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PRESENTATION

Operator

Good day and welcome to the Flagstar Bank fourth-quarter 2016 earnings conference 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 Urban - *Flagstar Bancorp, Inc. - IR Director*

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

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

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.

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

Thank you, Dave, and thank you, everyone, for joining us today. In addition to Dave, I am joined this morning by Jim Ciroli, our Chief Financial Officer, Lee Smith, our Chief Operating Officer, and Steve Figliuolo, our Chief Risk Officer.

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

During the fourth quarter, we saw the payoff of our efforts to create a business model that would keep us profitable through the ups and downs of the mortgage cycle. In a quarter where we faced seasonal lows in mortgage production and an unexpected spike in interest rates, we still increased our earning assets and net interest income thanks to strong gains in commercial real estate and commercial and industrial loans. Included in that mix is the builder finance initiative that we launched last year, which is showing good traction. It's the kind of steady, solid growth that is important in order to smooth out the volatility of the mortgage business.

While the election results provided some optimism for the banking industry and the economy in general, it did bring an unprecedented increase in the 10-year note rate. Initially following November 8, our lock activity was on target with our projections, but, as we hit the middle of December, activity declined significantly and hedging became more challenging.

All things considered, I was pretty pleased with the way we weathered the storm despite experiencing a larger drop in locks during the quarter than we had anticipated. With the mortgage industry now clearly pivoting to a purchase scenario, we feel that we are well-positioned to pick up talent and business as refi shops struggle. The timing is right for us to leverage our market power to grow our market share in both our retail and TPO businesses.

Once again, we demonstrated a solid credit performance with low levels of delinquencies, nonperforming loans, and net charge-offs, and we continue to have no nonperforming commercial loans. Our coverage for loan losses remains excellent, and our provision for loan losses was de minimus at $1 million.

The lifting of the consent order with the OCC was certainly a milestone in the quarter and a validation of the quality of our operations in risk management and compliance. It has been a long journey to reach this point and a tremendous accomplishment for the entire Flagstar team. We fundamentally and forever changed the face of Flagstar and, along the way, created a better, stronger organization.

Looking back to 2016, we posted solid, consistent financial results every quarter despite volatile interest rates and seasonal changes in mortgage production. The growth in our banking business has been outstanding, producing the highest level of net interest income in the Bank's history. It's a testament to the strength and diversity of our business model.

What's more, we maintained a solid level of capital even after redeeming our TARP securities. This is a tribute to the hard work done in recent years to position Flagstar for profitability in all economic scenarios.

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

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

Thanks, Sandro. Turning to Slide 6, our net income this quarter was $28 million, $0.49 per share, as compared to adjusted net income of $41 million, $0.69 per share last quarter. For the full year, our net income was $155 million, $2.38 per share, adjusting for the DOJ benefit, versus net income of $158 million, $2.24 per share, in the prior year, an EPS increase of 6% from last year.

Our earnings this quarter were led by solid banking growth, good expense control, and strong credit performance. Our return on assets was 0.8%, and we returned 8.6% on common equity. These metrics were impacted by the seasonality of the mortgage business.

Looking at the full year, we had an adjusted ROA of 1.1% and an adjusted ROCE of 11.8%. It was another solid year with high quality earnings.

Let's turn to Slide 7 and dive deeper into the income statement. Our fourth-quarter net interest income rose 9% to $87 million. This reflected a $0.5 billion, or 4%, increase in earning assets, led by increases in both commercial and consumer loans held for investment.

Our NIM rose 9 basis points in the quarter to 2.67%, driven by a $2 million benefit from the termination of certain fixed-rate FHLB advances which impacted the NIM by 6 basis points. The remaining improvement in the NIM largely resulted from improved yields on loans held for investment.

The provision for loan losses totaled $1 million this quarter as compared to a provision of $7 million last quarter. Asset quality continues to be strong, and I will provide additional detail in a couple of slides.

Noninterest income declined on the basis of seasonally lower gain-on-sale revenue and the impact at the end of the quarter of the significant increase in interest rates during the quarter. This decline also resulted from the prior-quarter benefit that was recognized in other noninterest income from a drop in the fair value of the DOJ settlement liability totaling $24 million.

Fourth-quarter net gain on loan sales decreased $37 million, or 39%. The decrease from the prior quarter primarily reflected lower fallout-adjusted locks and a drop in the gain-on-sale margin. The gain-on-sale margin was 93 basis points, a decline of 20 basis points from last quarter, and we saw our fallout-adjusted locks decrease 27% due to anticipated seasonal factors and the same decrease others have reported from significantly higher interest rates.

The return on the mortgage servicing asset, net of hedging, was a loss of $5 million this quarter, consistent with our guidance, despite the volatile interest rate environment after the election. The net MSR return improved from last quarter due to slower prepayments and the charge of $7 million recognized last quarter for $50 million of MSR sales that closed this quarter. The R&W benefit rose $1 million this quarter as the R&W reserve fell to $27 million, the result of net recoveries, continued improvement in risk trends, and our success in defending against claims. At the end of the quarter, our repurchase demand pipeline was only $6 million.

Moving now to expenses, noninterest expense was unchanged at $142 million this quarter as compared to last quarter. Overall, higher legal and professional expense was largely offset by lower compensation and benefits.

The Company's efficiency ratio rose to 77% this quarter as revenues fell with stable expenses. The higher level of the efficiency ratio reflected a timing difference between when we book revenues and when the associated expense can be reduced. While we book gain-on-sale revenue at the time the customer locks in their rate, we don't recognize many of the expenses until the time of origination, that is loan funding. Origination volume was only down 7% from the prior quarter, and Lee will provide more detail on expense management.

The Company's effective tax rate this quarter was 33% as compared to 34% last quarter and for the full year 2016. This quarter's effective tax rate reflects the rate that we believe will be our effective tax rate going forward, barring anything that might happen in the way of tax reform.

Slide 8 highlights our average balance sheet. Average earning assets increased $0.5 billion, or 4%, led by growth in loans held for investment. Loans held for investment grew 5% as average commercial loans grew at 6%. This continued growth was in the commercial real estate and C&I portfolios where our combined ending balance was 5% higher than the average balance for the quarter, giving us a nice jumping off point for net interest income in Q1 2017.

Average deposits rose $107 million, or 1%, led by a 2% rise in retail deposits. We saw nice growth in all retail product categories.

At December 31, our common equity to assets ratio remained strong at 9.5% and our book value per share rose to $23.50, reflecting earnings retention and a positive change to accumulated other comprehensive income as our unrecognized gains from our cash flow hedges were only partially offset by a decline in the unrecognized gains in our securities portfolio.

Let's now turn to asset quality on Slide 9. Nonperforming loans were $40 million at the end of the quarter, unchanged from prior quarter, while the nonperforming loan ratio rose slightly to 67 basis points. Again, there were no commercial nonperforming loans.

Early-stage delinquencies also remain low. Only $10 million of consumer loans were over 30 days delinquent and still accruing, and there were no commercial loans at December 31 that were more than 30 days delinquent.

Net charge-offs were $2 million this quarter, representing 13 basis points of loans, compared to $7 million last quarter, or 51 basis points of loans. Included in this were charge-offs related to our loans with government guarantees of $1 million this quarter versus $5 million last quarter.

At December 31, our allowance coverage was 2.4% of total HFI loans, up slightly from the end of last quarter. Coverage remains strong at 3.3% of consumer loans and 1.6% of commercial loans.

Turning to Slide 10, capital remains strong. Our tier 1 leverage ratio was 8.9% at December 31, unchanged from September 30. Our CET1 ratio was 13.1%, and our tier 1 and total risk-based capital ratios remained well above peer averages. These ratios are even stronger when reflecting upon the lower level of risk in the balance sheet and the strong risk management function we've built.

We continued to grow our regulatory capital at a pretax rate as we utilized our net operating losses. At December 31, our tier 1 leverage ratio was reduced by 121 basis points through the NOL-related DTAs. And we anticipate the elimination of this deduction over the next two years, given our level of profitability.

MSRs in excess of the amounts allowable under Basel III also reduced tier 1 leverage by 110 basis points. Despite the increased level of MSRs this quarter, which resulted from higher interest rates, we plan to reduce this MSR deduction over the next five quarters through both flow and bulk sales. The combination of these two reveals more than 230 basis points of capital deductions that we believe could come back into regulatory capital over the next one to two years, providing an outsized level of internal regulatory capital growth during that period.

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

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

Thanks, Jim. Good morning, everyone. You've heard us talk about our one-of-a-kind business model on previous earnings calls and how our three major business lines, the community bank, mortgage originations and mortgage servicing, feed each other and enable us to generate high-quality interest-earning assets in multiple ways and yet provide complementary hedges so we can operate successfully in any interest rate environment. We believe this quarter demonstrated exactly what we meant.

Despite the typical seasonal slowdown experienced in the mortgage business, we also witnessed an unprecedented increase in interest rates during the middle part of the quarter that had a significant impact on our mortgage business, both from a volume and margin perspective. However, we were still able to grow average interest-earning assets $500 million in the quarter, which grew net interest income $7 million quarter-over-quarter and enabled us to generate solid earnings of $0.49 per diluted share.

For the full year, we generated $155 million of adjusted after-tax net income, or $2.38 per diluted share, excluding the third quarter's DOJ benefit. Remember, this EPS number include $0.20 per diluted share from the net impact of seven months of TARP dividends which have gone away. So if you adjust for that, EPS is $2.58 per diluted share over the last 12 months. These earnings, which equated to an adjusted return on assets of 1.1% in 2016, were also supported by several notable accomplishments during the year, including the lifting of the OCC consent order in December, earning asset growth of $1.7 billion, and establishing several new business lines, particularly on the commercial lending side of the business, growing average total deposits by $1.1 billion, organically growing our mortgage retail platform $530 million, or 39%, year-over-year, continued expense discipline and the repayment of our TARP funds in July. We are pleased with the progress we have made this year and feel we are well positioned to continue to grow and be successful across all three business lines in the future, especially given our strong capital and liquidity positions.

I will now outline some of the key operating metrics from each of our major business segments during the quarter and full fiscal year. Please turn to Slide 12.

Quarterly and full-year operating highlights for the community banking segment include, in the fourth quarter, average commercial loans increased $204 million, or 6%, to $3.35 billion, led by commercial real estate loans which increased $127 million, or 12%, and further bolstered by commercial and industrial lending, which grew $88 million, or 14%. One of our strategic objectives is to continue to grow average commercial loans held for investment in order to balance earning contributions between the mortgage and commercial businesses, smoothing out earnings volatility.

During the last 12 months, we have grown total average commercial loans by $1.3 billion, led by a $500 million, or 50%, increase in warehouse lending. Average CRE lending has grown $400 million, or 50%, over the last year, and C&I lending has grown $300 million, or 55%, over the same time period as we continue to execute on our relationship-based approach with borrowers in many different industries. This growth in higher-yielding commercial loans has led to us growing interest income by $62 million in 2016 to $417 million. We were able to grow interest-earning assets 17% year-over-year because we are growing capital at pretax rates, given our NOL-related deferred tax asset, and believe we can continue at the same pace in the future.

As you know, we introduced several new commercial lending business lines at the beginning of last year, including build-to-finance lending, MSR lending, and equipment finance lending. We currently have $181 million in outstandings of build-to-finance loans, $89 million in equipment finance outstandings, and continue to fund MSR facilities where we are also the sub servicer of the underlying loans with further potential deals in the pipeline. We also launched a syndications team during the fourth quarter. We believe these new business lines will complement our existing C&I and CRE lending channels, and we will continue to see solid, consistent growth as we move forward.

Furthermore, we can leverage these lending relationships to generate other synergies such as deposit growth, corresponding relationships through the warehouse business, and sub servicing opportunities.

We added $271 million of high-quality jumbo and conventional mortgage originations to our held-for-investment portfolio during the quarter as we look to balance earning asset growth between various asset classes to reduce risk. These mortgage loan additions increased overall average consumer loans by $111 million, or 4%, in the quarter. Year-over-year, average consumer loans decreased $732 million as we took advantage of market conditions earlier in 2016 to realize significant gain on loan sales, but also deployed our available capital and liquidity towards the higher-yielding commercial loans, as previously discussed.

Our NPLs remain flat at $40 million quarter-over-quarter, the lowest level in over 15 years, and 30-to-89-day delinquencies totaled a modest $10 million at the end of the quarter, which demonstrates both the quality of our overall book and attributes of our unique servicing platform. It should be noted we have no delinquent or nonperforming commercial loans on our books at this time.

Average total deposits grew $107 million, or 1%, in the quarter, led by higher retail deposits. Over the last 12 months, we have grown retail deposits by $500 million and Company-controlled deposits by $626 million for total deposit growth of $1.1 billion. This growth has been achieved through executing on several strategic initiatives, including our rebranding strategy that went into effect last year, putting greater emphasis on bringing in deposits from commercial customers and leveraging our sub servicing business for custodial and escrow deposits.

Looking forward, we believe we can continue the growth you have seen in our commercial businesses as we leverage the new lending channels while building on our core CRE and C&I businesses. We are very encouraged by the sustained growth in the community bank, our positioning and potential for the future.

Please turn to Slide 14. Fourth-quarter and full-year operating highlights for the mortgage origination business include fallout-adjusted lock volume decreased 27% to $6.1 billion, primarily due to anticipated seasonal factors and lower refinance activity from significantly higher interest rates in the latter part of the quarter. Mortgage closings declined a more modest 7% to $8.6 billion quarter-over-quarter. Generally, mortgage production was as expected during the quarter other than the last three weeks of December, when the higher interest rate environment combined with the holiday period reduced activity significantly. For the full year, we closed $32.5 billion of mortgages.

Our net gain on loan sale margin fell 20 basis points quarter over quarter to 93 basis points. The decrease in margin was driven by price competition as the industry adjusted to seasonal lower demand and looked to fill capacity during the quarter. The steps we've taken during 2016 to expand our distributed and direct-to-consumer retail businesses are yielding positive results with retail fallout-adjusted rate locks increasing $530 million, or 39%, year-over-year.

We are also leveraging our direct-to-consumer business to provide recapture services to clients we sub service loans for. This provides significant value to the owners of MSRs, or the underlying loans, and is another way our business lines complement one another.

We are also encouraged by the quality of our originations and the work of our fulfillment and underwriting teams. Because of this quality, our repurchase pipeline is less than $10 million, the lowest it has been in many years.

Looking forward, we will continue to pursue the growth of our retail footprint via organic and inorganic strategies, as well as to expand our third-party originations business via new customer activations or other market opportunities. As you know, we are the sixth-largest bank originator in the nation and are well positioned to benefit from any market dislocation as interest rates rise and the refinance boom goes away.

Moving to servicing, quarterly operating highlights for the mortgage servicing segment on Slide 15 include we executed on the sale of $6.7 billion in aggregate UPB of bulk and concurrent flow sales of residential MSRs during the quarter, which included a large bulk Ginnie Mae MSR pool reference last quarter representing approximately $4 billion in aggregate UPB.

We entered into two new agency MSR flow deals towards the end of the quarter, which will lead to incremental MSR sales every month. We entered into a capacity sub servicing agreement directly with Freddie Mac during the quarter, and while we cannot say how many loans this may result in us adding, it does give us tremendous confidence Freddie Mac thinks highly enough of our platform to award us this contract.

We currently service approximately 383,000 loans, of which 220,000 are sub service for others, making us the eighth largest sub servicer in the nation. The remaining 163,000 are loans where we own the MSR or they are part of our HFI book. Approximately 98% of our servicing book is performing loans and 2%, or approximately 9,200 loans, are 60-plus days delinquent. Average Company-controlled deposits, which are directly correlated to our servicing loan count, increased $20 million during the quarter to $1.9 billion as a result of growth in the number of loans serviced.

We remain focused on growing our fee income generating sub servicing business, which has the capacity to service up to 1 million loans, and execute on our MSR reduction strategy through efficient bulk and flow sales, given the requirements of Basel III.

Moving on to expenses on Slide 16, our noninterest expense was unchanged at $142 million in the fourth quarter. Higher legal and professional expense was largely offset by lower compensation and benefits. We didn't realize a more sizable decline in variable expense because mortgage costs are tied to closings, not fallout-adjusted locks.

Locks declined 27% while closings fell a more modest 7%. Slide 16 illustrates that discipline and how we have operated within a fairly tight range when it comes to expenses over the last five quarters. This is something we are very focused on as an organization.

Our efficiency ratio rose to 77% in the quarter compared to an adjusted ratio of 67% in the prior quarter. This was largely due to the reduction in mortgage revenues as a result of the usual seasonal softening and the unprecedented interest rate environment. Our variable mortgage costs, i.e., commissions and loan processing expense, are tied to closings and not locks, and so lagged the revenue side by about 45 to 60 days.

For the full year 2016, our adjusted efficiency ratio was 71%, which is consistent with 2015. However, we should be mindful of three things about 2016.

We were investing in growth initiatives during the year and the revenues typically lagged the cost investments. The interest on the senior debt used to repay TARP is included as an expense in the efficiency calculation in July through December. Prior to July, the dividends on the TARP did not affect the efficiency ratio.

The net return on the MSR asset was negative $26 million in 2016 versus a positive $28 million in 2015, a negative spread of $54 million year-over-year. This was predominantly a result of the interest rate environment leading to increased payoffs as more borrowers refinance their mortgages at lower rates. In a normalized interest rate environment, we target a return of approximately 6% on the MSR asset. When you consider these events, we believe we have made progress from an efficiency point of view, even if the calculation has remained flat year-over-year.

We've previously stated that our targeted long-term efficiency ratio is in the mid-60s%, and that remains our goal. Our immediate focus in achieving that goal is on growing revenues across all three major business lines while continuing to build on the cost discipline and risk management we have instilled throughout the organization.

We estimate noninterest expense will be between $142 million and $147 million during the first quarter of 2017 due to the seasonal slowdown in the mortgage business being offset by our investment in growth initiatives, including our mortgage retail channels and various commercial lending businesses. Furthermore, we believe our efficiency ratio will remain around 70% on an annualized basis, given the investment period that is needed to ramp up new business opportunities. We are very confident, however, that the new initiatives, together with the growth we anticipate in existing channels and our proven cost and expense discipline, will ultimately see us achieve our long-term goal of a mid-60s% efficiency ratio.

We are pleased with our progress in 2016 and excited for the future. We believe we have the right team, business model, and strategies in place that will enable us to deliver continued strong returns for our shareholders.

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

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

Thank you, Lee. I'm now going to close our prepared remarks with some guidance for Q1 and then open the call for questions and answers.

Please turn to Slide 18. We expect a slight increase in average earning assets from our year-end position, led by growth in C&I, CRE and jumbo mortgage loans, partially offset by a decline in warehouse loans from lower mortgage market volume. We anticipate a stable to slightly higher net interest margin. We expect gain on loan sale income to decline approximately 5%. We anticipate a moderate decline in the gain on sale margin on continued price competition. We expect that mortgage locks will increase approximately 6% on seasonality. We anticipate the net return on the mortgage servicing assets will approximate 4% to 6%. We expect that the balance of our MSRs will be relatively flat. We anticipate our provision expense will generally replace net charge-offs, consistent with our 2016 run rate. And, as Lee noted, noninterest expense will remain fairly stable, between $142 million and $147 million.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Paul Miller, FBR.

Paul Miller - *FBR & Co. - Analyst*

A couple of questions. The first one is I didn't see you break out -- I saw you break out the gain on sale of 93 basis points. But did you break out -- and you can get this to me if you don't have it -- your non-cash versus cash gain on sale?

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

No. We didn't break it down. We don't do that. I don't think it's in our 10-Q, either, is it, Jim?

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

No.

Paul Miller - *FBR & Co. - Analyst*

Okay. I would encourage you to do it, especially in these volatile environments, because I think a lot of people would like to know what's between cash and non-cash out there.

On the C&I loans, it was really like 12% growth year-over-year. Can you talk a little bit about what are you doing to drive that loan growth and can it continue?

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

I'll tell you, Paul, I couldn't be more pleased with the way our banking business grew in Q4 and, for that matter, for all of 2016. If you look at it closely, you'll see it's really diversified. The quality has been strong. Yields have been pretty solid and we have been able to fund pretty effectively.

I think -- we've said this before and I'll say it again -- I think that it's the people. If you can get the right people to join the organization, they will bring the right relationships, and we have been able to do that. Our team has done a really nice job over the last three to four years of becoming really relevant here in Southeast Michigan in particular, and that has allowed us to bring in the right people, and they have brought relationships not just in Michigan but we are starting to see the ability to go to other parts of the country as well with people that we have relationships with here in Michigan. So, it's a really good story. And I'll tell you, as good as 2016 was, I think 2017 can even be better.

Paul Miller - *FBR & Co. - Analyst*

Is there any specific industry that you guys are targeting that you are really getting a lot of impact, or is it just across the economy in general?

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

Yes, it's really broad. And we've got a slide back in the appendix that shows you how diversified the business is, which -- I think that being disciplined that way is the right way to go and not to get involved with any one particular thing.

Certainly, over the last year, given the fact that we introduced some new things like MSR lending and builder finance, you saw a little bit more growth in those areas. But this still is a pretty new line of business for us, and so when you look at where our concentrations are against most commercial banks, they are really pretty conservative.

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

This is Jim. You can see that diversity on Slide 32. I think it really does a good job of painting it.

Paul Miller - *FBR & Co. - Analyst*

Okay, guys. Thank you very much. I'll get back in the queue.

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

Paul, I love the fact that you are asking banking questions, by the way.

Paul Miller - *FBR & Co. - Analyst*

Okay, guys. Thanks.

Operator

Bose George, KBW.

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

Actually, a couple of things. First, on the net interest margin guidance, you said it will be up slightly, but, earlier in the call, you had mentioned that 6 basis point benefit from the FHLB. So for the starting point, should we use the margin including that 6 basis points or ex that?

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

I would go ex that, Bose. But our guidance contemplated the fact that we had that benefit in Q4.

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

Okay. Okay, great. And then actually just switching to the DOJ settlement, it looks like you've met most of the conditions there. Can you just discuss how that settlement is going to proceed in terms of the payouts?

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

Well, there's one big condition that hasn't been met, and that's the capital trigger. And I think that, last quarter, we outlined that pretty clearly in the 10-Q in terms of how that works. So at this point, we are sitting with the fair value -- I am starting to get into Jim's role here -- at $60 million. And we think that's the right number at this point. And we look at that every quarter, and we didn't make any adjustment this quarter. Jim, do you want to add anything?

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

Yes. Bose, the trigger for that is the Bank capital level. I'd say the only remaining trigger on that is the Bank capital level at 11%, tier 1 leverage at 11% or above. We ended the year at 10.5%, so there's still a little bit to go there. And even if that were to happen, you only make certain -- you'll only make $25 million of payments in any one particular year. So I would encourage you to go back and look at the Q from last quarter. And I'm sure, when the K comes out, it will have the same language. But we really spelled out the mechanics of that really well in the Q.

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

Okay. Great, thanks. And just one more. Can you just talk about the potential landscape for acquisitions, especially in terms of what you might do on the retail side in mortgage banking?

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

Sure. Well, given the fact that the consent order has been lifted, certainly M&A is more in the forefront of our thinking. We've got a lot of things that we're looking at right now, and that's probably always going to be the case going forward. So, I expect this year will be busy in that regard, but we are going to be really smart about this. We are only going to do what really makes sense on the mortgage side. And I've been -- we've been saying for a while that we'd like to see an acquisition of a retail mortgage originator, so we are continuing to look at that. We just haven't found exactly the right thing yet.

On the banking side, I think there's a lot of small banks that are interested in combining with a company like ours, and we will be searching for the right situation. I can't guarantee that something in that regard is going to happen this year, but I can tell you for sure that we're going to be looking at a lot of opportunities.

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

Okay, great. Thanks.

Operator

Scott Siefers, Sandler O'Neill.

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

This is actually Brendan on the line for Scott. A couple questions from me. First, on expenses, I certainly appreciate the guidance you offered for the first quarter. But just in terms of thinking a little bit further out in the year, if we are in what's likely to be a structurally lower mortgage environment in 2017, is there any opportunity to bring that expense base down from the $142 million to $147 million? Bearing in mind that I acknowledge that you guys are continuing to invest in the businesses.

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

This is Lee. So, the answer is yes. I think, as you've seen over the last couple of years, we have been dynamic in managing our expenses and we have created a variable cost model on the mortgage side. So, if we were in a lower mortgage environment in terms of production volumes, then, yes, you can expect the costs to come down to represent that.

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

Great, that's perfect. And then turning to credit, I'm just trying to get a little more granular on your guidance for the provision in charge-offs. Throughout the course of the year, your charge-offs came down pretty nicely each quarter. I'm just trying to square that with what that means for the provision in the first quarter and for charge-offs as well.

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

I think what we said was we anticipate it would be at the 2016 run rate. And so what we meant by that was take the total for the year, divide that by four, and that's what we think the first quarter is going to look like.

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

Got it. So I think that -- sorry, go ahead.

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

Less charge-offs than we would've had from loan sales that we experienced in 2016 earlier in the year and less what we temporarily experienced as EPOs.

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

We've got a slide in the appendix that breaks out the charge-offs. What number is that? Number 9. That will be helpful. And if you have any follow-up on that, just let us know.

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

Okay, I appreciate that. Then, finally, on the MSR asset, I just want to make sure I understand the moving parts here. We are looking for the net return on the MSR asset to be 46% in the first quarter. I think that roughly implies about a $4 million positive number for the line in the first quarter. I just want to get your sense of some of the moving parts. One, you have the pretty drastic move in the rate environment late in 2016, and then couple that with the fact that you are actively selling MSRs due to Basel III concentrations, just what your thoughts are there.

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

I'll give you my view. Jim may want to supplement that. As you said, there's a lot of things. Sales have an impact on that because there are costs associated with sales. And of course, the prepayment speeds have an impact on that, interest rates. All those are moving parts -- the hedging. All of those come into play. And to say that that was challenging to hedge that in December, in particular, with the 10-year increasing the way it did would be an understatement. And I've got to say that the way we ended up there, I think, is pretty darn good.

Jim, do you want to add anything to that?

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

I'd direct you to Slide 39, where we show you what the Vega looked like, the market implied volatility, that not only Flagstar but all of the industry had to hedge if you are holding MSRs during the quarter.

What I would also guide you to on the prior page, Page 38, is we give you an attribution model of how that MSR return breaks down. And you can see where things were in Q4 broken down into five different categories. I think that will be helpful as you start to project Q1.

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

Fantastic. Thank you for taking my questions.

Operator

Henry Coffey, Wedbush Securities.

Henry Coffey - *Wedbush Securities - Analyst*

Good morning and thank you. You've put together a great example of how the Bank and the mortgage company work together. But fortunately, we've got plenty of bank questions. So now, on the mortgage company, can you give us some sense of who's on the other side with the MSR sale? Is it other banks? Is it investors? Who's buying MSRs? And what percentage of your sales are such that you get to keep the sub servicing?

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

I'll turn to Lee on this one.

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

Yes, so I would say, Henry, if you look back at 2016, it was predominantly funds that were on the other sides of the transactions. What we've noticed in the fourth quarter and the beginning of this year, with the rise in interest rates, you are getting more buyers coming back into the market, both funds and banks. So, we're beginning to see more interest in MSRs, given what you've seen happen with the interest rate environment recently.

In terms of sales, I would say that, in 2016, we kept probably, in terms of the loans that we sub service, we probably kept about 70%, two-thirds, of what we sold. The other third we sold on a release basis.

Henry Coffey - *Wedbush Securities - Analyst*

And then, on the origination front, given your guidance, you are actually looking for something pretty much in line with last year. Is that because of the TRID block, or is that because you see some of these other channels growing?

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

I'm not sure I understand the question, Henry. Try me again on that.

Henry Coffey - *Wedbush Securities - Analyst*

If you look at your guidance in terms of expected locks and the like, you are pretty much in line with where you were last year in the first quarter. And yet I know first quarter was a pretty tough quarter. It's obviously going to be hard to grow the business going forward, given where rates are. But I was wondering. What is the composition of what you see coming at you in the March quarter? Why is it so much better than what -- why is it pretty much in line with last year? Is that just because of TRID, or is that because of gains in new channels?

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

Yes, I think it's tough to compare this year to last year because Q4 last year was so low for us, given the position we took on TRID.

What I would say about the mortgage business is with respect to the first quarter, typically, we would see better improvement in the first quarter, but this is going to be a tough start to this mortgage year, I think. I think, in particular, obviously refi shops are going to really struggle. And so when you look at our TPO business, those partners that rely heavily on refis, they are not going to have the originations that they have been having.

But I do think that the year will get stronger as we move through it. And I think, when it's all said and done, it will be strong enough that we can say we have had a successful year with the mortgage business. But clearly, I think we are being careful about Q1.

Henry Coffey - *Wedbush Securities - Analyst*

Is this a year where the Bank is fully going to dominate the earnings equation?

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

Well, I think fourth quarter was a bit of a pivot in that regard because, if you look, you can see that the net interest income, it was the highest we've ever experienced, was, I think, the first time it was higher than gain on sale. That's not typical for our Company. So, I think, clearly, we are moving the revenue from the mortgage business to the banking business, and we are going to keep doing that. And it's not that we want the mortgage revenue to decline; we don't want that. We want to stay very relevant in the mortgage business, but to get more out of the Bank so that the earnings are more predictable on an annual basis and a little smoother within the year.

Henry Coffey - *Wedbush Securities - Analyst*

Is the NIM in your Bank somewhat asset sensitive?

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

A touch, but not a lot, because it's a relatively new balance sheet, and we have built it to be very balanced from an interest rate perspective, so we chose not to put ourselves in a position to bet on the interest rate. So we should get a little bit, little benefit, but not as much as some other banks might.

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

This is Jim. Slide 42 gives you a sense of where our interest rate sensitivity is and the low level of interest rate risk that we take.

Henry Coffey - *Wedbush Securities - Analyst*

Great. Thank you very much and congratulations on a good quarter.

Operator

Kevin Barker, Piper Jaffray.

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

I just wanted to follow up on Page 26 of your presentation. You clearly lay out a $70 million reduction in your NOL on a pro forma tax basis. Correct me if I'm wrong, but does that -- assumes that the federal tax rate goes to 20%?

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

What we've laid out on 26 is a full chart. If you look on the right side there, you can see different potential federal tax rates, assuming implementation on 1/1/2018, what the impact would be to our income statement on our tier 1 capital.

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

And so the federal NOL --

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

The $70 million that you see up above in the table on the right is what we expect to utilize in 2017.

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

So when we think about potential impact to the NOL, if federal corporate income tax rates were to drop, is it equal exactly to the percentage decrease, or would there be some differentiation between the reserves for loan-loss reserve or reps and warrants, and not just the federal DTAs? In other words, is it a one-for-one decline?

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

Yes, yes. If you look at the lower chart on the right-hand side of this page, it is exactly that. So, if you take this delta -- if you look at our NOLs at $98 million projected at the end of 2017, and you apply the delta below that we are expecting in the tax rate, so it goes from 35% to 20%, that's a 15% delta -- knowing that the $98 million was calculated at a 35% rate, if you take, therefore, the resulting fraction or actually the inverse of the resulting fraction, you would come up with the chart below, both for the NOLs. And then in the other column, you would exactly guess what that is or you go to Footnote 2, the allowance, the R&W reserve, the DOJ liability, etc., is the reason for the net DTAs in the other column.

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

Thank you for that disclosure. It's helpful. Also, in regards to your deposits, I noticed that average deposits obviously increased in the fourth quarter. We saw a meaningful decline on period-end deposits, specifically around non-interest-bearing deposits. I understand there's some seasonality in that, but could you just remind us on one of the reasons why the deposit rates -- the deposit levels declined in the fourth quarter, and your expectations on a go-forward basis?

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

Yes. That's largely related to Company-controlled deposits, Kevin. So, it's the deposits that come through our servicing business, the P&I, T&I. So, those deposits are volatile. But if you look on an average basis, as I'm sure you saw, the deposits were actually up quarter over quarter. So, at any given point in time, depending on what's going on with prepayments and P&I, T&I payments, that will have an impact on the Company-controlled. But overall, the average deposit balances did grow, and we would continue to expect to see that.

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

So we should see that going into the first quarter, or is that something that would be seasonal related to the mortgage business?

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

Yes, so what I would do is go back and look at the Company-controlled deposits for the first quarter of last year, and that will give you a sense of first-quarter activity, and adjust for the number of loans that we service, because that has an impact on the Company-controlled deposits.

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

All right. Thank you for taking my questions.

Operator

Paul Miller, FBR.

Paul Miller - *FBR & Co. - Analyst*

I wanted to just delve -- I know somebody asked about the M&A question. And there's been a lot of discussion about, with the new administration, bank valuations are up across the board. Are you seeing a lot more people are interested in talking out there, or it hasn't changed since the election time period?

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

I'm going to steal a little saying that an investment banker friend of mine said here a week or two ago. He said, it seems a lot of people are rubbing sticks together. So we'll see. I don't know, Paul. But I think there's probably a feeling from a regulatory point of view that it might be more accommodating.

Paul Miller - *FBR & Co. - Analyst*

And then you talk about like, on the mortgage bank, you're looking for some type of retail operation that would make a lot of sense. And then, on the commercial bank side, are you looking mainly in Michigan, or will you go outside the state?

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

Well, let me split that up because you talked about both mortgage and commercial. So, on the mortgage side, certainly we are not focused on Michigan because any mortgage originator that we would acquire, where they are headquartered has little to do with anything because, generally speaking, they are originating mortgages in other parts of the country. So, if they are a good, solid operation, if they are clean, profitable and we can bring it in at a price that gives us a reasonable payback period and provide the right kind of accretion, then it doesn't matter where it's located.

With respect to banking, I think you want to be a little bit more thoughtful about that. But given that we currently operate nationally, and I think I've said this before, we are not afraid to go to other parts of the country. But clearly, within Michigan, if there was an opportunity from a cost perspective, that would make a lot more sense. But we are open-minded, and it's really more about getting the right deal from a payback and an accretion point of view.

Paul Miller - *FBR & Co. - Analyst*

Okay. Hey, thanks for taking my follow-up questions, guys.

Operator

Scott Valentin, Compass Point.

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

Jesus Bueno for Scott Valentin. It's good to see you got the NIM benefit from the reduction in the flow of financing. But I guess is there any opportunity going forward for maybe additional measures like that to benefit the NIM?

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

I wouldn't count on anything like that. Those are opportunistic situations that we take advantage of when the interest rate markets give us that opportunity. So, I certainly wouldn't build anything like that into your model.

I think our plan is to continue to grow the NIM on a very steady basis over time through the normal way of doing it, so adding the right assets funded by the right liability. So, that's the way I think I would look at it.

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

Just as it relates to volume that you are seeing, obviously the MBA is -- I think the projections are for around a 27% decline in volumes. As you look, are you seeing anything different in your pipeline, just given your guide for mortgage banking income I think, in the first quarter, that makes you maybe more upbeat relative to forecast?

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

I wouldn't say that I'm upbeat relative to the first quarter. I think that our guidance would suggest that. So, as I said in response to an earlier question, I think the first quarter is going to be really tough. The rest of the year is going to depend on what happens with the economy and whether the purchase market really kicks in or not. It remains to be seen whether these interest rates are going to stay at this level or not. In order to stay here, it's got to be supported by economic growth. And so we've sort of got the cart before the horse here, so we will have to see what happens. But I think first-quarter mortgage is going to be really difficult.

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

Thank you for taking my questions.

Operator

At this time, we have no further questions. I would like to turn the call back over to Sandro DiNello for any additional or closing comments.

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

Thanks, Alicia. And thanks to everyone for your interest in Flagstar.

Looking at our performance, I'm pleased with our success in posting other profitable quarter despite the headwinds of seasonality and mortgage originations and a significant unexpected increase in interest rates. We saw our business plan validated as results from the banking side provided diverse earnings to offset lower mortgage revenue. We are comfortable with our position as we move into the new year with solid credit quality, a growing community bank, and a mortgage business primed to take advantage of a purchase market. We hope to benefit not just from opportunities presented by dislocation in the industry but also from a stronger economy and steeper yield curve.

We are thankful to our shareholders for their support, especially as we work through the issues that led to the lifting of the consent order. And we extend our deepest appreciation to the hard-working and dedicated employees of Flagstar Bank for their contribution to another successful quarter.

Finally, thank you for your time this morning. I look forward to reporting Q1 results in April.

Operator

That does conclude our conference for today. We thank you for your participation.