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WFC - Q2 2012 Wells Fargo Earnings Conference Call

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OVERVIEW:

WFC reported 2Q12 YoverY revenue growth of 4%, earnings of $4.6b, and EPS of $0.82.

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PRESENTATION

Operator

Good morning. My name is Regina and I will be your conference operator today. At this time I would like to welcome everyone to the Wells Fargo second-quarter earnings conference call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. (Operator Instructions)

I would now like to turn the call over to Jim Rowe, Director of Investor Relations. Mr. Rowe, you may begin your conference.

Jim Rowe - *Wells Fargo & Company - IR*

Thank you, Regina; and good morning, everyone. Thank you for joining our call today during which our Chairman and CEO John Stumpf and our CFO Tim Sloan will review second-quarter results and answer your questions.

Before we get started, I would like to remind you that our second-quarter earnings release and quarterly supplement are available on our website. I would also like to caution you that we may make forward-looking statements during today's call that are subject to risks and uncertainties. Factors that may cause actual results to differ materially from expectations are detailed in our SEC filings, including the Form 8-K filed today containing our earnings release and quarterly supplement. Information about any non-GAAP financial measures referenced, including a reconciliation of those measures to GAAP measures, can also be found in our SEC filings, in the earnings release, and in the quarterly supplement available on WellsFargo.com.

I will now turn the call over to our Chairman and CEO, John Stumpf.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

Thank you, Jim; and good morning, everyone, and thanks for joining us today. Before I discuss our results this quarter, I want to take a moment to recognize that 160 years ago today, on July 13, 1852, Wells Fargo first opened its doors for business right here in San Francisco. So it is our birthday today. It has been quite a remarkable ride for the stagecoach for the last 160 years.

During that period of time we have been through many economic cycles. While the current economic recovery remains uneven, our strong performance in the second quarter reflects the strength of our franchise, the benefit of our diversified business model, and the advantage of an outstanding team working together to serve our customers. Our focus on meeting our customers' financial needs resulted in continued strong deposit growth, growth in consumer and commercial loans, and record cross-sell.

Let me quickly review some of the highlights of the quarter. We generated record net income, up 17% from a year ago; and EPS was also up 17%. Pretax pre-prevision profits increased 12%, and revenue grew 4% from a year ago. We had positive operating leverage, and our expense efficiency ratio improved by 300 basis points from a year ago.

Retail banking cross-sell reached a new record of 6 products per household for the entire community bank consumer base. Credit quality continued to improve, with our charge-off ratio declining to 1.15%, the lowest level since 2007 and down 37 basis points from a year ago. Our profitability ratios reflect these strong results, with our ROA growing to 1.41%, up 14 basis points from a year ago, the highest it has been in four years. Our return on equity increased to 12.86%, up 94 basis points from a year ago.

We purchased 53 million shares of common stock during the second quarter while we continued to grow capital. Our performance reflects growth throughout our businesses.

Our mortgage business generated record applications in the second quarter of $208 billion, up over 90% from a year ago and up 11% from last quarter. Obviously, the low rate environment is driving strong refi application volume.

But purchase volume was up over $19 billion or 43% in the first quarter, indicating increased strength in the overall housing market, where we have seen increases in sales and pricing in markets throughout the country, even in some of the hardest hit areas during the downturn.

We remain focused on our commitment to helping homeowners stay in their homes, with over 770,000 active trial or completed mortgage modifications since the beginning of 2009. We have also helped nearly 6.2 million customers secure new low-rate loans for home purchases or refinancing since the beginning of 2009. The strength of our mortgage business is just one example of how we have been able to generate new customer relationships and better serve our existing customers.

We grew commercial loans through portfolio acquisitions and organically; increased credit card penetration of the retail banking households to 31%; grew retail brokerage managed account assets by 7% from a year ago; and small business checking accounts are up nearly 4% from a year ago. This is just the beginning of the many opportunities we have to capitalize on the strength of our franchise and achieve the financial goals we shared with you at Investor Day.

Tim Sloan, our CFO, will now provide more details on our financial results. Tim?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Thanks, John, and good morning, everyone. My remarks will follow the presentation included in the first half of our quarterly supplement, which starts on page 2. And then John and I will take your questions.

As John highlighted, we had a very strong quarter with record earnings of $4.6 billion, up 9% from the first quarter and 17% from a year ago. Earnings per share were a record $0.82, also up 9% from last quarter and 17% from a year ago.

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This was our 10th consecutive quarter of earnings per share growth. Our ability to consistently grow earnings per share over the past two and a half years, when the economy has faced many challenges, reflects the benefit of our diversified business model.

I am going to start by highlighting some of the key drivers of our results this quarter, beginning on page 4; and then I will add more detail later in my remarks. We grew both our total and our core loan portfolios. Loan growth was broad-based and benefited from acquisitions and organic growth in both commercial and consumer portfolios.

Our securities portfolio declined $3.4 billion as new investments were more than offset by called lower-yield securities and runoff. We remain cautious on how we invest in this interest rate and credit environment.

Turning to the income statement, revenue declined $347 million from the first quarter, as growth in net interest income and fee growth across many of our businesses was offset by declines in trading, driven by lower deferred compensation plan investment income, and lower gains on equity investments.

Our expense efficiency ratio improved to 58.2%, as expenses declined $596 million from the first quarter, consistent with our expectations. Expenses related to the settlement with the Department of Justice which we announced yesterday have been fully accrued for as of the end of the second quarter.

Let me now cover our results in a little bit more detail. As shown on page 6, period-end loans were up $8.7 billion from the first quarter with growth across a number of commercial and consumer portfolios. The liquidating portfolio declined by $5.1 billion, and our core loan portfolio grew by $13.8 billion.

Commercial loans increased $8.3 billion, including $6.9 billion of loans acquired in the purchase of BNP Paribas's North American energy lending business and the purchase of WestLB's subscription finance portfolio. Our strong balance sheet has enabled us to take advantage of these opportunities in this economic environment.

Our portfolio purchases are in businesses we understand and include both new customers and customers we already serve, providing us the opportunity to deepen these relationships.

Consumer loans increased $375 million from the first quarter, as growth in first mortgages, auto, and credit card was partially offset by declines in junior lien mortgages. Average loan balances were down $359 million from the first quarter, which didn't benefit from the late-quarter close of the WestLB portfolio. However, many commercial and consumer loan portfolios increased average balances on a linked-quarter basis.

We had strong core deposit growth, with average core deposits up $10.1 billion from the first quarter, up $73.2 billion or 9% from a year ago. Core deposits were 115% of average loans.

Average core checking and savings deposits were up 12% from a year ago and were 93% of average core deposits. We have successfully grown deposits while reducing our deposit costs for seven consecutive quarters. Deposit costs in the second quarter were 19 basis points, down 1 basis point from the first quarter and down 9 basis points from a year ago.

Tax equivalent net interest income increased $155 million from the first quarter, driven by growth in earning assets of $16 billion, while our net interest margin was unchanged at 3.91%. The NIM included a 7 basis point benefit from higher variable items, including PCI loan resolutions in the second quarter.

These variable sources of income can be lumpy from quarter to quarter, and we would expect continued pressure on our NIM as the balance sheet reprices in the current low rate environment. But as we have said and stated many times in the past, we remain focused on growing net interest income.

Non-interest income declined $496 million from the first quarter, down 5%. The decline was partially due to $377 million of lower trading gains on $218 million of lower deferred compensation plan investment results, which was offset in employee benefit expense. Equity gains were also lower this quarter, down $122 million.

However, we continue to benefit from our diverse businesses, with growth in deposit service charges, trust and investment fees, card fees, processing fees, insurance, and mortgage banking.

Mortgage banking revenue increased $23 million from the first quarter, with continued strong originations and margins. Results included a $669 million provision for mortgage repurchase losses, which was $239 million higher than the first quarter; and I will discuss this more later.

Mortgage originations were $131 billion in the second quarter, up $2 billion from the strong first-quarter volumes, and were more than double what they were a year ago. 16% of our origination volume this quarter was from HARP, similar to last quarter. The unclosed mortgage pipeline at quarter end was a very strong $102 billion, up 29% from the first quarter and the second highest pipeline in our history.

Turning to expenses, non-interest expenses were down $596 million from the first quarter, driven by lower personnel expenses. Commission and incentive compensation expense decreased $63 million, as declines in seasonally high first-quarter expenses were partially offset by higher revenue-driven compensation. Employee benefit expense was down $559 million from a seasonally high first quarter, and reflects lower deferred compensation expense.

Second quarter expenses also included $524 million of operating losses, $47 million higher than the first quarter. Operating losses this quarter included an accrual for the settlement with the Department of Justice.

We first highlighted our expense reduction program during our earnings call a year ago. One year later, we have made solid progress at reducing expenses and we remain committed to improving our efficiency.

However, a lot has changed over the past 12 months, particularly in terms of revenue opportunities. As shown on slide 11, we achieved positive operating leverage, with revenue growing $903 million while non-interest expense declined $78 million over the past year. As we said all along, we will not pass up revenue opportunities in order to meet a specific expense target number.

Mortgage volumes have been much stronger than anyone expected a year ago -- or even three months ago for that matter -- with originations more than double what they were a year ago. And our mortgage pipeline, which should lead to future revenue and expense growth, has also doubled.

So while we have reduced total FTEs for Wells Fargo by 1% over the past year, we have increased FTEs in consumer real estate by 19% to capture the revenue opportunities from strong mortgage volumes. In fact we added over 2,000 FTEs in mortgage in the second quarter.

It is also important to note that revenue and expenses reflect the success we have had in completing several business and loan portfolio acquisitions over the past year, and we have continue to invest in our growing businesses. Also, litigation accruals have been high; and our mortgage servicing costs have been elevated due to the mortgage servicing settlement and foreclosure consent orders.

As shown on page 12, even with all of this business and expense growth, we have achieved efficiency improvements with our efficiency ratio in the second quarter improving to 58.2%, the lowest level in nine quarters. This improvement in our efficiency ratio demonstrates the success we have had at expense reduction, even as we have grown revenue.

Let me mention just a few examples. We have reduced FTEs in high-cost geographies by 10% since the beginning of 2011. We have reduced occupancy expense by 7%, including real estate reductions of 3 million square feet. And we have reduced third-party spend, reflecting renegotiated contracts and changes in demand.

As we highlighted at Investor Day, we have established an efficiency ratio target of 55% to 59%, and we were in that range this quarter. We currently expect to be within our target range for the rest of 2012. We believe that focusing on our efficiency ratio is the best way to demonstrate expense management, as we continue to focus on revenue opportunities for both this year and in the future.

Due to our strong revenue opportunities, particularly in mortgage, we now expect our fourth-quarter expenses to be higher than our previous target of $11.25 billion. However, current expenses are still too high; and we expect them to trend down over the remainder of the year from second-quarter levels.

Let me now briefly highlight on our segment results starting on page 13. Community banking earned $2.5 billion in the second quarter, up 8% from the first quarter. Retail banking reached a record cross-sell of 6 products per household, up from 5.82 a year ago.

Cross-sell growth occurred throughout our franchise, with the West increasing to 6.37 and the East increasing to 5.52, up 27 basis points from a year ago. The momentum in the East is also demonstrated by core product sales growing by 5% from a year ago.

Credit card penetration in our retail banking households continued to increase to 31%, up from 27% a year ago. We generated record consumer auto originations in the second quarter of $6.6 billion, up 6% from the first quarter and up 18% from a year ago.

Wholesale banking earned $1.9 billion in the second quarter, with record revenue of $6.1 billion, which was broad-based across our diversified commercial businesses. Revenue also benefited from increased PCI loan resolution income.

Wholesale banking had solid loan growth, up 1% from the first quarter and 11% from a year ago. The growth was broad-based, reflecting new and existing customer growth and our ability to capitalize on acquisition opportunities in this environment.

During the second quarter $3.7 billion of loans were acquired in the purchase of BNP Paribas's North American energy lending business, with nearly $9.4 billion in loan commitments. We also completed the acquisition of $3.2 billion of subscription finance loans from WestLB, with nearly $6 billion of commitments.

We have also had strong organic growth, with eight consecutive quarters of average loan growth in our commercial banking portfolio from new originations and increased line utilization from our middle-market customers.

Wealth, brokerage, and retirement earned $343 million, up 16% from the first quarter. Revenue declined $91 million from the first quarter. Excluding $122 million of lower deferred compensation plan investment results, revenue increased 1% driven by higher retail brokerage asset-based fees. Cross-sell continued to increase with our focus on meeting all of our customers' financial needs, growing to 10.22 up from 9.94 a year ago.

Credit quality continued to improve this quarter, as shown on page 16, with better performance across portfolios and credit metrics. Net charge-offs were down $195 million from the first quarter and were 1.15% of average loans, down 10 basis points from the last quarter. From the peak in the fourth quarter of 2009, charge-offs are down $3.2 billion or 59%.

Provision expense was $1.8 billion, including a $400 million reserve release. Absent significant deterioration in the economy, we continue to expect future reserve releases in 2012.

Nonperforming assets were down $1.8 billion from the first quarter, down 11% from a year ago. The linked-quarter decline reflects a $1.4 billion reduction in NPLs and a $310 million decline in foreclosed assets.

NPAs were 3.21% of total loans in the second quarter, the lowest level since 2009. Loans 90 days or more past-due were down $276 million or 17% from the first quarter, with declines in both commercial and consumer portfolios. Early-stage consumer loan delinquency balances and rates also improved from the first quarter and were also significantly better than a year ago.

We service $1.9 trillion of residential mortgages. This is a great business because of the new customer growth and cross-sell opportunities it provides, and our servicing portfolio positions us well to benefit from refinance waves like the one we are experiencing now, since existing customers usually give us the first chance when they refinance.

As we have been highlighting for several quarters, the delinquency and foreclosure rate on our servicing portfolio was over 400 basis points lower than the industry average, excluding Wells Fargo, based on the most recently publicly available data, demonstrating the quality of our portfolio. Our total delinquency and foreclosure rate was 7.14% in the first quarter, seasonally higher than -- excuse me; in the second quarter, seasonally higher than the first quarter, but down from 7.44% a year ago and a peak of 8.96% in the fourth quarter of 2009.

As I mentioned earlier we added $669 million to our repurchase reserve this quarter, up $239 million from the first quarter. While outstanding repurchase demands were down this quarter, we added to our repurchase reserve primarily due to an increase in expected demands from the GSEs regarding 2006 to 2008 vintages.

As we have mentioned in prior quarters we continue to see behavioral changes from the agencies, as they seem to be conforming their practices. This addition to the reserve was a result of our ongoing dialogue with them, including some communication very late in the quarter. We believe the additional reserve we added this quarter is appropriate to cover losses associated with these higher expected demands.

As shown on page 20, our capital position continued to grow, with our Tier 1 common equity ratio increasing to 10.0%, up 10 basis points from the last quarter. Our estimated Tier 1 common equity ratio under the latest Basel III proposals included in the Notices of Proposed Rulemaking issued by the regulators in June was 7.78% for the second quarter.

The proposed rules were largely consistent with our expectations, but changes in a few areas reduced our estimated ratio by approximately 30 basis points this quarter. Even after factoring in these changes, we are still in a strong capital position, as reflected in our estimated ratio; and we expect to achieve Basel minimums well in advance of any published guidelines.

We purchased 53 million shares in the second quarter and entered into a forward repurchase transaction for an estimated 11 million shares that is expected to settle in the third quarter. We redeemed $1.8 billion of trust preferred securities with an average coupon of 6.31% in the quarter. We have redeemed a total of $11.9 billion in TRUPS since the beginning of 2011.

In summary, our strong results again this quarter continued to demonstrate the benefit of our diversified business model. By following our consistent vision, we once again achieved record earnings, higher pretax pre-prevision profit, positive operating leverage with reduced expenses, and improved credit quality. Our return on assets was 1.41%, the highest in 16 quarters and within our target range of 1.3% to 1.6% that we provided on Investor Day. Our ROE grew to 12.86%, also within our target range of 12% to 15%.

And while we had great results this quarter, we have plenty of opportunity ahead for future growth, including a strong mortgage pipeline, recently completed acquisitions, improving cross-sell, increasing market share, and improving efficiency, all while remaining very focused on risk. I will now open the call up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Erika Penala, Bank of America Merrill Lynch.

Erika Penala - *BofA Merrill Lynch - Analyst*

Good morning, everybody. My first question is I guess I am just trying to figure out the movement in terms of core loan yield trends. So if I take out the $113 million of -- it seemed like outsize resolution that accreted back to your margin on the PCI book, it still seems as if your core loan yield would only be down less than 5%. So could you give us a sense of, A, was there some enhancement from the BNP transaction in your commercial loan yield this quarter? Or if not, what we are you doing differently to keep your pricing relatively resilient?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

That's a fair question, and I think your estimate of the impact of the special items is correct. Neither of the acquisitions -- either the BNP acquisition or WestLB -- really impacted the core loan yields. They were very similar to similar loans that we had in similar portfolios that we already had on the sheet. So there is really nothing in particular that is going on from a loan yield standpoint.

It is competitive out there. We continue to compete as best we can. We tend not to be -- to over-compete on price. We focus on competing on relationship and growing cross-sell. But there is nothing special there at all.

Erika Penala - *BofA Merrill Lynch - Analyst*

On the bond portfolio, you mentioned in the presentation that some lower yielding securities were called. What was the impact of that in terms of -- the AFS yields were up quarter over quarter. Was that primarily due to that, the lower yielding bonds getting called?

Also, if you could give us a sense in terms of what you were reinvesting in from a duration and yield perspective this quarter.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Yes, that was a driver for the increase in the yield. Really what happened is we had some very high-quality short-term government or government agency securities that were called that we had invested in, in the end of the third, early fourth quarter of last year, when we had all that excess liquidity that occurred. What we did is we looked across the spectrum and saw some of the best risk/return being in very high-quality municipal securities. And so that was the exchange.

Erika Penala - *BofA Merrill Lynch - Analyst*

Got it. Just one more on capital. Thank you so much for giving us an updated Basel III number. I was wondering, as you looked through how to interpret the risk weighting by LTV on the resi portfolio, did you give yourselves credit for the purchase accounting marks on the Wachovia book?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Yes, we did. We did. Again I think the important thing to think about when you -- as we look through the NPRs is that, while it did have about a 30 basis point impact, and there is a lot of give and takes that we are going to have with the regulators and the whole industry will have with the regulators on the various items, in terms of our ability to meet any sort of capital requirements on any reasonable set of time, we are going to meet them well in advance.

So we have got a lot of discussion to have with the regulators. But we are fine from a capital standpoint.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

Let me just emphasize that. We are in the unique position of not having to do anything uneconomic or different to somehow hoard capital or to meet something. We have such strong capital, such strong cash flows and earnings here, it puts us in a position where we can grow organically, do strategic and value-adding portfolio acquisitions, or whatever.

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So it really puts us in a great position. Capital simply is not an issue here.

Erika Penala - *BofA Merrill Lynch - Analyst*

Understood.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

Nothing I worry about.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Yes.

Erika Penala - *BofA Merrill Lynch - Analyst*

Thank you so much.

Operator

John McDonald, Sanford Bernstein.

John McDonald - *Sanford C. Bernstein - Analyst*

Yes, hi, good morning. A couple of nitty-gritty questions for Tim. Tim, on the share count, the average diluted shares were up despite the buyback, and even though the end of period is down. Is that just timing of when the buybacks were done? Something else there?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

John, it is a function of timing. It's a good question. It is a function of the timing and also the fact that we tend to have more share issuance in the first part of the year.

If you look over last year you saw something relatively similar, in that the share count drifted down a little bit toward the end of the year. But it is nothing special other than just timing.

John McDonald - *Sanford C. Bernstein - Analyst*

Okay. Then on the variable source items contributing to NIM this quarter and the 7 basis points, besides loan resolutions can you just give us a feel for what other types of variable sources are affecting the NIM?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

It was mostly loan resolutions, John, and that is why we called it out. The NIM has been flat quarter over quarter, and we wanted to make sure that you all appreciated that 7 basis points was something that was relatively special.

John McDonald - *Sanford C. Bernstein - Analyst*

Okay.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

And John, as we have mentioned in the past and we will say it again, NIM will be under pressure as -- in this low rate environment. And while we don't manage to it, we surely talk about it.

But what is important here is we are able to grow net interest income, and that is really the driver.

John McDonald - *Sanford C. Bernstein - Analyst*

Okay. Do you see more opportunity to buy loan books from other banks? What is the market like for that kind of opportunity?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

I think the market continues to provide opportunities for firms that have the liquidity and the capital to be able to take advantage of it. Whether or not we will be successful I certainly can't promise you, because we turn down more than we pursue.

But we were just very, very pleased over the past year to have been in position to make the acquisitions that we have done. To date they have all worked out well and we look forward to looking at more acquisitions in the future.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

Yes, John, like I said we kick a lot of tires, we say no to more stuff than we say yes to. But if we don't do another deal that's -- we will do other things; but we are still looking at a lot of things.

John McDonald - *Sanford C. Bernstein - Analyst*

Okay. The last thing for me, understanding that it is not a big deal, that it is only one quarter of capital build for you, but what in the Basel III NPRs drove that 30 basis point revision to your pro forma outlook, Tim?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

There were a couple of things in the numerator, John. First, in terms of how the OCI related to our pension would be handled; and then second was the MSR floor.

Then on the denominator side, it was primarily an RWA adjustment for the removal of the credit rating for AFS securities. But again it wasn't significant.

John McDonald - *Sanford C. Bernstein - Analyst*

Okay. Right, right. Okay, that's helpful. Thank you.

Operator

Chris Mutascio, Stifel Nicolaus.

Chris Mutascio - *Stifel Nicolaus - Analyst*

Tim, I got a couple quick questions, want to make sure I heard you correctly. But the sequential quarter built in the loan repurchase reserves, roughly $240 million above first-quarter levels. Would you consider it more of a one-time true-up for what you are seeing from the GSEs recently?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

I wouldn't say it is a one-time true-up, Chris. I would love to be able to tell you that that is the case. It may be; it may not be, in terms of what we see in the future.

]I think we are just continuing to be -- to want to make sure that we have got that reserve absolutely accrued for appropriately. We saw the agencies continuing to adjust their requests. Again, these are not specific demands; this is in advance of demands. But it is our best expectations of what the demands are going to look like in the future.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

But Chris, let me say this. Just because there is demands -- I mean, we are going to push back. We have a team and we look through this stuff, and this is -- and we have been successful in the past in that.

But we just wanted to give you a heads-up about what we expect in the future. But there is a whole team here that takes this very seriously.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Yes, there is a lot of give and take in each relationship. You can see that we are good at making progress in terms of those discussions because of the fact that demands were actually down.

When we get something, we work through it. Sometimes we agree; sometimes we don't. But it is a pretty healthy conversation.

Chris Mutascio - *Stifel Nicolaus - Analyst*

I appreciate that. The TRUPs were paid off late in the quarter. If I did my math right, that saves you maybe $115 million or so a year.

What about the subdebt? What was the yield on the subdebt, the $2.2 billion that saves you in interest expense going forward?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

You know what, Chris? To be honest with you I don't have it handy. We will get back to you on that. But it was lower than -- much lower than the TRUPs.

Chris Mutascio - *Stifel Nicolaus - Analyst*

Got you.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Yes, I want to say 200 to 300 basis points. But we will get back to you on that.

Chris Mutascio - *Stifel Nicolaus - Analyst*

Okay. But again they both happened late in the quarter, so that's a bit of an offset going forward in terms of lower expense.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Correct. I mean I think just overall the TRUPs repurchase and the fact that we did it as early as we did has been a real benefit for us and will continue to be a benefit.

Chris Mutascio - *Stifel Nicolaus - Analyst*

Can I have one final question? The securities yields are actually up 13 basis points sequentially. Are you taking more duration risk in the current environment to get that type of yield increase sequentially?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

No, we are not. We are not taking any significant duration risk or any significant credit risk. This is still a very high-quality portfolio and the duration is relatively short.

Chris Mutascio - *Stifel Nicolaus - Analyst*

Then how does the yield go up sequentially with the rates going down?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Yes, fair question. Similar to where Erika was coming out. And that is it was really an exchange of some very, low-yield, short-term, very high-quality government or government agency securities in exchange for some municipals and for some MBS.

Chris Mutascio - *Stifel Nicolaus - Analyst*

My apologies that was asked before. I have been pretty busy this morning.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

No, no, no. No problem. No.

Chris Mutascio - *Stifel Nicolaus - Analyst*

All right. Thank you very much. Thank you.

Operator

Ken Usdin, Jefferies.

Ken Usdin - *Jefferies & Co. - Analyst*

Thanks, good morning guys. I want to ask you a first question just on expenses. I think everyone understands the better revenue outlook for the better expense outlook for the fourth quarter. But can you at this point help us to understand how much more of an impact Project Compass will be as we look forward into next year?

There will be seasonality obviously early next year. But just from a run rate, as you expect things, broader picture, do you guys have a sense of the magnitude of incremental saves that can still come out of the run rate?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Fair question. We have not begun our detailed planning for next year. Having said that, I think that we continued to see pretty significant changes that we can make as it relates to any sort of the run rate which would be Project Compass. We also have some environmental items like higher operating losses due to litigation accruals and the like that hopefully will come out over time.

So we think we can make some progress. That is one of the reasons why we provided the range of 55% to 59% at Investor Day. If we thought that we were at the end and we were going to be at 58%, 59% we wouldn't have provided that range to 55%.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

And let me state we still have opportunity. Expenses are still too high around here, given the operating environment.

So we -- all hands are on deck. We have lost none of our enthusiasm or opportunity or passion to do that.

This is not a destination; this is a journey. And it will continue next, quarter, the quarter after, into next year.

But also what's important is not only Compass expenses but expenses in businesses that move up and down. How quickly we can take mortgage costs out when mortgage -- when the refi boom ends. And those are also critically important.

But we get this in spades, and that is why we have been so public about the fact that we have opportunity here.

Ken Usdin - *Jefferies & Co. - Analyst*

Great. My second question just relates to two questions on the loan book. First of all, I was wondering if you could just comment on just commercial activity, your just general sense from customers out there, just given the uncertainty in the environment and outlook there.

Then the second question is, it looked like the pace of runoff was a little bigger this quarter in that part of the portfolio. Just what you generally expect from a pace of runoff going forward.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

Yes. Let me take the last question first. The pace of runoff in the commercial portfolio was impacted in some of our commercial real estate loans which drove the PCI resolution. That was a primary driver there. I wish I could tell you that was going to happen every quarter, but I can't.

In terms of overall commercial loan demand, it is still seems -- it seems good. I wouldn't call it great. I mean I think we are in the midst of a recovery. It is a slow recovery.

But what was good from our perspective was to see a more broad-based level of loan growth in our commercial portfolio in addition to the acquisitions. We also saw, and I mentioned in my remarks, a continued increase in line usage. It is not significant; but we bottomed in terms of line usage about a year or so ago, and it has been slowly but steadily going up.

But I would call it good. And it is a very competitive market.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

I should also mention that we actually had -- we saw some opportunities or some performance on the consumer side, which is really healthy. We are doing very well in auto. We did very well in small business. We did very well in card this quarter.

So that is very positive. Because we have -- home equity is coming down. So to show some improvement there, it was very encouraging.

Ken Usdin - *Jefferies & Co. - Analyst*

Okay, great. Thanks a lot.

Operator

Marty Mosby, Guggenheim.

Marty Mosby - *Guggenheim Securities - Analyst*

Good morning. I wanted to ask you about the pipeline and the impact that that could have on originations. If you look at the last couple of quarters, your pipeline converted into originations at about a 1.7 ratio. So in other words, whatever you had in pipeline you originated 70% more in the next quarter.

With a $102 billion pipeline, will that equate to north of -- it puts you around $170 billion in originations in the next quarter. Is that anywhere close to where you think you could see the numbers?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

You know, Marty, I hope that is the case. But when you think about the conversion it is just as much as what is going to happen in terms of business this month and the beginning of August.

We have ramped up our team members in mortgage to be able to move the pipeline through as quickly as we can. But again -- so I hope $170 billion is the right number, but it could be a little bit different.

Marty Mosby - *Guggenheim Securities - Analyst*

The third quarter typically is a good seasonal quarter for home purchase as well. So you at least have that coming back in, if we are seeing any strength there, which is a positive.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Yes, that's right.

Marty Mosby - *Guggenheim Securities - Analyst*

The other thing I was going to ask is, if I calculate it right, it looks like the gain on sale went from about 240 down to around 210 this quarter. Is it starting to stabilize? Or should there -- any more return to more normal, which would be just a little bit below 2%?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Yes, your numbers are actually pretty close, Marty. Our number was closer to about 220, 225 or so, but in that ZIP code. And it is remaining pretty stable.

Marty Mosby - *Guggenheim Securities - Analyst*

Okay. Then when we go back, one more try on the mortgage repurchase activity, you said you had some discussions with agencies. We had a couple other companies that took special hits in the sense of reserving for future losses given better information they were getting from the agencies, which really reflects an acceleration of future losses that they expect to see.

Would you couch this $669 million number in that kind of range, or in that kind of aspect?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

You know, Marty, I wouldn't want to speculate on what is going to happen in the future. What we wanted to do is make sure that we were appropriately reserved for this quarter.

As John said, there is going to be a lot of healthy conversation with the agencies on whatever future demands they are going to provide. Again these were based on conversations in which we expected future demands as opposed to specific demands.

Marty Mosby - *Guggenheim Securities - Analyst*

Okay. Then the last question is the 7 basis points impact from PCI on the margin, is that an incremental benefit or how would that compare to last quarter?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

That is the incremental benefit, Marty, and that is why we wanted to call it out.

Marty Mosby - *Guggenheim Securities - Analyst*

Got you. Okay, thanks.

Operator

Paul Miller, FBR.

Paul Miller - *FBR & Company - Analyst*

Yes, how are you guys doing? Great quarter by the way, guys. Just to follow up on the mortgage banking side, you got -- I mean, I can't get this out. On the HARP stuff, and back on your Investor Day you said HARP wasn't playing as big a role as a lot of the media people were talking about. Are you seeing an increase in HARP? Or are you still in that category that you are not seeing a lot of HARP loans coming through the pipeline?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Yes, Paul, good question. What we were referring to at the Investor Day was the media reports at the time that indicated that the HARP margins were outsize relative to the rest of the originations, which wasn't the case then and isn't the case now. The fundings have actually been pretty stable in terms of -- I think at the Investor Day we might've said 15%.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

16%.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Now it is 16% now. And that is about -- it just seems pretty stable in that percentage. I mean it could go up or down a few percentage, but 16% is a pretty good number.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

Now for others it might be higher as a percentage because they do less other things. The denominator is different. But for us it has been pretty flat.

Paul Miller - *FBR & Company - Analyst*

Okay. Then I don't know, because I've been running around all day this morning with JPMorgan. But did you guys talk a little bit about -- have you seen any decline at all? Because a lot of people have been talking about the refi indexes being down. But we are hearing mixed reviews out there, that if the flow or the demand is really going down out there in the month of July.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

We haven't published any of the July information. But as of just a couple of weeks ago with the pipeline that we have, the business is good and we are optimistic about it.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

Very optimistic.

Paul Miller - *FBR & Company - Analyst*

Okay. I think those are my questions. Thank you very much, gentlemen.

Operator

Mike Mayo, CLSA.

Mike Mayo - *CLSA - Analyst*

Hi, I understand the long-term; you had your whole Investor Day. And I understand the short-term, mortgage, you are very optimistic. It is the medium-term. If and when mortgage slows, what fills that bucket? What replaces that?

Could there be an oh-no quarter where mortgage slows and you haven't cut the expenses yet?

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

Well, Mike, we could always have an oh-no quarter. This is a volatile business that we are in, for sure.

I think that when you look at the history of the Company, we have had a profitable mortgage business for decades. But within that profitability we have had a lot of cycles.

We understand that the mortgage business is a very cyclical business, particularly when you look at the refi cycles that we have had over the past few years. I would just point to the fact that, while I can't promise this is going to be the case, while we have printed 10 consecutive quarters of earnings growth we have had ups and downs in the mortgage business.

I think what that reflects is the benefit of the fact that we have got a very diversified business model. The mortgage business is important to us; but when you look at the percentage of mortgage revenues for last year and the year before, it goes down because we are growing the rest of the business quite nicely.

So I can't tell you specifically what would take the place of the decline in mortgage revenues -- which will occur. We know that is going to happen, because it is unlikely that we will continue at this pace for the medium term as you point out.

But we do believe that because we saw loan growth in many of our portfolios, we saw fee growth in many of our businesses, that we can continue to grow even in the medium term.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

And Mike, Tim is absolutely right in that. But even within the mortgage business, think about it. We are already seeing more purchase volume activity, and the business is balanced pretty nicely between the servicing side and the originations side. So when originations tend to ebb, the servicing tends to do better.

So I mean there is a whole bunch of stuff. We always say there is lots of different horses pulling this coach; and one pulls harder when the other one doesn't pull as hard.

So that is the beauty of this balanced business model. But I will tell you one thing, Mike, we will not stretch for something. I mean it is just not in our culture to do that. So if we happen to have something that goes down one quarter, that is life.

Mike Mayo - *CLSA - Analyst*

And what if you are not pulling as much in the coach? What about eliminating a couple horses, to stretch the analogy?

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

We are trimming manes all the time.

Mike Mayo - *CLSA - Analyst*

But you are within range of your efficiency target. How quickly would you be able to take out the mortgage expenses if you see mortgage slowing? Is that one quarter, is it five quarters?

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

That is a very fair question. We have become I think really, really good at how to deal with -- how to make what would traditionally have been more permanent expenses variable in that business.

So we do -- we have lots of skill in that area. But it can't happen in one week, I mean. But we are always looking for improvements in how to become much more variable in expenses that used to be more fixed.

Mike Mayo - *CLSA - Analyst*

All right, thank you.

Operator

Greg Ketron, UBS.

Greg Ketron - *UBS - Analyst*

Good morning. Thanks for taking my questions. One on the mortgage production outlook, at least as best as you can tell at this point. When you think about the sources -- I know HARP 2.0 you had mentioned it's 15% to 16% of production; then there is also the other refi volume.

As you look at those opportunities going forward, is there a percent of eligible refinance that you feel like you have worked through and there is a percent remaining that we will see over the next couple of quarters?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

We talk about that all the time. We talk to our mortgage folks about that all the time. But that is a really, really hard number to come up with, with any specificity.

So I wouldn't want to throw out something and then you guys take our market share of that and then assume we are going to get over the next few quarters. I hope we do; but I am not confident enough on that.

Greg Ketron - *UBS - Analyst*

Okay. Is there a sense though, with this refi opportunity between HARP 2.0 and the sensitivity around the rate changes, where there could be additional refinancing? That the cycle has at least a couple of quarters' legs left in it, and we should see production levels stay relatively strong?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Well, I hope that is the case. And given that we start this quarter with a pretty strong pipeline, we think that will be the case for the near term.

I do think that one of the differences about this refinancing cycle, which I think is where you're going and it is right on point, is that because of some of these other programs it is going to create a little bit more of a foundation in terms of demand for a longer period of time.

Greg Ketron - *UBS - Analyst*

Okay, great. Then on share repurchases, with the 53 million done and 11 million forward, is there any view that you can provide in terms of additional share repurchase activity for the rest of this year?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Yes; fair question. I want to point out that we were not able to purchase shares in the first quarter of this year, just like we weren't able in the first quarter of last year, just because of the timing of the CCAR process. So when you look at our share repurchase that we did in the second quarter, I wouldn't necessarily multiply that by 2 to get what we are going to do in the third and the fourth quarter.

But we are going to continue to repurchase shares. We have got the ability to do it. We continue to believe our shares are undervalued, and we are going to continue to be in the market.

Greg Ketron - *UBS - Analyst*

Okay. Then last question; was there any valuation adjustment that was significant in the quarter?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

No.

Greg Ketron - *UBS - Analyst*

Okay. Thank you.

Operator

Fred Cannon, KBW.

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

Thanks. I appreciate it, and just really one follow-up question on the -- Tim, your comment concerning the securities yields. You mentioned that the reason for the security yield increase was on the -- was because of a prepayment on agency securities. But it was in the non-agency securities on the mortgage-backeds that we saw the linked-quarter increase in the yield. And I was wondering what might be going on there.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Well, it is a function of -- you are talking about the line item that says securities of US states and political subdivisions? Is that the one?

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

No, under mortgage-backed securities you have got the line item Federal Agencies; and then you have got Residential and Commercial, which I am assuming is non-agency MBS. That is the line item where you saw the yield increase.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Yes, I would just describe that as just more of a mix in terms of individual securities. There is nothing special that is going on there.

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

But over time that 6.97% yield, we should expect that to decline if you are taking less risk. Is that fair?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Oh, I think, Fred, as we've talked about I think where we have the biggest impact in terms of yields is in our AFS book. It is under pressure, and that is one of the drivers of our concern about the NIM.

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

Right. It was just that I think we had a linked-quarter increase of 17 basis points there. But so that is just more of a one-quarter blip we should think of rather than a trend?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

I wish I could tell you that is going to continue, but I don't think that is going to be the case.

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

One other question on the mortgage business. In the DOJ announcement yesterday, it said that you would discontinue funding mortgages at originated price and sold by independent mortgage brokers through your wholesale channel. I was wondering how much of the wholesale channel that is, that you are shutting that down, and any reasons behind that.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Well, in terms of the percentage it was about 5% of our originations.

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

And you are shutting down that entire 5%?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

That's correct. We are going to take applications through today; and then there is a time period by which we need to get that information and they need to close by.

But that is correct. We are exiting that portion of the business.

Fred Cannon - *Keefe, Bruyette & Woods - Analyst*

Okay, great. Thanks so much.

Operator

Moshe Orenbuch, Credit Suisse.

Moshe Orenbuch - *Credit Suisse - Analyst*

Thanks a lot. Following up actually on the mortgage business, you are shutting the wholesale channel, what you said about 5%. At the Investor Day you talked a little bit about having picked up a little market share in correspondent, but wondering whether you were going to keep it there.

Can you talk a little bit about what your thoughts are, if they have changed any? And also whether the industry as a whole has been quick or slow to add capacity, and whether you think that is good for pricing going forward.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

I think in terms of our view on the correspondent business it really hasn't changed. We think it is a good business. As we mentioned on Investor Day, I think Mike Heid did a really good job of walking through the opportunities that we have had over the past year in particular, in terms of adding correspondence.

And we have been very careful to make sure that we add the right correspondence. We have long, strong relationships with a number of correspondents; and again we like the business.

In terms of adding staff to be able to process the volume we have had, I mean, these have been unprecedented times in terms of how quickly volume has changed. We have been adding folks to be able to underwrite and process these as quickly as we can, and we will continue to do that.

But at the same time when volume start to decline, we need to be ready to reduce, too. But there is nothing different going on here. You just need to make sure that you have got sustained volume before you add a lot of people.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

Just maybe, just so we are all on the same wavelength here. The wholesale that we are shutting down is different from correspondent. Correspondent is where -- you know that today. Where they close on -- this is where the loan is priced and originated but we close it; and that is the part the wholesale piece that we couldn't be sure (multiple speakers)

Moshe Orenbuch - *Credit Suisse - Analyst*

It's a risk management decision.

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

That's correct.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

Exactly. So it's completely different things.

Moshe Orenbuch - *Credit Suisse - Analyst*

Okay, but it just feels like the industry has been a little slower to add costs and capacity this cycle. Would you agree with that?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

No, I wouldn't say that at all. I mean I think it's -- yes.

Moshe Orenbuch - *Credit Suisse - Analyst*

Okay. Thank you.

Operator

Ed Najarian, ISI Group.

Ed Najarian - *ISI Capital - Analyst*

Good morning, guys. Just two quick questions just to help us with the forecasting outlook a little bit. When I am thinking about operating costs and I am looking at that $524 million of operating losses, I understand why it was high in each of the last two quarters. But is there any particular reason that that should stay at this level? Or is it reasonable to expect that number to come down fairly significantly in subsequent quarters?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

I think one way to think about, Ed, is if you look back on how that has gone up and down over the last year, for example. You have seen quarters where it has been $200 million, $300 million lower.

We are hoping that those operating losses will go down as we continue to put any sort of particularly legal, open legal issue behind us. So I hope that is the case.

Ed Najarian - *ISI Capital - Analyst*

But the vast, vast majority of that number is litigation accrual, correct?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

A good portion of it is. But we are generally not specific in terms of exactly how much of it is related to litigation accruals.

Ed Najarian - *ISI Capital - Analyst*

Okay. Then secondarily when I am thinking about net interest margin, and you talked about the extra 7 basis points primarily from the extra PCI loan resolution income, it seems like you are alluding to the idea that you could get additional margin pressure off of a 3.84% starting point, as opposed to a 3.91% starting point.

First question, I guess is -- is that the right way to think about it? And second question is -- as you look at the PCI portfolio, should we think it is reasonably likely to expect future quarters where we see some meaningful resolution income?

Tim Sloan - *Wells Fargo & Company - Senior EVP, CFO*

Well, in answer to your last question we are hopeful that we get meaningful resolution income every quarter. But -- and there is still more to get, right? We are not done with the PCI loan portfolio.

Having said that, you hit the nail on the head. That is why we called out the 7 basis points. Without that we would have been in the mid-3.80%s. And we know where yields are today on securities in particular.

But again I think you got to put it in the context of the fact that the majority of our earning assets -- 70%, 75%-plus -- are loans, and the yields are within a reasonable range. Where we are having the biggest -- we have the biggest impact is on our securities portfolio.

But you are right. I think thinking about this in kind of a mid-3.80% number and having some downside from there is a fair way to look at it.

Ed Najarian - *ISI Capital - Analyst*

Okay, great. Very helpful. Thank you.

Operator

At this time there are no further questions.

John Stumpf - *Wells Fargo & Company - Chairman, President, CEO*

Okay. Well, thank you very much for joining us for our second-quarter call. We will talk to you 90 days from now. Thank you very much. Bye-bye.

Operator

Ladies and gentlemen, this does conclude today's conference. Thank you all for participating and you may now disconnect.