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Regions Financial Corp. (RF)

Q3 2015 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'll 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 Mr. List Underwood to begin.

M. List Underwood
Director of Investor Relations

Thank you, operator, and good morning, everyone. We appreciate your participation in our call today. Our presenters are Grayson Hall, our Chief Executive Officer; David Turner, our Chief Financial Officer. Other members of management are present and available to answer questions as appropriate. Also, as part of our earnings call, we will be referencing a slide presentation that is available under the Investor Relations section of regions.com.

Finally, let me remind you that in this call, and potentially in the Q&A that follows, we may make forward-looking statements which reflect our current views with respect to future events and financial performance. For further details, please reference our forward-looking disclaimer that is located in the appendix section of the presentation. With that I'll turn it over to Grayson.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

Thank you, List, and good morning, everyone. We're pleased you could join us for our call today. For the third quarter we reported earnings from continuing operations of $246 million or $0.19 per diluted share. These results reflect total adjusted revenue growth, despite an operating environment that remains challenging. In the third quarter we continued to deliver growth in categories that we believe are fundamental to future income growth. Our fundamentals are strong with growth in households, accounts, loans and deposits. In fact, one of the most important categories is checking accounts, which we've grown by more than 2% year-to-date. We remain focused on expanding and deepening relationships through our need-based approach to relationship banking.

Total net interest income increased 2% from the second quarter, representing the highest quarterly increase in approximately two years. For the same period, total loans increased 1% on an ending basis and were up 2% on average basis, contributing to the increase in net interest income.

Business lending had a good quarter, driven by real estate and corporate banking groups. Within real estate, REIT business growth was strong. The growth within corporate banking reflects the strength of our business model as local bankers collaborate with industry and product specialists to grow loans. In the third quarter all specialized industries experienced growth led by power, utilities, technology and defense, restaurant and healthcare. Consumer lending had another strong quarter reaching $30 billion in total outstandings on an ending basis with growth in every loan category. Our new point of sale initiative led this growth as consumers took advantage of the convenience of this product offering. Additionally, indirect vehicle lending continues to be strong supported by robust auto sales during the summer.

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Total noninterest revenue in the third quarter declined compared to a strong second quarter. The majority of the decline was attributable to a lower benefit from mortgage servicing rights and related hedges. Despite this decline, we have continued to experience good momentum in several areas, including capital markets and wealth management as our prior investments continue to produce results.

Wealth management income was strong this quarter, up 13% over prior year. We remain focused on our strategy to grow wealth management by continuing to recruit, retain and develop talent required to meet the diverse needs of our clients. We will continue to look for insurance acquisitions and lift-outs, similar to our recent addition in Georgia. Clearly this operating environment continues to be challenging as we have continued to face lower interest rates for an extended period of time. Furthermore, we expect the pace of increases in interest rates to be slow and measured.

Given this backdrop, it's essential that we take more aggressive action as it relates to expense management. We've instituted a number of initiatives and are carefully evaluating a number of other actions that we will provide more details at our Investor Day on November 19.

Credit quality was relatively stable during the quarter, with some weakening in the energy portfolio. As expected there's been some downward migration risk ratings inside this portfolio. These shifts could continue if oil prices remain at current levels. Overall, we believe our energy customers are taking appropriate actions by reducing costs and making other infrastructure adjustments to create liquidity, preserve our capital, and reduce debt to mitigate vulnerabilities to this environment. As a result, we expect any future losses related to this portfolio to be manageable. We have remained focused on our strategic initiatives for 2015 and have made progress diversifying, growing total revenue by continuing to effectively deploy capital. We remain committed to generating positive operating leverage over time and in the near term will rigorously seek operating efficiencies.

With that, I'll now turn it over to David, who'll cover the details for the third quarter. David.

David J. Turner, Jr.

Chief Financial Officer & Senior Executive Vice President

Thank you, and good morning, everyone. I'll take you through the third quarter details and then wrap up with our expectations for the remainder of 2015. Loan balances totaled $81 billion at the end of the third quarter, up $914 million or 1% from the previous quarter. Year-to-date, loans have increased $3.8 billion or 5%. Business services achieved solid growth with balances totaling $51 billion at quarter end, an increase of 1%. Commercial and industrial loans grew $559 million or 2% and commitments also increased 2%. As previously mentioned, real estate corporate banking and all specialized lending areas experienced growth in the third quarter.

Consumer lending had another strong quarter. Loans in this portfolio totaled $30 billion, an increase of 2% over the prior quarter. Indirect vehicle lending increased 3% while production increased 8%. And other indirect lending, which focuses primarily on home improvement retailers, increased $107 million linked quarter or 28%. Year-to-date, loans in this new portfolio have increased $284 million and we plan to continue to grow this business into 2016.

Mortgage loan balances increased $141 million, while production declined compared to a seasonally strong second quarter, total production remained healthy at $1.4 billion, an increase of 11% over the prior year. Looking at the credit card portfolio, balances increased 2% from the previous quarter and our penetration rate into our existing customer base now stands at 17%, up almost 200 basis points from the third quarter of last year. And finally, total home equity balances increased $48 million from the previous quarter as new production outpaced portfolio runoff in the third quarter.

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Let's take a look at deposits. Supported by our multi-channel platform, average deposit balances increased $66 million and totaled $97 billion at quarter end. Consumer and wealth deposits represented 75% of total deposits. Of note, our average account balance is smaller and is expected to be less volatile in a rising rate environment. Deposit costs remained at historically low levels at 11 basis points, while total funding costs remained at 25 basis points. Now let's see how this impacted our results.

Net interest income on a fully taxable basis was $855 million, an increase of $16 million or 2% from the previous quarter. Higher loan balances and balance sheet hedging strategies were the primary drivers behind the linked quarter increase. In an effort to mitigate impacts from a continued low rate environment, we executed hedges involving interest rate derivatives. These strategies benefited net interest income while only modestly reducing asset sensitivity. The net interest margin was primarily affected by pressure on asset yields and higher cash balances, resulting in a 3 basis point margin decline to 3.13%.

Total noninterest income declined after a particularly strong second quarter, driven in part by lower mortgage revenue due to lower benefits from mortgage servicing rights and the related hedges. However, our investments in and commitment to diversifying and growing fee-based revenues yielded positive results in several areas.

Total wealth management income increased 5% linked quarter, driven by insurance income and investment services fee income. Insurance income increased 15%, driven in part by the acquisition that Grayson previously mentioned. And investment services fee income grew 15% as our financial consultants continue to expand and deepen relationships, primarily through our Regions360 approach to needs-based selling.

Capital markets income increased $2 million over the previous quarter, primarily related to a pickup in loan syndication income. This reflects our continued investment in people and products in order to grow and diversify revenue. Card and ATM fees increased 3% as a result of increased credit card usage as well as an increase in active credit cards.

Let's move on to expenses. Total reported expenses in the third quarter were $895 million, an increase of $35 million on an adjusted basis. This included an increase of $31 million in deposit administrative fees. In the third quarter we incurred an expense of $23 million related to prior assessments. Also impacting the linked quarter variance were refunds that we received in the second quarter of $6 million from overpayments. We expect the future quarterly run rate for this expense item to be in the $22 million to $25 million range.

Salaries and benefits were down 1% linked quarter. Additional head count related primarily to strategic investments drove an increase in base salaries; however, this was offset by reductions in performance-based incentives.

Expenses related to occupancy increased linked quarter due to seasonal increases in utilities. And additionally, furniture and fixtures increased from the previous quarter due to investments in technology and back-office infrastructure which will improve efficiency over the long-term. This expense item is expected to increase modestly over the next few quarters, reflecting these investments. Outside services declined $2 million from the prior quarter, partially related to lower risk management and compliance cost.

Our adjusted efficiency ratio was 66.8% in the quarter; however, excluding the additional expenses related to deposit administrative fees, the resulting ratio was 65%. As Grayson previously noted, in this operating environment, we must do even more to improve our efficiencies and lower operating cost. To that end, we have recently instituted hiring restrictions and continue to rigorously review all discretionary expenditures.

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Additionally, we have allocated expense challenges and goals by business unit and we will provide more details on these additional steps when we meet with you for Investor Day next month.

Let's move on to asset quality. Total net charge-offs increased and represented 30 basis points of average loans. Importantly, this increase does not reflect the broad deterioration in credit quality. Total business services criticized and classified loans increased $304 million, or 10% from the prior quarter. And nonaccrual loans increased 5%. These increases were driven by some weakening in a small number of larger loans, primarily within the energy portfolio.

As it relates to the energy portfolio, we remain in close contact with our energy customers. Rigorous credit servicing activities are ongoing and we have instituted heightened requirements for loan renewals. As previously stated, we anticipate additional migration into non-pass categories but expect any losses in this portfolio to be manageable. Based on what we know today, over the next 12 months to 18 months losses could range in the $30 million to $50 million range; however, we have adequate reserves to cover these losses.

The provision for loan losses was $60 million, matching net charge-offs, and our allowance for loan losses was relatively stable at 1.38% at the end of the third quarter. Compared to the prior quarter, troubled debt restructured loans, or TDRs, declined 7%. And at quarter end, our loan loss allowance to nonaccrual loans, or coverage ratio, was 141%. And given where we are in the credit cycle, volatility in certain credit metrics can be expected, especially related to larger dollar commercial credits in our portfolio and fluctuating commodity prices.

Let's move on to capital and liquidity. During the quarter, we repurchased $270 million, or 26.6 million shares of common stock, and declared dividends of $79 million. Under the Basel III provisions, the Tier 1 ratio was estimated at 11.7% and the common equity Tier 1 ratio was estimated at 11%. On a fully phased-in basis, common equity Tier 1 was estimated at 10.7%, well above current regulatory minimums. Our loan and deposit ratio at the end of the quarter was 83% and regarding the liquidity coverage ratio Regions remains well-positioned to be fully compliant with the January 2016 implementation deadline.

Now, let me have a brief review of current expectations for the remainder of 2015. We expect total loan growth to be in the 4% to 6% range on a point-to-point basis and probably end up at the higher end of that range. Regarding deposits, we continue to expect full-year average deposit growth in the 1% to 2% range. With respect to the margin, we expect performance through year end to be marginally better than the full year guidance communicated in early 2015, which call for a decline of 10 basis points to 12 basis points, if rates remain persistently low. However, even if rates remain low, net interest income is expected to grow moderately.

Finally, we expect to continue to benefit from revenue initiatives and we will take steps to prudently manage our expenses. We remain committed to generating positive operating leverage over time.

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

M. List Underwood

Director of Investor Relations

Thank you, David. We are ready to begin the Q&A session of our call. In order to accommodate as many participants as possible this morning, I would like to ask each caller to please limit yourself to one primary question and one related follow-up question. I appreciate your cooperation. Now let's open up the line for questions. Operator?

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QUESTION AND ANSWER SECTION

Operator: [Operator Instruction] Your first question comes from Stephen Scouten of Sandler O'Neill.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer **A**

Good morning, Steve.

Stephen Kendall Scouten
Sandler O'Neill & Partners LP **Q**

Hey, good morning, guys. Thanks for taking my question, here. First, one of the things about the energy portfolio and the reserves. I know you guys don't tend to disclose, maybe specific reserves related to the energy portfolio, but did you take any incremental provision related to that $30 million to $50 million in potential losses that you could see? Or was that, as you said, just kind of matching the net charge-offs you had in the quarter?

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer **A**

Stephen, thank you, that's a good question. And I'll ask Barb Godin, our Chief Credit Officer to make a few comments in that regard. And then John Turner, Head of Corporate Banking, to follow that up. Barb?

Barb Godin
Senior Executive Vice President & Chief Credit Officer **A**

Thanks very much, Grayson. Yes, we actually did take some incremental reserves this quarter on the energy portfolio. And we currently stand at around 4.7% of that portfolio being reserved. So, we are well reserved given where we feel the losses will be in the next 12 months to 18 months.

John M. Turner, Jr.
Senior Executive Vice President, Head-Corporate Banking Group **A**

And I would just add we provided some additional detail, particularly on the Oil Field Services sector, in our release. I think what you'll see is that we have, as we said before, a smaller number of customers that comprise our portfolio. We believe that we've been very prudent in the selection of those clients, stay very close to them. We think they're doing all the right things to react to the crisis that they have faced, the declining oil prices. And so we remain cautiously optimistic about the performance of our book.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer **A**

Thank you.

Stephen Kendall Scouten
Sandler O'Neill & Partners LP **Q**

Okay, thanks, I appreciate that. And, yeah, definitely I appreciate the additional color there in the slide deck. And then, just as a follow-up as it relates to capital deployment. Obviously the share buyback was a little bit; it seemed accelerated, in the quarter. I'm assuming just taking advantage of the lower share prices. Is that something that

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you guys can continue to do in this current quarter as the share remains maybe lower than it should be, in my view? And how much flexibility do you have there?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

This is David. So we have, obviously, a capital plan that was not objected to by regulatory supervisors for which we are executing against. We were able to move up a small portion of that into a different quarter, but in order to have any meaningful change in our total buyback we would have to go through a submission to our regulatory supervisors for future – any increases in the buyback over our CCAR request.

Stephen Kendall Scouten
Sandler O'Neill & Partners LP

Q

Okay. So the $875 million will remain the same but you could pull that forward kind of like we saw here in the current quarter?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

That's what – we did pull a piece of that forward this past quarter, but we can't change the $875 million.

Stephen Kendall Scouten
Sandler O'Neill & Partners LP

Q

Perfect. Thank you guys so much. I appreciate the color.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

Thank you.

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

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

Hey, Ken, good morning.

Kenneth M. Usdin
Jefferies LLC

Q

Hi. Good morning, Grayson. Hey, just a quick question just on the outlook for net interest income. David, your comments about less bad than the prior guidance earlier in the year was kind of lost in sequential so just wondering can you help us understand; do we still see kind of the core compression of the NIM from here on an ex-rates basis? And what other drivers do you have to help support that further?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

Yeah, I think so we will still have a couple basis points of compression expected for the quarter. We really are speaking more to NII. We believe that can continue to grow, though. But obviously you're continuing to see the impact, partially higher cash balances for us, our driver, and then this low rate environment grinding down, but will put in a couple of basis point pressure from here to the end of the year.

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Kenneth M. Usdin
Jefferies LLC

Q

And underneath that it looked like the loan yields have started to flatten out. Was that just finally getting past the natural rollover or was there any incremental help from swaps or hedging activity that helped as well?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

It's a little bit of both. So you're seeing low rates work through to some degree, but you have to have help from some of the derivatives that we put on as well.

Kenneth M. Usdin
Jefferies LLC

Q

Okay, thank you.

Operator: Your next question comes from Marty Mosby of Vining Sparks.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

Good morning, Marty.

Marty Lacey Mosby
Vining Sparks IBG LP

Q

Morning. David, I had two questions for you. One is, looking at the investment process that you've been in, that kind of forced your expenses to grow faster than your revenues over the last year. Do you anticipate that you're kind of getting to the inflection point where the return on investments begin to flip that around and you can start to create that operating leverage that you're talking to in your outlook?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

That's a great question, Marty. So I would tell you we've made investments in a lot of areas to execute our strategy which is to diversify our revenue stream into some NIR sources. In some cases we have further investments to make and in others we're just about finished. So an example of that would be our financial consultants that we have and wealth management. We had a goal to hire about 225 of those through September 30.

We have about 219, so we've got a handful more to go in the fourth quarter and we'll be done. And so what you'll start seeing is the payoff of these investments will start becoming even stronger relative to the investments or the expense that we had earlier. And so it just depends on which investment we're talking about. Our goal is to grow our income, diversify our revenue stream and to have better returns on capital over time, which is why we've needed to make those investments early on. And they're starting to pay off for us. They are performing exactly like we expected. As a matter of fact, in some cases they're actually ahead of schedule. So you've seen expense go up and we've talked about making the investments. We still believe it's been the right thing for us to do and you'll see the benefit as we get into 2016 and beyond.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

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But Marty, to add to that, we obviously have made what we think are very prudent investments and the results we've seen from those investments have been very positive and we continue to see opportunities for that. That being said, given the current rate environment and our rate forecast for what we believe the next few quarters hold, we've had become much more rigorous on expense management. We are trying to self-fund a lot of our investments to make sure that as David said, over time we can generate positive operating leverage as a company.

So you will see us be more rigorous around expense management over the next few quarters. We just think given the rate environment that it's prudent to do that. That being said, we really are trying to create long-term franchise value while being sensitive to quarter-to-quarter earnings pressure. But we need to make sure that we're thoughtful about how we manage expenses and to make sure that we continue to build franchise value over time.

Marty Lacey Mosby
Vining Sparks IBG LP
Q

Thanks. And then, David, this won't be a surprise, so my next question, but you started to step out with hedging and neutralizing some of your asset sensitivity position. You kind of said net it really didn't affect your pickup when rates go up. Is that enough? You're still letting cash balances build. Shouldn't you start thinking about neutralizing that balance sheet over, let's say, the next 12 months, at least, more aggressively? And I know you're smiling there listening me to ask that same question I've asked several times before, but just wanted to ask you that again.

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President
A

So Marty, we continue to challenge ourselves on the positioning of the balance sheet. We have been asset-sensitive for an extended period of time. We believe staying asset-sensitive is the right thing for us as we seek to extract the value out of our competitive advantage, which is our deposit base, our granular, sticky, consumer-oriented deposit base. And to neutralize rate sensitivity in this environment, we think, is the wrong thing to do.

We did put on some hedges to protect ourselves, primarily, on a prolonged low rate or declining rate environment, but we didn't want to take too much sensitivity off. So we're still up instantaneous 100 basis points, we're still at about $155 million of NII impact, down from about $165 million. So, it was a slight change down. But we believe maintaining that sensitivity is the right thing for Regions, given the construct of our deposit franchise and that side of the balance sheet.

Marty Lacey Mosby
Vining Sparks IBG LP
Q

Thanks.

Operator: Your next question comes from Betsy Graseck of Morgan Stanley.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer
A

Good morning, Betsy.

Elizabeth Lynn Graseck
Morgan Stanley & Co. LLC
Q

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Good morning. Couple of questions. One, Barb, I just wanted to make sure – you indicated that, regarding the energy, you feel like you've done the reserving you need to do here today. And could you just give us a sense of, that's at current oil price or the forwards on oil and the kind of timeframe that your price outlook persists?

Barb Godin
Senior Executive Vice President & Chief Credit Officer

A

Yeah. When we go through our process, including sizing up what we think the losses might be, et cetera, we go through looking at a number of models, but we also do an account-by-account bottoms-up review. We do that on a monthly basis, staying close to our customers, close to their balance sheets, et cetera. And when we look at the price of oil, we look at the spot price; we also look at the futures price as well. So all of that is incorporated into our thought process as to how we determine what the appropriate level of allowance was.

Elizabeth Lynn Graseck
Morgan Stanley & Co. LLC

Q

And what kind of discount do you give to spot and futures?

Barb Godin
Senior Executive Vice President & Chief Credit Officer

A

Well, again, we go through the standard. We start off with the number of barrels of oil that our engineers feel are in the basins, we apply our price deck to it – our current price deck base is $46, stressed $36.80, we discount that by the PD9. So discount it by 9%. Then we risk adjust all of that, again, one more time. We do that at approximately a 10% level, and then we do a borrowing base, the borrowing base is about 65% of all of that. So, long story short, is you'll end up with 53% of what's in the ground is what we'll lend against.

Elizabeth Lynn Graseck
Morgan Stanley & Co. LLC

Q

And do you think that there's going to be much in the way of a reduction in supply here, based on all of that and what you and others are doing with regard to these redeterminations or do you think supply kind of kicks along as is?

Barb Godin
Senior Executive Vice President & Chief Credit Officer

A

Well, I know with the borrowing base redeterminations we believe that we'll probably reduce another 15% to 20%, which is roughly what we did in the prior quarter as well. And we do see a lot of supply that's still out there.

Elizabeth Lynn Graseck
Morgan Stanley & Co. LLC

Q

Okay. And then just separately on the outlook for operating leverage, what I'm hearing is with the hiring restrictions and we'll see the benefits of the hiring that you've done over the last 12 months to 18 months come through, that we should look for operating leverage to improve as we go through the next two, three, four quarters. Is that a fair assessment?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

That's right. We wanted to continue, as Grayson mentioned, to make investments to grow revenue and we're going to self-fund those. So we're going to look at all areas of our company to control our expenses with the goal of

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generating positive operating leverage. It just takes time to work through. I think the question came earlier in terms of the investments; it takes time to generate the revenue that pays for the investment we made. But we are on track and we think you'll see that improvement coming through in 2016.

Elizabeth Lynn Graseck
Morgan Stanley & Co. LLC

Q

And then in the past you've talked a little bit about the insurance growth from lift-outs. I know it's a modest effort relative to the size of the overall company, but would that continue in this outlook for slowing down hiring or putting a freeze on hiring?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

No...

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

Go ahead, David.

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

We've continued to expect to make investments, as we mentioned. So, those are not included into the hiring numbers we've talked about, the freeze, as you mentioned, the restrictions. So you should see us continuing to look for opportunities to grow that insurance business.

Elizabeth Lynn Graseck
Morgan Stanley & Co. LLC

Q

Okay. All right. I know it's threading the needle between the words, just wanted to make sure where it starts and stops with regard to insurance, so I appreciate that. Thanks.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

As I said earlier, we recognize in this environment that the most prudent thing for us to do is to be much more rigorous, much more disciplined in managing expenses. That being said, we have to do that in a thoughtful way that doesn't degrade franchise value, that actually affords us the opportunity to continue to increase franchise value. And where there are opportunities, such as the insurance lift-outs, that provide us a situation that we believe that gives us economic benefit in a relatively short period of time, we're still going to seize those opportunities.

Elizabeth Lynn Graseck
Morgan Stanley & Co. LLC

Q

Okay. All right. Thanks.

Operator: Your next question comes from David Eads of UBS.

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O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

Morning, David.

David Eads
UBS Securities LLC

Q

Good morning. Maybe following up on energy just quickly – great color you've given so far. Just curious, particularly on the Oil Field Services side, if you can give any color on how you guys think about loss frequency and severity in that book.

Barb Godin
Senior Executive Vice President & Chief Credit Officer

A

Yeah, this is Barb Godin again. You know, Oil Field Services in total is about $1.2 billion. 24% of that book is close to the well head. But what you need to know about that book is 66 customers make up 98% of that book. So we're very close to them.

As I look at that overall book, what the largest piece of that book is is marine and we have just under $500 million, $494 million in marine, but 23 obligors. So, again, not very granular. But 70% of what we do in marine is deep water marine. So only 30% is on the Gulf of Mexico shelf. So, again, looking at that book we feel pretty good about the marine piece of that book. Quite frankly, all of the other pieces are quite manageable. The one that I would worry about the most would be the fluid piece and we have eight obligors in fluid and we have $99 million in outstandings for fluid. So, again, we're paying them a lot of love and attention these days.

David Eads
UBS Securities LLC

Q

Thanks for that. And then kind of on the loan growth side, obviously another quarter where almost everything is looking good, the main exception there being a continued runoff in the unoccupied commercial real estate portfolio. Are you any closer to kind of knowing when we might get an inflection point in that portfolio?

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

It's a great question, and it's one we challenge ourselves with frequently. As David had said earlier, one of our primary goals is to try to not only grow revenue but to diversify our revenue streams. And if you look at what's different this quarter versus last quarter, certainly versus a quarter a year ago, we've really gotten greater diversity and gotten greater growth more broadly across the different lending segments. And as you pointed out, the one segment that we did not get growth in, have not hit an inflection point on, has been in owner-occupied real estate, which has predominantly been our small to medium size businesses that we provide banking product to.

And in that small business community we have seen this year an improvement in production. What we've not seen is enough production to offset the normal amortization of that portfolio. And it's predominantly an amortizing portfolio. There's some line usage in that group, but mostly it's amortizing. We continue to look for that inflection point. We don't think it's too far down the road. But it's – that one product segment has been the one that we've been most challenged to reach that inflection point on. But good production numbers and I think the confidence of that segment is improving. But that small business sector has been sort of the last to recover from a confidence perspective.

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David Eads
UBS Securities LLC

Q

Great. Thanks for taking the question.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

It's been a great deposit sector, though. We really have been growing deposits in that group. So, we're encouraged, but still not at that inflection point yet.

Operator: Your next question comes from Paul Miller of FBR.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

Good morning, Paul.

Paul J. Miller
FBR Capital Markets & Co.

Q

Yes. Thank you very much. Guys, I do want to commend you on the energy side. I do like it. I just had a question about your – how do you define indirect exposure and in that sense I get a lot of people – feedback I get from clients is, I'm not really worried about the direct exposure, I'm worried about the indirect exposure, i.e., small businesses in these communities, that are mainly oil-driven. Are you seeing any real deterioration in any of these communities, I guess, in the Gulf or where you do business?

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

Well, I'll start and then I'll let Barb Godin speak just a second on that. We've really tried to take a broad view of what the implications of the drop in the commodity prices and the energy sector have been. And I think that some segments of that energy portfolio are fairly easy to define.

When you get down to the indirect piece, there's some subjectivity and objectivity that's required to define those. And I would tell you that we've seen in certain cases some softness in some of those indirect segments. Overall, in some of our markets we operate in, New Orleans, Baton Rouge, Houston, there's a lot of activities that's offsetting the softness in this activity from a community perspective, but some individual companies absolutely you see, do see some softness. Barb?

Barb Godin
Senior Executive Vice President & Chief Credit Officer

A

Yes, thank you, Grayson. We would define indirect as those types of companies, as an example transportation, that majority of their business is done to support something going on in the energy sector. So we capture all of that, that's incremental almost $500 million that we talk about.

Relative to the other contagion effects that we would look at i.e., consumer, small business, commercial real estate, et cetera, we look at all that. Consumer side is a positive, it's a net positive, they're enjoying the low gas prices, it's helping them a lot, we're seeing that pickup, as an example, in our restaurant business that we have a specialty in. We're seeing better results there. Relative to some of the other areas as we think about Texas, the only area of any heightened attention is the Houston market, the office sector. We're looking at that. It's still doing well

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but we're keeping an eye on that. And New Orleans, of course has suffered a little bit from softening demand, as well. And that is pushing their vacancy rates up.

Overall retail and all of those sectors have done well, a lot of the Gulf of Mexico and Houston as well. But we don't want to be a Pollyanna. We absolutely want to keep our heads up and keep attuned to making sure that if we do see some softness that we react quickly.

Paul J. Miller
FBR Capital Markets & Co.
Q

And as a follow-up, have you seen – have you got any feedback from the Fed with rates staying low on any guidance on your capital management? Or is your capital management good to go for the year until the next CCAR?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President
A

Yeah, I think – so we can't discuss anything with our regulatory supervisors. But suffice it to say that all capital planning that we have built into this year's expectations have been via the non-objection we received in our CCAR. So, if we wanted to do something outside of that, it would require some form of off-cycle request to our regulatory supervisors.

Paul J. Miller
FBR Capital Markets & Co.
Q

Okay, guys, thank you very much.

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

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer
A

Morning, John.

John Pancari
Evercore ISI
Q

Morning. Just a question regarding the loss range of $30 million to $50 million on energy that you put out there. Can you give us a little bit of color on how you arrived at that? Did you look at the past cycles and what basis do you have behind the numbers on the calc?

Barb Godin
Senior Executive Vice President & Chief Credit Officer
A

John, this is Barb Godin again. Again, we use both quantitative as well as qualitative. The quantitative being, yes, we look at models that we run. It includes historical information as well as current information of what we think will happen in the future. But, again, we supplant a lot of that with an ongoing monthly looking at every file, every customer, looking at what their balance sheets look like, looking at what their cash flows look like. So that, as we talk about our estimate of losses, we talk about – I can't talk about through the cycle, I don't know when the cycle will end, we use the 12 month to 18 month horizon to say we have pretty good visibility for that period of time. So, again, pretty comfortable with the number we put out there.

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John Pancari
Evercore ISI

Q

Now, Barb, is that 12 months to 18 months from now or for the cycle?

Barb Godin
Senior Executive Vice President & Chief Credit Officer

A

Yes.

John Pancari
Evercore ISI

Q

Okay. So now, do you have any way of identifying what that implies in terms of the accum loss assumption that you're now incorporating?

Barb Godin
Senior Executive Vice President & Chief Credit Officer

A

No, I wouldn't go that far.

John Pancari
Evercore ISI

Q

Okay. All right. And then separately, David, just on the interest rate side, on the swaps. I'm not sure if you've disclosed, but did you indicate how much in swaps you added? And then also, can you give us just your thinking in terms of the willingness to add incremental swaps here or is this it?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

Yeah, so we will be disclosing our swaps in the Q. We put about $3 billion of received fixed swaps. They're a little longer dated. We had some short-term that we took off, so we were up about $1 billion net on notional. John, as we think about interest rate risk positioning, it kind of gets back to Marty's question. We challenge ourselves every day on where we need to have this. We think taking that sensitivity away and foregoing that nice lift and nice benefit we think we'll get when rates rise would be the wrong long-term answer for our shareholders. So we'll pay the freight today for the benefit that we'll get tomorrow and we'll manage our profitability the way we've done. So we've put some incremental swaps on. We don't have any current plans to execute further swaps, but if conditions change, then we could change our mind as well.

John Pancari
Evercore ISI

Q

Okay. And if I could just ask one more. You may punt me to your Investor Day for the answer for this one, but I know you've been investing in a lot of your fee-based businesses that tend to be higher efficiency ratio businesses like wealth management and cap markets, but less capital-intensive and accordingly higher ROE. So can you give us just a – how do you think about that, how it could all come out in the wash in terms of the ultimate benefit to your ROE from these investments?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

Yeah, that's a very good question. We challenge ourselves on that. You've nailed exactly the math there. We have to look at all of our businesses working together and the synergistic effect they can have on our total business and

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the diversification and how we might react in a stressed environment versus a normal environment. All those come into play as we think about the investments we want to make in businesses. We well understand that the investments in some of these businesses are less efficient. That's part of where our efficiency ratio is today, but they take a very little amount of capital, as well, so the return on capital is pretty strong. And they have a tendency to be annuity-based so that you can count on them year in and year out, so that's worth something.

You will see – so I'll half punt to Investor Day, you'll see how all this comes together in terms of our outlook over the next three-year period with the investments that we have made and plan to make. And how we're going to self-fund these investments, as Grayson mentioned, from an expense standpoint so that we can improve our bottom line over time, so that we can become more efficient over time as well. So that we can – our business model can address whatever interest rate environment might be out there, we're going to put together a plan that shows you how we win in all those scenarios.

John Pancari
Evercore ISI

Q

All right. Thank you, David.

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

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

Morning, Erika.

Erika P. Najarian
Bank of America Merrill Lynch

Q

Good morning. Just a follow-up question on the previous question on efficiency. If I take your adjusted efficiency ratio of 65% and I put together everything that you've said so far. So modest NII growth even if rates stay low because loan growth has been solid. You know, fee income starting to benefit from some of the investments that you've made, but naturally a more higher efficiency ratio business in terms of wealth management, capital markets and self-funding some of the investments, I guess over the next 12 months how much improvement can you generate on that 65% assuming no increase in rates from the expense side?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

Yeah. Well, let me talk about it in terms of all of our businesses coming together and this will be a discussion we'll have at Investor Day but, as you know, we've sought to be in the lower 60%s. We believe we can get there based on all the things we've talked to you about this morning. We'll get more granular on how if you'll come to Investor Day. But, our long-term goal with rates increasing was still in those higher 50%s that we've talked about previously. But we're building the business model and if we don't get the rate increase, how do we continue to improve bottom line, how do we continue to become more efficient, that is, get below 65 and trend towards the lower 60%s without rates increasing? So, we believe we can do that, we're going to show you more specifically how we'll do that on November the 19th.

Erika P. Najarian
Bank of America Merrill Lynch

Q

Got it. And just maybe as we think about the next quarter, David, is the correct base for adjusted expenses as we think about a fourth quarter $872 million to $875 million?

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David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

That is the basis on what you should extrapolate anything in the fourth quarter, yes.

Erika P. Najarian
Bank of America Merrill Lynch

Q

Okay, thank you so much.

Operator: Your next question comes from Matt Burnell of Wells Fargo Securities.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer

A

Morning, Matt.

Matthew H. Burnell
Wells Fargo Securities LLC

Q

Good morning, Grayson. Good morning, everybody. Thanks for taking my question. First of all, David, maybe a question for you. It looked like your long-term borrowings were up roughly two times quarter-over-quarter. I didn't – if I look at some industry sources, it didn't look like you had issued quite that much debt. Could you give us a little sense as to what's going on there? And also in terms of any preferred issuance that you might think about going forward to fill up that regulatory bucket?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

Sure. So we did increase our long-term debt. We did have the debt issuance during the quarter. It was about $750 million, I think your – that you've seen. We did take out some short-term FHLB debt in place of long-term FHLB debt. Part of that was to fund loan growth. Part of that's sitting in cash as well as we think about LCR. But that was really the big – the biggest driver. And the second part of the question...?

Matthew H. Burnell
Wells Fargo Securities LLC

Q

In terms of any possible preferred issuance going forward?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President

A

So, we do acknowledge we probably need a little more non-common Tier 1. And to issue it right now, without a good place to put the proceeds, though, is really cost-prohibitive. The carry on that is something we want to avoid. If we can kind of work that through our optimization of our capital stack over time, I think would be the better play for us as we trade out a more expensive common instrument for a less expensive preferred issuance and get our delta, delta between common equity Tier 1 and our Tier 1 to be a little better than we have today. So, you'll see that in time.

Matthew H. Burnell
Wells Fargo Securities LLC

Q

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Sure. Makes sense. Barb, my follow-up's directed towards you, I mean, if I take, I guess, an admittedly conservative view of the $30 million to $50 million range that you've talked about over the next 12 months, that's roughly a 1.5% loss rate on your overall energy exposure. How does that compare, perhaps, with the 12 month to 18 month loss rate that you may have had on an energy portfolio back in the 2008-2009 timeframe when energy prices were down about 70%?

Barb Godin
Senior Executive Vice President & Chief Credit Officer A

Yeah, we look back on that timeframe and we had very few losses. If I recall, it was something give or take around $8 million, I think, and we've had none since then.

Matthew H. Burnell
Wells Fargo Securities LLC Q

Right. Okay. Thank you very much.

Operator: Your next question comes from Gerard Cassidy of RBC.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer A

Good morning, Gerard.

Gerard S. Cassidy
RBC Capital Markets LLC Q

Hi, Grayson. Good morning. David, maybe you can share with us, on the LCR I think you said you guys are well positioned to reach the, I guess 90% is where most of the regional banks need to be by January of 2016. Assuming that's correct, if rates don't change in 2016 and you then lift the LCR to 100% next year to reach the January of 2017 target, should we expect some margin pressure as you do that, if you're not already at 100%?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President A

Yeah, I think you would see some downward pressure there. I would not call it significant. We continue to have – that's why we're positioned where we are today. And we have a little bit more in cash. It has already weighed down our margins. Over time, there could be a little bit of further compression, but not significant enough – not a significant amount.

Gerard S. Cassidy
RBC Capital Markets LLC Q

Thank you. And on the follow-up question, you've given us good detail on the oil portfolio and how you guys have looked at it. One of the banks, JPMorgan, when they released numbers gave us some sensitivity analysis suggesting if oil got to $30 a barrel they would take another $500 million to $750 million in reserves. Have you guys stress-tested this portfolio? I know you're using the future prices and discounting it back for the next 12 months to 18 months, but have you gone beyond that, saying if oil got to $35, $30 or $25 a barrel, what would happen to the portfolio?

Barb Godin
Senior Executive Vice President & Chief Credit Officer A

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This is Barb. We have not run those models specifically with a $30 number, but we have done an awful lot of dialogue on what happens if it goes to $30. And it's not just a matter of the price; it's the speed at which it would go down to $30. If it goes down to $30 slowly over time, everyone has an opportunity to adjust their CapEx, adjust their expense models, et cetera. If it goes quickly, of course you're going to feel more pain. But, so far, what we've found with our customers is they have taken all of the right measures at the right pace to make sure that they're adjusting their operating models as quickly as they can.

Gerard S. Cassidy
RBC Capital Markets LLC
Q

Thank you.

Operator: Your next question comes from Jennifer Demba of SunTrust Robinson.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer
A

Good morning, Jennifer.

Jennifer Demba
SunTrust Robinson Humphrey, Inc.
Q

Good morning. I was wondering if you could give your perspective on the Houston market specifically right now and what you're seeing in terms of your overall Texas loan growth.

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President
A

Jennifer, we couldn't hear you very well.

Jennifer Demba
SunTrust Robinson Humphrey, Inc.
Q

I'm sorry. Could you give us some commentary on what you're seeing in the Houston economy right now? And what you're seeing in terms of the company's Texas loan growth over the last three months to six months?

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer
A

Yeah, I think when you look at the markets that we're seeing in Texas, clearly we're still seeing some good strength in most of the markets in Texas. Obviously, there's some softness in Houston. We have – we're spending a lot of time focused on that market because it's one of the markets most exposed to the energy industry and our customers that are there.

But, so far, the Texas markets have held up surprisingly well. As Barb had mentioned a moment ago, the consumer in particular has shown some good strength in terms of benefiting from the lower pump prices, but also there's a lot of diversification in a lot of the economy in Texas. I think everyone's worried about what the contagion that may occur in some of these markets. Quite frankly, we haven't seen it in Houston yet. We look for it, especially in the commercial real estate market, which we're monitoring very closely.

Barb Godin
Senior Executive Vice President & Chief Credit Officer
A

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I'd add a little bit to that. This is Barb. Demand continues across all the Texas markets vigorously, in fact, for newly constructed single-family housing, particularly in Austin, Dallas, Fort Worth, San Antonio. In Houston, it's decelerated somewhat for newly constructed units exceeding $600,000, so pretty high price point. But sales of the lower priced units, those under $600,000 continue at a healthy clip. And the home builder industry has responded pretty quickly. They've reduced construction activity. We look at that – looking at permits, et cetera. So, again, the market has been adjusting to the reduction in the oil prices.

Operator: Your next question comes from Dan Werner of Morningstar.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer
A

Good morning, Dan.

Dan Werner
Morningstar Research
Q

Good morning. Thank you for taking my question. With respect to – just a little more color on the commercial portfolio. Is it primarily from drawdowns from existing lines or is there a more organic growth? And maybe kind of give some color on the energy in terms of the lines themselves. It looks like you still had some increase in midstream. I was wondering if that's from existing lines and kind of how you guys are addressing those.

John M. Turner, Jr.
Senior Executive Vice President, Head-Corporate Banking Group
A

So, this is John Turner. I would say that the commercial growth that we see is fairly broad-based and it is both a reflection of customers borrowing under lines of credit, though, we actually saw about a 30 basis point reduction in utilization of lines of credit during the quarter. And customers borrowing to finance transactions to acquire new businesses, to expand, to add to their working capital or support their working capital needs associated with expansion of their businesses. So we've seen a variety of activities that have resulted in growth in the book, and as we said, that growth has occurred across our businesses, particularly in real estate and in our corporate banking business across our specialized industries verticals. Good growth in power utilities, in our restaurant book, in technology and defense. So we think nicely diversified and reflecting good fundamentals in that sector of the economy.

With respect to the energy book, we have added a couple of midstream names over the course of the last 12 months. We've done that typically through our Regions Business Capital group where we feel like we've got a very good asset support. Those particular customers are operating under longer term contracts. We think there's a lot of stability in that business and industry and we've seen an opportunity to grow a couple of nice relationships as a result of bringing those customers on.

Dan Werner
Morningstar Research
Q

Okay, thank you.

Operator: Your next question comes from Vivek Juneja of JPMorgan.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer
A

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Good morning, Vivek.

Vivek Juneja
JPMorgan Securities LLC Q

Hi. I just wanted to check a couple of things. Firstly, the check posting order change that you'll were going to go through, did that start in the third quarter or is that coming in 4Q?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President A

Yeah, Vivek, this will start in the fourth quarter. You'll see a piece of that.

Vivek Juneja
JPMorgan Securities LLC Q

Okay, because I saw that your service charges were down 8% year-on-year, which is a little faster rate. Any color on that then? What's making that go down a little bit faster, David?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President A

I just think it's more seasonality. There's really nothing that stood out for us. We continue to grow accounts and customers and feel good about service charges and I'll be a little more specific, that posting order will start about mid quarter for us, so we're still in that guidance we've given you on the posting order of $10 to $15 million per quarter.

O. B. Grayson Hall, Jr.
Chairman, President & Chief Executive Officer A

But no real changes in the third quarter. I mean, still growing accounts, growing transactions, growing balances. But seasonally we did see service charges slowdown. But I think it's just normal seasonal adjustments.

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President A

Vivek, were you comparing quarter-to-quarter or year...?

Vivek Juneja
JPMorgan Securities LLC Q

No, I was looking actually year-on-year for the minus 8%, quarter-over-quarter it was down – it was more flattish. Because the year-on-year was down 8% so I was trying to get a sense of is there a customer behavior further change or is anything else that's causing that.

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President A

No, the primary driver there was, if you remember, we exited the Ready Advance product about a year ago so that was in your number last year that's not in your number this year. That was the biggest component of that difference.

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Vivek Juneja
JPMorgan Securities LLC

Q

Okay. A quick question for Barb. Barb, last quarter you'll talked about national credits where you had some issues. Can you give us some update on where that stands? One of your peers this morning took some additional provisions for weakness based on global manufacturing conditions. Could you weave any thoughts on what you're seeing in relation to that into your comments too?

Barb Godin
Senior Executive Vice President & Chief Credit Officer

A

Yeah, the shared national credits, as you know, there's currently going to be two reviews a year. The second review is going to take place starting in November, but it's only for the large players. We will not be involved in that other than as a participant, so we'll get some of those results, likely January or so by the time they put the results out. Relative to the overall shared national credit book though. It's a very strong book, a very good book for us. We're happy with those credits. Again, we don't specifically look at the shared national credits and say because it's a shared national credit I reserve for it any differently. We look account by account, credit by credit; to see what the underlying issues are and what the appropriate level of reserve should be against it.

Vivek Juneja
JPMorgan Securities LLC

Q

And any color on the manufacturing stuff that Fifth Third talked about this morning? They're seeing some weakness so they've taken some provisions. What are you seeing in your manufacturing clients?

Barb Godin
Senior Executive Vice President & Chief Credit Officer

A

Yeah, what we're seeing is aluminum casting, steel companies, we're seeing a little bit of softness there, keeping an eye on that sector. But, again, as they move through our risk rating process, if any of those credits do deteriorate, of course they'll get a larger allowance as they move through our normal process.

Vivek Juneja
JPMorgan Securities LLC

Q

Thank you.

Operator: At this time there are no further questions. I will now turn the floor back over to management for any closing remarks.

M. List Underwood
Director of Investor Relations

Well, let me close and just say thank you for your time, your attention and your questions today. We would encourage you to attend our Investor Day on November 19 and we thank you, again, and we stand adjourned.

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

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