HomeStreet, Inc.

Q2 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

Mark Mason – *Chairman, Chief Executive Officer, and President*

Mark Ruh – *Executive Vice President and Chief Financial Officer*

PRESENTATION

Operator
Good day and welcome to the HomeStreet Second Quarter 2018 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star (*) key followed by zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (*), then one (1) on your telephone keypad. To withdraw your question, please press star (*), then two (2). Please note this event is being recorded.

I would now like to turn the conference over to Mark Mason, Chief Executive Officer. Please go ahead.

Mark Mason
Hello and thank you for joining us for our second quarter 2018 earnings call. Before we begin, I would like to remind you that our detailed earnings release was furnished yesterday to the SEC on Form 8-K and is available on our website at ir.homestreet.com under the news and events link. In addition, a recording and a transcript will be available at the same address following the call.

On today's call, we will make some forward-looking statements. Any statement that isn't a description of historical fact is probably forward-looking and is subject to many risks and uncertainties. Our actual performance may fall short of our expectations, or we may take actions different from those we currently anticipate. Those factors include conditions affecting the mortgage market such as changes in interest rates and housing supplies that affect the demand for our mortgages and that impact our net interest margin and other aspects of our financial performance; the actions, findings, or requirements of our regulators; and the general economic conditions that affect our net interest margins, borrower credit performance, loan origination volumes, and the value of mortgage servicing rights. Other factors that may cause actual results to differ from our expectations or that may cause us to deviate from our current plans are identified in our detailed earnings release and in our SEC filings, including our most recently filed quarterly report on Form 10-Q, as well as our various other SEC filings.

Additionally, information on any non-GAAP financial measures referenced in today's call, including a reconciliation of those measures to GAAP measures, may be found in our SEC filings and in the detailed earnings release available on our website. Please refer to our detailed earnings release for more discussion of our financial condition and results of operations.

Joining me today is our Chief Financial Officer, Mark Ruh. In just a moment, Mark will present our financial results. But first, I would like to give an update on the results of operations and review our progress in executing our business strategy.

During the second quarter of 2018, we continued to meet the challenges presented by the mortgage market, and we made substantial progress toward our growth and diversification goals. Our commercial and consumer banking segment continued to produce strong loan growth of 3% in the quarter. Commercial and industrial loans increased by 6% as our investments in growing our C&I lending business are bearing fruit. Additionally, home equity loans increased over 9% as borrowers with low interest rate first mortgages are beginning to shift to home equity loan products to access their equity instead of refinancing into a new higher interest first mortgage. As mortgage rates continue to increase, we expect this trend to continue. The growth was funded by strong growth in business deposits of over 5% and growth in our de novo branches of 6% in the quarter.

Meanwhile, asset quality continued to improve, with our non-performing asset ratio decreasing to 14 basis points of total assets representing the lowest level of problem assets since 2006. Our early warning credit indicators continue to reflect strong fundamentals in all of our markets, which is not surprising, given we do business in some of the strongest markets in the United States today. Job creation, unemployment, commercial and residential development activity and absorption, vacancies, cap rates, and all other leading indicators of economic activity reflect strong economies in our primary markets.

As part of our ongoing balance sheet and capital management, we announced the sale of approximately $4.9 billion in total unpaid principal balance of single-family mortgage loans serviced for Fannie Mae and Freddie Mac. This sale represented approximately 20% of our total single-family mortgage loans serviced for others as of March 31st. In conjunction with this sale, we will also transfer approximately $27.2 million of related deposit balances to the purchaser. The file transfer, servicing, and deposits is scheduled to be completed by August 16th, and we will continue to service the loans until the file transfer date.

In addition to capital relief, we expect this transaction to improve our risk management results through reduced convexity costs in the remaining mortgage servicing rights portfolio. Retaining servicing on most of our mortgage loans we originate and sell is an important part of our mortgage banking strategy to which we remain committed. This strategy has historically been a competitive advantage and has provided other benefits to the company, including low cost deposits and these assets have generated strong returns on equity through the cycle. We also modified our loss sharing arrangement with Fannie Mae related to our DUS multi-family servicing, moving from standard loss sharing to a pari passu loss sharing basis. This change significantly lowered our consolidated risk-weighted assets.

Partial sale of single-family mortgage servicing and the change in our loss share arrangement on our DUS servicing increased our consolidated regulatory capital ratios. It will provide regulatory capital to support the continued growth of our commercial and consumer banking business and accelerate the diversification of the company's net income.

Given the persistent shortage of new and resale housing and increased interest rates reducing demand for both purchase and refinanced mortgages, along with recent decrease in our composite margins, we took additional steps in the quarter to streamline our mortgage banking operations by closing, consolidating, or reducing space in 20 single-family offices. These steps also included a reduction in headcount of approximately 127 full-time equivalent employees.

In the second quarter, we recorded $6.9 million in pre-tax restructuring charges related to these actions and we estimate an additional $1.7 million of pre-tax restructuring charges in the third quarter of this year. We expect these actions will result in annualized pre-tax savings of $13.1 million. The office closures and consolidations are concentrated in Arizona and coastal California and were designed to improve profitability of the segment by reducing the proportion of lower profit, jumbo nonconforming mortgages and reducing direct origination expenses by exiting higher cost, lower market share regions.

During the quarter, the price competition amongst mortgage originators eased somewhat, resulting in an improvement in our composite profit margin. Our streamlining initiatives should also improve our deposit profit margin as our profit mix should favor lower general nonconforming loan production going forward. We are continuously making efforts to improve the profitability of the mortgage banking segment while maintaining our competitive advantage as a market leading originator and servicer. Mortgage banking has been an important part of HomeStreet's history and success. We expect mortgage banking will continue to be a contributor to our success going forward as we work through this challenging part of the mortgage cycle.

Lastly, we took additional steps to refresh our Board of Directors, including naming Donald R. Voss as our lead Independent Director, succeeding Scott Boggs; and named Sandra Cavanaugh as a new board member. The Board believes that Sandra’s strong background in banking and asset management will be an asset for the company as we continue to execute on our strategic plan.

And now I will turn it over to Mark who will share the details of our financial results.

Mark Ruh
Thank you, Mark. Good morning everyone and thank you again for joining us. I will first talk about our consolidated results and then provide detail on our two operating segments. Regarding our consolidated results, net income for the second quarter of '18 was $7.1 million, or $0.26 per diluted share compared with $5.9 million, or $0.22 per diluted share for the first quarter. Included in net income for the second quarter of '18 was a total of $5.4 million of restructuring expenses net of tax. Excluding impact of these restructuring charges, core net income for the second quarter was $12.5 million or $0.46 per diluted share compared to core net income of $5.6 million, or $0.21 per diluted share for the first quarter. The increase in core net income from the prior quarter was primarily due to higher non-interest income, largely from higher net gain on loan originations and sale activities in both our mortgage banking segment and our commercial and consumer banking segment, somewhat offset by higher core non-interest expenses.

Net interest income increased by $2.5 million to $51 million in the second quarter from $48.5 million in the first. This increase in net interest income is primarily due to the higher balances of loans held for investment and loans held for sale. Our second quarter net interest margin of 3.25% remained steady from the first quarter of '18. While our retail deposit betas have remained relatively low, our wholesale deposit and borrowing costs have increased. During the quarter, this increase in funding cost was offset by higher yields on our interest earning assets. Non-interest expense, including the impact of restructuring-related expenses, increased to $103.7 million in the second quarter from $101 million in the first quarter. This increase in non-interest expense was primarily from higher commission costs on higher closed single-family mortgage loan volume. Our effective tax rate was 19.6% for the second quarter and differs from our expected 21% to 22% tax range, primarily due to the impact of higher tax-exempt interest income and adjustments to prior periods.

As Mark previously mentioned, the partial sale of our mortgage servicing rights and the changes in our loss sharing agreement related to our Fannie Mae DUS servicing had a positive impact on our regulatory capital ratios. Specifically, our consolidated risk-based capital ratios realized significant increases with our consolidated total risk-based ratio ending the quarter at 12.32%, an increase of 135 basis points from the prior quarter. Due to the sale of the mortgage servicing rights, Tier one capital also increased and both consolidated and bank level regulatory capital ratio all realized improvement.

I'll now discuss some key points from our commercial and consumer banking segment results. Commercial and consumer banking segment's core net income was $11.9 million in the second quarter, increasing 17% over core net income of $10.2 million in the first quarter. Net interest income increased $2.3 million, or 5% from the first quarter of 2018 to $47.7 million, primarily due to the growth in our loans held for investment. The portfolio of loans held for investment increased by $123.1 million, or 3% to $4.9 billion in the second quarter. Segment non-interest income increased quarter-to-quarter to $8.4 million from $7.1 million. This increase was primarily due to higher net gains from our sales of multi-family commercial real estate loans during the second quarter. Secondary market demand for our multi-family commercial real estate loans is typically seasonal, and we expect to see increased sales as the calendar year progresses.

Segment core non-interest expense was $39.3 million, an increase of $940,000 from the first quarter of '18. This increase was primarily due to the continued growth of our lending unit branch networks and due to higher information systems cost and the IT assessments as a result of our deposit growth. Nonperforming assets declined to $10.4 million, or 14 basis points of assets at June 30th, compared to nonperforming assets of $11.2 million, or 16 basis points of assets at March 31st. This decrease was a result of a reduction in nonaccrual loans.

We recorded a $1 million provision for credit losses in the second quarter compared to $750,000 in the first quarter. This increase in provision expense was primarily due to $464,000 of net charge-offs during the second quarter compared to a net recovery of $580,000 during the first quarter. Deposit balances were $5.1 billion at Jun 30th, an increase of $71.3 million from March 31st, driven primarily by a 5% increase in business deposit accounts. Deposits in our de novo branches for those opened within the past five years increased 6% during the quarter.

I'll now share some key points from our mortgage banking segment results. Mortgage banking segment's core net income in the second quarter was $630,000 compared to a core net loss of $4.6 million in the first quarter. We had increased interest rates lock commitments in the second quarter, and improved composite margins that resulted in an increase in core earnings from gain on loan origination and sale activities.

The intense competitive pressure on margin eased during the second quarter, resulting in some recovery of our deposit profit margins. Our gain on mortgage loan origination sales deposit margin increased 22 basis points over the last quarter, following the reduction of 25 basis points in the first quarter of 2018. The increase in interest rate lock commitments during the quarter was primarily due to the seasonal increase in home buying activity as refinanced mortgages decreased on an absolute basis quarter-over-quarter and represented only 18% of our total loan volumes, down from 27% during the first quarter. The volume of interest rate lock and forward sale commitments at $1.7 billion was lower than closed loans designated for sale by 3% this quarter.

Note that single-family interest rate locks being less than closings in a given quarter negatively affects mortgage banking segment earnings, as the majority of mortgage revenue is recognized at interest rate lock, while the majority of origination costs, including commissions, are recognized upon closing. The flattening yield curve also increased negative convexity in our mortgage servicing portfolio and adversely impacts risk management results.

Single-family mortgage servicing was $6.1 million in the second quarter, a decrease from $6.7 million in the first quarter. This decrease was primarily due to lower net servicing fees offset somewhat by improved risk management results. Included in the single-family mortgage servicing income was $572,000 of pre-tax revenue net of transaction costs and prepayment reserves resulting from the sale of the previously mentioned mortgage servicing rights.

Mortgage banking segment core non-interest expense of $64.4 million increased $1.6 million from the first quarter, primarily due to the increase in commissions paid as a result of the increase in closed mortgage loan volumes. Our portfolio of single-family loans serviced for others decreased to $19.1 billion of unpaid principal balances at June 30, compared to $23.2 billion at March 31, reflecting the $4.9 billion of unpaid principal balance sales completed during the quarter. The value of our mortgage servicing rights relative to the balance of loans serviced for others was 129 basis points at quarter end, an increase of two basis points compared to the prior quarter end.

I will now turn it back over to Mark Mason to provide some additional insights on HomeStreet's outlook for the future.

Mark Mason
Thank you, Mark. Looking forward to the next two quarters in our mortgage banking segment, we currently anticipate single-family mortgage loan lock and forward sale commitment volume of $1.4 billion and $1.3 billion in the third and four quarters of this year respectively. We anticipate mortgage held for sale of closing volumes of $1.6 billion and $1.3 billion for the same period. The unusually lower volume of interest rate lock commitments relative to closed loan volume forecast for the third quarter is due to the closing of home loan centers previously discussed. Locked volume was immediately impacted while we remain responsible for closing the pipeline of mortgages originated by these closed offices.

For the full year of 2018, we now anticipate single-family mortgage loan lock and forward sale commitments to total $6 billion and held for sale closing volume to also total $6 billion. Additionally, we expect our mortgage composite profit margin to remain in the range of between 315 basis points and 325 basis points during the remainder of the year.

In our commercial and consumer banking segment, we continue to expect our 2018 quarterly loan portfolio growth to average between 2% and 4% for the remainder of the year. Reflecting the yield curve as of the end of the second quarter and asset changes in market rates of loan prepayment speeds, we expect our consolidated net interest margin to increase in the third quarter to a range of 325 basis points to 335 basis points and remain in that range for the fourth quarter of 2018. During the third quarter and fourth quarters, we expect our total core non-interest expense to decrease an average of 3% to 5% per quarter, given seasonally lower closed single-family mortgage loan expectations and the impact of our streamlining.

Changes in our total core non-interest expenses will vary somewhat quarter-over-quarter driven by seasonality and cyclicality in both our single-family and commercial real estate closed mortgage loan volume. Core non-interest expenses in our commercial and consumer banking segment are expected to increase between 2% and 3% per quarter for the third and fourth quarters of this year. Notwithstanding the increase in core non-interest expense in the commercial and consumer banking segment, we expect segment revenues to grow at more than twice the rate of this expense growth during these periods.

This concludes our prepared comments. Thank you for your attention today. Mark and I would be happy to answer any questions you have at this time.

QUESTIONS AND ANSWERS

Operator
We will now begin the question-and-answer session. To ask a question, you may press star (*), then one (1) on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star (*), then two (2).

At this time we will pause momentarily to assemble our roster. The first question comes from Jeff Rulis of D.A. Davidson. Please go ahead.

Jeff Rulis
Good morning.

Mark Mason
Good morning, Jeff.

Jeff Rulis
On the--just on the staffing, I just--that 127 employee headcount reduction. Was that all completed as of the end of 2Q?

Mark Mason
Actually no, they were all noticed and the branches that were closed were vacated. But some of those individuals have termination dates in the third quarter as they're part of the group that is closing out the remaining pipeline.

Jeff Rulis
Do you have a percent of–just a rough number of that–those individuals are still around? Or is it, I mean, how many are?

Mark Mason
Yes. I'd say roughly, roughly a third continue into the quarter, third quarter.

Jeff Rulis
Okay. And then, as of now just on the expense side, it's just the remaining $1.7 million in 3Q, no other restructuring costs anticipated and a pretty clean 4Q?

Mark Mason
That's correct.

Jeff Rulis
Okay. Got it. Another question on the–on the sale of the MSR and the loss share change with Fannie Mae, does that impact or reduce the servicing income outlook?

Mark Mason
No, it doesn't. It's a part of the structure of the Fannie Mae program. You can choose between two options on total potential losses and the increments by which you may be exposed to them. The loss sharing arrangement we were under and had been under for I guess 30 years to this point was one that included exposure to the first 5% of losses in what was essentially a deductible, but it capped losses at 20% of original principal balance, roughly.

We moved to a what's called a pari passu loss sharing arrangement where you share equally from dollar one but up to 33% of that original principal balance, which, you know, it sounds like greater exposure, but in reality it isn't because of this first loss piece, the deductible piece. The losses in Fannie Mae's program overall have been very minimal. In our case, in 30 years we've never experienced a loss, we've never actually had a 30-day delinquency in this line of business. And we thought it was a good change for us to move to a pari passu arrangement. It reduces the exposure to first losses, and since we feel very strongly about our performance in underwriting, we thought that that was going to be a good risk management change. The regulators also agree with that, and so the way you account for or determine the level of risk-based assets, they have to come back on balance sheet from this recourse portfolio–servicing portfolio, is lower, and that's what gave us the risk-based capital relief.

Jeff Rulis
Okay. So there–it's strictly a loss share change, not a–you don't have to give back some sort of profit or income from the arrangement?

Mark Mason
No, no. Fannie Mae is sort of ambivalent as to which one you choose. They perceive from their standpoint, their risk management standpoint them to be equivalent. We don't because of our very strong credit quality.

Jeff Rulis
Got it. And maybe one last one, just on the credit side, kind of you've flipped it to modest net charge-offs from a long string of recoveries. Any–do you read anything into that or is it just sort of a lumpy quarter? Any comment on the net charge-off trend?

Mark Mason
This is more a story of recoveries and not charge-offs, right? Our charge-offs come from consumer loans primarily. Once in a while we'll have a small business charge-off. But recoveries have been the story for a couple of years now and what we, as we said I think at the end of last year we can't expect recoveries to continue to completely cover charge-offs, and now you're starting to see that.

Jeff Rulis
Yes. Okay. Thank you.

Operator
The next question comes from Steve Moss of B. Riley FBR. Please go ahead.

Steve Moss
Hi, good morning. On the…

Mark Mason
Good morning, Steve.

Steve Moss
On the–gain on sale margin here, you mentioned improvement in your markets in markets helping improve the gain on sale quarter-over-quarter. So wondering, does that refer to changes in the Puget Sound market? Can you give us some more color around that?

Mark Mason
You know, I think it's all the markets. What we did see, and it's a volume-related question,

right? In the fourth quarter, and really as the year progressed last year, you saw a seasonally lower volume than expected. And then when you got to the very low volume portion of the season, fourth quarter and first quarter, the volume–the industry volume dropped even lower than expected.

And you had the impact of excess capacity pushing people to stretch their pricing even further to garner more of the remaining volume. And people typically go too far, right? They give too many price exceptions and then they close the books at the end of the periods and oh my gosh, we've gone too far, right? And this is what typically happens in this business when you have a–an extraordinary change in rates and something like what we are currently experiencing in this availability problem in housing that we have a substantial overcapacity condition. And the first thing people will do is try to grab more of what's left. And then they realize well, that's not good for business, because we're going to lose a lot of money. The industry did. If you're following the MBA statistics on that point, no one essentially made money out of originations in the first quarter. And so, the appropriate business reaction to that is: okay, we have to increase our profit margins again. And I think that's generally what you're seeing.

Steve Moss
Okay. And then I guess on the mortgage servicing side with the sale here, just a little color as to what you're expecting around revenues. It sounds like you may have, obviously there's some moving pieces, but you may have some benefits from hedging going forward that you haven't had in the last couple of quarters. And also, just any update or thoughts around how quickly you can rebuild the servicing portfolio?

Mark Mason
Sure. Well, first, consider collected fees, they should go down around 20%, right, offset by new growth in the portfolio. That's the easy calculation. The tougher one is risk management results. And you see in the quarter that we're still experiencing negative risk management results through the end of the quarter. We're expecting those to improve somewhat as convexity was reduced a little bit. But the biggest challenge with risk management results today is the yield curve. And the fact that we made money and servicing historically out of a positively slow yield curve, because of the amount of our hedge comprises swaps and that, which is a substantial part of the hedge today, I mean I think it's roughly 80% today of our hedge is swaps, from 30 days to a couple of tenors, seven-year, 10-year, 15-year tenors. And those are pretty flat calculations today. And so we're going to get some help on convexity costs from the sale, but the thing that's really going to turn around our servicing results from a risk management standpoint is going to be getting some steepness in the yield curve.

Steve Moss
Okay. And then in terms of just on the–do you think you grow this the MSR book back over the next 12 months to 24 months? How should we think about that and…?

Mark Mason
Well, obviously it's going to grow again, right? The pace of growth is going to be slower than it used to be, because origination volume is lower, right? Lower industry-wise, lower because we have reduced the capacity of the system, right, here recently with loan center closings. I would expect that it will take until third quarter of next year sometime, second or third quarter to rebuild to the same presale $23 billion level.

Steve Moss
Okay. That's helpful. And then in terms of–just on the earning assets side, you sold some

jumbo mortgages here from the loan portfolio and the securities book, you shortened the duration. Just kind of wondering what to look for on the yields?

Mark Mason
On portfolio yields in general or individual?

Steve Moss
Yes, in general.

Mark Mason
Oh, in general. Well, they are rising, right? Not just as a consequence of the Fed, but about a third of our portfolio adjusts monthly. About a–another third or so adjusts on a schedule, right? And so, those loans are still adjusting up from prior changes in rates, right? As we–as they hit their adjustment date.

And so, we see or expect yields to rise, if you guys give me a chart quickly and I'll give a more informed answer, meaningfully, by year-end, right, something in the range of 20-plus basis points and more, and then more the following year, right? Again, that's without any other changes. A combination of change in mix and scheduled, expected increases in rates on periodically adjusted loans.

Steve Moss
All right. Thank you very much.

Operator
The next question comes from Jackie Bohlen of KBW. Please go ahead.

Jackie Bohlen
Hi, guys. Good morning.

Mark Mason
Hi, Jackie.

Jackie Bohlen
Mark, I just wanted to look into headcount a little bit more, and understanding that you still have about a third left of the individuals who were part of the restructuring, how are you thinking about headcount in both the divisions heading into the latter half of the year and into 2019?

Mark Mason
Total headcount in the banking division is going to rise somewhat going forward as a consequence of one, continuing to open branches. We still have a pipeline of branches over the horizon to open. We have some open positions, also, and even what we forecast, we never accomplish because we never seem to hire all the currently open positions. But headcount in the bank could rise 40 or 50 FTE by year-end, if we were to accomplish all that we're hoping to. In the mortgage bank, now of course headcount is falling, right? And the headcount typically falls seasonally toward year-end, right, as we allow attrition to help reduce our capacity in the fourth quarter. And so, I would expect headcount in the mortgage bank to fall 5% to 10% potentially through attrition by year-end and sort of hang around at that number going forward.

Jackie Bohlen

Okay. And I would assume that growth in the commercial consumer bank in terms of headcount in 2019 is likely to be higher than any potential additions in the mortgage bank, and would you think there would be any additions in the mortgage bank in 2019? I know it's a long way off.

Mark Mason
Yes, I mean currently we are expecting it to be flat in the mortgage bank next year. Understand, you know, we continue to analyze ways to improve the results at this low part of the cycle. So, I can only be so definitive, right? In the commercial bank, again, with expected growth in deposits and branches we would expect to see some continued growth, but not meaningful. Not meaningful. And remember of course that any growth in expenses whether it be headcount or non-personnel expenses, we're expecting revenue to grow multiple of those numbers, right? I mean, these are additions related to revenue generation.

Jackie Bohlen
Okay. No, definitely understood. And given the capital benefits from the MSR sale and then from the change in the loss method that you use with Fannie Mae, does that accelerate any of your growth goals for the commercial consumer segment?

Mark Mason
I wouldn't say that it accelerates them. It ensures we don't need outside capital that would be dilutive potentially. It may accelerate them based upon results. We feel comfortable now with our plan going forward on the near-term horizon that we can accomplish it without the need for additional capital or anything outside of our control, and so I'd say it helps the probability of achievement.

Jackie Bohlen
Okay. Great. Thank you.

Mark Mason
Thank you.

Operator
The next question comes from Tim O'Brien of Sandler O'Neill. Please go ahead.

Tim O'Brien
Good morning. Thanks for taking my call. Question for you, $31.6 million in commercial business loan growth this quarter, can you talk a little bit about the underwriting there and are they prime based loans, that's what I'm assuming. Can you give us some color?

Mark Mason
Sure. We've been making pretty meaningful investment in trying to grow our C&I business, particularly in California. And those investments are beginning to show returns. And the lending is both prime based and LIBOR-based. It depends on the market and depends on the size of the customer frankly. The larger the customer, the more likely the index is going to be LIBOR. The size of the lending relationships is growing somewhat, though we continue to be a community bank with SBA business and other smaller lending, our focus for C&I has been larger relationships on both the deposit and the lending side. And what you would see is a variety of industries and really solid underwriting. We have a pretty conservative credit culture here. And even in the C&I business we are trying to grow without taking extraordinary credit risk, and so that's what you would see if you were to look at the details of that lending. We're comfortable with it. We're comfortable with the credit quality. We're comfortable with the

customers, and finally seeing some, some results, and we're expecting that to accelerate.

Tim O'Brien
So, of the $319 million in commercial business loans you guys had at the end of June, what percentage of those loans are prime-based versus LIBOR-based versus something else, CMT, I don't know?

Mark Mason
I don't have that answer on my fingertips. I would say that prime is more pervasive than LIBOR today. But that relationship is slowly changing.

Tim O'Brien
And the primary source of repayment is cash flows I'm assuming?

Mark Mason
Well, we are primarily a collateral-based lender. We do have some cash flow-based loans in service industries primarily right, where you don't have a lot of assets. But in cash flow lending, we look for a very solid histories of repeatable cash flows, strong margins, and just very strong managements. And so, cash flow lending is a small minority of the loans we make. We may have underlying cash flow, but we typically have collateral.

Tim O'Brien
And what's the largest loan that you have in that portfolio or relationship you have in that portfolio? Or largest couple, largest three, I guess?

Mark Mason
The largest relationship is $63 million.

Tim O'Brien
I'm sorry Mark, did you say $53 million?

Mark Mason
$63 million, it is to a multi-state hospitality company, hotel and restaurant operator. The credit facilities range from several significant commercial real estate loans to operating lines and equipment lines.

Tim O'Brien
And the next largest?

Mark Mason
I was playing for time, well, I'm trying to think of…

Tim O'Brien
No, yes, that's okay.

Mark Mason
Yes, it drops really quickly, I guess, it's really what I should be saying is, that's our largest, far and away our largest relationship, a big part of that is a commercial real estate relationship, right, it's not all operating lines. It falls pretty quickly down into the $20 million range, right? So, the portfolio remains pretty granular.

Tim O'Brien
Do you have any shared credits or SNCs embedded in that portfolio?

Mark Ruh
We do--we have about $120 million of loans, they're not all officially shared national credits, most of them are what I call club deals, right.

Tim O'Brien
Yes.

Mark Ruh
Where we're not the lead lender, but several of them are shared national credits and they're all performing. They're all performing well. We try to stay with regional credits, but we know the businesses that they have to be larger than we would lead.

Tim O'Brien
And then…

Mark Mason
Actually, right now of leading our first club credit like that.

Tim O'Brien
Great. Well it was a heck of a quarter, good progress on that front. Was any of the production this quarter attributable to participations or club deals or was it all…?

Mark Mason
It was and I'd have to get back to you to make sure this comment is correct, I think we funded a $10 million participation in a deal, but I'd have to get back to you to confirm that.

Tim O'Brien
And do you require operating accounts in C&I, I mean non-interest-bearing checking accounts of any fully funded in-house produced deal that you guys make for C&I?

Mark Mason
We require a full banking relationship on all of C&I deals except sometimes some SBA deals we can't get when you have multiple SBA loans and you have multiple lenders, right? But typically, we require the relationship.

Tim O'Brien
And just looking out, I don't know two years or five years or something, Mark, how, obviously, you've talked about this being a focus of investment, particularly now, but I think you've kind of stayed in the game and focused on growing this part of your business as a part of your long-term strategy. How much of your business, of your book of loans would you envision seeing commercial business lines accounting for? I don't know, it's a meaningful period looking out, how do you want to judge long-term success of HomeStreet as far as the strategy that you're, that you've set course on?

Mark Mason
We would love to…

Tim O'Brien

Either a dollar amount or percentage?

Mark Mason
We would love to have a third of our loan balances in C&I, Tim. I mean it's obviously below that now, it’s in, what, the low teens, mid-teens somewhere like that. We’d like to double the current concentration. And I think that's a reasonable target for someone in our situation who has had to build that business almost from scratch, right, with a balance sheet that’s still growing. I think that may be a pretty lofty goal, but I think that's a reasonable target when you look at the competition, what’s available in the marketplace, and overlay that with our pretty conservative credit culture that if we were able to get to a third of the loan portfolio, I think that that would be a pretty strong performance for us. Hey, and in answer your prior question, we had an $8 million closing on a participation in the quarter.

Tim O'Brien
Great. And then last question on the deposit side, noninterest-bearing checking account--noninterest-bearing accounts checking and savings, $626 million, 12.3% of total deposits. How much of that is tied to your commercial and consumer segment? You know, how much is--you know part of that business do you attribute to that business?

Mark Mason
Bear with me for a second…

Tim O'Brien
Even ballpark it, Mark. Like is it the majority of it, is it, you know what I mean? I guess my question is, you know, what one of the reasons commercial banks are successful is because they can effectively lock in a stickier low-cost funding base to support growth in the commercial lending business, you know, in real estate even beyond C&I lending, and I’m assuming that’s a critical part of your strategy here as well. So how much would you like to see non-interest-bearing grow, you know, over time, over some extended period of time, and for HomeStreet’s success for strategy to prove successful?

Mark Mason
Okay. So that’s a bunch of questions in that…

Tim O'Brien
I guess how much would you like that deposit base non-interest-bearing checking and savings associated or attributed to commercial and consumer, I guess, to grow and account for as a percentage of your deposit base?

Mark Mason
Well…

Tim O'Brien
You know it's 12.3% at the end of June and…

Mark Mason
Let me answer the first question, which was composition today, Tim, how about that?

Tim O'Brien
Okay.

Mark Mason
Of the non-interest-bearing deposits at quarter end, which were approximately...right, so it's about a $1 billion, right, between servicing deposits and non-servicing.

Tim O'Brien
Yes.

Mark Mason
Of the non-servicing deposits, so the $627 million, $432 million were business. Now that's business that both comes from the C&I business, which is the majority, but also small business that walks into the branches, right? So the majority…

Tim O'Brien
You bet.

Mark Mason
Of that about 80% roughly is commercial. And that number, Tim, when I got here was almost zero.

Tim O'Brien
Yes. And then growth and vision down the road…

Mark Mason
That's going to be dependent upon our success in growing both large and small business. I mean, the question I can't answer as we sit here is how much of that is large business versus small. And the small business component is I expect to be larger than you might imagine. So it's important for us to be good on the street with small business and through our general lending activities and general cash management activities we do with larger businesses.

We'd love for that to dominate the company's deposit. We are both a consumer and a commercial bank, but the largest growth upcoming will continue to be in the commercial area and I still expect it to dominate.

Tim O'Brien
Thanks for answering my questions. It took up too much of your time, but I appreciate it.

Mark Mason
Thanks, Tim.

Operator
The next question comes from Tim Coffey of FIG Partners. Please go ahead.

Tim Coffey
Great. Thanks, good morning, gentlemen.

Mark Mason
Good morning, Tim.

Tim Coffey
Hi, Mark. If I'm reading the tea leaves right, it looks like payoffs have averaged right above $300 million a quarter, am I getting that right? On the commercial bank, of course.

Mark Mason
Bear with me one second, I'll get you a real answer. Payoffs continue to be high, right?

Tim Coffey
Yes.

Mark Mason
And that's for sure. In the quarter, payoffs, paydowns, and sales, right, were up about 50%, right. The first quarter was about $400 million. It was over $600 million in the second quarter. Part of that was sales, though. Remember, we grew the loan portfolio in the commercial real estate area more in the first quarter we had less sales, in the second quarter we had more sales and that attributed to some of that effect. Actual prepayment speeds, I don't have that information in front of me. I can tell you they haven't slowed down. I think I can say that safely.

Tim Coffey
Yes. And that's kind of what I was looking at as well. And so, then my question would be, do you anticipate doing more loan sales out of the DUS product or the SBA, or even like you did this quarter the CRE non-DUS and single-family stuff to offset some of those elevated payoffs?

Mark Mason
No, our strategy on that type of loan mortgage banking or SBA banking is what it is, right? I mean, we originate SBA loan sales to sell the insured portion. That's the most effective use of capital, right? The return on capital invested in those loans is based by creating servicing and originating more. So, we sell them as we originate them. Same with the Fannie Mae DUS loans, they originated for sale, or actually promised or contractually sold or committed by Fannie Mae at the date of origination. So, we don't really have the ability to hold those loans. That activity will rise and fall with activity in marketplace and our ability to execute on it. Now, run-off, let me give you a quick answer though, annualized run-off this quarter in the entire portfolio was about 27.5%. That was up from 21.5% in the first quarter. So, you're right, you are seeing higher run-off. The fourth quarter of last year was even higher, 35%, and I think that includes sales, right? So…

Tim Coffey
Right.

Mark Mason
That additional activity will make that number jump around.

Tim Coffey
Okay. With your comments about growing, about commercial bank revenues and expense growth going forward, what do you think, say, an achievable efficiency ratio in that segment say a year from now?

Mark Mason
Well, I hate to be overly optimistic because I've missed my own targets in the past. But we do make steady progress, right? If you're watching this number, you've seen it continue to decline. It is seasonal during the year, right? Because of the seasonality of Fannie Mae DUS and SBA loan origination and sale, the efficiency is worsening our first two quarters of the year, and better in the second two quarters.

If you look at last year, the same pattern, the average month 70% efficiency last year. We've averaged a little over that in the first half of this year. The second half of the year, we should average in the low 60% range, you know, 63% to 65%, somewhere in there. And that should give us something in the mid-60s for the year, this year. Next year, we think that number will be lower by 2 or 3 basis points, maybe 4 – 2% or 3% or maybe 4% or 5% next year as we continue to work the number down. We think that number can go meaningfully lower. We are trying to do, not the impossible but something very challenging, investing growth and improve efficiency. Now, the efficiency improvements we're getting through operating leverage, right? It's a production of our growth. We could simply stop and improve the efficiency ratio by stopping investing in growth and trying to optimize the ratio. Because we have this role of-–goal of diversification we have to try to do both. And so we're-–we are slower to accomplish our goals and efficiency as a consequence of feeling the need to grow and diversify.

Tim Coffey
Okay. Understood. And then, what was kind of the weighted average yield on the new loan production this quarter, I apologize if I missed this from earlier?

Mark Mason
I'm sure we stated it, but I will tell you, 4.92% but that, that's overall, right? If you look at, well, there's whole lot of categories, right. I mean, in fixed lending mortgages, construction was 5.5%, business banking 5.9%, consumer banking 6.22%. If we go into mortgages, single-family fixed is about 5.5%, fixed CRE 5.11%. The composite 4.92%, the range probably 4.3% to 6.2% roughly.

Tim Coffey
Okay. What were the lower yields? Was that the HELOCs?

Mark Mason
The lowest yield in lending we're doing today is in variable, adjustable commercial real estate, short-term bridge construction, monthly adjusting, right, low rate risk.

Tim Coffey
Okay. All right. And you took care of my follow-up question on that one. And then in the expenses this quarter was a nice surprise. Did that include some of the expenses from the proxy contest?

Mark Mason
Clearly, we had some, right? But we had a full quarter of investment. We opened three branches right at the end of the second quarter, if you were paying attention, or one is in the first quarter--into the first quarter. Thank you and so, we had a full quarter of those expenses, right?

Tim Coffey
Yes. Okay. But, the proxy-–the expenses related to proxy were not really material?

Mark Mason
Not really material-–look, they're expenses we are not happy about incurring, but in relation to total expenses, they're not really material.

Tim Coffey
Okay. All right. Well, all my other questions have been answered. Thank you.

Mark Mason
Thanks, Tim.

Operator
Again, if you have a question please press star (*), then one (1). The next question comes from Henry Coffey of Wedbush. Please go ahead.

Henry Coffey
Two of a kind. I hope you-–and I apologize if you've addressed this before. I got on the call late, but I know there had been a lot of resistance in the past to selling servicing, because in a true sale, you inevitably give up too much control. Can you talk about what changed in your thinking and was it sort of a geographic decision saying, well, we don't have offices in those states anymore, you might as well sell the servicing or was it something different?

Mark Mason
It was a number of things. One, an interest in ensuring that the company will be able to continue its business strategy in light of its low stock price, right? Instead of considering going to the market at this time for more capital later this year or beyond, we wanted to make sure that we have the capital. The prices are very, very good right now, right?

Henry Coffey
Right, right.

Mark Mason
So in terms of market timing, again this was the highest sale of the year, right. If you look at all servicing sales, absolutely the highest value paid. That drove part of it. And there's no free lunch though, right? It is a very negative activity here on a lot of fronts. One, we're losing revenue, right, 20% of our monthly servicing revenue just got sold. All you're doing is accelerating revenue, when you sell it, right?

We've recognized a small gain, but that in and of itself would not be worth the activity. The business has enjoyed a competitive advantage on the Street by retaining servicing. I mean, the mortgage banking part of this business is almost 100 years old, and it is important to our customers, our retail customers, that we will retain that relationship post-sale. So when we don't do that, we hear about it, and we are still hearing about it, right? But we have to offset that with the capital benefits. So what did we do to choose, which ones we're going to sell and how much?

We didn't want to sell clearly more than we thought was needed for our general business strategy. Two, the loans we chose were the lowest rate, highest value loans in the portfolio. Two, they were the least likely refinancing accordingly. So it had a least negative impact on future operations. Three, we tried to select loans that were outside of our retail banking footprint and/or loans originated by loan officers no longer with the company, right? So on all of the most negative aspects-–potential aspects of the transaction, we tried to be sensitive to reduce that impact to the greatest extent possible. And even doing that, we end up of course, selling some loans from some current originators and in-market customers because they have very low rates and they're not happy with us, but we'll maintain those relationships and get through it.

Henry Coffey
Does there exist a universe in which you could sell MSR, so to speak, retain the servicing relationship and through, as a sub-servicer, and still satisfy future capital release requirements

or is that just an impossibility?

Mark Mason
Well, again, no free lunch, right? You can do that. The last time we sold servicing in 2014, we had it bid both ways with and without retained sub-servicing. And the discount to execution was so significant, at that time we chose to sell the full servicing without sub-servicing. This time, having checked with dealers, we expected the same discount. And so we only had it bid as a full-sale servicing. Very hard to accomplish everything by the measure you're looking for. We would have had to sell more servicing to accomplish the same capital relief.

Henry Coffey
So, since the capital relief is not an issue going forward, could you think about it as a business strategy because there's--on the outside chance that the yield curve does continue to flatten et cetera, because the commodity trends never compete, never, they seem to never smile on us. So is there a scenario in which you could begin to change the servicing business model? Sell more servicing, retain the sub-servicing, obviously book a smaller gain but that's okay because you don't need the MSR profitability, and then be able to grow the business more aggressively? Or is the current thought, well, we sold a bunch of servicing, we'll originate more in-market servicing and regrow the MSR?

Mark Mason
That's a tough question, right? If you knew the future, you could make those decisions well. The thing that we know is the returns on equity for us historically in servicing have been very, very high. They're not particularly good right now, right, because of the flat yield curve. But when the curve steepens, the returns get really, really attractive, and it is a cyclical business. The yield curve is a cyclical animal and it will steepen again. It's a very tough set of questions as to, you know, are you making decisions based upon short-term outcomes or long-term outcomes? And these are things we wrestle with every day. So I wouldn't say we would never pursue that-–that strategy, but it's not our strategy today.

Henry Coffey
And then just a final question around the closing of the mortgage origination branches. Since I didn't see any technology charge, is that mainly sort of in an in-house product that you're using or are you using a third party to facilitate your originations, and with the closing down, is there going to be a cost disadvantage associated with any residual contract?

Mark Mason
Yes and yes. So, we did have some technology charge-offs that related to unappreciated equipment, right, that is, and network systems and things that were being amortized, and that has been embedded in the numbers you've seen. We do have a little bit of a disadvantage currently on our primary technology contract because of the minimums. That would be our loan origination system. We will work that out over time, but that's a little bit of a disadvantage currently, not too material.

Henry Coffey
Everybody complains about that aspect of that contract with that vendor. So thank you very much.

Mark Mason
That's an insightful question. I would just let that go.

Henry Coffey
Right. Thank you.

Operator
This concludes our question-and-answer session. I would like to turn the conference back over to Mark Mason for any closing remarks.

CONCLUSION

Mark Mason
Thank you all for your patience and attention today and the very insightful questions. We look forward to talking to you next quarter.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.