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FBC - Q1 2018 Flagstar Bancorp Inc Earnings Call

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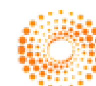

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PRESENTATION

Operator

Good day, and welcome to the Flagstar Bank First Quarter 2018 Earnings Call. Today's conference is being recorded.

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

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

Thank you, Brandon, and good morning, everyone. Welcome to the Flagstar First Quarter 2018 Earnings Call. Before we begin, I would like to mention that our first quarter earnings release and presentation are available on our website at flagstar.com. I would also like to remind you that any forward-looking statements made during today's call are subject to risks and uncertainty. Factors that could materially change our current forward-looking assumptions are described on Slide 2 of today's presentation, in our press release and in our 2017 Form 10-K 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'd like to now turn the call over to Sandro DiNello, our President and Chief Executive Officer.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Thank you, David, and thank you, everyone, for joining us today. In addition to David, I'm joined this morning by Jim Ciroli, our Chief Financial Officer; Lee Smith, our Chief Operating Officer; Kristy Fercho, our President of Mortgage; and Steve Figliolo, our Chief Risk Officer.

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 details on our financial results. Lee will follow with a review of our business segments and strategic initiatives, and I'll conclude with guidance for the second quarter before opening up the lines for questions.

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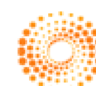

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We're pleased to announce net income of $35 million or $0.60 per diluted share. Once again, we produced solid consistent earnings. Our growing portfolio of high-quality relationship-based commercial loans, along with efficient funding and prudent expense management, helped us deliver these results.

We made a lot of progress in building the business in the first quarter. We continue to grow commercial real estate and commercial and industrial loans offsetting seasonal weakness and held for sale and warehouse loans. We also grew same branch deposits approximately $400 million. And despite deposit betas industry-wide, we were able to maintain a stable net interest margin.

We also closed on 2 strategic acquisitions that helped both sides of the balance sheet. First, we finalized our purchase of the mortgage warehouse business from Santander Bank, bringing approximately $500 million of mortgage warehouse loans to the balance sheet. This acquisition gives us more strength in a business where we were already a player and catapults us to a leadership position as the fourth largest warehouse lender in the country.

We also acquired the branches of Desert Community Bank, an 8-branch franchise in California that brings not only about $600 million in low-cost deposits to help fund our growth but also opportunities for organic growth and synergies with Opes Advisors, our retail mortgage division in California.

Our servicing business continue to flourish as we brought down more servicing accounts. Once we close on our latest sales of mortgage servicing rights and onboard contracted non-Flagstar originated loans in May and June, we will reach a new milestone, servicing over 500,000 accounts in our portfolio. The quality of our servicing platform and our ability to quickly scale up have made Flagstar an appealing choice for buyers of MSRs looking to outsource their servicing.

Although mortgage revenue was down a bit from last quarter, it was above last year's first quarter. That said, there are still too many lenders chasing too few loans, and until that shakes out, revenue will continue to be challenged. However, we believe our diversified origination platform and our variable cost model will help us weather this market, and in time, take advantage of market dislocation.

We're off to a good start this year with a clean balance sheet supported by strong capital. We'll continue to work hard on growing a well-diversified community bank, delivering consistent earnings.

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

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

Thanks, Sandro. Turning to Slide 6. Our net income this quarter was $35 million, $0.60 per share as compared to adjusted net income of $35 million or $0.60 per share last quarter. As you'll recall, our fourth quarter results included a noncash charge to the provision for income taxes of $80 million or $1.37 per share resulting from tax reform.

The quarter proved the resilience of our earnings as we experienced a very challenging quarter for the mortgage industry. We saw fallout-adjusted locks declined 11%, and margins dropped 14 basis points as competition intensified and rates remain volatile. The resulting impact was lower production-related expenses, and we were able to hold the line on expenses in other areas of the bank. We were able to continue growing C&I, CRE and HELOC loans and maintain deposit costs despite a higher interest rate environment. Credit costs remain virtually nonexistent. As net charge-offs were negligible, nonperformers and delinquencies stayed at their very low levels, and our allowance coverage at 1.7% of total loans was the strongest among our peers. We'll dive deeper into the balance sheet in a few minutes. Finally, our capital position was strong. Our Tier 1 leverage ratio was 8.7%, and we expect our Tier 1 leverage ratio to be 9.2% if the proposed capital simplification regulations are adopted.

So let's turn to Slide 7 and dive deeper into the income statement. Net interest income this quarter was $106 million as earning assets in our net interest margin remained stable compared to last quarter. The slight decline reflected 2 fewer days in the quarter. Average earning assets were steady at $15.4 billion as higher consumer CRE and C&I balances offset seasonal declines in loans held for sale and warehouse loans.

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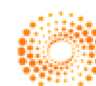

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The net interest margin remained stable at 2.76% as we continue to book attractively spread assets while managing deposit costs. This quarter, we grew higher spread, low duration loan portfolios, and accordingly, expect to continue growing net interest income next quarter. Additionally, the acquisition of the warehouse lending business occurred late in the quarter and should also provide nice growth in earning assets for next quarter.

Our average total deposit balances grew 3%, while deposit costs rose only 9 basis points as we have continued to outperform the deposit pricing betas that we've modeled despite 6 increases in short-term rates. Overall, it was a strong performance by the entire community banking team at Flagstar.

Credit costs were negligible this quarter. The lack of provision expense reflected continued strong asset quality. At the end of the third quarter of 2017, we had earmarked a small portion of our allowance to cover any uncertainties that we might have due to some natural disasters that had occurred, hurricanes in Texas and Florida and fires in California. Now 2 quarters later, we've seen minimal impact on credit quality from those risks and reduce the allowance by $1 million.

Non-interest income fell $13 million or 10% this quarter, primarily due to a net drop in mortgage revenues of $11 million as our gain on sale revenue fell $19 million while the return on mortgage servicing assets improved by $8 million. The decrease in gain on sale revenues largely reflected a lower gain on sale margin this quarter from competitive pricing pressures. The gain on sale margin fell to 77 basis points. Fallout-adjusted locks fell 11%, reflecting a seasonal decline in mortgage originations. The percentage of purchase mortgage volume rose from 54% of originations last quarter to 59% of originations this quarter. The net return on mortgage servicing rates improved $8 million, resulting in a net gain of $4 million this quarter as compared to a net loss of $4 million last quarter. This quarter's return was impacted by $2 million of transaction costs.

Moving now to expenses. Noninterest expense fell 3% to $173 million this quarter as compared to $178 million last quarter. Reflecting the lower mortgage volume, commissions and loan processing expenses were, together, down $7 million compared to last quarter. Otherwise, expenses were relatively flat compared to last quarter despite $1 million of merger-related expenses in the current quarter associated with the closing and conversion of the Desert Community Bank branches and the acquired warehouse lending business. Lee will provide more detail later in the presentation. Finally, the company's effective tax rate this quarter was 20%, reflecting the new tax reform bill and consistent with our expectations.

Let's now turn to Slide 8, which highlights our average balance sheet this quarter. Average earning assets were steady as average loans held for investment rose $192 million or 3%. On a combined basis, average commercial real estate and commercial and industrial loans rose a solid 6%. We also saw a nice growth in our HELOC portfolio. Growth in these portfolios offset lower levels of average mortgage loans held for sale and average warehouse loans. When combined with the late quarter acquisition of the warehouse lending business, we ended the quarter with $16 billion of earning assets, putting us in a strong position to start the second quarter. Average deposits rose $287 million or 3% in the quarter led by higher government and retail deposits. Average government deposits rose $151 million, while average retail deposits grew $109 million or 2% as higher retail CDs offset a decline in retail savings deposits. Despite a slight extension of duration in the portfolio from a higher percentage of CDs, costs remained under control and continued to perform better than the deposit pricing betas we've modeled.

At March 31, our tangible common equity-to-assets ratio remained strong at 7.65%, while our tangible book value per share fell to $23.62 from recent acquisitions. We'll cover regulatory capital levels shortly.

Let's now turn to asset quality on Slide 9. Nonperforming loans were $29 million at the end of the quarter, unchanged from the prior quarter, while the nonperforming loan ratio dropped to 35 basis points. Importantly, early-stage delinquencies remained low. Only $5 million of consumer loans were over 30 days delinquent and still accruing at March 31, unchanged from December 31. There were no commercial loans over 30 days delinquent and still accruing and no commercial nonperformers. At March 31, our allowance coverage was 1.7% of total HFI loans, well above the coverage levels of any other mid-sized banking peer. Coverage remains strong at 2.0% of consumer loans and 1.5% of commercial loans. This commercial loan coverage is even stronger because 30% of that portfolio is in warehouse loans, which are fully secured and we hold the collateral.

Turning to Slide 10. Capital remained robust. Our Tier 1 leverage ratio was 8.7% at March 31, up 21 basis points from last quarter, resulting from earnings retention and MSR sales, partially offset by a 32 basis point impact from the 2 acquisitions in the quarter.

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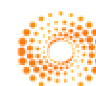

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At March 31, our Tier 1 leverage ratio had 372 basis points of stress buffer, above the minimum level needed to be considered well capitalized. If the capital simplification proposal is enacted, we would expect to have a capital buffer of approximately 420 basis points of Tier 1 leverage capital in excess of our well-capitalized minimum level. If the increase in risk weights on both mortgage servicing rights and deferred tax assets to 250% combine with the continued growth in commercial loans, which typically have a risk weighting of 100%, our total risk-based capital now stands at 14.14%, which is 414 basis points above its well-capitalized minimum level. If enacted, capital simplification regulations would add approximately 10 basis points to this ratio, leaving it roughly in line with the stress buffer for the Tier 1 leverage ratio. Considering the low level of risk in our business, stellar asset quality with strong allowance coverage and neutral rate risk position and strong liquidity levels, combined with a robust risk management function, we expect to continue to target a range of 89% for the Tier 1 leverage ratio over the long term and target a range of 13.5% to 14.5% for the total risk-based capital ratio. Given our low-risk profile and strong level of allowance coverage, we'd be comfortable operating in the lower end of both of these ranges. Further, we expect that we will recover in 2018 most of the 39 basis points of capital that is still trapped in our deferred tax assets as we utilize our NOLs. If we do become constrained by the total risk-based capital ratio, it would make residential mortgages and other lower risk-weighted assets more viable for the balance sheets. Since we could hold a lower level of regulatory capital for these assets, they could more effectively provide an appropriate return on capital, giving us even more options to continue to grow earning assets.

I'll now turn to Lee for more insight in each of our businesses.

Lee Matthew Smith - *Flagstar Bancorp, Inc. - COO, Executive VP, COO of Flagstar Bank and Executive VP of Flagstar Bank*

Thanks, Jim, and good morning, everyone. We're very pleased with our operating earnings of $0.60 per diluted share for the quarter despite a challenging mortgage market. I think this further illustrates how we've diversified our earnings and made them more predictable by growing the community bank over the last few years. Our businesses also act as a natural hedge against each other, which means our earnings are less volatile and more consistent in both rising and declining interest rate environments.

In addition to our solid earnings, we've also executed on some key strategic initiatives in the quarter, including we closed on the acquisition of 8 Desert Community Bank branches in San Bernardino County from East West Bank. These branches provided approximately $600 million of high-quality, low-cost deposits to fund loan growth and expand our banking footprint outside of Michigan and into California, our largest mortgage origination state. The transition was seamless, which is testament to the thorough and meticulous work of our integration team and the Desert Community Bank team, who we welcome to the Flagstar family.

We announced and closed on the acquisition of the mortgage warehouse business from Santander Bank. The portfolio includes approximately $1.7 billion in mortgage loan commitments and is complementary to our existing warehouse lending business. This transaction makes us the fourth largest residential mortgage warehouse lender in the country and is an asset class with good spreads and low credit risk.

The expansion of our direct-to-consumer mortgage lending platform in the quarter further strengthens and diversifies our mortgage business, a means we have the ability to produce at scale in all mortgage channels from direct-to-consumer to distributed retail, broker, nondelegated correspondent, delegated correspondent and bulk. We closed on the sale of $9 billion of mortgage servicing rights that we announced last quarter and have also sold or agreed to sell an additional $10 billion of mortgage servicing rights this quarter. We have retained the subservicing on 100% of these sales, which is testament to our best-in-class servicing platform and team. Further illustrating this point, we were also awarded the Fannie Mae STAR performer award in the General Servicing category for 2017, the third consecutive year we've won this accolade.

Our capital ratios remain strong as we ended the year with a Tier 1 leverage ratio of 8.72%, and this is after closing the 2 acquisitions I just referred to.

It's been a strong start to 2018. We're executing on our strategic plan and feel we are well positioned to continue to grow and be successful across all 3 business lines this year and beyond.

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. Operating highlights for the community banking segment include: Average commercial loans was steady at $4 billion, a solid growth in CRE and C&I, was offset by a seasonal decline in warehouse loan balances.

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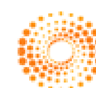

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Average commercial real estate loans grew $88 million or 5%, while commercial and industrial loans grew $81 million or 7%, continuing that transition to a strong community bank.

Average interest-earning assets have increased $3 billion or 24% over the last 12 months, and net interest income has increased $23 million or 28% in Q1 2018 versus Q1 2017. Of this growth, $1.8 billion has been driven by higher commercial and consumer loans held for investment. I believe this illustrates not only the exceptional asset-generating capabilities of our business model but also our commitment to diversifying earnings by growing the community bank. Following the acquisitions of both Desert Community Bank and the warehouse lending business from Santander, we believe we can continue to grow at a similar rate in the future.

Average consumer loans increased $214 million in the quarter as we added high-quality home equity lines of credit and jumbos to our portfolio. We are now originating HELOCs through multiple mortgage channels as well as through our bank branches and believe we will see an increase in HELOC originations moving forward given the rising interest rate environment and increase in-house price index.

Average total deposits increased $287 million or 3% in the quarter, led by an increase in government and retail deposits. The acquisition of Desert Community Bank closed towards the end of the quarter, so it had very little impact on quarterly average balances.

We remain focused on executing on several strategic initiatives to drive further organic and inorganic deposit growth, including acquisition opportunities like Desert Community Bank, building out a digital strategy, putting greater emphasis on bringing in deposits from commercial customers and leveraging our subservicing business for escrow deposits. We're very encouraged by the performance of the community bank, our positioning and potential for continued future growth.

Please turn to Slide 13. Operating highlights for the mortgage origination business include: Fallout-adjusted lock volume fell 11% to $7.7 billion quarter-over-quarter, primarily due to a seasonal decline in mortgage originations and a 21% drop in refinance activity, given the rising interest rate environment; our net gain on loan sale margin fell 14 basis points quarter-over-quarter to 77 basis points, given competitive pricing pressure in the market; and gain on sale revenues fell to $60 million in Q1 versus $79 million in Q4 as a result. It's pretty clear this existing mortgage environment is difficult given the reduction in market size and rising rate environments. It's further exacerbated by a lack of inventory in certain geographies, which is meant purchase volume is increasing at a slower rate than refinance volume is decreasing and is clearly excess operating capacity, which is putting pressure on margins.

We issued our third securitization in Q1, which consisted a $495 million of fully amortizing, high-balance conforming and jumbo fixed qualified mortgage loans. We were pleased with the execution, and this program gives us another outlet for the loans we were originating. We also priced our fourth securitization 2 weeks ago, which again consisted of high-balance conforming and jumbo fixed qualified mortgage loans, and we expect securitizations to be a regular activity for us throughout 2018. We believe we have one of the best and most diversified mortgage origination platforms in the country. We're very well positioned to take advantage of any dislocation in the industry given the smaller and more competitive market. Further consolidating our position as the fifth largest bank originator in the nation.

Moving to servicing. Quarterly operating highlights for the mortgage servicing segment on Slide 14 include: We were thrilled to be awarded the Fannie Mae STAR performer award in the General Servicing category for the third consecutive year. As our biggest customer for loan sales, Fannie Mae is well positioned to attest to our best-in-class servicing platform and exceptional servicing and customer engagement teams that have a relentless drive for outstanding customer service and operational excellence.

We currently service or subservice 470,000 loans, of which 360,000 are subserviced for others, making us the eighth largest subservicer in the country. So far in 2018, we've sold $19 billion in MSRs, of which $6.6 billion were closed in the second quarter, and we will retain the subservicing on 100% of these sales. After these sales all close, and together with non-Flagstar originated loans we are scheduled to onboard in May and June, we will comfortably be above 500,000 loans serviced or subserviced by the end of the second quarter.

I believe our unique servicing platform combines quality, operational expertise and complementary ancillary offerings. We also offer MSR lending, servicing advanced lending and recapture services for a compressive one-stop shop to owners of MSR assets. If you combine this offering with a robust risk and compliance infrastructure and a well-capitalized bank, you can see the attractiveness of our value proposition and our strength as

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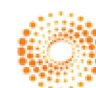

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a solid and reliable counterparty. The escrow deposits these loans generate also help us fund our balance sheet, and we held $1.5 billion of such deposits during the quarter, down slightly from Q4 as the reduction in refinance activity is partially offset by a higher loan count.

Our MSR to CET1 capital ratio at the end of March was 19%, and the capital simplification proposal would allow us to hold up to 25% of MSRs to CET1 capital before it became punitive. As previously discussed, this is obviously a significant and very positive development for Flagstar and would increase Tier 1 leverage by approximately 50 basis points as of March 31 if enacted as proposed. We will continue to grow our subservicing platform through a combination of MSR sales, where we subservice the underlying loans and onboarding non-Flagstar originated loans given the strength of our offering. We have increased the number of loans on our platform by 20% over the last 12 months and increased the number of loans we subservice by 49% over the same time period, predominantly through MSR sales and believe we can continue this rate of growth over the next 12 months.

Moving on to expenses on Slide 15. Our noninterest expense decreased $5 million to $173 million quarter-over-quarter, which was primarily driven by lower commissions and loan processing expenses, given the 19% reduction in mortgage closings quarter-over-quarter. We were also prudent in managing some other key expense categories. And this careful management, together with our variable cost model adjusting to the lower mortgage closings, are why we came in better than our guidance provided last quarter.

Our efficiency ratio increased 3% to 80% quarter-over-quarter, predominantly because of a reduction in gain on sale revenues of $19 million or 24% quarter-over-quarter. We estimate noninterest expense will be between $180 million and $185 million during the second quarter of 2018. $3.5 million of the increase in quarterly expenses is due to the acquisitions we closed in Q1, with the remainder being variable cost to support the growth in mortgage originations being forecast in the second quarter.

We remain focused on improving our efficiency ratio through increasing revenues, particularly from our new businesses and core businesses where we've invested in growth initiatives while maintaining our cost discipline across the organization. We're very pleased with how we've started 2018. We're executing on our strategic plan and believe we will continue to create significant value for our shareholders.

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

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Thank you, Lee. I'm now going to close our prepared remarks with some guidance for Q2, and then open the call for Q&A.

Please turn to Slide 17. We expect net interest income will rise 5% to 10% on the back of a large increase in warehouse loans from the Santander acquisition and a fairly steady net interest margin. We expect a 30% to 40% increase in gain on loan sale income led by a seasonal increase in mortgage locks of 20% to 25% and an increase in gain on sale margin of 5 to 10 basis points. We anticipate the net return on MSRs will approximate 5% to 7% on an annualized basis before transaction costs from the closing of MSR sales. We expect loan fees and charges will rise approximately 20% on higher mortgage loan closings, while all other non-interest income will decline 5% to 10%. And as Lee noted, noninterest expense will rise between $180 million and $185 million.

This concludes our prepared remarks, and we'll now open the call to questions from our listeners. Brandon?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question will come from Scott Siefers with Sandler O'Neill + Partners.

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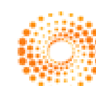

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Brendan Jeffrey Nosal - *Sandler O'Neill + Partners, L.P., Research Division - Director*

This is actually Brendan on the line from Scott's team this morning. I just wanted to start out on the gain on sale margin expectation for the second quarter. Just want to get your thoughts on what you think will drive that 5 to 10 basis point improvement. Is it a mix issue? Or is it an easing of competition in your view? Just curious.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

I think it's a combination of things. I'll let Kristy get into it a little bit more. But high level, I would say, we normally see a seasonal benefit in business in Q2, so that's a part of it. I think that we also think that the competition will ease a little as the -- as we see this grow. So we're pretty confident we can see an increase. If we look at past history, I think it makes sense. Kristy, anything to add there?

Kristy Fercho - *Flagstar Bank, FSB - President of Mortgage*

Yes, the other thing I'd add, Brendan, is just the continued growth in the retail for us. Retail growth continues to be important for the platform and really allows us not only to expand our distribution system, but better positions us in a rising rate environment and the growing purchase market. And so we think that mix as we continue to kind of grow retail will really continue to help that gain on sale margin.

Brendan Jeffrey Nosal - *Sandler O'Neill + Partners, L.P., Research Division - Director*

All right. Great. And then just kind of a top-level question on expenses. You guys have been investing in the business for the past couple of years, which of course has come with a higher expense base over time. Do you think you'll reach a point down the road where the investment spend tapers off and then expense growth is mostly just a function of origination volumes and then some natural rate of underlying growth?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Well, I don't think that expense growth necessarily tapers off, but I think that revenue growth will be quicker or more significant than expense growth. Well, I think that's the way Lee has kind of positioned the efficiency ratio in the past.

Lee Matthew Smith - *Flagstar Bancorp, Inc. - COO, Executive VP, COO of Flagstar Bank and Executive VP of Flagstar Bank*

Yes, I think that's right. The improvement in efficiency in time will be a faster ramp-up for the revenues given the growth we've invested in to date. And just looking at the guidance for Q2, the $180 million to $185 million of noninterest expense, $3.5 million of that is from the acquisitions that we made in Q1. So there is a primary example of growth investment, and we would expect the revenues to come through in time.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

And think of it this way, if we would say hypothetically grew assets, earning assets, $5 billion over the next, you pick it, 3 to 5 years, organically, there has to be expenses that go along with that growth because, alternatively, we could buy a $5 billion bank, and of course, we would add a bunch of expenses by doing that. So the key here is getting that efficiency ratio to improve as you grow the company.

Operator

The next question will come from Kevin Barker with Piper Jaffray.

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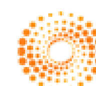

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Kevin James Barker - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

In regards to the competitive dynamic in the mortgage market, how long do you think it takes to shake out in the retail and then also in the corresponding channels?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

I don't know, Kevin. I mean, that's a tough question to answer. Lee outlined some of the challenges in the business with inventory issues and such, and so I don't know. I just don't have a crystal ball. Kristy?

Kristy Fercho - *Flagstar Bank, FSB - President of Mortgage*

Yes, I don't either. We actually had that question in kind of board meeting last week. I think one of the things I'd point to is Capital One kind of exited last quarter. You saw MB Financial exit the market this quarter. I mean, I think others will follow as the pressure continues to be on margins in a lower origination environment. I just think people will continue to fall out. So it's not a matter of if but when, and we'll let you know as soon as we know.

Kevin James Barker - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

And then in regards to the competitive dynamic, is it a lot of the larger players continuing the push for market share? Or some of the smaller players looking to have some liquidity and continue to push and stay where they are? Or is it something else that's out there that continues to push on competition?

Kristy Fercho - *Flagstar Bank, FSB - President of Mortgage*

Yes, Kevin, I think you have both dynamics. I think, definitely, the larger players are showing their scale and size and being really aggressive on pricing. And then I think on the lower range, you've got some of the smaller originators who are really fighting for each incremental loan. I mean, you have to think about people have the cost in their system right now, and so even if you do it at a lower margin to be able to keep the staff productive and busy, that's what people are opting to, so that pressure on margin is continuing. The one thing we're excited about in terms of the market, and I think the advantage that we have over some of the others is we have scale; we have a variable cost model; and we have diversified business channels, which we really built and invested in. So although volume is down and margins have narrowed, we really still like the business and think we're positioned to take advantage of the dislocation as it shakes out. We also were just being really focused on costs during this time and making sure that until the shakeout happens that we're well positioned to weather the storm, and we can really use our scale to take advantage of that.

Operator

(Operator Instructions) Next question will come from Bose George with KBW.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Just a follow-up on the gain on sale margin. The -- in terms of the pressure that is in the industry, is it kind of in all channels? Is it more pronounced in any particular area?

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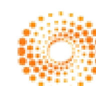

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Kristy Fercho - *Flagstar Bank, FSB - President of Mortgage*

Yes, it's in all channels. I mean, we haven't seen it this tight in a long time. And again, I'd just reiterate, I think that's where our diversification of the channels really helps, is that we are able to kind of flex our costs across those different models and take advantage where we see opportunity kind of in any given segment of the market.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

And I would add, our ability to build the securitization business has been very helpful as well. So you take all the diversification that Kristy just talked about and then our ability to maximize returns through the securitization has been a real plus for us.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. Makes sense. And then actually switching over to servicing. So you noted that you're adding some non-Flagstar loans in May and June, just curious what the size of those are and just how the traction is in terms of getting more third-party originators or servicing on there.

Lee Matthew Smith - *Flagstar Bancorp, Inc. - COO, Executive VP, COO of Flagstar Bank and Executive VP of Flagstar Bank*

Yes, no, good question, Bose. This is Lee. So I think by the end of the second quarter, we'll be somewhere between 530,000 and 540,000 loans. And as I mentioned, we're at 470,000 at the end of Q1. I think the market is very ripe at the moment. The MSR market is pretty hot given the rising interest rate environment. And the big buyers are the funds that like the asset class, and given our model where we offer all the ancillary services such as financing recapture, they like our proposition. We've got the quality, we won the Fannie Mae STAR award again, and so we work well with those buyers of MSRs.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Yes, look, Bose, I think we've been building this business for a number of years on the back of our own originations, and we've been calling on those that have MSR investments to bring their loans to us, and it's been happening, and it's been happening very successfully. The quality has been strong. They're happy with it, so they're bringing us more, and others are hearing about it. So the momentum is really building in that business for us.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. Great. Actually, just one more. I know you don't usually give longer-term guidance, but can you just talk a little bit about trends in the margin longer term with rising rates, if the increase in asset yields kind of largely going to offset that? Just any thoughts there would be great.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Yes, I don't know. I mean, I'd like to think, Bose, as the market shakes out and as then we see the purchase market mature more that we see expanding margins. I think one or the other is going to happen. If margins stay where they're at, then the business is going to get a lot smaller in terms of number of originators. So just logically, I think the business gets better. How quickly is the question. I just don't know how quickly it comes.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Actually, Sandro, I was actually referring more to the net interest margin, sorry.

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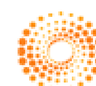

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Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Oh, I'm sorry. I'm sorry. So we're pretty pleased with that. In our situation, where we're growing organically, we need to bring the funding into the house. And of course, we have a fair amount of wholesale funding, and that gets hit by the increases in the fed rates right away. So the ability for us to maintain the margin pretty steady as we have, given the fact that we grew period end to period end $400 million in our deposit base, that's really good, and I doubt that there's many that had that kind of success. So over time, I think as we continue to add assets that are sensitive to change in rates through the LIBOR-based structure, we will see our margin get better, but I think it's going to slowly get better. I don't think it gets better real quickly, and that's why you see us guiding to a fairly steady margin here in the next quarter.

Operator

The next question will come from Terry McAvoy with Stephens.

Terence James McEvoy - *Stephens Inc., Research Division - MD and Research Analyst*

First question, if I look at the CRE and C&I loans held for investment, there was pretty nice growth quarter-over-quarter in both of those categories. Could you just talk about the nature of that growth? How much of it came from the homebuilder portfolio? And then with C&I kind of in footprint versus some of your national businesses?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

So it's pretty diverse geographically, I would say, without having the specific numbers in front of me. But I would say that the builder group continues to show strength, and that team has been adding people as time has gone on, and they've done a terrific job of growing the business. I think we now finance 6 of the top 10 builders in the country and 44 of the top 100 builders in the country. And the margins in that business are very strong, and these borrowers are very strong. Their net worths are strong. They all made it through the recession, and the underwriting guidelines have really become more difficult for them as time has gone on. So we feel real good about the growth that we're seeing in that business. We've seen good steady growth also in C&I as well as in the local market with CRE. So there are some people that are getting a little outside of what I would call the comfort box when it comes to rates and also deal structure, but we're not going there. We're staying true to ourselves and being very disciplined, and I think those decisions will serve us well over time.

Terence James McEvoy - *Stephens Inc., Research Division - MD and Research Analyst*

And then as a follow-up question, I guess, it's Slide 36, the new banker additions over the last 2 years. I think that number was up a few just in the first quarter alone. And I guess my question is, how many of those individuals are operating, call it, at capacity versus are still building out their book of business? And maybe could you, call it, a few of those businesses where you think the momentum is going to drive some of the strongest growth at least over the next 12 months?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Yes, good observation, Terry. This is how we've been growing this business over the last 3, 4 years, is by continuing to add very, very experienced people. You can see the number of years of experience on that slide that you referred to. Of course, it does take time for them to build their book, and so that's part of the investment in the business. When we talk about increasing expenses, it doesn't happen overnight. Typically, if they're high-level people, they do have nonsolicitation agreements. So it takes about a year for them to really get to a point where they're incrementally positive to the company, but it's been working for us. And I want to note that these people are coming from larger, more complex banks. They're not coming from thrifts. They're not coming from community banks or credit unions. They're coming from larger banks that -- and they've been

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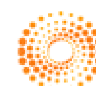

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through the credit train, and they've been around for a while. So this is how we've grown this business and how we will continue to grow it based on the people we're able to bring to the organization.

Operator

(Operator Instructions) The next question will come from Henry Coffey with Wedbush Securities.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

Now we'll go back to mortgage. On -- I mean, obviously, the bank itself is growing its loan balances exceptionally well. When you look at your opportunity set either from bringing on new teams or direct acquisitions, is it -- are we going to see acquisitions more like what we saw this quarter, where you buy a small bank and you buy a portfolio? Or do you think the business is ready to digest a major gulp?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Well, I think on the bank side in terms of a bank purchase, I don't see that anytime soon for a number of reasons. I mean, for us, we're in a position now with the addition of Desert Community Bank that we can -- we have an opportunity here to grow deposits in a different market, and so we're going to see how that works out for us. And I think there might be some other opportunities for branch acquisitions. A bank acquisition is not get good use of our capital right now, and so I don't see that happening. Relative to assets, the Santander deal was very opportunistic. That was there. It made a lot of sense. The efficiency of adding that business to ours and becoming the fourth largest was pretty much a slam dunk. On the mortgage side, acquisition-wise, when we bought the Opes franchise, that gave us the platform we're looking for. I don't see us buying another mortgage business, not that, that would be impossible or entirely out of the question, but it would have to be extremely compelling for us to go there right now.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

Are there like -- and this is more of a question for Kristy. Are there team lift-outs that might make a real difference in the second half of the year as you look to find ways to keep the growth of that business holding up?

Kristy Fercho - *Flagstar Bank, FSB - President of Mortgage*

Yes, Henry. I mean, I think Sandro mentioned the Opes acquisition, I mean, the hiring of the direct-to-consumer team from Capital One was a great example of they exited the business, we came in and lifted that team out. Obviously, as others with a dislocation will continue to have those conversations as we're really active in the market in terms of adding high-quality [LOs] being able to roll out new products and just enhance our technology not only to continue to grow retail but as players exit the market really try to take advantage of that. So we will be opportunistic in the market to take advantage of what we're sure is dislocation.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

If we see a real downdraft in the mortgage market in the second half of this year or the first part of next year, how would Flagstar manage around that?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Well, we're not waiting for that to happen. Let me say -- tell you, we've historically shown our ability to get in front of that. So we're already, and as Kristy noted in one of her earlier answers, I mean, we're already all over the cost situation. And I think the first quarter results are pretty good

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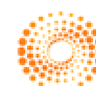

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proof of our ability to adjust to where the revenue is in the mortgage business, and we will continue to do that. We will not sit here and hope that things get better. We will act in advance of that bad stuff happening.

Operator

(Operator Instructions) The next question will come from Daniel Tamayo with Raymond James.

Daniel Tamayo

Just a little bit back to the commercial lending side, just wondering if you could talk a little bit about the competitive landscape that you're seeing in Michigan and both in terms of kind of -- for the loans themselves as well as if you guys are looking to continue to add bankers.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

So I'll take the bankers part first. We haven't seen any impact there. I think Flagstar's become an employer of choice here in Southeast Michigan, and so I think we can add people just as quickly as we feel like we can afford to add people. And as was noted earlier, we did that even in the first quarter. With respect to the business, the business definitely is picking up in competitiveness, and we've let a couple of deals go from us, go away from us, because we weren't satisfied with either the pricing or the deal structure. We will stay disciplined that way. There were banks that got through the recession, the financial crisis, in a profitable way, and that was because they avoided loan losses, and we will do that here. We will not stretch. And because we have different levers to pull, because we have different lines of business and because we aren't only able to lend in Michigan, and we can then through a number of our businesses nationally, we have optionality. So we can look for the right situations. And adding the $500 million in outstandings from the Santander acquisition gives us a lot of flexibility this year. So we don't have to push. We already know that we've got in the bag significant increase in earning assets. So I think we can play this out the right way. And as I said earlier, I think playing it out that way, those decisions will serve us well in the long term.

Operator

There are no further questions at this time. I'll now turn the conference back over to Sandro DiNello.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Thanks, Brandon, and thanks to everyone for your interest in Flagstar and taking some time with us today.

To put our results in perspective, the quarter demonstrated how the diversification of our business model continues to pay off. It's been all about having enough levers to pull so that we have strength in one area to offset weakness in another.

In the past quarter, community banking helped pick up the stack, compensating for a weaker mortgage business. Within community banking itself, we have both diversified and fortified businesses more than traditional commercial loans. We've built business lines like equipment leasing, home builder finance and warehouse lending that combine to make a big difference.

Today, our subservicing business far exceeds our own servicing, and as we've mentioned, it's a burgeoning business. It's also a source of fee income that's a counterpoint to our spreads in gain on sale income. And because we're an active seller of mortgage servicing rights, we have a direct pipeline to new business opportunities. We've diversified organically, and we've diversified through acquisitions, all with an eye to produce earnings that are resilient to changing market conditions. And that was what played out in the first quarter.

Finally, as you know, we continue to operate under a supervisory agreement with the Fed that was originally entered into between the bank and the OTS. This agreement transferred to the Fed when the Fed became our holding company's regulator. We have been in full compliance with

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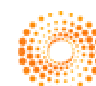

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agreement for quite some time and are now confident that it will be lifted in the not-too-distant future. While this agreement has not hampered our operations in any significant way, its lifting is important because it represents the last legacy regulatory issue that we've had to deal with.

In closing, we will continue to look for opportunities to balance and diversify our earnings with a goal of creating more value for our shareholders. A special call out to Flagstar employees for their exceptional efforts in the first quarter to bring Desert Community Bank and Santander onboard and all the things they do every day to make Flagstar a success.

Finally, thank you for your time this morning. I look forward to reporting Q2 results in July.

Operator

Thank you. Ladies and gentlemen, this concludes today's event. You may now disconnect your lines. Have a great day.

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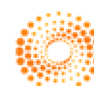

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