

Regions Financial Corporation NYSE:RF

Company Conference Presentation

Tuesday, June 13, 2023 6:45 PM GMT

Table of Contents

Call Participants	3
Presentation	4
Question and Answer	5

Call Participants

EXECUTIVES

David Jackson Turner
Senior EVP & CFO

M. Deron Smithy
Executive VP & Treasurer

ANALYSTS

Betsy Lynn Graseck
Morgan Stanley, Research Division

Presentation

Betsy Lynn Graseck

Morgan Stanley, Research Division

All right. We're going to kick off. I have a disclosure to read. For important disclosures, please see Morgan Stanley research disclosure website at morganstanley.com/researchdisclosures. The taking of photographs and use of recording devices is also not allowed.

If you have any questions, please reach out to your Morgan Stanley sales representative. Well, this afternoon, I'm delighted to have with us from Regions Financial, David Turner, CFO.

David Jackson Turner

Senior EVP & CFO

Thank you. Good to be here.

Betsy Lynn Graseck

Morgan Stanley, Research Division

And Deron Smithy, Treasurer.

M. Deron Smithy

Executive VP & Treasurer

Pleasure.

Question and Answer

Betsy Lynn Graseck

Morgan Stanley, Research Division

All right. Thanks so much. I did want to just kick off first with a guidance question. Just to get it out there, we've had some guidance conversations recently. And so I wanted to see if there's any updates from you on the quarter?

David Jackson Turner

Senior EVP & CFO

Yes. We put out our deck probably a little over a month ago. We really don't have any changes to that guidance. We have pointed to our operational losses that we had -- that we have had in the second quarter that are fraud-related.

We really want to make sure people read that. We had an 8-K on it. So you're going to see a bump in our expenses for the second quarter, can't extrapolate that. We're going to do some things in the back end of the second half that will serve to mitigate that to some degree. I can't quite -- can't offset it, but we can at least put a dent in it.

So our guidance -- our expense guidance for the year moved up to 6.5% for the year. I just want to make sure people don't miss that piece.

Betsy Lynn Graseck

Morgan Stanley, Research Division

And that -- you made that change, like a month ago or so?

David Jackson Turner

Senior EVP & CFO

That's right. Before we went on a non-deal roadshow and updated that.

Betsy Lynn Graseck

Morgan Stanley, Research Division

Right. And on that fraud expense, is there anything like unique or different about that or that's just normal course, it just happened to be there?

David Jackson Turner

Senior EVP & CFO

No, it's not normal. It was -- but it was basic deposit, check fraud. Right after that, I got a couple of calls from my peers that said thank you. So that's -- frauds move through our industry. Some had it hit last year. Some had it this year. I don't know the magnitude of any institution, but it was big enough for us to call out, change our expense guide, which we don't like to do, but it was the right thing to do.

And the good news is we're back down to normal levels. Unfortunately, fraud is, it just happens in our industry. And so we're back down to kind of the normal level, if you will. So I think this, hopefully, will be one and done, but there are a lot of bad people out there, whether they're cyber criminals or others, that are trying to infiltrate the banking system. We just have to be very good at it and respond appropriately.

Betsy Lynn Graseck

Morgan Stanley, Research Division

Okay. Great. So with guidance outlook out of the way, I just wanted to take it up a notch into strategy and ask the question around what's going on with your expectations and views in expanding your footprint, your product set, your opportunities to engage with clients.

I ask because in the past couple of years, you have completed several bolt-on acquisitions like Ascentium, EnerBank, ClearSight. But things have been relatively quiet in recent quarters. So just wanted to get a sense of do you feel that you're done with those kinds of opportunities? Or is it just more a matter of valuations or leaning into existing business?

David Jackson Turner
Senior EVP & CFO

Yes. So as we think about capital allocation, first off, we want to use that to grow our balance sheet lending, pay a dividend, the third step is for nonbank acquisitions.

And so we have had a number of those over the years that bring customers or bring a technology that we don't have. We're very happy with the ones we've had over the years. We have to get them integrated, get the people integrated into the culture. They're performing like we expect. We have not done one of late, but that doesn't mean we're not looking.

We're just being very cautious about where we're going to use our capital. So we're looking at capital markets as an area. We're looking at wealth management. Something in the payment space on the consumer side would be nice as well as the business side, treasury management related. Those are the kinds of things we look for. And something else will come along at some point in time, and we'll put our capital out for that.

Betsy Lynn Graseck
Morgan Stanley, Research Division

And so in the meantime, which is a normal course business, can we talk a little bit about opportunities you see to deepen market penetration within your existing footprint, types of customers or products that are really going to drive that?

David Jackson Turner
Senior EVP & CFO

Well, so we're in -- largely in the Southeast. We go to the Midwest, but our core is kind of in the Southeast. We're having a lot of migration of people and products coming into the Southeast from higher tax jurisdiction. So Texas and Tennessee and Florida, 3 states that are really benefiting from that growth.

Right now, there's obviously been a lot of change that's gone on since March 8 that we've done a good job of staying in touch with our clients, making sure that we're serving them appropriately. I think we can continue to leverage our footprint and a big portion of our footprint.

We don't have a large money center presence. We are kind of the money center. So having that density in our markets that are core to us, really, really important. And so continuing to invest in those markets and grow. And then a lot of those markets aren't major metros. They're smaller, some rural areas that is really kind of the hallmark of who we are.

And we talk about our customers, we think of deposits, and it's the checking account for a consumer. It's the operating account for a business. And so we look to grow from that from a relationship standpoint. We can get treasury management lending and all that around there. So looking for opportunities to grow in our existing footprint is really what we're about versus going to a geography we're not already in.

Betsy Lynn Graseck
Morgan Stanley, Research Division

So can we talk a little bit, as you indicated, core product is going to be checking account, cash management, treasury account. It's another word for deposits, I think.

And maybe we could talk a little bit about what you're seeing in deposits and deposit flows this quarter and give us a sense as to how your pricing has changed as we've gone through the quarter?

David Jackson Turner
Senior EVP & CFO

Yes. So deposits are really important. It's foundational to who we are. We had called even before the events of March 8 that we would have outflows of deposits in the \$3 billion to \$5 billion range, and that would happen in the first part of the year.

We're down about \$3.3 billion in the first quarter. Most of that before March 8, by the way. This quarter, we're trending to that \$5 billion mark, which would be from the beginning of the year. We could go over that slightly.

Most of that change are the pieces of the surge deposits that we had gotten in the pandemic that we're seeking higher yields than we've been willing to offer. And so it's a natural flow. We've counted on that. I think March 8 changed some folks in terms of how they view, what they're earning on their deposit balances.

You have the reverse repo facility at the Fed for the money funds going and offering up pretty good rates. And so we've seen some deposit flows out of the system, and that's going to probably continue a bit. We have a deposit beta assumption of 35% through this cycle. That's been the case. We are not changing that. I will tell you we had pretty good conservatism in that 35% beta. We're 19% cycle to date through the first quarter. So a lot has to happen to get to 35%.

We were, I think, very conservative there. Today, I would say that's probably the number. And so we're having to compete. We have certain peers that have moved deposit cost up a bit. We have to answer that to some degree. And so we've had a little increase in deposits, too, but not enough to cause us to abandon that 35% beta.

Betsy Lynn Graseck
Morgan Stanley, Research Division

And that's through the cycle? And when do you think you get to that through the cycle?

David Jackson Turner
Senior EVP & CFO

Well, now that's an interesting question because I would tell you, when you're looking at the forwards in March, which is what our guidance was on, it had 2 cuts at the end, so you'd say the cycle was finished this year.

But let's see what happens tomorrow and kind of what the message is. There is a risk that, that cycle extends past this year. So our 35% is more about what we think could happen this year. And so there's a risk that we actually have more beta coming in 2024. But do you want to add to that, Deron?

M. Deron Smithy
Executive VP & Treasurer

Yes. No, I think you teed that up well. I think the point is, we think, again, over the full cycle, which will likely largely play out this year in terms of Fed tightening activity that we would see that stabilize in around that 35% range.

But the longer we're at higher rates, the Fed has to stay at these levels for an extended period of time. You could see deposit costs continue to inch their way up beyond that. But again, I think we've built in a fair amount of that switching that you typically see late cycle out of lower cost deposits into CDs and higher cost deposits and still think that we've still got quite a bit of runway to see that play out this year and get to that 35%.

As David mentioned, there's the potential for it to be higher than 35%, but we're not anticipating that. What I would say there was -- we position the balance sheet so that to the extent the Fed has to remain at elevated levels for longer, and we do see betas higher than 35%, and we're still marginally asset sensitive. And so we've been somewhat conservative in how we position the balance sheet.

Now clearly, we're beginning to turn our attention to the eventual return to more neutral rates or lower rates if the economy has issues in the future. And our hedging program has helped to protect us in the event that happens, but we still think it's appropriate to stay marginally asset sensitive as the cycle plays out here for the rest of the year.

David Jackson Turner
Senior EVP & CFO

And I'd like to add one last thing. Generally speaking, we have tried to lock in a margin of 3.6% to 4%, regardless of which way rates go. And we think that's really important.

We have, I think, a pretty good slide on our hedging program that shows where we've locked that in over the next couple of years. We're working on '27 and '28. And so we have a little bit more work there. But being able to count on 3.60% to 4% is really important to us because 2/3 of our revenue comes from NII. So we're going to have that locked in. If you do the other piece of your business, we should have a pretty good return on tangible common equity at the end.

Betsy Lynn Graseck
Morgan Stanley, Research Division

And that's a goal that you're managing to not just for 2023 but beyond?

David Jackson Turner
Senior EVP & CFO

Yes. I think at the end of the day, the return on tangible common equity is closely correlated to your stock price. It's one of our key measures that our management teams held accountable to for our Board. We've worked hard since about 2015 to go from the bottom of the peer group to the top of the peer group.

We had a 26% return on tangible common equity last quarter. Now granted, the denominator has a benefit of losses. So if you carve that out and recalculate the number, it's 20%. That's still pretty good. And it's because we have high rates and good credit quality, and that's going to generate those high returns. And we are fixated on capital allocation and making sure we stay at the top peer group on that particular metric.

Betsy Lynn Graseck
Morgan Stanley, Research Division

Okay. So in the event that -- and can I ask you to remove your name tag because it's interfering with the mic?

David Jackson Turner
Senior EVP & CFO

Yes.

Betsy Lynn Graseck
Morgan Stanley, Research Division

Sorry. So I suppose the follow-up question here to the hedging that you just mentioned is in the event that you have an interest rate environment that is different from the forward curve, you're still anticipating that you can be protected?

David Jackson Turner
Senior EVP & CFO

Absolutely.

Betsy Lynn Graseck
Morgan Stanley, Research Division

Right. Okay. All right. So then just 2 other things on deposits. One is on the fact that the 35% is what you're anticipating right now today, it is below your peers. And maybe you can give us some color as to why you expect that's something that you're capable of doing?

M. Deron Smithy
Executive VP & Treasurer

Yes. I would start with just understanding our strategy. And this goes back to the period when the 2 companies; Regions and AmSouth were put together right before the great financial crisis.

Both companies had been more active in promoting higher cost deposits. So more CDs in the deposit mix was more common. There was a shift in the strategy to focus more on creating relationships as we've described through on the business side, starting with the operating account and treasury services and build a relationship around that.

Same on the consumer side, focusing on checking accounts less on trying to grow deposits but more on trying to grow customers and the components of their overall relationship with -- through time as you're growing deposits and relationships would grow deposits alongside that.

And so that strategy is really important because, again, that's one of the reasons why we have a higher concentration of noninterest-bearing deposits in our mix. And it's also why our portfolio is more granular and doesn't have the same percentage of high-cost, more rate-sensitive deposits as part of the portfolio base.

And so as we think about managing through the cycle, again, we want to stay competitive for those customers that are more rate sensitive. And we have attractive offers that are competitive across the peer group for those more rate-sensitive dollars within a deposit relationship, but that rate sensitive piece is a much smaller component of the overall portfolio.

David Jackson Turner
Senior EVP & CFO

Yes. And we have 5 million accounts. Average deposits, \$19,000 if you look at our consumer piece, and we're largely consumer deposit funded, it averages \$5,600. So it's a price insensitive and these are operating accounts and checking accounts where paychecks go in and money is spent.

You just do it over and over again. And so that's why our beta, the last 2 cycles has been lower than the peer group, and that's why it will be lower this time as well.

Betsy Lynn Graseck
Morgan Stanley, Research Division

That's great clarity. Thank you. Very granular. Question, last one here on deposits has to do with deposit duration. And -- you mentioned earlier on, David, that we had the events of March, deposit outflows from a couple of different banks. And the question I have for you is, does that make you relook at your deposit durations, anything to talk about there?

M. Deron Smithy
Executive VP & Treasurer

Yes. So duration is really a combination of the longevity of the dollars. So how sticky are they? And what's their rate sensitivity? So our assumption around deposit durations are between 4 and 5 years. And I think we've learned through this cycle that our portfolio, which, again, more granular, more sticky through cycles, probably gives us even greater confidence that our durations are at least as long as we're modeling, I would just point to the degree of primacy.

90-plus percent of our retail customers would say Regions as their primary bank, and 60% of those customers have been with us for longer than 10 years. And so the combination of that through the cycle stickiness and relative rate insensitivity does give us confidence that durations are at least as long as we're modeling.

Betsy Lynn Graseck
Morgan Stanley, Research Division

Okay. So just flipping it then to the securities book and how you're managing that. Anything to talk through there if the deposit durations are stable -- duration in the securities book stable? Or is there any...

M. Deron Smithy
Executive VP & Treasurer

Yes. Our duration in the securities book is just below 5 years and again has been calibrated to our overall balance sheet needs. I wouldn't expect that we would be managing to any different metrics there from a security standpoint. Clearly, to the extent that the AOCI changes become part of capital for us, we may shift a bit of our duration out of the securities book and more into the swaps book to help us manage interest rate risk, but again, no changes in the near term until we have greater clarity around that.

Betsy Lynn Graseck
Morgan Stanley, Research Division

Okay, including composition between different types of asset classes there?

David Jackson Turner
Senior EVP & CFO

Right.

Betsy Lynn Graseck
Morgan Stanley, Research Division

Okay. All right. Let's turn to loan growth. I just want to understand how you're thinking about the various buckets, in particular, C&I, obviously, key loans for you. Give us a sense as to how you're trending Q-to-date relative to H8 and a sense of where you see demand increasing, if anywhere? Or is it just kind of fading demand across the platform?

David Jackson Turner
Senior EVP & CFO

Yes. So again, back on guidance, we've guided to 4% growth for the year. We grew 1% for the first quarter, annualized 4%. So right on it. I would tell you demand is a little bit softer going into the quarter. We're still guiding to 4%.

I think businesses, as we talk to them are, there's uncertainties out there, where is the Fed going, where is the economy going. They want to be careful not to make too many leaps in terms of trying to grow. So I think they're cautious, but they are in good shape. And to the extent they get some clarity on where the economy is going, I think we could see growth pick up but we haven't seen that yet.

On the consumer side, our business -- our consumer book is largely driven by homeowners. So mortgage has not been where we want it to be because of rates. There is a lot of demand for homes, but prices are still high, although coming down and rates are still stuck at pushing on 7%.

So we got to see a little bit of relief there, which -- and our HELOC book is paying off more than growing and then EnerBank of the consumer assets. So that's an acquisition we did, as you mentioned earlier.

And we've been able to grow that a bit. So we're happy with that. I think we net all that down. 4% for the year seems to be the right number. We do hear and even came through the conference that some peers have are going to start [constricting] loan growth because of the funding side, which means we may have more opportunities to grow. And we want to be very careful that we don't grow too fast because we calibrate strategically our funding side with our asset side and 4% is the number we've sent to our businesses, and that's where we want it to be.

Now what we can do is unload one relationship that we're not getting paid as much as we'd like for another one and improve our lot, improve spreads in some case. So we may have an opportunity to improve the profitability, but probably is not going to use that to leverage up growth, if you will.

Betsy Lynn Graseck
Morgan Stanley, Research Division

Okay. And just to make sure, on EnerBank, you're still seeing growth, but it's slowing or it's at pace?

David Jackson Turner
Senior EVP & CFO

It's doing about what we thought it would be. It's a good business for us. We've gone through the period of integration. It's -- performance credit quality is actually better than we had thought, and it will normalize, too, over time. We'll get to a credit quality question, I'm sure, in a minute.

Betsy Lynn Graseck
Morgan Stanley, Research Division

And then what about commercial real estate, I mean...

David Jackson Turner
Senior EVP & CFO

Yes. Commercial real estate, so if you throw in our REIT business, it's about 15%. If you look at investor real estate, where the higher risk are, that's about 8% -- a little over 8%. Most of that for us is multifamily.

Multifamily probably won't grow even though there's a huge demand there. Today, it's a little harder to get the math done because rates are high and rents have kind of stabilized. And so to get that -- those new deals done is requiring more investment from the developer, more equity in the deal.

They're not so inclined to do that because it messes up their return on investment. And so we're kind of at loggerheads. So those deals aren't getting done, and that's where you start hearing about banks aren't lending or banks are tightening. Well, it's just a math problem, right?

It's the way the rate environment works and it will settle at some point and go back the other way, you shouldn't expect a lot of growth. We do have an office, about \$1.8 billion in the office. We're watching that very closely. 83% of it is Class A with the rest Class B and no Class C properties, most of it's suburban versus urban, most in the Sunbelt.

And we've shocked that with updated appraisals, and we still have pretty good coverage from a loan to value. So we think we're okay there, but you shouldn't expect us to be growing office loans regardless of what the return profile may be. So real estate is not going to be a growth for the rest of this year.

Betsy Lynn Graseck
Morgan Stanley, Research Division

And how do you think about reserving against that kind of book? I only ask because if the risk is at the role of the loan, right, when the term comes due, how do you think about managing against that, right?

David Jackson Turner
Senior EVP & CFO

Yes. So each deal has its own issues to deal with. We have a 2.2% reserve. I know some of our peers have 4x that. And I caution you, you just can't compare office staff. You got to know where is it? We're not in gateway cities.

We are -- have our own risk, but it's not some things in San Francisco or Manhattan or things of that nature. So I think that we look at collateral values, like I said, and shock that. We feel well protected. Things start to change. We will see this from a CECL standpoint to adjust accordingly.

But we think our 2.2% reserve for office is appropriate. And if you look at our overall allowance of 1.63%, it's one of the highest in the industry and it's a little unfair because we all have different portfolios. So just comparing the reserve coverage doesn't mean a whole lot, but it is a data point.

Betsy Lynn Graseck
Morgan Stanley, Research Division

And what is the assumptions in that reserve analysis? What kind of environment are you estimating or assuming when you put that reserve out there?

David Jackson Turner
Senior EVP & CFO

Yes. So we shock it for rate increases. We've shocked things as high as 250 to 300 points to see what it would look like. And we have to make adjustments or assumptions about the collateral values.

We have to make assumptions about will we get equity put in the deal. Sometimes, we will. Sometimes, we might not. And so it's just a host of things we'll take into consideration, along with the overall economic outlook, which is in the back of our book, by the way, in terms of unemployment being a driver.

Betsy Lynn Graseck
Morgan Stanley, Research Division

And just anything else on credit to speak to? Credit has been doing pretty well, maybe a little better than expected. But you do have, as you mentioned, the reserve that suggests that maybe it's normalizing?

David Jackson Turner
Senior EVP & CFO

Yes. I would say -- so our charge-off expectations are 35 basis points for the year. That's where they were in the first quarter. And we did have 1 credit in the first quarter. We didn't call it out at earnings because we hate to do it, but we'd mentioned it in a subsequent conference that we had 1 credit. It costs us 7 basis points.

And whoever we were talking to said, you should have said that. So I'm telling you that's what it was. We still think 35 is the right number, but that's below normal. Normal for us is pushing on 45 basis points of loss. And the reason we won't get there quite this year is because consumers and businesses are healthy. And the economy is pretty healthy.

And so I do think you should expect to see migration as the year goes, more criticized and classifieds, more nonperforming loans, charge-offs increasing. But not past that 35 for this year. And then we'll reset and we'll see where we are. If you look at the economic output or economic changes since March 31, when we ran CECL, it's slowly -- slightly deteriorated, which would imply some provisioning over charge-offs.

We'll have to wait until we get to June to figure out exactly what that is, but not a ton of loan growth, as you've seen in H8. So -- but I think CECL provisioning will pick up just on the -- you'll have a little bit over charge-offs this next quarter.

Betsy Lynn Graseck
Morgan Stanley, Research Division

Okay. A little bit more reserve build this quarter just because of loan growth?

David Jackson Turner
Senior EVP & CFO

A little bit of loan growth, but mainly because the economic environment is deteriorating, just slowing down and deteriorating just a bit. And credit quality is going to normalize.

So if you have criticized and classifieds and nonperformers going up some, and if it's more than you previously anticipated, that's key, it has to be more than you previously anticipated, that would also drive an increase in provision.

Betsy Lynn Graseck
Morgan Stanley, Research Division

I think it's just interesting because we've had this 500 basis point increase in interest rates and yet credit is doing so well, even in the categories that have that real-time impact of rates like credit card or C&I. Obviously, your C&I book is...

David Jackson Turner
Senior EVP & CFO

Well, a lot of -- so on the consumer side, a lot of it is fixed rate. So they hadn't had a payment shock. A lot of the business is hedged so they hadn't had a payment shock.

But yes, it speaks to the overall economy, though still doing pretty well. And -- but we do know over time as things slow down and rates stay higher that you're going to have more credit losses. But I don't see a runaway train here in the industry. I certainly don't see it at Regions.

Betsy Lynn Graseck
Morgan Stanley, Research Division

Okay. So I just did want to address fees and expenses in our final 5, 6 minutes here. Just turning to fees. For the past couple of years, we've had to discuss overdraft fees, and I know you've done a lot on revamping that product.

I just wanted to put a pin on it. Is everything finished and you're at run rate now? Or is there any other changes we should expect from here?

David Jackson Turner
Senior EVP & CFO

Yes. No, we're not at run rate yet. We're putting in our 24-hour grace that will go in this month. You'll start seeing the impact of that in the third and fourth quarter. That's why you can't take our service charge number and extrapolate that and get to the [5 50], which is in our guidance.

It's a guess. It's -- we've done the best job of trying to assume behavior. We'll see. If we need to modify that guidance, we will. But we feel pretty comfortable that [5 50] for service charge is the right number.

We've had pretty insight of that as treasury management. It's had nice growth. We've had some new products. We've got a new leader there a year or so ago, has done a fabulous job, putting onboard a client, take care of clients. So it's helping us on the service charge front.

But once we get past on the consumer side, this 24-hour race, that's kind of it. And so we'll have a pretty solid run rate. Hopefully, we get through the third quarter. After these changes, we'll have a pretty good idea of what it's going to be.

Betsy Lynn Graseck
Morgan Stanley, Research Division

Okay. And then next question is just on resi mortgage and wanted to understand how you're thinking about that fee line item as you have been taking some share there, but we realize that some of the book of business opportunities are not as big as they used to be given the refi markets down?

David Jackson Turner
Senior EVP & CFO

Yes, that's -- mortgage has been tough. It's still really important to us. We're all about the homeowner. That's what drives our consumer side of the business and on the lending side.

And those volumes aren't quite where we want them to be. I would say it's getting incrementally better, still going to be below where we wanted it to be. We purchased some mortgage servicing rights that I think will help the line item -- the mortgage line item for NIR.

And we've had to rightsize the shift there. And so if we don't have the volume, then we can't have the expense associated with it. So we -- our team has really done a good job of getting on top of that and making sure we tighten up the cost side of that. Hopefully, we'll break through rates will turn the other way, and we'll get a little better volume going through at the end of the year, perhaps 2024.

Betsy Lynn Graseck
Morgan Stanley, Research Division

And when you say it's a little bit better, is that a Q-on-Q statement?

David Jackson Turner
Senior EVP & CFO

I would say just from a volume standpoint, yes, it's kind of -- and it's on the hedges. So -- don't run away.

Betsy Lynn Graseck
Morgan Stanley, Research Division

Right. Modest, and embedded in your guidance. Okay. So back off, Betsy. Yes, okay. That's all right. All right. The other very important fee line item here, treasury management, did want to understand how we should be thinking about that one.

Now interest rates obviously do help it. Are we done with regard to the rate of change in growth we have in that line? Or is there opportunity?

David Jackson Turner
Senior EVP & CFO

Yes, I think the opportunities there are more driven by customer acquisition and client penetration. And like I said, we had a new leader there that's done a good job.

We've invested in that business from a technology standpoint. I think there's ability to grow because we have clients that we don't quite have all the relationship we want. And so yes, I'm looking at that to be a good contributor. Will it grow at the pace we have had thus far? I won't call for that quite yet. But it will be a good contributor to our service charge line.

Betsy Lynn Graseck
Morgan Stanley, Research Division

And is there -- I mean, how do you win people away from other shops because usually somebody has an account somewhere else? Is this a pricing ECR situation?

David Jackson Turner
Senior EVP & CFO

Yes. A bit of it's pricing, a bit of it's relationship, a bit of it's onboarding, being customer-centered and how you take care of clients. We have a good tool that analyzes cash flows of our clients, Today, we've built that about 1.5 years ago to help us understand the next best product that our customer may appreciate.

And I think that clients love you to help analyze their cash flows and help them to think about that. They much rather talk about that than the loan. So we're leveraging that products called [Our Click For Us]. And we think that's helped win some relationships over because we have the insights that maybe others don't.

Betsy Lynn Graseck
Morgan Stanley, Research Division

I know I've spoken with some of your folks and it's been very impressive what they're doing in treasury management. On the expense side, you expect to achieve positive operating leverage this year, right?

Can you just highlight some of the biggest drivers in delivering on that, especially as you've indicated there's a little bit of a slowdown happening in some parts of the business?

David Jackson Turner

Senior EVP & CFO

Yes. I think really driven by the expense side and controlling that. So we had, obviously, the fraud piece that I just talked about, a big headwind for us. I think we can overcome that by some savings that we'll get in the second half of the year, usually driven by attrition, people and not backfilling.

There are a lot of things we do because they're [nice to have], [not have to have]. And so we've asked people to cut back to the [have to have], and we'll worry about the [would like to have] later. So controlling our personnel cost, it's really important to us.

We're all over our vendors and making sure that, one, if we were asking consultants or third parties to provide a service that we absolutely have to have it. Our square footage, so we're working remotely. A lot of us are in at least 3 days a week. We want more people to come back in to help with the culture standpoint, but it's unlikely we'll go back to where we work, which means we don't need as much square footage.

So you should see us take that cost out over time. We are all having to make investments in things like our R2 transformation, which is putting in a new deposit into loan systems over the next several years. We're just in the planning stage right now. It's important for us, but we have to pay for that. We have to figure out where we can save elsewhere to do so.

So that 6.5% expense increase for the year estimate is much larger than we would have hoped for. With the FDIC, all of us are having to pay for increased FDIC. That's a percent. We had a pension benefit last year we're not getting this year. That's a percent.

So -- and then you have normally about 2.5% inflation in expenses, this year a little higher because of labor. And so that's been closer to 3% and change. If you add all that up, you get to the 6.5% number. And there is not a line item. There's not an expense bucket that we're not harping on.

Betsy Lynn Graseck

Morgan Stanley, Research Division

Okay. So lastly, on capital liquidity and just planning for things like TLAC and LCR you are running your CET1 near the upper end of your target range, right, 9.8% versus 10%. So you're very conservative there.

Just wondering how we should think about your approach to the dividend because you've also got a 35% to 45% dividend target payout ratio, and you're running a little bit at the lower end of that range. So should we expect to see a flex towards more dividend in the future?

M. Deron Smithy

Executive VP & Treasurer

Well, I think the short answer is, yes, we want to be in that 35% to 45% range as you pointed out. We've been struggling to get to just the lower end of that range because we've had good earnings growth. And we've had solid increases in the dividend, but we still haven't -- it hasn't caught up with the growth in earnings. And so you should expect us to try to at least get to the lower bound on that 35% to 45% of your expectation for earnings growth.

David Jackson Turner

Senior EVP & CFO

The capital, so we have an operating range of 9.25% to 9.75% on CET1. We had been targeting the middle of that. We said we're going to let it ride up a little bit because of some uncertainties.

We're at 9.8% as you just mentioned. We said because of all the things coming at us that we probably need to wait and see what the results are going to be from all the changes before we start buying our stock back. We've been accreting about 30 basis points a quarter on CET1.

So that would put us over 10% after this next quarter. And I think we'll hear on B3 -- Basel III Endgame by the end of the month, that will be an indicator of where we're going to be. We don't anticipate a ton of change there, but we don't know. And so we'll adapt and overcome whatever is thrown at us.

And what we want to do is optimize our capital for the risk profile that we have, where you share buybacks as a mechanism to help manage that after we use our capital to grow loans and pay an appropriate dividend there and just mentioned, we see a nonbank acquisition coming through, we'll be after that, too.

Betsy Lynn Graseck

Morgan Stanley, Research Division

Okay. Great. Well, a lot to look forward to. Thanks so much for your time today, David and Deron.

David Jackson Turner

Senior EVP & CFO

Thank you.

M. Deron Smithy

Executive VP & Treasurer

Thank you.

Copyright © 2023 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.

These materials have been prepared solely for information purposes based upon information generally available to the public and from sources believed to be reliable. No content (including index data, ratings, credit-related analyses and data, research, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P Global Market Intelligence or its affiliates (collectively, S&P Global). The Content shall not be used for any unlawful or unauthorized purposes. S&P Global and any third-party providers, (collectively S&P Global Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Global Parties are not responsible for any errors or omissions, regardless of the cause, for the results obtained from the use of the Content. THE CONTENT IS PROVIDED ON "AS IS" BASIS. S&P GLOBAL PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Global Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages. S&P Global Market Intelligence's opinions, quotes and credit-related and other analyses are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P Global Market Intelligence may provide index data. Direct investment in an index is not possible. Exposure to an asset class represented by an index is available through investable instruments based on that index. S&P Global Market Intelligence assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P Global Market Intelligence does not act as a fiduciary or an investment advisor except where registered as such. S&P Global keeps certain activities of its divisions separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain divisions of S&P Global may have information that is not available to other S&P Global divisions. S&P Global has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P Global may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P Global reserves the right to disseminate its opinions and analyses. S&P Global's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P Global publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

© 2023 S&P Global Market Intelligence.