when we say that.

Henry Coffey - *Wedbush Securities - Analyst*

Great. Thank you very much.

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

Thanks Henry, Cody, any other questions?

Operator

There are no questions currently in the queue Sir.

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

Alright, thanks Cody and thanks everyone for your interest in Flagstar. Looking at the quarter I'm very pleased with the quality of our earnings. Even without the DOJ benefit they were very strong. They were led by continued growth in our banking business, supplemented by strong mortgage revenues. We also realized a lower cost of capital from TARP redemption.

These strong, consistent, results over the past few quarters demonstrate the underlying strength and reliability of our one-of-a-kind business model. Post TARP we are in a better position to pursue opportunities to grow our community bank, expand retail mortgage originations, and build our subservicing business. We will continue to look for ways to increase profits and shareholder value, and we believe we are uniquely positioned to deliver industry-leading results. We appreciate the support of our shareholders and their confidence in our business plan. And we thank our employees, for their hard work, they do it every day, and make Flagstar a success in these results belong to them. Finally, thank you for your time this morning, I look forward to reporting Q4 results in January.

Operator

And that does conclude today's conference. Thank you for your participation.