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Regions Financial Corp. (RF)

Q2 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Regions Financial Corporation's Quarterly Earnings Call. My name is Paula, and I will be your operator for today's call. I would like to remind everyone that all participant phone lines have been placed on listen-only. At the end of the call, there will be a question-and-answer session. [Operator Instructions]

I will now turn the call over to Ms. Dana Nolan to begin.

Dana W. Nolan

Executive Vice President - Head of Investor Relations, Regions Financial Corp.

Thank you, Paula. Good morning and welcome to Regions' second quarter 2017 earnings conference call. Grayson Hall, our Chief Executive Office, will review highlights of our second quarter year-over-year financial performance, and David Turner, our Chief Financial Officer, will take you through the details compared to the prior quarter. Other members of management are also present and available to answer questions. A copy of the slide presentation referenced throughout this call as well as our earnings release and earnings supplement are available under the Investor Relations section at regions.com.

I'd also like to caution you that we will make forward-looking statements during today's call that are subject to risks and uncertainties and we'll also refer to non-GAAP financial measures. Factors that may cause actual results to differ materially from expectations as well as GAAP to non-GAAP reconciliations are detailed in our SEC filings.

I will now turn the call over to Grayson.

O. B. Grayson Hall

Chairman, President & Chief Executive Officer, Regions Financial Corp.

Thank you, Dana, good morning and thank you for joining our call today. Let me begin by saying that we're pleased with our second quarter results, which demonstrate that we are continuing to execute our strategic plan via long-term sustainable growth, while delivering value to our customers, communities and shareholders.

For the quarter, our earnings available to common shareholders from continuing operations increased 18% to $301 million and earnings per share increased 25% to $0.25 compared to the second quarter of 2016.

Importantly by expanding our customer base, we delivered results in areas we believe are fundamental to future income generation. This is evidenced by growth in checking accounts, households, credit cards, and wealth management relationships as well as total assets under management.

We continue to benefit from our asset-sensitive balance sheet, as interest rate increases drove a 4% increase in net interest income year-over-year and the resulting net interest margin increased 17 basis points. Expenses remain well controlled with adjusted non-interest expenses increasing 1% year-over-year, as our efficiency efforts continue to mitigate core expense inflation and the impact of investments in new initiatives.

As it relates to our loan portfolio, we remain focused on our deliberate and intentional diversification strategy, while we also seek to achieve appropriate risk-adjusted returns. We are experiencing success with our remixing

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efforts. For example, we were early movers to reduce exposure in certain asset classes including auto and multi-family lending.

While our customers remain optimistic, many still do not have the confidence necessary to make meaningful investments and take on additional debt. That said, we're seeing some positive signs. For example, we experienced solid loan production increases across most loan portfolios during the second quarter, and we fully expect this momentum to continue through the second half of the year. In the near term, our interest rate sensitivity profile continues to position us well to grow net interest income, even in the absence of meaningful loan growth, aided in part by the strength of our deposit franchise. With respect to asset quality, our disciplined approach to credit continues to deliver positive results as we reported improvements in almost every credit metric. We continue to characterize overall credit quality as stable, and our volatility from quarter-to-quarter in certain credit metrics can be expected, especially as it relates to large-dollar commercial credits.

Turning to capital deployment, we remain committed to achieving our long-term targets. We are focused on effectively deploying our capital through organic growth, strategic investments that increase revenue or reduce ongoing expenses, while also returning an appropriate amount of capital to our shareholders. We continue to benefit from the robust capital planning process that we've developed over a number of years as evidenced by our recent CCAR results where our planned capital actions once again received no objection.

As part of the capital plan, our board has authorized a share repurchase program of up to $1.47 billion of common stock beginning in the third quarter. Subject to board approval, the plan includes a 29% increase in Regions' quarterly common stock dividend of $0.09 per share beginning in the third quarter. During the quarter Regions was recognized by Javelin Strategy & Research as a Trust in Banking Leaders Award winner, reflecting our reliability in meeting customers' needs and the confidence our customers have in Regions to look out for their best interest.

In addition Regions also received the Gallup Great Workplace Award for the third consecutive year. These examples illustrate how Regions' comprehensive approach to providing financial services creates greater value for all of our stakeholders.

In summary, our second quarter results reflect the continued execution of our strategic plan and our commitment to our three primary initiatives: growing and diversifying revenue, practicing disciplined expense management and effectively deploying our capital.

With that, I'll turn it over to David to cover details of the second quarter.

David J. Turner

Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

Thank you, Grayson, and good morning, everyone. Let's get started with the balance sheet and take a look at average loans. In the second quarter, average loan balances remained relatively stable at $80.1 billion. Average balances in the consumer lending portfolio totaled $31.1 billion, a decline of $87 million. Consumer production increased 22% but this growth was offset by the company's decision to exist the third-party arrangement within the indirect vehicle portfolio.

Excluding this runoff, average consumer loans increased approximately $140 million over the first quarter. Average indirect vehicle balances declined $201 million or 5% during the quarter. Runoff in the third-party portfolio of $224 million was partially offset by an increase of $23 million in our dealer financial services portfolio.

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The third-party portfolio is expected to decline between $500 million and $600 million on a full-year average basis during 2017. Average mortgage balances increased $168 million or 1%, consistent with seasonal increases typically experienced in the second quarter. We expect mortgage production in the second half of the year to be comparable with the first half of the year despite additional declines in refinancing activity.

Historically, our mortgage production mix has been weighted more heavily to home purchase versus refinancing activity and enhancements to our online home loan direct mortgage channel will continue to provide a modest increase in production.

Average home equity balances decreased $131 million, or 1%. Growth in average home equity loans of $52 million was offset by a decline of $183 million in average home equity lines of credit. Further, average line utilization decreased 66 basis points compared to the first quarter.

Although home equity balances are declining, the risk profile of the portfolio has improved significantly. We eliminated the interest-only option last year, and today, approximately 64% of total balances are in a first-lien position. We also continue to have success with our other indirect lending portfolio, which includes point-of-sale lending initiatives. This portfolio increased $64 million, or 7% linked quarter on an average basis.

In addition, at the end of the second quarter, we purchased approximately $138 million of unsecured consumer loans, which are included in our other indirect lending portfolio. And we will continue to explore additional opportunities to further expand this portfolio.

Average balances in our consumer credit card portfolio remained relatively stable with the prior quarter as the number of active cards increased approximately 2%, helping to offset a seasonal decline in outstanding balances.

Turning to the business lending portfolio, average balances totaled $49 billion in the second quarter, an increase of $19 million, as growth in commercial and industrial was partially offset by declines in owner-occupied commercial real estate and investor real estate construction loans.

As Grayson mentioned, we experienced solid production increases during the second quarter, with commercial and investor real estate loan production increasing 56% and 35%, respectively.

In addition, commercial line utilization increased 20 basis points and commitments for new loans increased approximately $700 million from the previous quarter. Growth in average commercial and industrial loans was led by new or expanded relationships in government and institutional banking, asset-based lending, financial services, and the real estate investment trust portfolios.

However, this growth continues to be offset as we've reduced exposure in certain [ph] instances (10:38). For example, average direct energy loans decreased $67 million or 3% during the quarter, and now represent less than 2.5% of total loans outstanding. Average medical office building loans decreased $40 million or 12%.

In addition, investor real estate construction loans decreased $41 million due in part to our ongoing efforts to better diversify production between construction and term lending. While production is improving, the declines in average owner-occupied commercial real estate loans reflect the continued softness in demand and competition from middle market and small business loans.

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We expect to maintain the momentum experienced this quarter through the second half of the year, with future growth driven in part by the technology and defense, financial services, power and utilities, and asset-based lending portfolios.

So let's take a look at deposits. Total average deposits decreased $478 million, less than 1% from the previous quarter, while average low-cost deposits decreased $335 million. Total average deposits in the Consumer segment increased $890 million or 2% in the quarter. And this growth reflects the unique strength of our retail franchise and the overall health of the consumer.

Average Corporate segment deposits decreased $581 million or 2% during the quarter, impacted by seasonal declines in public funds deposits. Average deposits in the Wealth Management segment declined $496 million or 5% as a result of ongoing strategic reductions of collateralized deposits. Certain institutional and corporate trust customer deposits, which require collateralization by securities, continued to shift out of deposits and into other fee income-producing customer investments.

Average deposits in the Other segment decreased $291 million or 8%, driven primarily by declines in average retail brokered sweep deposits. We will continue to manage and optimize our overall deposit base in the context of our balance sheet growth.

Let's take a look at the composition of our deposit base. Second quarter deposit costs remained low at 15 basis points and total funding costs were 34 basis points, illustrating our deposit advantage. As a reminder, our deposit base is more heavily weighted toward retail customers. Approximately 74% of average interest-bearing deposits and 53% of average interest-free deposits are considered retail.

In addition, we have a loyal customer base as more than 44% of our consumer low-cost deposits have been deposit customers at Regions for more than 10 years. And finally, approximately 50% of our deposits come from MSAs with less than 1 million people and approximately 35% from MSAs with less than 500,000 people. Both are in the top quartile versus our peer group. It's for these reasons, we believe that our deposit base is a key component of our franchise value and is a competitive advantage, in particular in a rising rate environment.

So let's look at how this impacted our results. Net interest income on a fully taxable basis was $904 million in the second quarter, an increase of $23 million or 3% from the first quarter. The resulting net interest margin was 3.32%, an increase of 7 basis points. Both net interest margin and net interest income benefited from several factors during the quarter, including higher interest rates and favorable credit-related interest recoveries. Further, one additional day in the quarter benefited net interest income by approximately $5 million, but negatively impacted net interest margin by approximately 2 basis points.

Looking forward to the third quarter, we expect continued growth in net interest income. Net interest margin will be stable to up modestly. And this includes the negative impact of one additional day in the quarter and the potential need to issue debt in the near term.

Non-interest income increased $15 million, or 3% in the quarter. This included the recognition of a $5 million deferred gain associated with the sale of affordable housing mortgage loans that occurred in the fourth quarter of 2016, and an operating lease impairment charge of $7 million recorded during the second quarter, compared to a $5 million impairment charge recorded in the first quarter.

When indications of possible impairment arise we evaluate the current value of operating lease assets and record impairment charges when necessary. These impairment charges are recorded as reductions to other non-interest

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income. Adjusted non-interest income increased $9 million or 2% in the quarter, driven primarily by increases in capital markets income and bank-owned life insurance.

Capital markets income increased $6 million or 19% as increases in fees generated from Fannie Mae DUS real estate placements and merger and acquisition advisory services were partially offset by declines in revenues associated with debt underwriting and loan syndications.

Bank-owned life insurance increased $3 million as a result of higher claim benefits. Mortgage production increased 25% during the quarter, while mortgage income remained relatively stable. Within total mortgage production 80% was related to purchase activity and 20% was related to refinancing. An increase in mortgage servicing income was offset by modest spread compression and lower hedging gain. During the quarter, we completed the purchase of rights to service $2.7 billion of mortgage loans, and including this transaction, we have purchased the rights to service more than $15 billion of mortgage loans over the past four years, and looking ahead increased servicing income is expected to help offset the impact of lower refinancing volumes.

Looking forward, we expect a pickup in capital markets revenue along with modest growth in wealth management, mortgage and card and ATM fees to contribute to overall growth in adjusted non-interest income during the second half of the year.

Let's take a look at expenses. Total non-interest expenses increased 4% during the quarter. On an adjusted basis, expenses totaled $899 million, an increase of $27 million, or 3%, compared to the first quarter.

Total salaries and benefits increased $19 million, and included $10 million associated with a pension settlement charge. Excluding the pension settlement charge, salaries and benefits increased $9 million, or 2%, and included a full quarter's impact of merit increases, as well as increases in production-based incentives. These increases were partially offset by lower payroll taxes and a modest decline in staffing levels.

Looking ahead to the third quarter, we expect higher production-based incentives commensurate with revenue growth. However, we expect total salaries and benefits to decline as pension settlement charges are not expected to repeat at this level.

Professional and legal expenses increased $6 million during the quarter, primarily due to an increase in legal settlement expense.

Merger and equipment expense increased $5 million primarily associated with capital investment projects including an enhanced online banking platform and other technology initiatives.

As these are now included in our run rate, we expect furniture and equipment expense to remain approximately at this level for the remainder of the year. The second quarter adjusted efficiency ratio increased 50 basis points to 63.2% and includes the impact of the pension settlement and operating lease impairment charges. These charges negatively impacted the adjusted efficiency ratio by 100 basis points during the quarter. And despite the negative impact of these charges, we continue to expect the full-year adjusted efficiency ratio to be approximately 62%. With respect to taxes, the effective tax rate improved 90 basis points in the quarter to 29.5%.

Now shifting to asset quality, net charge-offs totaled $68 million in the second quarter, a 32% improvement over the first quarter and represented 34 basis points of average loans. The provision for loan losses was $20 million less than net charge-offs. A reduction in non-performing and criticized loans resulted in an allowance for loan and lease losses decline of 3 basis points to 1.3% of total loans outstanding. The allowance for loan and lease losses

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associated with the direct energy loan portfolio increased to 6.9% in the quarter compared to 6.1% in the first quarter, reflecting a specific reserved increase related to one oil field service credit. Total non-accrual loans excluding loans held for sale decreased $181 million or 18% to 1.03% of loans outstanding, driven by broad-based improvement in commercial loans.

Total business services criticized loans decreased 7% and total delinquencies decreased 5%. The improvement in criticized loans was primarily due to declines in energy and transportation and warehousing loans.

The allowance for loan losses as a percentage of total non-accrual loans or coverage ratio was 127% at quarter end. Excluding energy, the coverage ratio increased from 135% to 163% in the second quarter. Total direct energy charge-offs were $18 million during the quarter, bringing the year-to-date total to $31 million.

Let's move on to capital and liquidity. During the quarter, we repurchased $125 million or 9.1 million shares of common stock and declared $84 million in dividends to common shareholders, resulting in 70% of earnings being returned to shareholders. At the same time, our capital ratios remain robust. Under Basel III, the Tier 1 capital ratio was estimated at 12.2% and the fully phased-in common equity Tier 1 ratio was estimated at 11.3%.

And finally, our liquidity position remains solid with a low loan to deposit ratio of 82% and we were fully compliant with the liquidity coverage ratio rule as of quarter end.

As Grayson mentioned, we are pleased with our CCAR results and remain committed to prudently investing in our businesses for future growth as well as returning an appropriate level of capital to our shareholders.

Turning to our outlook for the balance of 2017, our expectations remain essentially unchanged from last quarter. Excluding the impact of our third-party indirect vehicle portfolio, we expect full-year average loans to be flat to slightly down compared to the prior year. However, looking ahead, we expect to modestly grow average and ending loans on a sequential linked quarter basis over the second half of the year.

We expect full-year average deposit balances to be relatively stable with the prior year. We expect net interest income and other financing income growth of 3% to 5% and full-year adjusted non-interest income growth of 1% to 3%. Total adjusted non-interest expenses in 2017 are expected to increase between zero and 1%, and we remain committed to achieving a full-year adjusted efficiency ratio of approximately 62% with positive adjusted operating leverage in the 2% to 4% range. We now expect the full-year effective tax rate in the 30% to 31% range. And we expect full-year net charge-offs to remain in the 35 to 50 basis points range.

So in summary, we are very pleased with our second quarter results and remain focused on continuing to execute our strategic plan to drive growth and shareholder value.

With that, we thank you for your time and attention this morning. And I'll now turn it back over to Dana for instructions on the Q&A portion of the call.

Dana W. Nolan

Executive Vice President - Head of Investor Relations, Regions Financial Corp.

Thank you, David. Before we begin the Q&A, as a courtesy to others, please limit your questions to one primary and one follow-up to accommodate as many participants as possible this morning. We will now open the line for your questions.

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QUESTION AND ANSWER SECTION

Operator: Thank you. The floor is now open for questions. [Operator Instructions] Your first question comes from the line of Betsy Graseck of Morgan Stanley.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

Good morning.

Elizabeth Lynn Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Hi, good morning. Couple of questions. One, I appreciate all the detail on deposits composition that you gave us, and I'm just wondering in the context of your loan-to-deposit ratio 82%, can you just give us a sense as to where you're anticipating – what levers you can pull to drive the deposit growth up to continue to fund the loan growth? And are you thinking about that loan to deposit ratio staying flat or are you comfortable having it migrate higher?

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

Yeah. I mean, I'll start then I'll ask David to add to it. One, we had a very thoughtful and a prescriptive deposit strategy. And if you look at our deposit composition over the last two to three years, you've seen us really drive to create greater diversity in that portfolio, more granularity and less cost. And you've seen us execute a strategy where we've reduced some of our highest cost deposits, we've reduced a substantial amount of deposits that require securities for collateralization. And so we're very proud of the deposit base we put together. And as rates have started rising, you look at the deposit betas that we've been able to deliver and we feel good about that. We think that the big part of the value of this franchise is the strength of our deposit mix.

We would actually like to see our loan-to-deposit ratio improve, go up, if you will. We believe that we've got the capability and the capacity to fund a great deal of our growth with deposits out of the communities we operate in.

David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

Yeah. Betsy, I want to add a couple of things. We don't focus on trying to get to any particular loan and deposit ratio. We believe the core of any bank franchise is its ability to attract and retain low-cost core deposits, and we are very good at that, regardless of – if our loan-to-deposit ratio was even lower. We send a message to the field every day, all day about attracting low-cost core deposit that's just so fundamental to our profitability.

That being said, we would love to have those deposits deployed in the loan book versus somewhere else, securities or otherwise. And we're looking to grow loans as is prudent. And we did a little better this quarter. We'll talk about loans in a minute, but we have good core funding, we're ready to grow loans, but we're not going to force it. We're going to take what's out there. Our teams are working hard to grow appropriately. And again, we're not trying to solve for a given ratio.

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O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

Yeah. I mean, we've made a very conscious effort to take a different risk appetite on certain of our lending segments; energy and multi-family, medical office building. You've seen us do that in auto lending as well. We had made some risk changes into our equity lending products that take risk off of that. So we've been very thoughtful about what part of our lending portfolio we want to grow, and we feel like we've sort of remixed both our deposit and our loan balance sheet.

So we think we're in a very good position to grow. As we said earlier in our prepared marks, we had over a 20% increase in consumer lending production this quarter and over a 50% increase in our commercial lending production. So we think that second half of the year we can see much improved numbers.

Elizabeth Lynn Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Okay. No, that makes sense. I was just – I really like the detail on NIB and how much of that is coming from retail. And I just – when I heard your comment about the outlook for issuing some debt, I was a little bit confused there. Are you looking to hold the LDR flat and issue debt to fund growth, but maybe there's a different reason why you're issuing the debt? Maybe you could just explain that a little bit.

David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

Yeah. It's a great question, because we're really talking about holding company debt versus bank debt. The liquidity profile the bank is in great shape, as we just mentioned. We do have some corporate [ph] need, (31:24) so at the holding company, that we need to take care of. The exact timing of that, not sure which quarter that will hit in. It'll likely be towards the end of the year.

So I don't know that there'll be a whole lot of impact from that this year, could be some. But the general corporate purposes, they include things like our share buyback, too, that we have to think through how we fund that. So, that's really what it's about.

Elizabeth Lynn Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And so it's more on optimization of capital structure as opposed to any kind of regulatory request?

David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

Yes, that's correct.

Elizabeth Lynn Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And do you have a sense of the size of the debt issuance?

David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

We've talked about anywhere from $750 million to $1 billion range that we'd be looking at.

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Elizabeth Lynn Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Perfect. Thanks.

Operator: Your next question comes from John McDonald of Bernstein.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

Good morning, John.

John Eamon McDonald
Analyst, Sanford C. Bernstein & Co. LLC

Q

Hi, good morning. I was wondering if you could talk a little bit about the puts and take to the outlook for the margin next quarter stable to up modestly. And what are some of the underlying assumptions for your NII and NIM guidance for the year?

David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

Yeah, sure. So before we get to NIM, which is just the result, we'll talk about NII. So we believe we can continue to grow NII. We talked about the fact that we had good production from a loan standpoint. We expect loan growth to be more robust in the second half of the year than it was in the first half of the year. We've done a good job of controlling our deposit costs. Our deposit costs were up 1%, call that at 10% beta. Thus far, what I've been able to see has been among the lowest of our peer group. And it really gets back to all the discussion we had on our deposit franchise and our beta, and there are more rural, smaller market that we get deposits from.

So we think that the curves helped a little bit. I would tell you on the Corporate side, LIBOR starts to move before increases happen. So we did get the June increase, the commercial side of that, started to reflect it earlier because LIBOR moved in advance. We do pick up a little bit more on the Consumer side at our prime base. Who knows in terms of the probability of the December rate increase. It's not very high from a probability standpoint right this minute. But as the market starts to anticipate that LIBOR could move to, I think our outlook really takes into the account today's forwards.

From a NIM standpoint, we did have 2 basis points that came through NIM this past quarter on recoveries, credit recoveries. We had guided to 3 to 5 basis points. Last quarter, we ended up with 7 basis points and the 2 points really came from that. We don't forecast those recoveries. If they happen, they happen. And so that's a little piece of the disconnect, where you're trying to figure out why it's stable to up modestly. You also have to look at where we are. I mean, we have on a relative basis to our peers a pretty, pretty strong NIM and when we have the curve it's pretty flat. So the profitability of what goes on relative to our existing NIM is even harder. So you don't see quite the expansion that we've had, but if you take out the 2 points that I just mentioned, we should see growth similar to what we saw in the last quarter.

John Eamon McDonald
Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay, that's helpful. And just as a follow up, David, wanted to ask about your updated thoughts on normalizing the equity base and getting that CET1 to the 9.5% you talked about. I think earlier in the year you were talking maybe

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end of 2018, early 2019, getting there. I was wondering if the successful CCAR and the big ask did help you get there faster or just reinforce your confidence about getting to that target?

David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

Yeah. We put in a plan to get down to that 9.5% by the end of 2018. We've mentioned numerous times we can't quite get there, we don't think at least it depends on what loan growth looks like over that period of time, we'll get close. We had anticipated – of course, we knew what our ask was at the time, we just are reluctant about sharing anything specific until our regulatory supervisors have an opportunity to object or not object. And so we were confident at the submission, even though we didn't know, and we're confident we can get to that 9.5% in due time, and we're confident we're going to get to our 12% to 14% return on tangible common by the end as well. So everything is coming together as we planned, as we stated at Investor Day over a year and half ago, we feel very good about where we're marching towards that goal at this point in time.

John Eamon McDonald
Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay, fair enough. Thank you.

Operator: Your next question comes from Matthew O'Connor of Deutsche Bank.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

Good morning, Matt.

Matthew O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

Good morning. Overall credit quality was quite good. I did notice an increase in the commercial TDRs, and apologies if I missed any opening comments on that, but what drove that rise?

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

No. I mean, I think what you saw this quarter is that, we've characterized our credit quality as stable, we continue to believe that. There is some volatility from quarter to quarter. And then the granularity of that portfolio isn't quite as small as we like, so one or two credits can make a difference in TDRs. That's the case, there is one or two energy credits. But I'll ask Barb Godin, our Chief Credit Officer to expand on that.

Barbara I. Godin
Chief Credit Officer & Senior Executive Vice President, Regions Financial Corp.

A

Thank you, Grayson. And that's exactly what it was. It's a small handful of a few energy credits and an credits on the energy side. Of course, we've just finished or in the midst of finishing our spring borrowing base redetermination. So there's some of that and working with our oil field services clients, so nothing systemic at all and in fact I think that number, you will start to see it move down through the balance of the year as well based on what we know.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

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Thank you.

Matthew O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Thank you. Thank you.

Operator: Your next question comes from Erika Najarian of Bank of America.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

Good morning, Erika.

Erika Penala Najarian
Analyst, Bank of America Merrill Lynch

Q

Hi, good morning. The investor community seems to be losing a little bit of faith in terms of the revenue outlook for the industry generally as the year has progressed. And I'm wondering as we think about your efficiency target for sub 60% for next year, for the full year of next year, is there enough sort of as you look out on the budget and the expense pipeline to continue to support that target, even if sort of the rate outlook once again is maybe a little bit short of what we thought it was going to be to begin the year.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

Erika, we clearly, we can't bet on rates. We've got to maintain a very disciplined, very rigorous expense management program. We are absolutely committed to that. We don't believe – we believe that's fundamentally the right thing for us to be doing in a low rate, low growth economy. We continue to press hard on a number of fronts to make sure that we're delivering on that. As David said earlier, our personnel expenses quarter-over-quarter, our staffing is relatively flat. But we had to absorb – we had to absorb merit increases and also I guess year-over-year we're down a little over 300 positions. We have tried to structurally change our expense base and continue to do that. I'm going to ask John Owen if he will speak for just a moment, we continue to rationalize our branch franchise and recently made some announcements to further complete some commitments we made at Investor Day a year and a half ago about what we're going to do in branch closures. So, John?

John B. Owen
Senior Executive Vice President & Head-Regional Banking Group, Regions Financial Corp.

A

Sure. Good morning. This week we announced the consolidation of 22 additional branches. At Investor Day, we made a commitment that we would consolidate between 100 branches and 150 branches, and we've got about 160 right now. Over the last 10 years from our peak, 2,127 branches when we peaked, we're down now to about 1,500 branches. So overall, we're down about 30%.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

And we're delivering on that 150, which is now at 160 a year early.

John B. Owen
Senior Executive Vice President & Head-Regional Banking Group, Regions Financial Corp.

A

Right.

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O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

And so I mean, I just used that as an example of where not only are we trying to reduce expenses, but we're trying to accelerate the pace of that, the expense management activity.

Erika Penala Najarian
Analyst, Bank of America Merrill Lynch

Q

Got it. And as we look forward, this is a follow-up to John's line of questioning. Clearly, best-in-class in terms of total payout, as we look forward over the next couple of years, how are you balancing the preference between dividend and buybacks, and over the medium term, what's a more normalized dividend payout ratio for your bank, and given what you've observed of your CCAR results?

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

Yeah. So it's a great question. Clearly, it's critical that we get our Common Equity Tier 1 and other ratios to follow along with that, to an appropriate level of capital for our company, and optimize best as we can, both in common and uncommon items like preferred. And I think that we can do that over this fairly short period of time. As you optimize your capital, based on the risk within your balance sheet, we do start leaning more towards a higher percentage of our income being paid out in the form of dividend. So we had espoused a ratio in the 30% to 40% range. That's moving up in the 35% to 45% range. Anyhow, as time goes we'll refine that as well, but I would think that right now based on where we are, the 35% to 45% would seem to be a reasonable dividend payout ratio for us.

Erika Penala Najarian
Analyst, Bank of America Merrill Lynch

Q

Got it. Thank you.

Operator: Your next question comes from Ken Usdin of Jefferies.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

Good morning.

Ken Usdin
Analyst, Jefferies LLC

Q

Thanks. Good morning, guys. I wanted to ask you a question on expenses and, David, good control again if you take the $909 million, and then you had the two $10 million items. So if we're starting at somewhere in the $80 million, $90 million-ish types of range which is I think around the zone that you had kind of spoken to as possible in the past, can you just give us an understanding of just seasonality and growth from here, how well can you kind of control given the points you made earlier about the branch plan and other initiatives. Can you keep them pretty tight from here?

David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

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Yeah, Ken, it's a great question. And you did the math exactly right. So you're – you take that $899 million and back out the settlement fees, you get closer to and the other items you mentioned you get about where our run rate is.

Clearly, we are intently focused on managing our expense base. Grayson mentioned revenue was a challenge, Erika brought up revenue being challenged. We get that, we're not counting on rates to balance out, and as a result we are focused on everything expense-related from people, process, technology. And – but right now, we think that that run rate that you mentioned is fairly accurate for us for the remainder of this year.

Ken Usdin
Analyst, Jefferies LLC

Q

Got it. And to your point about adjusting to revenues, last year you had talked about the 300 program, you upped that to 400, but you kind of rolled out the timeline of that too. Are there things within the program that you could bring forward if you needed to, so I know you're focused on it, but how much of that is – how much optionality is there around timing of those expected saves that you have for – over the time?

David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

Yeah. As you know, about 60% – well over 60% of our – or right at 60% of our total expenses is competition related. So if you kind of move the meter on expenses, you're going to move it based on that. And so being able to – we have natural attrition as every company does, takes care of piece of that, trying to change processes up quicker than we otherwise would have done is a piece of that, not having to backfill people that attrite is important. We'll continue, as John mentioned, the branch consolidation, so we put 22 on the board. And maybe we don't consolidate quite at pace that we have done in recent history. We continue to look at our retail footprint in terms of consolidation and additions. So for us, managing expenses is all about optimizing everything that we do and we have a pretty high sense of urgency to get that done. So we're going to look to bring forward as much as we can. Again, our goal is focusing on hitting our return by the end of 2018 in that range of 12% to 14% and expense management is a critical piece of that.

Ken Usdin
Analyst, Jefferies LLC

Q

Yeah. Understood. Thanks, David.

Operator: Your next question comes from John Pancari of Evercore ISI.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

Good morning, John.

John Pancari
Analyst, Evercore Group LLC

Q

Good morning. On the efficiency ratio and operating leverage, I know you gave the 2017 expectation of 62% and 2% to 4%. I'm wondering where do you think that could go for 2018, just given the progress you've made on the expense front. I mean, do you think you can get to a 60% level or anything like that in 2018 without the help of rates, or conversely, how about with the help of rates? So just curious where you think you could go?

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David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

Yeah. I think that's kind of where Erika was going with her question, too. Clearly, rates matter. To the extent that we don't get increases that we had anticipated, that puts a lot more pressure on us being able to get there. But as we're talking though all these questions, if the revenue is not there, then it's going to cause us to have to put even more pressure on our expense base because we have certain goals that we want to meet and makes it more challenging, makes it more difficult. I can't say in absolute right now for 2018. We're in the middle of our strategic planning process. And of course, we'll roll out a new budget towards the end of the year. We'll give you better guidance into 2018, but we're committed to doing the best we can to get – ultimately we believe to be in the 60% and even over time we think below that.

John Pancari
Analyst, Evercore Group LLC

Q

Okay. All right. Thanks, David. And then, on the credit side a quick one there. I know you bled the reserve about 7 basis points or so this quarter. It's about 1.26, I believe, in terms of a ratio to loan. Curious where you think that could go. Could it go a little lower? I believe the industry is maybe a little bit below that, but just wanted to get your thought.

Barbara I. Godin
Chief Credit Officer & Senior Executive Vice President, Regions Financial Corp.

A

John, it's Barb. Yeah, we moved it from a 1.33 last quarter to 1.30 this quarter. We are looking at the reserve as you know every quarter. And so there is always opportunity for some downward movement. A lot of that is dependent on continued improvement as we've seen so far in all of our credit metrics and in particular in our energy portfolio.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

Well, and the composition of the portfolio. All of that drives it, as we de-risk the composition of our portfolio and de-risk individual credits. The allowance has done what it ought to do. It's rationalized to that inherent risk of the portfolio. And we think we continue to see opportunities to improve that.

John Pancari
Analyst, Evercore Group LLC

Q

Okay. Thanks. One more, I know you said the beta right now on the deposit side is 10%, a ballpark. What do your assumptions assume about where that could go over the one or two like?

David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

Yeah. So, I'll give you some parameters. So we don't really factor in beta for the next quarter. But kind of over the next 12 months, our beta assumptions really haven't changed. They start at 40%, end up at 60% at terminal pass-through. I think a good guide that you might want to have thereby could use is for every five beta points it's about $8 million for us. So, if we get a hike, that could be anywhere from $15 million to $60 million of NII, just depending on what happens from a beta standpoint.

We do think that the pace of change, the pace of rate increases is helpful to keep beta down. But we also are realistic in knowing at some point, we're going to have to pass through some of the increase at a faster pace than

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we have today, which is only 10%. So we think we are probably a little conservative in terms of our longer term beta assumption, especially for the next increase or two.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

I mean, the other side of it is, we're coming from a relatively low position and thus far our industry, our competition has been pretty rational on deposit pricing, but with the modest loan growth that we're seeing, modest economic growth, then you should anticipate modest betas until a point in time that competition for deposits increases.

John Pancari
Analyst, Evercore Group LLC

Q

Okay. Thank you.

Operator: Your next question comes from Steve Moss of FBR.

Steve Moss
Analyst, FBR Capital Markets & Co.

Q

Good morning. In terms of the loan growth here, it sounds like it's turning the corner a bit. I was wondering is this a result of pricing or as runoff is getting closer to the bottom here.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

No. If you look at the economic recovery, fixed business investment has been really modest throughout the recovery. And that's a combination of confidence and courage and uncertainty, but we saw really good production numbers particularly in the commercial middle market space this past quarter. And while we still aren't certain that we're turning the corner there, we are seeing some encouraging signs. And I'll ask John Turner, who runs that business for us, to make a few comments, to give a little bit more detail around it.

John Turner
Senior Executive Vice President-Head of Corporate Banking Group, Regions Financial Corp.

A

I think that we are in a better place to begin experiencing some loan growth. I think the de-risking activities that we've undertaken certainly are beginning to slow a bit. We saw good growth in a couple of different industry sectors. Our pipelines remain stable. When I look at our loss business reporting, we had still about $2.5 billion in opportunities over the last six months that we lost either because of our dissatisfaction with pricing or some sort of structural elements – some other structural elements associated with credit, another $700 million or so related to internal limits that we impose on ourselves to ensure that we have good balance and diversity within our loan portfolio.

So, when you think about production being up over 50% quarter-over-quarter and yet we still have some opportunity in our pipeline through continued just good execution, I think as portfolio mitigation strategies begin to play out and we don't have the kind of runoff that we have been experiencing and assuming that we can turn the tide and runoff in owner-occupied real estate, I think we will begin to see some growth, particularly as business investment activities as Grayson suggests picks up.

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And our pipelines are pretty stable, economies are still growing slowly in the markets where we operate. But there are some types of businesses gaining some confidence, or at least just running out of patience so to speak and saying they're going to take some risks that they haven't been willing to take so far.

Steve Moss Q
Analyst, FBR Capital Markets & Co.

Got you. And then, on the de-risking subject here, wondering what's the prospect of moving your 9.5% target down towards 9% or lower given your balance sheet profile ahead of next year's CCAR?

David J. Turner A
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

Yeah, that's a great question. And glad you brought it up because that's not a static number, the 9.5% we evaluate that all the time. We look at our risk profile, we think through the de-risking that we've done, that 9.5% could go both ways. I mean, if we put more risk on the balance sheet because we decided to do something else, we'll hold the appropriate GAAP before, but if we de-risk, continue to de-risk the 9.5% goes lower than that and I think it's incumbent upon us. We just passed 9.5% and we kind of left it alone at that because we are at 11.3%. Let us get to 9%, as we start approaching 9.5%, we'll give you a better indication as to what, tight that up a little bit, but it will be over time for us to get to that number.

Steve Moss Q
Analyst, FBR Capital Markets & Co.

Thank you very much.

Operator: Our final question comes from the line of Geoffrey Elliott of Autonomous Research.

O. B. Grayson Hall A
Chairman, President & Chief Executive Officer, Regions Financial Corp.

Good morning, Geoffrey.

Geoffrey Elliott Q
Analyst, Autonomous Research LLP

Good morning, thank you for taking the question. It's another one on capital, if I look at the DFAS release, that was about a 70 basis point gap between your common equity Tier 1 and your Tier 1 on distress; third, if we look at CCAR, that increases to about 140 basis points with a capital action, so that seems to suggest there's about 70 basis points of preferred issuance baked into that. I just wanted to check that that was correct?

David J. Turner A
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

You did really good math, that's about where we'll be. We need right at $700 million of preferred over time to bolster our Tier 1, which we're solving through common equity. So, our capital regime is really about getting the capital down to the appropriate level, but optimizing the stack as well. So we want to solve the Common Equity Tier 1 with common equity obviously and non-common needs to be a component of that. It's cheaper than our cost of common today and you nailed it.

Geoffrey Elliott Q
Analyst, Autonomous Research LLP

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And then I get clearly that preferred is cheaper than common. But why issue any preferred at all when post capital actions, post stress, you're still at 7.4%. That's still a long way ahead of the, I think it's a 6% minimum preferred for total Tier 1 under stress in CCAR. Why issue any preferred at all?

David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

Well, we won't and we will, we're going to wait as long as we can because we don't want to have the negative carry. And we'll do that in conjunction with the whole optimization and rightsizing, so timing is critically important to us, and we got that timing down pat.

Geoffrey Elliott
Analyst, Autonomous Research LLP

Q

And then just lastly, are you committed to issuing that now, now that that's gone into the CCAR ask, barring any resubmission or anything like that, are you kind of bound to issue non-preferred?

David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

To the extent that we have, so our commitment is to have an appropriate amount of capital, common equity Tier 1 as well as Tier 1. If we're solving Tier 1 with common equity, I don't think there's regulatory supervisor at the tiers that you saw with that type of capital instrument. So, we don't have to issue a non-common instrument or preferred instrument unless we are taking our common out as well at the same time. So, we're not forced to have negative periods is where I think it's going.

Geoffrey Elliott
Analyst, Autonomous Research LLP

Q

Great. Thank you very much.

David J. Turner
Chief Financial Officer & Senior Executive VP, Regions Financial Corp.

A

Okay.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

A

Well, thank you.

Operator: This concludes – I'm sorry, go ahead with your concluding remarks.

O. B. Grayson Hall
Chairman, President & Chief Executive Officer, Regions Financial Corp.

Well, that being our last question, we really appreciate everyone's time. We thank you for your attendance today, appreciate your interest in Regions Financial, and look forward to speaking to you next quarter. Thank you.

Operator: Thank you. This concludes today's conference call. Your may now disconnect.

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