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FBC - Q2 2019 Flagstar Bancorp Inc Earnings Call

EVENT DATE/TIME: JULY 23, 2019 / 3:00PM GMT

CORPORATE PARTICIPANTS

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

Andrew W. Ottaway *Flagstar Bancorp, Inc. - Executive VP & President of Banking*

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

Kenneth Schellenberg *Flagstar Bancorp, Inc. - VP of IR*

Kristy Williams Fercho *Flagstar Bank, FSB - Executive VP & President of Mortgage*

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

CONFERENCE CALL PARTICIPANTS

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

Daniel Tamayo *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Edward Christopher Gamaitoni *Compass Point Research & Trading, LLC, Research Division - MD & Head of Research*

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

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

Robert Scott Siefers *Sandler O'Neill + Partners, L.P., Research Division - Principal of Equity Research*

Stephen M. Moss *B. Riley FBR, Inc., Research Division - Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Good day and welcome to the Flagstar Bank Second Quarter 2019 Earnings Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Ken Schellenberg. Please go ahead, sir.

Kenneth Schellenberg - *Flagstar Bancorp, Inc. - VP of IR*

Thank you, Paula, and good morning. Welcome to the Flagstar Second Quarter 2019 Earnings Call.

Before we begin, I'd like to mention that our second quarter earnings release and presentation are available on our website at flagstar.com.

I would also like to remind you that any forward-looking statements made during today's call are subject to risks and uncertainty. Factors that could materially change our current forward-looking assumptions are described on Slide 2 of today's presentation, in our press release and in our 2018 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, Ken. Good morning to everyone listening in. I appreciate your taking the time to join us today.

In addition to Ken, I'm joined this morning by Jim Ciroli, our Chief Financial Officer; Lee Smith, our Chief Operating Officer; Kristy Fercho, our President of Mortgage; Drew Ottaway, our President of Banking; and Steve Figliuolo, our Chief Risk Officer.

As usual, 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 line for questions.

Overall, I was pleased with our results for the second quarter. The top line revenue growth and effective expense management combined to produce positive operating leverage. Our adjusted net income of $41 million or $0.71 per diluted share exceeded the $37 million or $0.64 per diluted share we achieved in the previous quarter, but was down 18% from the same quarter last year, driven by the write-down of our commercial loans in Live Well Financial, our mortgage loan originator, which we disclosed as a concern in our first quarter 10-Q. I'll fetch on this matter more later.

It's important to note that the increase in noninterest expenses is mostly attributable to a nice bump in mortgage originations during the quarter, especially in our growing retail channel where commission expenses are directly tied to originations.

Results from the quarter demonstrated once again how our unique business model works. In this case, an unexpected drop in interest rates that put pressure on interest margins presented as an opportunity to significantly increase mortgage revenues, which helped produce a solidly profitable quarter. It's an example of our flexible business model in action.

To expand on the commercial loans in Live Well, we experienced a $30 million partial charge-off after they unexpectedly ceased operations and we came to learn that the collateral supporting the loan was not worth as much as had been consistently reported to us. Though there are some unusual circumstances around this credit, as evidenced by the ongoing law enforcement and FCC investigations, it would be an understatement to say that I am extremely disappointed that this happened at all. We've conducted a rigorous postmortem and have taken every step to reduce the likelihood of the recurrence of an event like this.

Additionally, we are actively pursuing all legal remedies both within and outside bankruptcy proceedings. This, of course, means that we may not be able to provide you with more details at this time.

Turning to our banking business. We once again have a solid story. Net interest income grew 10% compared to the prior quarter, driven by exceptional growth in earning assets. This growth was led by a 70% increase in warehouse lending, as we benefited from the proactive management of utilization rates coupled with a seasonally higher mortgage market. We continue to see stable growth in our commercial and industrial, commercial real estate and consumer lending portfolios and the strength of relationships our teams have fostered over the years. While we have seen pressure on yields, we have not compromised any of our credit standards, and we have passed on a sizable number of opportunities due to thin spreads.

Our servicing segment continues to grow nicely and its contributions to our bottom line keeps growing each quarter, solidifying our position as a key player in this space.

Our mortgage team delivered an outstanding quarter as they maintained pricing discipline and focused on optimizing volume and expanding margin. Gain-on-sale margin improved 17 basis points compared to the first quarter. The spiking of mortgage origination that we saw in March carried over into the second quarter, and our team did an excellent job of identifying opportunities to grow volume and expand margins while carefully managing capacity. Fallout-adjusted locks rose to $8.3 billion, a 26% increase from last quarter. When you put this all together, the result is a quarter-over-quarter increase in mortgage revenue of $25 million, an industry-leading 45%.

Looking ahead, we have increased our projection for total originations for 2019 only slightly. For the most part, we see we are shaping up as we have projected in terms of the overall size of the origination market.

The key will be if we can continue to grow mortgage revenue as we did in Q2. We do believe capacity of adjusted debt and pricing has become more rational. This positions us well to leverage our strong customer relationships, our commitment to service and the consistency of that service. Quality is the backbone of our competitive advantage.

In closing, it was a quarter that highlighted a primary strength of our business model, our ability to consistently meet earnings expectations without adding significant risk. All of our business segments are critical to our success, and we can leverage any one depending on market conditions to help us continue to deliver consistent and durable earnings.

That concludes my comments. Now let me turn it over to Jim.

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

Thanks, Sandro. Turning to Slide 6. Our adjusted net income this quarter was $41 million or $0.71 per diluted share, even with a 30 million charge-off. This performance compared to the $37 million or $0.64 per diluted share of adjusted net income last quarter. This quarter was highlighted by revenue growth of 20% leading to strong operating leverage of 8%. Our results for the quarter were led by strong growth in net interest income and a higher level of mortgage revenue. We'll discuss earnings in more detail when we get to Slide 7.

Asset quality negatively impacted this quarter by the $30 million Live Well loan charge-off discussed earlier. As a result, our nonperforming loan ratio increased 30 basis points. Additionally, we reduced our reserve by $17 million, mostly driven by the full payoff of 3 substandard loans and also due to continued low levels of charge-offs in the rest of our loan portfolio.

Our allowance coverage of the loan portfolio decreased to 0.9%, reflecting the charge-off activity for the quarter, the reserve reductions and strong growth in carried in warehouse loan balances. I'll provide more details when we get to asset quality.

Expenses also scaled nicely this quarter, showing only 12% growth in reaction to a 20% increase in revenues. The mortgage origination volume drove $20 million of the increase. On the basis of $1 billion of targeted loan warehouse loan growth, our capital ratios were lower this quarter. While our total risk-based capital was 11.6% on June 30, this capital ratio would have been relatively flat to last quarter without that warehouse loan growth. And we believe those warehouse loans have little to no credit risk. Capital simplification will improve this ratio by 38 basis points, and I'll take it through a more extensive analysis of our capital later.

So let's turn to Slide 7 and dive deeper into the income statement. Net interest income grew $12 million to $138 million in the second quarter, which was 20% higher than last year's second quarter, and excluding the fourth quarter's $29 million hedge gain, surpassed $130 million in a quarter for the first time. The results primarily were flat, 9% increase in average earning assets led by 22% growth in average commercial loans. On the basis of this loan growth, the net interest margin was relatively flat. We'll discuss earning assets more in the next slide.

Noninterest income increased $59 million to $168 million. The quarter benefited from a $25 million reduction in the fair value of the DOJ settlement liability. The lower value of this liability reflects a reduced likelihood and longer timing for any payments that will be made related to the settlement agreements. Excluding the DOJ benefit, second quarter noninterest income increased $34 million or 31% to $143 million. The increase was led by mortgage-related activity as mortgage revenues increased $25 million and loan fees and charges increased $7 million.

Our gain-on-sale revenue of $75 million represented an increase of $26 million or 53% from the prior quarter. The improved gain-on-sale revenue was driven by a 17% -- 17 basis point increase in gain-on-sale margin as our mortgage team targeted higher-margin sales channels at more attractive prices instead of chasing volume.

Additionally, fallout-adjusted locks increased by 26% in the quarter. As you expect, the return on the mortgage servicing asset decreased by $1 million due to lower rates impacting prepaid fees. Our treasury team did an exemplary job in hedging our MSR position despite the volatility in the quarter. In fact, due to the changes in rates during the quarter and other factors, we had a negative impact to our MSR position of $40 million, and we were able to hedge $39 million of that impact and still deliver a return of 6%.

Loan administration income decreased $5 million or 45%, driven by an increase in interest paid on facility of deposits, which saw significant growth for the quarter. I'll cover the increase in average custodial balances later.

Noninterest expense was $214 million, up $23 million from the prior quarter. The increase was primarily related to mortgage volume-driven expenses such as commissions, loan processing and compensation due to higher levels of production and a shift mix toward the retail channel. The remaining expense categories were relatively flat from prior quarter, demonstrating scalability of our business.

I'd also note that our effective tax rate increased to 19% as a result of the DOJ benefit in the quarter. Nonetheless, we expect that our effective tax rate for the full year will be at or slightly lower than our rate in the first quarter, which is 18%.

Credit costs reflect the level of charge-off this quarter as well as a higher level of charge-offs coming from the unsecured loans that we acquired with the Wells Fargo branch acquisition. These smaller balance loans have a higher rate of losses and therefore have a higher interest rate. The charges this quarter represent some cleanup of that portfolio that came with the acquisition.

We'll dive deeper in credit quality in a couple of slides, but let's move to Slide 8, which highlights our average balance sheet this quarter. Average loans held for investment grew $1.4 billion, driven by an increase in average warehouse loans and well-balanced loan growth across our remaining investment -- loans-held-for-investment portfolio. We saw more opportunities in the quarter with high-quality loans in the portfolio, especially in the warehouse, C&I and nonauto indirect portfolios, and from those assets, the margin, the core deposits while keeping the net interest margin flat to last quarter. In fact, there were over $500 million of additional warehouse lending opportunities in the quarter that we didn't take as we thought the spreads would be narrow. Though the average warehouse loans was a part of the actions we took to grow net interest income and leveraging the loans we acquired in the warehouse acquisitions in early 2018, were also experiencing seasonally higher volume.

The nonauto indirect loan growth reflects the continued growth of the business as average balances increased $154 million or 84% compared to the first quarter.

Also during the quarter, we managed the loans-held-for-sale portfolio to a lower level than we expected, considering the increase in origination volume, but we decreased available-for-sale securities. Both actions were taken to rotating the higher-yielding assets and to support this quarter's loan growth.

Average deposits increased $1.3 billion or 10% in the quarter, driven by a higher custodial and community banking deposits.

Average custodial deposits rose $936 million or 37% from a higher level of loan prepayments underlying our servicing portfolio, the growth of the number of accounts serviced and seasonally higher levels for T&I escrows.

Total retail deposits grew $332 million or 4% for the quarter.

Finally, our tangible book value per share increased $1.51 to $26.16 per share.

So let's turn to asset quality on Slide 9. As noted earlier, the quarter was significantly impacted by the Live Well loan that is partially charged off and placed in the nonaccrual status during the quarter. At June 30, this loan has been charged down to $37 million, reflecting our estimate as a value of the underlying collateral. We expect to take possession of the collateral at some point during the third quarter, and we are evaluating most appropriate course of action once we take possession.

Excluding the impact of Live Well, credit quality in the loan portfolio remained strong. Real estate delinquencies continued to be negligible. Only $8 million of total loans were over 30 days delinquent and still occurring on June 30 and improvements in the level of delinquencies last quarter.

At June 30, our allowance coverage was 0.9% of total held-for-investment loans. I'll point out that this coverage reflects 23% of our loans held for investments in warehouse loans. Our warehouse loan portfolio has a little to no credit loss content as these loans are fully secured and we control the collateral. Excluding warehouse loans from the denominator, given their relatively clean credit loss history, our allowance to loans held-for-investment coverage ratio would stand at 1.2% on June 30, still relatively strong in the industry.

We continue to work for implementing CECL and intend to provide a more comprehensive update as we get closer to adoption.

With that being said, we don't believe the events from this quarter, including the reduction of our coverage ratio, has impacted our overall view, but we are set up as well as any mid-sized bank for whatever CECL's impact might be.

Turning to Slide 10. Capital remained solid. The total risk-based capital ratio was 11.6% on June 30. This represents the cushion of $226 million of total capital over the minimum level needed to be considered well capitalized. Final capital simplification regulations, which take effect in Q2 of 2020, will increase this ratio by 38 basis points.

As I mentioned earlier, our risk-based capital ratio has declined, but we had $1 billion of warehouse loan growth during the quarter. This factor alone reduced our total risk-based capital ratio by 85 basis points. Our target operating range, the size of the strategic flexibility buffer and the stress buffer of both well-capitalized status are only formed by our stress tests. Due to the very low level of losses that we would expect to have from the warehouse loan portfolio and even in the adverse economic scenario combined with our expectation of our warehouse loan balances with current CECL in the second half of the year, we remain comfortable with capital levels at June 30.

Our Tier 1 leverage ratio is 8.0% at June 30, down 41 basis points from the last quarter. Capital simplification will increase this ratio by 63 basis points, which will put us at the upper end of the target operating range of 8% to 9%.

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

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

Thanks, Jim, and good morning, everyone. We're very pleased with how quickly we pivoted during the quarter to maximize revenue and earnings from our mortgage business, given the lower 10-year treasury note rate, as we saw healthy increases in both fallout-adjusted locks and gain-on-sale margin quarter-over-quarter.

Average earning assets increased a commendable 9% or almost $1.5 billion as we experienced positive growth in all consumer and commercial lending channels. The warehouse lending business we acquired a little over a year ago is paying dividends as we increased average warehouse balances an impressive 70% or $822 million quarter-over-quarter.

Average deposits increased $1.3 billion or 10%, and we're now servicing or subservicing almost 1 million loans under the big largely subservicer in the country, which provides us with another source of stable earnings.

We're obviously disappointed with the Live Well commercial loan partial charge-off of $30 million during the quarter after they abruptly and unexpectedly ceased operations. We're confident that this situation is not reflected by the deterioration in our remaining commercial portfolio. And the underlying collateral to this loan was unique and not something we have elsewhere in our portfolio.

We ended the quarter with almost $20 billion in average assets and have once again demonstrated the flexibility of our business model where the different businesses act as a natural hedge, meaning we can generate strong earnings in any interest rate environment.

I'll now outline some of the key operating metrics from each of our major business segments during the second quarter. Please turn to Slide 12. Operating highlights for the community banking segment include average commercial and industrial and commercial real estate loans increased $294 million or 8% in the quarter, and the growth was evenly balanced between the 2 portfolios.

Average consumer loans held for investment increased $333 million or 8% in the quarter as we added high-quality nonauto indirect loans, HELOCs, and first-lien mortgages to our portfolio. Average warehouse lending loans increased a remarkable $822 million or 70% in the quarter due to the increased activity in the mortgage industry, but also helped by our acquisition of a warehouse lending business, which has helped bolster this growth. Given our organic ability to originate loans both consumer and commercial together with our relationship-based approach, we believe we will continue to originate high-quality consumer, commercial and warehouse loan balances going forward.

Average retail deposits increased $332 million or 4% during the quarter, while custodial and escrow deposits increased $936 million or 37% given the high number of loans subserviced and the low rate environment increasing refinance activities and therefore leading to higher principal and interest balances. We're very satisfied with the performance of our community bank as it continues to grow and further diversify the earnings power of the bank.

Please turn to Slide 13. Operating highlights for the mortgage origination business include: fallout-adjusted lock volume increased 26% to $8.3 billion quarter-over-quarter, while the net gain on loan sale margin rose 17 basis points or 24% to 89 basis points. As a result, gain-on-sale revenues increased $26 million to $75 million in Q2 versus $49 million in Q1. The increase in fallout-adjusted lock volume quarter-over-quarter was due to both seasonally higher volume and the lower 10-year treasury note rate, and we were able to maneuver quickly in order to expand capacity and optimize earnings from our mortgage business.

We also maintained our disciplined pricing approach to ensure we focused on generating business in the most profitable channels. It's this discipline that enabled us to increase our gain-on-sale margins 24% to 89 basis points quarter-over-quarter.

We will continue to take advantage of this lower rate environment and remain disciplined in our pricing and capacity management in order to maximize earnings from the mortgage business while providing excellent service to our customers.

Moving to servicing. Quarterly operating highlights for the mortgage servicing segment on Slide 14 include: we serviced or subserviced approximately 983,000 loans, of which over 816,000 or 83% are subserviced for others, making us the fifth largest subservicer in the country as of March 31 per Inside Mortgage Finance. We've increased the number of loans serviced or subserviced by 440,000 or 81% in the last 12 months and have been one of the fastest-growing subservicers in the industry during that period.

Today, we have the capacity to service or subservice 2 million loans as well as provide ancillary offerings such as recapture services and financing solutions to MSR owners.

We recently announced that we would be acquiring the default servicing operation in Jacksonville, Florida, exclusively supporting our seriously delinquent mortgage loans, which is currently managed by third party. The transaction is scheduled to close at the end of September. With the rapid growth of our subservicing portfolio, it makes sense to strengthen our capabilities on the default side and bring the operation back in-house. This acquisition further leverages our industry-leading oversight and monitoring while providing clients the risk and compliance infrastructure benefits Flagstar has to offer.

The custodial deposits these loans generate also help us fund our loan growth. We held $3.5 billion of average custodial deposits throughout the quarter, an increase of $936 million or 37% quarter-over-quarter.

We're very pleased with how we've grown our subservicing business over the last 18 months and believe you will continue to see flourish as we move forward.

Moving on to expenses on Slide 15. Our noninterest expenses increased 12% or $23 million to $214 million quarter-over-quarter, while revenues increased 20% or $46 million during the same period excluding the DOJ benefit. This led to positive operating leverage of 8% in Q2 as our variable cost structure and dynamic business model allowed us to take advantage of market opportunities, particularly in the mortgage business. The majority of the increase in noninterest expense was due to the increase in mortgage activity with 87% or $20 million of the $23 million increase quarter-over-quarter being because of higher mortgage production.

Our adjusted efficiency ratio, excluding the DOJ benefit, was 76% for the second quarter, which was an improvement of 5% from the prior quarter. If you write it down further, gain-on-sale revenues and loan fees and charges increased $33 million in the quarter, while costs related to this business increased $20 million, meaning revenues from other business lines increased $13 million and associated costs increased $3 million. The point being, we have made thoughtful and deliberate cost investment decisions that have benefited the earnings of the bank and created shareholder value.

We estimate noninterest expense will be between $220 million and $225 million during the third quarter. The slight increase in expenses is all related to increased mortgage production volume.

It's been a solid 3 months. We pivoted quickly and efficiently to take advantage of the lower rate environment, particularly with our mortgage business. We saw excellent commercial and consumer loan growth together with strong deposit growth. And our subservicing business continues to prosper, bringing consistent noninterest fee income to our earnings. Given our diversified and flexible business model supported by our robust risk and compliance infrastructure, we believe we're well positioned to continue to add value for our shareholders as we move forward.

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

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

Thank you, Lee. I'm going to close our prepared remarks with some guidance for Q3 and then open the call for questions and answers.

Please turn to Slide 17. We expect net interest income to improve approximately 5%, while net interest margin will be flat or declined slightly.

We anticipate gain on loan sale income will increase 15% to 20%. We expect the return on the MSR to decline slightly. All other noninterest income is expected to decline 5% to 10%.

As Lee noted, we anticipate noninterest expenses to be between $220 million and $225 million, and we expect the effective tax rate to be 18%.

This concludes our prepared remarks. We'll now open the call to questions from our listeners. So I turn the call over to you, Paula.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll take our first question from Scott Siefers with Sandler O'Neill.

Robert Scott Siefers - *Sandler O'Neill + Partners, L.P., Research Division - Principal of Equity Research*

I guess, first question is just on the gain-on-sale margins. I mean really, really strong improvement this quarter and appreciate the context you put in, in about the -- regarding the improved NIM basically. But just curious if you could talk a little about how much is left if you continue to enrich in the mix of originations? And then just on sort of a steady state, in another words, if you had not improved the mix of originations, what kinds of trends are you seeing by channel on gain-on-sale margins?

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

I'll give Kristy a second to think about that. But my reaction, Scott, is I think we've seen improvement in our margin in all areas, some more than others. And I think that is because as we said in our prepared comments that we have really focused on optimizing the production as opposed to just optimizing volume. And I think that has proven to work very well for us. As I said, we increased our mortgage revenue by 45% quarter-over-quarter, and I think that compares pretty favorably to other large mortgage originators.

Kristy Williams Fercho - *Flagstar Bank, FSB - Executive VP & President of Mortgage*

Yes, Scott, what I would add is the big story and the mix really came in bulk, and so the way you saw the volume coming in, bulk we are seeing easily 1.4 billion a day, and we just maintained the discipline there where the margins were in terms of the bulk channel, choosing to do more in the retail originations as we said in our prepared remarks. So the volume certainly is there. It was the discipline around where we wanted to maximize that and take margin and not just take volume for volume's sake.

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

And, Scott, it's Lee. I'll just add. If you actually just look at Q1 over Q2, and this is going back to Sandro's point, the volume growth we saw in multiple channels, particularly corresponded non-debt, broker and retail and that's where we saw the margin expansion. And it's because those are the higher-margin channels and we focused on getting the business from those channels, which is why the margin increased so much quarter-over-quarter.

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

But the real important point really more than volume or margin is revenue. That's what we were focused on, and the revenue growth is what I was most pleased with.

Robert Scott Siefers - *Sandler O'Neill + Partners, L.P., Research Division - Principal of Equity Research*

Yes, that's perfect. Let me switch gears to the Live Well situation. Maybe just a comment or 2 about what's left, and I guess, what gives you comfort that it's well secured? In other words, some question on the collateral valuation at the beginning. So just maybe a little more color on what's left if there's any question or additional risk to it or if you feel like this was a good, very conservative whack at the apple, so to speak?

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

Yes, we felt extremely comfortable with where we've valued the collateral. And so we can't say anything for sure, of course, but we're confident that the ultimate resolution will be similar to where we've marked the asset, and then as we go through the legal process, perhaps there's other opportunities for the [Federal].

Operator

Moving on, we'll go to Bose George with KBW.

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

Just a follow-up on the gain on sale. Is the guidance for next quarter for the increase driven by volumes or margins or both?

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

Probably a little bit of both, but I think more so on margin than on volume. But you never know, Bose, right? It's hard to know what's going to happen tomorrow let alone over the next 3 months. I think what I'd like to emphasize is we'll adjust to where the opportunity is. And so if there's more opportunity for volume at a narrow margin, but we think that brings us more net revenue, that's what we'll do. And I think we've been able to show quarter-over-quarter, we can make good and swift decisions on where the best opportunity is.

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

Okay. Great. And then actually just switching to the guidance on the net interest margin, can you just talk about the drivers there? And are you incorporating the 2 rate cuts or how does that work?

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

Well, let's look at yields and then costs, right? On the yield side as, I mean, noted in our prepared comments, we're definitely seeing pressure on the yield side on the commercial book. And so we're concerned about how that's going to react not only from the pressure from competition but then, of course, if you get a 25 basis point decline and the Fed cuts rate next week, then you're going to see all the adjustable loans adjust pretty quickly. And you never know for sure just how quickly you can adjust the [added] cost to match up with that decline. So we're a little cautious on that, and so I think that's what we're -- how I would answer your question. Jim, do you want to add?

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

Yes. The guidance we've given for the quarter reflects what you're seeing for right now, which is almost a certainty, as Sandro said, the rate cut next week, a small change to the 50 basis point cut, but we just go with what the market tells us. When you focus then on the short term -- the short end of the curve, we are slightly asset sensitive. And I think Sandro said it well, that slight asset sensitivity defines what our goal is in terms of managing our deposit costs. So we'll get out and we'll manage those deposit costs in a very thoughtful and deliberate way, and we know we have to do to maintain that flat to down guide on NIM.

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

Yes. I'll say -- add, Bose, that I was very pleased that we only saw 1 basis point narrowing of our margin this past quarter, given all the pressures that were in the business and the way the interest rates reacted over the last 3 months. So I'm pretty confident that we can manage the margin reasonably well.

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

Okay. And just one more just on the servicing fee. Your average servicing fee has gone up quite a bit over the last year. I'm just curious are you getting better execution just holding more excess servicing or mixed shift or is anything else going on there?

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

Yes. On the MSR, well, we're definitely holding more G&A, and that's having a positive impact on the carry. I mean, we're holding a bigger asset. That's what you see, Bose.

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

Yes, Bose. Jim did a good job in his comments talking about how well our team manage that investment. As you know, we do a lot of warehouse lendings, so we see a lot of other companies. And of course, the nonbank mortgage companies don't hedge their MSR in this environment we're in the last month to see only $1 million deterioration and the value of our MSR is pretty remarkable. And I think that shows how strong our team is in managing that MSR in day-to-day basis that we've been able to keep it pretty much unchanged despite increasing or decreasing interest rates.

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

I'll answer that. That track record goes back to -- for the team goes back to 2016.

Operator

Up next, we have Steve Moss with B. Riley FBR.

Stephen M. Moss - *B. Riley FBR, Inc., Research Division - Analyst*

I guess just following up on the Live Well asset here, just wondering what are your thoughts with regard to whether you retain the asset or liquidate it?

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

Well, I can't -- I don't know. I can't speculate. It depends on what the market opportunity is. We don't have a desire to own the collateral loan term necessarily, but if that is the best most efficient way to go, that's what we'll do. But as I said in the -- to the earlier question, I'm not too concerned about where we have it marked. I think we're in a good place with it and I think that we're going to be able to work through it meaningfully well. Jim, anything you want to add there?

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

Yes, what I'll add to that is we did bring some consultants in to help us evaluate the collateral, evaluate what our strategies, pricing was with collateral. So I'd say that Sandro's comments were really informed by what that consultant was able to inform us about with respect to collateral pricing loans.

Stephen M. Moss - *B. Riley FBR, Inc., Research Division - Analyst*

Okay. And then, I guess, just perhaps digging little further on funding costs and in particular deposit costs here, if we do see 50 basis points this quarter, what would we expect for your deposit pricing?

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

Well, as you may know, Steve, I've been managing or I did manage the deposit base here for many, many years. And my philosophy has always been that on the way down, you don't wait for others to move, you move them. So we will be aggressive in our adjustment of deposit rate. That's been our history. I'm going to balance that against our need for funding. So I'm not going to tell you that we're going to reduce deposit rates by 25 basis points if the Fed drops 25. But we're not going to be overly cautious about it either. I think managing the deposit cost may be important to -- extremely important for managing the margin. And as I just said, we're a touch asset sensitive, and so the way we deal with that is by being more aggressive on the deposit side. So we're not going to be afraid to do that.

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

I think when you look at our balance sheet, Steve, you'll see all of the -- it's easy to see the assets that are going to reprice down. It's largely the commercial loan portfolio. If you look at the FHLB, if you look at the interest we pay where we're the subservicer on custodial deposits, you look at the trust preferreds, there's a whole host of liabilities that we'll also price down. So the liability -- the asset liabilities are continuing. That shortening of the curve is really something that we feel is within our ability to manage to whatever degree we have to manage it depending on what we see in terms of rate cut and Fed.

Stephen M. Moss - *B. Riley FBR, Inc., Research Division - Analyst*

Jim, on those custodial deposits is actually my next question. The interest there is paid is an offset to loan administration income. Just kind of thinking how do we think about that line item. How indexed are those deposits, if you will? And perhaps how can that translate into fee income for you guys?

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

Well, we've given you a new page in the deck. It's actually Slide 37 in the appendix. That will, I think, give you a lot more information than we've ever given before. And I'll turn it over to Lee to elaborate.

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

Yes. I think you're exactly right, Steve. The loan admin income includes servicing and subservicing fees less the amounts paid to MSR on those for the interest on those escrow deposits. And remember, we're subservicing 84% of the overall portfolio. The benefit Flagstar receives from those deposits is shown in interest income. So it isn't matched up on the GAAP rules, which is why, to Jim's point, if you look at Page 37 of the deck, which is a new slide, we've included this non-GAAP servicing profitability slide where we do match the interest income and interest expense from escrow deposits. And as you can see from that, just from a servicing profitability point of view, we are achieving $4 million to $6 million of operating profit pretax for every 100,000 loans we have.

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

Well, Steve, I think if you look at that page, it's interesting to look how the interest expense has grown quarter-over-quarter related to the custodial deposits. And as was noted in the prepared comments, custodial deposits increased $1 billion last quarter. So there's a lot of -- and partially in large part because of the prepayment of loans, because a number of loans that we service really didn't change much quarter-over-quarter. So that dealing of deposit, that's all tied to LIBOR. It ranges from LIBOR plus, a little LIBOR minus sort of something, but it's all tied to LIBOR is what the important point is. So as the LIBOR declines, the cost of those deposits does decline immediately and that's completely really efficient form of funding.

Operator

Moving on, we'll go to Kevin Barker with Piper Jaffray.

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

Just going back to some of the comments that Jim made on capital and the share buybacks, looks like you paused or bought back very little in the second quarter. And then how the priority looked going forward, given where your capital ratio stands today and the amount of growth that you put on the balance sheet, especially in the second quarter?

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

Well, let's just come back to the share buybacks. If you recall, buyback we executed beginning of February to January was an accelerated share repurchase. And the way that works is that we work with another -- we work with an investment bank and we execute an immediate buyback and there is a settle-up transaction later, which happened for us kind of mid-second quarter. So really the way we think about it from a share buyback, we've done in February with a small settle-up that we had. That's what you're seeing come through Q2. So we used our total $50 million of authorization.

But I go back to my prepared remarks, when we look at the capital ratios at the end of the quarter and you think about meeting capital for the risk of possible loss, I just don't -- when you look at the $1 billion worth of balance sheet inflation that we had, which will also come down through the second half of the year from that warehouse loan increase, it is not something that bothers us, concerns us. And if the balance sheet deflates, you'll see the capital ratios come back up because of that and also because of the -- just the earnings accumulation we'll experience over the next couple of quarters.

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

Yes. Not to mention, capital simplification next year. So to your point, Kevin, we're managing the capital very closely and making sure that the assets we put on the books bring us the return and make sense, given the use of the capital. And that's why you've heard a couple of us stating in our prepared remarks that we passed on quite a bit -- quite a few opportunities, but we were comfortable with from a credit point of view, but we couldn't get to hurdle from earning point of view.

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

Okay. And then, obviously, warehouse loans helped quite a bit and your loans held for investment picked up quite a bit here in the same quarter. And you gave the guidance for the third quarter. But as you look into the slower seasonal months in the fourth and first quarter, what do you expect as far as in average balance? Or do you feel like you can sustain your current loan balances as we move through those quarters, given the seasonality of the balance sheet at this point?

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

Well, only speaking to the third quarter, right? And we look at our guidance and we said that we think that net interest income was going to go above 5%. So that would suggest that there isn't a significant growth in the balance sheet projected over the next quarter. So while we might see some growth here, we might see some decline there and -- but past that, I'm not going to comment.

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

Would you expect to be able to sustain that NII going into the fourth and first quarter, especially given the shape of the yield curve?

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

Well, again, I don't want to speculate on anything further out. If you look historically at our net interest income performance, you can come to your own conclusion as to how we were able to perform in the fourth and first quarter. But I'm not going to comment on that.

Operator

And Henry Coffey with Wedbush has our next question.

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

It's interesting to see how quickly you kind of turned on the mortgage machine to take advantage of the rate decline. When we look at the collateral behind your mortgage warehouse loan that you are having issues with, the press says it was...

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

Henry, let me correct you, just one second. Okay? That is not a warehouse loan. We did have a warehouse loan. Let me just explain. We had 2 loans with Live Well. One was a warehouse loan. The warehouse loan was completely paid off without any loss or charge-off. The other loan, which was secured by marketable securities is where the issue was.

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

Okay. Yes. Thanks for clarifying that. When you look at Live Well, the press says that the problem was that you had Ginnie Mae IO collateral that you and others that were exposed to that credit were counting on Ginnie Mae IO collateral, which obviously is a pretty volatile item. I'm going to assume that's correct. I would take it from some of the remarks you made on the call that you don't have other loans so collateralized. Is that accurate or...

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

Yes. That's accurate. But I also want to say one other thing, maybe just a clarification from what -- something you just said. The -- we do not believe that the collateral issue is related to market conditions. I want to be very clear about that. There's a different problem that we're researching. Slide made reference to the law enforcement and the SEC investigation. We don't have all the answers to that. I can't really comment on it any further. But I just want to be clear that we do not believe that the collateral issue that we experienced and the charge-off associated with that had anything, anything to do with market conditions.

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

So there's no -- you're not looking at your overall approach to the business and saying, "Oh oh, we need a better telescope here?" You are happy with your telescope, so to speak?

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

Yes. Given the uniqueness of this particular credit, absolutely. Now that doesn't mean we don't inform ourselves and look deep into our operations to make sure that there could be something similar, but we've done that, and I'm comfortable answering the question the way that I did.

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

Great. The other thing kind of from a broader look, a couple of banks have been talking about issues in their AC&D acquisition and development portion of their portfolio, which obviously includes both commercial and residential activity. You have a pretty broad scope on that -- view on that market. Are you seeing weakness in the AC&D business, strength in the AC&D business, because the way the mortgage market is, what are your thoughts on the overall tone of that sub-portion of the lending market?

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

I'll let Drew comment. I'll just say to begin that we haven't seen any weakness whatsoever from a credit perspective. So we don't have delinquencies at any level in the AC&D. But Drew, I know you probably want to chime in here.

Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP & President of Banking*

Yes -- no, had to get on. I mean we're really happy with the way we've grown that book of business. It's very well diversified. We bank 7 of the top 10. We bank 51 of the top 100s. We have really tight concentration policies around what we take as collateral, that mix of that collateral and how we monitor that collateral. So as Sandro said, we haven't any concerns to take -- with that book of business. I think affordability is still an issue out there, but I think price appreciation is slowing. So we think there's ample room for us to continue to grow that book of business.

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

The opportunities are coming almost every week and our loan committee was seeing new opportunities in this space.

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

What the -- are the builders at the very low end of the spectrum, maybe that's not even the top 100, the 5 trucks and 20 homes a year? Is that builder having access to credit? Or is that builder in your view credit-starved?

Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP & President of Banking*

I mean I do think that the market overall is still constrained by available credit. We don't happen to bank builders like that. We only bank large regional builders that do significantly more than 20 houses and 5 trucks.

Operator

Next, we'll go to Chris Gamaitoni with Compass Point.

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Head of Research*

I wanted to clarify one of the guidance points on the all other noninterest income down 5% to 10%. Is that inclusive or exclusive of the DOJ fair value change?

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

Yes. The DOJ is completely exclusive from many comments that we've made.

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Head of Research*

Okay. That's helpful. And then thinking about the HFI growth, 5% to 10% quarter-over-quarter, is there any thoughts on kind of the composition of that? Is that strength in core commercials? Is it homebuilder loans? Is it greater warehouse balances? Just wondering to kind of get a better understanding of what's going on in the business to drive that.

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

In the best -- in the past quarter, are you speaking to Q2...

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Head of Research*

No, the future guidance.

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

Yes. I think it's going to be very similar to what we saw in Q2, and honestly, that's what you see this led every quarter for Flagstar is that doesn't significantly come in any one area. Now Q2 was unique in that we had such a big increase in the warehouse business. And there's a lot of reasons for that, and we touched upon in our prepared comments: number one, Drew and his team did a really good job of maximizing the utilization rate. So jumping on top of the opportunities that presented itself, once the rates produced a little bit of improvement in refinance area, reacting quickly to overlying requests and things of that nature that allowed us to grow that business that is nearly good from probably 10% or quickly. But otherwise it's very balanced against CRE and inside of CRE with builder finance and then with C&I. And then also the continual growth of our consumer loan book and the nonauto indirect has performed really well here this year. So I wouldn't expect to be much different in June or...

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

Well. I think that's exactly right. I mean I think we have a really good mix of commercial and consumer and warehouse. And I think we've been able to take advantage where any advantages presented themselves. In this quarter, we had an outsized advantage towards warehouse that we jumped on. And we have a great book even within warehouse, over 300 customers. So it's not like a type we're concentrated in any one name. And frankly, the acquisition that we had last year has helped bolster those results. But the C&I is very well diversified in terms of local core businesses and national platforms that we service. CRE, very much the same thing. And then you can see the continued diversification in the consumer book of business, including the nonauto indirect.

Operator

Our next question will come from Daniel Tamayo with Raymond James.

Daniel Tamayo - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

So this is kind of a longer-term question on the asset growth. You've obviously had very strong asset growth and deposit growth in the last several years even excluding the Well's branches. I think you've talked in the past about kind of a $3 billion to $5 million number over 2 to 3 years on an organic basis. Is that still something you think is achievable going forward here? Or how do you think -- how are you thinking about kind of long-term balance sheet growth now?

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

Well, growing the company is important than growing earnings per share. But I think that where we're at today, given capital levels and the growth that we have achieved, we've got to be careful that the growth that we have going forward is meeting higher return levels. And so we're very, very focused on that. And the opportunities are going to be there, because we have lots of good people that have come to work at Flagstar that have great relationships, not only here in Southeast Michigan, but across the country. And so we know that we're going to get the opportunities. What we don't know is whether the opportunities will, to say, return that will be satisfactory to support the use of our capital. So we're probably going to be a little bit more cautious about that going forward, but only because of capital levels. But as we've done in the past, we will take advantage of the opportunities that present themselves to us, and we'll execute on them in a positive way.

Daniel Tamayo - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

And then how does the kind of the held-for-investment loan-to-deposit ratio, which has crept over 8% here factor into that? Or is capital still the kind of defining threshold for -- how are you thinking about loan growth?

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

Well, yes, I think capital is defining threshold, not to say that HFI or the ratio that you referred to is not considered, but clearly I think capital. Jim, would you agree?

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

Yes. And I think Sandro said it well. It's not that we ignore both multi-loan and deposit ratio. We're always cognizant of what our runway is from a liquidity standpoint. But as we look at it right now, we've invested the capital that we have in improving the outlook and stability of the company, now have the ability to buy back stock. We initiated the dividend earlier this year. So we've been talking about management tools that enable us. If we don't like the returns that we're seeing, what's presented to us, we can always sit back on the capital or maybe even buy some of it back if we think that's the right thing to do. So we've got more tools available to us to manage that return on equity mix as we go forward.

Operator

And we do have a follow-up from Kevin Barker with Piper Jaffray.

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

My question has been answered.

Operator

And now I'll turn it back to Mr. Sandro DiNello for any additional or closing comments.

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

Thanks, Paula. All said, it was a good quarter with solid contributions across the board from retail banking, commercial and mortgage, including servicing. They all came through with strong results. In this quarter in particular, we can see the payoff of our acquisitions. Wells Fargo and DCB and the deposits have efficiently funded our loan growth, focused on the strong performance of our retail mortgage channel in Santander and the huge upswing in warehouse lending. Plus the new businesses we started such as our indirect nonauto lending are emerging as important contributors. When you put it all together, you get the profile of a unique bank with many diverse pieces that were together and complement each other to deliver consistent earnings and long-term growth in shareholder value.

In closing, thanks again to the Flagstar family for your outstanding performance. Thanks to our shareholders for your support. And thank you again for taking the time to listen in today. I look forward to reporting third quarter results in October.

Operator

And that does conclude today's conference. We'd like to thank everyone for their participation. You may now disconnect.
