FLAGSTAR BANCORP INC
Form 10-Q
November 03, 2014
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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, 2014

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 or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No ý.
As of October 30, 2014, 56,271,116 shares of the registrant’s common stock, $0.01 par value, were issued and outstanding.

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
Flagstar Bancorp, Inc.
Consolidated Statements of Financial Condition
(In thousands, except share data)

	September 30, 2014 (Unaudited)	December 31, 2013
Assets		
Cash and cash equivalents		
Cash and cash items ($2,855 and $1,129 of consolidated VIEs, respectively) (1)	$44,374	$55,913
Interest-earning deposits	62,466	224,592
Total cash and cash equivalents	106,840	280,505
Investment securities available-for-sale	1,378,093	1,045,548
Loans held-for-sale ($1,415,938 and $1,140,507 measured at fair value, respectively) (2)	1,468,668	1,480,418
Loans repurchased with government guarantees	1,191,826	1,273,690
Loans held-for-investment, net		
Loans held-for-investment ($222,348 and $238,322 measured at fair value which includes $140,331 and $155,012 of consolidated VIEs, respectively) (1) (2)	4,184,624	4,055,756
Less: allowance for loan losses	(301,000)	(207,000)
Total loans held-for-investment, net	3,883,624	3,848,756
Mortgage servicing rights	285,386	284,678
Repossessed assets, net	27,149	36,636
Federal Home Loan Bank stock	209,737	209,737
Premises and equipment, net	238,261	231,350
Net deferred tax asset	449,575	414,681
Other assets	386,251	301,302
Total assets	$9,625,410	$9,407,301
Liabilities and Stockholders' Equity		
Deposits		
Noninterest bearing	$1,299,405	$930,060
Interest bearing	5,934,991	5,210,266
Total deposits	7,234,396	6,140,326
Federal Home Loan Bank advances	150,000	988,000
Long-term debt ($92,140 and $105,813 of consolidated VIEs at fair value, respectively) (1) (2)	339,575	353,248
Representation and warranty reserve	57,000	54,000
Other liabilities ($80,100 and $93,000 measured at fair value and $136 and $136 of consolidated VIEs, respectively) (1) (2)	492,834	445,853
Total liabilities	8,273,805	7,981,427
Stockholders' Equity		
Preferred stock $0.01 par value, liquidation value $1,000 per share, 25,000,000 shares authorized; 266,657 issued and outstanding, respectively	266,657	266,174
Common stock $0.01 par value, 70,000,000 shares authorized; 56,261,652 and 56,138,074 shares issued and outstanding, respectively	563	561
Additional paid in capital	1,480,955	1,479,265
Accumulated other comprehensive income (loss)	(250)	(4,831)
Accumulated deficit	(396,320)	(315,295)

Total stockholders’ equity	1,351,605	1,425,874
Total liabilities and stockholders’ equity	$9,625,410	$9,407,301

(1) Amounts represent the assets and liabilities of consolidated variable interest entities ("VIEs").
(2) Amounts represent the assets and liabilities for which the Company has elected the fair value option.

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Unaudited)		(Unaudited)	
Interest Income				
Loans	$64,060	$75,633	$184,638	$249,312
Investment securities available-for-sale or trading	10,880	1,465	28,303	5,397
Interest-earning deposits and other	154	1,709	417	4,145
Total interest income	75,094	78,807	213,358	258,854
Interest Expense				
Deposits	8,461	10,023	21,688	35,680
Federal Home Loan Bank advances	591	24,434	1,725	72,766
Other	1,679	1,665	4,957	4,960
Total interest expense	10,731	36,122	28,370	113,406
Net interest income	64,363	42,685	184,988	145,448
Provision for loan losses	8,097	4,053	126,567	56,030
Net interest income after provision for loan losses	56,266	38,632	58,421	89,418
Noninterest Income				
Loan fees and charges	18,661	20,876	56,272	84,152
Deposit fees and charges	5,618	5,410	15,660	15,749
Net gain on loan sales	52,175	75,073	152,275	357,404
Loan administration income	5,599	1,454	18,826	2,752
Net return on the mortgage servicing asset	1,346	27,217	22,475	73,949
Net gain on sale of assets	4,874	98	10,626	2,120
Total other-than-temporary impairment (loss) gain	—	—	—	(8,789)
Net impairment losses recognized in earnings	—	—	—	(8,789)
Representation and warranty reserve – change in estimate	(12,538)	(5,205)	(16,092)	(51,541)
Other noninterest income	9,453	9,373	2,583	63,402
Total noninterest income	85,188	134,296	262,625	539,198
Noninterest Expense				
Compensation and benefits	53,503	61,552	174,291	209,696
Commissions	10,346	12,099	26,098	44,962
Occupancy and equipment	20,471	18,644	60,265	60,218
Asset resolution	13,666	16,295	43,108	48,661
Federal insurance premiums	5,633	7,910	17,402	26,941
Loan processing expense	10,472	10,890	26,406	43,390
Legal and professional expense	15,044	19,593	39,826	64,822
Other noninterest expense	50,254	11,453	52,598	30,732
Total noninterest expense	179,389	158,436	439,994	529,422

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Unaudited)		(Unaudited)	
(Loss) income before income taxes	(37,935)	14,492	(118,948)	99,194
(Benefit) provision for income taxes	(10,303)	220	(38,407)	(5,888)
Net (loss) income	(27,632)	14,272	(80,541)	105,082
Preferred stock dividend/accretion	—	(1,449)	(483)	(4,336)
Net (loss) income applicable to common stock	$(27,632)	$12,823	$(81,024)	$100,746
(Loss) income per share				
Basic	$(0.61)	$0.16	$(1.79)	$1.61
Diluted	$(0.61)	$0.16	$(1.79)	$1.59
Weighted average shares outstanding				
Basic	56,249,300	56,096,376	56,224,850	56,041,844
Diluted	56,249,300	56,541,089	56,224,850	56,458,898

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Unaudited)		(Unaudited)	
Net (loss) income	$(27,632)	$14,272	$(80,541)	$105,082
Other comprehensive (loss) income, before tax				
Investment securities available-for-sale				
Unrealized (loss) gains on investment securities available-for-sale	(8,531)	3,441	10,126	6,087
Reclassification of (loss) gain on sale of investment securities available-for-sale	(2,382)	—	(3,057)	—
Subsequent decreases in the fair value of investment securities available-for-sale previously written down as impaired	—	—	—	(2,681)
Additions for the amount related to the credit loss for which an other-than-temporary impairment was not previously recognized	—	—	—	8,789
Total investment securities available-for-sale, before tax	(10,913)	3,441	7,069	12,195
Other comprehensive income, deferred tax (loss) benefit				
Deferred tax loss (benefit) related to other comprehensive income resulting from unrealized gains and losses on investment securities available-for-sale	3,842	—	1,723	—
Deferred tax loss (benefit) related to other comprehensive income resulting from the dissolution and sales of investments securities available-for-sale	—	—	(4,212)	(6,108)
Other comprehensive (loss) income, net of tax	(7,071)	3,441	4,580	6,087
Comprehensive (loss) income	$(34,703)	$17,713	$(75,961)	$111,169

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

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Flagstar Bancorp, Inc.
Consolidated Statements of Stockholders' Equity
(In thousands)

	Preferred Stock	Common Stock	Additional Paid in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (Accumulated Deficit)	Total Stockholders' Equity
Balance at December 31, 2012 (Unaudited)	$260,390	$559	$1,476,569	$ (1,658)	$ (576,498)	$1,159,362
Net income	—	—	—	—	105,082	105,082
Total other comprehensive income	—	—	—	6,087	—	6,087
Restricted stock issued	—	1	(1)	—	—	—
Accretion of preferred stock	4,336	—	—	—	(4,336)	—
Stock-based compensation	—	1	1,823	—	—	1,824
Balance at September 30, 2013	$264,726	$561	$1,478,391	$ 4,429	$ (475,752)	$1,272,355
Balance at December 31, 2013 (Unaudited)	$266,174	$561	$1,479,265	$ (4,831)	$ (315,295)	$1,425,874
Net income	—	—	—	—	(80,541)	(80,541)
Total other comprehensive income	—	—	—	4,580	—	4,580
Restricted stock issued	—	2	(2)	—	—	—
Accretion of preferred stock	483	—	—	—	(483)	—
Stock-based compensation	—	—	1,692	—	—	1,692
Balance at September 30, 2014	$266,657	$563	$1,480,955	$ (251)	$ (396,319)	$1,351,605

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

Flagstar Bancorp, Inc.
Consolidated Statements of Cash Flows
(In thousands)

	Nine Months Ended September 30,	
	2014	2013
	(Unaudited)	
Operating Activities		
Net (loss) income	$(80,541)	$105,082
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Provision for loan losses	126,567	56,030
Depreciation and amortization	17,936	17,200
Loss on fair value of mortgage servicing rights	36,505	3,236
Loss on fair value of long-term debt	5,307	5,139
Net gain on the sale of assets	(14,399)	(16,749)
Net gain on loan sales	(152,275)	(357,404)
Net transaction costs on sales of mortgage servicing rights	4	10,246
Net gain on investment securities available for sale	(3,057)	—
Net gain on trading securities	—	(85)
Other than temporary impairment losses on investment securities available-for-sale	—	8,789
Net gain on transferors' interest	—	(45,534)
Proceeds from sales of loans held-for-sale	13,249,012	35,038,925
Origination and repurchase of loans held-for-sale, net of principal repayments	(18,927,059)	(32,445,369)
Net change in:		
Decrease in repurchase loans with government guarantees, net of claims received	81,865	609,577
(Increase) decrease in accrued interest receivable	(12,284)	42,680
Proceeds from sales of trading securities	—	120,122
(Increase) decrease in other assets	(103,020)	5,432
Decrease in payable for mortgage repurchase option	(16,450)	(56,978)
Representation and warranty reserve - change in estimate	16,092	51,541
Net charge-offs in representation and warranty reserve	(18,017)	(85,129)
Increase (decrease) in other liabilities	20,107	(235,284)
Net cash (used in) provided by operating activities	(5,773,707)	2,831,467
Investing Activities		
Proceeds received from the sale of investment securities available-for-sale	6,317,522	—
Repayment of investment securities available-for-sale	117,795	45,769
Purchase of investment securities available-for-sale	(755,414)	(436,585)
Net change from sales of loans held-for-investment	(368,904)	(471,249)
Principal repayments net of origination of loans held-for-investment	(150,402)	1,551,144
Proceeds from the disposition of repossessed assets	29,812	83,139
Acquisitions of premises and equipment, net of proceeds	(26,279)	(27,067)
Proceeds from the sale of mortgage servicing rights	155,498	222,804
Net cash provided by investing activities	5,319,628	967,955

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Flagstar Bancorp, Inc.
Consolidated Statements of Cash Flows, continued
(In thousands)

	Nine Months Ended September 30,	
	2014	2013
	(Unaudited)	
Financing Activities		
Net increase (decrease) in deposit accounts	1,094,071	(1,645,010)
Net decrease in Federal Home Loan Bank advances	(838,000)	(272,402)
Payment on long-term debt	(18,980)	(12,165)
Net receipt (disbursement) of payments of loans serviced for others	38,867	(282,968)
Net receipt of escrow payments	4,456	11,440
Net cash provided by (used in) financing activities	280,414	(2,201,105)
Net (decrease) increase in cash and cash equivalents	(173,665)	1,598,317
Beginning cash and cash equivalents	280,505	952,793
Ending cash and cash equivalents	$106,840	$2,551,110
Supplemental disclosure of cash flow information		
Loans held-for-investment transferred to repossessed assets	$48,875	$167,898
Interest paid on deposits and other borrowings	$23,272	$109,342
Income taxes paid	$100	$8,509
Reclassification of loans originated for investment to loans held-for-sale	$384,329	$542,822
Reclassification of mortgage loans originated held-for-sale to loans held-for-investment	$15,425	$53,208
Reclassification of mortgage loans held-for-sale to investment securities available-for-sale	$6,001,134	$—
Mortgage servicing rights resulting from sale or securitization of loans	$198,051	$323,216
Recharacterization of investment securities available-for-sale to loans held-for-investment	$—	$73,283
Reconsolidation of HELOC's of variable interest entities (VIEs)	$—	$170,507
Reconsolidation of long-term debt of VIEs	$—	$119,980

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

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Flagstar Bancorp, Inc.
Notes to the Consolidated Financial Statements (Unaudited)

Note 1 – Nature of Business

Flagstar Bancorp, Inc. ("Flagstar" or the "Company"), the holding company for Flagstar Bank, FSB (the "Bank") is a Michigan-based savings and loan holding company founded in 1993. The Company's business is primarily conducted through its principal subsidiary, the Bank, a federally chartered stock savings bank founded in 1987. At September 30, 2014, the Company's total assets were $9.6 billion. The Company has the largest bank headquartered in Michigan and one of the top ten largest savings banks in the United States.

In preparing these consolidated financial statements, subsequent events were evaluated through the time the financial statements were issued. All material subsequent events have been either recognized in the Consolidated Financial Statements or disclosed in the Notes to the Consolidated Financial Statements.

The Company's operations are conducted through four operating segments: Mortgage Originations, Mortgage Servicing, Community Banking, and Other, which includes the remaining reported activities. The Mortgage Originations segment, in which the Company originates or purchases residential mortgage loans throughout the country and sells them into securitization pools, primarily to Federal National Mortgage Association ("Fannie Mae"), Federal Home Loan Mortgage Corporation ("Freddie Mac") and Government National Mortgage Association ("Ginnie Mae") (collectively, the "Agencies") or as whole loans. Mortgage loans are originated through 32 home loan centers located in 18 states, a direct to consumer call center, the Internet, wholesale brokers and correspondents. The Mortgage Servicing segment services mortgage loans on a fee basis for others and also services residential mortgages held-for-investment by the Community Banking segment and mortgage servicing rights held by the Other segment. See Note 19 - Segment Information for additional information.

The Company also offers a range of products and services to consumers and businesses through the Community Banking segment. As of September 30, 2014, the Company operated 106 banking centers in Michigan. The Company offers consumer products including deposit accounts, commercial loans and personal loans, including auto and boat loans. Commercial products offered include deposit and sweep accounts, telephone banking, term loans and lines of credit, lease financing, government banking products and treasury management services including remote deposit and merchant services.

The Bank is subject to regulation, examination and supervision by the Office of the Comptroller of the Currency ("OCC") of the U.S. Department of the Treasury ("U.S. Treasury"). The Bank is also subject to regulation, examination and supervision by the Federal Deposit Insurance Corporation ("FDIC") and the Consumer Financial Protection Bureau (the "CFPB"). The Bank's deposits are insured by the FDIC through the Deposit Insurance Fund. The Company is subject to regulation, examination and supervision by the Board of Governors of the Federal Reserve ("Federal Reserve"). The Bank is also a member of the Federal Home Loan Bank ("FHLB") of Indianapolis.

Note 2 – Basis of Presentation and Accounting Policies

The accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the SEC for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America ("U.S. GAAP") for complete financial statements. These interim financial statements include all adjustments, consisting of normal recurring accruals that management believes are necessary for a fair presentation of the results of operations, financial position and cash flows. The results of operations for the three and nine months ended September 30, 2014, are not necessarily indicative of the results that may be expected for any other interim period or for the full year ending

December 31, 2014. In addition, certain prior period amounts have been reclassified to conform to the current period presentation. These consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013, which are available on the Company’s Investor Relations website, at www.flagstar.com, and on the SEC website, at www.sec.gov.

Variable Interest Entities

The accompanying unaudited consolidated financial statements include variable interest entities ("VIEs") in which the Company has determined to have a controlling financial interest. The Company consolidates a VIE if it has: (i) a variable interest in the entity; (ii) the power to direct activities of the VIE that most significantly impact the entity's economic performance; and (iii) the obligation to absorb losses of the entity or the right to receive benefits from the entity that could potentially be significant to the VIE (i.e., the Company is considered to be the primary beneficiary).

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At June 30, 2013, the Company became the primary beneficiary of the FSTAR 2005-1 and FSTAR 2006-2 HELOC securitization trusts because the Company obtained the power to direct the activities that most significantly impact the economic performance of the trusts (power to select or remove the servicer) and the obligation to absorb expected losses and receive residual returns (support of the guarantor and holder of residual interests in trusts), which is reflected in the Consolidated Financial Statements as a VIE. See Note 8 for information on VIEs.

Recently Issued Accounting Pronouncements

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board ("FASB") or other standard setting bodies that are adopted by the Company as of the specified effective date. Unless otherwise discussed, the impact of recently issued standards that are not yet effective will not have a material impact on the Consolidated Financial Statements or the Notes thereto or results of operations upon adoption.

In April 2014, the FASB issued ASU No. 2014-08, "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." The amendments in this guidance will allow discontinued operations to include a component of an entity or a group of components of an entity. A disposal is required to be reported in discontinued operations if it represents a strategic shift that has (or will have) a major effect on an entity’s operations and financial results. This guidance is effective prospectively, for annual and interim periods, beginning after December 15, 2014. The adoption of the guidance is not expected to have a material effect on the Company’s Consolidated Financial Statements or the Notes thereto.
In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." Under the amended guidance, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This guidance is effective prospectively, for annual and interim periods, beginning after December 15, 2016. Management is currently evaluating this guidance and does not expect this guidance to have a material impact on the Company’s Consolidated Financial Statements, but significant disclosures to the Notes thereto will be required.

In June 2014, the FASB issued ASU No. 2014-11, "Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financing, and Disclosures." The amendments in this guidance requires repurchase-to-maturity transactions to be accounted for as secured borrowings. The guidance for certain transactions accounted for as a sale, repurchase agreements, securities lending transactions and repurchase-to-maturity transactions accounted for as secured borrowings is effective prospectively, for annual and interim periods, beginning after December 15, 2014. The adoption of the guidance is not expected to have a material effect on the Company’s Consolidated Financial Statements or the Notes thereto.

In August 2014, the FASB issued ASU No. 2014-13, Consolidation (Topic 810). A reporting entity that consolidates a collateralized financing entity within the scope of this update may elect to measure the financial assets and the financial liabilities of that collateralized financing entity using either the measurement alternative included in this update or Topic 820 on fair value measurement. When the measurement alternative is not elected for a consolidated collateralized financing entity within the scope of this update, the amendments clarify that (1) the fair value of the financial assets and the fair value of the financial liabilities of the consolidated collaterlized financing entity should be measured using the requirements of Topic 820 and (2) any differences in the fair value of the financial assets and the fair value of the financial liabilities of that consolidated collateralized financing entity should be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss). The amendments in this update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. The adoption of this guidance is not expected to have a material effect on the Company’s

Consolidated Financial Statements or the Notes thereto.

In August 2014, the FASB issued ASU Update No. 2014-14, Receivables - Troubled Debt Restructuring by Creditors (Subtopic 310-40). The amendments in this update require that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) The loan has a government guarantee that is not separable from the loan before foreclosure. (2) At the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim. (3) At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The amendments in this update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The adoption of this guidance is not expected to have a material effect on the Company’s Consolidated Financial Statements or the Notes thereto.

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In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40). In connection with preparing financial statements for each annual and interim reporting periods, an entity's management should evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable). Management's evaluation should be based on relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued (or at the date that the financial statements are available to be issued when applicable). The amendments in this update are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. The adoption of this guidance is not expected to have a material effect on the Company’s Consolidated Financial Statements or the Notes thereto.

Note 3 – Fair Value Measurements

The Company utilizes fair value measurements to record certain assets and liabilities at fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability through an orderly transaction between market participants at the measurement date. The determination of fair values of financial instruments often requires the use of estimates. In cases where quoted market values in an active market are not available, the Company uses present value techniques and other valuation methods to estimate the fair values of its financial instruments. These valuation models rely on market-based parameters when available, such as interest rate yield curves, credit spreads or unobservable inputs. Unobservable inputs may be based on management's judgment, assumptions and estimates related to credit quality, the Company's future earnings, interest rates and other relevant inputs. These valuation methods require considerable judgment and the resulting estimates of fair value can be significantly affected by the assumptions made and methods used.

Valuation Hierarchy

U.S. GAAP establishes a three-level valuation hierarchy for disclosure of fair value measurements that is based on the transparency of the inputs used in the valuation process. The three levels of the hierarchy, highest ranking to lowest, are as follows.

Level 1 - Quoted prices (unadjusted) for identical assets or liabilities in active markets in which the Company can participate as of the measurement date;

Level 2 - Quoted prices for similar instruments in active markets, and other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument; and

Level 3 - Unobservable inputs that reflect the Company's own assumptions about the expectations that market participants would use in pricing an asset or liability.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input within the valuation hierarchy that is significant to the overall fair value measurement. Transfers between levels of the fair value hierarchy are recognized at the end of the reporting period.

The following is a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Assets

Investment securities available-for-sale. These securities are comprised of U.S. government sponsored agencies and municipal obligations. The Company measures fair value using prices obtained from pricing services. A review is performed on the security prices received from the pricing services, which includes discussion and analysis of the inputs used by the pricing services to value our securities. Where possible, fair values are generated using market inputs including quoted prices (the closing price in an exchange markets), bid prices (the price at which a buyer stands ready to purchase) and other market information. For fixed income securities that are not actively traded, the pricing services use alternative methods to determine fair value for the securities, including; quotes for similar fixed-income securities, matrix pricing, discounted cash flow using benchmark curves or other factors to determine fair value. U.S. government sponsored agency mortgage backed securities are classified within Level 2 of the valuation hierarchy, U.S. government sponsored collateralized mortgage obligation securities are classified within Level 2 of the valuation hierarchy and all other debt securities are classified within Level 3 of the valuation hierarchy.

Loans held-for-sale. The Company generally estimates the fair value of loans held-for-sale based on quoted market prices for securities backed by similar types of loans. Where quoted market prices were available, such market prices were utilized as estimates for fair values. Otherwise, the fair value of loans was computed by discounting cash flows using observable inputs inclusive of interest rates, prepayment speeds and loss assumptions for similar collateral. These measurements are classified as Level 2.

Loans held-for-investment. Loans held-for-investment are generally recorded at amortized cost. The Company does not record these loans at fair value on a recurring basis. However, from time to time, a loan becomes impaired when it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement. Once a loan is identified as impaired, the fair value of the impaired loan is estimated using one of several methods, including collateral value, market value of similar debt, or discounted cash flows. The fair value of the underlying collateral is determined, where possible, using market prices derived from appraisals or broker price opinions which are considered to be Level 3. Fair value may also be measured using the present value of expected cash flows discounted at the loan's effective interest rate. The Company records the impaired loans as a non-recurring Level 3 valuation.

Loans held-for-investment that are recorded at fair value on a recurring basis are loans that were previously recorded as loans held-for-sale but subsequently transferred to the held-for-investment category. As the Company selected the fair value option for the held-for-sale loans, they continue to be reported at fair value and measured consistent with the Level 2 methodology for loans held-for-sale.

The HELOC loans associated with the FSTAR 2005-1 and FSTAR 2006-2 securitization trusts have been recorded in the Consolidated Financial Statement as loans held-for-investment, at fair value. The Company records these loans as a recurring Level 3 valuation.

Also, included in loans held-for-investment are the second mortgage loans associated with the previous FSTAR 2006-1 mortgage securitization trust. The loans are carried at fair value and valued using a discounted estimated net future cash flow model and therefore classified within the Level 3 valuation hierarchy as the model utilizes significant inputs which are unobservable. See Note 8 - Private-Label Securitization and Variable Interest Entities for additional information.

Repossessed assets. Repossessed assets are measured and reported at fair value through a charge-off to the allowance for loan losses based upon the fair value of the repossessed asset. The fair value of repossessed assets, upon initial recognition, are estimated using Level 3 inputs based on customized discounting criteria. The significant unobservable inputs used in the Level 3 fair value measurements of the Company's impaired loans and repossessed assets included in the table above primarily relate to internal valuations or analysis.

Mortgage Servicing Rights ("MSRs"). The current market for MSRs is not sufficiently liquid to provide participants with quoted market prices. Therefore, the Company uses an option-adjusted spread valuation approach to determine the fair value of MSRs. This approach consists of projecting servicing cash flows under multiple interest rate scenarios and discounting these cash flows using risk-adjusted discount rates. The key assumptions used in the valuation of MSRs include mortgage prepayment speeds and discount rates. Management obtains third-party valuations of the MSR portfolio on a quarterly basis from independent valuation experts to assess the reasonableness of the fair value calculated by its internal valuation model. In certain circumstances, based on the probability of the completion of a sale of MSRs pursuant to a bona-fide purchase offer, the Company considers the bid price of that offer and identifiable transaction costs in comparison to the calculated fair value and may adjust the estimate of fair value to reflect the terms of the pending transaction. Due to the nature of the valuation inputs, MSRs are classified within Level 3 of the valuation hierarchy. See Note 9 - Mortgage Servicing Rights, for the key assumptions used in the residential MSR valuation process.

Derivative financial instruments. Certain classes of derivative contracts are listed on an exchange and are actively traded, and they are therefore classified within Level 1 of the valuation hierarchy. These include U.S. Treasury futures and U.S. Treasury options. The Company's forward loan sale commitments and interest rate swaps are valued based on quoted prices for similar assets in an active market with inputs that are observable and are classified within Level 2 of the valuation hierarchy. Rate lock commitments are valued using internal models with significant unobservable market parameters and therefore are classified within Level 3 of the valuation hierarchy. The Company assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and determined that the credit valuation adjustments were not significant to the overall valuation of its derivatives. The derivatives are reported in either other assets or other liabilities on the Consolidated Statements of Financial Condition.

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Liabilities

Warrants. Warrant liabilities are valued using a binomial lattice model and are classified within Level 2 of the valuation hierarchy. Significant observable inputs include expected volatility, a risk free rate and an expected life. Warrant liabilities are reported in "other liabilities" on the Consolidated Statements of Financial Condition.

Long-term debt. The Company records the long-term debt associated with the FSTAR 2005-1 and FSTAR 2006-2 HELOC securitization trusts at fair value. The fair value of the debt is estimated using quantitative models which incorporate observable and, in some instances, unobservable inputs including security prices, interest rate yield curves, option volatility, currency, commodity or equity rates and correlations between these inputs. The Company also considers the impact of its own credit spreads in determining the discount rate used to value these liabilities. The credit spread is determined by reference to observable spreads in the secondary bond markets, which are considered to be Level 3. The Company records this debt as a recurring Level 3 valuation.

Litigation settlement. On February 24, 2012, the Company announced that the Bank had entered into an agreement (the "DOJ Agreement") with the U.S. Department of Justice ("DOJ") relating to certain underwriting practices associated with loans insured by the Federal Housing Administration ("FHA") of the Department of Housing and Urban Development ("HUD"). The Bank and the DOJ entered into the DOJ Agreement pursuant to which the Bank agreed to comply with all applicable HUD and FHA rules related to the continued participation in the direct endorsement lender program, make an initial payment of $15.0 million within 30 business days of the effective date of the DOJ Agreement, make payments of approximately $118.0 million contingent upon the occurrence of certain future events (the "Additional Payments"), and complete a monitoring period by an independent third party chosen by the Bank and approved by HUD. The Company made the initial payment of $15.0 million on April 3, 2012.

The Company elected the fair value option to account for the liability representing the obligation to make Additional Payments under the DOJ Agreement considering multiple scenarios and possible outcomes for the timing of the Additional Payments. As of September 30, 2014, the Bank has accrued $80.1 million, which represents the fair value of the Additional Payments. The signed DOJ Agreement establishes a legally enforceable contract with a stipulated payment plan that meets the definition of a financial liability. The undiscounted amount of the DOJ liability remains at $118.0 million.

At September 30, 2014 and December 31, 2013, the cash flows were discounted using a 8.1 percent and 9.9 percent, respectively, discount rate that is inclusive of the risk free rate based on the expected duration of the liability and an adjustment for non-performance risk that represents the Company's credit risk. The model assumes that the Company will have met substantially all of the stipulations required for the commencement of payments to the DOJ.

The liability is classified within Level 3 of the valuation hierarchy as the projections of earnings and growth rate assumptions are unobservable inputs which affect the estimated timing of the cash flow payments. The Company considers factors which could affect those projections from the perspective of a market participant, which is incorporated into the assessment of fair value. The litigation settlement is included in other liabilities on the Consolidated Financial Statements and changes in the fair value of the litigation settlement will be recorded each quarter in other noninterest expense on the Consolidated Statements of Operations.

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Assets and liabilities measured at fair value on a recurring basis

The following tables present the financial instruments carried at fair value as of September 30, 2014 and December 31, 2013, by caption on the Consolidated Statement of Financial Condition and by level in the valuation hierarchy (as described above).

	Level 1	Level 2	Level 3	Total Fair Value
September 30, 2014	(Dollars in thousands)			
Investment securities available-for-sale				
Agency	$—	$306,101	$—	$306,101
Agency-collateralized mortgage obligations	—	1,068,481	—	1,068,481
Municipal obligations	—	—	3,511	3,511
Loans held-for-sale				
Residential first mortgage loans	—	1,415,938	—	1,415,938
Loans held-for-investment				
Residential first mortgage loans	—	26,075	—	26,075
Second mortgage loans	—	—	55,942	55,942
HELOC loans	—	—	140,331	140,331
Mortgage servicing rights	—	—	285,386	285,386
Derivative assets				
Forward agency and loan sales	—	2,301	—	2,301
Rate lock commitments	—	—	27,066	27,066
Interest rate swaps	—	3,556	—	3,556
Total derivative assets	—	5,857	27,066	32,923
Total assets at fair value	$—	$2,822,452	$512,236	$3,334,688
Derivative liabilities				
Forward agency and loans sales	$—	$(7,392)	$—	$(7,392)
Rate lock commitments	—	—	(386)	(386)
U.S. Treasury futures	(177)	—	—	(177)
Agency forwards	(630)	—	—	(630)
Interest rate swaps	—	(3,496)	—	(3,496)
Total derivative liabilities	(807)	(10,888)	(386)	(12,081)
Warrant liabilities	—	(7,716)	—	(7,716)
Long-term debt	—	—	(92,140)	(92,140)
Litigation settlement	—	—	(80,100)	(80,100)
Total liabilities at fair value	$(807)	$(18,604)	$(172,626)	$(192,037)

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	Level 1	Level 2	Level 3	Total Fair Value
December 31, 2013	(Dollars in thousands)			
Investment securities available-for-sale				
Agency	$—	$422,844	$—	$422,844
Agency-collateralized mortgage obligations	—	605,404	—	605,404
Municipal obligations	—	17,300	—	17,300
Loans held-for-sale				
Residential first mortgage loans	—	1,140,507	—	1,140,507
Loans held-for-investment				
Residential first mortgage loans	—	18,625	—	18,625
Second mortgage loans	—	—	64,685	64,685
HELOC loans	—	—	155,012	155,012
Mortgage servicing rights	—	—	284,678	284,678
Derivative assets				
U.S. Treasury futures	1,221	—	—	1,221
Forward agency and loan sales	—	19,847	—	19,847
Rate lock commitments	—	—	10,329	10,329
Forward agency and loan sales	—	—	—	—
Interest rate swaps	—	1,797	—	1,797
Total derivative assets	1,221	21,644	10,329	33,194
Total assets at fair value	$1,221	$2,226,324	$514,704	$2,742,249
Derivative liabilities				
Agency forwards	$(1,665)	$—	$—	$(1,665)
Interest rate swaps	—	(1,797)	—	(1,797)
Total derivative liabilities	(1,665)	(1,797)	—	(3,462)
Warrant liabilities	—	(10,802)	—	(10,802)
Long-term debt	—	—	(105,813)	(105,813)
Litigation settlement	—	—	(93,000)	(93,000)
Total liabilities at fair value	$(1,665)	$(12,599)	$(198,813)	$(213,077)

A determination to classify a financial instrument within Level 3 of the valuation hierarchy is based upon the significance of the unobservable inputs to the overall fair value measurement. However, Level 3 financial instruments typically include, in addition to the unobservable or Level 3 inputs, observable inputs (that is, inputs that are actively quoted and can be validated to external sources). Also, the Company manages the risk associated with the observable components of Level 3 financial instruments using securities and derivative positions that are classified within Level 1 or Level 2 of the valuation hierarchy; these Level 1 and Level 2 risk management instruments are not included in the Level 3 rollforward table below, and therefore the gains and losses in the tables do not reflect the effect of the Company's risk management activities related to such Level 3 instruments. If the market for an instrument becomes more liquid or active and pricing models become available which allow for readily observable inputs, the Company will transfer the instruments from Level 3 to Level 2 valuation hierarchy.

The Company transferred $3.5 million of municipal obligations to Level 3 from Level 2 in the valuation hierarchy during the period. The Company had no other transfers of assets or liabilities recorded at fair value between the fair value Levels for the three and nine months ended September 30, 2014.

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Fair value measurements using significant unobservable inputs

The tables below include a roll forward of the Consolidated Statement of Financial Condition amounts for the three and nine months ended September 30, 2014 and 2013 (including the change in fair value) for financial instruments classified by the Company within Level 3 of the valuation hierarchy.

		Recorded in Earnings		Recorded in OCI						
Three Months Ended September 30, 2014	Balance at Beginning of Period	Total Unrealized Gains / (Losses)	Total Realized Gains / (Losses)	Total Unrealized Gains / (Losses)	Purchases	Sales	Settlements	Transfers In (Out)	Balance at End of Period	Changes in Unrealized Gains / (Losses) Held at End of Period (3)
Assets	(Dollars in thousands)									
Investment securities available-for-sale (1)(2)										
Municipal obligation	$—	$—	$—	$—	$—	$—	$—	$3,511	$3,511	$—
Loans held-for-investment										
Second mortgage loans	58,660	1,340	414	—	—	—	(4,472)	—	55,942	1,340
HELOC loans	146,933	(1,333)	1,143	—	142	—	(6,554)	—	140,331	(7,887)
Mortgage servicing rights	289,185	(12,732)	—	—	78,556	(69,623)	—	—	285,386	(4,799)
Totals	$494,778	$(12,725)	$1,557	$—	$78,698	$(69,623)	$(11,026)	$3,511	$485,170	$(11,346)
Liabilities										
Long-term debt	$(97,722)	$—	$(2,221)	$—	$—	$—	$7,803	$—	$(92,140)	$—
Litigation settlement	(78,000)	(2,100)	—	—	—	—	—	—	(80,100)	—
Totals	$(175,722)	$(2,100)	$(2,221)	$—	$—	$—	$7,803	$—	$(172,240)	$—
Derivative financial instruments (net)										
Rate lock commitments	$50,974	$10,397	$—	$—	$66,101	$(85,380)	$(15,412)	$—	$26,680	$1,051
Totals	$50,974	$10,397	$—	$—	$66,101	$(85,380)	$(15,412)	$—	$26,680	$1,051
Three Months Ended September 30, 2013										
Loans held-for-investment										
Second mortgage loans	$73,327	$1,548	$265	$—	$—	$—	$(5,881)		$69,259	$14,192
HELOC loans	170,507	526	2,750	—	96	—	(12,118)		161,761	16,020
Mortgage servicing rights	729,019	169	—	—	86,109	—	(18,268)	—	797,029	(67)
Derivative financial instruments										
Rate lock commitments	(23,746)	32,390	—	—	75,433	(16,804)	(3,078)	—	64,195	37,441
Totals	$949,107	$34,633	$3,015	$—	$161,638	$(16,804)	$(39,345)	$—	$1,092,244	$67,586
Liabilities										

Long-term debt	$(119,980)	$—	$(5,139)	$ $—	$—	$12,165		$(112,954)	$—
Litigation settlement	(23,270)	(5,200)	—	——	—	—	—	(28,470)	—
Totals	$(143,250)	$(5,200)	$(5,139)	$ $—	$—	$12,165		$(141,424)	$—

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		Recorded in Earnings		Recorded in OCI						
Nine Months Ended September 30, 2014	Balance at Beginning of Period	Total Unrealized Gains / (Losses)	Total Realized Gains / (Losses)	Total Unrealized Gains / (Losses)	Purchases	Sales	Settlements	Transfers In (Out)	Balance at End of Period	Changes In Unrealized Held at End of Period (3)
Assets	(Dollars in thousands)									
Investment securities available-for-sale (1)(2)(3)										
Municipal obligation	$—	$—	$—	$—	$—	$—	$—	$3,511	$3,511	$—
Loans held-for-investment										
Second mortgage loans	64,685	1,770	1,243	—	—	—	(11,756)	—	55,942	1,770
HELOC loans	155,012	(1,213)	1,268	—	319	—	(15,055)	—	140,331	(16,267)
Mortgage servicing rights	284,678	(36,505)	—	—	198,051	(160,838)	—	—	285,386	(11,345)
Totals	$504,375	$(35,948)	$2,511	$—	$198,370	$(160,838)	$(26,811)	$3,511	$485,170	$(25,842)
Liabilities										
Long-term debt	$(105,813)	$—	$(5,307)	$—	$—	$—	$18,980	$—	$(92,140)	$—
DOJ litigation	(93,000)	12,900	—	—	—	—	—	—	(80,100)	—
Totals	$(198,813)	$12,900	$(5,307)	$—	$—	$—	$18,980	$—	$(172,240)	$—
Derivative financial instruments (net)										
Rate lock commitments	$10,329	$109,426	$—	$—	$202,790	$(243,839)	$(52,026)	$—	$26,680	$24,268
Totals	$10,329	$109,426	$—	$—	$202,790	$(243,839)	$(52,026)	$—	$26,680	$24,268
Nine Months Ended September 30, 2013										
Investment securities available-for-sale (1)(2)										
Mortgage securitization	$91,117	$—	$(8,789)	$871	$—	$(73,327)	$(9,872)	$—	$—	$—
Loans held-for-investment										
Second mortgage loans	—	1,548	(6,951)	—	80,543	—	(5,881)		69,259	14,192
HELOC loans	—	526	2,750	—	170,603	—	(12,118)		161,761	16,020
Transferor's interest	7,103	(174)	45,708	—	—	(52,637)	—	—	—	—
	710,791	84,161	—	—	323,216	(233,742)	(87,397)	—	797,029	63,507

Mortgage servicing rights
Derivative financial instruments