FLAGSTAR BANCORP INC
Form 10-Q
November 06, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2017
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 Incorporation or organization)	(I.R.S. Employer 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 ý 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 ý No ¨.

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

Large accelerated filer¨	Accelerated filer ý
Non-accelerated filer o (Do not check if smaller reporting company)	Smaller reporting company ¨
	Emerging growth company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 7(a)(2)(B) of the Securities Act ¨.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No ý.

As of November 2, 2017, 57,181,536 shares of the registrant’s common stock, $0.01 par value, were issued and outstanding.

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GLOSSARY OF ABBREVIATIONS AND ACRONYMS

The following list of abbreviations and acronyms are provided as a tool for the reader and may be used throughout this Report, including the Consolidated Financial Statements and Notes:

Term	Definition	Term	Definition
AFS	Available for Sale	HELOC	Home Equity Lines of Credit
Agencies	Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association, Collectively	HELOAN	Home Equity Loan
ALCO	Asset Liability Committee	Home equity	second mortgages, HELOANs, HELOCs
ALLL	Allowance for Loan & Lease Losses	HTM	Held to Maturity
AOCI	Accumulated Other Comprehensive Income (Loss)	LIBOR	London Interbank Offered Rate
ASU	Accounting Standards Update	LHFI	Loans Held-for-Investment
Basel III	Basel Committee on Banking Supervision Third Basel Accord	LHFS	Loans Held-for-Sale
C&I	Commercial and Industrial	LTV	Loan-to-Value
CDARS	Certificates of Deposit Account Registry Service	Management	Flagstar Bancorp’s Management
CFPB	Consumer Financial Protection Bureau	MBIA	MBIA Insurance Corporation
CLTV	Combined Loan to Value	MBS	Mortgage-Backed Securities
Common Stock	Common Shares	MD&A	Management's Discussion and Analysis
CRE	Commercial Real Estate	MSR	Mortgage Servicing Rights
DFAST	Dodd-Frank Stress Test	N/A	Not Applicable
DOJ	United States Department of Justice	NYSE	New York Stock Exchange
DTA	Deferred Tax Asset	OCC	Office of the Comptroller of the Currency
EVE	Economic Value of Equity	OTTI	Other-Than-Temporary-Impairment
Fannie Mae/FNMA	Federal National Mortgage Association	QTL	Qualified Thrift Lending
FASB	Financial Accounting Standards Board	RWA	Risk Weighted Assets
FDIC	Federal Deposit Insurance Corporation	SEC	Securities and Exchange Commission
FEMA	Federal Emergency Management Agency	SFR	Single Family Residence
FHA	Federal Housing Administration	TARP Preferred	Troubled Asset Relief Program Fixed Rate Cumulative Perpetual Preferred Stock, Series C
FHLB	Federal Home Loan Bank	TDR	Trouble Debt Restructuring
FICO	Fair Isaac Corporation	UPB	Unpaid Principal Balance
FRB	Federal Reserve Bank	U.S. Treasury	United States Department of Treasury
Freddie Mac	Federal Home Loan Mortgage Corporation	VIE	Variable Interest Entities
FTE	Full Time Equivalent	XBRL	eXtensible Business Reporting Language
GAAP	United States Generally Accepted Accounting Principles		

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PART I. FINANCIAL INFORMATION
ITEM 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following is Management's Discussion and Analysis of the financial condition and results of operations of Flagstar Bancorp, Inc. for the third quarter of 2017, which should be read in conjunction with the financial statements and related notes set forth in Part I, Item 1 of this Form 10-Q and Part II, Item 8 of Flagstar Bancorp, Inc.'s 2016 Annual Report on Form 10-K for the year ended December 31, 2016.

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. These statements are based on the current beliefs and expectations of our management. Actual results may differ from those set forth in forward-looking statements. See Forward-Looking Statements on page 38 of this Form 10-Q and Part I, Item 1A, Risk Factors of Flagstar Bancorp, Inc.'s 2016 Annual Report or Form 10-K for the year ended December 31, 2016. Additional information about Flagstar can be found on our website at www.flagstar.com.

Where we say "we," "us," "our," the "Company," "Bancorp" or "Flagstar," we usually mean Flagstar Bancorp, Inc. However, in some cases, a reference to "we," "us," "our," the "Company" or "Flagstar" will include our wholly-owned subsidiary Flagstar Bank, FSB (the "Bank"). See the Glossary of Abbreviations and Acronyms on page 3 for definitions used throughout this Form 10-Q.

Introduction

We are a leading 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. Based on our assets at September 30, 2017, we are one of the largest banks headquartered in Michigan, providing commercial, small business, and consumer banking services, and the 5th largest bank mortgage originator in the nation. At September 30, 2017, we had 3,495 full-time equivalent employees inclusive of account executives and loan officers. Our common stock is listed on the NYSE under the symbol "FBC." As of September 30, 2017, we are considered a controlled company for NYSE purposes, because approximately 62.3 percent of our common stock is owned by MP Thrift Investments, L.P. which is managed by MatlinPatterson, a leading global alternative asset manager.

We have a unique, relationship-based business model which leverages our full-service bank’s capabilities with our national mortgage customer base to create and build enduring commercial relationships with growth opportunities. Our banking network emphasizes the delivery of a complete set of banking and mortgage products and services and we distinguish ourselves by crafting specialized solutions for our customers, local delivery, high quality customer service and competitive product pricing. Our community bank growth model has focused on attracting seasoned bankers with larger, regional bank lending experience who can bring their long-term customer relationships to Flagstar. At September 30, 2017, we operated 99 full service banking branches throughout Michigan's major markets where we offer a full set of banking products to consumer, commercial, and government customers.

We originate mortgages through a wholesale network of brokers and correspondents in all 50 states, as well as 95 retail locations in 27 states, representing the combined retail branches of Flagstar and Opes Advisors' mortgage division. The Bank has the opportunity to expand these relationships by providing warehouse lending, mortgage servicing and other services to our third party originators. Servicing and subservicing of loans provides fee income and generates a stable long-term source of funding through company controlled deposits.

We believe our transformation into a strong commercial bank, our flexible mortgage servicing platform, and focus on service creates a significant competitive advantage in the markets in which we compete. The management team we have assembled is focused on developing substantial and attractive growth opportunities that generate profitable results from operations. We believe our lower risk profile and strong capital level position us to take advantage of opportunities to deliver attractive shareholder returns over the long term.

Operating Segments

Our operations are conducted through our three operating segments: Community Banking, Mortgage Originations, and Mortgage Servicing. Additionally, our Other segment includes the remaining reported activities. For additional information, please see MD&A - Operating Segments and Note 19 - Segment Information.

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Selected Financial Ratios
(Dollars in millions, except share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016 (1)	2017	2016 (1)
Selected Mortgage Statistics:				
Mortgage rate lock commitments (fallout-adjusted) (2)	$8,898	$8,291	$23,896	$23,281
Mortgage loans sold and securitized	8,924	8,723	22,397	23,611
Selected Ratios:				
Interest rate spread	2.58 %	2.36 %	2.56 %	2.43 %
Net interest margin	2.78 %	2.58 %	2.74 %	2.62 %
Return on average assets	0.99 %	1.61 %	0.94 %	1.40 %
Return on average equity	11.10 %	16.53 %	10.23 %	12.59 %
Return on average common equity	11.10 %	17.45 %	10.23 %	14.52 %
Equity/assets ratio (average for the period)	8.95 %	9.75 %	9.16 %	11.05 %
Efficiency ratio	73.5 %	59.9 %	73.9 %	66.9 %
Effective tax provision rate	32.4 %	34.3 %	32.3 %	33.8 %
Average Balances:				
Average common shares outstanding	57,162,025	56,580,238	57,062,696	56,556,188
Average fully diluted shares outstanding	58,186,593	57,933,806	58,133,296	57,727,262
Average interest-earning assets	$14,737	$12,318	$13,709	$11,944
Average interest paying liabilities	$12,297	$9,773	$11,481	$9,600
Average stockholders' equity	$1,471	$1,379	$1,412	$1,515

	September 30, 2017	December 31, 2016	September 30, 2016 (1)
Selected Statistics:			
Book value per common share	$ 25.38	$ 23.50	$ 22.72
Tangible book value per share (3)	$ 25.01	$ 23.50	$ 22.72
Number of common shares outstanding	57,181,536	56,824,802	56,597,271
Equity-to-assets ratio	8.60 %	9.50 %	9.01 %
Common equity-to-assets ratio	8.60 %	9.50 %	9.01 %
Capitalized value of MSRs	1.15 %	1.07 %	0.96 %
Bancorp Tier 1 leverage (to adjusted avg. total assets) (4)	8.80 %	8.88 %	8.88 %
Bank Tier 1 leverage (to adjusted avg. total assets)	9.38 %	10.52 %	10.55 %
Number of banking centers	99	99	99
Number of FTE	3,495	2,886	2,881

(1) Includes redemption of TARP Preferred occurring on July 29, 2016, which resulted in a reduction of $372 million in stockholder's equity. Also, includes $250 million issuance of 6.125% Senior Note occurring on July 11, 2016, which was used to redeem and bring current the dividends on the TARP Preferred.

(2) 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 previous historical experience and the level of interest rates.

(3) Excludes goodwill and intangibles of $21 million, zero, and zero at September 30, 2017, December 31, 2016, and September 30, 2016, respectively, included in Other Assets on the Consolidated Statement of Financial Condition. See Non-GAAP Financial Measures for further information.

(4) Basel III transitional.

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Executive Overview

The third quarter 2017 resulted in solid earnings of $40 million, or $0.70 per diluted share. Our transformation into a strong commercial bank continued this quarter. In the nine months ended September 30, 2017, net interest income was $47 million on average earning asset growth of $1.8 billion, or 15 percent led by increases in our commercial loan portfolio. The expansion of our commercial loan portfolio has generated net interest income growth and provides earnings stability in a challenging mortgage environment. We also continued to maintain solid liquidity and disciplined deposit growth, which saw total average deposits increase $244 million, or 3 percent in the first nine months of 2017 driven by higher retail deposits.

Even in the currently challenging mortgage market, our mortgage closings increased 3 percent in the nine months ended September 30, 2017 compared to the first nine months ended September 30, 2016 driven by our 2017 acquisitions of Opes Advisors (Opes) and the delegated correspondent business of Stearns Lending (Stearns). Our gain on loan sale margin was 84 basis points at September 30, 2017 reflecting the increase in distributed retail due to the integration of Opes. We believe this shift in mix should positively impact our gain on sale margin going forward.

Our noninterest expense increased $47 million in the first nine months ended September 30, 2017 compared to the nine months ended September 30, 2016 largely due to our ongoing growth initiatives and operating expenses from Opes. The remaining expenses, associated with balance sheet expansion and growing Community Bank revenues, reflected our cost discipline and had a very low, incremental efficiency ratio. Credit costs were negligible, as net charge-offs, nonperforming loans and delinquencies remain at very low levels.

The federal banking agencies issued a notice of proposed rulemaking (NPR) regarding several proposed simplifications of the Basel III capital rules. If enacted as proposed, these changes would accelerate the capital formation necessary to support further balance sheet growth, improve our capital flexibility to better manage the uncertainties of the MSR market and allow us to hold more MSRs which are a high yielding asset that we fund efficiently and hedge well. We believe this should improve our position to continue to execute on our business strategy, matching superior asset generation capabilities, supported by the capital and liquidity to grow the Bank prudently, thereby creating value for our shareholders.

Earnings Performance

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2017	2016	Change	2017	2016	Change
	(Dollars in millions, except share data)					
Net interest income	$103	$80	$23	$283	$236	$47
Provision (benefit) for loan losses	2	7	(5)	4	(9)	13
Total noninterest income (1)	130	156	(26)	346	389	(43)
Total noninterest expense	171	142	29	465	418	47
Provision for income taxes	20	30	(10)	52	73	(21)
Net income	$40	$57	$(17)	$108	$143	$(35)
Income per share						
Basic	$0.71	$0.98	$(0.27)	$1.90	$2.21	$(0.31)
Diluted	$0.70	$0.96	$(0.26)	$1.86	$2.16	$(0.30)

(1)

Included in both the three and nine months ended September 30, 2016 is a $24 million benefit ($16 million after tax benefit) related to a decrease in the fair value of the Department of Justice ("DOJ") settlement liability.

Net income decreased $17 million for the three months ended September 30, 2017, compared to the three months ended September 30, 2016. Net interest income increased $23 million for the three months ended September 30, 2017, compared to the three months ended September 30, 2016 primarily driven by a $2.4 billion increase in interest-earning assets led by strong commercial loan growth and higher LHFS along with an increase in average rates. The improvement in net interest income was more than offset by a $29 million increase in noninterest expense primarily driven by ongoing growth initiatives and operating expenses associated with the recent acquisition of Opes and a $26 million decrease in noninterest income primarily resulting from a $24 million decrease in the fair value of the DOJ settlement liability we recognized in the third quarter of 2016.

Net income decreased $35 million for the nine months ended September 30, 2017, compared to the nine months ended September 30, 2016. Net interest income increased $47 million for the nine months ended September 30, 2017, compared to the nine months ended September 30, 2016, primarily driven by growth in interest-earning assets, partially offset by a $9 million

increase in interest expense related to our Senior Notes which were issued in the third quarter 2016 to fund the redemption of our TARP Preferred. The increase in net interest income was offset by an increase in noninterest expense of $47 million, primarily driven by an increase in operating expenses associated with our 2017 acquisitions of Opes and Stearns. In addition, we had a decrease in noninterest income of $43 million, primarily due to lower net gain on loan sales and a $24 million decrease in the fair value of the DOJ settlement liability recognized in the third quarter of 2016. In the nine months ended September 30, 2017, our provision for loan losses of $4 million reflects the strong credit quality of our loan portfolios and the sustained low level of net charge-offs. The $9 million benefit for loan losses for the nine months ended September 30, 2016 resulted primarily from the sale of $1.2 billion UPB of performing residential first mortgage loans and $110 million UPB of nonperforming, TDR and non-agency loans.

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,					
	2017			2016		
	Average Balance	Interest	Annualized Yield/ Rate	Average Balance	Interest	Annualized Yield/ Rate
	(Dollars in millions)					
Interest-Earning Assets						
Loans held-for-sale	$4,476	$ 45	3.99 %	$3,416	$ 30	3.51 %
Loans held-for-investment						
Residential first mortgage	2,594	22	3.32 %	2,090	17	3.17 %
Home equity	486	6	5.11 %	460	6	5.03 %
Other	26	—	4.52 %	30	—	4.59 %
Total Consumer loans	3,106	28	3.61 %	2,580	23	3.52 %
Commercial Real Estate	1,646	19	4.43 %	1,082	9	3.43 %
Commercial and Industrial	1,073	13	4.77 %	633	7	4.27 %
Warehouse Lending	978	12	4.82 %	1,553	17	4.21 %
Total Commercial loans	3,697	44	4.63 %	3,268	33	3.96 %
Total loans held-for-investment (1)	6,803	72	4.16 %	5,848	56	3.77 %
Loans with government guarantees	264	3	4.58 %	432	4	3.88 %
Investment securities	3,101	20	2.58 %	2,516	16	2.55 %
Interest-earning deposits	93	—	1.23 %	106	—	0.48 %
Total interest-earning assets	14,737	140	3.77 %	12,318	106	3.42 %
Other assets	1,702			1,830		
Total assets	$16,439			$14,148		
Interest-Bearing Liabilities						
Retail deposits						
Demand deposits	$489	$ —	0.14 %	$509	$ —	0.20 %
Savings deposits	3,838	7	0.76 %	3,751	8	0.77 %
Money market deposits	276	—	0.57 %	250	—	0.41 %
Certificates of deposit	1,182	4	1.19 %	1,071	3	1.05 %
Total retail deposits	5,785	11	0.78 %	5,581	11	0.75 %
Government deposits						
Demand deposits	250	—	0.43 %	243	—	0.39 %
Savings deposits	362	1	0.71 %	478	1	0.52 %
Certificates of deposit	329	1	0.89 %	355	—	0.52 %
Total government deposits	941	2	0.70 %	1,076	1	0.49 %
Wholesale deposits and other	35	—	1.49 %	—	—	—%
Total interest-bearing deposits	6,761	13	0.78 %	6,657	12	0.71 %
Short-term Federal Home Loan Bank advances and other	3,809	11	1.17 %	1,073	1	0.44 %
Long-term Federal Home Loan Bank advances	1,234	6	1.99 %	1,576	7	1.81 %
Other long-term debt	493	7	5.09 %	467	6	4.86 %
Total interest-bearing liabilities	12,297	37	1.19 %	9,773	26	1.06 %
Noninterest-bearing deposits (2)	2,244			2,469		
Other liabilities	427			527		
Stockholders' equity	1,471			1,379		
Total liabilities and stockholders' equity	$16,439			$14,148		

Net interest-earning assets	$2,440			$2,545		
Net interest income		$ 103			$ 80	
Interest rate spread (3)		2.58	%		2.36	%
Net interest margin (4)		2.78	%		2.58	%
Ratio of average interest-earning assets to interest-bearing liabilities		119.9	%		126.0	%

(1) Includes nonaccrual loans, for further information relating to nonaccrual loans, see Note 4 - Loans Held-for-Investment.
(2) Includes noninterest-bearing 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.

	Nine Months Ended September 30,							
	2017				2016			
	Average Balance	Interest	Annualized Yield/ Rate		Average Balance	Interest	Annualized Yield/ Rate	
	(Dollars in millions)							
Interest-Earning Assets								
Loans held-for-sale	$4,014	$ 119	3.96	%	$3,071	$ 83	3.64	%
Loans held-for-investment								
Residential first mortgage	2,497	62	3.34	%	2,365	56	3.14	%
Home equity	453	17	5.04	%	485	19	5.23	%
Other	26	1	4.52	%	29	1	4.82	%
Total Consumer loans	2,976	80	3.61	%	2,879	76	3.51	%
Commercial Real Estate	1,482	47	4.15	%	936	24	3.40	%
Commercial and Industrial	929	33	4.71	%	601	19	4.12	%
Warehouse Lending	840	30	4.70	%	1,279	41	4.25	%
Total Commercial loans	3,251	110	4.45	%	2,816	84	3.94	%
Total loans held-for-investment (1)	6,227	190	4.05	%	5,695	160	3.72	%
Loans with government guarantees	300	10	4.41	%	450	12	3.40	%
Investment securities	3,093	59	2.55	%	2,589	50	2.58	%
Interest-earning deposits	75	1	1.08	%	139	1	0.50	%
Total interest-earning assets	13,709	379	3.68	%	11,944	306	3.40	%
Other assets	1,697				1,767			
Total assets	$15,406				$13,711			
Interest-Bearing Liabilities								
Retail deposits								
Demand deposits	$502	$ 1	0.16	%	$479	$ 1	0.17	%
Savings deposits	3,899	22	0.76	%	3,720	21	0.78	%
Money market deposits	264	1	0.49	%	285	1	0.44	%
Certificates of deposit	1,116	9	1.12	%	789	7	1.21	%
Total retail deposits	5,781	33	0.76	%	5,273	30	0.77	%
Government deposits								
Demand deposits	228	1	0.41	%	234	1	0.39	%
Savings deposits	410	2	0.59	%	432	2	0.52	%
Certificates of deposit	314	1	0.73	%	563	1	0.35	%
Total government deposits	952	4	0.59	%	1,229	4	0.42	%
Wholesale deposits and other	16	—	1.21	%	—	—	—	%
Total interest-bearing deposits	6,749	37	0.74	%	6,502	34	0.70	%
Short-term Federal Home Loan Bank advances and other	3,028	23	1.01	%	1,190	4	0.41	%
Long-term Federal Home Loan Bank advances	1,211	17	1.92	%	1,587	22	1.88	%
Other long-term debt	493	19	5.06	%	321	10	4.05	%
Total interest-bearing liabilities	11,481	96	1.12	%	9,600	70	0.97	%
Noninterest-bearing deposits (2)	2,098				2,101			
Other liabilities	415				495			
Stockholders’ equity	1,412				1,515			
Total liabilities and stockholders' equity	$15,406				$13,711			
Net interest-earning assets	$2,228				$2,344			
Net interest income		$ 283				$ 236		
Interest rate spread (3)			2.56	%			2.43	%
Net interest margin (4)			2.74	%			2.62	%

Ratio of average interest-earning assets to interest-bearing liabilities	119.4 %	124.4 %

(1) Includes nonaccrual loans, for further information relating to nonaccrual loans, see Note 4 - Loans Held-for-Investment.
(2) Includes noninterest-bearing 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.

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. The table 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 rate.

	Three Months Ended September 30, 2017 Versus 2016 Increase (Decrease) Due to:		
	Rate	Volume	Total
	(Dollars in millions)		
Interest-Earning Assets			
Loans held-for-sale	$6	$ 9	$15
Loans held-for-investment			
Residential first mortgage	1	4	5
Total Consumer loans	1	4	5
Commercial Real Estate	5	5	10
Commercial and Industrial	1	5	6
Warehouse Lending	1	(6)	(5)
Total Commercial loans	7	4	11
Total loans held-for-investment	8	8	16
Loans with government guarantees	1	(2)	(1)
Investment securities	—	4	4
Total interest-earning assets	$15	$ 19	$34
Interest-Bearing Liabilities			
Interest-bearing deposits	$1	$ —	$1
Short-term Federal Home Loan Bank advances and other	7	3	10
Long-term Federal Home Loan Bank advances	1	(2)	(1)
Other long-term debt	—	1	1
Total interest-bearing liabilities	9	2	11
Change in net interest income	$6	$ 17	$23

	Nine Months Ended September 30, 2017 Versus 2016 Increase (Decrease) Due to:		
	Rate	Volume	Total
	(Dollars in millions)		
Interest-Earning Assets			
Loans held-for-sale	$10	$ 26	$36
Loans held-for-investment			
Residential first mortgage	3	3	6
Home equity	—	(2)	(2)
Total Consumer loans	3	1	4

Commercial Real Estate	9	14	23
Commercial and Industrial	4	10	14
Warehouse Lending	3	(14)	(11)
Total Commercial loans	16	10	26
Total loans held-for-investment	19	11	30
Loans with government guarantees	2	(4)	(2)
Investment securities	(1)	10	9
Total interest-earning assets	$30	$ 43	$73
Interest-Bearing Liabilities			
Interest-bearing deposits	$1	$ 2	$3
Short-term Federal Home Loan Bank advances and other	14	5	19
Long-term Federal Home Loan Bank advances	—	(5)	(5)
Other long-term debt	4	5	9
Total interest-bearing liabilities	19	7	26
Change in net interest income	$11	$ 36	$47

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Comparison to Prior Year Quarter

Net interest income increased $23 million or 29 percent for the three months ended September 30, 2017, compared to the same period in 2016. This increase was primarily driven by growth in interest-earning assets and an increase in average rates within the LHFI and LHFS portfolios. This was partially offset by an increase in average rates and average balance on short-term FHLB advances.

Our net interest margin for the three months ended September 30, 2017 was 2.78 percent, compared to 2.58 percent for the three months ended September 30, 2016. The net 20 basis point increase was driven by an increase in higher yielding commercial loans and higher interest income on LHFS. This increase was partially offset by higher average rates on short-term FHLB advances.

For the three months ended September 30, 2017 as compared to the three months ended September 30, 2016, total interest-earning assets increased $2.4 billion to $14.7 billion, led by growth in LHFS primarily due to accumulation of loans in support of residential mortgage backed securitizations. Additionally, the $955 million increase in LHFI average balance was primarily driven by a $526 million increase in consumer loans through the addition of high quality jumbo loans and HELOCs and a $429 million increase in average commercial loans was consistent with our strategy to grow the community bank. Average warehouse loans have decreased $575 million which is more than offset by increases in our C&I and CRE portfolios demonstrating our shift to higher yielding loans.

Average interest-bearing liabilities increased $2.5 billion for the three months ended September 30, 2017, compared to the three months ended September 30, 2016. The increase was primarily driven by a $2.7 billion increase in short-term FHLB advances used to fund our most liquid assets including LHFS.

Comparison to Prior Year to Date

Net interest income increased $47 million for the nine months ended September 30, 2017, compared to the same period in 2016, primarily driven by growth in interest-earning assets, led by an increase in LHFS, and an increase in average rates. This was partially offset by an increase in average rates and average balances of borrowings, primarily related to short-term FHLB advances and the issuance of our Senior Notes in the third quarter 2016.

Our net interest margin for the nine months ended September 30, 2017 was 2.74 percent, compared to 2.62 percent for the nine months ended September 30, 2016. The net 12 basis point increase was positively impacted by an increase in market rates, a higher yielding commercial loan portfolio and stable core deposits. This improvement was partially offset by higher rates on short-term FHLB advances driven by an increase in market rates and the issuance of our Senior Notes in the third quarter 2016.

For the nine months ended September 30, 2017 as compared to the nine months ended September 30, 2016, average interest-earning assets increased $1.8 billion, led by a $943 million increase in LHFS due to extending turn times and accumulation of loans in support of residential mortgage backed securitizations. The combined $939 million increase in average investment securities and average commercial loans was consistent with our strategy to grow the community bank and enhance the yield on our interest-earning assets. Commercial loans increased 15 percent due to growth in the CRE and C&I portfolios, including growth in home builder lending all of which more than offset the decrease in warehouse lending.

Average interest-bearing liabilities increased $1.9 billion for the nine months ended September 30, 2017, compared to the nine months ended September 30, 2016. The increase was primarily driven by a net $1.5 billion increase in FHLB advances used to fund balance sheet growth, $247 million increase in total deposits and the issuance of our Senior Notes in the third quarter 2016.

Provision (Benefit) for Loan Losses

Comparison to Prior Year Quarter

The provision (benefit) for loan losses was a provision of $2 million during the three months ended September 30, 2017, compared to a provision of $7 million during the three months ended September 30, 2016. During the three months ended September 30, 2017, the $2 million provision reflects continued low level of net charge-offs and the strong credit quality of our loan portfolios. The $7 million provision during the three months ended September 30, 2016 was largely to reserve for loans with government guarantees.

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Comparison to Prior Year to Date

The provision (benefit) for loan losses was a provision of $4 million for the nine months ended September 30, 2017, compared to a benefit of $9 million during the nine months ended September 30, 2016. The $4 million provision for the nine months ended September 30, 2017 reflects continued low level of net charge-offs and the strong credit quality of the loan portfolio. The $9 million benefit for the nine months ended September 30, 2016 resulted primarily from the sale of $1.2 billion UPB of performing residential first mortgage loans and $110 million UPB of nonperforming, TDR and non-agency loans.

For further information on the provision for loan losses see MD&A - Allowance for Loan Losses.

Noninterest Income

The following tables provide information on our noninterest income along with additional details related to our net gain on loan sales and other mortgage metrics:

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2017	2016	Change	2017	2016	Change
	(Dollars in millions)					
Net gain on loan sales	$75	$94	$ (19)	$189	$259	$ (70)
Loan fees and charges	23	22	1	58	56	2
Deposit fees and charges	5	5	—	14	17	(3)
Loan administration income	5	4	1	16	14	2
Net return (loss)on mortgage servicing rights	6	(11)	17	26	(21)	47
Representation and warranty benefit	4	6	(2)	11	12	(1)
Other noninterest income	12	36	(24)	32	52	(20)
Total noninterest income	$130	$156	$ (26)	$346	$389	$ (43)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(Dollars in millions)			
Mortgage rate lock commitments (fallout-adjusted) (1)	$8,898	$8,291	$23,896	$23,281
Net margin on mortgage rate lock commitments (fallout-adjusted) (1) (2)	0.84 %	1.13 %	0.79 %	1.05 %
Gain on loan sales LHFS + net return (loss) on the MSR	$81	$83	$215	$223
Mortgage loans sold and securitized	8,924	8,723	22,397	23,611
Net margin on loans sold and securitized	0.84 %	1.08 %	0.84 %	1.03 %

(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 LHFS to fallout-adjusted mortgage rate lock commitments.

Comparison to Prior Year Quarter

Total noninterest income decreased $26 million during the three months ended September 30, 2017, compared to the same period in 2016.

Net gain on loan sales decreased $19 million during the three months ended September 30, 2017, compared to the three months ended September 30, 2016. The net gain on loan sales margin decreased 24 basis points with fallout adjusted lock yields decreasing 0.29 basis points to 0.84 percent primarily due to more competitive pricing. Lower margins were partially offset by a 7.3 percent increase in fallout adjusted mortgage locks driven primarily by the Opes and Stearns acquisitions that occurred in 2017.

Net return on MSRs (including the impact of economic hedges) increased $17 million during the three months ended September 30, 2017, compared to the three months ended September 30, 2016. The increase was primarily driven by improvements in fair value due to a more stable prepayment environment and improvements in our hedging program, partially offset by a decrease in service fee income resulting from lower MSR balance due to sales that occurred throughout 2017.

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Other noninterest income decreased $24 million during the three months ended September 30, 2017, compared to the three months ended September 30, 2016 due to a $24 million reduction in the DOJ settlement liability that occurred in the third quarter of 2016.

Comparison to Prior Year to Date

Total noninterest income decreased $43 million during the nine months ended September 30, 2017, compared to the same period in 2016.

Net gain on loan sales decreased $70 million during the nine months ended September 30, 2017, compared to the nine months ended September 30, 2016. The net gain on loan sales margin decreased 19 basis points primarily driven by more competitive pricing and our decision to extend turn times on sales of LHFS which shifts earnings from gain on sale to net interest income. During the nine months ended September 30, 2017, turn times on sales of LHFS were an average of 52 days compared to an average of 35 days during the nine months ended September 30, 2016. As of September 30, 2017, we continue to selectively decide whether to extend turn times on sale of LHFS if, in its estimation, such extensions provide favorable economics. The decrease in net gain on loan sales was also attributed to the sale of performing LHFI that occurred during the nine months ended September 30, 2016 which resulted in a $14 million gain. The decreases in net gain on loan sales were partially offset by a shift in mix which includes an increase in distributed retail due to the integration of Opes.

Deposit fees and charges decreased $3 million during the nine months ended September 30, 2017, compared to the nine months ended September 30, 2016. The decrease was primarily due to lower exchange fee income resulting from limitations set by the Durbin amendment, which became applicable to the Bank on July 1, 2016.

Net return on MSRs was $26 million for the nine months ended September 30, 2017, compared to a loss of $21 million during the nine months ended September 30, 2016. The $47 million increase was primarily driven by a more stable prepayment environment and improvements in our hedging program, partially offset by lower servicing fee income resulting from a lower MSR balance and higher transaction costs driven by MSR sales that occurred in the first nine months of 2017. During the nine months ended September 30, 2017, we sold MSRs with a fair value of $260 million.

Other noninterest income decreased $20 million during the nine months ended September 30, 2017, compared to the nine months ended September 30, 2016. The decrease was primarily due to a $24 million reduction in the DOJ settlement liability that occurred in the third quarter of 2016.

Noninterest Expense

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

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2017	2016	Change	2017	2016	Change
	(Dollars in millions)					
Compensation and benefits	$76	$69	$7	$219	$203	$16
Commissions	23	16	7	49	40	9
Occupancy and equipment	28	21	7	75	64	11
Loan processing expense	15	13	2	41	40	1
Legal and professional expense	7	5	2	22	20	2

Other noninterest expense	22	18	4	59	51	8
Total noninterest expense	$ 171	$ 142	$ 29	$ 465	$ 418	$ 47
Efficiency ratio	73.5 %	59.9 %	13.6 %	73.9 %	66.9 %	7.0 %

	September 30, 2017	June 30, 2017	Change	September 30, 2017	December 31, 2016	Change
Number of FTE	3,495	3,432	63	3,495	2,886	609

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Comparison to Prior Year Quarter

Noninterest expense increased $29 million to $171 million during the three months ended September 30, 2017, compared to $142 million during the three months ended September 30, 2016. The increase is driven by growth initiatives and operating expenses associated with the recent acquisition of Opes which will support future revenue growth. Increases in those related expenses include an increase in compensation and benefits due to higher headcount, an increase in commissions attributable to increased loan production, and an increase in occupancy and equipment costs to support the capital needs of our expanded business.

Comparison to Prior Year to Date

Noninterest expense increased $47 million to $465 million during the nine months ended September 30, 2017, compared to $418 million during the nine months ended September 30, 2016. The increase was primarily driven by higher operating expenses associated with growth initiatives and our 2017 acquisitions of Opes and Stearns, including an increase in compensation and benefits due to an increase in headcount and higher commissions. Additionally, noninterest expense increased as a result of higher occupancy and equipment to support the capital needs of our expanded business and an increase in advertising related to a direct mail and brand awareness campaign.

Provision (benefit) for Income Taxes

Our provision for income taxes for the three and nine months ended September 30, 2017 was $20 million and $52 million, respectively, compared to a provision of $30 million and $73 million during the three and nine months ended September 30, 2016, respectively.

Our effective tax provision rate for the three and nine months ended September 30, 2017 was 32.4 percent and 32.3 percent, respectively, compared to 34.3 percent and 33.8 percent for the three and nine months ended September 30, 2016, respectively.

Our effective tax provision rate for the three and nine months ended September 30, 2017 differs from the combined federal and state statutory tax rate primarily due to a benefit from tax-exempt earnings, partially offset by nondeductible expenses.

For further information, see Note 15 - Income Taxes.

Loan Originations, Sales and Servicing

The majority of our total loan originations during the nine months ended September 30, 2017 represented mortgage loans that were collateralized by residential first mortgages on single-family residences and were eligible for sale to the Agencies. During the nine months ended September 30, 2017, sales of loans totaled $22.4 billion, or 90.8 percent of originations compared to $23.6 billion, or 99.0 percent of originations during the nine months ended September 30, 2016, with the decrease primarily due to the accumulation of loans in support of our residential mortgage backed securitizations. As of September 30, 2017, we had outstanding commitments to sell $6.6 billion of mortgage loans. Generally, these commitments are funded within 120 days. At September 30, 2017 and December 31, 2016, consumer LHFS totaled $4.9 billion and $3.2 billion, respectively, which are primarily residential mortgage loans. The $1.7 billion increase is the result of seasonally higher mortgage activity and the accumulation of loans in support of our next residential mortgage backed securitization.

On October 31, 2017, the Company closed on a securitization of $576 million of residential mortgage-backed certificates (RMBS) issued by Flagstar Mortgage Trust 2017-2 (FSMT 2017-2). On July 31, 2017, the Company

closed on a securitization of $444 million of RMBS issued by Flagstar Mortgage Trust 2017-1 (FSMT 2017-1). Both loan sales are comprised of loans Flagstar originated through our retail, broker and correspondent channels. The collateral consists of high-quality 15 to 30 year, fully amortizing conforming and jumbo fixed-rate loans.

In addition, we originate or purchase residential first mortgage loans, other consumer loans, and commercial loans for our LHFI portfolios. Our revenues include noninterest income from sales of residential first mortgages to the Agencies, net interest income, and revenue from servicing of loans for others.

We utilize multiple production channels to originate or acquire mortgage loans on a national scale to generate high returns on capital. This helps grow the servicing business and provides stable, low cost funding for the Community Bank segment. We continue to leverage technology to streamline the mortgage origination process, thereby bringing service and

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convenience to borrowers and correspondents. We also continue to make available to our customers various web-based tools that facilitate the mortgage loan process through each of our production channels. We intend to continue to seek new ways to expand our relationships with borrowers and correspondents to provide the necessary capital and liquidity to grow the Mortgage Servicing and the Community Bank segments.

The following table presents loan originations by portfolio:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(Dollars in millions)			
Consumer loans				
Residential first mortgage	$9,572	$9,192	$24,659	$23,856
Home equity (1)	94	50	225	137
Total consumer loans	9,666	9,242	24,884	23,993
Commercial loans (2)	265	248	932	496
Total loan originations	$9,931	$9,490	$25,816	$24,489

(1) Includes second mortgage loans, HELOC loans, and other consumer loans.
(2) Includes commercial real estate and commercial and industrial loans.

Additionally, our Mortgage Servicing segment provides servicing of residential mortgages for our own LHFI portfolio and may service or subservice loans which we have sold or securitized. Mortgage loans are serviced and subserviced for others on a fee for service basis and we may also collect ancillary fees and earn income through the use of noninterest-bearing escrows. 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 UPB (net of write downs) of residential loans serviced and subserviced and the number of accounts associated with those loans.

	September 30, 2017		December 31, 2016	
	Amount	Number of accounts	Amount	Number of accounts
	(Dollars in millions)			
Residential loan servicing				
Serviced for own loan portfolio (1)	$7,376	31,135	$5,816	29,244
Serviced for others	21,342	87,215	31,207	133,270
Subserviced for others (2)	62,351	296,913	43,127	220,075
Total residential loans serviced	$91,069	415,263	$80,150	382,589

(1) Includes LHFI (residential first mortgage and home equity), LHFS (residential first mortgage), loans with government guarantees (residential first mortgage), and repossessed assets.
(2) Includes temporary short-term subservicing performed as a result of sales of servicing-released MSRs. Includes repossessed assets.

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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 19 - Segment Information, and other sections of this report for a full understanding of our consolidated financial performance.

The following table presents net income (loss) by operating segment:

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2017	2016	Change	2017	2016	Change
	(Dollars in millions)					
Community Banking	$10	$7	$ 3	$26	$34	$ (8)
Mortgage Originations	31	39	(8)	87	99	(12)
Mortgage Servicing	(4)	(3)	(1)	(12)	(9)	(3)
Other	3	14	(11)	7	19	(12)
Total net income	$40	$57	$ (17)	$108	$143	$ (35)

Community Banking

Comparison to Prior Year Quarter

During the three months ended September 30, 2017, the Community Banking segment reported net income of $10 million, compared to $7 million for the three months ended September 30, 2016. The increase in net income was primarily due to a $9 million increase in net interest income from higher average loan balances, led by growth in commercial loans and higher average loan yields as well as a $6 million improvement in provision for loan losses due to improved credit quality. These increases were partially offset by a $7 million increase in noninterest expense driven by higher volume-driven expenses and growth initiatives which will support future revenue growth.

Comparison to Prior Year to Date

During the nine months ended September 30, 2017, the Community Banking segment reported net income of $26 million, compared to $34 million for the nine months ended September 30, 2016. The $8 million decrease in net income was primarily due to a $15 million decrease in net gain on loans sales and a $12 million increase in provision for loan losses, primarily resulting from the sale of performing residential loans out of the LHFI portfolio during the nine months ended September 30, 2016. These decreases were partially offset by a $21 million increase in net interest income due to loan growth, led by an increase in commercial loans and higher average loan yields.

Mortgage Originations

Comparison to Prior Year Quarter

The Mortgage Originations segment's net income decreased $8 million to $31 million during the three months ended September 30, 2017, compared to $39 million in the three months ended September 30, 2016. The decrease was primarily due to a $24 million increase in noninterest expense during the three months ended September 30, 2017,

primarily driven by higher compensation and benefits due to growth initiatives and higher commissions resulting from higher loan production. Additionally, the net gain on loans sales decreased $16 million driven by a 29 basis point decrease in margin resulting from a more competitive market and product mix. These decreases in net income were partially offset by a $17 million increase in the net return on MSRs driven by increases in the interest rate environment experienced during the third quarter of 2017 which resulted in lower prepayments and favorable fair value adjustments, as well as a $10 million increase in net interest income primarily due to an increase in mortgage volume and the benefit of extended turn times which shifts earnings from gain on sale to net interest income.

Comparison to Prior Year to Date

The Mortgage Originations segment's net income decreased $12 million to $87 million during the nine months ended September 30, 2017, compared to $99 million in the nine months ended September 30, 2016. The decrease was primarily due to

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a $55 million decrease in net gain on loan sales driven by a 26 basis point decrease in margin resulting from product mix and a more competitive market. Other noninterest expense increased $39 million primarily due to higher operating expenses associated with growth initiatives, which include an increase in compensation and benefits and higher commissions resulting from an increase in mortgage volume. These decreases in net income were partially offset by a $47 million increase in net return on MSRs primarily due to an increase in the interest rate environment in the first nine months of 2017 which resulted in lower prepayments and favorable fair value adjustments. Net interest income increased $29 million primarily resulting from an increase in mortgage activity and the benefit of extending turn times.

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, 2017, compared to a net loss of $3 million for the three months ended September 30, 2016. The increase in net losses is primarily due to a decrease in loan administration income, partially offset by higher subservicing fees driven by an increase in average portfolio volume and an improvement in other noninterest expenses.

Comparison to Prior Year to Date

The Mortgage Servicing segment reported a net loss of $12 million for the nine months ended September 30, 2017, compared to a net loss of $9 million for the nine months ended September 30, 2016. The increase in net losses is primarily due to a decrease in loan administration income and a decrease in net interest income due to lower average company controlled deposits, partially offset by higher subservicing fees driven by higher average portfolio volume.

Other

Comparison to Prior Year Quarter

For the three months ended September 30, 2017, the Other segment's net income was $3 million, compared to net income of $14 million for the three months ended September 30, 2016. The $11 million decrease is primarily due to a $24 million decrease in the fair value of the DOJ settlement liability which was recorded in the third quarter of 2016. This decrease is partially offset by an increase in net interest income due to higher average investment balances due to the pulling ahead of planned purchases of investments to take advantage of a higher market return.

Comparison to Prior Year to Date

For the nine months ended September 30, 2017, the Other segment's net income was $7 million, compared to net income of $19 million for the nine months ended September 30, 2016. The $12 million decrease was primarily due a $24 million decrease in the fair value of the DOJ settlement liability which was recorded in the third quarter of 2016, partially offset by decrease in noninterest expense.

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RISK MANAGEMENT

Like all financial services companies, we engage in 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. We have made significant investments in our risk management activities which 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 risks 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, 2016. Some of the more significant processes used to manage and control credit, liquidity, market, and operational 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. We provide loans, extend credit, purchase securities, and enter into financial derivative contracts, all of which have related credit risk.

We maintain a strict credit limit, in compliance with regulatory requirements, in order to maintain a diversified loan portfolio and manage our credit exposure to any one borrower or obligor. Under the Home Owners Loan Act ("HOLA"), savings associations are generally subject to national bank limits on loans to one borrower. Generally, per HOLA, the Bank may not make a loan or extend credit to a single or related group of borrowers in excess of 15 percent of Tier 1 and Tier 2 capital plus any portion of the allowance for loan losses not included in Tier 2 capital. This lending limit was $249 million as of September 30, 2017. Flagstar maintains a maximum internal Bank limit of $100 million (commitment level) to any one borrower/obligor relationship, which is more conservative than the limit required by HOLA. All credit exposures that exceed $50 million must be approved by the Board of Directors.

The majority of our credit risk is associated with lending activities, as the acceptance and management of credit risk is central to profitable lending. We manage our credit risk by establishing sound credit policies for underwriting and adhering to well controlled processes. We utilize various credit risk management and monitoring activities to mitigate risks associated with loans that we hold, acquire, and originate.

Loans held-for-investment

The following table summarizes loans held-for-investment by category:

	September 30, 2017	December 31, 2016	Change
	(Dollars in millions)		
Consumer loans			
Residential first mortgage	$2,665	$ 2,327	$338
Home equity	496	443	53
Other	26	28	(2)
Total consumer loans	3,187	2,798	389
Commercial loans			
Commercial real estate (1)	1,760	1,261	$499
Commercial and industrial	1,097	769	328
Warehouse lending	1,159	1,237	(78)

Total commercial loans	4,016	3,267	749
Total loans held-for-investment	$7,203	$ 6,065	$1,138

(1) Includes $270 million and $245 million of owner occupied commercial real estate loans at September 30, 2017 and December 31, 2016, respectively.

Loans held-for-investment increased $1.1 billion, at September 30, 2017 from December 31, 2016. This increase was due to our continued effort to grow both the consumer loan portfolio and commercial loan portfolio.

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The commercial loan portfolio growth strengthens our Community Banking segment by improving margins through the additions of higher yielding loans. As a result, the commercial loan portfolio has grown $749 million, or 23 percent, since December 31, 2016. During the nine months ended September 30, 2017, our CRE portfolio grew $499 million and C&I $328 million.

For further information, see Note 4 - Loans Held-for-Investment.

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 scores. Loans with LTVs exceeding 80 percent are required to obtain mortgage insurance. We hold for investment, higher yielding loans and loans that will diversify or enhance the interest rate characteristics of our balance sheet.

The following table presents our total residential first mortgage LHFI by major category:

	September 30, 2017	December 31, 2016
	(Dollars in millions)	
Current estimated LTV ratios		
Less than 80% and refreshed FICO scores (1):		
Equal to or greater than 660	$2,389	$ 2,077
Less than 660	76	95
80% and greater and refreshed FICO scores (1):		
Equal to or greater than 660	132	78
Less than 660	8	9
U.S. government guaranteed	60	68
Total	$2,665	$ 2,327
Geographic region		
California	$1,059	$ 858
Michigan	267	236
Florida	193	193
Texas	174	138
Washington	160	136
Illinois	97	84
Arizona	73	65
New York	72	68
Colorado	66	60
Maryland	65	59
Others	439	430
Total	$2,665	$ 2,327

(1) FICO scores are updated at least on a quarterly basis or sooner if available.

Home equity. Our home equity portfolio includes first and second lien positions for HELOANs and HELOCs. These loans require full documentation and are underwritten and priced in an effort to ensure high credit quality and loan profitability. Our debt-to-income ratio on second mortgages is capped at 43 percent and for HELOCs is capped at 45 percent. We currently limit the maximum CLTV to 89.99 percent and FICO scores to a minimum of 660. Current second mortgage loans/HELOANS are fixed rate loans and are available with terms up to 15 years. HELOC loans are

adjustable-rate loans that contain a 10-year interest-only draw period followed by a 20-year amortizing period.

Commercial and industrial loans. Commercial and industrial LHFI facilities typically include lines of credit and term loans and leases to businesses for use in normal business operations to finance working capital, equipment and capital purchases, acquisitions and expansion projects. We lend to customers with a history of profitability and a long-term business model. Generally, leverage conforms to industry standards and the minimum debt service coverage is 1.20. Most of our C&I loans earn interest at a variable rate.

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The following table presents our total C&I LHFI by borrower's geographic location and industry type:

	Michigan	Texas	Florida	California	Tennessee	Other	Total	% by industry
	(Dollars in millions)							
September 30, 2017								
Industry Type								
Financial & Insurance	$23	$—	$50	$—	$12	$228	$313	28.5 %
Services (1)	71	73	—	34	—	114	292	26.6 %
Manufacturing	61	5	—	23	—	87	176	16.0 %
Healthcare	29	7	1	1	44	27	109	9.9 %
Distribution	57	—	—	2	—	—	59	5.4 %
Servicing advances	—	—	21	—	—	25	46	4.2 %
Rental & leasing	44	—	—	—	—	2	46	4.2 %
Government & education	9	—	—	—	—	36	45	4.1 %
Commodities	5	—	—	—	—	6	11	1.0 %
Total	$299	$85	$72	$60	$56	$525	$1,097	100.0 %
Percent by state	27.3 %	7.7 %	6.6 %	5.5 %	5.1 %	47.9 %	100.0 %	

(1) Includes unsecured home builder loans of $98 million at September 30, 2017.

Commercial real estate loans. Flagstar has a well-diversified commercial real estate portfolio, largely based in Michigan. Generally, the maximum LTV is 80 percent, or 85 percent for owner-occupied real estate, and debt service coverage of 1.20 to 1.35 times. This portfolio also includes owner occupied real estate loans and secured home builder loans.

In 2016, we launched a national home builder finance program to grow our balance sheet, increase commercial deposits and develop incremental revenue through our retail purchase mortgage channel. We finance and have active relationships with homebuilders nationwide. At September 30, 2017, home builder loans totaled $516 million. Of that $98 million is unsecured which is included in our C&I portfolio and $418 million is collateralized which is included in our CRE portfolio. We had an additional $505 million of unused home builder lending commitments at September 30, 2017.

The following table presents our total CRE LHFI by borrower's geographic location and collateral type:

	Michigan	Florida	California	Colorado	Texas	Ohio	Other	Total (1)
	(Dollars in millions)							
September 30, 2017								
Collateral Type								
Single family residence (2)	$54	$78	$28	$80	$81	$—	$51	$372
Retail (3)	185	30	7	—	—	5	14	241
Apartments	125	23	—	7	—	47	39	241
Industrial	155	—	35	—	—	—	4	194
Office	164	—	19	—	—	—	—	183
Land - Residential (4)	11	21	32	24	11	—	31	130
Hotel/motel	79	—	—	—	—	—	35	114
Senior Living facility	50	—	—	—	—	12	10	72
Parking garage/Lot	68	—	—	—	—	—	—	68
Non Profit	37	—	—	—	—	—	10	47
Shopping Mall (5)	27	—	—	—	—	—	—	27
Marina	23	—	—	—	—	—	—	23
Movie Theater	20	—	—	—	—	—	—	20

All other (6)	21	—	1	—	—	—	6	28
Total	$1,019	$152	$ 122	$ 111	$92	$64	$200	$1,760
Percent by state	57.9 %	8.6 %	6.9 %	6.3 %	5.2 %	3.6 %	11.4 %	100.0 %

(1) Includes $270 million of commercial owner occupied real estate loans at September 30, 2017.
(2) Includes home builder loans secured by SFR 1-4 properties whether under construction or completed.
(3) Includes multipurpose retail space, neighborhood centers, strip centers and single-use retail space.
(4) Land residential includes development and unimproved vacant land.
(5) Comprised of one shopping mall with an anchor store.
(6) All other primarily includes: condominium, mini storage facilities, ice arena, golf course, gas station, car wash, etc.

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Warehouse lending. We offer warehouse lines of credit to other mortgage lenders which allow the lender to fund the closing of residential mortgage loans. Each extension, advance, or draw-down on the line is fully collateralized by residential mortgage loans and is paid off when the lender sells the loan to an outside investor or, in some instances, to the Bank. For the three months ended September 30, 2017, the warehouse advance amount of loans sold to the Bank totaled $2.9 billion or 36.3 percent. For the nine months ended September 30, 2017, the warehouse advance amount of loans sold to the Bank totaled $8.0 billion or 38.5 percent.

Underlying mortgage loans are predominantly originated using the Agencies' underwriting standards. The guideline for debt to tangible net worth is 15 to 1. Despite the contraction in warehouse lending which occurred in the first quarter 2017, we are continuing to focus on 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. We have a national platform with relationship managers covering both coasts and a large Michigan-based sales team. The aggregate committed amount of adjustable-rate warehouse lines of credit granted to other mortgage lenders at September 30, 2017 was $2.7 billion, of which $1.2 billion was outstanding, compared to $2.9 billion at December 31, 2016, of which $1.2 billion was outstanding.

Credit Quality

Trends in certain credit quality characteristics such as nonperforming loans and past due statistics remain very strong and continue to show improvement. This is predominantly a result of effectively managing credit risks and sales of legacy portfolios that included nonperforming and TDR loans which have been replaced by new loans with strong credit characteristics. The credit quality of our loan portfolios is demonstrated by low delinquency levels, minimal charge-offs and low levels of nonperforming loans.

For all loan categories 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.

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Nonperforming assets

The following table sets forth our nonperforming assets:

	September 30, 2017	December 31, 2016
	(Dollars in millions)	
LHFI		
Consumer loans		
Residential first mortgage	$14	$ 18
Home equity	1	4
Commercial		
CRE	1	—
Total nonperforming LHFI	16	22
TDRs		
Consumer loans		
Residential first mortgage	11	11
Home equity	4	7
Total nonperforming TDRs	15	18
Total nonperforming LHFI and TDRs (1)	31	40
Real estate and other nonperforming assets, net	9	14
LHFS	8	6
Total nonperforming assets	$48	$ 60
Nonperforming assets to total assets (2)	0.24%	0.39 %
Nonperforming LHFI and TDRs to LHFI	0.44%	0.67 %
Net charge-offs to LHFI ratio (annualized) (1)	0.08%	0.13 %
Nonperforming assets to LHFI and repossessed assets (2)	0.58%	0.90 %
Nonperforming assets to Tier 1 capital (to adjusted total assets) + ALLL (2)(3)	2.57%	3.93 %

(1) Includes less than 90 day past due performing loans placed on nonaccrual. Interest is not being accrued on these loans.
(2) Ratio excludes LHFS.
(3) Refer to MD&A - Use of Non-GAAP Financial Measures for calculation of ratio.

At September 30, 2017, we had $48 million of nonperforming assets compared to $60 million of nonperforming assets at December 31, 2016. This decrease was primarily due to a $7 million decrease in nonperforming consumer LHFI offset by a $1 million increase in nonperforming commercial LHFI at September 30, 2017 compared to December 31, 2016. Additionally, nonperforming TDRs decreased $3 million at September 30, 2017 compared to December 31, 2016. The overall improvement in our nonperforming assets is due to our continued effort to grow our loan portfolio with strong credit quality loans combined with a slowing emergence of nonperforming loans driven by decreased levels of delinquencies.

The ratio of nonperforming assets, excluding LHFS, to total assets decreased to 0.24 percent at September 30, 2017 from 0.39 percent at December 31, 2016. Net charge-offs in the third quarter 2017 were 0.08 percent of LHFI compared to 0.13 percent at December 31, 2016.

The following table sets forth activity related to our nonperforming LHFI and TDRs:

	Three Months Ended September	Nine Months Ended September

	30, 2017	2016	30, 2017	2016
	(Dollars in millions)			
Beginning balance	$30	$44	$40	$66
Additions	5	7	19	30
Reductions				
Principal payments and loan sales	(2)	(2)	(6)	(9)
Charge-offs	—	—	(2)	(4)
Returned to performing status	(1)	(8)	(1)	(15)
Transfers to REO	(1)	(1)	(19)	(28)
Total nonperforming LHFI and TDRs (1)	$31	$40	$31	$40

(1) Includes less than 90 day past due performing loans which are deemed nonaccrual. Interest is not being accrued on these loans.

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As of September 30, 2017, nonperforming consumer loans decreased $9 million from December 31, 2016, due to the sale of nonperforming loans and improvements to the overall credit quality of our loan portfolios. We had a decrease in additions to nonperforming LHFI and TDRs along with an increase in loans returning to performing status during both the three and nine months ended September 30, 2017 as compared to the three and nine months ended September 30, 2016, respectively. During the three months ended September 30, 2017, we had no charge-offs.

Delinquencies

The following table sets forth our performing LHFI which are past due 30-89 days:

	September 30, 2017	December 31, 2016
	(Dollars in millions)	
Performing loans past due 30-89:		
Consumer loans		
Residential first mortgage	$ 3	$ 6
Home equity	2	3
Other	—	1
Total performing loans past due 30-89 days	$ 5	$ 10

Early stage delinquencies remained low with the 30 to 89 days past due loans decreasing to $5 million at September 30, 2017, compared to $10 million at December 31, 2016. There were no past due commercial loans at September 30, 2017 and December 31, 2016.

Troubled debt restructurings (held-for-investment)

Troubled debt restructurings ("TDRs") are modified loans in which a borrower demonstrates financial difficulties and for which a concession has been granted as a result. Nonperforming TDRs are included in nonaccrual loans. TDRs remain in nonperforming status until a borrower has made at least six consecutive months of payments under the modified terms. Performing TDRs are excluded from nonaccrual loans because it is reasonably assured that all contractual principal and interest due under the restructured terms will be collected.

The following table sets forth a summary of TDRs by performing status:

	September 30, 2017	December 31, 2016
	(Dollars in millions)	
Performing TDRs		
Residential first mortgage	$ 20	$ 22
Home equity	26	45
Total performing TDRs	46	67
Nonperforming TDRs	4	8
Nonperforming TDRs at inception but performing for less than six months	11	10
Total nonperforming TDRs	15	18
Total TDRs (1)	$ 61	$ 85

(1) The ALLL on consumer TDR loans totaled $12 million and $9 million at September 30, 2017 and December 31, 2016.

At September 30, 2017 our total TDR loans decreased $24 million compared to December 31, 2016 primarily due to the sale of nonperforming loans and lower delinquency rates during the nine months ended September 30, 2017. Of

our total TDR loans, 75.5 percent were in performing status at September 30, 2017.

For further information, see Note 4 - Loans Held-for-Investment.

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Allowance for Loan Losses

The ALLL represents management's estimate of probable losses that are inherent in our LHFI portfolio but which have not yet been realized. For further information, see Note 4 - Loans Held-for-Investment.

The ALLL as a percentage of LHFI decreased to 2.0 percent as of September 30, 2017 from 2.4 percent as of December 31, 2016. This decrease is attributable to the continued low levels of delinquencies and net charge-offs in our portfolio. Additionally, our loan growth has been in high credit quality assets across both our consumer and commercial portfolios. At September 30, 2017, our allowance as a percent of our consumer loan portfolio was 2.3 percent and our allowance as percent of our commercial loan portfolio was 1.7 percent.

The percentage of ALLL to LHFI and loans with government guarantees (excluding fair value loans), decreased to 1.9 percent as of September 30, 2017 from 2.2 percent as of December 31, 2016.

The following tables set forth certain information regarding the allocation of our ALLL to each loan category:

	September 30, 2017			
	Loans Held-for-Investment	Percent of Portfolio	Allowance Amount	Allowance as a Percent of Loan Portfolio
	(Dollars in millions)			
Consumer loans				
Residential first mortgage	$2,656	36.9 %	$ 52	2.0 %
Home equity	492	6.8 %	20	4.1 %
Other	26	0.4 %	1	3.8 %
Total consumer loans	3,174	44.1 %	73	2.3 %
Commercial loans				
Commercial real estate	1,760	24.5 %	42	2.4 %
Commercial and industrial	1,097	15.3 %	19	1.7 %
Warehouse lending	1,159	16.1 %	6	0.5 %
Total commercial loans	4,016	55.9 %	67	1.7 %
Total consumer and commercial loans (1)	$7,190	100.0 %	$ 140	1.9 %

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(Dollars in millions)			
Beginning balance	$140	$150	$142	$187
Provision (benefit) for loan losses (1)	2	—	4	(16)
Charge-offs				
Consumer loans				
Residential first mortgage	(1)	(7)	(6)	(26)
Home equity	(2)	(1)	(3)	(4)
Other consumer	—	(1)	(1)	(3)

Total charge offs	(3)	(9)	(10)	(33)
Recoveries				
Consumer loans				
Residential first mortgage	—	—	1	1
Home equity	1	1	2	2
Other consumer	—	1	1	2
Total recoveries	1	2	4	5
Charge-offs, net of recoveries	(2)	(7)	(6)	(28)
Ending balance	$140	$143	$140	$143

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

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The following table provides information on our charge-offs and credit quality ratios:

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2017	2016	Change	2017	2016	Change
	(Dollars in millions)					
Charge-offs, net of recoveries	$2	$7	$(5)	$6	$28	$(22)
Charge-offs associated with loans with government guarantees	1	6	(5)	3	13	(10)
Charge-offs associated with the sale or transfer of nonperforming loans and TDRs	—	—	—	1	8	(7)
Charge-offs, net of recoveries, adjusted (1)	$1	$1	$—	$2	$7	$(5)
Net charge-offs to LHFI ratio (annualized) (2)	0.08%	0.51%	(0.43)%	0.12%	0.66%	(0.54)%
Net charge-off ratio, adjusted (annualized)(1)(2)	0.06%	0.15%	(0.09)%	0.05%	0.15%	(0.10)%

(1) Excludes charge-offs associated with loans with government guarantees and charge-offs associated with the sale or transfer of nonperforming loans and TDRs.
(2) Excludes loans carried under the fair value option

As a result of the strong credit quality throughout our loan portfolios, net charge-offs for the three months ended September 30, 2017 decreased to $2 million, compared to $7 million for the three months ended September 30, 2016. As a percentage of average LHFI, net charge-offs for the three months ended September 30, 2017 decreased to 0.08 percent from 0.51 percent for the three months ended September 30, 2016.

Net charge-offs for the nine months ended September 30, 2017 decreased to $6 million, compared to $28 million for the nine months ended September 30, 2016, primarily from the sale of $110 million UPB of nonperforming, TDR and non-agency loans and net charge-offs associated with loans with government guarantees. As a percentage of average LHFI, net charge-offs for the nine months ended September 30, 2017 decreased to 0.12 percent from 0.66 percent for the nine months ended September 30, 2016, partially driven by sales of nonperforming loans which occurred in the first nine months of 2016.

There were no net charge-offs of commercial loans for the nine months ended September 30, 2017 and September 30, 2016.

Market Risk

Market risk is the risk of reduced earnings and/or declines in the net market value of the balance sheet due to changes in market rates. Our primary market risk is interest rate risk which impacts our net interest income, fee income related to interest sensitive activities such as mortgage origination and servicing income, and loan and deposit demand.

We are subject to interest rate risk due to:

- The maturity or repricing of assets and liabilities at different times or for different amounts
- Differences in short-term and long-term market interest rate changes
- The remaining maturity of various assets or liabilities may shorten or lengthen as interest rates change

The Asset/Liability Committee ("ALCO"), which is composed of our executive officers and certain members of management, monitors interest rate risk on an on-going basis in accordance with policies approved by our board of directors. The ALCO reviews interest rate positions and considers the impact projected interest rate scenarios have on

earnings, capital, liquidity, business strategies, and other factors. However, management has the latitude to change interest rate positions within certain limits if, in management's judgment, the change will enhance profitability.

To assess and manage interest rate risk, sensitivity analysis is used to determine the impact on earnings and the net market value of the balance sheet across various interest rate scenarios, balance sheet trends, and strategies.

Net interest income sensitivity

Management uses a simulation model to analyze the sensitivity of net interest income to changes in interest rates across various interest rate scenarios which demonstrates the level of interest rate risk inherent in the existing balance sheet. The analysis holds the current balance sheet values constant and does not take into account management intervention. In addition, we assume certain correlation rates, often referred to as a “deposit beta,” of interest-bearing deposits, wherein the

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rates paid to customers change at a different pace when compared to changes in benchmark interest rates. The effect on net interest income over a 12 month time horizon due to hypothetical changes in market interest rates is presented in the table below. In this interest rate shock test, as of the periods presented, interest rates have been adjusted by instantaneous parallel changes rather than in a ramp test which applies interest rate changes over time. All rates, short-term and long-term, are changed by the same amount (plus or minus 200 basis points) resulting in the shape of the yield curve remaining unchanged. The minus 200 basis point shock scenario is effectively a flattener scenario as rates are floored at zero given the current interest rate levels.

September 30, 2017			
Scenario	Net interest income	$ Change	% Change
	(Dollars in millions)		
200	$458	$ 25	5.9 %
Constant	433	—	— %
(200)	373	(60)	(14.0)%

December 31, 2016			
Scenario	Net interest income	$ Change	% Change
	(Dollars in millions)		
200	$321	$ 19	6.3 %
Constant	301	—	— %
(200)	245	(57)	(18.9)%

In the net interest income simulation, our balance sheet exhibits slight asset sensitivity. When interest rates rise our net interest income increases. Conversely, when interest rates fall our net interest income decreases. At September 30, 2017, the $132 million increase in the net interest income in the constant scenario as compared to December 31, 2016 was primarily driven by increased size of balance sheet.

As of September 30, 2017, we have also projected the potential impact to net interest income in a hypothetical "bear flattener" interest rate scenario, in which short-term interest rates have been instantaneously increased by 100 basis points while holding the longer term interest rates constant. Over a 12-month and 24-month period, based on our existing balance sheet, the simulation resulted in a loss of $39 million and $52 million, respectively.

The net interest income sensitivity analysis has certain limitations and makes various assumptions. Key elements of this interest rate risk exposure assessment include maintaining a static balance sheet and parallel rate shocks. The direction of future interest rates not moving in a parallel manner across the yield curve, how the balance sheet will respond and shift based on a change in future interest rates and how the Company will respond are not included in this analysis and limit the predictive value of these scenarios.

Economic value of equity

Management also utilizes (EVE), a point in time analysis of the economic value of our current balance sheet position, which measures interest rate risk over a longer term. The EVE calculation represents a hypothetical valuation of equity, and is defined as the market value of assets, less the market value of liabilities, adjusted for the market value of off-balance sheet instruments. The assessment of both short-term earnings (Net Interest Income Sensitivity) and

long-term valuation (EVE) approaches provides a more comprehensive analysis of interest rate risk exposure than Net Interest Income Sensitivity alone.

There are assumptions and inherent limitations in any methodology used to estimate the exposure to changes in market interest rates and as such, sensitivity calculations used in this analysis are hypothetical and should not be considered to be predictive of future results. This analysis evaluates risks to the current balance sheet only and does not incorporate future growth assumptions. Additionally, the analysis assumes interest rate changes are instantaneous and the new rate environment is constant but does not include actions management may undertake to manage risk in response to interest rate changes. Each rate scenario reflects unique prepayment, repricing, and reinvestment assumptions. Management derives these assumptions by considering published market prepayment expectations, repricing characteristics, our historical experience, and our asset and liability management strategy. This analysis assumes that changes in interest rates may not affect or could partially affect certain instruments based on their characteristics.

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The following table is a summary of the changes in our EVE that are projected to result from hypothetical changes in market interest rates. The interest rates, as of the dates presented, are adjusted by instantaneous parallel rate changes upward to +300 basis points and downward (100) basis points.

September 30, 2017					December 31, 2016				
Scenario	EVE	EVE%	$ Change	% Change	Scenario	EVE	EVE%	$ Change	% Change
	(Dollars in millions)					(Dollars in millions)			
300	$2,109	12.6 %	$ (155)	(6.9)%	300	$1,927	13.9 %	$ (173)	(8.2)%
200	2,185	13.0 %	(79)	(3.5)%	200	2,005	14.4 %	(95)	(4.5)%
100	2,250	13.4 %	(14)	(0.6)%	100	2,073	14.9 %	(28)	(1.3)%
Current	2,264	13.5 %	—	— %	Current	2,100	15.1 %	—	— %
(100)	2,233	13.3 %	(31)	(1.4)%	(100)	2,067	14.9 %	(33)	(1.6)%

Our balance sheet exhibits liability sensitivity in a rising interest rate scenario as the EVE decreases. The decrease in EVE is the result of the amount of liabilities that would be expected to reprice exceeding the amount of assets repriced in the +200 scenario. The December 31, 2016 (100) is effectively a flattener scenario as shorter term rates are unable to decrease 100 basis points due to the absolute level of rates. Therefore, the yields of the longer term variable rate assets decrease by the full 100 basis points, but the liabilities repricing to shorter term rates decrease to less than 100 basis points, leading to a reduction in EVE.

Derivative financial instruments

As a part of our risk management strategy, we use derivative financial instruments to minimize fluctuation in earnings caused by interest rate risk. We use interest rate swaps, swaptions and forward sales commitments to hedge our mortgage origination pipeline, funded mortgage LHFS and MSRs. All of our derivatives and mortgage loan production originated for sale are accounted for at fair market value. Changes to mortgage commitments are based on changes in fair value of the underlying loan, which is impacted by changes in interest rates and changes in the probability that the loan will not fund within the terms of the commitment, referred to as a fallout factor or pull through rate. Market risk on interest rate lock commitments and mortgage LHFS is managed using corresponding forward sale commitments. The adequacy of these hedging strategies, the ability to fully or partially hedge market risk, rely on various assumptions or projections, including a fallout factor. For further information, see Note 8 - Derivative Financial Instruments and Note 18 - Fair Value Measurements.

Mortgage Servicing Rights (MSRs)

Our MSRs are sensitive to interest rate volatility and are highly susceptible to prepayment risk, basis risk, market volatility and changes in the shape of the yield curve. We utilize derivatives and other fair value assets as part of our overall hedging strategy to manage the impact of changes in the fair value of the MSRs, but these risk management strategies do not completely eliminate repricing risk. Our hedging strategies rely on assumptions and projections regarding assets and general market factors, many of which are outside of our control. If one or more of these assumptions or projections proves to be incorrect our hedging strategies may not adequately mitigate the impact of changes in interest rates or prepayment speeds, and as a result may negatively impact earnings. For further information, see Note 7 - Mortgage Servicing Rights and Note 8 - Derivative Financial Instruments.

Liquidity Risk

Liquidity risk is the risk that we will not have sufficient funds to meet current and future cash flow needs as they become due. The liquidity of a financial institution reflects the ability to meet loan demand, to accommodate possible outflows in deposits and to take advantage of interest rate and market opportunities. The ability of a financial institution to meet current financial obligations is a function of the balance sheet structure, the ability to liquidate

assets, and access to various sources of funds.

Parent Company Liquidity

The Company obtains its liquidity from multiple sources, including dividends from the Bank and the issuance of debt and equity securities. The primary uses of the Company's liquidity are debt service and operating expenses, which includes compensation and benefits, legal and professional expense and general and administrative expenses. At September 30, 2017, the Company held $200 million of cash at the Bank, or 3.8 years of expense and debt service coverage.

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The OCC regulates all capital distributions made by the Bank, directly or indirectly, to the holding company, including dividend payments. A subsidiary of a savings and loan holding company, such as the Bank, must file a notice or application with the OCC at least 30 days prior to each proposed capital distribution. Whether an application is required is based on a number of factors including whether the institution qualifies for expedited treatment under the OCC rules and regulations or if the total amount of all capital distributions (including each proposed capital distribution) for the applicable calendar year exceeds net income for that year to date plus the retained net income for the preceding two years. In addition, as a subsidiary of
a savings and loan holding company, the Bank must receive approval from the FRB before declaring any dividends. Additional restrictions on dividends apply if the Bank fails the QTL test.

In the third quarter 2017, we paid dividends of $84 million from the Bank to the Bancorp. 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.

For further information and restrictions related to the Bank's payment of dividends, see MD&A - Capital and Regulatory Risk.

Bank Liquidity

We primarily originate agency-eligible LHFS and therefore the majority of new residential first mortgage loan originations are readily convertible to cash, either by selling them as part of our monthly agency sales, private party whole loan sales, or by pledging them to the FHLB of Indianapolis and borrowing against them. We use the FHLB of Indianapolis as a significant source for funding our residential mortgage banking business due to the flexibility in terms of being able to borrow or repay borrowings as daily cash needs require.

We have arrangements with the FRB of Chicago to borrow as appropriate from its discount window. The discount window is also a borrowing facility that is intended to be used only for short-term liquidity needs arising from special or unusual circumstances. The amount we are allowed to borrow is based on the lendable value of the collateral that we provide. To collateralize the line, we pledge investment securities and loans that are eligible based on FRB of Chicago guidelines. At September 30, 2017 and December 31, 2016, we had no borrowings outstanding against this line of credit.

The amount we can borrow, or the value we receive for the assets pledged to our liquidity providers, varies based on the amount and type of pledged collateral as well as the perceived market value of the assets and the "haircut" of the market value of the assets. That value is sensitive to the pricing and policies of our liquidity providers and can change with little or no notice.

Our Consolidated Statements of Cash Flows shows cash used in operating activities of $19.2 billion and $10.1 billion for the nine months ended September 30, 2017 and 2016, respectively. This primarily reflects our mortgage operations and is a reflection of the manner in which we execute certain loan sales for which the cash outflow is considered an operating activity and the corresponding cash inflow is considered an investing activity. For the period ending September 30, 2017, operating cash flows declined primarily due to our election to extend the amount of time we hold mortgage-backed securities related to our LHFS portfolio.

As governed and defined by our internal liquidity policy, we maintain adequate excess liquidity levels appropriate to cover unanticipated liquidity needs. In addition to this liquidity, we also maintain targeted minimum levels of unused collateralized borrowing capacity as another cushion against unexpected liquidity needs. Each business day, we forecast 90 days of daily cash needs. This allows us to determine our projected near term daily cash fluctuations and

also to plan and adjust, if necessary, future activities. As a result, in an adverse environment, we would be able to make adjustments to operations as required to meet the liquidity needs of our business, including adjusting deposit rates to increase deposits, planning for additional FHLB borrowings, accelerating sales of LHFS (agencies and/or private), selling LHFI or investment securities, borrowing through the use of repurchase agreements, reducing originations, making changes to warehouse funding facilities, or borrowing from the discount window.

Our liquidity position is continuously monitored and adjustments are made to the balance between sources and uses of funds as deemed appropriate. We balance the liquidity of our loan assets to our available funding sources. Our LHFI portfolio is funded with stable core deposits whereas our warehouse and LHFS may be funded with FHLB borrowings.

Management is not aware of any events that are reasonably likely to have a material adverse effect on our liquidity, capital resources or operations.

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Liquidity Table

	September 30, 2017	December 31, 2016	Change
	(Dollars in millions)		
Demand deposit accounts	$1,234	$ 1,134	$100
Savings accounts	3,718	3,887	(169)
Money market demand accounts	291	247	44
Certificates of deposit/CDARS	1,297	1,056	241
Total retail deposits	6,540	6,324	216
Government deposits	1,068	1,030	38
Wholesale deposits	43	—	43
Company controlled deposits	1,510	1,446	64
Total deposits	$9,161	$ 8,800	$361
Federal Home Loan Bank advances	$5,365	$ 2,980	$2,385
Other long-term debt	493	493	—
Total borrowed funds	$5,858	$ 3,473	$2,385

Deposits

The following table presents a composition of our deposits:

	September 30, 2017			December 31, 2016			Change
	Balance	% of Deposits		Balance	% of Deposits		Change
	(Dollars in millions)						
Retail deposits							
Branch retail deposits							
Demand deposit accounts	$930	10.2	%	$852	9.7	%	$ 78
Savings accounts	3,653	39.9	%	3,824	43.5	%	(171)
Money market demand accounts	214	2.3	%	138	1.6	%	76
Certificates of deposit/CDARS (1)	1,295	14.1	%	1,055	12.0	%	240
Total branch retail deposits	6,092	66.5	%	5,869	66.7	%	223
Commercial retail deposits							
Demand deposit accounts	304	3.3	%	282	3.2	%	22
Savings accounts	65	0.7	%	63	0.7	%	2
Money market demand accounts	77	0.8	%	109	1.2	%	(32)
Certificates of deposit/CDARS (1)	2	—	%	1	—	%	1
Total commercial retail deposits	448	4.9	%	455	5.2	%	(7)
Total retail deposits	$6,540	71.4	%	$6,324	71.9	%	$ 216
Government deposits							
Demand deposit accounts	$272	3.0	%	$250	2.8	%	$ 22
Savings accounts	414	4.5	%	451	5.1	%	(37)
Certificates of deposit/CDARS (1)	382	4.2	%	329	3.7	%	53
Total government deposits (2)	1,068	11.7	%	1,030	11.7	%	38
Wholesale deposits	43	0.5	%	—	—	%	—
Company controlled deposits (3)	1,510	16.5	%	1,446	16.4	%	64
Total deposits (4)	$9,161	100.0	%	$8,800	100.0	%	$ 361

(1)

The aggregate amount of certificates of deposit with a minimum denomination of $100,000 was approximately $1.3 billion and $1.0 billion at September 30, 2017 and December 31, 2016.

(2) Government deposits include funds from municipalities and schools.

(3) These accounts represent a portion of the investor custodial accounts and escrows controlled by us in connection with loans serviced for others and that have been placed on deposit with the Bank.

(4) The aggregate amount of deposits with a balance over $250,000 was approximately $4.2 billion and $4.0 billion at September 30, 2017 and December 31, 2016.

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Total deposits increased $361 million, or 4.1 percent at September 30, 2017, compared to December 31, 2016, primarily due to growth in branch retail deposits. Branch retail deposits increased $223 million at September 30, 2017 compared to December 31, 2016, primarily due to an increase in retail certificates of deposit/CDARS.

We utilize local governmental agencies and other public units, as an additional source for deposit funding. As a Michigan bank, we are not required to hold collateral against our government deposits from Michigan government entities as they are covered by the Michigan Business and Growth Fund. This results in higher margins earned on these deposits which can be used to fund loans. Government deposit accounts include $382 million of certificates of deposit with maturities typically less than one year and $686 million in checking and savings accounts at September 30, 2017.

Company controlled deposits arise due to our servicing or sub-servicing of loans for others and represent the portion of the investor custodial accounts on deposit with the Bank. Certain deposits require us to reimburse the owner for the spread on these funds. This cost is a component of net loan administration income. During the nine months ended September 30, 2017, these deposits increased $64 million, primarily due to the increase in subservicing and taxes and insurance.

Company controlled deposits are used to fund our most liquid assets including LHFS and warehouse loans. As not all asset categories require the same level of liquidity, our loan-to-deposit ratio shows how we manage our liquidity position, how much liquidity we have and the agility of our balance sheet. The Company's HFI loan-to-deposit ratio, which excludes warehouse loans and company controlled deposits, was 78 percent at September 30, 2017, which provides substantial liquidity for continued growth.

We participate in the CDARS program, through which certain customer CDs are exchanged for CDs of similar amounts from other participating banks. This gives customers the potential to receive FDIC insurance up to $50 million. At September 30, 2017, we had $199 million of total CDs enrolled in the CDARS program. The total CDARS balances decreased $31 million at September 30, 2017 from December 31, 2016.

FHLB Advances

We rely upon advances from the FHLB as a source of funding for the origination or purchase of loans for sale in the secondary market and for providing duration specific short-term and long-term financing. The outstanding balance of FHLB advances fluctuates from time to time depending on our current inventory of mortgage LHFS and the availability of lower cost funding sources. Our portfolio includes short-term fixed rate advances, long-term LIBOR adjustable advances, and long-term fixed rate advances. Interest rates on the LIBOR index 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 FHLB provides loans, also referred to as advances, on a fully collateralized basis, to savings banks and other member financial institutions. We are currently authorized through a resolution of our board of directors to apply for advances from the FHLB using approved loan types as collateral, which includes residential first mortgage loans, home equity lines of credit, and commercial real estate loans. At September 30, 2017, we had the authority and approval from the FHLB 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, 2017, we had $5.4 billion of advances outstanding and an additional $1.1 billion of collateralized borrowing capacity available at the FHLB. At September 30, 2017, we pledged collateral to the Federal Reserve Discount Window amounting to $435 million with a lendable value of $418 million. At December 31, 2016, we pledged collateral to the Federal Reserve Discount Window amounting to $496 million with a lendable value of $474 million. At September 30, 2017 and December 31, 2016, we had no borrowings outstanding against this line of credit.

Debt

As part of our overall capital strategy, we previously raised capital through the issuance of junior subordinated notes to our special purpose trusts formed for the offerings, which issued Tier 1 qualifying preferred stock (trust preferred securities). The trust preferred securities are callable by us at any time. Interest is payable on a quarterly basis; however, we may defer interest payments for up to 20 quarters without default or penalty. At September 30, 2017, we had no deferred interest payments.

On July 11, 2016, we issued $250 million of Senior Notes which mature on July 15, 2021. The proceeds from these notes were used to bring current and redeem our then outstanding TARP Preferred Stock.

Prior to June 15, 2021, we may redeem some or all of the Senior Notes at a redemption price equal to the greater of 100 percent of the aggregate principal amount of the Senior Notes to be redeemed or the sum of the present values of the remaining scheduled payments plus, in each case, accrued and unpaid interest.

For further information, see Note 9 - Borrowings.

Operational Risk

Operational risk is the risk of loss due to human error; inadequate or failed internal systems and controls; violations of, or noncompliance with, laws, rules and regulations, prescribed practices, or ethical standards; and external influences such as market conditions, fraudulent activities, disasters, and security risks. We continuously strive to strengthen our system of internal controls to ensure compliance with laws, rules, and regulations, and to improve the oversight of our operational risk.

We evaluate internal systems, processes, and controls to mitigate loss from cyber-attacks and, to date, have not experienced any material losses. The goal of this framework is to implement effective operational risk techniques and strategies, minimize operational and fraud losses, and enhance our overall performance.

Natural disasters or other catastrophic events may cause damage or disruption to our operations. We have a nationwide mortgage lending presence through a network of brokers, correspondents and retail locations, as well as employees, customers and loans collateralized by properties across the country. As such, events like Hurricanes Harvey and Irma, as well as the recent California wildfires have the potential to impact our business.

During the third quarter of 2017, Hurricanes Harvey and Irma made landfall in Texas and Florida which represent our second and third largest markets for mortgage originations, respectively. These hurricanes could potentially affect credit losses, our ability to close mortgages and generate new loans, or cause us to incur greater losses when repurchasing FHA loans. While our assessment of the impact of these events is still ongoing, our LHFI portfolio contains approximately $279 million loans at risk within the counties which have been deemed disaster areas by FEMA. Based on our initial assessment, we believe damages and any credit impact from the hurricanes will not be significant and that our allowance coverage levels established at September 30, 2017 are adequate to cover any exposure we might have to further credit risk. In accordance with investor guidelines, homeowners within FEMA counties in Texas, Florida, Puerto Rico and the U.S. Virgin Islands have been offered a 90 day forbearance on their mortgage payments and we are working with borrowers on repayment plans in order to allow them extra time for payments to ease their financial burden.

Loans with government guarantees

Substantially all of our loans with government guarantees continue to be insured or guaranteed by the FHA or the U.S. Department of Veterans Affairs and management believes that the reimbursement process is proceeding appropriately. Nonperforming repurchased loans in this portfolio earn interest at a rate based upon the 10-year U.S. Treasury note rate from 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. In the three and nine months ended September 30, 2017, we experienced net charge-offs of $1 million and $3 million, respectively, and have reserved for the remaining risks within other assets and as a component of our ALLL on residential first mortgages. These charge-offs arise due to insurance limits on VA insured loans and FHA property foreclosure and preservation requirements that may result in a loss, all or in part, of the guarantee.

Our loans with government guarantees portfolio totaled $253 million at September 30, 2017, as compared to $365 million at December 31, 2016. The decrease is primarily due to loans transferred to LHFS and resold to Ginnie Mae

out-pacing new purchases.

For further information, see Note 5 - Loans with Government Guarantees.

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Representation and warranty reserve

When we sell mortgage loans, we make customary representations and warranties to the purchasers, including sponsored securitization trusts and their insurers (primarily Fannie Mae and Freddie Mac).

The representation and warranty benefit of $4 million and $11 million during the three and nine months ended September 30, 2017, respectively, was primarily due to lower loss severities for agency repurchases, and sustained lower volumes of repurchases and the continued reduction in our repurchase demand pipeline.

During the nine months ended September 30, 2017, we had $12 million in Fannie Mae new repurchase demands and $6 million in Freddie Mac new repurchase demands. These amounts are down as compared to the nine months ended September 30, 2016 when we had $14 million in Fannie Mae new repurchase demands and $10 million in Freddie Mac new repurchase demands. The total UPB of 2009 and later vintage loans, which are subject to the representation and warranty reserve, sold to Fannie Mae and Freddie Mac was $195 million and $177 million at September 30, 2017 and September 30, 2016, respectively.

For further information on Representation and Warranty Reserve, see Note 10 - Representation and Warranty Reserve.

Regulatory Risks

Consent Orders

On September 29, 2014, the Bank entered into a Consent Order with the CFPB. The Consent Order relates to alleged violations of federal consumer financial laws arising from the Bank's residential first mortgage loan loss mitigation practices and default servicing operations dating back to 2011. Under the terms of the Consent Order, the Bank paid $28 million for borrower remediation and $10 million in civil money penalties. The settlement does not involve any admission of wrongdoing on the part of the Bank or our employees, directors, officers, or agents. For further information and a complete description of all of the terms of the Consent Order, please refer to our Current Report on Form 8-K filed on September 29, 2014.

Supervisory Agreement

On January 28, 2010, we became subject to the Supervisory Agreement, which will remain in effect until terminated, modified, or suspended in writing by the Federal Reserve. The failure to comply with the Supervisory Agreement could result in the initiation of further enforcement action by the Federal Reserve, including the imposition of further operating restrictions, and could result in additional enforcement actions against us. We have taken actions which we believe are appropriate to comply with, and intend to maintain compliance with, all of the requirements of the Supervisory Agreement. For further information and a complete description of all of the terms of the Supervisory Agreement, please refer to the copy of the Supervisory Agreement filed with the SEC as an exhibit to our 2016 Form 10-K for the year ended December 31, 2016.

Department of Justice Settlement Agreement

On February 24, 2012, the Bank entered into a Settlement Agreement with the DOJ under which we made an initial payment of $15 million and agreed to make future payments totaling $118 million in annual increments of up to $25 million upon meeting all of the following conditions which are evaluated quarterly and include: (a) the reversal of the DTA 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 July 2016; and (c) the Bank having a

Tier 1 Leverage Capital Ratio of 11 percent or greater as filed in the Call Report with the OCC.

No payment would be required until six months after the Bank files its Call Report first reporting that its Tier 1 Leverage Capital Ratio was 11 percent or greater. If all other conditions were then satisfied, an initial annual payment of $25 million would be due at that time. The next annual payment is only made if all conditions continue to be satisfied otherwise payments are delayed until all such conditions are met. Further, making such a payment must not violate any material banking regulatory requirement, and the OCC must not object in writing.
The combination of (a) future dividends from the Bank to Bancorp and (b) continued growth in earning assets at the Bank are expected to continue to limit the growth rate of the Bank's Tier 1 Leverage Capital Ratio, which could have an impact on the timing of expected cash flows under the Settlement Agreement.

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Consistent with our business and regulatory requirements, Flagstar shall seek in good faith to 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 conditions.

Additionally, if the Bank or Bancorp become party to a business combination in which the Bank and Bancorp represent less than 33.3 percent of the resulting company's assets, annual payments would commence twelve months after the date of that business combination.

The Settlement Agreement meets the definition of a financial instrument for which we elected the fair value option. The fair value of the liability is subject to significant uncertainty and is impacted by forecasted estimates of equity, earnings, timing and amount of dividends and growth of the balance sheet and their related impacts on forecasted Tier 1 Leverage Capital Ratio. We consider the assumptions a market participant would make to transfer the liability and evaluate multiple possible outcomes and our estimates of the likelihood of these outcomes, which may change over time.

Capital

Under the OCC's capital distribution regulations, a savings bank that is a subsidiary of a savings and loan holding company must either notify or seek approval from the OCC of a capital distribution at least 30 days prior to the declaration of a dividend or the approval by the board of directors of the proposed capital distribution. The 30-day period allows the OCC to determine whether the distribution would not be advisable. Also, under Federal Reserve requirements, the Bank must provide a 30-day notice to the Federal Reserve prior to declaring or paying dividends. In addition, under the Supervisory Agreement, the Company agreed to request prior non-objection of the Federal Reserve to pay dividends or other capital distributions. We seek to manage our capital levels and overall business in a manner which we consider to be prudent and work with our regulators to ensure that our capital levels are appropriate considering our risk profile and evaluation of the capital levels maintained by peer institutions.

Regulatory Capital Composition - Transition

The maintenance of appropriate levels of capital is monitored by management on a regular basis. We manage our funding and capital positions by making adjustments to our balance sheet size and composition and hold capital to protect liability holders from the risk of loss.

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by regulators about components, risk weightings, and other factors. We are currently subject to regulatory capital rules issued by U.S. banking regulators.

Effective January 1, 2015, we became subject to the Basel III rules, which include certain transition provisions. Capital deductions to the Company's MSRs and deferred tax assets are recognized in 20 percent annual increments, and will be fully recognized as of January 1, 2018. When presented on a fully phased-in basis, capital, risk-weighted assets, and the capital ratios assume all regulatory capital adjustments and deductions are fully recognized. At September 30, 2017, the Company and the Bank were subject to the transitional phase-in limitation on deductions related to MSRs and certain deferred tax assets. The annual incremental change in the deductions due to the increase in the transitional phase-in from 60 percent in 2016 to 80 percent in 2017 reduced our regulatory capital ratios. These transitional phase in amounts increase to 100 percent in 2018.

Effective January 1, 2016, we became subject to the capital conservation buffer under the Basel III rules, subjecting a banking organization to certain limitations on capital distributions and discretionary bonus payments to executive officers if the organization does not maintain a capital conservation buffer above the minimum risk based capital requirements. The capital conservation buffer for 2017 must be greater than 1.25 percent in order to not be subject to limitations. The Company and the Bank had a capital conservation buffer of 7.0 percent and 7.9 percent, respectively, as of September 30, 2017. When fully phased-in on January 1, 2019, the capital conservation buffer must be greater than 2.5 percent.

Dodd-Frank Act Section 171, commonly known as the Collins Amendment, grandfathered the regulatory capital treatment of hybrid securities, such as trust preferred securities issued prior to May 9, 2010, for banks or holding companies with less than $15 billion in total consolidated assets as of December 31, 2009.

At September 30, 2017, we were considered "well-capitalized" for regulatory purposes.

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The following tables show the regulatory capital ratios as of the dates indicated:

	September 30, 2017		December 31, 2016	
	Amount	Ratio	Amount	Ratio
	(Dollars in millions)			
Bancorp				
Tier 1 leverage (to adjusted avg. total assets)	$1,423	8.80 %	$1,256	8.88 %
Total adjusted avg. total asset base (1)	16,165		14,149	
Tier 1 capital (to RWA)	$1,423	13.72 %	$1,256	15.12 %
Common equity Tier 1 (to RWA)	1,208	11.65 %	1,084	13.06 %
Total capital (to RWA)	1,554	14.99 %	1,363	16.41 %
Risk-weighted asset base (1)	$10,371		$8,305	

	September 30, 2017		December 31, 2016	
	Amount	Ratio	Amount	Ratio
	(Dollars in millions)			
Bank				
Tier 1 leverage (to adjusted avg. total assets)	$1,519	9.38 %	$1,491	10.52 %
Total adjusted avg. total asset base (1)	16,191		14,177	
Tier 1 capital (to RWA)	$1,519	14.61 %	$1,491	17.90 %
Common equity Tier 1 (to RWA)	1,519	14.61 %	1,491	17.90 %
Total capital (to RWA)	1,651	15.88 %	1,598	19.18 %
Risk-weighted asset base (1)	$10,396		$8,332	

(1) Based on adjusted total assets for purposes of Tier 1 leverage capital and RWA for purposes Tier 1, common equity Tier 1, and total risk-based capital.

Our Bancorp Tier 1 leverage ratio decreased at September 30, 2017, compared to December 31, 2016, primarily as a result of an increase in average assets during the nine months ended September 30, 2017.

Banks with assets greater than $10 billion are required to submit a DFAST under the final rules established by their primary regulator. DFAST requires banks to project results over a nine-quarter planning horizon under three scenarios (baseline, adverse, and severely adverse) published by the Federal Reserve and to show that the bank would exceed regulatory minimum capital standards for the Tier 1 leverage ratio, Tier 1 common ratio, Tier 1 risk-based capital ratio, and the Total risk-based capital ratio under all of these scenarios. We are not subject to the Federal Reserve’s Comprehensive Capital Analysis and Review program.

Additionally, we conduct quarterly capital stress tests and capital adequacy assessments. These quarterly capital stress tests utilize internally defined scenarios that are designed to help management and the Board better understand the integrated sensitivity of various risk exposures through quantifying the potential financial and capital impacts of hypothetical stressful events and scenarios.

The following table contains certain regulatory capital ratios for the Bank and the Company:

	Regulatory Minimums	Regulatory Minimums to be Well-Capitalized	Bank	Bancorp
September 30, 2017				
Basel III Ratios (transitional)				
Common equity Tier I capital ratio	4.50 %	6.50 %	14.61 %	11.65 %

Tier I leverage ratio	4.00 %	5.00 %	9.38 %	8.80 %
Basel III Ratios (fully phased-in) (1)				
Common equity Tier I capital ratio	4.50 %	6.50 %	13.80 %	10.58 %
Tier I leverage ratio	4.00 %	5.00 %	9.13 %	8.43 %

(1) Refer to MD&A - Use of Non-GAAP Financial Measures.

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The impact under the fully phased in Basel III rules to our Tier 1 leverage ratio is mostly driven by the treatment that MSRs receive under Basel III. Once fully phased in, the Basel III capital rules will significantly reduce the allowable amount of the fair value of MSRs included in Tier 1 capital. At September 30, 2017, we had $246 million of MSRs, representing 17.3 percent of Tier 1 capital. Our ratio of MSRs to Tier 1 capital was 26.7 percent at December 31, 2016. During the nine months ended September 30, 2017, we had $260 million in bulk MSR sales. Over the long term, we plan to continue to reduce our MSRs to Tier 1 ratio, taking into consideration market conditions to guide our pace of MSR reduction.

On August 22, 2017, in preparation for a forthcoming proposal that would simplify regulatory capital requirements, the federal banking regulators proposed a rule that would extend the existing transitional capital treatment for certain regulatory capital deductions and risk weights. The Agencies are proposing to extend the existing transition provisions for a targeted set of items: MSRs, certain DTAs, investments in the capital instruments of unconsolidated financial institutions, and minority interests. This proposal would postpone the implementation of the fully phased-in requirements for these items by banking organizations that are not subject to the advanced approaches capital rules prior to the Agencies' consideration of simplification to the capital rules.

On September 27, 2017, the federal banking agencies released a Notice of Proposed Rulemaking (NPR), proposing changes to certain aspects of the bank capital rules under the "standardized approach." The proposal is to modify the approach to the capital treatment of acquisition, development, and construction (ADC) loans characterized under the current capital rules as high volatility commercial real estate (HVCRE) exposures. The rule is intended to simplify the capital treatment of ADC loans and broaden the number ADC loans subject to a higher risk weighting, while reducing the risk weight for covered loans from 150% to 130%.

In addition, the new proposal would simplify the threshold deduction treatment for MSRs, temporary difference DTAs not realizable through carryback, and investments in the capital of unconsolidated financial institutions. The proposal would require that non-advanced approaches banking organizations deduct from common equity tier 1 capital any amount of MSRs, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions that individually exceeds 25 percent of the common equity tier 1 capital deduction threshold. Consistent with the capital rule, under the proposal, a banking organization would continue to apply a 250 percent risk weight to any MSRs or temporary DTAs not deducted. Also, any investments in the capital of unconsolidated financial institutions that are not deducted, would be assigned a risk weight according to the exposure category of the investment.

We are currently reviewing the proposed rules and the potential impact they may have on our regulatory capital. If enacted as proposed, we believe the rules should accelerate the capital formation necessary to support further balance sheet growth and, under a limit of 25 percent of capital, give us the flexibility to better manage the uncertainties that may exist within the MSR market at any given time. This will allow us to hold more MSRs which are a high yielding asset that we fund efficiently and for which we hedge exposure to changes in interest rates, convexity and implied future volatility. Flagstar Bancorp's Tier 1 Leverage ratio should increase approximately 70 basis points after applying the simplified capital rules under the NPR.

Use of Non-GAAP Financial Measures

In addition to results presented in accordance with GAAP, this report includes non-GAAP financial measures such as the estimated fully implemented Basel III capital levels and ratios and tangible book value per share. We believe these non-GAAP financial measures provide additional information that is useful to investors in helping to understand the underlying performance and trends of the Company.

Non-GAAP financial measures have inherent limitations, which are not required to be uniformly applied and are not audited. Readers should be aware of these limitations and should be cautious with respect to the use of such measures. To mitigate these limitations, we have practices in place to ensure that these measures are calculated using the appropriate GAAP or regulatory components in their entirety and to ensure that our performance is properly reflected

to facilitate consistent period-to-period comparisons. Our method of calculating these non-GAAP measures may differ from methods used by other companies. Although we believe the non-GAAP financial measures disclosed in this report enhance investors' understanding of our business and performance, these non-GAAP measures should not be considered in isolation, or as a substitute for those financial measures prepared in accordance with GAAP. Where non-GAAP financial measures are used, the most directly comparable GAAP or regulatory financial measure, as well as the reconciliation to the most directly comparable GAAP or regulatory financial measure, can be found in this report.

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Nonperforming assets / Tier 1 + Allowance for Loan Losses. The ratio of nonperforming assets to Tier 1 and ALLL divides the total level of nonperforming LHFI assets by Tier 1 capital (to adjusted total assets), as defined by bank regulations, plus ALLL. We believe these measurements are meaningful measures of capital adequacy used by investors, regulators, management and others to evaluate the adequacy of capital in comparison to other companies within the industry.

	September 30, 2017	December 31, 2016
	(Dollars in millions)	
Nonperforming assets	$40	$ 54
Tier 1 capital (to adjusted total assets)	1,423	1,256
Allowance for loan losses	140	142
Tier 1 capital + ALLL	$1,563	$ 1,398
Nonperforming assets / Tier 1 capital + ALLL	2.6 %	3.9 %

Tangible book value per share. The Company believes that tangible book value per share provides a meaningful representation of its operating performance on an ongoing basis. Management uses this measure to assess performance of the Company against its peers and evaluate overall performance. The Company believes this non-GAAP financial measure provides useful information for investors, securities analysts and others because it provides a tool to evaluate the Company's performance on an ongoing basis and compared to its peers.

	September 30, 2017	December 31, 2016	September 30, 2016
	(Dollars in millions, except share data)		
Total stock holders' equity	$1,451	$ 1,336	$ 1,286
Preferred stock	—	—	—
Goodwill and intangibles	21	—	—
Tangible book value	$1,430	$ 1,336	$ 1,286
Number of common shares outstanding	57,181,536	56,824,802	56,597,271
Tangible book value per share	$25.01	$ 23.50	$ 22.72

Basel III (transitional) to Basel III (fully phased-in) reconciliation. On January 1, 2015, the Basel III rules became effective, subject to transition provisions primarily related to regulatory deductions and adjustments impacting common equity Tier 1 capital and Tier 1 capital. When fully phased-in, Basel III, will increase capital requirements through higher minimum capital levels as well as through increases in risk-weights for certain exposures. Additionally, the final Basel III rules place greater emphasis on common equity. In October 2013, the OCC and Federal Reserve released final rules detailing the U.S. implementation of Basel III and the application of the risk-based and leverage capital rules to top-tier savings and loan holding companies. We have transitioned to the Basel III framework beginning in January 2015 and are subject to a phase-in period extending through 2018. Accordingly, the calculations provided below and on the previous page, are estimates. These measures are considered to be non-GAAP financial measures because they are not formally defined by GAAP and the Basel III implementation regulations. The Common Equity Tier 1, Tier 1, Total Capital and Leverage ratios will not be fully phased-in until January 1, 2018 and the Capital Conservation buffer will not be fully phased-in until January 1, 2019. The regulations are subject to change as clarifying guidance becomes available and the calculations currently include our interpretations of the requirements including informal feedback received through the regulatory process. The federal banking regulators have issued a series of new proposals regarding regulatory capital which may freeze or eliminate the transitional rules. See MD&A -Regulatory Capital Composition - Transition section for further information. Other entities may calculate the Basel III ratios differently from ours based on their interpretation of the guidelines. Since

analysts and banking regulators may assess our capital adequacy using the Basel III framework, we believe that it is useful to provide investors information enabling them to assess our capital adequacy on the same basis.

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	Common Equity Tier 1 (to RWA)	Tier 1 leverage (to adjusted avg. total assets)	Tier 1 Capital (to RWA)	Total Risk-Based Capital (to RWA)
	(Dollars in millions)			
September 30, 2017				
Flagstar Bancorp				
Regulatory capital – Basel III (transitional) to Basel III (fully phased-in)				
Basel III (transitional)	$1,208	$1,423	$1,423	$1,554
Increased deductions related to deferred tax assets, MSRs, and other capital components	(90)	(65)	(65)	(62)
Basel III (fully phased-in) capital	$1,118	$1,358	$1,358	$1,492
Risk-weighted assets – Basel III (transitional) to Basel III (fully phased-in)				
Basel III assets (transitional)	$10,371	$16,165	$10,371	$10,371
Net change in assets	191	(65)	191	191
Basel III (fully phased-in) assets	$10,562	$16,100	$10,562	$10,562
Capital ratios				
Basel III (transitional)	11.65 %	8.80 %	13.72 %	14.99 %
Basel III (fully phased-in)	10.58 %	8.43 %	12.86 %	14.13 %

	Common Equity Tier 1 (to RWA)	Tier 1 leverage (to adjusted avg. total assets)	Tier 1 Capital (to RWA)	Total Risk-Based Capital (to RWA)
	(Dollars in millions)			
September 30, 2017				
Flagstar Bank				
Regulatory capital – Basel III (transitional) to Basel III (fully phased-in)				
Basel III (transitional)	$1,519	$1,519	$1,519	$1,651
Increased deductions related to deferred tax assets, MSRs, and other capital components	(44)	(44)	(44)	(41)
Basel III (fully phased-in) capital	$1,475	$1,475	$1,475	$1,610
Risk-weighted assets – Basel III (transitional) to Basel III (fully phased-in)				
Basel III assets (transitional)	$10,396	$16,191	$10,396	$10,396
Net change in assets	293	(45)	293	293
Basel III (fully phased-in) assets	$10,689	$16,146	$10,689	$10,689
Capital ratios				
Basel III (transitional)	14.61 %	9.38 %	14.61 %	15.88 %
Basel III (fully phased-in)	13.80 %	9.13 %	13.80 %	15.06 %

Critical Accounting Estimates

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 and the Notes, are described in Item 1. These policies relate to: (a) the determination of our ALLL; and (b) fair value measurements. We believe the judgment, estimates and assumptions used in the preparation of our Consolidated Financial Statements and the Notes are appropriate given the factual circumstances at the time. However, given the sensitivity of our Consolidated Financial Statements and the Notes 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 Form 10-K for the year ended December 31, 2016, which is available on our website, flagstar.com, under the Investor Relations section, or on the website of the Securities and Exchange Commission, at sec.gov.

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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. 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, 2016 and Item 1A to Part II of this Quarterly Report on Form 10-Q, which are incorporated by reference herein.

Other than as required under United States securities laws, Flagstar Bancorp does not undertake to update the forward-looking statements to reflect the impact of circumstances or events that may arise after the date of the forward-looking statements.

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Item 1. Financial Statements

Flagstar Bancorp, Inc.
Consolidated Statements of Financial Condition
(In millions, except share data)

	September 30, 2017 (Unaudited)	December 31, 2016 (Unaudited)
Assets		
Cash	$ 88	$ 84
Interest-earning deposits	145	74
Total cash and cash equivalents	233	158
Investment securities available-for-sale	1,637	1,480