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PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Flagstar Bank Third Quarter 2019 Earnings Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Kenneth Schellenberg, Head of Investor Relations. Please go ahead.

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

Thank you, Nicole, and good morning. Welcome to the Flagstar Third Quarter 2019 Earnings Call. Before we begin, I'd like to mention that our third quarter earnings release and presentation are available on our website at flagstar.com.

I would also like to remind you that any forward-looking statements made during today's call are subject to risks and 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 those 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, and good morning to everyone listening in . I appreciate you 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 fourth quarter before opening up the line for questions.

Needless to say, I'm very pleased with the performance of our company this quarter. We reported net income of $63 million or $1.11 per diluted share for the third quarter, up $22 million or 54% of the adjusted net income we achieved last quarter. What stands out about these results is that they don't come from any one part of our business. We've built our balance sheet to be flexible in multiple interest rate environments and the results speak for themselves. When the mortgage business was challenging, we efficiently adjusted cost so that mortgage remain profitable, and thus it contributed enough to allow the company to achieve very respectable returns on assets and equity. During that time, we continued to build both our banking and servicing businesses smartly. We did a reasonably good job of managing overall costs and avoided mistakes on credit that we couldn't overcome. Now we find ourselves in an environment that is beneficial to our mortgage business, and we're taking advantage of that in a disciplined way. And the investments we made in people and technology, not to mention the expansion into the bulk correspondent business and more broadly into retail channel through acquisitions and lift-outs are paying dividends. As we always do, we are managing our volume to maintain industry-leading service levels and in doing so, are producing margin and revenue levels we haven't seen in a very long time. In fact, our team turned a 10% increase in volume into an impressive 47% increase in revenue.

Turning to banking. Since we were careful about how we grew our banking business, our asset sensitivity is manageable as evidenced by the stability of our net interest margin. Top all that off with the servicing business that continues to prosper, and we believe we have a strategy for success. The balance we have worked to achieve in our revenue streams is paying dividends just the way we planned it. Having the ability to grow noninterest income and fees in the current interest rate environment is key to being able to sustain high levels of return, and we are positioned to do just that.

Finally, while there has been a lot of chatter about a possible recession, we have built Flagstar for all seasons, and I'm confident we'll continue to succeed no matter what the economy throws our way. That concludes my comments. Now I'll turn the meeting over to Jim for more detail around the numbers.

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

Thanks, Sandro. Turning to Slide 6. Our net income this quarter was $63 million or $1.11 per share. This performance is compared to the $41 million or $0.71 per share last quarter adjusted for the DOJ benefit. This quarter was highlighted by adjusted revenue growth of 13% led by a higher level of mortgage revenue and net interest income. Net interest income was up $8 million or 6% over the prior quarter. Average earning assets grew $1.2 billion, mostly in our loan portfolio, with $511 million of growth occurring in warehouse lending. All major categories of loans were up from last quarter.

The net interest margin held up well in the face of 2 rate cuts during the quarter as the community banking team did a nice job of holding deposit spreads.

Mortgage revenues were strong as all channels increased nicely over last quarter, and we were able to flex in each of the channels to optimize our revenue mix. The combination of a 10% increase in volume, combined with a 35% improvement in margin, resulted in revenues that were 47% higher than last quarter.

Asset quality remained strong as net charge-offs were only 2 basis points, our nonperforming loan ratio decreased to 21 basis points and our allowance coverage of the loan portfolio remained solid at 0.9%.

Capital also remained solid. Our total risk-based capital was 11.5% at quarter end, up 2 basis points compared to the prior quarter despite nearly $2 billion of period-end asset growth. More than 3/4 of this period-end asset growth was in warehouse loans and loans held for sale, 2 portfolios that have a very low risk content and should naturally deflate in the next couple of quarters.

We'll go 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 $8 million to $146 million for the third quarter, which was 6% higher compared to last quarter.

The results primarily reflect a 7% increase in average earning assets led by 12% growth in average commercial loans. With the loan growth and 2 rate cuts in the quarter, we were able to hold the net interest margin relatively flat. This was the result of higher escrow deposits, which displaced at the margin or expensive wholesale borrowings. We're pleased with the relatively modest impact that the 2 rate cuts had on our net interest margin. So let's take a look at this relationship more closely.

We have approximately $7.7 billion of loans that react to movements in short-term rates. That is, most of our commercial loans including all of our warehouse loans and our home equity loans, which are mostly prime-based. On the liability side, there are about $6.4 billion of rate-sensitive liabilities, about 80% of our custodial deposits. All of our short-term FHLB borrowings are trust-preferred securities and approximately $600 million of our noncustodial deposits. As a result of that high degree of natural offset, the task of managing the costs of the remaining interest-bearing deposits is quite manageable.

Noninterest income increased $3 million or 2% to $171 million. Excluding last quarter's DOJ benefit, noninterest income increased $28 million. The increase was led by mortgage-related activity as mortgage revenues increased $28 million and loan fees and charges increased $5 million. Our gain on sale revenue of $110 million represented an increase of $35 million or 47% from last quarter. The improved gain on sale revenue was driven by a 31 basis point increase in gain on sale margin. All sales channels were up on double-digit revenue growth, once again demonstrating the value of our multi-channel capabilities.

Refinance volume was 56% of our lock volume this quarter. As you'd expect, the increased refinance activity accelerated prepayments, creating a net loss on mortgage servicing rights of $2 million compared to a net return of $5 million in the last quarter. Noninterest expense was $238 million, up $24 million from last quarter. The increase was primarily related to mortgage volume-driven expenses such as commissions, loan processing expenses and compensation due to higher levels of production and a shift in mix toward the retail channel.

Our mortgage line of business accounted for $20 million of the $24 million in quarter-over-quarter expense growth. The remaining expense categories were relatively flat with the prior quarter, demonstrating the scalability of our business and cost discipline of our people.

Let's now turn to Slide 8, which highlights our average balance sheet this quarter. Average loans held for investment grew $1.1 billion, driven by an increase in average warehouse loans and diversified loan growth across our remaining loan portfolios. We saw more opportunities in the quarter to put high-quality loans in the balance sheet, especially in the warehouse, CRE and non-auto indirect businesses and from those assets at the margin with core deposits while keeping the net interest margin relatively flat to last quarter.

The non-auto indirect loan portfolio continued this growth as average balances increased $111 million or 27% compared to last quarter.

Average deposits increased $1.7 billion or 12% in the quarter, driven by higher custodial and community banking deposits. Average custodial deposits rose $1.1 billion or 31% due to higher level of loan prepayments from our servicing business, growth in the number of accounts serviced and seasonally higher levels for T&I escrow payments. Total retail deposits grew $125 million or 1% for the quarter.

Finally, our tangible book value per share increased $1.46 to $27.62 per share.

So let's now turn to asset quality on Slide 9. Credit quality in the loan portfolio remained strong. Early-stage delinquencies continued to be negligible. Only $12 million of total loans were over 30 days delinquent, still accruing as of September 30. Our allowance coverage ratio was 0.9% of total HFI loans. I'd point out that this coverage reflects 26% of these loans being warehouse loans. So excluding warehouse loans from the denominator, given their relatively clean credit loss history, our coverage ratio would stand at 1.1%, relatively strong in the industry.

We believe we are in good shape for implementing CECL at the beginning of next year. Based on our current models and using a reasonable forecast of the future, we would estimate that the impact of adopting CECL would be to increase our reserves including our reserve unfunded loan commitments by 30% to 40% pretax.

While we don't think that CECL will have a meaningful impact on our loan growth strategies, it does have an additional capital cost, which could impact how we optimize our balance sheet for profitability. We are continuing to evaluate these estimates for reasonableness.

Turning to Slide 10. Despite balance sheet growth, our capital ratios improved, albeit slightly. Total risk-based capital was 11.5% at September 30, up 2 basis points while our Tier 1 leverage ratio of 8.0% and our CET1 ratio of 9.3% were both up a bit more. As you are aware, these ratios are based on existing capital rules. Under capital simplification, the risk-based capital ratios would increase 20 to 30 basis points and the Tier 1 leverage ratio would improve 46 basis points. It might be helpful to look more closely at the quarter-to-quarter change in our total risk-based capital ratio, which is still our tightest capital ratio. Earnings retention increased the ratio by 46 basis points. Balance sheet growth and just the loans held for sale and warehouse lending portfolios reduced this ratio by 34 basis points.

All other activity accounted for a net 10 basis points of improvement. We're quite comfortable with the capital used in growing these 2 portfolios.

In warehouse lending, we had under $5 million of losses cumulatively over the last 12 years, a period that includes the Great Recession. Loans held for sale are carried at fair value and that portfolio turns over on a regular basis. Approximately 450 basis points of our total risk-based capital are dedicated to these 2 asset categories. Higher balances in these 2 categories, therefore, do not meaningfully change the outputs from our capital stress testing models, and we remain comfortable with our capital levels of September 30.

I'll now turn to Lee for more insight into 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 our net income of $1.11 per diluted share for Q3, and believe this quarter, in particular, has demonstrated the strength of our business model. We've said before that the different business lines act as a natural hedge, meaning we can be successful and deliver strong earnings in a variety of interest rate environments. As declining interest rates have put pressure on interest income for many banks, our mortgage and servicing businesses continue to thrive and provide solid noninterest fee income, which more than offset any net interest margin compression.

During the third quarter, 46% of our revenues came from net interest income while 54% came from noninterest or fee income. We have intentionally created a balance between interest income and fee income generating businesses in order to fortify the model.

We are unique in this regard and are confident that we have the ability to continue to deliver value for our shareholders going forward. There were several other notable developments in the quarter, which included average earning assets increased 7% or $1.2 billion, as we saw a good growth across all commercial and consumer loan categories while we are able to keep our net interest margin relatively flat at 3.05% despite 2 rate cuts during the quarter.

Mortgage banking had its most successful quarter from a gain on sale revenue point of view in over 6 years. We ended the quarter servicing or sub- servicing 994,000 loans as our sub-servicing business continues to go from strength to strength, generating consistent noninterest fee income. We also closed and successfully integrated the default servicing operation we acquired and announced last quarter. The CFPB consent order expired on September 30, the last remaining legacy regulatory issue.

Capital remained strong, particularly when you consider we will be accelerating capital simplification adoption to the first quarter of 2020. Asset quality is solid, and we have the necessary liquidity to fund our anticipated future growth.

It was another exciting quarter as we continued to execute on our business strategy.

I will now outline some of the key operating metrics from each of our major business segments during the third quarter.

Please turn to Slide 12. Operating highlights for the community banking segment include average commercial and industrial and commercial real estate loans increased $223 million or 5% with the growth being driven predominantly by our homebuilder finance team within our commercial real estate division. Average consumer loans held for investment increased $396 million or 9% in the quarter, as we continued to add high-quality non-auto indirect loans, HELOCs and first-lien mortgages to our portfolio.

We've added over $1 billion of consumer loans to the balance sheet over the last 12 months, with most of that growth coming from non-auto indirect loans and HELOCs. Average warehouse lending increased $511 million or 26% to $2.5 billion. The growth was due to the increased activity in the mortgage industry, a result of the lower interest rate environment. Overall, this means average loans held for investment increased $1.1 billion during the quarter, which is a significant driver of the $9 million increase in net interest income quarter-over-quarter.

Furthermore, given our relationship-based approach and expanded footprint following last year's warehouse lending and bank branch acquisitions, we believe, we will continue to originate high-quality consumer, commercial and warehouse loan balances going forward.

Average demand and savings deposits increased $136 million while average wholesale deposits increased $327 million. As a result of the increased number of loans subserviced and the lower rate environment increasing refinance activity, average custodial and escrow deposits increased $1.1 billion or 31% during the quarter.

We've always talked about how our servicing business provides liquidity for our balance sheet through these escrow deposits. And we averaged $4.5 billion of such deposits throughout Q3. We're very pleased with the performance of our community bank, as it continues to grow and provide predictable and stable earnings for the bank.

Please turn to Slide 13. Operating highlights for the mortgage origination business include: fallout-adjusted lock volume increased 10% to $9.2 billion quarter-over-quarter, while the net gain on loan sale margin rose 31 basis point or 35% to 120 basis points.

As a result, gain-on-sale revenues increased an impressive $35 million to $110 million in Q3 versus $75 million in Q2. The increase in fallout-adjusted lock volume was due to the continuation of low interest rates, driving increased refinance activity, which accounted for 56% of our lock volumes during the quarter.

Because of the variable nature of our mortgage operations, we expanded capacity and optimized earnings from our mortgage business, without compromising service quality to our customers. We also maintained our disciplined pricing approach to ensure we focused on generating business in the most profitable channels. We want to maximize revenues, and it's this discipline that enabled us to increase our gain-on-sale margins 35% to 120 basis points quarter-over-quarter. We have a diversified mortgage business given we originate loans in all 6 mortgage channels.

This affords us the ability to look across all verticals and focus attention where we can maximize revenues and earnings for the bank. We will continue to take advantage of this lower rate environment given our nimble model and disciplined approach.

Moving to servicing. Quarterly operating highlights for the mortgage servicing segment on Slide 14 include: we serviced or subserviced approximately 994,000 loans, of which over 826,000 or 83% are subserviced for others, making us the fifth largest subservicer in the nation. We've increased the number of loan serviced or subserviced by 375,000 or 61% in the last 12 months, and have been one of the fastest-growing subservicers in the industry during that time.

Given our Q4 subservicing on-boarding schedule, we expect to end 2019 with approximately 1.1 million loans on our servicing platform.

For the first time last quarter, we included a slide in the earnings deck, outlining the profitability of our servicing business. If you look at Slide 36, you will see that we are achieving our $4 million to $6 million of operating profit before tax for every 100,000 loans we add to the platform. Of the $5.4 billion in MSRs we sold during the third quarter, $4.4 billion or 81% were via flow sales, which gives you an indication of the strong relationships we have with MSR buyers and the confidence they have in the underlying quality of our originations and seamless transfer to our subservicing model.

To date, 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.

During the quarter, we successfully closed and integrated the default servicing transaction and operation we announced in June. 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 transaction further leverages our industry-leading oversight and monitoring while providing clients the risk and compliance infrastructure benefits Flagstar has to offer. I welcome the new employees in Jacksonville, Florida and know they are committed to delivering the best-in-class service our clients expect from us. We're thrilled with how we've grown our subservicing business, the benefits it creates in other areas of the bank, and you will continue to see flourish as we move forward.

Moving on to expenses on Slide 15. Our noninterest expenses increased 11% or $24 million to $238 million quarter-over-quarter while revenues increased 13% or $35 million during the same period. This led to positive operating leverage as our variable cost structure allowed us to take advantage of market opportunities, particularly in the mortgage business. The majority of the increase in noninterest expense was due to additional mortgage activity with 84% or $20 million of the $24 million increase quarter-over-quarter being because of higher mortgage production.

Our efficiency ratio was 75% for the third quarter, which was an improvement of 1% from the prior quarter. Mortgage revenues, including net return on the MSR asset, fees and charges, increased $33 million in the quarter while costs related to this business increased $20 million.

We estimate noninterest expense will be approximately $230 million to $235 million during the fourth quarter, the slight decrease in expenses being the result of slightly less mortgage activity given the seasonality of the business.

It's been an outstanding quarter. The community bank was able to exercise strong margin management while adding high-quality commercial, consumer and warehouse loans to the balance sheet. The mortgage origination team took advantage of the market opportunity afforded by the lower interest rate environment, and the servicing business continues to grow and provide a stable source of noninterest fee income and funding to the bank. Given our unique business model, which can thrive in multiple interest rate environments, supported by our robust risk and compliance infrastructure, we believe we are well positioned to continue to add value for our shareholders going 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 now with some guidance for Q4 and then open the call for questions and answers.

Please turn to Slide 17. We expect net interest income to be flat with the net interest margin declining 5 to 10 basis points and interest-earning assets growing slightly. We anticipate mortgage revenue including gain-on-sale and net return on MSR will decrease 15% to 20% due to the seasonality of the mortgage market. All other noninterest income is expected to be slightly higher. As we noted, we anticipate noninterest expense will fall to $230 million to $235 million, primarily reflecting lower mortgage-related expenses.

This concludes our prepared remarks. And we'll now take your questions. Operator?

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*

Sandro, I was hoping you could just sort of expand upon your thoughts on the fourth quarter on the mortgage side, specifically how you see the origination environment holding up overall? I mean, obviously, there is some seasonality that will impact things, but overall, how you see the environment holding up the longevity of it? And then, how well you see gain on sale margins holding up?

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

Well, I think our guidance suggests -- we'll give you that answer. I mean we think that we're going to see normal seasonality in the purchase business. So that accounts for the decline in locks that we're guiding to. I think on the income side, we're guiding to a little lower, but related to volume not so much margin. Kristy, anything you'd like to add to that?

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

Yes. The only thing I'd add is that the forecast in September, the GSEs and the MBA increased their forecast over $2 trillion for the first time that year with 39% of it being from refinances. So given our refinance share runs at 7% to 10% above the industry average, we think the outlook will continue to present an opportunity for us as we go into Q4, and so we are optimistic about it.

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

Okay. Perfect. And then just on the cost side. Just curious as to your thoughts on why expenses wouldn't come down more as originations normalize given that virtually, all the cost increase in the third quarter is related to mortgage volume. So then maybe beyond that, if they don't come down in the fourth quarter, would they continue to flex down afterward as the environment sort of normalizes from this elevated level?

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

Yes. Scott, it's Lee. This is a bit of a timing issue here. Gain on sale is recognized at lock whereas mortgage expenses, commissions and loan processing fees, in particular, are recognized at closing. So that results in a bit of a timing issue. So that's what you're seeing when we're looking at guidance in Q4. What we'd say is we will continue to be diligent in our cost management across all expense categories as we always have been.

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

Yes, Scott, as we grow retail and we total -- slightly bigger share of our total, that dynamic that Lee just talked about gets emphasized a little bit more, so I think that's an explanation to your question.

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

Okay. So I guess beyond the -- I'm just sort of looking at the second half run rates including the fourth quarter guide relative to where you were in the first half sort of around $200 million, maybe $200 million to $205 million in the first half and then we are going to average probably $230 million to $235 million in the second half, so there's a lot of gap in between those 2. Like -- could we ever get back down to the first half level or we get structurally a higher point?

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

Well, no, we could, but we wouldn't want to because that would mean that the mortgage business is slowing down quite a bit, so this is almost entirely related to mortgage activity. It's not a base cost increase.

Operator

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

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

Can't hear you Bose. Maybe you're on mute.

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

Sorry. I was on mute button. Just a follow-up first, on the expenses. It looks like your commissions increased as a percentage of the volume. Is that also being driven by the retail mix?

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

Yes.

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

Yes.

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

Yes. Totally.

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

Okay, that's straightforward. And then actually just going back to your comments on CECL. The -- does that go through the P&L? Is that the first quarter of 2020? And then prospectively, I guess, presumably, there's no loss provision unless your assumptions change. Is that right?

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

So the 30% to 40% that we guided would be the day-1 impact, which is going to be to capital -- to retain earnings. Anything subsequent to that, you're right, would go through earnings, but the 30% to 40% that I am talking about is, is going through capital, and of course, that gets amortized over a 3-year period.

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

Did you catch our last part, Bose? Because the regulatory -- the regulators are allowing that capital hit to be deferred over a 3-year period.

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

Okay. So the impact -- the capital impact is going to be over 3 years? Is that right?

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

Correct. It's amortized over a 3-year period.

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

Okay. And then just to understand the P&L impact going -- the provision going forward, will there -- is there a provision? Or is that only based on a change in assumptions?

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

That will be both, right. So as we grow, when we book a new loan, you got to put the expected credit losses that you're going to have over the life of that loan, you got to take that on day 1. So any -- we'll have a provision that's related to loan growth and then there is this overall credit quality, and I would say, even the economics -- in the economic environment, the external factors that could impact the quality of our portfolio change and our reasonable and supportable forecasts change, that will also have an impact to the loan loss provisions.

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

Bose, I think we all have -- still have a lot to learn about the CECL thing as we go forward. We're giving you our best estimates based on what we know today. We're still refining all of this, and we'll be able to talk more intelligently about it at the end of Q4, of course.

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

Okay. Great. Just one more from me. The -- just the relationship with GreenSky given the headlines out there. Any update on that on the agreement there?

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

Yes. No update. I mean if you look in the releases, we got about $58 million of those loans on our balance sheets at the end of Q3. The program has been going for about a year now as you know. So we're originating $4 million to $5 million a month, not huge amounts, and the loans are performing as expected.

Operator

We have a question from Kevin Barker with Piper Jaffray.

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

Sandro or Jim, could you just give us an idea or maybe how are you changing your -- what capital levels you're going to maintain given the impact of CECL on capital? And I understand it amortizes over 3 years and it's taken a little while, but you're eventually going to have to target those regulatory capital ratios when it's fully implemented. So could you just -- are you thinking about adjusting your capital targets just given CECL?

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

No. Look, we have enough capital today. Nothing's changed. The loans are still the same loans. The capital is good today at a 12% number. And some accounting change, some book change causes that to now be 11.5%. I don't think that really impacts how much capital you have. I think it just impacts -- it's 2 different measuring systems. So you still have adequate capital in both situations.

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

Regular losses or the capital haven't change at all, it's just where it's located on the balance sheet?

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

And when you recognize it.

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

Yes. Right, and...

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

I don't expect the regulators to change their expectations relative to capital, and I don't see us changing our targets relative to capital.

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

Okay. And then to follow up on some of Scott's questions regarding the mortgage outlook. Are you expecting you to be near capacity in the fourth quarter given the demand that sits out there for refinances today?

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

We're always near capacity, that's way we run the business, so I don't mean to sound...

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

Flippant.

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

Flippant, yes, but I mean that's a serious answer. We always run to capacity. That's why we've been able to manage this the way we have managed it.

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

Okay. Does that imply that you are able to ramp up retail originations like you have in the third quarter, just definitely helping out the margin?

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

Yes. That's right.

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

And then just to follow up on loan administration fees. They've been under a little bit of pressure even though you're growing your subservicing portfolio. Is there some offset there just because of higher prepays fees? Or is there something else that's impacting the loan administration?

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

Yes, yes. It's -- from the GAAP point of view, the interest on the escrows that we pay to the MSR owners runs through that loan admin income line. And that's why we've laid out on Slide 36 of the deck, the servicing profitability so you can really get an idea of the profitability of that business line. So the disconnect or what you're getting in the loan admin income line, for GAAP purpose is the interest on those escrows that we're paying.

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

The slide does a really nice job of laying all that out.

Operator

We have a question from Chris Gamaitoni with Compass Point.

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

Thank you for the additional disclosure on CECL. I was wondering if you could give us a sense of which portfolios you're seeing the most inflation in, which loan categories?

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

I don't think we're ready to get into that detail yet, Chris. There's a lot of -- inside of that range that Jim gave you, there is ranges for each piece of the puzzle, and I think it would be dangerous for us to try to give you more specific guidance on that at this point. Maybe next quarter, we'll say, but we're not ready to be that granular.

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

Okay. And then on the custodial deposit base, do you have any sense of maybe the near-term outlook for that portfolio based on what you see with your customers?

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

No. I mean as we said in the prepared remarks, the higher custodial base is because of the higher subservicing loan count. We are close to 1 million loans. There were higher payoffs in the quarter, which created more P&I, and then just given those higher T&I balances, that's a seasonal thing. So as long as the interest rate environment stays low, and we continue to grow our subservicing business, I think the balances that you saw in Q3 will probably hold relatively the same.

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

Chris, the biggest factor there is the refis, so that expanded just because of the refi volume that's flowing through the escrows. And so it really depends on what's your view on -- the mortgage market is going to be into the future, as to what the size of that custodial balance is going to be.

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

Right. And just trying to look at the mortgage guide and take into account normal seasonality, there's, I think there's been a pullback in the correspondent business. Would you expect that to maybe pick up a little bit in the fourth quarter? Or is kind of your guidance based off of a similar, call channel mix quarter-over-quarter?

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

Yes. What I see Chris is we're going to continue to deploy the strategy that we have all year, which is evaluating the opportunities that they present themselves, and we'll look at channels, we'll look at products and determine where we can most take advantage of that market, and so that will continue to be our strategy as we look in Q4.

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

I think as we try to highlight that's the -- that's an advantage that we have with the scale and the broad delivery channels that we can choose from, allows us to shift, move, take advantage of the opportunities where they might be. And it does change at times, and sometimes service is more important than other times. And so I think what we've been able to do this year is very reflective of the nimbleness that we have and our ability to adjust to the business opportunities that present themselves.

Operator

We will take our next question from Steve Moss with B. Riley FBR.

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

I wanted to ask about the mortgage warehouse, pretty big increase in commitments here this quarter. Just wondering the drivers of commitment growth there and where you're seeing pricing in that segment?

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

I'll make some introductory comments and then I'll have Drew chime in as well. Obviously, the mortgage business is stronger and so for that reason, we have more opportunities in warehouse, and so you've seen the outstandings as well as the commitments grow quite a bit. There is definitely pricing pressure out there, and our resolve is being tested, but our resolve holds strong up to this point, and I expect that it will continue to. I think we told you last quarter that we passed on close to $0.5 billion of opportunities because of price. That dynamic continues, and so I think one of the reasons why we're able to continue to grow income of the company is because we are disciplined about price across all of our lines of business.

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

Yes. Just a modest amount to add to that. I mean I do think that as the refi market has picked up, you've seen more volume coming through that part of the warehouse business, which tends to be some of the largest players and so more pronounced pressure on rate as Sandro alluded to, but we're sticking to our guidance. We're not leaning into credit, we're not leaning into the pricing. We have a really diversified book of business all the way from the smaller firms up to the larger ones. And so we are able to be very, I think, disciplined in terms of where that growth is coming from. I think you can see that we've had really good growth even relative to the market sizing, and we expect that to continue and it's really a function of our lenders and the service we provide to our clients.

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

And just to add. I mean you mentioned commitments, it's really the outstandings that have increased and the thing we're most pleased about is the utilization rate. The utilization rate for our warehouse business is in the mid-60s, which we're thrilled about. And I think you're also seeing the benefit of the acquisition we did last year as well as on the warehouse side, which is also having a good impact for us.

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

Okay. That's helpful. And then FEMA equipment were also up pretty good quarter-over-quarter. I know some of that was homebuilder. Just wondering where else you saw that?

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

Yes. No, we saw some pretty good growth in commercial and the balance of that was really split primarily between our commercial real estate book and our homebuilder finance book. I think, as Jim alluded to, homebuilder finance led the charge. There are some really solid originations as well as some fundings underneath some of the originations that we had throughout the year. I think if you look at that market, despite some affordability issues, I think just the interest rate environment that we're in, the book that we've developed the relationships that we have, we really feel like we've got good runway there.

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

I would add it wasn't really anything unusual though. The growth in commercial, if you add all of them together, C&I, CRE, homebuilder, warehouse, I mean we've been doing that quarter-after-quarter for a number of years now. So I don't view it as anything unusual. I think that's what we're accustomed to. And that's what hopefully we can continue to see.

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

Yes. I think that's exactly right, I think much like Kristy's remarks about mortgage. Each quarter, we're able to take advantage of what the market's offering. This quarter, it happened to be more in warehouse than some other lines, but we've seen good growth across all those lines of business, to your point.

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

Okay, that's helpful. And then one last question on the margin here. Just wondering what your great assumptions are for the fourth quarter, if you're assuming additional rate cut? And where are you seeing deposit pricing cost as well?

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

So we're seeing -- we expect the federal cut next week. They may or may not cut in December, but that's not really going to have an impact on the fourth quarter if they do. So let's just -- we assume that they're going to cut at the end of October. Regarding how that impacts, I made some remarks in my prepared part of the speech to talk about what the natural offset in our balance sheet was and when you go back and look at the administratively priced deposits, I think there is some attainable level of administratively priced movements that we're going to have to do in order to outperform or be at the lower end of that range. The range that we guided to though is not all deposit-beta driven, I'd say part of it's just a natural mix driven component of our balance sheet as we go from third quarter with more mortgage volume to a fourth quarter where some of the portfolios kind of naturally contract and then they expand again in the second and third quarter. So some of it's that mix component, just mixing down especially out of warehouse loans and some of it is just that deposit cost. We're assuming a pretty modest beta, of around 40% to 50%. And then we challenge ourselves to get to that level. I think we rose to the challenge in the third quarter.

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

Yes. One thing that I would add and it's just an embellishment of Jim, of what Jim just said is that we're going to continue to be very resolute on deposit pricing, similar to what I commented on a few moments ago regarding loan pricing. That's what you have to do to manage a margin in a declining interest rate environment. And because we have a lot of funding that isn't directly retail-driven, we have the ability or we will see those funding costs come down pretty quickly as LIBOR or the Fed changes. So it's a challenge for sure, but we do think that we're more resilient than many relative to managing -- our ability to manage that margin.

Operator

And our next question comes from Daniel Tamayo with Raymond James.

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

So let me just follow up again on the margin questions, on the net interest bearing. So the deposit beta, you just reported 50%. But -- and there was a component of that margin pressure with deposit costs. Does that assume that noninterest-bearing comes down at all in the fourth quarter? Or are you assuming those kind of stay flat? And then the second part being, you think you hit an inflection point in interest-bearing deposit cost in the third quarter and that those can start to come down now?

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

Noninterest bearing, was your question relative to the balance of noninterest-bearing deposits?

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

You're right. Right, average balances.

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

Yes. I don't think the interest rate environment really impacts that much. Those are real core deposits and they don't change much. If anything perhaps, they'll grow a little bit as opposed to decline. And yes, I think that we're -- now clearly, everybody believes in a declining interest rate environment including the retail customer base. So I think there's more -- now there's an acceptance, so that's the world we're in, and so that does allow us to maybe be a little bit more aggressive though I will say, our team was very aggressive in the third quarter on reducing rates already. So I don't know if that will change a whole lot for us. But, yes, I think the mental dynamic of where we stand in the market, there probably was an inflection point in the third quarter.

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

Okay. And can you remind me the custodial deposits, does those fit into the noninterest-bearing category? Or those are independent?

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

We've broken them out in the press release separately for you, so that should help, but mostly they're noninterest-bearing.

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

Let me be clear though. The noninterest-bearing and have no cost if we own the MSR.

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

Correct.

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

If we don't own the MSR then we do pay for those deposits. And we do disclose that and that is part of the profitability that we show on Slide...

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

36.

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

36 for the servicing business.

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

Which flows through the net loan admin income line when you're looking at the GAAP P&L.

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

But those are largely -- the paths of those funds are largely tied to LIBOR, almost entirely...

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

Entirely.

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

Yes. So when LIBOR does down, those costs go down as well.

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

Immediately, yes.

Operator

And we'll take a question from Henry Coffey with Wedbush.

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

Just some more detail sort of stuff on the servicing business breakout, which is very helpful. You include the revenue and related cost from your own servicing? Or is it just consumer servicing business?

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

No. This is including our own servicing business. The reason being the MSR of Flagstar, just think of it being owned by treasury and our servicing business is the manufacturing company that subservices those loans for our treasury group, so those economics are in Page 36.

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

A good rule of thumb, Henry, is about 80% of those deposits are controlled by external parties, about 20% are our own MSR.

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

Actually I am looking at the servicing revenue. So there's a transfer -- I mean basically what we're looking at is the profitability of the subservicing business, or we are looking at -- and so there's a transfer price between treasury and the servicing business?

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

Yes. Correct. We -- the servicing business just treats the treasury group like any other MSR owner.

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

And so if we were to look at the total equation, we could also fold in whatever you're getting -- whatever the treasury group is earning and then we'd have a full -- sort of a complete picture of what's going on?

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

Yes. You're turning in the external picture.

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

Yes. And if we were going to use the transfer prices, can you disclose that? Or is that -- or can we pick that up in the queue?

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

No, but what I did say earlier, when you look at these numbers, it is a whole, so it's 100% both what we service for ourselves and what we service for others. And it's about an 80-20 split, 80% service for others, 20% service for ourselves.

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

It's actually 83-17. Not to get too finer with it. So 83% ...

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

It was 83-point-what?

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

I can give it, if you like, Henry.

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

No, No. But yes, that's helpful, and we'll dig into that a little bit more. When you look at your CECL guidance, you basically -- if we're going to put together a pro forma, should we assume basically that your loss reserve goes from 0.9% to something in the 1.2% range? Is that the way to think about it today? And then the related question...

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

(inaudible)

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

Well, you said, up 30% to 40%.

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

It's probably the sum of the coverage ratio.

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

Yes, that's probably the right way to think about it. But also, I want to point out, Henry, one of my remarks was I said that we are also including the impact of the unfunded loan commitments, which would be sitting in the liability section. So you're thinking about it right, it's just not going to show up exactly that way because the liability or the reserve we have for credit losses on unfunded loan commitments is technically a liability. So it's in the liability section of our balance sheet.

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

And this is an area, this unfunded loan commitment piece, where this is more -- quite a bit of change from the past.

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

I think...

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

(inaudible) We've done a lot of work on CECL and to be perfectly blunt, it's solving a problem that doesn't exist, but it is what it is, and we're all going to adjust.

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

Lot of heads nodding over here.

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

So the obvious question that comes from all this around CECL, you don't lose any money. Your losses are certainly low. So how do you come up with lifetime losses on a business that doesn't lose money? You just have to assume a once-in-a-lifetime recession? And then you ...

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

We're using external information that help guide us here, I guess. And...

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

Yes, we are. We're using just kind of like average -- we're using Moody's. And so we're going back to our reference set of credit losses on our portfolio. So I think we've proven that we can outperform what those expectations are. We're better than average on managing credit, but for now I don't think we get credit. I think we can get credit for that over time in our accounting numbers.

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

And then finally given you've got this crosswind from CECL. You could halt, obviously, alter your loans held for sale and some other things. How does the GreenSky business fit into any of this? I mean is there a franchise value that comes from that? Or is it just a financial return that's now going to have a much higher reserve content to it?

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

I actually don't think it changes much at all. The reserve content on GreenSky will be unchanged as we view it, and it's $50 million, so the impact on a $22-billion company is just nothing.

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

So what's the benefit of it?

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

Well, that's the part of diversification. There's a lot of things that we have that don't have billions of dollars -- that we don't have billions of dollars invested in, but if you can find something that, in this case, all the expenses are pretty much borne by a third party that brings you some loans, and it brings you some -- a return that hurdles then why not? So there's a lot of little pieces that don't get the attention that GreenSky does.

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

There are a lot of bigger pieces that don't get the attention that GreenSky does show...

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

All right, no, I ...

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

0.3% of our balance sheet.

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

No. GreenSky has just come into the news because it's got a lot of controversy around the stock but, yes, no, that's helpful.

Operator

And there are no further questions in the queue at this point. I would like to turn the call back over to our speakers for any concluding remarks.

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

Thank you. As Lee highlighted, Flagstar is a unique company, a $20-billion bank with a $30 billion mortgage business. While most banks decided that mortgage is not a good business to be in, we have a different view. It's a business that started our bank, it's in our DNA and we understand the challenges better than anyone. Volatility, expense management, MSR management, compliance, the politics of regulation, and how to best manage all of these things, so let's look at where we are. We have proven very we can manage volatility. Does anyone manage mortgage profitability through volatility better than Flagstar? We've proven we can manage expenses. Did anyone adjust more quickly when volumes declined? We met the challenge that Basel III presented us with respect to investments in MSRs. Does anyone had a better track record managing their MSRs? And we've built a risk and compliance framework that I will put up against any ones in the industry. And one more thing, does any bank built a servicing business post-Recession, not to mention one that stands on its own, is growing and is making money? Very well balanced and diversified banking business on top of all that and yes, we have a unique company. That's why we like the model. It's one that works in any market and one we will continue to invest in to keep delivering solid operating results quarter-after-quarter. Finally, none of our success would have been possible without the selfless contributions from the Flagstar team. My sincere thanks to everyone in the Flagstar family for the important contributions they have made to our success. Thanks, again, for spending some time with us this morning to hear our story. I hope you have a great fall and holiday season.

Operator

And once again, that does conclude today's conference. We appreciate your participation today.