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Regions Financial Corp. (RF)

Q2 2022 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 Christine, and I will be your operator for today's call. I would like to remind everyone that all participant phone lines have been placed on listen-only. At the end of the call, there will be a question-and-answer session. [Operator Instructions]

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

Dana W. Nolan

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

Thank you, Christine. Welcome to Regions' second quarter 2022 earnings call. John and David will provide high level commentary regarding the quarter. Earnings documents, which include our forward- looking statement disclaimer and non-GAAP information are available in the Investor Relations section of our website. These disclosures cover our presentation materials, prepared comments and Q&A.

With that, I'll turn the call over to John.

John M. Turner, Jr.

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

Thank you, Dana, and good morning, everyone. We appreciate you joining our call today. Once again, we're very pleased with our quarterly results. Earlier this morning, we reported earnings of $558 million, resulting in earnings per share of $0.59.

And importantly, our second quarter adjusted pre-tax pre-provision income represents the company's highest level on record. We continue to successfully execute our strategic plan and delivered strong results. Sentiment among our business customers today is cautiously optimistic. They're rebuilding inventories and looking for opportunities to expand their businesses. Loan commitments and pipelines remain strong and utilization rates continue to increase.

The consumer remains healthy. Net population migration inflows into our markets remain robust, and majority of our footprint has returned to equal or better than pre-pandemic employment levels. In fact, unemployment rates in six of our top eight deposit markets are essentially at all-time lows. Today, broad segments of consumers still maintain substantial cushion in their deposit accounts. For example, consumers with less than $1,000 on average in their checking accounts prior to the pandemic are averaging a balance today that remains approximately six times higher than pre-pandemic levels.

Overall asset quality remained strong during the quarter, with most metrics remaining substantially better than historical levels. However, we'll continue to closely monitor early warning indicators for any signs of deterioration. Our capital ratios remain strong. And in fact, earlier this week, our board approved an 18% increase to our common stock dividend to $0.20 per share. We have a strong balance sheet, deliberately positioned to withstand an array of economic conditions.

Investments we're making across our businesses are continuing to pay off. In the Corporate Bank, we continue to invest in talent, technology and strategic acquisitions to expand our products, capabilities and expertise.

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Excluding acquisitions, we have added over 200 new positions in the Corporate Bank since 2019, with approximately 85% in revenue-generating or supporting roles.

Our most recent acquisitions, Sabal Capital Partners and Clearsight Advisors, are contributing to overall capital markets revenue growth in 2022. We're also strengthening our credit product capabilities for small businesses. Ascentium Capital is exceeding our expectations as provider of essential equipment financing. We recently restructured our SBA organization and continued to invest in key talent to build out our non-restaurant franchise lending division, positioning Regions as a trusted resource for franchisees within our footprint.

We've been investing in our Treasury Management and payments business for several years and are experiencing strong revenue growth. Today, we offer a comprehensive and competitive suite of solutions positioned to meet the complex needs of any client. We continue to invest in these businesses, rolling out new products and enhancements across our Treasury platform, including real-time payments and fraud mitigation as well as APIs and new cash flow analysis tools.

Within the Consumer Bank, we continue to make advancements to become the premier lender to homeowners. In recent years, we've expanded our mortgage loan origination team, upgraded our mortgage contact relationship management platform, and continued to simplify the overall sales process.

We also continued to invest in our mortgage servicing portfolio. Year-to-date, we've completed bulk purchases for the rights to service approximately $13 billion in mortgage loans. EnerBank, a leader in the prime and super prime home improvement point-of-sale space helps us meet customer needs while generating quality asset growth.

Within Wealth Management, we continue to invest in talent and technology to optimize the client and associate experience. Since 2019, we've added 44 new revenue-generating positions in our Wealth Group, primarily in Private Wealth Management and Investment Services.

Last month, we launched our digital investing product, which combines the ease of a self-directed digital tool with the option of support from a financial advisor. These investments contributed to a strong performance in the first half of 2022.

So, wrapping up, we have a solid strategic plan, an outstanding team, and a proven track record of successful execution. While sentiment across both business and consumers remains generally positive, we will continue to monitor our portfolios for indicators of stress. We have a robust credit risk management framework and a disciplined, dynamic approach to managing concentration risk, which has positioned us well to weather any economic environment and continue to deliver consistent, sustainable, long-term performance.

Now, David will provide some highlights regarding the quarter.

David Jackson Turner, Jr.

Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

Thank you, John. Let's start with the balance sheet. Average loans grew 3% while ending loans grew 5% during the quarter. Average business loans increased 5%, reflecting broad-based growth across all businesses and industries. A majority of the growth this quarter was driven by existing clients accessing and expanding their credit lines to rebuild inventories and to expand their businesses. While still below pre-pandemic levels, commercial line utilization ended the quarter at approximately 44.4%, increasing 50 basis points over the prior quarter.

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Loan production also remained strong with linked-quarter commitments up approximately $5.5 billion. Importantly, digging into this commercial loan growth, we're maintaining a very high asset quality portfolio. In fact, balances considered investment-grade equivalent are up 30% compared to a year ago. And approximately 44% of our total commitments are also considered investment-grade equivalent, representing its highest level on record.

Similarly, our overall probability of default in this portfolio has improved approximately 35 basis points since mid of 2019. Average consumer loans remained relatively stable, while ending loans increased 3%. Growth in average mortgage and other consumer was offset by declines in other categories. Within other consumer, EnerBank loans grew approximately 7% compared to the first quarter.

As a reminder, EnerBank has a track record of well-controlled loss rates throughout multiple cycles and primarily originates prime and super prime loans to homeowners who tend to be lower-risk borrowers. Looking forward, we currently expect to hold total loans relatively stable over the remainder of the year, which would result in full year 2022 average loan growth of approximately 8% compared to 2021. This assumes a slowing rate of growth compared to the second quarter, but also assumes increased capital markets activity in the back half of the year.

So, let's turn to deposits. Deposit balances acquired throughout the pandemic remain mostly stable early in the Fed's tightening cycle. Importantly, seasonal patterns related primarily to income tax payments returned to those experienced prior to the pandemic. While average deposit balances grew, ending balances declined.

Ending Consumer deposits were mostly stable, while Corporate and Wealth Management balances decreased approximately $1 billion each. In addition to seasonal patterns, and in line with our expectations, the declines also include certain commercial and wealth clients beginning to reduce some of their excess balances.

We continue to expect a range of $5 billion to $10 billion of overall balance reduction for the full year of 2022, resulting from tightening monetary policy. The combination of our legacy deposit base, along with the more stable components of surge deposits, represents a significant opportunity for us as rates continue to increase.

Let's shift to net interest income and margin. Net interest income grew $93 million or 9% linked quarter, evidencing strong balance sheet growth and asset sensitivity in a rising interest rate environment. Cash averaged $22 billion during the quarter, and when combined with PPP, reduced second quarter's reported margin by 38 basis points. Our adjusted margin was 3.44%.

The reduction in cash this quarter resulted mostly from strong asset growth, both loans and securities, as well as seasonal deposit outflows. Average loan balances grew $2.9 billion, or 3% in the second quarter. Additionally, $1.2 billion of securities were added. The recent increase in rates have certainly validated our decision to wait on a better rate environment to deploy cash into securities. While not included in our current outlook, additional security purchases would provide incremental benefit.

The primary driver of net interest income growth this quarter was higher interest rates and our decision to remain exposed to rates in the near term. Importantly, deposit balance and yield outperformance, including a 5% cycle to date deposit beta allowed net interest income to grow by more than our previous guidance. Total net interest income is projected to increase 8% to 10% in the third quarter as expectations for rate hikes have been pulled forward, so has our outlook for NII. Fourth quarter net interest income is now expected to be approximately 23% to 25% higher than our first quarter.

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Regions' balance sheet remains well-positioned to benefit from continuing increases in interest rates. Incremental 25-basis-point increases in the Fed funds rate are projected to add between $40 million and $60 million over a full 12-month period, as deposit betas are projected to increase into the 25% to 35% range.

This NII benefit is supported by a large portion of stable deposit funding and a significant amount of earning assets held in cash, which compares favorably to the industry overall. Over a longer horizon, a more normal interest rate environment, or roughly a 2.5% to 3% Fed funds rate will support a net interest margin range of approximately 3.75% to 3.8%. This target incorporates the execution of recent hedging activity at higher rate levels than originally contemplated.

While we have purposefully retained leverage to the higher interest rates during a period of low rates, we have begun to manage a more normal interest rate risk profile as the interest rate environment normalizes. This includes the addition of $8.3 billion of forward starting receive fix swaps and a $1.2 billion of spot starting securities during the quarter.

Through the first half of 2022, we have added $15 billion of swaps and securities. The swaps become effective in the latter half of 2023 and 2024 and have a term of generally three years. This represents approximately 75% of the total hedging amount expected this cycle. With the sizable amount of hedging complete, we will balance market rate levels and potential risk as we decide the appropriate time to finish the program.

Now, let's take a look at fee revenue and expense. Adjusted non-interest income increased 10% from the prior quarter, primarily due to improvement in capital markets and card and ATM fees. Within capital markets, growth was driven by higher fees and M&A advisory and real estate loan syndications as well as a $20 million benefit from CVA and DVA. We continue to expect capital markets to generate quarterly revenue of $90 million to $110 million, excluding the impact of CVA and DVA.

While we expect to be on the lower end of the range next quarter, we do anticipate activity will pick up in the coming quarters. Card and ATM fees reflect seasonally higher interchange on both debit and credit cards. Spend was up 3% year-over-year as inflation has impacted several categories, including a 30% increase in fuel, while discretionary categories such as retail goods, department stores, and apparel are actually down.

Mortgage and wealth management income remained relatively stable during the quarter despite unfavorable conditions. Seasonally higher mortgage production overcame first quarter gains associated with the sale of previously repurchased Ginnie Mae loans. While we anticipate a decline in mortgage income relative to 2021, mortgage as well as wealth management will remain key contributors to our overall fee revenue.

Service charges declined during the quarter as seasonal increases were offset by NSF and overdraft policy changes. The second phase of previously announced NSF and overdraft policy changes were effective at the end of the second quarter, and the remaining changes will be implemented in the third quarter. These changes, when combined with previously implemented changes, are expected to result in full year 2022 service charges of approximately $600 million.

We also expect to implement a grace period feature sometime in 2023, and now, expect full year 2023 service charges of approximately $550 million. We expect 2022 adjusted total revenue to be up 7.5% to 8.5% compared to the prior year, driven primarily by growth in net interest income. This growth includes the impact of lower PPP-related revenue and the anticipated impact of NSF and overdraft changes.

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Let's move on to non-interest expense. Adjusted non-interest expenses increased 2% compared to the prior quarter. Salaries and benefits increased 5%, primarily due to annual merit increases, which became effective on April 1. Higher variable-based and incentive compensation associated with increased financial performance and better credit experience, as well as one additional workday in the quarter. These increases were partially offset by a decrease in payroll taxes and lower HR asset valuations.

We will continue to prudently manage expenses, while investing in technology, products and people to grow our business. As a result, our core expense base will grow. We expect 2022 adjusted non-interest expenses to be up 4.5% to 5.5% compared to 2021. Importantly, this includes the full year impact of recent acquisitions as well as anticipated inflationary impacts. With the changes in revenue and expense guidance, we expect to generate positive adjusted operating leverage of approximately 3% in 2022.

Overall, credit performance remained strong. Annualized net charge-offs decreased 4 basis points to 17 basis points. Non-performing loans increased modestly during the quarter, but remained below pre-pandemic levels at 39 basis points of total loans. While business services criticized loans and total delinquencies continue to improve. Provision expense was $60 million this quarter and included a modest build to our allowance for credit losses attributable primarily to strong loan growth, and to a limited degree, general macroeconomic uncertainty, as well as some early signs of normalization within select commercial sectors.

Our allowance for credit loss ratio is 1.62% of total loans, while the allowance as a percentage of non-performing loans remains very strong at 410%. Our annualized year-to-date net charge-off ratio is 19 basis points. Given increasing expectations for a slowing economy, combined with inevitable normalization, we are maintaining our full year net charge-off expectations in the 20 to 30-basis-point range, but currently expect to be towards the lower end.

Based on the recent stress test results, our preliminary stress capital buffer requirement for the fourth quarter of 2022 through the third quarter of 2023 is expected to remain at 2.5% once our supervisory results are confirmed in August of 2022.

We ended the quarter with our Common Equity Tier 1 ratio at an estimated 9.2%, reflecting continued strong loan growth, particularly during the last week of the quarter. And while loan growth remains our top priority for capital deployment, we expect to manage to the midpoint of our 9.25% to 9.75% operating range over time. Also, as John mentioned, our board of directors declared a quarterly common stock dividend of $0.20 per share, an 18% increase over the prior quarter, which reflects strong earnings growth.

So, wrapping up on the next slide, our updated 2022 expectations, which we've already addressed, in closing, we have delivered strong year-to-date performance despite volatile economic conditions. We will continue to be a source of stability to our customers, but also remain vigilant with respect to any indicators of potential market contraction. Pre-tax pre-provision income remains strong, expenses are well controlled, credit risk is relatively benign and capital and liquidity are solid.

With that, we're happy to take your questions.

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QUESTION AND ANSWER SECTION

Operator: Thank you. We will now be conducting a question-and-answer session. [Operator Instructions] Thank you. Our first question comes from the line of Peter Winter with Wedbush. Please proceed with your question.

Peter J. Winter
Analyst, Wedbush Securities, Inc.

Q

Thanks. Good morning. I wanted to start off on the net interest income. Just based on the guidance, it looks like it's going to end the year about $1.26 billion. So, the question is, if the Fed were to stop raising rates at year end, it seems like you have a lot of strong momentum for growth into next year. Could you just talk about some of the big picture trends that you see for next year?

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah, sure, Peter, this is David. So, we do have an expectation that Fed continues to raise rates, probably finishing the year in a 3.25% to 3.50% range. And they could go past that. They could stay there for a while. We do believe there's risk that the economy slows to a point where they have to become more accommodative in the latter part of 2023 and 2024, hence why you started to see us place some forward starting swaps in those positions to protect us to the extent that that happens.

Clearly, rates could not come down and they may stay flat or go even higher. But at that point, we're generating the kind of NIM that we talked about that's on our slide, I don't have the page number, but a very strong net interest margin, and more importantly, a very good return on tangible common equity profile. So, the benefit is through our deposit base. We think we're going to continue to have a lower beta through the cycle than our peers. It may be higher than last time for everybody, but nonetheless, we think that's our competitive advantage, even if the Fed stops at year end without any further increases.

Peter J. Winter
Analyst, Wedbush Securities, Inc.

Q

Got it. And then just as a follow-up, just could you give a little bit more color on the loan growth guidance in the second half of the year with it slowing? It just surprised given the momentum on the period-end basis.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Sure. So, one, we have to acknowledge we had pretty strong loan growth. I think the industry had pretty good loan growth in the first quarter. Obviously, things are slowing down a bit. We think we're going to have a lot of opportunity to grow. But this is when you need to be very cautious, very careful, and make sure your client selectivity is robust and ensure that you get paid for the risks that you're taking. And so, we may be a little conservative in terms of our loan balances from here on out.

What we wanted to make sure is we don't want to send the message that we're going to grow at the pace we just did the first quarter. We don't think that would be appropriate for us. We still see good demand in a lot of sectors; financial services, utilities, wholesale durables, just to name – and elements of transportation are strong. And we think even in investor real estate, there are some places that we've been able to grow in the multifamily sector in

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particular, as well as in the – in industrial area. So, I think it's a bit of cautious tone is all we're sending and we will grow as the market gives us permission with the right metrics.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Peter, this is John. The other thing I would add is that all the volatility has obviously created disruption in the capital markets. And so, we've seen, particularly our larger customers rely on the pro rata bank market for funding. At some point, we expect a little more clarity about the path of the economy.

And so, we believe that what is pent-up demand amongst issuers will – they'll begin to access the capital markets again, which will result in some pay-downs in some of the larger credit exposure that we have enjoyed over the last two or three quarters. So, that is part of our projection as well. And as David said, it may be a conservative point of view, but we believe it will happen at some point in the next few quarters.

Peter J. Winter
Analyst, Wedbush Securities, Inc.
Q

Got it. Thanks for taking the question.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Thank you.

Operator: Our next question comes from the line of Ebrahim Poonawala with Bank of America. Please proceed with your question.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Good morning.

Ebrahim H. Poonawala
Analyst, BofA Securities, Inc.
Q

Good morning. I guess, David, just following up on your comment around the margin. I think you mentioned, if I heard you correctly, a 3.75% to 3.80% normalized margin for Regions. One, I mean, if you could tell us like what the Fed funds needs to get to in order for you to get to that level for the net interest margin. And once we get there, based on the hedging strategy that you have, what you've laid out, do you think that becomes something that's relatively stable absent a big change in the rate backdrop and obviously the protection that you have on the downside?

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Sure. So, if you look at our slide deck on page 8, we try to lay that out. That gives you at least some parameters on where we think the margin could be in different scenarios. So, if the Fed's going to get close to 3% at the end of the day and stay there for a while, we think we can have a margin profile that's in that 3.80% range.

And if the Fed doesn't move any further or doesn't reverse course and come back the other way, that's probably where we'll be. If the Fed starts to come the other way, our margin will decline some, but we think we can protect.

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Today, we can protect about 3.60% as rates continue to move up and we finish our hedging program, we're about three quarters of the way through, and we have another 25% to do. If we're patient enough, and we kind of understand where the economy is going, perhaps we can lock in a downside protection a bit higher than the 3.60%, and that's really what our goal is. And we think 3.60% is a great level today, but can we get another few basis points on top of that if we're patient? We think so.

Ebrahim H. Poonawala
Analyst, BofA Securities, Inc.

Q

That's helpful. And I think, just tied to that, you mentioned, deposit betas for this – the core customer base could be higher relative to the last cycle. I'm wondering if anything that you've seen so far in the last two to four weeks that would imply that customers' conversations around higher rates have picked up and you could actually see a higher beta this cycle versus last.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Well, so the answer to that is no. We've been a bit surprised, frankly, on both betas, as well as balances but – for the industry, so our beta, cumulative beta thus far is 5%. We're one of the lowest peer group I think as the median is about double that. So, I – we keep calling for deposit balances to decline some $5 billion to $10 billion. The largest contributor of that would be corporate deposits that are going, we believe, in time, seek a higher return. We are starting to see that pick up a bit.

Again, we're surprised that it hadn't moved quicker, but if Fed moved 75 basis points in their next move in September, yeah, in September – I'm sorry, at the end of – end of July, this month, and an expectation of another 50 in September, then we think those balances will start to move off balance sheet. And frankly we're going to help facilitate that for our customers because we can earn a little bit of a fee on that and give them a better return today. That's happened some already.

So, if you look at corporate customers, they actually have either deposit balances with us or off balance sheet that we've helped facilitate and if you add those two together, actually a little higher than they were at year-end. So, we've been pleased with our deposit base and our betas thus far.

Ebrahim H. Poonawala
Analyst, BofA Securities, Inc.

Q

That's good color. Thank you so much.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Thank you.

Operator: Our next question comes from the line of Bill Carcache with Wolfe Research. Please proceed with your question.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning, Bill.

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Bill Carcache
Analyst, Wolfe Research LLC

Q

Thank you. Good morning. Good morning. You've all proven yourselves to be astute managers of risk. I'd love to hear how you're thinking about the risk that the strength we continue to see in labor markets and you mentioned the balances in consumer accounts and strong liquidity and spending in general, and to the extent to which all of that is in and of itself inflationary and could lead the Fed to have to do more.

So, everything seems great now but we all know the hiking cycle works on a significant lag and we could see unemployment continue to rise well after the last Fed hike and we've started to see initial claims creep up a little bit. So, maybe if you could just [ph] rank for us (00:31:01) how that dynamic, even though you're not seeing it at the micro level yet, perhaps how that, if at all, impacts the actions that you're taking today across the business?

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. Bill, it's a great question. And it's one we challenge ourselves with constantly as a team. In our discussions with others in the industry, including our regulatory supervisors and the Fed in particular, about where they really want to go, I think we all believe there's an expectation of getting to "neutral" as fast as they can is what they would like to do. But I think every time there's a move, there's a need to pause and see what impact that's going to have on the economy. We do have inflation that can get addressed by slowing the economy down, which is taking effect now. But as much as they want to get "to neutral" that I don't think the Fed wants to wreck the economy either.

So, what we're trying to do is read all the tea leaves, look at all the data that we can, study our customers, whether it be consumers or corporate customers, to try and get an understanding of what they're thinking, how their business is, how they're managing their personal money, to gather an understanding of the slowdown in the economy and what the Fed may or may not do. We believe that the Fed's going to get to 3.25% to 3.50% by the end of the year. Don't know if they'll move exactly like the market thinks, but we think that's going to be a place where they likely stop and let things play out over time. But we have to be prepared for them to keep going.

And if that's the case, because inflation is not under control, there could be some ramifications to that long term, which is why we're cautious on extending credit while we want to manage our bank as efficiently as we can. Because you have to have scenarios for anything that could possibly happen as we seek to continue to have appropriate returns on capital to our shareholders.

Bill Carcache
Analyst, Wolfe Research LLC

Q

That's great color and very helpful response. Thank you. If I may follow up on EnerBank, can you remind us how growth math dynamics impact EnerBank? What's the interplay between the need to build reserves and the strong loan growth that you're seeing versus the timing of the revenue benefits? And then, more broadly, if you could also speak to the trajectory of the reserve rate from here?

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Okay. I'll start on EnerBank. So, EnerBank, we said represented 1% of an industry that was about $175 billion. So, call that $1.7 billion of annual production for them that generates growth in the double digits. We've seen that play out. We don't think about the provisioning getting ahead of the earnings, because if we did that, we would not make any loans ever. That's why it's a terrible standard. But I won't go into that. It is what it is.

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So, what we want to do is be there for our clients to extend credit regards to the fact that we have to set up a reserve in advance. So, then come into play, we've had nice growth with EnerBank, and very excited about that. Get paid for the risk we're taking. And it's worked exactly like we thought it would be.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

He asked about the growth math component of our return is fee versus interest income, has that – that was his question.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. Well, primarily, the – you've got carry, you've got net interest income as the biggest driver of our profitability there. And it comes in two fronts. It comes from the customer paying a certain rate and there's a discount from the vendor that's providing the service to the customer, an HVAC contractor for instance. We take those two pieces and that's our yield adjustment. Now, that's – should average in the 9% range over time. And that's the primary profitability that you'll see from EnerBank.

Bill Carcache
Analyst, Wolfe Research LLC

Q

That's very helpful. And the broader trajectory of the reserve rate from here that we should be thinking about?

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. So, we set the reserves under CECL based on the economic forecast at each quarter end. We have to look out through the life of the loan to do that. We have a reserve of 1.62%. We think it's very robust. And based on the risk that we see in the portfolio, we feel very good about that.

The biggest driver of the increase in our reserves this quarter, by far, was loan growth. And so, we aren't seeing broad-based deterioration in credit at all. As a matter of fact, we think it's actually pretty good. We did have an increase in NPLs primarily attributable to one particular customer. But overall, we feel really good about credit. We do think there's going to be some normalization. I mean, we're at 17 basis points of charge-offs this quarter. That's lower than "normal". And we think over time, it will get back to normal. I don't know that it will get there in 2022. We're forecasting charge-offs in the range of 20 to 30 basis points and actually towards the lower end of that.

2023, you could see losses pick up as the economy slows as certain industries start to struggle a bit more than others. And I think you'll see it manifest itself first in, really, small businesses that'll have bigger challenges than a larger business and certain consumer groups might struggle more than others.

Bill Carcache
Analyst, Wolfe Research LLC

Q

That's great. Thank you so much. Very helpful. Appreciate your taking my questions.

Operator: Our next question comes from the line of Gerard Cassidy with RBC Capital Markets. Please proceed with your question.

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John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning, Gerard.

Gerard Cassidy
Analyst, RBC Capital Markets LLC

Q

Hi John. How are you? Hi David. David, can you elaborate a little further on your comments about the capital market fees that you expect to be at the lower end of the range? I think you said in your prepared comments in the upcoming quarter. What type of capital markets environment are you contemplating for that kind of guidance? Is it currently what we just had this quarter or is it an improvement? And then within the capital markets, obviously, you guys are not ECM players. Where are you seeing or you think you're going to see the strength in the upcoming quarters?

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. I think that, so, we were – if you cut out the CVA/DVA, we're kind of at the lower end of the range. We think that that's kind of where we'll be here, at least, in the short term. Capital markets activity is not as robust. I think you've seen that play out across the board, in particular in the money center banks that have more ECM. Obviously, we don't have that.

M&A advisory and loan syndications are the places, where we think can continue to be robust for us. And I wish we were going to be at the upper end of that range. We've had to revise that down from the beginning of the year a couple of times. But we think that's a pretty good – really good place to be. Real estate capital markets and leveraging our Sabal Capital Partners that we bought at the end of last year, I think is helping us. And – but I think we would be remiss if we didn't say that's going to be a little more challenging than we would had hoped just because the capital markets aren't quite where we all would like them to be at this point.

Gerard Cassidy
Analyst, RBC Capital Markets LLC

Q

Very good. And then as a follow-up question to your comments about the lending, the strength of your lending and how you recognize and you guys are very well experienced in handling problems that from the downturn in 2008, 2009. So, nobody expects you to make any errors like that.

But can you share with us what are you – I think you used the word robust in client selection. What are you doing at the – if we are in an end-of-the-cycle in the economy, and that's debatable, of course, but when you see the growth, not just for you, but for the industry, everybody is showing good loan growth toward the end of – maybe as economic expansion, how can you reassure us that you guys are – got metrics in place that you just won't really have the problems that can be – that other banks may run into?

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Yeah. Gerard, this is John. We learned a lot from that 2009-2010 sort of timeframe and particularly the importance of balance and diversity. These are good times, but you can make your worst loans in the best of times. And so, we're being very thoughtful about what we're putting on the books. 83% of our new production was to existing customers. We've been working very closely with those customers, particularly over the last two-and-a-half years, as we worked through the pandemic. I think we have a really good sense of what's going on in their businesses.

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We have been focused, as you know, for a number of years on recycling capital, on risk-adjusted returns. We've been exiting certain portfolios and relationships that didn't generate an appropriate return on capital for us. I think that's great. Discipline that exists within the company, we have strong metrics and key performance indicators built around all of our businesses and, again, really dedication to a strong concentration methodology to ensure that we have good balance and diversity.

We assume a variety of different scenarios when stress testing credits and stress testing portfolios. And as a result, we feel good about – really good about the credit risk management culture that we have developed over time and think that our portfolios will perform well no matter what the economic conditions or how the economic conditions evolve.

Gerard Cassidy
Analyst, RBC Capital Markets LLC

Q

Very good. Thank you.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Thank you.

Operator: Our next question comes from the line of Ryan Nash with Goldman Sachs. Please proceed with your question.

Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC

Q

Hey, good morning, John. Good morning, David.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Good morning.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Hey, Ryan.

Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC

Q

David, you talked about the $5 billion to $10 billion of potential deposit outflow starting to pick up. And, if we were to assume they exit over the next quarter or so, can you maybe just talk about your expectations for deposit growth? And given John's comments regarding what you guys think about loan growth in the second half, how do you think about the tradeoff between growing deposits versus optimizing the mix and the cost of deposits?

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

So, the first part of that, we do expect, as I mentioned earlier, those excess deposits from our corporate clients to seek a better, higher-yielding home. We also have about $1 billion aid in brokered deposits that we picked up

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from the EnerBank transaction. So, I think that we're always looking for quality relationships, deposit relationships, Treasury Management relationships. We were able to grow that 14% this quarter in Treasury Management. So, we're excited about that.

And I think that from a consumer standpoint, we're in a good part of the country, where ought to see better migration of people into our footprint and take – and we should be able to take advantage of that. So, we should be able to continue to grow core checking accounts. We do have, obviously, inflationary pressures on consumers. We – I think we've put in our slide deck that we've even looked at – segmented our deposit base. On the consumer side, those that had their $1,000 or less in their checking account pre-pandemic have six times more cash in their account today than pre-pandemic.

Now, that's going to start declining if inflation continues at a faster clip. But continuing to grow customers ought to help us maintain pretty solid deposits. Our loan-to-deposit ratio is among the lowest in the peer group at 67% change, may be close to 68%. And so, we're optimizing our deposit book. We're growing deposits as foundational to how we make money. And so, we are even remotely close to having to worry about wholesale funding. There are some of our peers that had to dip into that because of loan-to-deposit ratio. But this is where Regions shines. This is our competitive advantage is our deposit base. And we're looking to continue to grow that and grow customers and take care of our customers along the way.

Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC

Q

Got it. And then second, David, you're targeting 300 basis points of positive operating leverage. And I know it's early to think about 2023. But maybe just to follow up on Peter's question from earlier, if you think about just reaching the NII run rate and assuming no further growth, that would give you about 8% revenue growth into next year. So, how do you think about investing? And this obviously is a tricky environment with the potential for an economic slowdown. But do you expect that we could potentially see accelerating positive operating leverage in that type of environment?

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Well, I think you answered that question upfront. It's a little early to get into 2023. But let me help you here. We have a continuous improvement program where we are constantly focusing on how to get better at what we do. We had a pretty strong efficiency ratio this quarter of, call it, 54% on an adjusted basis. We'd like that to be lower. We're substantially below the median, which is 400 basis points higher than we are. And I think that at the end of the day, if we could get closer to 50% that would be great.

And we're going to figure out how to try and do that. We cannot count on revenue growth just being the only driver of how we continue to be efficient. So, if we stay focused on that, Ryan, I think we can generate pretty solid, positive operating leverage.

Now, there's a caveat. We have to continue to take our winnings, if you will, and reinvest those in our company to grow. That means we have to reinvest in talent. We have to reinvest in technology. We will reinvest in our transformation that we're going to go through on the deposit side primarily and other areas. And we do that while continuing to control our cost increases, which I told you earlier in the year, the vast majority of our increase early in the year was really related to acquisitions. So, we're – we've been a good expense managers and I think you'll see that continue into 2023.

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Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC

Q

Got it. I'll make sure we [ph] hold you to (00:46:43) that 50%. Thanks, David.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Okay.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Target. Target.

Operator: Our next question comes from the line of Erika Najarian with UBS. Please proceed with your question.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning...

Erika Najarian
Analyst, UBS Securities LLC

Q

Hi.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

...Erika.

Erika Najarian
Analyst, UBS Securities LLC

Q

Good morning. And Dana, great job on slide 8, by the way. Yeah, David, I wanted to go back to slide 8. Can you [audio gap] (00:47:07) what your plans are for securities book, your cash balances from here. Obviously, if IOER continues to [indiscernible] (00:47:17) to Fed funds, your cash is going to be working a lot harder by the end of the year.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. So, I'm glad you pointed that out. That's 100% beta on that opportunity there. We're at 1.65% on reserves. We've been patient with our cash. We didn't need to put it in the securities book to help NII. We had the benefit of our hedging program doing that for us. So, we have been patient. We're glad we have. We put a little bit to work in the securities book because the spreads got to a point where it was – we were paid for the duration that we were going to take. And that securities investment is really part of our hedging program as well.

We were able to use our cash this quarter to fund all of our loan growth. I think we're down to, call it, $18 billion of cash at the end of the quarter. And normally, that number is going to be $500 million to $2 billion worth of cash at the Fed. So, we've got some of that that we need to hold on to for that deposit outflow that I just talked about, whether it's the corporate deposits or whether it's the EnerBank-brokered deposits that we'll lead over time. And

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then, we'll have some for loan growth. So, we don't see the need to tap into our alternative sources of funding, FHLB and the like, or certainly, no bank debt issuances are necessary either at this time.

So, we've been cautious. It's paid off for us. I think, the securities we invested this quarter yielding at [ph] 3.30-ish (00:49:04) range. So – and as you could see that in the change in tangible common equity in terms of our decline was much lower than our peers.

Erika Najarian
Analyst, UBS Securities LLC
Q

So, I just wanted to make sure we're taking away the right message here. From second quarter NIM 3.06%, and hit a net interest margin of 3.70% to 3.80%, right, from low – higher beta to base case at a Fed funds rate of 3%. And if the Fed starts cutting rates, your swap program has protected you to 3.60%.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

That's correct.

Erika Najarian
Analyst, UBS Securities LLC
Q

Okay. And my other question for you, David, is if we were to prepare for a mild recession, how should we think about how [audio gap] (00:50:03) more ACL builds there may need to be from that 1.62%?

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

So, you cut out on the first part of that. But I think your question was how do we see the reserve build from here from 1.62% in a mild recession?

Erika Najarian
Analyst, UBS Securities LLC
Q

Yeah, in a mild recession.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Yeah. So, we're having to forecast out through life of loan today, which has elements of a slowdown already built into it. So, it really is dependent on how severe it is relative to our expectations already. And we kind of went through that, I guess, in the pandemic. You saw our adjustment quickly.

Right now, we don't see that changing a lot because we think we're covered. And the real change to the allowance are just two things, whatever charge-offs have, reducing it and then the provision primarily for loan growth, which is what you saw this quarter. Our credit quality metrics are stable. Net-net, all in, we feel good about where we are but if the economy starts to slip, and we're going to have to have higher provisioning going forward.

Erika Najarian
Analyst, UBS Securities LLC
Q

Got it.

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David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

And every quarter stands on its own. So, we'll have to reassess at the end of September.

Erika Najarian
Analyst, UBS Securities LLC
Q

Got it. Thank you.

Operator: Our next question comes from the line of Ken Usdin with Jefferies. Please proceed with your question.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Good morning, Ken.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Hey, Ken.

Ken Usdin
Analyst, Jefferies & Company
Q

Hey, thanks. Good morning. Just two quick close-outs here. Just one question, David, on the C&I loan yields, just not up as much, of course, as the NIM. And I'm sure some of that is the hedging. Just wondering if you can kind of just help us understand how much of that is the hedging impact, and how much of that might just be mix and pricing, et cetera? Thanks.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Yeah. I would say most of that is related to hedging. Our old hedges that we had protecting us, those start to roll off. We have some still protecting us that they are still in place, so we're not expanding it quite to pace that maybe others that didn't hedge are. But we still have pretty good loan yields net-net. And if you look at adjusted net interest income, that's after charge-offs, we're one of the leaders in the peer group. So, that's a good indicator telling us we're being paid for the credit risk that we're taking.

Ken Usdin
Analyst, Jefferies & Company
Q

Yeah. Got it. Okay. And then on capital, 9.2% CET1, you're mentioning you want to get back to the middle of the 9.25% to 9.75% and presuming that's to give room for loan growth. Just wondering, obviously, that probably implies that no buybacks for now. Can you just talk us through capital return expectations versus RWA? And then also just – is it just a little bit more conservatism about the environment? All right. Thanks.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Yeah. So, the reason we want to be in that range is to give us flexibility to make investments when we see opportunities. In this particular quarter, it was loan growth. So, we had really robust loan growth and you could

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see our capital, our Common Equity Tier 1 declined. The primary use of that was in fact RWA growth through the loans. We're generating, call it, 50 basis points of Common Equity Tier 1 each quarter or at least we did this past quarter, and we'll use a third of that to pay a dividend and then the rest of it's for investment.

First off, it's for loan growth. We've already sent the message that we don't expect loan growth at the pace we just saw the first quarter. We think that'll level off a bit and, therefore, we can accrete back from the 9.2% where we are, closer to the 9.5%, probably can't get there at the end of the third quarter, take us into the fourth quarter. But we use share repurchases as the last item to control our capital level. We think 9% – that 9.25% to 9.75% still is a great range for us based on the risk we see in our book, taking into account all the macro factors that exist today. So, you'll see us accrete up – back up towards that 9.50% before we get into share repurchases.

Ken Usdin
Analyst, Jefferies & Company

Q

Makes sense. Thanks, David.

Operator: Our next question comes from the line of Betsy Graseck with Morgan Stanley. Please proceed with your question.

Betsy L. Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Two questions, one on the securities book, I know we just had a bit of a chat on that, but I wanted to understand what the kind of repricing speed is? Duration? Like how quickly should we be thinking about the back book migrating to the front book of 3.3% that you just talked about?

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Well, if you look at all-in gross, so the 3.3% I just mentioned was an element of what we invested primarily as part of our hedging program. We did have other security purchases. So, all-in yield going on was about 3.13%. That's replacing 2.23%. So, we're picking up about 90 points on that. As we think about duration, we're looking at, call it, right at five years today. And we don't think that extends a whole lot on us based on what we're buying. So, I think that – I think I got what you wanted, Betsy.

Betsy L. Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Yeah. So, like 20% roll rate annually.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

That's right.

Betsy L. Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And then, on page 22 of the deck, you have your base R&S economic outlook. So, is this giving us the base case? And then, you've got a probability assigned to the base case, you've got a probability assigned to the bull and the bear, and that's what's feeding into the CECL reserve analysis, or would you say this page 22 discloses your probability-weighted scenario?

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David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Yeah. So, we do ours a little different. We use a scenario and – as our CECL provisioning. We do run stress testing, obviously, using very different scenarios. But we don't probability-weight different things. So, what you're seeing here on 22 is the driver of our CECL provisioning.

Betsy L. Graseck
Analyst, Morgan Stanley & Co. LLC
Q

Got it. Okay. Super. Thanks.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Okay.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Thank you.

Operator: Thank you. Your final question comes from the line of Vivek Juneja with JPMorgan. Please proceed with your question.

Vivek Juneja
Analyst, JPMorgan Securities LLC
Q

Hi. Thanks.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Hi, Vivek.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Hey, Vivek, morning.

Vivek Juneja
Analyst, JPMorgan Securities LLC
Q

Morning. Just a clarification, David, do you expect your liquid assets to actually go down to $750 million? Because you're obviously much higher today...

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Yeah. No...

Vivek Juneja
Analyst, JPMorgan Securities LLC
Q

...but is that realistic or...

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David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

No, I was saying hypothetically in normal times, we could take those down, that cash down to a level much lower than the $18 billion that we're having, that we have today. And that would be over time. So, we wouldn't seek to get there any time soon. We want to maintain a lot of liquidity to take care of deposit flows because remember, we had some $40 billion worth of growth and, what we're calling surge deposits, and we've made our best estimate as to how we think those things will behave over time. And we have about $13 billion, $14 billion of it that we think has either a very high beta or it's going to seek a better alternative, which means we need to have the cash to pay for that if it starts to happen. But yeah, in normal times, we could be down in that – I've said somewhere between $500 million to $2 billion and of course then we'd have the FHLB as our toggle to take care of other liquidity needs.

Vivek Juneja
Analyst, JPMorgan Securities LLC
Q

Okay. And one more, which commercial sectors are you seeing early signs of normalization?

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

From a credit risk standpoint, Vivek.

Vivek Juneja
Analyst, JPMorgan Securities LLC
Q

Yes.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

I think David talked about small business. We have some concern around the transportation, particularly on the lower end of the sector, where you have transportation companies who are involved in less than truckload hauling and the impact of diesel fuel inflationary cost labor. We have been following office for some time and senior housing as well are portfolios that we're keeping an eye on. I wouldn't say in those two instances that we're seeing a normalization, but we do have a watchful eye on them.

Vivek Juneja
Analyst, JPMorgan Securities LLC
Q

Okay. Great. Thank you, David. Thank you, John.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Thank you.

David Jackson Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Thank you.

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John M. Turner, Jr.

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

Well, appreciate everybody's participation in today's call. Thanks for your interest in Regions. If you have any follow-up questions, please contact Dana and the Investor Relations team. Have a great day.

Operator: This concludes today's teleconference. You may now disconnect your lines.

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