

FLAGSTAR BANCORP INC  
Form 10-Q  
November 07, 2016  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2016

OR  
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-16577

(Exact name of registrant as specified in its charter).

Michigan 38-3150651  
(State or other jurisdiction of (I.R.S. Employer  
Incorporation or organization) Identification No.)

5151 Corporate Drive, Troy, Michigan 48098-2639  
(Address of principal executive offices) (Zip code)  
(248) 312-2000  
(Registrant's telephone number, including area code)

Not applicable  
(Former name, former address and formal fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No .

As of November 4, 2016, 56,606,499 shares of the registrant's common stock, \$0.01 par value, were issued and outstanding.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

Flagstar Bancorp, Inc.

Consolidated Statements of Financial Condition

(In millions, except share data)

	September 30, December 31, 2016                      2015 (Unaudited)	
Assets		
Cash	\$ 76	\$ 54
Interest-earning deposits	98	154
Total cash and cash equivalents	174	208
Investment securities available-for-sale	1,115	1,294
Investment securities held-to-maturity	1,156	1,268
Loans held-for-sale (\$3,352 and \$2,541 measured at fair value, respectively)	3,393	2,576
Loans held-for-investment (\$80 and \$111 measured at fair value, respectively)	6,290	6,352
Loans with government guarantees	404	485
Less: allowance for loan losses	(143	) (187
Total loans held-for-investment and loans with government guarantees, net	6,551	6,650
Mortgage servicing rights	302	296
Federal Home Loan Bank stock	172	170
Premises and equipment, net	271	250
Net deferred tax asset	305	364
Other assets	834	639
Total assets	\$ 14,273	\$ 13,715
Liabilities and Stockholders' Equity		
Noninterest bearing deposits	\$ 2,544	\$ 1,574
Interest bearing deposits	6,827	6,361
Total deposits	9,371	7,935
Short-term Federal Home Loan Bank advances and other	905	2,116
Long-term Federal Home Loan Bank advances	1,577	1,425
Other long-term debt	493	247
Representation and warranty reserve	32	40
Other liabilities (\$60 and \$84 measured at fair value, respectively)	609	423
Total liabilities	12,987	12,186
Stockholders' Equity		
Preferred stock \$0.01 par value, liquidation value \$1,000 per share, 25,000,000 shares authorized; 0 and 266,657 issued and outstanding, respectively	—	267
Common stock \$0.01 par value, 70,000,000 shares authorized; 56,597,271 and 56,483,258 shares issued and outstanding, respectively	1	1
Additional paid in capital	1,494	1,486
Accumulated other comprehensive (loss) income	(20	) 2
Accumulated deficit	(189	) (227
Total stockholders' equity	1,286	1,529
Total liabilities and stockholders' equity	\$ 14,273	\$ 13,715

The accompanying notes are an integral part of these Consolidated Financial Statements.



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Flagstar Bancorp, Inc.  
Consolidated Statements of Operations  
(In millions, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Interest Income	(Unaudited)			
Loans	\$90	\$ 77	\$256	\$ 216
Investment securities	16	14	50	43
Interest-earning deposits and other	—	—	—	1
Total interest income	106	91	306	260
Interest Expense				
Deposits	12	10	34	30
Short-term debt	1	2	4	2
Long-term debt	7	4	22	11
Other debt	6	2	10	6
Total interest expense	26	18	70	49
Net interest income	80	73	236	211
Provision (benefit) for loan losses	7	(1	) (9	) (18
Net interest income after provision (benefit) for loan losses	73	74	245	229
Noninterest Income				
Net gain on loan sales	94	68	259	242
Loan fees and charges	22	17	56	53
Deposit fees and charges	5	7	17	19
Loan administration income	4	8	14	19
Net (loss) return on mortgage servicing rights	(11	) 12	(21	) 19
Net (loss) gain on sale of assets	—	1	(2	) (1
Representation and warranty benefit	6	6	12	13
Other noninterest income	36	9	54	9
Total noninterest income	156	128	389	373
Noninterest Expense				
Compensation and benefits	69	58	203	178
Commissions	16	10	40	31
Occupancy and equipment	21	20	64	60
Asset resolution	2	—	6	13
Federal insurance premiums	3	6	9	18
Loan processing expense	13	14	40	40
Legal and professional expense	5	10	20	27
Other noninterest expense	13	13	36	40
Total noninterest expense	142	131	418	407
Income before income taxes	87	71	216	195
Provision for income taxes	30	24	73	70
Net income	\$57	\$ 47	\$143	\$ 125
Income per share				
Basic	\$0.98	\$ 0.70	\$2.21	\$ 1.82
Diluted	\$0.96	\$ 0.69	\$2.16	\$ 1.80
Weighted average shares outstanding				
Basic	56,580,238	58,436,026	56,556,188	58,419,354

Diluted

57,933,806 207,503 57,727,262 205,789

The accompanying notes are an integral part of these Consolidated Financial Statements.

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Flagstar Bancorp, Inc.  
 Consolidated Statements of Comprehensive Income  
 (In millions)

	Three Months Ended September 30, 2016 2015 (Unaudited)		Nine Months Ended September 30, 2016 2015 (Unaudited)	
Net income	\$57	\$47	\$143	\$125
Other comprehensive income, net of tax				
Investment securities				
Unrealized gain (loss) (net of tax effect \$1, (\$5), (\$10) and (\$5), respectively)	(1 )	9	17	9
Less: Reclassification of net (gain) on sale (net of tax effect \$2, \$0, \$3 and \$0, respectively)	(3 )	—	(5 )	—
Net change in unrealized gain (loss) on investment securities, net of tax	(4 )	9	12	9
Derivatives and hedging activities				
Unrealized gain (loss) (net of tax effect \$0, \$2, \$23 and \$2, respectively)	—	(5 )	(44 )	(5 )
Less: Reclassification of net loss (gain) on derivative instruments (net of tax effect (\$2), \$0, (\$6) and \$0, respectively)	3	—	10	—
Net change in derivatives and hedging activities, net of tax	3	(5 )	(34 )	(5 )
Other comprehensive (loss) income, net of tax	(1 )	4	(22 )	4
Comprehensive income	\$56	\$51	\$121	\$129

The accompanying notes are an integral part of these Consolidated Financial Statements.

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Flagstar Bancorp, Inc.

Consolidated Statements of Stockholders' Equity

(In millions, except share data)

	Preferred Stock		Common Stock			Accumulated Other Comprehensive Income (Loss)	Retained Earnings (Accumulated Deficit)	Total Stockholders' Equity
	Number of Shares Outstanding	Amount of Preferred Stock	Number of Shares Outstanding	Amount of Common Stock	Additional Paid in Capital			
Balance at December 31, 2014 (Unaudited)	266,657	\$ 267	56,332,307	\$ 1	\$ 1,482	\$ 8	\$ (385 )	\$ 1,373
Net income	—	—	—	—	—	—	125	125
Total other comprehensive income	—	—	—	—	—	4	—	4
Stock-based compensation	—	—	103,719	—	2	—	—	2
Balance at September 30, 2015	266,657	\$ 267	56,436,026	\$ 1	\$ 1,484	\$ 12	\$ (260 )	\$ 1,504
Balance at December 31, 2015 (Unaudited)	266,657	\$ 267	56,483,258	\$ 1	\$ 1,486	\$ 2	\$ (227 )	\$ 1,529
Net income	—	—	—	—	—	—	143	143
Total other comprehensive loss	—	—	—	—	—	(22 )	—	(22 )
Preferred stock redemption	(266,657)	(267 )	—	—	—	—	—	(267 )
Dividends on preferred stock	—	—	—	—	—	—	(105 )	(105 )
Stock-based compensation	—	—	114,013	—	8	—	—	8
Balance at September 30, 2016	—	\$ —	56,597,271	\$ 1	\$ 1,494	\$ (20 )	\$ (189 )	\$ 1,286

The accompanying notes are an integral part of these Consolidated Financial Statements.

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Flagstar Bancorp, Inc.

Consolidated Statements of Cash Flows

(In millions)

	Nine Months Ended September 30,	
	2016	2015
	(Unaudited)	
Operating Activities		
Net income	\$143	\$125
Adjustments to reconcile net income to net cash used in operating activities:		
(Benefit) provision for loan losses	(9 )	(18 )
Representation and warranty (benefit) provision	(12 )	(13 )
Depreciation and amortization	24	17
Deferred income taxes	59	68
Net gain on loan and asset sales	(257 )	(241 )
Change in fair value and other non-cash changes	(268 )	(231 )
Proceeds from sales of loans held-for-sale ("HFS")	14,097	15,247
Origination, premium paid and purchase of loans, net of principal repayments	(23,826 )	(22,180)
Decrease (increase) in accrued interest receivable	1	(6 )
(Increase) decrease in other assets, excluding purchase of other investments	(104 )	155
Increase in other liabilities	24	10
Net cash used in operating activities	(10,128 )	(7,067 )
Investing Activities		
Proceeds from sale of available for sale securities including loans that have been securitized	10,876	6,603
Collection of principal on investment securities available-for-sale ("AFS")	116	185
Purchase of investment securities available-for-sale and other	(203 )	(783 )
Collection of principal on investment securities held-to-maturity ("HTM")	126	38
Purchase of investment securities HTM	(15 )	(10 )
Proceeds received from the sale of held-for-investment loans ("HFI")	228	788
Origination and purchase of loans HFI, net of principal repayments	(1,297 )	(2,249 )
Purchase of bank owned life insurance	(85 )	(175 )
Proceeds from the disposition of repossessed assets	14	19
Net (purchase) redemption of Federal Home Loan Bank stock	(2 )	42
Acquisitions of premises and equipment, net of proceeds	(44 )	(28 )
Proceeds from the sale of mortgage servicing rights	35	183
Net cash provided by investing activities	9,749	4,613
Financing Activities		
Net increase in deposit accounts	1,436	1,068
Net change in short-term FHLB borrowings and other short-term debt	(1,211 )	—
Proceeds from long-term Federal Home Loan Bank advances and other debt	395	22,235
Repayment of long-term Federal Home Loan Bank advances	—	(20,725)
Repayment of long-term debt	—	(55 )
Net receipt (disbursement) of payments of loans serviced for others	91	(23 )
Preferred stock dividends	(105 )	—
Redemption of preferred stock	(267 )	—
Net receipt of escrow payments	6	13
Net cash provided by financing activities	345	2,513
Net (decrease) increase in cash and cash equivalents	(34 )	59

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Beginning cash and cash equivalents	208	136
Ending cash and cash equivalents	\$174	\$195
Supplemental disclosure of cash flow information		
Interest paid on deposits and other borrowings	\$89	\$42
Income tax payments	\$3	\$3
Non-cash reclassification of investment securities AFS to HTM	\$—	\$1,136
Non-cash reclassification of loans originated HFI to loans HFS	\$1,331	\$1,113
Non-cash reclassification of mortgage loans originated HFS to HFI	\$2	\$30
Non-cash reclassification of mortgage loans HFS to AFS securities	\$10,588	\$6,617
Mortgage servicing rights resulting from sale or securitization of loans	\$173	\$220
Non-cash reclassification of loans with government guarantee to other assets	\$—	\$373

The accompanying notes are an integral part of these Consolidated Financial Statements.

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Flagstar Bancorp, Inc.

Notes to the Consolidated Financial Statements (Unaudited)

## Note 1 – Basis of Presentation

The accompanying financial statements of Flagstar Bancorp, Inc. ("Flagstar," or the "Company"), including its wholly owned principal subsidiary, Flagstar Bank, FSB (the "Bank"), have been prepared using U.S. generally accepted accounting principles ("GAAP") for interim financial statements. Where we say "we," "us," or "our," we usually mean Flagstar Bancorp, Inc. However, in some cases, a reference to "we," "us," or "our" will include our wholly owned subsidiary Flagstar Bank, FSB (the "Bank").

These consolidated financial statements do not include all of the information and footnotes required by GAAP for a full year presentation and certain disclosures have been condensed or omitted in accordance with rules and regulations of the Securities and Exchange Commission ("SEC"). These interim financial statements are unaudited and include, in our opinion, all adjustments necessary for a fair statement of the results for the periods indicated, which are not necessarily indicative of results which may be expected for the full year. These consolidated financial statements and notes should be read in conjunction with the consolidated financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2015, which is available on our website, at [flagstar.com](http://flagstar.com), and on the SEC website, at [sec.gov](http://sec.gov). Certain prior period amounts have been reclassified to conform to the current period presentation.

## Note 2 – Investment Securities

As of September 30, 2016 and December 31, 2015, investment securities were comprised of the following:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(Dollars in millions)				
September 30, 2016				
Available-for-sale securities				
Agency - Commercial	\$ 500	\$ 10	\$ —	\$ 510
Agency - Residential	563	10	—	573
Municipal obligations	32	—	—	32
Total available-for-sale securities (1)	\$ 1,095	\$ 20	\$ —	\$ 1,115
Held-to-maturity securities				
Agency - Commercial	\$ 619	\$ 9	\$ —	\$ 628
Agency - Residential	537	12	—	549
Total held-to-maturity securities (1)	\$ 1,156	\$ 21	\$ —	\$ 1,177
December 31, 2015				
Available-for-sale securities				
Agency - Commercial	\$ 766	\$ 3	\$ (3 )	\$ 766
Agency - Residential	514	2	(2 )	514
Municipal obligations	14	—	—	14
Total available-for-sale securities (1)	\$ 1,294	\$ 5	\$ (5 )	\$ 1,294
Held-to-maturity securities				
Agency - Commercial	\$ 634	\$ —	\$ (2 )	\$ 632
Agency - Residential	634	—	(4 )	630
Total held-to-maturity securities (1)	\$ 1,268	\$ —	\$ (6 )	\$ 1,262
(1)				

There were no securities of a single issuer, which are not governmental or government-sponsored, that exceeded 10 percent of stockholders' equity at September 30, 2016 or December 31, 2015.

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Credit related declines in the available-for-sale and held-to-maturity securities that are determined to be other than temporary are reported as a separate component of noninterest income within the Consolidated Statement of Operations. An impaired investment security is considered to be other than temporary if (1) we intend to sell the security; (2) it is more likely than not we will be required to sell the security before recovery of its amortized cost basis; or (3) the present value of expected cash flows is not sufficient to recover all contractually required principal and interest payments.

We evaluate our securities portfolio each quarter to determine if any security is considered to be other than temporarily impaired. In making this evaluation, management considers its ability and intent to hold securities to recover current market losses. During the three and nine months ended September 30, 2016 and September 30, 2015, we had no other than temporary impairments.

### Available-for-sale securities

Securities available-for-sale are carried at fair value, with unrealized gains and unrealized losses, to the extent they are temporary in nature, reported as a component of other comprehensive income.

We purchased \$136 million and \$203 million, of available-for-sale securities, which included U.S. government sponsored agency mortgage-backed securities and municipal obligations, during the three and nine months ended September 30, 2016, respectively. We purchased \$59 million and \$783 million, of available-for-sale securities, which included U.S. government sponsored agencies comprised of mortgage-backed securities, collateralized mortgage and municipal obligations during the three and nine months ended September 30, 2015, respectively. During the third quarter 2015, we subsequently transferred \$462 million of the securities purchased to held-to-maturity investments.

Gains (losses) on sales of available-for-sale securities are reported in other noninterest income in the Consolidated Statements of Operations. During the three and nine months ended September 30, 2016, there were \$115 million and \$290 million, respectively, in sales of available-for-sale securities, which did not include those related to mortgage loans that had been securitized for sale in the normal course of business. These sales resulted in a realized gain of \$3 million and \$4 million during the three and nine months ended September 30, 2016, respectively. During both the three and nine months ended September 30, 2015 there were no sales of available-for-sale securities, except those related to mortgage loans that had been securitized for sale in the normal course of business.

### Held-to-maturity securities

Investment securities held-to-maturity are carried at amortized cost and adjusted for amortization of premiums and accretion of discounts using the interest method. Unrealized losses are not recorded to the extent they are temporary in nature.

Transfers of investment securities into the held-to-maturity category from the available-for-sale category are accounted for at fair value on the date of transfer. The related unrealized gain, net of tax that was included in the transfer is retained in other comprehensive income amortizing as an adjustment to interest income over the remaining life of the securities. During the third quarter 2015, we transferred \$1.1 billion of available-for-sale securities to held-to-maturity securities at a premium of \$8 million, reflecting our intent and ability to hold those securities to maturity. The related \$5 million of unrealized holding gain, net of tax, that was included in the transfer is retained in other comprehensive income (loss) and is being amortized as an adjustment to interest income over the remaining life of the securities. There were no gains or losses recognized as a result of this transfer.

We purchased zero and \$15 million of held-to-maturity securities, which included U.S. government sponsored agency mortgage-backed securities during the three and nine months ended September 30, 2016, respectively. During both the

three and nine months ended September 30, 2015, we purchased \$10 million of held-to-maturity securities.

Gains (losses) on sales of held-to-maturity securities are reported in other noninterest income in the Consolidated Statements of Operations. During both the three and nine months ended September 30, 2016 and September 30, 2015, there were no sales of held-to-maturity securities. During both the three and nine months ended September 30, 2016 and September 30, 2015, there were no maturities and \$25 million of maturities in held-to-maturity securities, respectively.



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The following table summarizes by duration the unrealized loss positions on investment securities:

Type of Security	Unrealized Loss Position with Duration 12 Months and Over			Unrealized Loss Position with Duration Under 12 Months		
	Fair Value	Number of Securities	Unrealized Loss	Fair Value	Number of Securities	Unrealized Loss
September 30, 2016						
Available-for-sale securities						
Agency - Commercial	\$6	1	\$ —	\$ —	—	\$ —
Agency - Residential	—	—	—	75	6	—
Municipal obligations	—	—	\$ —	—1	1	—
Held-to-maturity securities						
Agency - Commercial	\$ —	—	\$ —	\$20	2	\$ —
Agency - Residential	—	—	—	19	2	—
December 31, 2015						
Available-for-sale securities						
Agency - Commercial	\$ —	—	\$ —	\$482	27	\$ (3 )
Agency - Residential	8	2	—	224	15	(2 )
Held-to-maturity securities						
Agency - Commercial	\$ —	—	\$ —	\$471	27	\$ (2 )
Agency - Residential	—	—	—	547	50	(4 )

The amortized cost and estimated fair value of securities at September 30, 2016, are presented below by contractual maturity:

	Investment Securities Available-for-Sale				Investment Securities Held-to-maturity			
	Amortized Cost	Fair Value	Weighted Average Yield		Amortized Cost	Fair Value	Weighted Average Yield	
September 30, 2016								
Due after one year through five years	\$18	\$18	3.94 %		\$—	\$—	— %	
Due after five years through 10 years	7	7	2.64 %		61	63	2.50 %	
Due after 10 years	1,070	1,090	2.45 %		1,095	1,114	2.40 %	
Total	\$1,095	\$1,115			\$1,156	\$1,177		

We pledge investment securities, primarily municipal taxable and agency collateralized mortgage obligations, to collateralize lines of credit and/or borrowings. At September 30, 2016, we had pledged investment securities of \$918 million compared to \$14 million at December 31, 2015.

### Note 3 – Loans Held-for-Sale

The majority of our mortgage loans originated as loans held-for-sale are sold into the secondary market on a whole loan basis or by securitizing the loans and selling the securities. At September 30, 2016 and December 31, 2015, loans held-for-sale totaled \$3.4 billion and \$2.6 billion, respectively. For the three and nine months ended September 30, 2016, we had net gains on loan sales associated with loans held-for-sale, excluding the gains from the sale of mortgage loans transferred from loans held-for-investment, of \$94 million and \$244 million, respectively, as compared to \$68 million and \$242 million during the three and nine months ended September 30, 2015, respectively.

At September 30, 2016 and December 31, 2015, \$40 million and \$35 million, respectively, of loans held-for-sale were recorded at lower of cost or fair value. The remainder of the loans in the portfolio are recorded at fair value as we have elected the fair value option for such loans.

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## Note 4 – Loans Held-for-Investment

Loans held-for-investment are summarized as follows:

	September 30, 2016	December 31, 2015
	(Dollars in millions)	
Consumer loans		
Residential first mortgage	\$2,136	\$ 3,100
Second mortgage	127	135
HELOC	326	384
Other	30	31
Total consumer loans	2,619	3,650
Commercial loans		
Commercial real estate (1)	1,168	814
Commercial and industrial	708	552
Warehouse lending	1,795	1,336
Total commercial loans	3,671	2,702
Total loans held-for-investment	\$6,290	\$ 6,352

(1) Includes \$252 million and \$188 million of owner occupied commercial real estate loans at September 30, 2016 and December 31, 2015, respectively.

During the nine months ended September 30, 2016 and September 30, 2015, we transferred \$2 million and \$30 million, respectively, of loans held-for-sale to loans held-for-investment, based upon a change in our intent.

During the nine months ended September 30, 2016, we sold nonperforming, TDR and non-agency loans with unpaid principal balances of \$110 million. Upon a change in our intent, the loans were transferred to held-for-sale and subsequently sold resulting in a loss on sale of \$2 million during the nine months ended September 30, 2016, which is recorded in net loss on sale of assets on the Consolidated Statements of Operations. The loans sold also resulted in a charge-off of \$8 million during the nine months ended September 30, 2016.

Also, during the nine months ended September 30, 2016, we sold performing residential first mortgage loans with unpaid principal balances of \$1.2 billion. Upon a change in our intent, the loans were transferred to held-for-sale and subsequently sold resulting in a gain of \$14 million, which is recorded in net gain on loan sales on the Consolidated Statements of Operations.

During the nine months ended September 30, 2015, we sold or transferred interest-only residential first mortgage loans with unpaid principal balances totaling \$600 million, along with \$420 million of nonperforming troubled debt restructuring ("TDR") and non-agency first mortgage loans. Upon a change in our intent, the loans were transferred to held-for-sale and subsequently sold resulting in a net loss on sale of less than \$1 million during the nine months ended September 30, 2015. The loans sold also resulted in a charge-off of \$67 million.

During the nine months ended September 30, 2016, we purchased jumbo residential first mortgage loans with an unpaid principal balance of \$150 million and a premium of \$1 million. During the nine months ended September 30, 2015, we purchased \$197 million of home equity lines of credit ("HELOC") loans with a premium of \$7 million.

We have pledged certain loans held-for-investment, loans held-for-sale, and loans with government guarantees to collateralize lines of credit and/or borrowings with the Federal Reserve Bank of Chicago and the Federal Home Loan Bank of Indianapolis. At September 30, 2016 and December 31, 2015, we had pledged loans of \$5.6 billion and \$5.8 billion, respectively.

Allowance for Loan Losses

We determine the appropriate estimate of the allowance for loan losses on at least a quarterly basis. Refer to Note 1, "Description of Business, Basis of Presentation, and Summary of Significant Accounting Policies" to the consolidated financial statements in the Annual Report on Form 10-K for the year ended December 31, 2015, for a description of the methodology. The all

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allowance for loan losses, other than for loans that have been identified for individual evaluation for impairment, is determined on a loan pool basis by grouping loan types with common risk characteristics to determine our best estimate of incurred losses.

The allowance for loan losses by class of loan are summarized in the following table:

	Residential First Mortgage (1)	Second Mortgage	HELOC	Other Consumer	Commercial Real Estate	Commercial and Industrial	Warehouse Lending	Total
(Dollars in millions)								
Three Months Ended September 30, 2016								
Beginning balance allowance for loan losses	\$81	\$ 10	\$ 20	\$ 1	\$ 19	\$ 11	\$ 8	\$150
Charge-offs (2)	(7 )	—	(1 )	(1 )	—	—	—	(9 )
Recoveries	—	—	1	1	—	—	—	2
Provision (benefit) (3)	(4 )	(1 )	(4 )	—	6	3	—	—
Ending balance allowance for loan losses	\$70	\$ 9	\$ 16	\$ 1	\$ 25	\$ 14	\$ 8	\$143
Three Months Ended September 30, 2015								
Beginning balance allowance for loan losses	\$151	\$ 14	\$ 25	\$ 1	\$ 15	\$ 12	\$ 4	\$222
Charge-offs (2)	(21 )	(1 )	(1 )	(1 )	—	(3 )	—	(27 )
Recoveries	1	1	—	1	—	—	—	3
Provision (benefit)	(2 )	(1 )	(1 )	—	(2 )	5	—	(1 )
Ending balance allowance for loan losses	\$129	\$ 13	\$ 23	\$ 1	\$ 13	\$ 14	\$ 4	\$197
Nine Months Ended September 30, 2016								
Beginning balance allowance for loan losses	\$116	\$ 11	\$ 21	\$ 2	\$ 18	\$ 13	\$ 6	\$187
Charge-offs (2)	(26 )	(2 )	(2 )	(3 )	—	—	—	(33 )
Recoveries	1	1	1	2	—	—	—	5
Provision (benefit) (3)	(21 )	(1 )	(4 )	—	7	1	2	(16 )
Ending balance allowance for loan losses	\$70	\$ 9	\$ 16	\$ 1	\$ 25	\$ 14	\$ 8	\$143
Nine Months Ended September 30, 2015								
Beginning balance allowance for loan losses	\$234	\$ 12	\$ 19	\$ 1	\$ 17	\$ 11	\$ 3	\$297
Charge-offs (2)	(80 )	(2 )	(2 )	(3 )	—	(3 )	—	(90 )
Recoveries	3	1	—	2	2	—	—	8
Provision (benefit)	(28 )	2	6	1	(6 )	6	1	(18 )
Ending balance allowance for loan losses	\$129	\$ 13	\$ 23	\$ 1	\$ 13	\$ 14	\$ 4	\$197

(1) Includes allowance and charge-offs related to loans with government guarantees.

(2)

Includes charge-offs of zero and \$16 million related to the transfer and subsequent sale of loans during the three months ended September 30, 2016 and September 30, 2015, respectively, and \$8 million and \$67 million related to the sale of loans during the nine months ended September 30, 2016 and September 30, 2015, respectively. Also includes charge-offs related to loans with government guarantees of \$6 million and \$13 million during the three and nine months ended September 30, 2016, respectively.

Does not include \$7 million provision for loan losses recorded in the Consolidated Statements of Operations to (3) reserve for repossessed loans with government guarantees during the three and nine months ended September 30, 2016.

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The loans held-for-investment and allowance for loan losses by class of loan is summarized in the following table:

	Residential First Mortgage (1)	Second Mortgage	HELOC	Other Consumer	Commercial Real Estate	Commercial and Industrial	Warehouse Lending	Total
(Dollars in millions)								
September 30, 2016								
Loans held-for-investment								
Individually evaluated	\$42	\$ 26	\$ 4	\$ —	\$ —	\$ 1	\$ —	\$73
Collectively evaluated (2)	2,087	60	291	30	1,168	707	1,795	6,138
Total loans	\$2,129	\$ 86	\$ 295	\$ 30	\$ 1,168	\$ 708	\$ 1,795	\$6,211
Allowance for loan losses								
Individually evaluated	\$7	\$ 6	\$ 1	\$ —	\$ —	\$ —	\$ —	\$14
Collectively evaluated (2)	63	3	15	1	25	14	8	129
Total allowance for loan losses	\$70	\$ 9	\$ 16	\$ 1	\$ 25	\$ 14	\$ 8	\$143
December 31, 2015								
Loans held-for-investment								
Individually evaluated	\$87	\$ 28	\$ 3	\$ —	\$ —	\$ 2	\$ —	\$120
Collectively evaluated (2)	3,007	65	318	31	814	550	1,336	6,121
Total loans	\$3,094	\$ 93	\$ 321	\$ 31	\$ 814	\$ 552	\$ 1,336	\$6,241
Allowance for loan losses								
Individually evaluated	\$12	\$ 6	\$ 1	\$ 1	\$ —	\$ —	\$ —	\$20
Collectively evaluated (2)	104	5	20	1	18	13	6	167
Total allowance for loan losses	\$116	\$ 11	\$ 21	\$ 2	\$ 18	\$ 13	\$ 6	\$187

(1)Includes allowance related to loans with government guarantees.

(2)Excludes loans carried under the fair value option.

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The following table sets forth the loans held-for-investment aging analysis as of September 30, 2016 and December 31, 2015, of past due and current loans:

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due (1)	Total Past Due	Current	Total Investment Loans
(Dollars in millions)						
September 30, 2016						
Consumer loans						
Residential first mortgage	\$4	\$ 1	\$ 29	\$ 34	\$2,102	\$ 2,136
Second mortgage	—	—	4	4	123	127
HELOC	1	—	7	8	318	326
Other	1	1	—	2	28	30
Total consumer loans	6	2	40	48	2,571	2,619
Commercial loans						
Commercial real estate	—	—	—	—	1,168	1,168
Commercial and industrial	—	—	—	—	708	708
Warehouse lending	—	—	—	—	1,795	1,795
Total commercial loans	—	—	—	—	3,671	3,671
Total loans (2)	\$6	\$ 2	\$ 40	\$ 48	\$6,242	\$ 6,290
December 31, 2015						
Consumer loans						
Residential first mortgage	\$7	\$ 3	\$ 53	\$ 63	\$3,037	\$ 3,100
Second mortgage	—	—	2	2	133	135
HELOC	2	1	9	12	372	384
Other	1	—	—	1	30	31
Total consumer loans	10	4	64	78	3,572	3,650
Commercial loans						
Commercial real estate	—	—	—	—	814	814
Commercial and industrial	—	—	2	2	550	552
Warehouse lending	—	—	—	—	1,336	1,336
Total commercial loans	—	—	2	2	2,700	2,702
Total loans (2)	\$10	\$ 4	\$ 66	\$ 80	\$6,272	\$ 6,352

(1) Includes loans that are less than 90 days past due, which have been placed on nonaccrual.

(2) Includes \$12 million and \$10 million of loans 90 days or greater past due, accounted for under the fair value option at September 30, 2016 and December 31, 2015, respectively.

For all classes within the consumer and commercial loan portfolio, loans are placed on nonaccrual status when any portion of principal or interest is 90 days past due (or are determined to be impaired), or earlier when we become aware of information indicating that collection of principal and interest is in doubt. When a loan is placed on nonaccrual status, the accrued interest income is reversed. Loans return to accrual status when principal and interest become current and are anticipated to be fully collectible.

Interest income is recognized on nonaccrual loans using a cash basis method. Interest that would have been accrued on impaired loans totaled \$1 million and \$2 million during the three and nine months ended September 30, 2016, respectively, and \$1 million and \$4 million during the three and nine months ended September 30, 2015, respectively. At September 30, 2016 and December 31, 2015, we had no loans 90 days past due and still accruing.





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## Troubled Debt Restructuring

We may modify certain loans in both consumer and commercial loan portfolios to retain customers or to maximize collection of the outstanding loan balance. We have programs designed to assist borrowers by extending payment dates or reducing the borrower's contractual payments. All loan modifications are made on a case-by-case basis. Our standards relating to loan modifications consider, among other factors, minimum verified income requirements, cash flow analysis, and collateral valuations. TDRs result in those instances in which a borrower demonstrates financial difficulty and for which a concession has been granted, which includes reductions of interest rate, extensions of amortization period, principal and/or interest forgiveness and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of collateral. These loans are classified as nonperforming TDRs if the loan was nonperforming prior to the restructuring, or based upon the results of a contemporaneous credit evaluation. Such loans will continue on nonaccrual status until the borrower has established a willingness and ability to make the restructured payments for at least six months, after which they will begin to accrue interest.

Some loan modifications classified as TDRs may not ultimately result in the full collection of principal and interest, as modified, but may give rise to potential incremental losses. We measure impairments using a discounted cash flow method for performing TDRs and measure impairment based on collateral values for re-defaulted TDRs.

The following table provides a summary of TDRs outstanding by type and performing status:

	TDRs		
	Performing	Nonperforming	Total
September 30, 2016	(Dollars in millions)		
Consumer loans			
Residential first mortgage	\$23	\$ 10	\$33
Second mortgage	33	3	36
HELOC	14	4	18
Total consumer loans	70	17	87
Commercial loans			
Commercial and industrial	1	—	1
Total commercial loans	1	—	1
Total TDRs (1)(2)	\$71	\$ 17	\$88

December 31, 2015

Consumer loans			
Residential first mortgage	\$49	\$ 27	\$76
Second mortgage	32	1	33
HELOC	20	7	27
Total TDRs (1)(2)	\$101	\$ 35	\$136

(1) The allowance for loan losses on consumer TDR loans totaled \$11 million and \$15 million at September 30, 2016 and December 31, 2015, respectively.

(2) Includes \$26 million and \$32 million of TDR loans accounted for under the fair value option at September 30, 2016 and December 31, 2015, respectively.

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The following table provides a summary of newly modified TDRs during the three and nine months ended September 30, 2016 and 2015.

	New TDRs		
	Number of Accounts	Pre-Modification Unpaid Principal Balance	Post-Modification Unpaid Principal Balance (1)
			Increase in Allowance at Modification
Three Months Ended September 30, 2016		(Dollars in millions)	
Residential first mortgages	1	\$ —	\$ —
Second mortgages	16	1	1
HELOC (2)(3)	1	—	—
Total TDR loans	18	\$ 1	\$ 1
Three Months Ended September 30, 2015			
Residential first mortgages	48	\$ 13	\$ 14
Second mortgages	15	1	1
HELOC (2)	46	4	4
Total TDR loans	109	\$ 18	\$ 19
Nine Months Ended September 30, 2016			
Residential first mortgages	17	\$ 3	\$ 4
Second mortgages	42	2	2
HELOC (2)(3)	86	6	5
Commercial and industrial	1	2	1
Total TDR loans	146	\$ 13	\$ 12
Nine Months Ended September 30, 2015			
Residential first mortgages	239	\$ 66	\$ 65
Second mortgages	83	4	3
HELOC (2)(3)	204	12	11
Other consumer	3	—	—
Total TDR loans	529	\$ 82	\$ 79

(1) Post-modification balances include past due amounts that are capitalized at modification date.

(2) HELOC post-modification unpaid principal balance reflects write downs.

(3) Includes loans carried at the fair value option.

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The following table provides a summary of TDR loans that were modified within the previous 12 months, which subsequently defaulted during the three and nine months ended September 30, 2016 and 2015. All TDR classes within consumer and commercial loan portfolios are considered subsequently defaulted when they are greater than 90 days past due.

	TDRs that were modified in the previous 12 months, which have subsequently defaulted				Increase in Allowance at Subsequent Default
	Number of Accounts	Unpaid Principal Balance			
Three Months Ended September 30, 2016	(Dollars in millions)				
HELOC (1)	3	\$	—	\$	—
Total TDR loans	3	\$	—	\$	—
Three Months Ended September 30, 2015					
Residential first mortgages	1	\$	—	\$	—
Total TDR loans	1	\$	—	\$	—
Nine Months Ended September 30, 2016					
Residential first mortgages	1	\$	—	\$	—
HELOC (1)	7	—	—	—	—
Total TDR loans	8	\$	—	\$	—
Nine Months Ended September 30, 2015					
Residential first mortgages	1	\$	—	\$	—
Second mortgages	1	—	—	—	—
Total TDR loans	2	\$	—	\$	—

(1)HELOC post-modification unpaid principal balance reflects write downs.

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## Impaired Loans

Loans are considered impaired if it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement or when any portion of principal or interest is 90 days past due. The following table presents individually evaluated impaired loans and the associated allowance:

	September 30, 2016			December 31, 2015		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
(Dollars in millions)						
With no related allowance recorded						
Consumer loans						
Residential first mortgage	\$2	\$ 1	\$ —	\$20	\$ 20	\$ —
Commercial loans						
Commercial and industrial	1	1	—	5	2	—
	\$3	\$ 2	\$ —	\$25	\$ 22	\$ —
With an allowance recorded						
Consumer loans						
Residential first mortgage	\$40	\$ 41	\$ 7	\$65	\$ 67	\$ 12
Second mortgage	26	26	6	28	28	6
HELOC	4	4	2	3	3	1
Other consumer	—	—	—	—	—	1
	\$70	\$ 71	\$ 15	\$96	\$ 98	\$ 20
Total						
Consumer loans						
Residential first mortgage	\$42	\$ 42	\$ 7	\$85	\$ 87	\$ 12
Second mortgage	26	26	6	28	28	6
HELOC	4	4	2	3	3	1
Other consumer	—	—	—	—	—	1
Commercial loans						
Commercial and industrial	1	1	—	5	2	—
Total impaired loans	\$73	\$ 73	\$ 15	\$121	\$ 120	\$ 20

The following table presents average impaired loans and the interest income recognized:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2016		2015		2016		2015	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
(Dollars in millions)								
Consumer loans								
Residential first mortgage	\$43	\$ —	\$ 96	\$ 1	\$55	\$ 1	\$ 172	\$ 4
Second mortgage	25	—	29	—	26	1	30	—
HELOC	5	—	15	—	5	—	6	—
Commercial loans								
Commercial and industrial	1	—	2	—	2	—	1	—
Total impaired loans	\$74	\$ —	\$ 142	\$ 1	\$88	\$ 2	\$ 209	\$ 4



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### Credit Quality

We utilize an internal risk rating system in accordance with the Rating Credit Risk booklet of the Comptroller's Handbook, April 2011 and the Uniform Retail Credit classification and Account Management Policy issued June 20, 2000 by the Federal Financial Institution Examination Council ("FFIEC") which is applied to all consumer and commercial loans. Descriptions of our internal risk ratings as they relate to credit quality follow the ratings used by the U.S. bank regulatory agencies as listed below.

**Pass.** Pass assets are not impaired nor do they have any known deficiencies that could impact the quality of the asset.

**Watch.** Watch assets are defined as pass rated assets that exhibit elevated risk characteristics or other factors that deserve management's close attention and increased monitoring. However, the asset does not exhibit a potential or well-defined weakness that would warrant a downgrade to criticized or adverse classification.

**Special mention.** Assets identified as special mention possess credit deficiencies or potential weaknesses deserving management's close attention. Special mention assets have a potential weakness or pose an unwarranted financial risk that, if not corrected, could weaken the assets and increase risk in the future. Special mention assets are criticized, but do not expose an institution to sufficient risk to warrant adverse classification.

**Substandard.** Assets identified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. For HELOC loans and other consumer loans, we evaluate credit quality based on the aging and status of payment activity and any other known credit characteristics that call into question full repayment of the asset. Nonperforming loans are classified as either substandard, doubtful or loss.

**Doubtful.** An asset classified as doubtful has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. A doubtful asset has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification as loss is deferred. Doubtful borrowers are usually in default, lack adequate liquidity or capital, and lack the resources necessary to remain an operating entity. Pending events can include mergers, acquisitions, liquidations, capital injections, the perfection of liens on additional collateral, the valuation of collateral, and refinancing. Generally, pending events should be resolved within a relatively short period and the ratings will be adjusted based on the new information. Because of high probability of loss, non-accrual accounting treatment is required for doubtful assets.

**Loss.** An asset classified as loss is considered uncollectible and of such little value that the continuance as a bankable asset is not warranted. This classification does not mean that an asset has absolutely no recovery or salvage value, but, rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

### Commercial Loans

Management conducts periodic examinations which serve as an independent verification of the accuracy of the ratings assigned. Loan grades are based on different factors within the borrowing relationship: entity sales, debt service coverage, debt/total net worth, liquidity, balance sheet and income statement trends, management experience, business stability, financing structure of the deal, and financial reporting requirements. The underlying collateral is also rated based on the specific type of collateral and corresponding loan-to-value ("LTV"). The combination of the borrower and collateral risk ratings result in the final rating for the borrowing relationship.

## Consumer Loans

Consumer loans consist of open and closed end loans extended to individuals for household, family, and other personal expenditures, and includes consumer loans, loans to individuals secured by their personal residence, including first mortgage, home equity, and home improvement loans. Because consumer loans are usually relatively small-balance, homogeneous exposures, consumer loans are rated primarily on payment performance. Payment performance is a proxy for the strength of repayment capacity and loans are generally classified based on their payment status rather than by an individual review of each loan.

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In accordance with regulatory guidance, we assign risk ratings to consumer loans in the following manner:

- Consumer loans are classified as Watch once the loan becomes 60 days past due.
- Open and closed-end consumer loans 90 days or more past due are classified Substandard.

Commercial Credit Loans	Commercial Real Estate	Commercial and Industrial	Warehouse	Total Commercial
September 30, 2016	(Dollars in millions)			
Grade				
Pass	\$ 1,122	\$ 654	\$ 1,659	\$ 3,435
Watch	37	20	86	143
Special mention	3	33	50	86
Substandard	6	1	—	7
Total loans	\$ 1,168	\$ 708	\$ 1,795	\$ 3,671

December 31, 2015

Grade				
Pass	\$ 766	\$ 492	\$ 1,181	\$ 2,439
Watch	42	30	155	227
Special mention	2	21	—	23
Substandard	4	9	—	13
Total loans	\$ 814	\$ 552	\$ 1,336	\$ 2,702

Consumer Credit Loans	Residential Mortgage	Secured First Mortgage	HELOC	Other Consumer	Total
September 30, 2016	(Dollars in millions)				
Grade					
Pass	\$ 2,081	\$ 90	\$ 305	\$ 29	\$ 2,505
Watch	24	33	14	1	72
Substandard	31	4	7	—	42
Total loans	\$ 2,136	\$ 127	\$ 326	\$ 30	\$ 2,619

December 31, 2015

Grade					
Pass	\$ 2,993	\$ 101	\$ 353	\$ 31	\$ 3,478
Watch	49	32	22	—	103
Substandard	58	2	9	—	69
Total loans	\$ 3,100	\$ 135	\$ 384	\$ 31	\$ 3,650

#### Note 5 – Loans with Government Guarantees

Substantially all loans with government guarantees are insured or guaranteed by the Federal Housing Administration ("FHA") and U.S. Department of Veterans Affairs. FHA loans earn interest at a rate based upon the 10-year U.S. Treasury note rate at the time the underlying loan becomes delinquent, which is not paid by the FHA until claimed. Certain loans within our portfolio may be subject to indemnifications and insurance limits which exposes us to limited credit risk. We have reserved for these risks within other assets and as a component of our allowance for loan losses on residential first mortgages.

At September 30, 2016 and December 31, 2015, loans with government guarantees totaled \$404 million and \$485 million, respectively. At September 30, 2016 and December 31, 2015, repossessed assets and the associated claims

recorded in other assets totaled \$152 million and \$210 million, respectively.

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## Note 6 – Variable Interest Entities ("VIEs")

In 2015, we executed clean-up calls of the FSTAR 2005-1 and FSTAR 2006-2 long-term debt associated with the HELOC securitization trusts. As a result, the FSTAR 2005-1 and FSTAR 2006-2 HELOC securitization trusts were dissolved and we have no consolidated VIEs as of September 30, 2016 and December 31, 2015.

We have a continuing involvement, but are not the primary beneficiary for one unconsolidated VIE related to the FSTAR 2007-1 mortgage securitization trust. In accordance with the settlement agreement with MBIA Insurance Corporation ("MBIA"), there is no further recourse to us related to FSTAR 2007-1, unless MBIA fails to meet their obligations. At September 30, 2016 and December 31, 2015, the FSTAR 2007-1 mortgage securitization trust included 2,608 loans and 3,061 loans, respectively, with an aggregate principal balance of \$96 million and \$117 million, respectively.

## Note 7 – Mortgage Servicing Rights

We have investments in mortgage servicing rights ("MSRs") that result from the sale of loans to the secondary market for which we retain the servicing. The primary risk associated with MSRs is the potential reduction in fair value as a result of higher than anticipated prepayments due to loan refinancing prompted, in part, by declining interest rates or government intervention. Conversely, these assets generally increase in value in a rising interest rate environment to the extent that prepayments are slower than anticipated. We utilize derivatives as economic hedges to offset changes in the fair value of the MSRs resulting from the actual or anticipated changes in prepayments stemming from changing interest rate environments. There is also a risk of valuation decline due to higher than expected increases in default rates, which we do not believe can be effectively managed using derivatives. See Note 8 of the Notes to the Consolidated Financial Statements, herein, for further information regarding the derivative instruments utilized to manage our MSR risks.

Changes in the carrying value of residential first mortgage MSRs, accounted for at fair value, were as follows:

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
	(Dollars in millions)			
Balance at beginning of period	\$301	\$317	\$296	\$258
Additions from loans sold with servicing retained	51	74	173	220
Reductions from sales	(17 )	(73 )	(41 )	(144 )
Changes in fair value due to (1)				
Decrease in MSR due to pay-offs, pay-downs and run-off	(19 )	(9 )	(45 )	(34 )
Changes in estimates of fair value (2)	(14 )	(15 )	(81 )	(6 )
Fair value of MSRs at end of period	\$302	\$294	\$302	\$294

(1) Changes in fair value are included within net (loss) return on mortgage servicing rights on the Consolidated Statements of Operations.

(2) Represents estimated MSR value change resulting primarily from market-driven changes.

The following table summarizes the hypothetical effect on the fair value of servicing rights carried at fair value using adverse changes of 10 percent and 20 percent to the weighted average of certain significant assumptions used in valuing these assets:

September 30, 2016                      December 31, 2015

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	Actual	Fair value impact due to 10% adverse change		Actual	Fair value impact due to 10% adverse change	
		20%	20%		20%	20%
Option adjusted spread	9.20	% \$295	\$ 288	8.24	% \$287	\$ 279
Constant prepayment rate	15.68	% 290	280	12.63	% 285	275
Weighted average cost to service per loan	\$70.75	299	295	\$71.86	292	288

The sensitivity calculations above are hypothetical and should not be considered to be predictive of future performance. Changes in fair value based on adverse changes in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. To isolate the effect of the specified

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change, the fair value shock analysis is consistent with the identified adverse change, while holding all other assumptions constant. In practice, a change in one assumption generally impacts other assumptions, which may either magnify or counteract the effect of the change.

See Note 17 of the Notes to the Consolidated Financial Statements, herein, for further fair value disclosures relating to mortgage servicing rights.

Contractual servicing and subservicing fees. Contractual servicing and subservicing fees, including late fees and other ancillary income are presented below. Contractual servicing fees are included within net (loss) return on mortgage servicing rights on the Consolidated Statements of Operations. Contractual subservicing fees including late fees and other ancillary income are included within loan administration income on the Consolidated Statements of Operations. Subservicing fee income is recorded for fees earned, net of third party subservicing costs, for loans subserviced.

The following table summarizes income and fees associated with contractual servicing rights:

	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
	(Dollars in millions)			
Income on mortgage servicing rights				
Servicing fees, ancillary income and late fees (1)	\$22	\$18	\$60	\$52
Changes in fair value (2)	(33 )	(24 )	(126 )	(38 )
Gain on MSR derivatives (3)	(1 )	15	44	10
Net transaction costs	1	3	1	(5 )
Total (loss) return, included in net return on mortgage servicing rights	\$(11)	\$12	\$(21)	\$19

(1) Servicing fees are recorded on the accrual basis. Ancillary income and late fees are recorded on a cash basis.

(2) Includes a \$2 million gain related to the sale of MSRs during the nine months ended September 30, 2015.

(3) Changes in the derivatives utilized as economic hedges to offset changes in fair value of the MSRs.

The following table summarizes income and fees associated with our mortgage loans subserviced:

	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
	(Dollars in millions)			
Income on mortgage loans subserviced				
Subservicing fees, ancillary income and late fees (1)	\$7	\$8	\$21	\$24
Other servicing charges	(3 )	—	(7 )	(5 )
Total income, included in loan administration	\$4	\$8	\$14	\$19

(1) Servicing fees are recorded on the accrual basis. Ancillary income and late fees are recorded on cash basis.

#### Note 8 – Derivative Financial Instruments

Derivative financial instruments are recorded at fair value in other assets and other liabilities on the Consolidated Statements of Financial Condition after taking into account the effects of legally enforceable bilateral collateral and

master netting agreements. We are exposed to non-performance risk by the counterparties to our various derivative financial instruments. We believe that the non-performance risk inherent in all our derivative contracts is minimal based on credit standards and the collateral provisions of the derivative agreements. A majority of our derivatives are centrally cleared through a Central Counterparty Clearing House or consist of residential mortgage interest rate lock commitments further limiting our exposure to non-performance risk.

Derivatives not designated as hedging instruments: We maintain a derivative portfolio of interest rate swaps, futures and forward commitments used to manage exposure to changes in interest rates, MSR asset values and to meet the needs of customers. We also enter into interest rate lock commitments, which are commitments to originate mortgage loans whereby the interest rate on the loan is determined prior to funding and the customers have locked into that interest rate. Market risk on interest rate lock commitments and mortgage loans held-for-sale is managed using corresponding forward sale commitments.

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Changes in fair value of derivatives not designated as hedging instruments are recognized in the Consolidated Statements of Income.

Derivatives designated as hedging instruments: We have designated certain interest rate swaps as cash flow hedges of certain interest rate payments of our variable-rate Federal Home Loan Bank advances.

Changes in the fair value of derivatives designated as cash flow hedges are recorded in other comprehensive income (loss) on the Consolidated Statement of Financial Condition and reclassified into interest expense in the same period in which the hedge transaction is recognized in earnings. At September 30, 2016, we had \$37 million (net-of-tax) recorded of unrealized losses on derivatives classified as cash flow hedges recorded in accumulated other comprehensive income (loss), compared to \$3 million at December 31, 2015. The estimated amount to be reclassified from other comprehensive income into earnings during the next 12 months represents \$7 million of losses (net-of-tax).

Derivatives that are designated in hedging relationships are assessed for effectiveness using regression analysis at inception and throughout the hedge period. All hedge relationships were and are expected to be highly effective as of September 30, 2016. Cash flows and the profit impact associated with designated hedges are reported in the same category as the underlying hedged item.

The net gain (loss) recognized in income on derivative instruments, net of the impact of offsetting positions, were as follows:

	Location of Gain/(Loss)	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2015	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2015
		(Dollars in millions)			
Derivatives not designated as hedging instruments:					
U.S. Treasury, swap and euro dollar futures	Net (loss) return on mortgage servicing rights	\$4	\$3	\$8	\$6
Interest rate swaps and swaptions	Net (loss) return on mortgage servicing rights	(7 )	10	21	2
Mortgage backed securities forwards	Net (loss) return on mortgage servicing rights	2	2	15	2
Rate lock commitments and forward agency and loan sales	Net gain on loan sales	15	(24 )	14	(4 )
Rate lock commitments	Other noninterest income	—	1	1	(1 )
Interest rate swaps	Other noninterest income	2	2	3	2
Total derivative (loss) gain		\$16	\$(6)	\$62	\$7

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The notional amount, estimated fair value and maturity of our derivative financial instruments were as follows:

	Notional Amount	Fair Value	Expiration Dates
	(Dollars in millions)		
September 30, 2016			
Derivatives designated as hedging instruments:			
Assets			
Interest rate swaps on FHLB advances	\$200	\$ 3	2026
Liabilities (1)			
Interest rate swaps on FHLB advances	\$825	\$ 55	2023-2025
Derivatives not designated as hedging instruments:			
Assets (2)			
U.S. Treasury, swap and euro dollar futures	\$5,450	\$ 1	2016-2019
Mortgage backed securities forwards	1,317	2	2016
Rate lock commitments	6,357	63	2016
Interest rate swaps and swaptions	2,273	53	2016-2046
Total derivative assets	\$15,397	\$ 119	
Liabilities (1)			
U.S. Treasury, swap and euro dollar futures	\$635	\$ —	2019-2020
Mortgage backed securities forwards	5,849	24	2016
Rate lock commitments	87	—	2016
Interest rate swaps	558	17	2016-2026
Total derivative liabilities	\$7,129	\$ 41	
December 31, 2015			
Derivatives designated as hedging instruments:			
Liabilities (1)			
Interest rate swaps on FHLB advances	\$825	\$ 4	2023-2025
Derivatives not designated as hedging instruments:			
Assets (2)			
U.S. Treasury, swap and euro dollar futures	\$1,892	\$ —	2016-2019
Mortgage backed securities forwards	1,931	7	2016
Rate lock commitments	3,593	26	2016
Interest rate swaps and swaptions	1,554	25	2016-2035
Total derivative assets	\$8,970	\$ 58	
Liabilities (1)			
U.S. Treasury, swap and euro dollar futures	\$768	\$ 1	2016-2019
Mortgage backed securities forwards	2,655	6	2016
Rate lock commitments	168	—	2016
Interest rate swaps	422	7	2016-2025
Total derivative liabilities	\$4,013	\$ 14	

(1) Derivative liabilities are included in other liabilities on the Consolidated Statements of Financial Condition.

(2) Derivative assets are included in other assets on the Consolidated Statements of Financial Condition.





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U.S. Treasury, swap and euro dollar futures	\$1	\$ —	\$ 1	\$ <del>2</del>
Mortgage backed securities forwards	6	—	6	— 8
Interest rate swaps and swaptions (1)	7	—	7	— 12
Total derivative liabilities	\$14	\$ —	\$ 14	\$ <del>22</del>

(1) Additional funds are pledged to a central counterparty clearing house in the amount of \$56 million as of September 30, 2016 and \$7 million as of December 31, 2015 to maintain initial margin requirements. This collateral is in addition to the amount required to be maintained for potential market changes shown in the cash collateral column above.

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We pledged a total of \$84 million of cash collateral to counterparties and had an obligation to return cash of \$24 million at September 30, 2016 for derivative activities. We pledged a total of \$41 million of cash collateral to counterparties and had an obligation to return cash of \$14 million at December 31, 2015 for derivative activities. The net cash pledged is restricted and is included in other assets on the Consolidated Statements of Financial Condition.

## Note 9 – Debt

## Federal Home Loan Bank Advances and other

The following is a breakdown of our Federal Home Loan Bank advances and other short-term debt outstanding:

	September 30, 2016		December 31, 2015	
	Amount	Rate	Amount	Rate
	(Dollars in millions)			
Short-term adjustable rate (1)	\$20	0.67%	\$—	—%
Short-term fixed rate term advances	865	0.37%	2,116	0.32%
Other short-term (2)	20	0.55%	—	—%
Total Short-term Federal Home Loan Bank advances and other	\$905		\$2,116	
Long-term LIBOR adjustable advances	1,025	0.94%	825	0.70%
Long-term fixed rate advances (3)	552	1.44%	600	1.37%
Total Long-term Federal Home Loan Bank advances	\$1,577		\$1,425	
Total Federal Home Loan Bank advances and other	\$2,482		\$3,541	

(1) Includes short-term adjustable rate federal funds line of credit.

(2) Other short-term debt consists of borrowings that settle through the Federal Reserve Bank.

(3) Includes the current portion of fixed rate advances of \$125 million and \$175 million at September 30, 2016 and December 31, 2015, respectively.

We settled \$375 million in long-term fixed rate Federal Home Loan Bank advances during the fourth quarter 2015, which resulted in a gain on extinguishment of debt of \$3 million, included in other noninterest income.

We are required to maintain a minimum amount of qualifying collateral. In the event of default, the Federal Home Loan Bank advance is similar to a secured borrowing, whereby the Federal Home Loan Bank has the right to sell the pledged collateral to settle the fair value of the outstanding advances.

At September 30, 2016, we had the authority and approval from the Federal Home Loan Bank to utilize a line of credit of up to \$7.0 billion and we may access that line to the extent that collateral is provided. At September 30, 2016, we had \$2.5 billion of advances outstanding and an additional \$2.0 billion of collateralized borrowing capacity available at the Federal Home Loan Bank. The advances can be collateralized by non-delinquent single-family residential first mortgage loans, loans with government guarantees, certain other loans and investment securities.

At September 30, 2016, \$1.0 billion of the outstanding advances were adjustable rate based on the three-month LIBOR index. Interest rates on these advances reset every three months and the advances may be prepaid without penalty, with notification at scheduled three month intervals after an initial 12 month lockout period.

The following table contains detailed information on our Federal Home Loan Bank advances and other borrowings:

Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2015	2016	2015

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(Dollars in millions)

Maximum outstanding at any month end	\$3,182	\$2,127	\$3,557	\$2,198
Average outstanding balance	2,649	1,798	2,777	1,610
Average remaining borrowing capacity	1,626	1,738	1,106	1,711
Weighted average interest rate	1.26	% 1.17	% 1.25	% 1.05 %

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The following outlines our Federal Home Loan Bank advances and other final maturity dates as of September 30, 2016:

	September 30, 2016 (Dollars in millions)
2016	\$ 1,030
2017	50
2018	125
2019	—
Thereafter	1,277
Total	\$ 2,482

## Senior Notes and Trust Preferred Securities

The following table presents long-term debt:

	September 30, 2016		December 31, 2015	
	(Dollars in millions)			
Senior Notes				
Senior notes, matures 2021	\$246	6.125 %	\$—	
Trust Preferred Securities				
Floating Three Month LIBOR				
Plus 3.25%, matures 2032	\$26	4.11 %	\$26	3.85 %
Plus 3.25%, matures 2033	26	3.93 %	26	3.57 %
Plus 3.25%, matures 2033	26	3.88 %	26	3.85 %
Plus 2.00%, matures 2035	26	2.68 %	26	2.32 %
Plus 2.00%, matures 2035	26	2.68 %	26	2.32 %
Plus 1.75%, matures 2035	51	2.60 %	51	2.26 %
Plus 1.50%, matures 2035	25	2.18 %	25	1.82 %
Plus 1.45%, matures 2037	25	2.30 %	25	1.96 %
Plus 2.50%, matures 2037	16	3.35 %	16	3.01 %
Total Trust Preferred Securities	\$247		\$247	
Total long-term debt	\$493		\$247	

## Senior Notes

On July 11, 2016, we issued \$250 million of senior notes (“2021 Senior Notes”) which mature on July 15, 2021. The proceeds from these notes were used to bring current and redeem our outstanding Series C Preferred Stock. The notes are unsecured and rank equally and ratably with the unsecured senior indebtedness of Flagstar Bancorp, Inc.

Prior to June 15, 2021, we may redeem some or all of the 2021 Senior Notes at a redemption price equal to the greater of 100 percent of the aggregate principal amount of the notes to be redeemed or the sum of the present values of the remaining scheduled payments discounted to the redemption date on a semi-annual basis using a discount rate equal to the Treasury Rate plus 0.50 percent, plus, in each case accrued and unpaid interest.

## Trust Preferred Securities

We sponsor nine trust subsidiaries, which issued preferred stock to third party investors. We issued trust preferred securities to those trusts which we have included in long-term debt which are the sole assets of the trusts.

The trust preferred securities are callable by us at any time. Interest is payable quarterly; however, we may defer interest payments for up to 20 quarters without default or penalty. In January 2012, we exercised our contractual rights to defer interest payments. On July 14, 2016, we ended the deferral and made a \$34 million payment to bring current our previously deferred interest as of that date.

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## Note 10 - Representation and Warranty Reserve

At the time a loan is sold, an estimate of the fair value of the guarantee associated with the mortgage loans is recorded in the representation and warranty reserve in the Consolidated Statements of Financial Condition which reduces the net gain on loan sales in the Consolidated Statements of Operations. Subsequent to the sale, the liability is re-measured on an ongoing basis based on an estimate of probable losses. Changes in the estimate are recorded in the representation and warranty provision (benefit) on the Consolidated Statements of Operations.

The following table shows the activity impacting the representation and warranty reserve:

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	(Dollars in millions)			
Balance, beginning of period	\$36	\$48	\$40	\$53
Provision (benefit)				
Gain on sale reduction for representation and warranty liability	1	2	4	6
Representation and warranty provision (benefit)	(6)	(6)	(12)	(13)
Total	(5)	(4)	(8)	(7)
Charge-offs, net	1	1	—	(1)
Balance, end of period	\$32	\$45	\$32	\$45

Due to our sustained low level of charge-offs and a lower level of demands received, we have reduced our estimate of probable losses related to our representation and warranty liability as of September 30, 2016 compared to September 30, 2015.

## Note 11 — Warrants

## May Investor Warrant

We granted warrants (the "May Investor Warrants") on January 30, 2009 under anti-dilution provisions applicable to certain investors (the "May Investors") in our May 2008 private placement capital raise.

For the nine months ended September 30, 2016, 32,721 May Investor Warrants were exercised resulting in the issuance of 21,068 shares of Common Stock. The May Investors held warrants to purchase 583,240 shares at an exercise price of \$10.00 at September 30, 2016.

The May Investor Warrants do not meet the definition of a contract that is indexed to our own stock under U.S. GAAP. Therefore, the May Investor Warrants are classified as other liabilities on the Consolidated Statements of Financial Condition and are measured at fair value. Warrant liabilities are valued using a Black Scholes model and are classified within Level 2 of the valuation hierarchy. Significant observable inputs include share price, expected volatility, a risk free rate and an expected life. The warrants are accounted for under the equity method.

At September 30, 2016 and December 31, 2015, the liability from May Investors Warrants amounted to \$10 million and \$8 million, respectively. See Note 17 of the Notes to the Consolidated Financial Statements, herein, for further recurring fair value disclosures.

TARP Warrant

On January 30, 2009, in conjunction with the sale of 266,657 shares of Series C fixed rate cumulative non-convertible perpetual preferred stock ("Series C Preferred Stock"), we issued a warrant to purchase up to approximately 645,138 shares of Common Stock at an exercise price of \$62.00 per share (the "Warrant") for \$267 million.

The Warrant is exercisable through 2019 and remains outstanding subsequent to the redemption of TARP, which occurred during the third quarter 2016.



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## Note 12 - Accumulated Other Comprehensive Income (Loss)

The following table sets forth the components in accumulated other comprehensive income (loss) for each type of investment securities available-for-sale, investment securities held-to-maturity, and cash flow hedges:

	Held-to-Maturity Securities	Available-for-Sale Securities	Cash Flow Hedges	Accumulated Other Comprehensive Income (Loss) Net of Tax
(Dollars in millions)				
Accumulated other comprehensive income (loss) ("AOCI")				
Balance at December 31, 2015, net of tax	\$5	\$ —	\$ (3 )	\$ 2
Net unrealized loss, net of tax	—	17	(44 )	(27 )
Reclassifications out of AOCI	(1 )	(4 )	10	5
Balance at September 30, 2016, net of tax	\$4	\$ 13	\$ (37 )	\$ (20 )
Balance at December 31, 2014, net of tax	\$—	\$ 8	\$ —	\$ 8
Net unrealized gain, net of tax	—	9	(5 )	4
Transfer of net unrealized loss from AFS to HTM	5	(5 )	—	—
Balance at September 30, 2015, net of tax	\$5	\$ 12	\$ (5 )	\$ 12

## Note 13 – Earnings Per Share

Basic earnings per share, excluding dilution, is computed by dividing earnings available to common stockholders by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised and converted into common stock or resulted in the issuance of common stock that could then share in our earnings.

The following table sets forth the computation of basic and diluted earnings per share of common stock:

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
(Dollars in millions, except share data)				
Net income	\$57	\$ 47	\$143	\$ 125
Deferred cumulative preferred stock dividends	(2 )	(8 )	(18 )	(22 )
Net income applicable to common stockholders	\$55	\$ 39	\$ 125	\$ 103
Weighted average shares				
Weighted average common shares outstanding	56,580,264	56,436,026	56,556,188	56,419,354
Effect of dilutive securities				
May Investor warrants	364,791	339,478	339,893	290,840
Stock-based awards	988,777	431,999	831,181	340,595
Weighted average diluted common shares	57,933,806	57,207,503	57,727,262	57,050,789
Earnings per common share				
Basic earnings per common share	\$0.98	\$ 0.70	\$2.21	\$ 1.82
Effect of dilutive securities				
May Investor warrants	—	—	(0.02 )	(0.01 )
Stock-based awards	(0.02 )	(0.01 )	(0.03 )	(0.01 )

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Diluted earnings per share	\$0.96	\$ 0.69	\$2.16	\$ 1.80
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On July 29, 2016, we completed the previously announced \$267 million redemption of our Series C Preferred Stock. This transaction reduced stockholders equity by approximately \$372 million with a \$267 million reduction in Preferred Stock and a \$105 million reduction related to the payment of deferred dividends.

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Under the terms of the Series C Preferred Stock the Company was able to defer payments of dividends. We elected to defer dividend payments beginning with the February 2012 dividend. Although, while being deferred, the impact was not included in quarterly net income from continuing operations, the deferral still impacted net income applicable to common stock for the purpose of calculating earnings per share, as shown above.

## Note 14 – Income Taxes

The provision for income taxes in interim periods requires us to make a best estimate of the effective tax rate expected to be applicable for the full year. This estimated effective tax rate is then applied to interim consolidated pre-tax operating income to determine the interim provision for income taxes.

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
Provision for income taxes	\$30	\$24	\$73	\$70
Effective tax provision rate	34.3%	34.4%	33.8%	36.0%

(Dollars in millions)

We believe that it is unlikely that the unrecognized tax benefits will change by a material amount during the next 12 months. We recognize interest and penalties related to unrecognized tax benefits in provision for income taxes.

## Note 15 — Regulatory Matters

## Regulatory Capital

We, along with the Bank, must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that could have a material effect on the Consolidated Financial Statements. On January 1, 2015, the Basel III rules became effective and include transition provisions through 2018.

To be categorized as "well-capitalized," the Company and the Bank must maintain minimum tangible capital, Tier 1 capital, common equity Tier 1, and total capital ratios as set forth in the table below. We, along with the Bank, are considered "well-capitalized" at both September 30, 2016 and December 31, 2015. There have been no conditions or events that management believes have changed our or the Bank's category.

The following table shows the regulatory capital ratios as of the dates indicated:

Bancorp	Actual		For Capital Adequacy Purposes		Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in millions)					
September 30, 2016						
Tangible capital (to tangible assets)	\$ 1,225	8.88 %	N/A	N/A	N/A	N/A
Tier 1 capital (to adjusted tangible assets)	1,225	8.88 %	\$ 552	4.00 %	\$ 690	5.00 %

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Common equity Tier 1 capital (to RWA)	1,056	12.04%	395	4.50	%	570	6.50	%
Tier 1 capital (to risk-weighted assets)	1,225	13.98%	526	6.00	%	701	8.00	%
Total capital (to risk-weighted assets)	1,338	15.26%	701	8.00	%	877	10.00	%
December 31, 2015								
Tangible capital (to tangible assets)	\$1,435	11.51%	N/A	N/A		N/A	N/A	
Tier 1 capital (to adjusted tangible assets)	1,435	11.51%	\$ 499	4.0	%	\$ 624	5.0	%
Common equity Tier 1 capital (to RWA)	1,065	14.09%	340	4.5	%	491	6.5	%
Tier 1 capital (to risk-weighted assets)	1,435	18.98%	454	6.0	%	605	8.0	%
Total capital (to risk-weighted assets)	1,534	20.28%	605	8.0	%	756	10.0	%
N/A - Not applicable								

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Bank	Actual		For Capital Adequacy Purposes			Well Capitalized Under Prompt Corrective Action Provisions		
	Amount	Ratio	Amount	Ratio		Amount	Ratio	
September 30, 2016								
Tangible capital (to tangible assets)	\$ 1,459	10.55%	N/A	N/A		N/A	N/A	
Tier 1 capital (to adjusted tangible assets)	1,459	10.55%	\$ 553	4.00	%	\$ 691	5.00	%
Common equity tier 1 capital (to RWA)	1,459	16.59%	396	4.50	%	572	6.50	%
Tier 1 capital (to risk-weighted assets)	1,459	16.59%	528	6.00	%	704	8.00	%
Total capital (to risk-weighted assets)	1,571	17.87%	704	8.00	%	879	10.00	%
December 31, 2015								
Tangible capital (to tangible assets)	\$ 1,472	11.79%	N/A	N/A		N/A	N/A	
Tier 1 capital (to adjusted tangible assets)	1,472	11.79%	\$ 500	4.0	%	\$ 625	5.0	%
Common equity tier 1 capital (to RWA)	1,472	19.42%	341	4.5	%	493	6.5	%
Tier 1 capital (to risk-weighted assets)	1,472	19.42%	455	6.0	%	607	8.0	%
Total capital (to risk-weighted assets)	1,570	20.71%	607	8.0	%	758	10.0	%
N/A - Not applicable								

## Note 16 – Legal Proceedings, Contingencies and Commitments

## Legal Proceedings

We and our subsidiaries are subject to various pending or threatened legal proceedings arising out of the normal course of business operations. In addition, the Bank is routinely named in civil actions throughout the country by borrowers and former borrowers relating to the origination, purchase, sale, and servicing of mortgage loans. From time to time, governmental agencies also conduct investigations or examinations of various mortgage-related practices of the Bank. In the course of such investigations or examinations, the Bank cooperates with such agencies and provides information as requested.

We assess the liabilities and loss contingencies in connection with such pending or threatened legal and regulatory proceedings on at least a quarterly basis and establish accruals when we believe it is probable that a loss may be incurred and that the amount of such loss can be reasonably estimated. Once established, litigation accruals are adjusted, as appropriate, in light of additional information.

Management does not believe that the amount of any reasonably possible losses in excess of any amounts accrued with respect to ongoing proceedings or any other known claims will be material to our financial statements, or that the ultimate outcome of these actions will have a material adverse effect on our financial condition, results of operations or cash flows.

## DOJ litigation settlement

In 2012, the Bank entered into a Settlement Agreement with the United States Department of Justice ("DOJ") which meets the definition of a financial liability (the "DOJ Liability").

In accordance with the Settlement Agreement, we made an initial payment of \$15 million and agreed to make future annual payments totaling \$118 million. The Settlement Agreement provides that the Bank will make annual payments in increments of up to \$25 million towards the \$118 million still due upon meeting all conditions which are evaluated quarterly and include: (a) the reversal of the deferred tax asset valuation allowance, which occurred at the end of 2013;

(b) the repayment of the Fixed Rate Cumulative Perpetual Preferred Stock, Series C (the "TARP Preferred"), which occurred in the current quarter, (or, in the absence of repayment, adjusting our Bank Tier 1 Capital Ratio for any unextinguished TARP Preferred); (c) our Bank's Tier 1 Leverage Capital Ratio is 11 percent or more. Additionally, if the Bank and Bancorp become party to a business combination in which the Bank or Bancorp represent less than 33.3 percent of the resulting company's assets, such annual payments must commence twelve months after the date of that business combination.

Within six months of satisfying the conditions specified above, the Bank would make an additional payment, to occur no more frequently than annually, provided that doing so would not violate any material banking regulatory requirement or the OCC does not object in writing. Consistent with our business and regulatory requirements, Flagstar shall seek in good faith to

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fulfill the conditions, and will not undertake any conduct or fail to take any action the purpose of which is to frustrate or delay our ability to fulfill any of the above conditions.

We elected to account for the DOJ Liability under the fair value option. To determine the fair value, we utilize a discounted cash flow model. Key assumptions for the discounted cash flow model include using a discount rate as of September 30, 2016 of 7.2 percent; probability weightings of multiple cash flow scenarios and possible outcomes which contemplate the above conditions and estimates of forecasted net income, size of the balance sheet, capital levels, dividends and their impact on the timing of cash payments and the assumptions we believe a market participant would make to transfer the liability. The fair value of the DOJ Liability was \$60 million and \$84 million at September 30, 2016 and December 31, 2015, respectively.

The lower value resulted from a change in the expectation as to the timing of payments to the DOJ as a result of a \$200 million dividend from the Bank to the Bancorp and the issuance of \$250 million in Senior Notes, both of which occurred in July 2016, to a) bring current the interest payments on our trust preferred securities, b) become current on our deferred interest and dividends related to our TARP Preferred and c) repay our TARP Preferred. To support the on-going debt service and other Bancorp expenses, we also intend to reduce our Bancorp double leverage and debt to equity ratios to be more consistent with such ratios at other mid-sized banks, which would likely require further dividend payments from the Bank to the Bancorp for the foreseeable future.

## Other litigation accruals

At September 30, 2016 and December 31, 2015, excluding the fair value liability relating to the DOJ litigation settlement, our total accrual for contingent liabilities and settled litigation was \$6 million and \$2 million, respectively.

## Commitments

A summary of the contractual amount of significant commitments is as follows:

	September 30, 2016	December 31, 2015
	(Dollars in millions)	
Commitments to extend credit		
Mortgage loans interest-rate lock commitments	\$6,503	\$ 3,792
HELOC commitments	295	150
Other consumer commitments	9	22
Warehouse loan commitments	1,123	871
Standby and commercial letters of credit	24	13
Commercial and industrial commitments	165	151
Other commercial commitments	851	497

Commitments to extend credit are agreements to lend. Since many of these commitments expire without being drawn upon, the total commitment amounts do not necessarily represent future cash flow requirements. Commitments generally have fixed expiration dates or other termination clauses. We evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by us, upon extension of credit is based on management's credit evaluation of the counterparties.

We enter into mortgage interest-rate lock commitments with our customers. These commitments are considered to be derivative instruments and changes in the fair value of these commitments are recorded in the Consolidated Statements of Financial Condition in other assets. Further discussion on derivative instruments is included in Note 8 of the Notes to the Consolidated Financial Statements, herein.

We have unfunded commitments under our contractual arrangement with the HELOC borrowers. Commitments to extend, originate or purchase credit are primarily lines of credit to consumers and have specified rates and maturity dates. Many of these commitments also have adverse change clauses, which allow us to cancel the commitment due to deterioration in the borrowers' creditworthiness.



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Other consumer commitments are conditional commitments issued to accommodate the financial needs of customers. The commitments are under various terms to lend funds to consumers, which include revolving credit agreements, term loan commitments and short-term borrowing agreements.

Warehouse loan commitments are lines of credit provided to mortgage originators to fund loans they originate and then sell. The proceeds of the sale of the loans are used to repay the draw on the line used to fund the loans.

Standby and commercial letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. Standby letters of credit generally are contingent upon the failure of the customer to perform according to the terms of the underlying contract with the third party, while commercial letters of credit are issued specifically to facilitate commerce and typically result in the commitment being drawn on when the underlying transaction is consummated between the customer and the third party.

Commercial and industrial and other commercial commitments are conditional commitments issued under various terms to lend funds to business and other entities. These commitments include revolving credit agreements, term loan commitments and short-term borrowing agreements. Many of these loan commitments have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of these commitments are expected to expire without being funded, the total commitment amounts do not necessarily represent future liquidity requirements.

These instruments involve, to varying degrees, elements of credit and interest rate risk beyond the amount recognized on the Consolidated Statements of Financial Condition. Our exposure to credit losses in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. We utilize the same credit policies in making commitments and conditional obligations as we do for balance sheet instruments. Commitments to extend credit are agreements to lend to a customer as long as there is not a violation of any condition established in the contract.

We maintain a reserve for the estimate of probable credit losses inherent in unfunded commitments to extend credit. Unfunded commitments to extend credit include unfunded loans with available balances, new commitments to lend that are not yet funded, and standby and commercial letters of credit. The balance of \$3 million and \$2 million for September 30, 2016 and December 31, 2015, respectively, is reflected in other liabilities on the Consolidated Statements of Financial Condition.

Note 17 – Fair Value Measurements

We utilize fair value measurements to record or disclose the fair value on certain assets and liabilities. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability through an orderly transaction between market participants at the measurement date. The determination of fair values of financial instruments often requires the use of estimates. In cases where quoted market values in an active market are not available, we use present value techniques and other valuation methods to estimate the fair values of our financial instruments. These valuation models rely on market-based parameters when available, such as interest rate yield curves or credit spreads. Unobservable inputs may be based on management's judgment, assumptions and estimates related to credit quality, our future earnings, interest rates and other relevant inputs. These valuation methods require considerable judgment and the resulting estimates of fair value can be significantly affected by the assumptions made and methods used. Refer to Note 24 to the consolidated financial statements of the Annual Report on Form 10-K for the year ended December 31, 2015 for a description of our valuation methodologies and information about the fair value hierarchy.

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Assets and liabilities measured at fair value on a recurring basis.

The following tables present the financial instruments carried at fair value as of September 30, 2016 and December 31, 2015, by caption on the Consolidated Statement of Financial Condition and by level in the valuation hierarchy.

	Level 1	Level 2	Level 3	Total Fair Value
September 30, 2016	(Dollars in millions)			
Investment securities available-for-sale				
Agency - Commercial	\$—	\$510	\$—	\$ 510
Agency - Residential	—	573	—	573
Municipal obligations	—	32	—	32
Loans held-for-sale				
Residential first mortgage loans	—	3,352	—	3,352
Loans held-for-investment				
Residential first mortgage loans	—	8	—	8
Second mortgage loans	—	—	41	41
HELOC loans	—	—	31	31
Mortgage servicing rights	—	—	302	302
Derivative assets				
Rate lock commitments	—	—	63	63
U.S. Treasury, swap and euro dollar futures	1	—	—	1
Mortgage backed securities forwards	—	2	—	2
Interest rate swaps and swaptions	—	53	—	53
Total derivative assets	1	55	63	119
Total assets at fair value	\$1	\$4,530	\$437	\$ 4,968
Derivative liabilities				
Interest rate swap on FHLB advances	\$—	\$(52 )	\$—	\$(52 )
Mortgage backed securities forwards	—	(24 )	—	(24 )
Interest rate swaps and swaptions	—	(17 )	—	(17 )
Total derivative liabilities	—	(93 )	—	(93 )
Warrant liabilities	—	(10 )	—	(10 )
DOJ litigation settlement	—	—	(60 )	(60 )
Total liabilities at fair value	\$—	\$(103 )	\$(60 )	\$(163 )

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	Level 1	Level 2	Level 3	Total Fair Value
December 31, 2015	(Dollars in millions)			
Investment securities available-for-sale				
Agency - Commercial	\$—	\$766	\$—	\$766
Agency - Residential	—	514	—	514
Municipal obligations	—	14	—	14
Loans held-for-sale				
Residential first mortgage loans	—	2,541	—	2,541
Loans held-for-investment				
Residential first mortgage loans	—	6	—	6
Second mortgage loans	—	—	42	42
HELOC loans	—	—	64	64
Mortgage servicing rights	—	—	296	296
Derivative assets				
Rate lock commitments	—	—	26	26
Mortgage backed securities forwards	—	7	—	7
Interest rate swaps and swaptions	—	25	—	25
Total derivative assets	—	32	26	58
Total assets at fair value	\$—	\$3,873	\$428	\$4,301
Derivative liabilities				
U.S. Treasury, swap and euro dollar futures	\$(1)	\$—	\$—	\$(1)
Mortgage backed securities forwards	—	(6)	—	(6)
Interest rate swap on FHLB advances	—	(4)	—	(4)
Interest rate swaps	—	(7)	—	(7)
Total derivative liabilities	(1)	(17)	—	(18)
Warrant liabilities	—	(8)	—	(8)
DOJ litigation settlement	—	—	(84)	(84)
Total liabilities at fair value	\$(1)	\$(25)	\$(84)	\$(110)

We had no transfers of assets or liabilities recorded at fair value between fair value levels during the nine months ended September 30, 2016 and 2015.

We utilized swaptions, swap and euro dollars futures, forward agency and loan sales and interest rate swaps to manage the risk associated with mortgage servicing rights and rate lock commitments. Gains and losses for individual lines in the tables do not reflect the effect of our risk management activities related to such level 3 instruments.

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Fair value measurements using significant unobservable inputs

The tables below include a roll forward of the Consolidated Statement of Financial Condition amounts for the three and nine months ended September 30, 2016 and 2015 (including the change in fair value) for financial instruments classified by us within level 3 of the valuation hierarchy:

Three Months Ended September 30, 2016	Balance at Beginning of Period	Recorded in Earnings		Recorded in OCI		Purchases / Originations	Sales	Settlements	Transfer In (Out)	Balance at End of Period
		Total Unrealized Gains / (Losses)	Total Realized Gains / (Losses)	Total Unrealized Gains / (Losses)	Total Unrealized Gains / (Losses)					
(Dollars in millions)										
Assets										
Loans held-for-investment										
Second mortgage loans	\$38	\$ (2 )	\$ —	—	—	\$ —	\$ (3 )	\$ 8		\$ 41
HELOC loans	44	6	—	—	—	—	(11 )	(8 )		31
Mortgage servicing rights	301	(33 )	—	—	51	(17 )	—	—		302
Totals	\$383	\$ (29 )	\$ —	—	\$ 51	\$(17 )	\$(14 )	\$ —		\$ 374
Liabilities										
DOJ litigation settlement	\$(84 )	\$ 24	\$ —	—	—	\$ —	\$ —	\$ —		\$(60 )
Derivative financial instruments (net)										
Rate lock commitments	\$82	\$ 33	\$ —	—	116	\$(150)	\$(18 )	\$ —		\$ 63
Three Months Ended September 30, 2015										
Assets										
Other investments										
Other investments	\$100	\$ —	\$ —	—	—	\$ —	\$ —	\$ —		\$ 100
Loans held-for-investment										
Second mortgage loans	48	—	—	—	—	—	(3 )	—		45
HELOC loans	93	2	—	—	—	—	(15 )	—		80
Mortgage servicing rights	317	(24 )	—	—	74	(73 )	—	—		294
Totals	\$558	\$ (22 )	\$ —	—	\$ 74	\$(73 )	\$(18 )	\$ —		\$ 519
Liabilities										
Long-term debt	\$(36 )	\$ —	\$ —	—	—	\$ —	\$ 4	\$ —		\$(32 )
DOJ litigation settlement	(84 )	—	—	—	—	—	—	—		(84 )
Totals	\$(120)	\$ —	\$ —	—	—	\$ —	\$ 4	\$ —		\$(116)
Derivative financial instruments (net)										
Rate lock commitments	\$30	\$ 53	\$ —	—	81	\$(104)	\$(16 )	\$ —		\$ 44

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Nine Months Ended September 30, 2016	Balance at Beginning of Period	Recorded in Earnings		Recorded in OCI		Purchases / Originations	Sales	Settlements	Transfer In (Out)	Balance at End of Period
		Total Unrealized Gains / (Losses)	Total Realized Gains / (Losses)	Total Unrealized Gains / (Losses)	Total Unrealized Gains / (Losses)					
(Dollars in millions)										
<b>Assets</b>										
Loans held-for-investment										
Second mortgage loans	\$42	\$(1 )	\$ —	\$ —	—	\$ —	\$ (8 )	8		41
HELOC loans	64	3	—	—	—	—	(28 )	(8 )		31
Mortgage servicing rights	296	(126 )	—	—	173	(41 )	—	—		302
Totals	\$402	\$(124)	\$ —	\$ —	—\$ 173	\$(41 )	\$(36 )	\$ —		\$374
<b>Liabilities</b>										
DOJ litigation	\$(84 )	\$24	\$ —	\$ —	—	\$ —	\$ —	—		\$(60 )
Derivative financial instruments (net)										
Rate lock commitments	\$26	\$153	\$ —	\$ —	—\$ 303	\$(371)	\$(48 )	\$ —		\$63
Nine Months Ended September 30, 2015										
<b>Assets</b>										
Other investments										
Investment securities available-for-sale	\$100	\$ —	\$ —	\$ —	—\$ —	\$ —	\$ —	\$ —		\$100
Municipal obligation	2	—	—	—	—	—	(2 )	—		—
Loans held-for-investment										
Second mortgage loans	53	2	1	—	—	—	(11 )	—		45
HELOC loans	132	(4 )	—	—	—	—	(48 )	—		80
Mortgage servicing rights	258	(40 )	—	—	220	(144 )	—	—		294
Totals	\$545	\$(42 )	\$ 1	\$ —	—\$ 220	\$(144)	\$(61 )	\$ —		\$519
<b>Liabilities</b>										
Long-term debt	\$(84 )	\$ —	\$ (3 )	\$ —	—	\$24	\$ 31	\$ —		\$(32 )
DOJ litigation	(82 )	(2 )	—	—	—	—	—	—		(84 )
Totals	\$(166)	\$(2 )	\$(3 )	\$ —	—\$ —	\$24	\$ 31	\$ —		\$(116 )
Derivative financial instruments (net)										
Rate lock commitments	\$31	\$60	\$ —	\$ —	—\$ 272	\$(276)	\$(43 )	\$ —		\$44

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The following tables present the quantitative information about recurring level 3 fair value financial instruments and the fair value measurements as of September 30, 2016 and December 31, 2015:

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
September 30, 2016 (Dollars in millions)				
Assets				
Second mortgage loans	\$41	Discounted cash flows	Discount rate Constant prepayment rate Constant default rate	8.0% - 12.0% (10.0%) 10.9% - 16.4% (13.6%) 2.7% - 4.1% (3.4%)
HELOC loans	\$31	Discounted cash flows	Discount rate	6.6% - 9.9% (8.2%)
Mortgage servicing rights	\$302	Discounted cash flows	Option adjusted spread Constant prepayment rate Weighted average cost to service per loan	7.4% - 11.0% (9.2%) 12.8% - 18.5% (15.7%) \$57 - \$85 (\$71)
Liabilities				
DOJ litigation settlement	\$(60)	Discounted cash flows	Discount rate	5.7% - 8.5% (7.1%)
Derivative financial instruments				
Rate lock commitments	\$63	Consensus pricing	Origination pull-through rate	66.6% - 99.9% (83.3%)
December 31, 2015 (Dollars in millions)				
Assets				
Second mortgage loans	\$42	Discounted cash flows	Discount rate Constant prepayment rate Constant default rate	7.2% - 10.8% (9.0%) 13.5% - 20.2% (16.9%) 2.6% - 4.0% (3.3%)
HELOC loans	\$64	Discounted cash flows	Discount rate	6.8% - 10.1% (8.4%)
Mortgage servicing rights	\$296	Discounted cash flows	Option adjusted spread Constant prepayment rate Weighted average cost to service per loan	6.6% - 9.9% (8.2%) 10.3% - 14.8% (12.6%) \$57 - \$86 (\$72)
Liabilities				
DOJ litigation settlement	\$(84)	Discounted cash flows	Discount rate	4.9% - 9.5% (7.2%)
Derivative financial instruments				
Rate lock commitments	\$26	Consensus pricing	Origination pull-through rate	67.6% - 101.5% (84.6%)

## Recurring Significant Unobservable Inputs

The significant unobservable inputs used in the fair value measurement of the second mortgage loans are discount rates, constant prepayment rates, and default rates. The constant prepayment and default rates are based on a 12 month historical average. Significant increases (decreases) in the discount rate in isolation would result in a significantly lower (higher) fair value measurement. Increases (decreases) in prepay rates in isolation result in a higher (lower) fair value and increases (decreases) in default rates in isolation result in a lower (higher) fair value.

The HELOC loans are valued utilizing a loan-level discounted cash flow model which projects expected cash flows given three potential outcomes: (1) paid-in-full at scheduled maturity, (2) default at scheduled maturity (foreclosure), and (3) modification at scheduled maturity into an amortizing HELOC. Loans are placed into the potential outcome buckets based on their underlying current delinquency, FICO scores and property CLTV all of which are unobservable inputs. Estimated cash flows are then discounted back using an unobservable discount rate. Loans within the loan portfolios contain FICO scores with a minimum of 447, maximum of 816, and a weighted average of 665. For the loans, increases (decreases) in the discount rate, in isolation, would lower (higher) the fair value measurement.

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The significant unobservable inputs used in the fair value measurement of the MSR are option adjusted spreads, prepayment rates, and cost to service. Significant increases (decreases) in all three assumptions in isolation would result in a significantly lower (higher) fair value measurement. Additionally, the key economic assumptions used in determining the fair value of MSRs capitalized during the three and nine months ended September 30, 2016 and 2015 periods were as follows:

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
Weighted average life (in years)	6.7	7.9	6.9	7.9
Weighted average constant prepayment rate	13.4%	11.0%	13.5%	11.2%
Weighted average option adjusted spread	11.8%	8.9 %	9.5 %	8.7 %

The key economic assumptions reflected in the overall fair value of the entire portfolio of MSRs were as follows:

	September 30, 2016		December 31, 2015	
Weighted average life (in years)	6.0		7.3	
Weighted average constant prepayment rate	15.7	%	12.6	%
Weighted average option adjusted spread	9.2	%	8.2	%

The significant unobservable input used in the fair value measurement of the DOJ litigation settlement is the discount rate. Significant increases (decreases) in the discount rate in isolation could result in a marginally lower (higher) fair value measurement. For further information on the fair value inputs related to the DOJ litigation, see Note 16 of the Notes to the Consolidated Financial Statements, herein.

The significant unobservable input used in the fair value measurement of the rate lock commitments is the pull through rate. The pull through rate is a statistical analysis of our actual rate lock fallout history to determine the sensitivity of the residential mortgage loan pipeline compared to interest rate changes and other deterministic values. New market prices are applied based on updated loan characteristics and new fallout ratios (i.e., the inverse of the pull through rate) are applied accordingly. Significant increases (decreases) in the pull through rate in isolation would result in a significantly higher (lower) fair value measurement.



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## Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

We also have assets that under certain conditions are subject to measurement at fair value on a nonrecurring basis. These assets are measured at the lower of cost or market and had a fair value below cost at the end of the period as summarized below:

	Total	Level 2	Level 3
	(1)		
	(Dollars in		
	millions)		
September 30, 2016			
Loans held-for-sale (2)	\$10	\$10	\$—
Impaired loans held-for-investment (3)			
Residential first mortgage loans	22	—	22
Commercial and industrial loans	1	—	1
Repossessed assets (4)	15	—	15
Totals	\$48	\$10	\$38
December 31, 2015			
Loans held-for-sale (2)	\$8	\$8	\$—
Impaired loans held-for-investment (3)			
Residential first mortgage loans	40	—	40
Commercial real estate loans	2	—	2
Repossessed assets (4)	17	—	17
Totals	\$67	\$8	\$59

(1) The fair values are obtained at various dates during the nine months ended September 30, 2016 and the year ended December 31, 2015, respectively.

(2) We recorded less than \$1 million in fair value losses on loans held-for-sale for which we did not elect the fair value option (included in interest income on the Consolidated Statements of Operations) during both the three and nine months ended September 30, 2016, respectively, compared to less than \$1 million in fair value losses on loans held-for-sale during both the three and nine months ended September 30, 2015, respectively.

(3) We recorded \$11 million and \$31 million in fair value losses on impaired loans (included in provision (benefit) for loan losses on Consolidated Statements of Operations) during the three and nine months ended September 30, 2016, respectively, compared to \$20 million and \$76 million in fair value losses on impaired loans during the three and nine months ended September 30, 2015, respectively.

(4) We recorded zero and \$2 million in losses related to write downs of repossessed assets based on the estimated fair value of the specific assets during the three and nine months ended September 30, 2016, respectively, and recognized net gain of \$1 million and \$2 million on sales of repossessed assets (both write downs and net gains/losses are included in assets resolution expense on the Consolidated Statements of Operations) during the three and nine months ended September 30, 2016. We recorded \$1 million and \$2 million in losses related to write downs of repossessed assets based on the estimated fair value of the specific assets during the three and nine months ended September 30, 2015, respectively, and recognized a net gain of \$1 million and \$2 million on sales of repossessed assets during the three and nine months ended September 30, 2015, respectively.

The following tables present the quantitative information about nonrecurring level 3 fair value financial instruments and the fair value measurements as of September 30, 2016 and December 31, 2015:

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
September 30, 2016	(Dollars in millions)			
Impaired loans held-for-investment				
Residential first mortgage loans	\$22	Fair value of collateral	Loss severity discount	23% - 28% (25.6%)

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Commercial and industrial loans	\$1	Fair value of collateral	Loss severity discount	50% - 55%	(53.4%)
Repossessed assets	\$15	Fair value of collateral	Loss severity discount	35% - 98%	(61.7%)

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	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
December 31, 2015	(Dollars in millions)			
Impaired loans held-for-investment				
Residential first mortgage loans	\$40	Fair value of collateral	Loss severity discount	35% - 45% (35.2%)
Commercial real estate loans	\$2	Fair value of collateral	Loss severity discount	45% - 55% (50.1%)
Repossessed assets	\$17	Fair value of collateral	Loss severity discount	16% - 100% (48.7%)

## Nonrecurring Significant Unobservable Inputs

The significant unobservable inputs used in the fair value measurement of the impaired loans and repossessed assets are appraisals or other third-party price evaluations which incorporate measures such as recent sales prices for comparable properties.

## Fair Value of Financial Instruments

The following table presents the carrying amount and estimated fair value of financial instruments that are carried either at fair value, cost, or amortized cost:

	September 30, 2016				
	Carrying Value	Total	Level 1	Level 2	Level 3
	(Dollars in millions)				
Assets					
Cash and cash equivalents	\$174	\$174	\$174	\$—	\$ —
Investment securities available-for-sale	1,115	1,115	—	1,115	—
Investment securities held-to-maturity	1,156	1,177	—	1,177	—
Loans held-for-sale	3,393	3,394	—	3,394	—
Loans with government guarantees	404	391	—	391	—
Loans held-for-investment, net	6,147	6,134	—	8	6,126
Repossessed assets	15	15	—	—	15
Federal Home Loan Bank stock	172	172	—	172	—
Mortgage servicing rights	302	302	—	—	302
Bank owned life insurance	269	269	—	269	—
Other assets, foreclosure claims	152	152	—	152	—
Derivative financial instruments, assets	119	119	1	55	63
Liabilities					
Retail deposits					
Demand deposits and savings accounts	\$(5,204)	\$(4,961)	\$—	\$(4,961)	\$ —
Certificates of deposit	(1,083)	(1,095)	—	(1,095)	—
Government deposits	(1,176)	(1,158)	—	(1,158)	—
Company controlled deposits	(1,908)	(1,839)	—	(1,839)	—
Federal Home Loan Bank advances	(2,482)	(2,450)	—	(2,450)	—
Other long-term debt	(493)	(257)	—	(257)	—
Warrant liabilities	(10)	(10)	—	(10)	—
DOJ litigation settlement	(60)	(60)	—	—	(60)
Derivative financial instruments, liabilities	(93)	(93)	—	(93)	—



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	December 31, 2015				
	Carrying Value	Total	Level 1	Level 2	Level 3
	Estimated Fair Value				
	(Dollars in millions)				
<b>Assets</b>					
Cash and cash equivalents	\$208	\$208	\$208	\$—	\$ —
Investment securities available-for-sale	1,294	1,294	—	1,294	—
Investment securities held-to-maturity	1,268	1,262	—	1,262	—
Loans held-for-sale	2,576	2,578	—	2,578	—
Loans with government guarantees	485	469	—	469	—
Loans held-for-investment, net	6,165	6,121	—	6	6,115
Repossessed assets	17	17	—	—	17
Federal Home Loan Bank stock	170	170	—	170	—
Mortgage servicing rights	296	296	—	—	296
Bank owned life insurance	178	178	—	178	—
Other assets, foreclosure claims	210	210	—	210	—
Derivative financial instruments, assets	58	58	7	25	26
<b>Liabilities</b>					
<b>Retail deposits</b>					
Demand deposits and savings accounts	\$(5,008)	\$(4,744)	\$—	\$(4,744)	\$ —
Certificates of deposit	(826 )	(833 )	—	(833 )	—
Government deposits	(1,062 )	(1,045 )	—	(1,045 )	—
Company controlled deposits	(1,039 )	(947 )	—	(947 )	—
Federal Home Loan Bank advances	(3,541 )	(3,543 )	—	(3,543 )	—
Long-term debt	(247 )	(89 )	—	(89 )	—
Warrant liabilities	(8 )	(8 )	—	(8 )	—
DOJ litigation settlement	(84 )	(84 )	—	—	(84)
Derivative financial instruments, liabilities	(18 )	(18 )	(1 )	(17 )	—

The methods and assumptions used by us in estimating fair value of financial instruments which are required for disclosure only, are as follows:

Cash and cash equivalents. Due to their short-term nature, the carrying amount of cash and cash equivalents approximates fair value.

Investment securities held-to-maturity. Fair values are generated using market inputs, where possible, including quoted prices (the closing price in an exchange market), bid prices (the price at which a buyer stands ready to purchase), and other market information.

Loans with government guarantees. The fair value is estimated by using internally developed discounted cash flow models using market interest rate inputs as well as management's best estimate of spreads for similar collateral.

Loans held-for-investment. The fair value is estimated using internally developed discounted cash flow models using market interest rate inputs as well as management's best estimate of spreads for similar collateral.

Federal Home Loan Bank stock. No secondary market exists for Federal Home Loan Bank stock. The stock is bought and sold at par by the Federal Home Loan Bank. Management believes that the recorded value equals the fair value.

Bank owned life insurance. The fair value of bank owned life insurance policies is based on the cash surrender values of the policies as reported by the insurance companies.

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Other assets, foreclosure claims. The fair value of foreclosure claims with government guarantees approximates the carrying amount.

Deposit accounts. The fair value of deposits with no defined maturity is estimated based on a discounted cash flow model that incorporates current market rates for similar products and expected attrition. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for certificates of deposit with similar remaining maturities.

Federal Home Loan Bank advances. Rates currently available for debt with similar terms and remaining maturities are used to estimate the fair value of the existing debt.

Long-term debt. The fair value of the long-term debt is estimated based on a discounted cash flow model that incorporates current borrowing rates for similar types of borrowing arrangements.

## Fair Value Option

We elected the fair value option for certain items as discussed throughout the Notes to the Consolidated Financial Statements to mitigate a divergence between accounting losses and economic exposure. Interest income on loans held-for-sale is accrued on the principal outstanding primarily using the "simple-interest" method.

The following table reflects the change in fair value included in earnings of financial instruments for which the fair value option has been elected:

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
(Dollars in millions)				
<b>Assets</b>				
Loans held-for-sale				
Net gain on loan sales	\$151	\$134	\$440	\$276
Loans held-for-investment				
Interest income on loans	\$—	\$1	\$(2)	\$4
Other noninterest income	—	(1)	—	(35)
<b>Liabilities</b>				
Long-term debt				
Other noninterest income	\$—	\$3	\$—	\$28
Litigation settlement				
Other noninterest income	\$24	\$—	\$24	\$2
Other noninterest (expense)	\$—	\$—	\$—	\$(2)

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The following table reflects the difference between the aggregate fair value and aggregate remaining contractual principal balance outstanding as of September 30, 2016 and December 31, 2015 for assets and liabilities for which the fair value option has been elected:

	September 30, 2016 (Dollars in millions)			December 31, 2015		
	Unpaid Principal Balance	Fair Value	Fair Value Over / (Under) Unpaid Principal Balance	Unpaid Principal Balance	Fair Value	Fair Value Over / (Under) Unpaid Principal Balance
<b>Assets</b>						
Nonaccrual loans						
Loans held-for-sale	\$2	\$2	\$ —	\$1	\$—	\$ (1 )
Loans held-for-investment	18	12	(6 )	21	10	(11 )
Total nonaccrual loans	\$20	\$14	\$ (6 )	\$22	\$10	\$ (12 )
Other performing loans						
Loans held-for-sale	\$3,217	\$3,350	\$ 133	\$2,451	\$2,541	\$ 90
Loans held-for-investment	81	68	(13 )	112	101	(11 )
Total other performing loans	\$3,298	\$3,418	\$ 120	\$2,563	\$2,642	\$ 79
Total loans						
Loans held-for-sale	\$3,219	\$3,352	\$ 133	\$2,452	\$2,541	\$ 89
Loans held-for-investment	99	80	(19 )	133	111	(22 )
Total loans	\$3,318	\$3,432	\$ 114	\$2,585	\$2,652	\$ 67
<b>Liabilities</b>						
Litigation settlement (1)	\$(118 )	\$(60 )	\$ 58	\$(118 )	\$(84 )	\$ 34

(1) We are obligated to pay \$118 million in installment payments upon meeting certain performance conditions.

## Note 18 – Segment Information

Our operations are conducted through four operating segments: Mortgage Originations, Mortgage Servicing, Community Banking and Other, which includes the remaining reported activities. Operating segments are defined as components of an enterprise that engage in business activity from which revenues are earned and expenses incurred for which discrete financial information is available that is evaluated regularly by executive management in deciding how to allocate resources and in assessing performance. The operating segments have been determined based on the products and services offered and reflect the manner in which financial information is currently evaluated by management. Each segment operates under the same banking charter, but is reported on a segmented basis for this report. Each of the operating segments is complementary to each other and because of the interrelationships of the segments, the information presented is not indicative of how the segments would perform if they operated as



independent entities.

Effective January 1, 2016, we reorganized our reportable segments to align with our new management reporting structure and to align with our long-term strategy. Prior period segment financial information has been recast to conform to the current presentation. Prior to the reorganization, representation and warranty reserves were reported in the Mortgage Servicing segment and the MSR asset and associated costs were reported in the Other segment. As a result of this change, representation and warranty reserves, as well as the MSR asset and associated costs are now reported in the Mortgage Originations segment.

The Mortgage Originations segment originates, acquires and sells one-to-four family residential mortgage loans. The origination and acquisition of mortgage loans comprises the majority of the lending activity. Mortgage loans are originated through home loan centers, national call centers, the Internet and unaffiliated banks and mortgage banking and brokerage companies, where the net interest income and the gains from sales associated with these loans are recognized in the Mortgage Originations segment.

The Mortgage Servicing segment services and sub-services mortgage loans, on a fee basis, for others. Also, the Mortgage Servicing segment services, on a fee basis, residential mortgages held-for-investment by the Community Banking segment and mortgage servicing rights held by the Mortgage Originations segment. The Mortgage Servicing segment may also collect ancillary fees, such as late fees, and earns income through the use of noninterest-bearing escrows.

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The Community Banking segment originates loans, provides deposits and fee based services to consumer, business, and mortgage lending customers through its Branch Banking, Business Banking and Commercial Banking, Government Banking, Warehouse Lending and Held-for-Investment Portfolio groups. Products offered through these teams include checking accounts, savings accounts, money market accounts, certificates of deposit, consumer loans, commercial loans, home builder finance loans and warehouse lines of credit. Other financial services available to consumer and commercial customers include lines of credit, revolving credit, customized treasury management solutions, equipment leasing, inventory, and accounts receivable lending and capital markets services such as interest rate risk protection products.

The Other segment includes the treasury functions, funding revenue associated with stockholders' equity, the impact of interest rate risk management, the impact of balance sheet funding activities, and miscellaneous other expenses of a corporate nature. Treasury functions include administering the investment securities portfolios, balance sheet funding, and interest rate risk management. In addition, the Other segment includes revenue and expenses related to treasury and corporate assets and liabilities and equity not directly assigned or allocated to the Mortgage Originations, Mortgage Servicing or Community Banking operating segments.

Revenues are comprised of net interest income (before the provision (benefit) for loan losses) and noninterest income. Noninterest expenses are fully allocated to each operating segment. Allocation methodologies may be subject to periodic adjustment as the internal management accounting system is revised and the business or product lines within the segments change.

The following tables present financial information by business segment for the periods indicated:

	Three Months Ended September 30, 2016				
	Mortgage Originations	Mortgage Servicing	Community Banking	Other	Total
	(Dollars in millions)				
Summary of Operations					
Net interest income	\$21	\$ 10	\$ 54	\$(5)	\$80
Net gain on loan sales	95	—	(1)	—	94
Representation and warranty benefit	6	—	—	—	6
Other noninterest income	4	13	8	31	56
Total net interest income and noninterest income	126	23	61	26	236
(Provision) benefit for loan losses	—	—	(7)	—	(7)
Asset resolution	—	(2)	—	—	(2)
Depreciation and amortization expense	(2)	—	(1)	(5)	(8)
Other noninterest expense	(64)	(25)	(43)	—	(132)
Total noninterest expense	(66)	(27)	(44)	(5)	(142)
Income (loss) before income taxes	60	(4)	10	21	87
Provision for income taxes	—	—	—	30	30
Net income (loss)	\$60	\$(4)	\$ 10	\$(9)	\$57
Intersegment revenue	\$(1)	\$ 5	\$ —	\$(4)	\$—
Average balances					
Loans held-for-sale	\$3,400	\$ —	\$ 16	\$ —	\$3,416
Loans with government guarantees	—	432	—	—	432
Loans held-for-investment	5	—	5,843	—	5,848
Total assets	4,238	623	5,904	3,383	14,148
Deposits	—	1,853	7,273	—	9,126



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	Three Months Ended September 30, 2015				
	Mortgage Origination	Mortgage Servicing	Community Banking	Other	Total
Summary of Operations	(Dollars in millions)				
Net interest income	\$18	\$ 3	\$ 45	\$7	\$73
Net gain on loan sales	72	—	(4 )	—	68
Representation and warranty benefit	6	—	—	—	6
Other noninterest income	26	15	11	2	54
Total net interest income and noninterest income	122	18	52	9	201
(Provision) benefit for loan losses	—	—	1	—	1
Depreciation and amortization expense	(1 )	(1 )	(1 )	(3 )	(6 )
Other noninterest expense	(56 )	(27 )	(39 )	(3 )	(125 )
Total noninterest expense	(57 )	(28 )	(40 )	(6 )	(131 )
Income (loss) before income taxes	65	(10 )	13	3	71
Provision for income taxes	—	—	—	24	24
Net income (loss)	\$65	\$ (10 )	\$ 13	\$(21)	\$47
Intersegment revenue	\$3	\$ 5	\$ (4 )	\$(4 )	\$—
Average balances					
Loans held-for-sale	\$2,179	\$ —	\$ 21	\$—	\$2,200
Loans with government guarantees	—	547	—	—	547
Loans held-for-investment	4	—	5,348	60	5,412
Total assets	2,709	860	5,336	3,400	12,305
Deposits	—	1,487	6,773	—	8,260

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	Nine Months Ended September 30, 2016				
	Mortgage Origination	Mortgage Servicing	Community Banking	Other	Total
Summary of Operations	(Dollars in millions)				
Net interest income	\$61	\$ 23	\$ 150	\$2	\$236
Net gain (loss) on loan sales	251	—	8	—	259
Representation and warranty benefit	12	—	—	—	12
Other noninterest income (loss)	17	39	21	41	118
Total net interest income and noninterest income	341	62	179	43	625
(Provision) benefit for loan losses	—	—	9	—	9
Asset resolution	—	(6	) —	—	(6
Depreciation and amortization expense	(4	) (2	) (5	) (12	) (23
Other noninterest expense	(182	) (70	) (131	) (6	) (389
Total noninterest expense	(186	) (78	) (136	) (18	) (418
Income (loss) before income taxes	155	(16	) 52	25	216
Provision for income taxes	—	—	—	73	73
Net income (loss)	\$155	\$ (16	) \$ 52	\$(48)	\$143
Intersegment revenue	\$1	\$ 16	\$ (1	) \$(16)	\$—
Average balances					
Loans held-for-sale	\$2,988	\$ —	\$ 83	\$—	\$3,071
Loans with government guarantees	—	450	—	—	450
Loans held-for-investment	6	—	5,689	—	5,695
Total assets	3,688	676	5,798	3,549	13,711
Deposits	—	1,523	7,080	—	8,603

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	Nine Months Ended September 30, 2015				
	Mortgage Origination	Mortgage Servicing	Community Banking	Other	Total
	(Dollars in millions)				
Summary of Operations					
Net interest income	\$52	\$ 10	\$ 126	\$23	\$211
Net gain (loss) on loan sales	255	—	(13 )	—	242
Representation and warranty benefit	13	—	—	—	13
Other noninterest income	60	42	19	(3 )	118
Total net interest income and noninterest income	380	52	132	20	584
(Provision) benefit for loan losses	—	—	18	—	18
Asset resolution	—	(12 )	(1 )	—	(13 )
Depreciation and amortization expense	(2 )	(2 )	(4 )	(9 )	(17 )
Other noninterest expense	(174 )	(80 )	(116 )	(7 )	(377 )
Total noninterest expense	(176 )	(94 )	(121 )	(16 )	(407 )
Income (loss) before income taxes	204	(42 )	29	4	195
Provision for income taxes	—	—	—	70	70
Net income (loss)	\$204	\$ (42 )	\$ 29	\$(66)	\$125
Intersegment revenue	\$9	\$ 13	\$ (13 )	\$(9 )	\$—
Average balances					
Loans held-for-sale	\$2,052	\$ —	\$ 36	\$—	\$2,088
Loans with government guarantees	—	679	—	—	679
Loans held-for-investment	3	—	4,786	96	4,885
Total assets	2,555	1,004	4,753	3,351	11,663
Deposits	—	1,189	6,602	—	7,791

## Note 19 – Recently Issued Accounting Pronouncements

Statement of Cash Flows - In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments. This amendment addresses eight issues which current GAAP does not include specific guidance or is unclear, pertaining to: Debt Prepayment or Debt Extinguishment Costs, Settlement of Zero-Coupon Debt Instruments, Contingent Consideration Payments Made after a Business Combination, Proceeds from the Settlement of Insurance Claims, Proceeds from the Settlement of Corporate-Owned or Bank-Owned Life Insurance Policies, Distributions Received from Equity Method Investees, Beneficial Interest in Securitization Transactions, and Separately Identifiable Cash Flows and Application of the Predominance Principle. ASU 2016-16 is effective for fiscal years beginning after December 15, 2018 and early adoption is permitted. Management is currently evaluating this guidance and does not expect this guidance to have a material impact on our Consolidated Financial Statements.

Credit Losses - In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses (Topic 326). The ASU alters the current method for recognizing credit losses within the reserve account. Currently, an institution uses the incurred loss method, the new guidance will require the allowance to be recorded on day one for the contractual term of the financial asset. ASU 2016-13 is effective for fiscal years beginning after December 15, 2019. Management is currently evaluating this guidance and the impact it will have on our Consolidated Financial Statements.

Stock Compensation - In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. The amendments in ASU 2016-09 affect all entities that issue share-based payment awards to their employees. The areas for simplification in ASU 2016-09 involve several aspects of the accounting for share-based payment transactions, including the income tax

consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 is effective retrospectively for fiscal years beginning after December 15, 2016 and early adoption is permitted. Management is currently evaluating this guidance and does not expect this guidance to have a material impact on our Consolidated Financial Statements.

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Derivatives and Hedging - In March 2016, the FASB issued ASU 2016-06, Derivatives and Hedging (Topic 815) - Contingent Put and Call Options in Debt Instruments. The amendments in ASU 2016-06 clarify the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. An entity performing the assessment under the amendments in ASU 2016-06 is required to assess the embedded call (put) options solely in accordance with the four-step decision sequence. ASU 2016-06 is effective retrospectively for fiscal years beginning after December 15, 2016 and early adoption is permitted. This guidance is not expected to have a material impact upon adoption on our Consolidated Financial Statements, but disclosures to the Notes thereto will be updated per the requirements.

Leases - In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842): Section A - Leases: Amendments to the FASB Accounting Standards Codification, Section B - Conforming Amendments Related to Leases: Amendment to the FASB Accounting Standards Codification, Section C - Background Information and Basis For Conclusions. Lessees will need to recognize almost all leases on their balance sheet as a right-of-use asset and a lease liability. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Classification will be based on criteria that are largely similar to those applied in current lease accounting. ASU 2016-02 is effective retrospectively for fiscal years beginning after December 15, 2019 and early adoption is permitted. The guidance in ASU 2016-02 supersedes Topic 840, Leases. Management is currently evaluating this guidance and does not expect this guidance to have a material impact on our Consolidated Financial Statements.

Financial Instruments - In January 2016, the FASB issued ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The new standard significantly revises an entity's accounting related to the classification and measurement of investments in equity securities and the presentation of certain fair value changes for financial liabilities measured at fair value. It also amends certain disclosure requirements associated with the fair value of financial instruments. ASU 2016-01 is effective retrospectively for fiscal years beginning after December 15, 2017 and early adoption is permitted. Management is currently evaluating this guidance and does not expect this guidance to have a material impact on our Consolidated Financial Statements, if any.

Revenue from Contracts with Customers - In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." Under the amended guidance, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The FASB has voted to approve a year deferral of the effective date from January 1, 2017 to January 1, 2018, while allowing for early adoption. In April 2016, the FASB clarified the following two aspects: identifying performance obligations and the licensing implementation guidance, while retaining the related principles for those areas. In May 2016, the FASB issued ASU 2016-12 Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients, to provide a limited number of changes to its revenue recognition standard. The amendments clarify the assessment of the likelihood that revenue will be collected from a contract, the guidance for presenting sales taxes and similar taxes, and the timing for measuring customer payments that are not in cash. The amendment also says a contract should be considered complete if all, or substantially all, of its revenue has been collected prior to making the transition to the new standard. In addition, the update clarifies the disclosure requirements for businesses and other organizations that make the transition to the new standard by adjusting amounts from prior reporting periods. The effects have to be disclosed for prior periods that were adjusted. Management is currently evaluating this guidance and does not expect this guidance to have a material impact on our Consolidated Financial Statements; however, changes to disclosures in the Notes thereto will be required.



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ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Where we say "we," "us," or "our," we usually mean Flagstar Bancorp, Inc. However, in some cases, a reference to "we," "us," or "our" will include our wholly owned subsidiary Flagstar Bank, FSB (the "Bank").

**FORWARD – LOOKING STATEMENTS**

Certain statements in this Form 10-Q, including but not limited to statements included within the Management's Discussion and Analysis of Financial Condition and Results of Operations, are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, as amended. In addition, Flagstar Bancorp, Inc. also may make forward-looking statements in our other documents filed with or furnished to the SEC, and our management may make forward-looking statements orally to analysts, investors, representatives of the media and others.

Generally, forward-looking statements are not based on historical facts but instead represent management's beliefs regarding future events. Such statements may be identified by words such as believe, expect, anticipate, intend, plan, estimate, may increase, may fluctuate, and similar expressions or future or conditional verbs such as will, should, would and could. Such statements are based on management's current expectations and are subject to risks, uncertainties and changes in circumstances. Actual results and capital and other financial conditions may differ materially from those included in these statements due to a variety of factors, including without limitation the precautionary statements included within each individual business' discussion and analysis of our results of operations and the risk factors listed and described in Item 1A to Part I of our Annual Report on Form 10-K for the year ended December 31, 2015 and Item 1A to Part II of this Quarterly Report on Form 10-Q, which are incorporated by reference herein, for further information on these and other factors affecting us.

Any forward-looking statements made by or on behalf of Flagstar Bancorp, Inc. speak only as to the date they are made, and we do not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made.

## General

We are a Michigan-based savings and loan holding company founded in 1993. Our business is primarily conducted through our principal subsidiary, the Bank, a federally chartered stock savings bank founded in 1987. At September 30, 2016, based on our assets, we are one of the largest banks headquartered in Michigan, providing commercial, small business, and consumer banking services. We have three major operating segments: Community Banking, Mortgage Originations, and Mortgage Servicing. Through these lines of business, we emphasize the delivery of a complete set of mortgage and banking products and services and are distinguished by local delivery, customer service and product pricing. Our common stock is listed on the New York Stock Exchange ("NYSE") under the symbol "FBC." We are considered a controlled company for NYSE purposes, because MP Thrift Investments, L.P. ("MP Thrift") held approximately 62.9 percent of our common stock as of September 30, 2016.

Effective January 1, 2016, we reorganized our reportable segments to align with our new management reporting structure and to align with our long-term strategy. Prior period segment financial information has been recast to conform to 2016 presentation. Prior to the reorganization, representation and warranty reserves were reported in the Mortgage Servicing segment and the MSR asset and associated costs were reported in the Other segment. As a result of this change, representation and warranty reserves, as well as the MSR asset and associated costs are now reported in the Mortgage Originations segment.

Our Community Banking segment provides deposits and fee based services to consumer, business, and mortgage lending customers through our Branch Banking, Business Banking, Commercial Banking, Government Banking, Warehouse Lending and Held-for-Investment Portfolio groups. We maintain a portfolio of commercial and industrial, commercial real estate and builder finance loans with our commercial customers and we originate or purchase residential mortgage loans through referrals from our branches, consumer direct call center and our website, flagstar.com. At September 30, 2016, we operated 99 branches in Michigan. We leverage the customer relationships we have gained throughout our branch network to cross-sell products to existing customers and increase our customer base. In 2016, we also began to offer new MSR lending and equipment finance lease products.

Through our Mortgage Origination segment, we originate or purchase residential mortgage loans throughout the country and sell them into securitization pools, primarily to Federal National Mortgage Association ("Fannie Mae"), Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Government National Mortgage Association ("Ginnie Mae") (collectively, the "Agencies") or as whole loans. In addition, we originate or purchase residential first mortgage loans and other consumer loans, and commercial loans to our held-for-investment loan portfolios. Our revenues include net interest income, income from banking services we provide to customers, and noninterest income from sales of residential first mortgage loans to the Agencies, and the servicing of loans for others. The combination of our retail, broker and correspondent channels gives us broad access to customers across diverse geographies to originate, fulfill, sell and service our residential mortgage loan products.

The majority of our total loan originations during the nine months ended September 30, 2016 represented mortgage loans that were collateralized by residential first mortgages on single-family residences and were eligible for sale to the Agencies. At September 30, 2016, we originated or purchased residential mortgage loans in all 50 states, the U.S. Virgin Islands, and the District of Columbia through relationships with 556 mortgage brokers and 729 correspondents. At September 30, 2016, we also operated 31 retail locations located in 21 states, which primarily originate one-to-four family residential mortgage loans as part of our Mortgage Originations segment. In addition, we originate other consumer and commercial loans through our Community Banking segment. We continue to expand existing business lines, such as our distributed retail and direct-to-consumer mortgage origination businesses.

Our Mortgage Servicing segment services and subservices mortgage loans for others on a fee for service basis and may also collect ancillary fees, such as late fees and earn income through the use of noninterest bearing escrows. Revenue on our subserviced loans is earned on a contractual fee basis, with the fees varying based on the status of the

underlying loans.

At September 30, 2016, we had 2,881 full-time equivalent employees inclusive of account executives and loan officers.

#### Critical Accounting Policies

Various elements of our accounting policies, by their nature, are subject to estimation techniques, valuation assumptions and other subjective assessments. Certain accounting policies that, due to the judgment, estimates and assumptions in those policies are critical to an understanding of our Consolidated Financial Statements, in Item 1. Financial Statements herein. These policies relate to: (a) fair value measurements; (b) the determination of our allowance for loan losses; (c) the

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accounting for income taxes; and (d) the determination of our representation and warranty reserve. We believe the judgment, estimates and assumptions used in the preparation of our Consolidated Financial Statements and the Notes, in Item 1, are appropriate given the factual circumstances at the time. However, given the sensitivity of our Consolidated Financial Statements and the Notes, in Item 1, herein, to these critical accounting policies, the use of other judgments, estimates and assumptions could result in material differences in our results of operations and/or financial condition. For further information on our critical accounting policies, please refer to our Annual Report on Form 10-K for the year ended December 31, 2015, which is available on our website, [flagstar.com](http://flagstar.com), under the Investor Relations section, or on the website of the Securities and Exchange Commission, at [sec.gov](http://sec.gov).

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## Selected Financial Ratios

(Dollars in millions, except share data)

	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
	2016	2015	2016	2015	
Mortgage loans originated (1)	\$9,198	\$7,876	\$23,880	\$23,578	
Mortgage loans sold and securitized	\$8,723	\$7,318	\$23,611	\$21,143	
Interest rate spread	2.36	% 2.56	% 2.43	% 2.59	
Net interest margin	2.58	% 2.75	% 2.62	% 2.76	
Average common shares outstanding	56,580,238	56,436,026	56,556,188	56,419,354	
Average fully diluted shares outstanding	57,933,806	57,207,503	57,727,262	57,050,789	
Average interest earning assets	\$12,318	\$10,693	\$11,944	\$10,165	
Average interest paying liabilities	\$9,773	\$8,354	\$9,600	\$8,044	
Average stockholders' equity	\$1,379	\$1,510	\$1,515	\$1,466	
Return on average assets	1.61	% 1.52	% 1.40	% 1.43	
Return on average equity	16.53	% 12.41	% 12.59	% 11.36	
Return on average common equity	17.45	% 15.08	% 14.52	% 13.88	
Efficiency ratio	59.9	% 65.0	% 66.9	% 69.6	
Equity-to-assets ratio (average for the period)	9.75	% 12.27	% 11.05	% 12.56	
Charge-offs to average LHFI (2)	0.51	% 1.84	% 0.66	% 2.34	
Charge-offs to average LHFI, adjusted (2)(3)	0.15	% 0.61	% 0.15	% 0.43	
			September 30, December 31, September 30,		
			2016	2015	2015
Book value per common share			\$ 22.72	\$ 22.33	\$ 21.91
Number of common shares outstanding			56,597,271	56,483,258	56,436,026
Mortgage loans serviced for others			\$ 31,372	\$ 26,145	\$ 26,306
Mortgage loans subserviced for others			\$ 38,801	\$ 40,244	\$ 42,282
Weighted average service fee (basis points)			28.1	27.7	28.3
Capitalized value of mortgage servicing rights			0.96	% 1.13	% 1.12
Mortgage servicing rights to Tier 1 capital			24.60	% 20.63	% 21.10
Ratio of allowance for loan losses to LHFI (2)			2.30	% 3.00	% 3.66
Ratio of allowance for loan losses to LHFI and loans with government guarantees (2)			2.16	% 2.78	% 3.34
Ratio of nonperforming assets to total assets			0.39	% 0.61	% 0.64
Equity-to-assets ratio			9.01	% 11.14	% 12.01
Common equity-to-assets ratio			9.01	% 9.20	% 9.88
Tier 1 leverage ratio (to adjusted total assets)			8.88	% 11.51	% 11.65
Common equity Tier 1 capital ratio (to risk-weighted assets)			12.04	% 14.09	% 14.93
Total risk-based capital ratio (to risk-weighted assets)			15.26	% 20.28	% 21.64
Number of bank branches			99	99	99
Number of FTE employees			2,881	2,713	2,677

(1) Includes residential first mortgage and second mortgage loans.

(2) Excludes loans carried under the fair value option.

Excludes charge-offs of zero and \$16 million related to the sale of loans during the three months ended September 30, 2016 and September 30, 2015, respectively, and \$8 million and \$67 million related to the transfer (3) and subsequent sale of loans during the nine months ended September 30, 2016 and September 30, 2015, respectively. Also excludes charge-offs related to loans with government guarantees of \$6 million and \$13 million during the three and nine months ended September 30, 2016.



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## Summary of Operations

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
	(Dollars in millions)			
Net interest income	\$80	\$73	\$236	\$211
Provision (benefit) for loan losses	7	(1)	(9)	(18)
Total noninterest income	156	128	389	373
Total noninterest expense	142	131	418	407
Provision for income taxes	30	24	73	70
Net income	\$57	\$47	\$143	\$125
Income per share:				
Basic	\$0.98	\$0.70	\$2.21	\$1.82
Diluted	\$0.96	\$0.69	\$2.16	\$1.80

Our net income increased \$10 million for the three months ended September 30, 2016, compared to the three months ended September 30, 2015. The increase was primarily due to a \$28 million improvement in noninterest income, driven by higher net gain on loan sales, while a decrease in fair value of the DOJ settlement liability was offset by higher loss on mortgage servicing rights. The noninterest income improvement was primarily offset by higher performance driven expenses and provision for income taxes.

Net income increased \$18 million for the nine months ended September 30, 2016, compared to the nine months ended September 30, 2015. The increase was primarily driven by a \$25 million increase in net interest income and \$16 million increase in noninterest income partially offset by higher performance driven expenses and a lower benefit for loan losses. Net interest income increased as a result of asset growth and our strategic initiative to replace lower credit quality assets with higher quality residential and commercial loans. As a result of this initiative, we grew average interest earning assets by 19 percent from \$10.2 billion during the nine months ended September 30, 2015 to \$11.9 billion during the nine months ended September 30, 2016. Within noninterest income, net gain on loan sales increased \$17 million while a decrease in fair value of the DOJ settlement liability was offset by a higher loss on mortgage servicing rights driven by low interest rates which result in higher prepayments and a more competitive market.

## Net Interest Income

The following tables present on a consolidated basis interest income from average assets and liabilities, expressed in dollars and yields:

	Three Months Ended September 30,							
	2016		2015		2016		2015	
	Average Balance	Annualized InterestYield/ Rate			Average Balance	Annualized InterestYield/ Rate		
	(Dollars in millions)							
<b>Interest-Earning Assets</b>								
Loans held-for-sale	\$3,416	\$ 30	3.51	%	\$2,200	\$ 22	3.94	%
Loans held-for-investment								
Consumer loans (1)	2,580	23	3.52	%	3,367	30	3.67	%
Commercial loans (1)	3,268	33	3.96	%	2,045	20	3.80	%
Loans held-for-investment	5,848	56	3.77	%	5,412	50	3.72	%
Loans with government guarantees	432	4	3.88	%	547	5	3.37	%
Investment securities	2,516	16	2.55	%	2,313	14	2.50	%
Interest-earning deposits	106	—	0.48	%	221	—	0.53	%
Total interest-earning assets	12,318	106	3.42	%	10,693	91	3.42	%
Other assets	1,830				1,612			
Total assets	\$14,148				\$12,305			
<b>Interest-Bearing Liabilities</b>								
<b>Retail deposits</b>								
Demand deposits	\$509	\$ —	0.20	%	\$429	\$ —	0.14	%
Savings deposits	3,751	8	0.77	%	3,732	8	0.84	%
Money market deposits	250	—	0.41	%	262	—	0.33	%
Certificates of deposit	1,071	3	1.05	%	785	2	0.80	%
Total retail deposits	5,581	11	0.75	%	5,208	10	0.75	%
<b>Government deposits</b>								
Demand deposits	243	—	0.39	%	286	—	0.39	%
Savings deposits	478	1	0.52	%	445	1	0.52	%
Certificates of deposit	355	—	0.52	%	335	—	0.40	%
Total government deposits	1,076	1	0.49	%	1,066	1	0.45	%
Total deposits	6,657	12	0.71	%	6,274	11	0.70	%
Short-term debt	1,073	1	0.44	%	12	—	4.50	%
Long-term debt	1,576	7	1.81	%	1,786	5	1.17	%
Other debt	467	6	4.86	%	282	2	2.53	%
Total interest-bearing liabilities	9,773	26	1.06	%	8,354	18	0.86	%
Noninterest-bearing deposits (2)	2,469				1,986			
Other liabilities	527				455			
Stockholders' equity	1,379				1,510			
Total liabilities and stockholders' equity	\$14,148				\$12,305			
Net interest-earning assets	\$2,545				\$2,339			
Net interest income		\$ 80				\$ 73		
Interest rate spread (3)			2.36	%			2.56	%
Net interest margin (4)			2.58	%			2.75	%
Ratio of average interest-earning assets to interest-bearing liabilities			126.0	%			128.0	%

(1)



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Consumer loans include: residential first mortgage, second mortgage, HELOC, and other consumer loans.

Commercial loans include: commercial real estate, commercial and industrial, and warehouse lending loans.

(2) Includes company controlled deposits that arise due to the servicing of loans for others.

(3) Interest rate spread is the difference between rates of interest earned on interest-earning assets and rates of interest paid on interest-bearing liabilities.

(4) Net interest margin is net interest income divided by average interest-earning assets.

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	Nine Months Ended September 30,				2015			
	2016		Annualized		Average		Annualized	
	Average	Interest	Yield/		Average	Interest	Yield/	
	Balance	Rate	Rate		Balance	Rate	Rate	
	(Dollars in millions)							
<b>Interest-Earning Assets</b>								
Loans held-for-sale	\$3,071	\$ 83	3.64	%	\$2,088	\$ 61	3.91	%
<b>Loans held-for-investment</b>								
Consumer loans (1)	2,879	76	3.51	%	2,968	83	3.75	%
Commercial loans (1)	2,816	84	3.94	%	1,917	57	3.92	%
Loans held-for-investment	5,695	160	3.72	%	4,885	140	3.82	%
Loans with government guarantees	450	12	3.40	%	679	15	2.86	%
Investment securities	2,589	50	2.58	%	2,260	43	2.54	%
Interest-earning deposits	139	1	0.50	%	253	1	0.50	%
Total interest-earning assets	11,944	306	3.40	%	10,165	260	3.41	%
Other assets	1,767				1,498			
Total assets	\$13,711				\$11,663			
<b>Interest-Bearing Liabilities</b>								
<b>Retail deposits</b>								
Demand deposits	\$479	\$ 1	0.17	%	\$428	\$ —	0.14	%
Savings deposits	3,720	21	0.78	%	3,683	22	0.81	%
Money market deposits	285	1	0.44	%	253	1	0.28	%
Certificates of deposit	789	7	1.21	%	778	4	0.73	%
Total retail deposits	5,273	30	0.77	%	5,142	27	0.72	%
<b>Government deposits</b>								
Demand deposits	234	1	0.39	%	241	1	0.39	%
Savings deposits	432	2	0.52	%	406	1	0.52	%
Certificates of deposit	563	1	0.35	%	341	1	0.36	%
Total government deposits	1,229	4	0.42	%	988	3	0.44	%
Total deposits	6,502	34	0.70	%	6,130	30	0.67	%
Short-term debt	1,190	4	0.41	%	15	—	1.28	%
Long-term debt	1,587	22	1.88	%	1,595	13	1.05	%
Other debt	321	10	4.05	%	304	6	2.44	%
Total interest-bearing liabilities	9,600	70	0.97	%	8,044	49	0.81	%
Noninterest-bearing deposits (2)	2,101				1,661			
Other liabilities	495				492			
Stockholders' equity	1,515				1,466			
Total liabilities and stockholders' equity	\$13,711				\$11,663			
Net interest-earning assets	\$2,344				\$2,121			
Net interest income		\$ 236				\$ 211		
Interest rate spread (3)			2.43	%			2.59	%
Net interest margin (4)			2.62	%			2.76	%
Ratio of average interest-earning assets to interest-bearing liabilities			124.4	%			126.4	%

(1) Consumer loans include: residential first mortgage, second mortgage, HELOC, and other consumer loans.

(2) Commercial loans include: commercial real estate, commercial and industrial, and warehouse lending loans.

(2) Includes company controlled deposits that arise due to the servicing of loans for others.

(3)

Interest rate spread is the difference between rates of interest earned on interest-earning assets and rates of interest paid on interest-bearing liabilities.

(4) Net interest margin is net interest income divided by average interest-earning assets.

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### Comparison to Prior Year Quarter

Net interest income increased \$7 million for the three months ended September 30, 2016, compared to the same period in 2015, primarily due to growth in interest earning assets, partially offset by a decrease in net interest margin driven by a lower interest rate environment.

Our net interest margin for the three months ended September 30, 2016 was 2.58 percent, compared to 2.75 percent for the three months ended September 30, 2015. The decrease from 2015 was driven primarily by higher interest rates on fixed rate long term debt used to match-fund our longer duration asset growth and increased interest expense on senior debt issued in conjunction with the TARP redemption.

Interest income increased \$15 million for the three months ended September 30, 2016, compared to the same period in 2015, primarily driven by higher average loans held-for-sale and loans held-for-investment partially offset by lower interest rates on loans held-for-sale. Average loans held-for-sale increased \$1.2 billion or 55.3 percent compared to the same period in 2015, primarily due to slower deliveries of saleable mortgage loans to the Agencies during the three months ended September 30, 2016, as compared to the three months ended September 30, 2015. Average loans held-for-investment for the three months ended September 30, 2016, increased \$0.4 billion or 8.1 percent, compared to the three months ended September 30, 2015. This was primarily due to a continued shift in mix, consistent with our strategy, of \$1.3 billion in average balance of high quality, higher yielding commercial loans and corresponding decrease of \$0.8 billion in average balance of primarily lower yielding residential first mortgage loans.

Interest expense increased \$8 million for the three months ended September 30, 2016, compared to the same period in 2015, primarily driven by higher interest rates from longer term fixed rate debt taken to match-fund our longer duration asset growth and interest expense as a result of the senior debt issued in conjunction with the TARP redemption. Also impacting the increase was a \$383 million increase in interest-bearing deposits driven by growth in deposits which has been used to fund our loan growth.

### Comparison to Prior Year to Date

Net interest income increased \$25 million for the nine months ended September 30, 2016, compared to the same period in 2015, primarily driven by continued growth in interest earning assets partially offset by a decrease in the net interest margin driven by a lower interest rate environment and issuance of senior debt used for TARP redemption.

Our net interest margin for the nine months ended September 30, 2016 was 2.62 percent, compared to 2.76 percent for the nine months ended September 30, 2015. The decrease for the nine months ended September 30, 2016 was driven by higher interest rates from longer term fixed rate debt taken to match-fund our longer duration asset growth, interest expense on senior debt issued for TARP redemption and lower interest rate environment experience in 2016, partially offset from a rotation of lower spread residential mortgage loans into higher spread commercial loans.

Interest income increased \$46 million for the nine months ended September 30, 2016, compared to the same period in 2015, primarily driven by higher average loans held-for-sale and loans held-for-investment partially offset by lower interest rates. Average loans held-for-sale increased \$1.0 billion for the nine months ended September 30, 2016, compared to the same period in 2015, primarily due to an increase in average volume, partially offset by a decrease in average yield resulting from a more competitive pricing market. Average loans held-for-investment increased \$0.8 billion for the nine months ended September 30, 2016, compared to the same period in 2015, primarily due to growth in warehouse, commercial and HELOC loans, partially offset by a decrease in average yield from more competitive pricing in the residential and consumer markets.

Interest expense increased \$21 million for the nine months ended September 30, 2016, compared to the same period in 2015, primarily driven by an increase in the average balance and higher rates on debt to match-fund our longer duration asset growth. Also impacting the increase was a \$4 million increase due to \$372 million higher average

interest-bearing deposits for the nine months ended September 30, 2016, compared to the same period in 2015 and a \$4 million increase in interest expense as a result of the senior debt issued in conjunction with the TARP redemption.

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## Rate/Volume Analysis

The following tables present the dollar amount of changes in interest income and interest expense for the components of interest-earning assets and interest-bearing liabilities that are presented in the preceding table. The table below distinguishes between the changes related to average outstanding balances (changes in volume while holding the initial rate constant) and the changes related to average interest rates (changes in average rates while holding the initial balance constant). The rate/volume variances are allocated to variances due to rate.

	Three Months Ended September 30, 2016 Versus 2015 Increase (Decrease) Due to:		
	Rate	Volume	Total
	(Dollars in millions)		
<b>Interest-Earning Assets</b>			
Loans held-for-sale	\$(4)	\$ 12	\$ 8
Loans held-for-investment			
Consumer loans (1)	(1 )	(6 )	(7 )
Commercial loans (2)	2	11	13
Total loans held-for-investment	1	5	6
Loans with government guarantees	—	(1 )	(1 )
Investment securities	(4 )	6	2
Total other interest-earning assets	\$(7)	\$ 22	\$ 15
<b>Interest-Bearing Liabilities</b>			
Retail deposits			
Certificates of deposit	\$—	\$ 1	\$ 1
Total deposits	—	1	1
Short-term debt	(15)	16	1
Long-term debt	3	(1 )	2
Other debt	3	1	4
Total interest-bearing liabilities	\$(9)	\$ 17	\$ 8
Change in net interest income	\$2	\$ 5	\$ 7

(1) Consumer loans include residential first mortgage, second mortgage, HELOC, and other consumer loans.

(2) Commercial loans include commercial real estate, commercial and industrial, and warehouse lending.

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	Nine Months Ended September 30, 2016 Versus 2015 Increase (Decrease) Due to:		
	Rate	Volume	Total
	(Dollars in millions)		
<b>Interest-Earning Assets</b>			
Loans held-for-sale	\$(7 )	\$ 29	\$ 22
<b>Loans held-for-investment</b>			
Consumer loans (1)	(5 )	(2 )	(7 )
Commercial loans (2)	1	26	27
Total loans held-for-investment	(4 )	24	20
Loans with government guarantees	2	(5 )	(3 )
Investment securities	(88 )	95	7
Total other interest-earning assets	\$(97)	\$ 143	\$ 46
<b>Interest-Bearing Liabilities</b>			
<b>Retail deposits</b>			
Demand deposits	\$—	\$ 1	\$ 1
Savings deposits	(1 )	—	(1 )
Certificates of deposit	2	1	3
Total retail deposits	1	2	3
<b>Government deposits</b>			
Savings deposits	—	1	1
Total government deposits	—	1	1
Total deposits	1	3	4
Short-term debt	(49 )	53	4
Long-term debt	9	—	9
Other debt	4	—	4
Total interest-bearing liabilities	\$(35)	\$ 56	\$ 21
Change in net interest income	\$(62)	\$ 87	\$ 25

(1) Consumer loans include residential first mortgage, second mortgage, HELOC, and other consumer loans.

(2) Commercial loans include commercial real estate, commercial and industrial, and warehouse lending.

## Provision (Benefit) for Loan Losses

## Comparison to Prior Year Quarter

The provision (benefit) for loan losses was a provision of \$7 million during the three months ended September 30, 2016, compared to a benefit of \$1 million during the three months ended September 30, 2015. During the three months ended September 30, 2016, the \$7 million provision was largely to reserve for repossessed loans with government guarantees. During the three months ended September 30, 2015, the benefit for loan losses included charge-offs of \$24 million and net originations of \$5 million offset by a release of reserves of \$30 million related to loan sales.

Net charge-offs for the three months ended September 30, 2016 decreased to \$7 million, compared to \$24 million for the three months ended September 30, 2015. For the three months ended September 30, 2016 and September 30, 2015, net charge-offs included \$6 million and zero of net charge-offs associated with loans with government guarantees,

respectively. For the three months ended September 30, 2015, net charge-offs included \$16 million associated with the sale or transfer of \$233 million unpaid principal balance of interest-only and non-agency loans. As a percentage of the average loans held-for-investment, net charge-offs for the three months ended September 30, 2016 decreased to 0.51 percent from 1.84 percent for the three months ended September 30, 2015. Excluding the charge-offs associated with loan sales or transfers and loans with government guarantees, net charge-offs as a percentage of the average loans held-for-investment were 0.15 percent during the three months ended September 30, 2016, compared to 0.61 percent during the three months ended September 30, 2015.



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## Comparison to Prior Year to Date

The provision (benefit) for loan losses was a benefit of \$9 million during the nine months ended September 30, 2016, compared to an \$18 million benefit during the nine months ended September 30, 2015. The \$9 million benefit resulted primarily from the sale of \$1.2 billion unpaid principal balance of performing residential first mortgage loans and \$110 million of unpaid principal balance of nonperforming, TDR and non-agency loans during the nine months ended September 30, 2016. During the nine months ended September 30, 2015, the provision (benefit) for loan losses included a net reduction in the allowance for loan losses relating to several loan sales, including a net reduction in the allowance relating to interest-only residential first mortgage loans, partially offset by an increase related to the growth in average loans held-for-investment loan portfolio.

Net charge-offs for the nine months ended September 30, 2016 decreased to \$28 million, compared to \$82 million for the nine months ended September 30, 2015. For the nine months ended September 30, 2016, net charge-offs included \$8 million associated with the sale of \$110 million unpaid principal balance of nonperforming, TDR and non-agency loans and \$13 million of net charge-offs associated with loans with government guarantees. For the nine months ended September 30, 2015, net charge-offs included \$67 million associated with the sale or transfer of interest-only residential first mortgage loans with unpaid principal balances totaling \$600 million, along with \$420 million of nonperforming, TDR and non-agency first mortgage loans. As a percentage of the average loans held-for-investment, net charge-offs for the nine months ended September 30, 2016 decreased to 0.66 percent from 2.34 percent for the nine months ended September 30, 2015. Excluding the charge-offs associated with loan sales or transfers and loans with government guarantees, net charge-offs as a percentage of the average loans held-for-investment were 0.15 percent during the nine months ended September 30, 2016, compared to 0.43 percent during the nine months ended September 30, 2015.

See the section captioned "Allowance for Loan Losses" in this discussion for further analysis of the provision (benefit) for loan losses.

## Noninterest Income

The following table sets forth the components of our noninterest income:

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
	(Dollars in millions)			
Net gain on loan sales	\$94	\$68	\$259	\$242
Loan fees and charges	22	17	56	53
Deposit fees and charges	5	7	17	19
Loan administration income	4	8	14	19
Net (loss) return on mortgage servicing rights	(11 )	12	(21 )	19
Net (loss) gain on sale of assets	—	1	(2 )	(1 )
Representation and warranty benefit	6	6	12	13
Other noninterest income	36	9	54	9
Total noninterest income	\$156	\$128	\$389	\$373



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The following loans held-for-sale table provides information on our net gain on loan sales reported in our consolidated financial statements and loans sold within the period:

	Three Months Ended					
	September 30, 2016	June 30, 2016	March 31, 2016	December 31, 2015	September 30, 2015	
	(Dollars in millions)					
Mortgage rate lock commitments (fallout-adjusted) (1)	\$8,291	\$8,127	\$6,863	\$5,027	\$6,495	
Net margin on mortgage rate lock commitments (fallout-adjusted) (1) (2)	1.13	% 1.04	% 0.96	% 0.92	% 1.05	%
Net gain on loan sales on HFS	\$94	\$85	\$66	\$46	\$68	
Net (loss) return on the mortgage servicing rights	\$(11)	\$(4)	\$(6)	\$9	\$12	
Gain on loan sales HFS + net (loss) return on the MSR	\$83	\$81	\$60	\$55	\$80	
Residential loans serviced (number of accounts - 000's) (3)	366	358	340	361	369	
Capitalized value of mortgage servicing rights	0.96	% 0.99	% 1.06	% 1.13	% 1.12	%
Mortgage loans sold and securitized	8,723	7,940	6,948	5,164	7,318	
Net margin on loan sales	1.08	% 1.07	% 0.94	% 0.90	% 0.93	%

(1) Fallout adjusted refers to mortgage rate lock commitments which are adjusted by a percentage of mortgage loans in the pipeline that are not expected to close based on our historical experience and the level of interest rates.

(2) Gain on sale margin is based on net gain on loan sales related to held-for-sale loans to fallout-adjusted mortgage rate lock commitments.

(3) Includes serviced for own loan portfolio, serviced for others and subserviced for others loans.

### Comparison to Prior Year Quarter

Total noninterest income was \$156 million during the three months ended September 30, 2016, which was a \$28 million increase from \$128 million during the three months ended September 30, 2015.

Net gain on loan sales increased \$26 million to \$94 million during the three months ended September 30, 2016, compared to \$68 million for the three months ended September 30, 2015. The increase was primarily due to higher fallout-adjusted locks which increased to \$8.3 billion during the three months ended September 30, 2016, compared to \$6.5 billion in the three months ended September 30, 2015 driven by a low interest rate environment in the third quarter of 2016. The fallout-adjusted net margin on mortgage rate lock commitments, excluding loans held-for-investment, increased 8 basis points to 1.13 percent during the three months ended September 30, 2016, compared to 1.05 percent for the three months ended September 30, 2015.

For the three months ended September 30, 2016, loan fees and charges increased \$5 million to \$22 million, as compared to \$17 million for the three months ended September 30, 2015. The increase in loan fees and charges during the three months ended September 30, 2016, primarily reflects higher mortgage loan closings.

For the three months ended September 30, 2016, loan administration income decreased \$4 million to \$4 million, as compared to \$8 million for the three months ended September 30, 2015. The decrease was primarily due to a decrease in fees charged on loans serviced for others.

Net loss on mortgage servicing rights was \$11 million for the three months ended September 30, 2016, compared to a return of \$12 million during the three months ended September 30, 2015. The \$23 million decrease was primarily due to higher prepayments and higher prepayment assumptions resulting in changes in fair value related to sales including a \$7 million change associated with pending MSR sales with a fair value of \$50 million expected to close in the fourth

quarter 2016.

Other noninterest income increased \$27 million to \$36 million during the three months ended September 30, 2016, compared to \$9 million for the three months ended September 30, 2015. The increase was almost entirely due to a \$24 million reduction in the fair value of the Company's DOJ settlement liability. The reduction of the DOJ liability was a result of a change in the expectation as to the timing of payments.

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Comparison to Prior Year to Date

Total noninterest income was \$389 million during the nine months ended September 30, 2016, which was a \$16 million increase from \$373 million during the nine months ended September 30, 2015.

Net gain on loan sales increased \$17 million during the nine months ended September 30, 2016, as compared to the same period in 2015. The increase was primarily due to higher fallout-adjusted lock volume and a \$14 million gain resulting from the sale of performing loans held-for-investment, partially offset by lower margin. The fallout-adjusted net margin on mortgage rate lock commitments, excluding loans held-for-investment decreased 13 basis points to 1.05 percent during the nine months ended September 30, 2016, compared to 1.18 percent for the nine months ended September 30, 2015.

Loan fees and charges increased \$3 million during the nine months ended September 30, 2016 to \$56 million, as compared to \$53 million during the nine months ended September 30, 2015. The increase is primarily due to higher mortgage loan closings.

Loan administration income decreased \$5 million during the nine months ended September 30, 2016 to \$14 million, as compared to \$19 million during the nine months ended September 30, 2015. The decrease was primarily due to a decrease in fee revenue from loans subserviced for others.

Net loss on mortgage servicing rights was \$21 million for the nine months ended September 30, 2016, compared to a return of \$19 million during the nine months ended September 30, 2015. The \$40 million decrease was primarily due to higher prepayments and a decrease in fair value driven by pending MSR sales.

Other noninterest income increased \$45 million during the nine months ended September 30, 2016, compared to the nine months ended September 30, 2015. The increase was primarily due to the benefit related to the decrease in the fair value of the DOJ settlement liability, gain on sale of available-for-sale investment securities and income earned on our bank owned life insurance whose average balances increased along with lower adjustments related to assets and liabilities held at fair value.

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## Noninterest Expense

The following table sets forth the components of our noninterest expense:

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
	(Dollars in millions)			
Compensation and benefits	\$69	\$58	\$203	\$178
Commissions	16	10	40	31
Occupancy and equipment	21	20	64	60
Asset resolution	2	—	6	13
Federal insurance premiums	3	6	9	18
Loan processing expense	13	14	40	40
Legal and professional expense	5	10	20	27
Other noninterest expense	13	13	36	40
Total noninterest expense	\$142	\$131	\$418	\$407
Efficiency ratio	59.9 %	65.0 %	66.9 %	69.6 %

## Comparison to Prior Year Quarter

Noninterest expense increased \$11 million to \$142 million during the three months ended September 30, 2016, compared to \$131 million during the three months ended September 30, 2015. The increase was primarily driven by investment in new strategic initiatives, higher stock compensation expense and increased business activity, primarily offset by a decrease in legal and professional expense.

## Comparison to Prior Year to Date

Noninterest expense was \$418 million for the nine months ended September 30, 2016 and \$407 million during the nine months ended September 30, 2015. The increase was primarily due to a \$25 million increase in compensation and benefits, and \$9 million in commissions driven by investment in new strategic initiatives, higher stock compensation expense and increased business activity. This increase was partially offset by a \$9 million decrease in federal insurance premiums due to an improvement in our risk profile along with a \$7 million decrease in asset resolution expense primarily due to a decrease in default servicing and foreclosure costs and a \$7 million decrease in legal and professional expense.

Other noninterest expense decreased \$4 million for the nine months ended September 30, 2016, compared to the nine months ended September 30, 2015, primarily driven by lower litigation settlement expenses. Additionally, in the second quarter 2016, we had a litigation settlement expense of \$6 million related to the settlement of a class action lawsuit during the period which was offset by a favorable settlement with a vendor for which we were the plaintiff.

## Provision for Income Taxes

Our provision for income taxes for the three and nine months ended September 30, 2016 was \$30 million and \$73 million, respectively, compared to a provision of \$24 million and \$70 million during the three and nine months ended September 30, 2015, respectively. Our effective tax rate for the three and nine months ended September 30, 2016 was 34.3 percent and 33.8 percent, respectively, compared to 34.4 percent and 36.0 percent for the three and nine months ended September 30, 2015, respectively. The effective rate for the three and nine months ended September 30, 2016 differs from the combined federal and state statutory tax rate primarily due to benefits associated with state tax

settlements and non-taxable bank owned life insurance earnings, partially offset by an increase in warrant expense and other nondeductible expenses.

For further information relating to income taxes, see Note 14 of the Notes to the Consolidated Financial Statements, herein.

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## OPERATING SEGMENTS

## Overview

For detail on each segment's objectives, strategies, and priorities, please read this section in conjunction with Note 18 of the Notes to Consolidated Financial Statements, herein, for a full understanding of our consolidated financial performance.

Effective January 1, 2016, we reorganized our reportable segments to align with our new management reporting structure and to align with our long-term strategy. All prior periods were reclassified to be consistent with the current presentation. Prior to the reorganization, representation and warranty reserves were reported in the Mortgage Servicing segment and the MSR asset and associated costs were reported in the Other segment. As a result of this change, representation and warranty reserves, as well as the MSR asset and associated costs are now reported in the Mortgage Originations segment.

The net income (loss) by operating segment is presented in the following table:

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
	(Dollars in millions)			
Mortgage Originations	\$60	\$65	\$155	\$204
Mortgage Servicing	(4 )	(10 )	(16 )	(42 )
Community Banking	10	13	52	29
Other	(9 )	(21 )	(48 )	(66 )
Total net income	\$57	\$47	\$143	\$125

## Mortgage Originations

## Comparison to Prior Year Quarter

The Mortgage Originations segment net income decreased \$5 million to \$60 million during the three months ended September 30, 2016, compared to \$65 million in the three months ended September 30, 2015. The decrease was primarily due to a \$23 million lower net return on MSRs resulting from increased runoff related to lower interest rates, primarily offset by a \$24 million increase in net gain on loan sales resulting from a \$1.5 billion increase in fallout-adjusted locks and a higher margin.

## Comparison to Prior Year to Date

The Mortgage Originations segment reported net income of \$155 million for the nine months ended September 30, 2016, compared to net income of \$204 million for the nine months ended September 30, 2015. The decrease was primarily driven by \$40 million lower net return on MSRs resulting from increased runoff related to lower interest rates and increased expectations for prepayments, as well as \$7 million higher commissions related to higher mortgage originations.

## Mortgage Servicing



Comparison to Prior Year Quarter

The Mortgage Servicing segment reported a net loss of \$4 million for the three months ended September 30, 2016, compared to a net loss of \$10 million for the three months ended September 30, 2015. The \$6 million improvement was primarily due to a \$6 million increase in interest income on company controlled deposits as a result of higher average balances and a decrease in loan processing expense.

Comparison to Prior Year to Date

The Mortgage Servicing segment reported a net loss of \$16 million for the nine months ended September 30, 2016, compared to a net loss of \$42 million for the nine months ended September 30, 2015. The \$26 million improvement was primarily due to \$13 million increase in interest income on company controlled deposits resulting from higher average balances, a \$6 million decrease in asset resolution expense and a decrease in loan processing expense.

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### Community Banking

#### Comparison to Prior Year Quarter

During the three months ended September 30, 2016, the Community Banking segment reported net income of \$10 million, compared to \$13 million for the three months ended September 30, 2015. The \$3 million decrease in net income was primarily due to an increase of \$10 million in net interest income due to growth in warehouse, commercial, and home builder finance loan balances, partially offset by a higher provision expense on higher loan balances and charge-offs.

#### Comparison to Prior Year to Date

During the nine months ended September 30, 2016, the Community Banking segment reported net income of \$52 million, compared to \$29 million for the nine months ended September 30, 2015. The \$23 million increase in net income was primarily due to a \$24 million increase in net interest income resulting from growth in our warehouse, commercial, and home builder finance loan balances. In addition, we had a net gain on loan sales of \$21 million which was primarily driven by the sale of performing residential first mortgage loans out of the held-for-investment portfolio during the nine months ended September 30, 2016. These increases were primarily offset by a \$15 million increase in other noninterest expenses and a \$9 million increase in provision for loan losses.

### Other

#### Comparison to Prior Year Quarter

For the three months ended September 30, 2016, the Other segment net loss was \$9 million, as compared to a net loss of \$21 million for the three months ended September 30, 2015. The \$12 million improvement was primarily due to an increase in noninterest income due to a \$24 million decrease in the fair value of the DOJ settlement liability, partially offset by an increase in interest expenses on higher average outstanding FHLB advances and senior debt issued for TARP redemption.

#### Comparison to Prior Year to Date

For the nine months ended September 30, 2016, the Other segment net loss was \$48 million compared to \$66 million for the nine months ended September 30, 2015. The \$18 million improvement was primarily due to an increase in noninterest income due to a \$24 million decrease in the fair value of the DOJ settlement liability, primarily offset by higher average outstanding FHLB advances and senior debt issued for TARP redemption.

## RISK MANAGEMENT

Like all financial services companies, we engage in certain business activities and assume the related risks. The risks we are subject to, in the normal course of business, include, but are not limited to, credit, regulatory compliance, legal, reputation, liquidity, market, operational and strategic. Our risk management activities are focused on ensuring we properly identify, measure, and manage such risks across the entire enterprise to maintain safety and soundness and maximize profitability. We hold capital to protect from the risk of unexpected loss.

A comprehensive discussion of risk management and capital matters affecting us can be found in the Risk Factors section included in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2015. Some of the more significant processes used to manage and control credit, liquidity, market, operational and capital risks are described in the following paragraphs.

## Credit Risk

Credit risk is the risk of loss to us arising from an obligor's inability or failure to meet contractual payment or performance terms. Like other financial services institutions, we make loans, extend credit, purchase securities, and enter into financial derivative contracts, all of which have related credit risk. The majority of our credit risk is associated with lending activities, as the acceptance and management of credit risk is central to profitable lending.

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## Mortgage Originations

Our Mortgage Originations segment originates, acquires and sells one-to-four family residential mortgage loans. We sell substantially all of the residential mortgage loans we produce into the secondary market on a whole loan basis or securitizing the loans into mortgage-backed securities with the Agencies. We utilize production channels to originate or acquire mortgage loans and each production channel originates mortgage loan products which are underwritten to the same standards. We expect to continue to leverage technology to streamline the mortgage origination process, thereby bringing service and convenience to brokers and correspondents. We also continue to make available to our customers various web-based tools that facilitate the mortgage loan origination process through each of our production channels. Brokers and correspondents are able to register and lock loans, check the status of inventory, deliver documents in electronic format, generate closing documents, and request funds through the Internet. Funding for our Mortgage Originations segment is provided primarily by deposits held in our Community Banking segment and borrowings.

**Correspondent.** In a correspondent transaction, an unaffiliated bank or mortgage company completes the loan paperwork and also supplies the funding for the loan at closing. After the bank or mortgage company has funded the transaction, we purchase the loan at a market price. We perform a full review of each loan, whether purchased in bulk or not, purchasing only those that were originated in accordance with our underwriting guidelines. We have active correspondent relationships with 729 companies, including banks, credit unions and mortgage companies located in all 50 states.

**Broker.** In a broker transaction, an unaffiliated bank or mortgage brokerage company completes several steps of the loan origination process including the loan paperwork, but the loans are underwritten on a loan-level basis to our underwriting standards and we supply the funding for the loan at closing (also known as "table funding") thereby becoming the lender of record. Currently, we have active broker relationships with 556 mortgage brokers, credit unions and mortgage brokerage companies located in all 50 states.

**Retail.** Our retail channel combines two business lines, home lending and direct-to-consumer. In a home lending transaction, loans are originated through our nationwide network of stand-alone home loan centers. At September 30, 2016, we maintained 31 retail locations in 21 states. In a direct-to-consumer lending transaction, loans are originated through our Community Banking segment banking centers and from a national direct-to-consumer call center. When loans are originated on a retail basis, most aspects of the lending process are completed internally, including the origination documentation (inclusive of customer disclosures), as well as the funding of the transactions. Our centralized loan processing provides efficiencies and allows lending sales staff to focus on originations.

We are a leading national originator of mortgage loans based on our residential first mortgage loan originations. The following tables disclose residential first mortgage loan originations by channel, type and mix for each respective period:

	Three Months Ended				
	September 30, 2016	June 30, 2016	March 31, 2016	December 31, 2015	September 30, 2015
	(Dollars in millions)				
Correspondent	\$6,994	\$6,200	\$4,761	\$4,115	\$5,584
Broker	1,555	1,625	1,270	1,406	1,930
Retail	643	496	312	294	353
Total	\$9,192	\$8,321	\$6,343	\$5,815	\$7,867
Purchase originations	\$3,898	\$3,837	\$2,688	\$2,875	\$4,357
Refinance originations	5,294	4,484	3,655	2,940	3,510

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Total	\$9,192	\$8,321	\$6,343	\$5,815	\$7,867
Conventional	\$5,062	\$4,763	\$3,799	\$3,351	\$4,452
Government	2,328	2,060	1,525	1,416	1,908
Jumbo	1,802	1,498	1,019	1,048	1,507
Total	\$9,192	\$8,321	\$6,343	\$5,815	\$7,867

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## Mortgage Servicing

The Mortgage Servicing segment services and subservices mortgage loans for others on a fee for service basis and may also collect ancillary fees and earn income through the use of noninterest bearing escrows. The Mortgage Servicing segment services residential mortgages for our own held-for-investment loan portfolio in the Community Banking segment for which it earns revenue via an intercompany service fee allocation. The segment also services and subservices loans for others, which primarily includes servicing Agency loans. Revenue for those serviced and subserviced loans is earned on a contractual fee basis, with the fees varying based on our responsibilities and the status of the underlying loans.

The following table presents the unpaid principal balance (net of write downs) of residential loans serviced and the number of accounts associated with those loans. We are a top 25 mortgage servicer in the nation.

	September 30, 2016		December 31, 2015	
	Amount	Number of accounts	Amount	Number of accounts
	(Dollars in millions)			
Residential loan servicing				
Serviced for own loan portfolio (1)	\$5,645	29,052	\$6,088	30,683
Serviced for others	31,372	138,711	26,145	118,662
Subserviced for others (2)	38,801	198,400	40,244	211,740
Total residential loans serviced (2)	\$75,818	366,163	\$72,477	361,085

(1) Includes loans held-for-investment (residential first mortgage, second mortgage, and HELOC), loans held-for-sale (residential first mortgage), loans with government guarantees and repossessed assets.

(2) Does not include temporary short-term subservicing performed as a result of sales of servicing-released mortgage servicing rights. Includes repossessed assets.

## Loans held-for-investment

Loans held-for-investment decreased from \$6.4 billion at December 31, 2015, to \$6.3 billion at September 30, 2016. This decrease was primarily due to a decrease in performing residential first mortgage loans from loan sales of \$1.2 billion unpaid principal balance resulting from a change in management's intent, partially offset by an increase in our higher spread, relationship-based commercial loan portfolio.

For further information relating to the concentration of credit of our loans held-for-investment, see Note 4 of the Notes to the Consolidated Financial Statements, herein.

Residential first mortgage loans. We originate or purchase various types of conforming and non-conforming fixed and adjustable rate loans underwritten using Fannie Mae and Freddie Mac guidelines for the purpose of purchasing or refinancing owner occupied and second home properties. The LTV requirements vary depending on occupancy, property type, loan amount, and FICO. Loans with LTVs exceeding 80 percent are required to obtain mortgage insurance.

At September 30, 2016, the largest geographic concentrations of our residential first mortgage loans in our held-for-investment portfolio were in California, Michigan and Florida, which represented 54.3 percent of such loans outstanding.



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The following table identifies our held-for-investment residential mortgages by major category, at September 30, 2016 and December 31, 2015:

	Unpaid Principal Balance (1)	Average Note Rate	Average Original FICO Score	Average Current FICO Score (2)	Weighted Average Maturity (months)	Average Original LTV Ratio	Housing Price Index LTV, as recalculated (3)
September 30, 2016 (Dollars in millions)							
Residential first mortgage loans							
Amortizing	\$2,040	3.47 %	754	755	319	66.2 %	56.8 %
Interest-only (4)	70	3.67 %	758	761	324	59.4 %	50.0 %
Other (5)	10	3.55 %	710	727	259	68.8 %	58.2 %
Total residential first mortgage loans	\$2,120	3.47 %	754	755	319	66.0 %	56.6 %
December 31, 2015							
Residential first mortgage loans							
Amortizing	\$2,999	3.52 %	752	752	304	68.3 %	62.5 %
Interest-only (4)	64	3.48 %	753	755	320	62.0 %	55.1 %
Other (5)	13	3.29 %	710	728	268	69.0 %	62.1 %
Total residential first mortgage loans	\$3,076	3.52 %	752	752	304	68.2 %	62.4 %

(1) Unpaid principal balance, net of write downs, does not include premiums or discounts.

(2) Current FICO scores obtained at various times during the nine months ended September 30, 2016.

(3) The HPI LTV is updated from the original LTV based on Metropolitan Statistical Area-level, Office of Federal Housing Enterprise Oversight ("OFHEO") data as of June 30, 2016.

(4) Includes only those loans that are currently in the interest-only phase of repayment. Loans originated as interest-only that are now amortizing are included in amortizing loans.

(5) Primarily Option ARMs.



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The following table identifies our residential first mortgage loans held-for-investment by major category, at September 30, 2016:

September 30, 2016	Unpaid Principal Balance (1)	Average Note Rate	Average Original FICO Score	Average Current FICO Score (2)	Weighted Average Maturity (months)	Average Original LTV Ratio	Housing Price Index LTV, as recalculated (3)
(Dollars in millions)							
Residential first mortgage loans							
Amortizing							
3/1 ARM	\$55	3.95 %	706	710	215	75.7 %	53.9 %
5/1 ARM	733	3.18 %	758	758	314	62.9 %	52.8 %
7/1 ARM	872	3.28 %	766	766	348	65.2 %	58.6 %
Other ARM	130	3.46 %	744	751	330	73.7 %	53.7 %
Fixed mortgage loans	250	4.85 %	717	713	254	73.4 %	63.8 %
Total amortizing	2,040	3.47 %	754	755	319	66.2 %	56.8 %
Interest-only							
3/1 ARM	1	3.28 %	616	687	254	69.0 %	62.5 %
5/1 ARM	9	3.28 %	733	724	266	69.6 %	76.0 %
7/1 ARM	1	3.21 %	694	723	244	53.4 %	51.3 %
Other ARM	53	3.43 %	771	776	343	55.6 %	41.8 %
Other interest-only	6	6.50 %	711	705	266	77.2 %	81.2 %
Interest-only (4)	70	3.67 %	758	761	324	59.4 %	50.0 %
Other (5)	10	3.55 %	710	727	259	68.8 %	58.2 %
Total residential first mortgage loans	\$2,120	3.47 %	754	755	319	66.0 %	56.6 %

(1) Unpaid principal balance, net of write downs, does not include premiums or discounts.

(2) Current FICO scores obtained at various times during the nine months ended September 30, 2016.

(3) The HPI LTV is updated from the original LTV based on Metropolitan Statistical Area-level OFHEO data as of June 30, 2016.

(4) Includes only those loans that are currently in the interest-only phase of repayment. Loans originated as interest-only that are now amortizing are included in amortizing loans.

(5) Primarily Option ARMs.

Adjustable-rate mortgage loans. Adjustable rate mortgage ("ARM") loans held-for-investment were originated using Fannie Mae and Freddie Mac guidelines as a base framework, and the debt-to-income ratio guidelines and documentation typically followed the automated underwriting system guidelines. Our underwriting guidelines were designed with the intent to minimize layered risk. The maximum ratios allowable for purposes of both the LTV ratio and the combined loan-to-value ("CLTV") ratio, which includes second mortgages on the same collateral, was 95 percent, but subordinate (or second mortgage) financing was not allowed over a 95 percent LTV ratio. At a 95 percent LTV ratio with private mortgage insurance, the minimum acceptable FICO score, or the "floor," was 620, and at lower LTV ratio levels, the FICO floor was also 620.

Set forth below as of September 30, 2016, are the amounts of the ARM loans in our held-for-investment loan portfolio with interest rate reset dates in the periods noted. As noted in the above table, loans may reset more than once over a three-year period and nonperforming loans do not reset while in the nonperforming status. Accordingly, the table below may include the same loans in more than one period. In addition, the table below excludes purchased loan portfolios.

1<sup>st</sup> Quarter   2<sup>nd</sup> Quarter   3<sup>rd</sup> Quarter   4<sup>th</sup> Quarter  
(Dollars in millions)

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2016 (1)	N/A	N/A	N/A	\$ 105
2017	\$113	\$ 118	\$ 121	114
2018	115	122	124	116
Later years (2)	347	575	863	850

N/A - Not applicable

(1) Reflects loans that have reset through September 30, 2016.

(2) Later years reflect one reset period per loan.

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Second mortgage loans. The majority of second mortgages we currently originate are closed in conjunction with the closing of the residential first mortgages originated by us. We generally require the same levels of documentation and ratios as with our residential first mortgages. Our current allowable debt-to-income ratio for approval of second mortgages is capped at 43 percent. We currently limit the maximum CLTV to 80 percent and FICO scores to a minimum of 680. Current fixed rate loans are available with terms up to 15 years. The second mortgage loans require full documentation and are underwritten and priced to ensure high credit quality and loan profitability.

Home Equity Line of Credit loans. Underwriting guidelines for our HELOC originations have been established to attract higher credit quality loans with long-term profitability. The minimum FICO is 680, maximum CLTV up to 89 percent, and the maximum debt-to-income ratio is 43 percent. HELOCs are adjustable-rate loans that generally contain a 10-year interest-only draw period followed by a 20-year amortizing period. We also offer HELOC loans for a term period of five to 15 years to repay. The minimum FICO is 680, maximum CLTV up to 89 percent, and the maximum debt-to-income ratio is 43 percent. Included in HELOC loans are interest-only loans. At September 30, 2016, the unpaid principal balance of our interest-only mortgage loans was \$70 million.

Commercial loans held-for-investment. During the nine months ended September 30, 2016, we have continued to grow our longer term commercial real estate and commercial and industrial loans. Our Business and Commercial Banking group includes relationships with relationship managers primarily throughout Michigan's major markets. Our commercial loans held-for-investment totaled \$3.7 billion at September 30, 2016 and \$2.7 billion at December 31, 2015. The portfolio consists of three loan types: commercial real estate, commercial and industrial, and warehouse loans, each of which is discussed in more detail below.

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The following table identifies the commercial loans held-for-investment portfolio by loan type and selected criteria at September 30, 2016 and December 31, 2015:

## Commercial Loans Held-for-Investment

	September 30, 2016			December 31, 2015		
	Balance	Average Note Rate		Balance	Average Note Rate	
(Dollars in millions)						
Commercial real estate loans:						
Fixed rate	\$55	4.8 %		\$52	4.9 %	
Adjustable rate	1,118	3.2 %		769	2.8 %	
Total commercial real estate loans (1)	1,173			821		
Net deferred fees and other	(5 )			(7 )		
Total commercial real estate loans, net	\$1,168			\$814		
Commercial and industrial loans:						
Fixed rate	\$86	4.2 %		\$44	4.7 %	
Adjustable rate	629	3.8 %		512	3.0 %	
Total commercial and industrial loans	715			556		
Net deferred fees and other	(7 )			(4 )		
Total commercial and industrial loans, net	\$708			\$552		
Warehouse loans:						
Adjustable rate	\$1,835	3.4 %		\$1,367	3.4 %	
Net deferred fees and other	(41 )			(31 )		
Total warehouse loans, net	\$1,794			\$1,336		
Total commercial loans:						
Fixed rate	\$141	4.4 %		\$96	4.8 %	
Adjustable rate	3,582	3.4 %		2,648	3.1 %	
Total commercial loans	3,723			2,744		
Net deferred fees and other	(53 )			(42 )		
Total commercial loans, net	\$3,670			\$2,702		

(1) Includes \$252 million and \$188 million, respectively, of commercial owner occupied real estate loans at September 30, 2016 and December 31, 2015.

Commercial real estate loans. Our commercial real estate held-for-investment loan portfolio is comprised of loans that are collateralized by real estate properties intended to be income-producing in the normal course of business. This portfolio also includes owner occupied real estate loans, in addition to secured home builder loans.

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The following table discloses our total unpaid principal balance (net of write downs) of commercial real estate held-for-investment loans by borrower geographic concentration and collateral type at September 30, 2016:

Collateral Type	State				Total (1)
	Michigan	Florida	California	Other	
	(Dollars in millions)				
Office	\$188	\$—	\$ 7	\$—	\$195
Retail	126	33	9	20	188
Apartments	130	—	—	42	172
Industrial	131	—	25	4	160
Single family residence, which includes land	44	21	—	53	118
Hotel/motel	62	—	—	—	62
Parking Garage/Lot	58	—	—	—	58
Special Purpose	49	1	1	—	51
Senior living facility	42	—	—	—	42
Shopping Center	36	—	—	4	40
Non Profit	32	—	—	—	32
Other	15	8	12	20	55
Total	\$913	\$ 63	\$ 54	\$143	\$1,173
Percent	77.8 %	5.4 %	4.6 %	12.2 %	100.0 %

(1) Unpaid principal balance, net of write downs, does not include premiums or discounts.

Includes \$252 million of commercial owner occupied real estate loans at September 30, 2016.

Commercial and industrial loans. Commercial and industrial held-for-investment loan facilities typically include lines of credit and term loans to small and middle market businesses for use in normal business operations to finance working capital needs, equipment purchases, and expansion projects. Most of our commercial and industrial loans earn interest at a variable rate and we offer our customers the ability to enter into interest rate swaps for which we offset our risk by entering into offsetting market trades.

Warehouse lending. We also offer warehouse lines of credit to other mortgage lenders. These allow the lender to fund the closing of residential first mortgage loans. Each extension or draw-down on the line is collateralized by mortgage loans being funded and is paid off once the underlying loan is sold to an outside investor which may be ourselves. Underlying mortgage loans are predominately originated using the agencies' underwriting standards. We believe we are increasing market share in the warehouse lending market through our strategic initiative to increase lending to customers who originate loans they then sell to outside third party investors. The aggregate committed amount of adjustable rate warehouse lines of credit granted to other mortgage lenders at September 30, 2016 was \$2.7 billion, of which \$1.8 billion was outstanding, compared to \$2.2 billion at December 31, 2015, of which \$1.3 billion was outstanding.

### Credit Quality

Management considers a number of qualitative and quantitative factors in assessing the level of our allowance for loan losses. See the section captioned "Allowance for Loan Losses" in this discussion. As illustrated in the following tables, trends in certain credit quality characteristics such as nonperforming loans and past due statistics continue to show improvement. This is predominantly a result of the nonperforming and TDR loan sales, as well as run off of the legacy portfolios and the addition of new loans with strong credit characteristics to the held-for-investment portfolio.



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The following table sets forth certain information about our nonperforming assets as of the end of each of the last five quarters:

## NONPERFORMING LOANS AND ASSETS

	September 30, 2016	June 30, 2016	March 31, 2016	December 31, 2015	September 30, 2015
	(Dollars in millions)				
Nonperforming loans held-for-investment	\$23	\$23	\$27	\$31	\$37
Nonperforming TDRs	8	6	6	7	6
Nonperforming TDRs at inception but performing for less than six months	9	15	20	28	20
Total nonperforming loans held-for-investment (1)	40	44	53	66	63
Real estate and other nonperforming assets	15	19	14	17	17
Nonperforming assets held-for-investment, net	\$55	\$63	\$67	\$83	\$80
Ratio of nonperforming assets to total assets	0.39%	0.46 %	0.49 %	0.61 %	0.64 %
Ratio of nonperforming loans held-for-investment to loans held-for-investment	0.63%	0.76 %	0.95 %	1.05 %	1.15 %
Ratio of allowance for loan losses to loans held-for-investment (2)	2.30%	2.62 %	2.93 %	3.00 %	3.66 %
Ratio of allowance for loan losses to LHFI and loans with government guarantees (2)	2.16%	2.43 %	2.70 %	2.78 %	3.34 %
Ratio of net charge-offs to average loans held-for-investment (annualized) (2)	0.51%	0.62 %	0.86 %	0.62 %	1.84 %
Ratio of nonperforming assets to loans held-for-investment and repossessed assets	0.87%	1.09 %	1.20 %	1.32 %	1.45 %
Ratio of nonperforming assets to Tier 1 capital + allowance for loan losses	4.03%	3.79 %	4.15 %	5.12 %	5.03 %

Does not include nonperforming loans held-for-sale of \$5 million, \$5 million, \$6 million, \$12 million and \$14 (1) million at September 30, 2016, June 30, 2016, March 31, 2016, December 31, 2015 and September 30, 2015, respectively.

(2) Excludes loans carried under the fair value option.

## Past due loans held-for-investment

For all portfolios within the consumer and commercial loan portfolio, loans are placed on nonaccrual status when any portion of principal or interest is 90 days past due (or nonperforming), or earlier when we become aware of information indicating that collection of principal and interest is in doubt. While it is the goal of management to collect on loans, we attempt to work out a satisfactory repayment schedule or modification with past due borrowers and will undertake foreclosure proceedings if the delinquency is not satisfactorily resolved. Our practices regarding past due loans are designed to both assist borrowers in meeting their contractual obligations and minimize losses incurred by the Bank. When a loan is placed on nonaccrual status, the accrued interest income is reversed. Loans return to accrual status when principal and interest become current and are anticipated to be fully collectible. At September 30, 2016, we had \$48 million of past due loans held-for-investment. Of those past due loans, \$40 million were nonperforming. At December 31, 2015, we had \$80 million of past due loans held-for-investment. Of those past due loans, \$66 million were nonperforming. The decrease from December 31, 2015 to September 30, 2016 was primarily due to improved asset quality and the sale of nonperforming residential first mortgage loans.

Consumer loans. As of September 30, 2016, nonperforming consumer loans decreased from December 31, 2015, primarily due to the sale of nonperforming residential first mortgage loans. Net charge-offs in consumer loans totaled

\$7 million and \$28 million for the three and nine months ended September 30, 2016, respectively, compared to \$21 million and \$81 million during the three and nine months ended September 30, 2015, respectively, primarily due to the charge-offs of \$8 million and \$67 million related to the sale or transfer of loans during the nine months ended September 30, 2016 and September 30, 2015, respectively.

Commercial loans. As of September 30, 2016, there were no nonperforming commercial loans, compared to \$2 million at December 31, 2015. There were no net charge-offs in commercial loans for the nine months ended September 30, 2016, compared to recoveries of \$2 million for the nine months ended September 30, 2015.



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The following table sets forth information regarding past due loans held-for-investment at the dates listed:

Days Past Due	September 30, 2016		December 31, 2015	
	(Dollars in millions)			

30 – 59 days				
Consumer loans				
Residential first mortgage	\$ 4		\$ 7	
HELOC	1		2	
Other	1		1	
Total 30-59 days past due	6		10	
60 – 89 days				
Consumer loans				
Residential first mortgage	1		3	
HELOC	—		1	
Other	1		—	
Total 60-89 days past due	2		4	
90 days or greater				
Consumer loans				
Residential first mortgage	29		53	
Second mortgage	4		2	
HELOC	7		9	
Commercial loans				
Commercial and industrial	—		2	
Total 90 days or greater past due (1)	40		66	
Total past due loans	\$ 48		\$ 80	

(1) Includes performing nonaccrual loans that are less than 90 days delinquent and for which interest cannot be accrued.

The \$32 million decrease in total past due loans at September 30, 2016, compared to December 31, 2015 was primarily due to improved asset quality coupled with the sale of \$20 million of nonperforming residential first mortgage loans during the nine months ended September 30, 2016. The 30 to 59 days past due loans decreased to \$6 million at September 30, 2016, compared to \$10 million at December 31, 2015, primarily driven by improved asset quality.

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The following table sets forth information regarding loans held-for-investment and nonperforming loans (i.e., 90 days or greater past due loans) as to which we have ceased accruing interest:

September 30, 2016

Loans Held-for-Investment	Nonaccrual Loans	As a % of		As a % of		
		Loan Portfolio	Specified Portfolio	Nonaccrual Loans	Nonaccrual Loans	
(Dollars in millions)						
Consumer loans						
Residential first mortgage	\$2,136	\$ 29	1.4	%	72.5	%
Second mortgage	127	4	3.1	%	10.0	%
HELOC	326	7	2.1	%	17.5	%
Other consumer	30	—	—	%	—	%
Total consumer loans	2,619	40	1.5	%	100.0	%
Commercial loans						
Commercial real estate	1,168	—	—	%	—	%
Commercial and industrial	708	—	—	%	—	%

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