FLAGSTAR BANCORP INC
Form 10-Q
May 09, 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 March 31, 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 (State or other jurisdiction of Incorporation or organization)	38-3150651 (I.R.S. Employer Identification No.)
5151 Corporate Drive, Troy, Michigan (Address of principal executive offices)	48098-2639 (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 May 8, 2014, 56,222,107 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)

	March 31, 2014	December 31, 2013
	(Unaudited)	
Assets		
Cash and cash equivalents		
Cash and cash items ($1,761 and $1,129 of consolidated VIEs, respectively) (1)	$56,968	$55,913
Interest-earning deposits	162,229	224,592
Total cash and cash equivalents	219,197	280,505
Investment securities available-for-sale	1,207,430	1,045,548
Loans held-for-sale ($1,372,978 and $1,140,507 measured at fair value, respectively) (2)	1,673,763	1,480,418
Loans repurchased with government guarantees	1,266,702	1,273,690
Loans held-for-investment, net		
Loans held-for-investment ($233,854 and $238,322 measured at fair value which includes $150,595 and $155,012 of consolidated VIEs, respectively) (1) (2)	4,019,871	4,055,756
Less: allowance for loan losses	(307,000)	(207,000)
Total loans held-for-investment, net	3,712,871	3,848,756
Mortgage servicing rights	320,231	284,678
Repossessed assets, net	31,076	36,636
Federal Home Loan Bank stock	209,737	209,737
Premises and equipment, net	233,195	231,350
Net deferred tax asset	451,392	414,681
Other assets	285,759	301,302
Total assets	$9,611,353	$9,407,301
Liabilities and Stockholders' Equity		
Deposits		
Noninterest bearing	$983,348	$930,060
Interest bearing	5,326,953	5,210,266
Total deposits	6,310,301	6,140,326
Federal Home Loan Bank advances	1,125,000	988,000
Long-term debt ($101,710 and $105,813 of consolidated VIEs at fair value, respectively) (1) (2)	349,145	353,248
Representation and warranty reserve	48,000	54,000
Other liabilities ($94,000 and $93,000 measured at fair value and $136 and $136 of consolidated VIEs, respectively) (1) (2)	427,627	445,853
Total liabilities	8,260,073	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; 56,221,056 and 56,138,074 shares issued and outstanding, respectively	562	561
Additional paid in capital	1,479,459	1,479,265
Accumulated other comprehensive loss	(1,197)	(4,831)
Accumulated deficit	(394,201)	(315,295)

Total stockholders’ equity	1,351,280	1,425,874
Total liabilities and stockholders’ equity	$9,611,353	$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 March 31,	
	2014	2013
	(Unaudited)	
Interest Income		
Loans	$58,668	$91,950
Investment securities available-for-sale or trading	7,538	2,094
Interest-earning deposits and other	145	946
Total interest income	66,351	94,990
Interest Expense		
Deposits	5,988	13,508
Federal Home Loan Bank advances	534	24,161
Other	1,628	1,652
Total interest expense	8,150	39,321
Net interest income	58,201	55,669
Provision for loan losses	112,321	20,415
Net interest (loss) income after provision for loan losses	(54,120)	35,254
Noninterest Income		
Loan fees and charges	12,311	33,360
Deposit fees and charges	4,764	5,146
Loan administration	19,584	20,356
Net gain on loan sales	45,342	137,540
Net transaction costs on sales of mortgage servicing rights	3,583	(4,219)
Net gain on sale of assets	2,216	958
Representation and warranty reserve – change in estimate	1,672	(17,395)
Other noninterest (loss) income	(14,519)	9,197
Total noninterest income	74,953	184,943
Noninterest Expense		
Compensation and benefits	65,572	77,208
Commissions	7,220	17,462
Occupancy and equipment	20,410	19,375
Asset resolution	11,508	16,445
Federal insurance premiums	5,010	11,240
Loan processing expense	7,735	17,111
Legal and professional expense	13,902	28,839
Other noninterest expense	7,895	8,910
Total noninterest expense	139,252	196,590

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

	Three Months Ended March 31,	
	2014	2013
	(Unaudited)	
(Loss) income before income taxes	(118,419)	23,607
Benefit for income taxes	(39,996)	—
Net (Loss) Income	(78,423)	23,607
Preferred stock dividend/accretion	(483)	(1,438)
Net (loss) income applicable to common stock	$(78,906)	$22,169
(Loss) income per share		
Basic	$(1.51)	$0.33
Diluted	$(1.51)	$0.33
Weighted average shares outstanding		
Basic	56,194,184	55,973,888
Diluted	56,194,184	56,415,057

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

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

	Three Months Ended March 31,	
	2014	2013
	(Unaudited)	
Net (loss) income	$(78,423)	$23,607
Other comprehensive income, before tax		
Investment securities available-for-sale		
Unrealized gains on investment securities available-for-sale	5,869	1,002
Reclassification of gain on sale of investment securities available-for-sale	(223)	—
Total investment securities available-for-sale, before tax	5,646	1,002
Other comprehensive income, deferred tax benefit		
Deferred tax benefit related to other comprehensive income resulting from unrealized gains and losses on investment securities available-for-sale	(2,200)	—
Deferred tax benefit related to other comprehensive income resulting from the dissolution and sales of investments securities available-for-sale	188	—
Other comprehensive income, net of tax	3,634	1,002
Comprehensive (loss) income	$(74,789)	$24,609

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	—	—	—	—	23,607	23,607
Total other comprehensive income	—	—	—	1,002	—	1,002
Restricted stock issued	—	1	(1)	—	—	—
Accretion of preferred stock	1,438	—	—	—	(1,438)	—
Stock-based compensation	—	1	56	—	—	57
Balance at March 31, 2013	$261,828	$561	$1,476,624	$ (656)	$ (554,329)	$1,184,028
Balance at December 31, 2013 (Unaudited)	$266,174	$561	$1,479,265	$ (4,831)	$ (315,295)	$1,425,874
Net loss	—	—	—	—	(78,423)	(78,423)
Total other comprehensive income	—	—	—	3,634	—	3,634
Restricted stock issued	—	1	(1)	—	—	—
Accretion of preferred stock	483	—	—	—	(483)	—
Stock-based compensation	—	—	195	—	—	195
Balance at March 31, 2014	$266,657	$562	$1,479,459	$ (1,197)	$ (394,201)	$1,351,280

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

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

	Three Months Ended March 31,	
	2014	2013
	(Unaudited)	
Operating Activities		
Net (loss) income	$(78,423)	$23,607
Adjustments to reconcile net income to net cash used in operating activities:		
Provision for loan losses	112,321	20,415
Depreciation and amortization	5,760	5,404
Loss on fair value of mortgage servicing rights	9,592	15,641
Loss of fair value of long-term debt	1,324	—
Net gain on the sale of assets	(2,974)	(7,034)
Net gain on loan sales	(45,342)	(137,540)
Net transaction costs on sales of mortgage servicing rights	(3,583)	4,219
Net gain on investment securities	(223)	—
Net gain on trading securities	—	(51)
Proceeds from sales of loans held-for-sale	3,555,682	13,850,730
Origination and repurchase of loans held-for-sale, net of principal repayments	(5,296,103)	(12,623,530)
Net change in:		
Decrease in repurchase loans with government guarantees, net of claims received	6,989	236,436
(Increase) decrease in accrued interest receivable	(3,183)	10,936
(Increase) decrease in other assets	(16,077)	76,280
Increase in payable for mortgage repurchase option	(4,973)	(13,966)
Representation and warranty reserve - change in estimate	(1,672)	17,395
Net charge-offs in representation and warranty reserve	(5,557)	(31,213)
Decrease in other liabilities	(41,189)	(32,653)
Net cash (used in) provided by operating activities	(1,807,631)	1,415,076
Investing Activities		
Proceeds received from the sale of investment securities available-for-sale	1,846,339	—
Repayment of investment securities available-for-sale	30,729	15,378
Purchase of investment securities available-for-sale	(205,497)	—
Net change from sales of loans held-for-investment	(276,412)	61,645
Principal repayments net of origination of loans held-for-investment	13,773	635,929
Proceeds from the disposition of repossessed assets	10,004	27,285
Acquisitions of premises and equipment, net of proceeds	(7,786)	(9,379)
Proceeds from the sale of mortgage servicing rights	5,690	89,928
Net cash provided by investing activities	1,416,840	820,786

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

	Three Months Ended March 31, 2014	2013
	(Unaudited)	
Financing Activities		
Net increase (decrease) in deposit accounts	169,975	(447,004)
Net increase (decrease) in Federal Home Loan Bank advances	137,000	(280,000)
Payment on long-term debt	(5,427)	—
Net disbursement of payments of loans serviced for others	24,895	(234,846)
Net receipt of escrow payments	3,040	3,881
Net cash provided by (used in) financing activities	329,483	(957,969)
Net (decrease) increase in cash and cash equivalents	(61,308)	1,277,893
Beginning cash and cash equivalents	280,505	952,793
Ending cash and cash equivalents	$219,197	$2,230,686
Supplemental disclosure of cash flow information		
Loans held-for-investment transferred to repossessed assets	$15,971	$50,247
Interest paid on deposits and other borrowings	$6,233	$37,339
Income taxes paid	$333	$6,671
Reclassification of loans originated for investment to loans held-for-sale	$281,040	$1,129
Reclassification of mortgage loans originated held-for-sale then to loans held-for-investment	$4,628	$62,774
Mortgage servicing rights resulting from sale or securitization of loans	$51,043	$126,494

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 March 31, 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. The consolidated financial statements are considered issued when they are widely distributed to all stockholders and other financial statement users, or filed with the U.S. Securities and Exchange Commission ("SEC"). All material subsequent events have been either recognized in the Consolidated Financial Statements or disclosed in the Notes to the Consolidated Financial Statements.

In January 2014, the Company reorganized the manner in which its operations are managed based on core operating functions. The segments are based on an internally-aligned segment leadership structure, which is also how the results are monitored and performance assessed. The Company's business model emphasizes the delivery of a complete set of mortgage and banking products and services, including originating, acquiring, selling and servicing one-to-four family residential first mortgage loans, which we believe is distinguished by timely processing and customer service.

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 first 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. The Mortgage Servicing segment services mortgage loans on a fee basis for others and residential mortgages held-for-investment by the Community Banking segment and mortgage servicing rights held by the Other segment. The Company has retained certain loan originations in the held-for-investment portfolio, which are held by the Community Banking segment. Mortgage loans are originated through 33 home loan centers located in 18 states, a direct to consumer call center, the Internet, wholesale brokers and correspondents.

The Company also offers a range of products and services to consumers and businesses through the Community Banking segment. As of March 31, 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. The Company offers treasury management services. 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, Accounting Policies and Recent Developments

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 months ended March 31, 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 web page, 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).

A VIE is an entity that lacks equity investors or whose equity investors do not have a controlling financial interest in the entity through their equity investments. The entity that has a controlling financial interest in a VIE is referred to as the primary beneficiary and consolidates the VIE. On a quarterly basis, the Company will reassesses whether it has a controlling financial interest in and is the primary beneficiary of a VIE. The quarterly reassessment process considers whether the Company has acquired or divested the power to direct the activities of the VIE through changes in governing documents or other circumstances.

The reassessment also considers whether the Company has acquired or disposed of a financial interest that could be significant to the VIE, or whether an interest in the VIE has become significant or is no longer significant. The consolidation status of the VIEs with which the Company is involved may change as a result of such reassessments. Changes in consolidation status are applied prospectively, with assets and liabilities of a newly consolidated VIE initially recorded at fair value. A gain or loss may be recognized upon deconsolidation of a VIE depending on the carrying amounts of deconsolidated assets and liabilities compared to the fair value of retained interests and ongoing contractual arrangements. The Company primarily uses VIEs for its securitization activities, in which the Company transfers whole loans or debt securities into a trust or other vehicle such that the assets are legally isolated from the creditors of the Company. Assets held in a trust can only be used to settle obligations of the trust. The creditors of these trusts typically have no recourse to the Company except in accordance with the Company's obligations under standard representations and warranties. When the Company is the servicer of whole loans held in a securitization trust, including home equity loans, the Company has the power to direct the most significant activities of the trust. The Company does not have the power to direct the most significant activities of a residential mortgage agency trust unless the Company holds substantially all of the issued securities and has the unilateral right to liquidate the trust. The Company consolidates a whole-loan securitization trust if it has the power to direct the most significant activities and also holds securities issued by the trust or has other contractual arrangements, other than standard representations and warranties, which could potentially be significant to the trust.

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 January 2014, the FASB issued ASU No. 2014-04, "Receivables-Troubled Debt Restructurings by Creditors (Topic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure." The guidance amends the guidance in the FASB Accounting Standards Codification Topic 310-40, "Receivables - Troubled Debt Restructurings by Creditors," in efforts to reduce diversity in practice through clarifying when an in substance repossession or foreclosure occurs. Essentially, the guidance addresses when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan so that the loan should be derecognized and the real estate property recognized in the financial statements. 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 impact on the consolidated financial statements or the Notes thereto.

Recent Developments

Organizational Restructuring

On January 16, 2014, the Company completed an organizational restructuring to reduce expenses consistent with its previously communicated strategy of optimizing its cost structure across all business lines. As part of this restructuring initiative, the Company has reduced full-time equivalents by approximately 350 during the first quarter 2014. Including the restructuring completed in the third quarter 2013, the Company has reduced staffing levels across the organization by approximately 600 full-time equivalents from its September 30, 2013 level.

Sale of Mortgage Servicing Rights

On December 18, 2013, the Company entered into a definitive agreement to sell $40.7 billion unpaid principal balance (net of write downs) of its MSR portfolio to Matrix Financial Services Corporation ("Matrix"), a wholly owned subsidiary of Two Harbors Investment Corp. Covered under the agreement are certain mortgage loans serviced for both Fannie Mae and Ginnie Mae, originated primarily after 2010. Simultaneously, the Company entered into an agreement with Matrix to subservice the residential mortgage loans sold to Matrix. As a result, the Company will receive subservicing income and retain a portion of the ancillary fees to be paid as the subservicer of the loans.

Note 3 – Fair Value Measurements

The Company utilizes fair value measurements to record certain assets and liabilities at fair value and to determine fair value disclosures. 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.

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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 agencies are classified within Level 1 of the valuation hierarchy and all other debt securities are classified as Level 2 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 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. These loans are recorded at fair value using the present value of expected cash flows discounted at market rates typical of assets with similar risk profiles. 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. Loans on which the underlying collateral has been repossessed are adjusted to fair value less costs to sell upon transfer to repossessed assets. Subsequently, repossessed assets are carried at the lower of carrying value or fair value, less anticipated marketing and selling costs. Fair value is generally based upon third-party appraisals or internal fair value estimates based on repossessed asset experience and considered a Level 3 classification.

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

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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.

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. As of March 31, 2014, the Bank has accrued $94.0 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.

At March 31, 2014 and December 31, 2013, the cash flows were discounted using a 9.5 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 given the projections of earnings and growth rate assumptions are unobservable inputs. 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. See Note 19 - Legal Proceedings, Contingencies and Commitments, for further information on the DOJ litigation settlement.

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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 March 31, 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
March 31, 2014	(Dollars in thousands)			
Investment securities available-for-sale				
U.S. government sponsored agencies	$1,195,066	$—	$—	$1,195,066
Municipal obligations	—	12,364	—	12,364
Loans held-for-sale				
Residential first mortgage loans	—	1,372,978	—	1,372,978
Loans held-for-investment				
Residential first mortgage loans	—	21,719	—	21,719
Second mortgage loans	—	—	61,540	61,540
HELOC loans	—	—	150,595	150,595
Mortgage servicing rights	—	—	320,231	320,231
Derivative assets				
U.S. Treasury futures	2,495	—	—	2,495
Forward agency and loan sales	—	3,298	—	3,298
Rate lock commitments	—	—	21,276	21,276
Interest rate swaps	—	2,386	—	2,386
Total derivative assets	2,495	5,684	21,276	29,455
Total assets at fair value	$1,197,561	$1,412,745	$553,642	$3,163,948
Derivative liabilities				
Agency forwards	$(97)	$—	$—	$(97)
Interest rate swaps	—	(2,386)	—	(2,386)
Total derivative liabilities	(97)	(2,386)	—	(2,483)
Warrant liabilities	—	(11,577)	—	(11,577)
Long-term debt	—	—	(101,710)	(101,710)
Litigation settlement	—	—	(94,000)	(94,000)
Total liabilities at fair value	$(97)	$(13,963)	$(195,710)	$(209,770)

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	Level 1	Level 2	Level 3	Total Fair Value
December 31, 2013	(Dollars in thousands)			
Investment securities available-for-sale				
U.S. government sponsored agencies	$1,028,248	$—	$—	$1,028,248
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
Interest rate swaps	—	1,797	—	1,797
Total derivative assets	1,221	21,644	10,329	33,194
Total assets at fair value	$1,029,469	$1,198,076	$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 had no transfers of assets or liabilities recorded at fair value between the fair value Levels for the three months ended March 31, 2014 and 2013.

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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 months ended March 31, 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 March 31, 2014	Balance at Beginning of Period	Total Unrealized Gains / (Losses)	Total Realized Gains / (Losses)	Total Unrealized Gains / (Losses)	Purchases	Sales	Settlements	Balance at End of Period	Unrealized Gains / (Losses) Held at End of Period (4)
Assets	(Dollars in thousands)								
Loans held-for-investment									
Second mortgage loans	$64,685	$(417)	$444	$—	$—	$—	$(3,172)	$61,540	$27
HELOC loans	155,012	(1,940)	1,513	—	57	—	(4,047)	150,595	7,257
Mortgage servicing rights	284,678	(9,592)	—	—	51,043	(5,898)	—	320,231	(4,099)
Derivative financial instruments									
Rate lock commitments	10,329	32,989	—	—	59,090	(64,887)	(16,245)	21,276	(637)
Totals	$514,704	$21,040	$1,957	$—	$110,190	$(70,785)	$(23,464)	$553,642	$2,548
Liabilities									
Long-term debt	$(105,813)	$—	$(1,324)	$—	$—	$—	$5,427	$(101,710)	$1,321
Litigation settlement	(93,000)	—	(1,000)	—	—	—	—	(94,000)	—
Totals	$(198,813)	$—	$(2,324)	$—	$—	$—	$5,427	$(195,710)	$1,321
Three Months Ended March 31, 2013									
Investment securities available-for-sale (1)(2)(3)									
Mortgage securitization	$91,117	$—	$—	$1,227	$—	$—	$(4,988)	$87,356	$—
Loans held-for-investment									
Transferors' interest	7,103	(174)	—	—	—	—	(57)	6,872	(174)
Mortgage servicing rights	710,791	(15,641)	—	—	126,494	(94,437)	—	727,207	17,540
Derivative financial instruments									
Rate lock commitments	86,200	(30,828)	—	—	139,514	(118,815)	(24,682)	51,389	3,230
Totals	$895,211	$(46,643)	$—	$1,227	$266,008	$(213,252)	$(29,727)	$872,824	$20,596
Liabilities									
Litigation settlement	$(19,100)	$—	$—	$—	$—	$—	$—	$(19,100)	$—

(1)

Realized gains (losses), including unrealized losses deemed other-than-temporary and related to credit issues, are reported in noninterest income.

(2) U.S. government agency investment securities available-for-sale are valued predominantly using quoted broker/dealer prices with adjustments to reflect any assumptions a willing market participant would include in its valuation. Non-agency CMOs investment securities available-for-sale are valued using internal valuation models and pricing information from third parties.

(3) Reflects the changes in the unrealized gains (losses) related to financial instruments held at the end of the period.

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The following tables present the quantitative information about recurring Level 3 fair value financial instruments and the fair value measurements as of March 31, 2014 and December 31, 2013.

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
March 31, 2014	(Dollars in thousands)			
Assets				
Second mortgage loans	$61,540	Discounted cash flows	Discount rate Prepay rate - 12 month historical average CDR rate - 12 month historical average	7.1% - 10.7% (8.9%) 8.8% - 13.1% (11.0%) 2.2% - 3.3% (2.7%)
FSTAR 2005-1 HELOC loans	$75,998	Discounted cash flows	Discount rate Prepay rate - 3 month historical average Cumulative loss rate Loss severity	5.6% - 8.4% (7.0%) 6.4% - 9.6% (8.0%) 11.7% - 17.5% (14.6%) 80.0% - 120.0% (100.0%)
FSTAR 2006-2 HELOC loans	$74,597	Discounted cash flows	Discount rate Prepay rate - 3 month historical average Cumulative loss rate Loss severity	7.2% - 10.8% (9.0%) 8.0% - 12.0% (10.0%) 40.0% - 60.1% (50.1%) 80.0% - 120.0% (100.0%)
Mortgage servicing rights	$320,231	Discounted cash flows	Option adjusted spread Constant prepayment rate Weighted average cost to service per loan	7.6% - 11.3% (9.4%) 7.5% - 10.9% (9.3%) 59.0% - 88.5% (73.8%)
Rate lock commitments	$21,276	Consensus pricing	Origination pull-through rate	65.7% - 98.5% (82.1%)
Liabilities				
FSTAR 2005-1 Long-term debt	$(53,354)	Discounted cash flows	Discount rate Prepay rate - 3 month historical average Cumulative loss rate Loss severity	5.6% - 8.4% (7.0%) 6.4% - 9.6% (8.0%) 11.7% - 17.5% (14.6%) 80.0% - 120.0% (100.0%)
FSTAR 2006-2 Long-term debt	$(48,356)	Discounted cash flows	Discount rate Prepay rate - 3 month historical average Cumulative loss rate Loss severity	7.2% - 10.8% (9.0%) 8.0% - 12.0% (10.0%) 40.0% - 60.1% (50.1%) 80.0% - 120.0% (100.0%)
Litigation settlement	$(94,000)	Discounted cash flows	Asset growth rate MSR growth rate Return on assets (ROA) improvement Peer group ROA	4.4% - 6.6% (5.5%) 0.9% - 1.4% (1.2%) 0.02% - 0.04% (0.03%) 0.5% - 0.8% (0.7%)

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	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
December 31, 2013	(Dollars in thousands)			
Assets				
Second mortgage loans	$64,685	Discounted cash flows	Discount rate Prepay rate - 12 month historical average CDR rate - 12 month historical average	7.1% - 10.7% (8.9%) 10.5% - 15.7% (13.1%) 2.2% - 3.2% (2.7%)
FSTAR 2005-1 HELOC loans	$78,009	Discounted cash flows	Discount rate Prepay rate - 3 month historical average Cumulative loss rate Loss severity	5.6% - 8.4% (7.0%) 12.8% - 19.2% (16.0%) 11.6% - 17.4% (14.5%) 80.0% - 120.0% (100.0%)
FSTAR 2006-2 HELOC loans	$77,003	Discounted cash flows	Discount rate Prepay rate - 3 month historical average Cumulative loss rate Loss severity	7.2% - 10.8% (9.0%) 9.6% - 14.4% (12.0%) 39.9% - 59.8% (49.9%) 80.0% - 120.0% (100.0%)
Mortgage servicing rights	$284,678	Discounted cash flows	Origination adjusted spread Constant prepayment rate Weighted average cost to service per loan	5.9% - 8.9% (7.7%) 9.7% - 14.0% (11.9%) 59.1% - 88.6% (73.8%)
Rate lock commitments	$10,329	Consensus pricing	Origination pull-through rate	65.9% - 98.8% (82.3%)
Liabilities				
FSTAR 2005-1 Long-term debt	$(55,172)	Discounted cash flows	Discount rate Prepay rate - 3 month historical average Cumulative loss rate Loss severity	5.6% - 8.4% (7.0%) 12.8% - 19.2% (16.0%) 11.6% - 17.4% (14.5%) 80.0% - 120.0% (100.0%)
FSTAR 2006-2 Long-term debt	$(50,641)	Discounted cash flows	Discount rate Prepay rate - 3 month historical average Cumulative loss rate Loss severity	7.2% - 10.8% (9.0%) 9.6% - 14.4% (12.0%) 39.9% - 59.9% (49.9%) 80.0% - 120.0% (100.0%)
Litigation settlement	$(93,000)	Discounted cash flows	Asset growth rate MSR growth rate Return on assets (ROA) improvement Peer group ROA	4.4% - 6.6% (5.5%) 0.9% - 1.4% (1.2%) 0.02% - 0.04% (0.03%) 0.5% - 0.8% (0.7%)

The significant unobservable inputs used in the fair value measurement of the second mortgage loans associated with the FSTAR 2006-1 mortgage securitization trust are discount rates, prepayment rates and default rates. Significant increases (decreases) in the discount rate in isolation would result in a significantly lower (higher) fair value measurement. Increases in both prepay rates and default rates in isolation result in a higher fair value; however, generally a change in the assumption used for the probability of default is accompanied by a directionally opposite change in the assumption used for prepayment rates, which would offset a portion of the fair value change.

The significant unobservable inputs used in the fair value measurement of the HELOC loans and long-term debt associated with the FSTAR 2005-1 and FSTAR 2006-2 securitization trusts are discount rates, prepayment rates, loss rates and loss severity. Significant increases (decreases) in the discount rate in isolation would result in a significantly lower (higher) fair value measurement. Increases (decreases) in prepay rates in isolation would result in a higher (lower) fair value measurement while increases (decreases) in loss rates in isolation would result in a lower (higher) fair value. Significant increases (decreases) in the loss severity rate in isolation would result in a significantly lower (higher) fair value measurement.

The significant unobservable inputs used in the fair value measurement of the MSRs are option adjusted spreads, prepayment rates, and cost to service. Significant increases (decreases) in all the assumptions in isolation would result in a significantly lower (higher) fair value measurement.

The significant unobservable input used in the fair value measurement of the rate lock commitments is the pull through rate. The pull through rate is a statistical analysis of the Company's actual rate lock fallout history to determine the sensitivity of the residential mortgage loan pipeline compared to interest rate changes and other deterministic values. New market prices are applied based on updated loan characteristics and new fall out ratios (i.e., the inverse of the pull through rate) are applied accordingly. Significant increases (decreases) in the pull through rate in isolation would result in a significantly higher (lower) fair value measurement. Generally, a change in the assumption utilized for the probability of default is accompanied by a directionally similar change in the assumption utilized for the loss severity and a directionally opposite change in assumption utilized for prepayment rates.

The significant unobservable inputs used in the fair value measurement of the DOJ litigation settlement are future balance sheet and growth rate assumptions for overall asset growth, MSR growth, peer group return on assets and return on

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assets improvement. The current assumptions are based on management's approved, strategic performance targets beyond the current strategic modeling horizon (2014). The Bank's target asset growth rate post 2014 is based off of growth in the balance sheet. Significant increases (decreases) in the bank's growth rate in isolation would result in a significantly lower (higher) fair value measurement. Significant increases (decreases) in the bank's MSR growth rate in isolation would result in a marginally lower (higher) fair value measurement. Significant increases (decreases) in the peer group's return on assets improvement in isolation would result in a marginally higher (lower) fair value measurement. Significant increases (decreases) in the bank's return on assets improvement in isolation would result in a marginally higher (lower) fair value measurement.

The Company also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets are measured at the lower of cost or fair value and had a fair value below cost at the end of the period as summarized below.

Assets Measured at Fair Value on a Non-recurring Basis

	Level 3 (Dollars in thousands)
March 31, 2014	
Impaired loans held-for-investment (1)	
Residential first mortgage loans	$50,585
Commercial real estate loans	1,500
Repossessed assets (2)	31,076
Totals	$83,161
December 31, 2013	
Impaired loans held-for-investment (1)	
Residential first mortgage loans	$68,252
Commercial real estate loans	1,500
Repossessed assets (2)	36,636
Totals	$106,388

(1) The Company recorded $9.9 million and $37.5 million in fair value losses on impaired loans (included in provision for loan losses on the Consolidated Statements of Operations) during the three months ended March 31, 2014 and 2013, respectively.

(2) The Company recorded $0.5 million and $0.8 million in losses related to write-downs of repossessed assets based on the estimated fair value of the specific assets, and recognized net gains of $0.8 million and $4.4 million on sales of repossessed assets (both write-downs and net gains/losses are included in asset resolution expense on the Consolidated Statements of Operations) during the three months ended March 31, 2014 and 2013, respectively.

The following tables present the quantitative information about non-recurring Level 3 fair value financial instruments and the fair value measurements as of March 31, 2014 and December 31, 2013.

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
March 31, 2014	(Dollars in thousands)			
Impaired loans held-for-investment				
Residential first mortgage loans	$50,585	Fair value of collateral	Loss severity discount	0% - 100% (46.2%)
Commercial real estate loans	$1,500	Fair value of collateral	Loss severity discount	0% - 100% (39.6%)
Repossessed assets	$31,076	Fair value of collateral	Loss severity discount	0% - 100% (44.9%)

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
December 31, 2013	(Dollars in thousands)			

Impaired loans held-for-investment				
Residential first mortgage loans	$68,252	Fair value of collateral	Loss severity discount	0% - 100% (44.9%)
Commercial real estate loans	$1,500	Fair value of collateral	Loss severity discount	0% - 100% (39.6%)
Repossessed assets	$36,636	Fair value of collateral	Loss severity discount	0% - 100% (45.3%)

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The Company has certain impaired residential first mortgage and commercial real estate loans that are measured at fair value on a nonrecurring basis. Such amounts are generally based on the fair value of the underlying collateral supporting the loan. Appraisals or other third party price opinions are generally obtained to support the fair value of the collateral and incorporate measures such as recent sales prices for comparable properties. In cases where the carrying value exceeds the fair value of the collateral less cost to sell, an impairment charge is recognized.

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.

Fair Value of Financial Instruments

The accounting guidance for financial instruments requires disclosures of the estimated fair value of certain financial instruments and the methods and significant assumptions used to estimate their fair values. Certain financial instruments and all non-financial instruments are excluded from the scope of this guidance. Accordingly, the fair value disclosures required by this guidance are only indicative of the value of individual financial instruments as of the dates indicated and should not be considered an indication of the fair value of the Company.

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

	March 31, 2014				
		Estimated Fair Value			
	Carrying Value	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)				
Financial Instruments					
Assets					
Cash and cash equivalents	$56,968	$56,968	$56,968	$—	$—
Investment securities available-for-sale	1,207,430	1,207,430	1,195,066	12,364	—
Loans held-for-sale	1,673,763	1,676,432	—	1,676,432	—
Loans repurchased with government guarantees	1,266,702	1,229,970	—	1,229,970	—
Loans held-for-investment, net	3,712,871	3,616,402	—	21,719	3,594,683
Repossessed assets	31,076	31,076	—	—	31,076
Federal Home Loan Bank stock	209,737	209,737	209,737	—	—
Mortgage servicing rights	320,231	320,231	—	—	320,231
Customer initiated derivative interest rate swaps	2,386	2,386	—	2,386	—
Liabilities					
Retail deposits					
Demand deposits and savings accounts	(4,027,068)	(3,883,336)	—	(3,883,336)	—
Certificates of deposit	(959,241)	(966,493)	—	(966,493)	—
Government deposits	(731,192)	(724,124)	—	(724,124)	—
Wholesale deposits	(275)	(235)	—	(235)	—
Company controlled deposits	(592,525)	(586,501)	—	(586,501)	—
Federal Home Loan Bank advances	(1,125,000)	(1,124,931)	(1,124,931)	—	—
Long-term debt	(349,145)	(195,188)	—	(93,478)	(101,710)
Warrant liabilities	(11,577)	(11,577)	—	(11,577)	—
Litigation settlement	(94,000)	(94,000)	—	—	(94,000)
Customer initiated derivative interest rate swaps	(2,386)	(2,386)	—	(2,386)	—
Derivative Financial Instruments					
Forward agency and loan sales	3,298	3,298	—	3,298	—
Rate lock commitments	21,276	21,276	—	—	21,276
U.S. Treasury and agency futures/forwards	2,398	2,398	2,398	—	—

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	December 31, 2013				
		Estimated Fair Value			
	Carrying Value	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)				
Financial Instruments					
Assets					
Cash and cash equivalents	$280,505	$280,505	$280,505	$—	$—
Investment securities available-for-sale	1,045,548	1,045,548	1,028,248	17,300	—
Loans held-for-sale	1,480,418	1,469,820	—	1,469,820	—
Loans repurchased with government guarantees	1,273,690	1,212,799	—	1,212,799	—
Loans held-for-investment, net	3,848,756	3,653,292	—	18,625	3,634,667
Repossessed assets	36,636	36,636	—	—	36,636
Federal Home Loan Bank stock	209,737	209,737	209,737	—	—
Mortgage servicing rights	284,678	284,678	—	—	284,678
Customer initiated derivative interest rate swaps	1,797	1,797	—	1,797	—
Liabilities					
Retail deposits					
Demand deposits and savings accounts	(3,919,937)	(3,778,890)	—	(3,778,890)	—
Certificates of deposit	(1,026,129)	(1,034,599)	—	(1,034,599)	—
Government accounts	(602,398)	(596,778)	—	(596,778)	—
Wholesale deposits	(8,717)	(8,716)	—	(8,716)	—
Company controlled deposits	(583,145)	(577,662)	—	(577,662)	—
Federal Home Loan Bank advances	(988,000)	(988,102)	(988,102)	—	—
Long-term debt	(353,248)	(202,887)	—	(97,074)	(105,813)
Warrant liabilities	(10,802)	(10,802)	—	(10,802)	—
Litigation settlement	(93,000)	(93,000)	—	—	(93,000)
Customer initiated derivative interest rate swaps	(1,797)	(1,797)	—	(1,797)	—
Derivative Financial Instruments					
Forward agency and loan sales	19,847	19,847	—	19,847	—
Rate lock commitments	10,329	10,329	—	—	10,329
U.S. Treasury and agency futures/forwards	(444)	(444)	(444)	—	—

The methods and assumptions used by the Company in estimating fair value of financial instruments that were not previously disclosed, are as follows:

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

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

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

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

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Deposit accounts. The fair value of demand deposits and savings accounts approximates the carrying amount. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for certificates of deposit with similar remaining maturities.

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

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

Fair Value Option

The Company elected to measure at fair value certain financial assets and financial liabilities. The Company elected fair value option for the following items to mitigate a divergence between accounting losses and economic exposure.

The Company elected the fair value option for held-for-sale loans, originated post 2009, and the litigation settlement liability to better reflect the management of these financial instruments on a fair value basis. Loan held-for-investment include loans that were originated as loans held-for-sale and later transferred to loans held-for-investment at fair value. Interest income on loans held-for-sale is accrued on the principal outstanding primarily using the "simple-interest" method. Interest expense on the litigation settlement will be included in the overall change in fair value of the liability each quarter. Direct loan origination cost and fees on loans held-for-sale are recognized in income at origination.

As of June 30, 2013, the Company dissolved the FSTAR 2006-1 mortgage securitization trust and transferred the second mortgage loans, underlying the collapsed FSTAR 2006-1 mortgage securitization which were carried at fair value in available-for-sale investment securities. The change in fair value relating to the loans is recorded in other noninterest income.

As of June 30, 2013, the Company elected the fair value option for the assets and liabilities of reconsolidated VIEs related to the HELOC securitization trusts. This option is generally elected for newly consolidated VIEs for which predominantly all of the Company's interests, prior to consolidation, are carried at fair value with changes in fair value recorded to earnings. The change in fair value relating to the assets and liabilities of these transactions is recorded in other noninterest income. Accordingly, such an election allows the Company to continue fair value accounting through earnings for those interests and eliminate income statement mismatch otherwise caused by differences in the measurement basis of the consolidated VIEs assets and liabilities.

The Company elected the fair value option to account for the liability representing the obligation to make Additional Payments under the DOJ Agreement. The signed DOJ Agreement establishes a legally enforceable contract with a stipulated payment plan that meets the definition of a financial liability. The Company made the fair value election as of December 31, 2011, the date the Company first recognized the financial instrument in its financial statements.

The following table reflects the change in fair value included in earnings (and the account recorded in) for the assets and liabilities for which the fair value option has been elected.

	Three Months Ended March 31,	
	2014	2013
Assets	(Dollars in thousands)	
Loans held-for-sale		
Net gain on loan sales	$63,001	$87,643
Loans held-for-investment		
Interest income on loans	$—	$(779)

Other noninterest income	(4,269)	—
Liabilities		
Long-term debt		
Other noninterest income	$4,107	$—
Litigation settlement		
Legal and professional expense	$(1,000)	$—

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The following table reflects the difference between the aggregate fair value and aggregate remaining contractual principal balance outstanding as of March 31, 2014 and December 31, 2013 for assets and liabilities for which the fair value option has been elected.

	March 31, 2014 (Dollars in thousands)			December 31, 2013		
	Unpaid Principal Balance	Fair Value	Fair Value Over / (Under) Unpaid Principal Balance	Unpaid Principal Balance	Fair Value	Fair Value Over / (Under) Unpaid Principal Balance
Assets						
Nonaccrual loans						
Loans held-for-sale	$—	$—	$—	$—	$—	$—
Loans held-for-investment	9,769	3,748	(6,021)	10,764	4,014	(6,750)
Total non-accrual loans	$9,769	$3,748	(6,021)	$10,764	$4,014	$(6,750)
Other performing loans						
Loans held-for-sale	$1,321,719	$1,372,978	$51,259	$1,109,517	$1,140,507	$30,990
Loans held-for-investment	252,840	230,106	(22,734)	257,665	234,308	(23,357)
Total other performing loans	$1,574,559	$1,603,084	$28,525	$1,367,182	$1,374,815	$7,633
Total loans						
Loans held-for-sale	$1,321,719	$1,372,978	$51,259	$1,109,517	$1,140,507	$30,990
Loans held-for-investment	262,609	233,854	(28,755)	268,429	238,322	(30,107)
Total loans	$1,584,328	$1,606,832	$22,504	$1,377,946	$1,378,829	$883
Liabilities						
Long-term debt	$(111,077)	$(101,710)	$(9,367)	$(116,504)	$(105,813)	$(10,691)
Litigation settlement	N/A (1)	(94,000)	N/A (1)	N/A (1)	(93,000)	N/A (1)

(1) Remaining principal outstanding is not applicable to the litigation settlement because it does not obligate the Company to return a stated amount of principal at maturity, but instead return an amount based upon performance on the underlying terms in the Agreement.

Note 4 – Investment Securities

As of March 31, 2014 and December 31, 2013, investment securities were comprised of the following.

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
March 31, 2014				
Available-for-sale securities				
U.S. government sponsored agencies	$1,198,397	$2,790	$(6,121)	$1,195,066
Municipal obligations	12,364	—	—	12,364
Total available-for-sale securities	$1,210,761	$2,790	$(6,121)	$1,207,430
December 31, 2013				
Available-for-sale securities				
U.S. government sponsored agencies	$1,037,289	$1,546	$(10,587)	$1,028,248
Municipal obligations	17,300	—	—	17,300
Total available-for-sale securities	$1,054,589	$1,546	$(10,587)	$1,045,548

Available-for-sale securities

Securities available-for-sale are carried at fair value, with unrealized gains and losses reported as a component of other comprehensive loss to the extent they are temporary in nature. Credit related declines in the securities are classified as other-than-temporary impairments ("OTTI") and are reported as a separate component of noninterest income within the Consolidated Statement of Operations. OTTI is considered to have occurred if (1) if the Company intends to sell the security; (2) if it is more likely than not the Company will be required to sell the security before recovery of its amortized cost basis; or (3) the present value of expected cash flows is not sufficient to recover all contractually required principal and interest payments.

The Company purchased $206.9 million and zero U.S. government sponsored agencies during the three months ended March 31, 2014 and 2013, respectively. There were no municipal obligations purchased during the three months ended March 31, 2014 and 2013, respectively.

The Company has pledged available-for-sale securities, primarily U.S. government sponsored agencies, to collateralize lines of credit and/or borrowings with Fannie Mae. At March 31, 2014, the Company pledged $4.1 million of available-for-sale securities, compared to $7.8 million at December 31, 2013.

The following table summarizes by duration the unrealized loss positions on investment securities available-for-sale.

	Unrealized Loss Position with Duration 12 Months and Over			Unrealized Loss Position with Duration Under 12 Months		
	Fair Value	Number of Securities	Unrealized Loss	Fair Value	Number of Securities	Unrealized Loss
Type of Security	(Dollars in thousands)					
March 31, 2014						
U.S. government sponsored agencies	$—	—	$—	$828,973	66	$(6,121)
December 31, 2013						
U.S. government sponsored agencies	$—	—	$—	$825,308	63	$(10,587)

The credit losses in the portfolio reflect the economic conditions present in the United States over the course of the last several years and the forecasted effect of changes in such conditions, including changes in the forecast level of home prices. The continued decline in the delinquency rates of the mortgages in the underlying securitization suggest a stabilization of expected future defaults and reflect the recent improvements in the housing market.

At March 31, 2014, the Company had no OTTI due to credit losses. At March 31, 2013, the cumulative amount of OTTI due to credit losses totaled $2.8 million on one mortgage securitization.

Gains (losses) on sales for available-for-sale securities are reported in net gain on securities available-for-sale in the Consolidated Statements of Operations. During the three months ended March 31, 2014, there were $18.7 million sales of U.S. government sponsored agencies, resulting in a gain of $0.2 million, compared to no sales of U.S. government sponsored agencies during the three months ended March 31, 2013.

Note 5 – Loans Held-for-Sale

At March 31, 2014 and December 31, 2013, loans held-for-sale totaled $1.7 billion and $1.5 billion, which includes residential first mortgage loans. The increase in the balance of loans held-for-sale was primarily due to loan originations exceeding loan sales during the three months ended March 31, 2014.

At March 31, 2014 and December 31, 2013, $1.4 billion and $1.1 billion of loans held-for-sale were recorded at fair value, respectively, under the fair value option. Such loans will be reported at fair value with any adjustments in fair value recorded through the income statement. The Company estimates the fair value of mortgage loans based on quoted market prices for securities backed by similar types of loans for which quoted market prices were available. The fair values of loans were estimated by discounting estimated cash flows using management’s best estimate of market interest rates for similar collateral.

At March 31, 2014 and December 31, 2013, $300.9 million and $340.0 million of loans held-for-sale were recorded at lower of cost or fair value based on a decision to sell the loans. Certain loans were transferred into the held-for-sale portfolio from the held-for-investment portfolio. After the transfer, any amount by which cost exceeded fair value was recorded as a valuation allowance.

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The following table sets forth the activity related to residential first mortgage loans held-for-sale.

	Three Months Ended March 31,	
	2014	2013
	(Dollars in thousands)	
Balance at beginning of period	$1,480,418	$3,939,720
Net loan originations	4,741,872	12,682,793
Net loans sold, servicing retained	(4,554,735)	(13,129,712)
Net loans sold, servicing released	(23,045)	(111,777)
Other loan sales	(303,495)	(859,025)
Loan amortization and prepayments	56,335	216,885
Loans transferred from (to) other loan portfolios	276,413	(61,645)
Balance at end of period	$1,673,763	$2,677,239

The Company has pledged certain loans held-for-sale to collateralize lines of credit and/or borrowings with the Federal Home Loan Bank of Indianapolis. At March 31, 2014 and December 31, 2013, the Company pledged $1.4 billion and $1.2 billion, respectively, of loans held-for-sale.

Note 6 – Loans Repurchased with Government Guarantees

Pursuant to Ginnie Mae servicing guidelines, the Company has the unilateral option to repurchase certain delinquent loans (loans past due 90 days or more) securitized in Ginnie Mae pools, if the loans meet defined delinquent loan criteria. As a result of this unilateral option, once the delinquency criteria have been met, and regardless of whether the repurchase option has been exercised, the Company must treat the loans as having been repurchased and recognize the loans as loans held-for-sale on the Consolidated Statement of Financial Condition and also recognize a corresponding liability for a similar amount recorded in other liabilities on the Consolidated Statement of Financial Condition. If the loans are actually repurchased, the Company transfers the loans to loans repurchased with government guarantees and eliminates the corresponding liability. At March 31, 2014, the amount of such loans actually repurchased totaled $1.3 billion and were classified as loans repurchased with government guarantees, and those loans which the Company had not yet repurchased but had the unilateral right to repurchase totaled $15.8 million and were classified as loans held-for-sale. At December 31, 2013, the amount of such loans actually repurchased totaled $1.3 billion and were classified as loans repurchased with government guarantees, and those loans which the Company had not yet repurchased but had the unilateral right to repurchase totaled $20.8 million and were classified as loans held-for-sale.

Substantially all of these loans continue to be insured or guaranteed by the FHA, and the Company's management believes that the reimbursement process is proceeding appropriately. These repurchased loans earn interest at a statutory rate, which varies and is based upon the 10-year U.S. Treasury note rate at the time the underlying loan becomes delinquent.

The Company has pledged certain loans repurchased with government guarantees to collateralize lines of credit and/or borrowings with the Federal Home Loan Bank of Indianapolis. At March 31, 2014 and December 31, 2013, the Company pledged $812.1 million and $787.1 million, respectively, of loans repurchased with government guarantees.

During the three months ended March 31, 2013, the Company participated in a HUD-coordinated market auction, which resulted in the conveyance in an accelerated fashion of $131.9 million unpaid principal balance (net of write downs) of loans to HUD.

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Note 7 – Loans Held-for-Investment

Loans held-for-investment are summarized as follows.

	March 31, 2014	December 31, 2013
	(Dollars in thousands)	
Consumer loans		
Residential first mortgage	$2,348,691	$2,508,968
Second mortgage	164,627	169,525
Warehouse lending	408,874	423,517
HELOC	273,454	289,880
Other	34,875	37,468
Total consumer loans	3,230,521	3,429,358
Commercial loans		
Commercial real estate	512,994	408,870
Commercial and industrial	266,176	207,187
Commercial lease financing	10,180	10,341
Total commercial loans	789,350	626,398
Total loans held-for-investment	4,019,871	4,055,756
Less allowance for loan losses	(307,000)	(207,000)
Loans held-for-investment, net	$3,712,871	$3,848,756

At March 31, 2014 and December 31, 2013, the loans held-for-investment include $233.9 million and $238.3 million of loans accounted for under the fair value option. During the three months ended March 31, 2014, the Company recorded a $21.1 million adjustment to the originally recorded fair value of performing repurchased residential first mortgage loans.

During the three months ended March 31, 2014, the Company transferred $4.6 million in loans held-for-sale to loans held-for-investment. During the three months ended March 31, 2013, the Company transferred $62.8 million in loans held-for-sale to loans held-for-investment. The loans transferred were carried at fair value, and will continue to be reported at fair value while classified as held-for-investment.

During the three months ended March 31, 2014, we sold nonperforming and TDR residential first mortgage loans with a carrying value in the amount of $25.6 million.

During the three months ended March 31, 2014, residential first mortgage jumbo loans with a carrying value in the amount of $254.1 million were transferred to loans available-for-sale and subsequently sold during the second quarter 2014.

The Company has pledged certain loans held-for-investment to collateralize lines of credit and/or borrowings with the Federal Reserve Bank of Chicago and the Federal Home Loan Bank of Indianapolis. At March 31, 2014 and December 31, 2013, the Company pledged $2.4 billion and $2.5 billion, respectively, of loans held-for-investment.

The Company's commercial leasing activities consist primarily of equipment leases. Generally, lessees are responsible for all maintenance, taxes, and insurance on leased properties. The following table lists the components of the net investment in financing leases.

	March 31, 2014	December 31, 2013
	(Dollars in thousands)	

Total minimum lease payment to be received	$10,374	$10,613
Estimated residual values of lease properties	530	503
Unearned income	(704)	(755)
Net deferred fees and other	(20)	(20)
Net investment in commercial financing leases	$10,180	$10,341

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The allowance for loan losses by class of loan is summarized in the following tables.

	Residential First Mortgage	Second Mortgage	Warehouse Lending	HELOC	Other Consumer	Commercial Real Estate	Commercial and Industrial	Commercial Lease Financing	Total
	(Dollars in thousands)								
Three Months Ended March 31, 2014									
Beginning balance allowance for loan losses	$161,142	$12,141	$1,392	$7,893	$2,412	$18,540	$3,332	$148	$207,000
Charge-offs	(10,863)	(1,068)	—	(2,689)	(461)	—	—	—	(15,081)
Recoveries	1,116	84	—	49	320	1,115	29	47	2,760
Provision	104,896	2,298	73	6,340	(833)	(1,524)	1,116	(45)	112,321
Ending balance allowance for loan losses	$256,291	$13,455	$1,465	$11,593	$1,438	$18,131	$4,477	$150	$307,000
Three Months Ended March 31, 2013									
Beginning balance allowance for loan losses	$219,230	$20,201	$899	$18,348	$2,040	$41,310	$2,878	$94	$305,000
Charge-offs	(25,692)	(1,955)	—	(2,061)	(699)	(13,162)	—	—	(43,569)
Recoveries	5,353	390	—	105	454	1,843	9	—	8,154
Provision	15,185	2,047	(367)	1,726	420	2,729	(1,315)	(10)	20,415
Ending balance allowance for loan losses	$214,076	$20,683	$532	$18,118	$2,215	$32,720	$1,572	$84	$290,000

	Residential First Mortgage	Second Mortgage	Warehouse Lending	HELOC	Other Consumer	Commercial Real Estate	Commercial and Industrial	Commercial Lease Financing	Total
	(Dollars in thousands)								
March 31, 2014									
Loans held-for-investment									
Individually evaluated	$396,038	$26,107	$—	$262	$—	$2,212	$—	$—	$424,619
Collectively evaluated (1)	1,930,934	76,980	408,874	122,597	34,875	510,782	266,176	10,180	3,361,398
Total loans	$2,326,972	$103,087	$408,874	$122,859	$34,875	$512,994	$266,176	$10,180	$3,786,017
Allowance for loan losses									
Individually evaluated	$81,209	$4,625	$—	$262	$—	$102	$—	$—	$86,198
	175,082	8,830	1,465	11,331	1,438	18,029	4,477	150	220,802

Collectively evaluated (1)									
Total allowance for loan losses	$256,291	$13,455	$1,465	$11,593	$1,438	$18,131	$4,477	$150	$307,000
December 31, 2013									
Loans held-for-investment									
Individually evaluated	$419,703	$24,356	$—	$406	$—	$1,956	$—	$—	$446,421
Collectively evaluated (1)	2,070,640	80,484	423,517	134,462	37,468	406,914	207,187	10,341	3,371,013
Total loans	$2,490,343	$104,840	$423,517						