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WFC - Q2 2013 Wells Fargo Earnings Conference Call

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OVERVIEW:

WFC reported 2Q13 earnings of $5.5b and EPS of $0.98.

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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 - Director, IR*

Thank you, Regina. Good morning, everyone. Thank you for joining our call today during which our Chairman and CEO, John Stumpf, and CFO, Tim Sloan, will discuss 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 at WellsFargo.com. 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 supplements. Information about any non-GAAP financial measures referenced, including the 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 our website.

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 thanks, everyone, for joining us today. Wells Fargo had a terrific quarter and has now generated 14 consecutive quarters of earnings per share growth with record earnings in the second quarter. This consistent, strong performance during a dynamic economic and interest rate environment again demonstrates the benefit of our diversified business model.

We are not dependent on any one business to generate growth. We have over 90 businesses that are all focused on just one thing -- meeting our customers' financial needs. Our results this quarter demonstrate the momentum we have throughout all of our businesses.

Our strong performance is broad-based. Compared to a year ago, we earned a record $5.5 billion, up 19%, and grew earnings per share 20%. We grew pretax pre-provision profit by 3%. We reduced our expenses and improved our efficiency ratio by 90 basis points to 57.3%. Our core loan portfolio grew by $42.3 billion, up 6%.

Our credit performance was outstanding, benefiting from our conservative underwriting and improving economic conditions, especially in housing, with net charge-offs down to 58 basis points and our total net charge-offs down 48% from just a year ago. Our strong deposit franchise, which becomes even more valuable in a rising rate environment, continued to grow with total deposits up 10% from a year ago while we reduced total deposit costs by 5 basis points to 14 basis points.

We achieved record retail cross-sell of 6.14 products per household. Wholesale banking grew their cross-sell to 6.9 products and Wells brokerage retirement cross-sell increased to over 10 products, 10.35 to be exact.

We grew return on assets by 14 basis points to 1.55% and return equity increased by 116 basis points to 14.02%. Our capital levels continued to grow with our estimated Tier 1 common equity ratio under Basel III increasing to 8.54%, and based on our initial review of the leverage ratio proposal issued this week, we believe our current leverage levels would exceed the well-capitalized requirements at both the bank and the holding company.

Our strong earnings growth has enabled us to grow our capital levels while returning more capital to our shareholders. In the second quarter we increased our dividends to $0.30 a share, up 36% from a year ago, and we continued to buy back stock.

Before turning the call over to Tim, let me conclude with some comments about my views on how the current economic and rate environment impacts Wells Fargo. We continue to be optimistic about the improvements we are seeing throughout the economy. While commercial loan demand is still modest, jobs are being created, consumer confidence is increasing, and the housing market continued to demonstrate strong momentum.

In fact, in the second quarter, the housing market improvement was stronger and more broad based than it had been since before 2008. Sales were up and residential property prices increased by 13% across the country, yet affordability still remains attractive, even with the increased prices and higher interest rates. The strength in the housing market was a positive catalyst to our results in the second quarter in a number of ways including higher originations for home purchases, lower environmental costs, reduced purchase reserves, and improved credit quality.

Assuming the housing market remains strong, and we currently believe it will, our overall results should continue to reflect these benefits.

While the economy continues its slow but steady improvement, the current rate environment is obviously very different than it was just nine days ago when we last announced our earnings. We knew rates would eventually rise and we have been planning for a rising rate environment for some time. The benefit of our diversified business model is that it provides opportunities to generate earnings growth over a variety of rate environments.

Some of our businesses naturally do better in a lower rate environment and others benefit from rising rates. Tim will highlight the growth we have achieved across a number of our businesses on our call today.

We do not manage Wells Fargo based on a specific rate environment. We manage Wells Fargo, as we have for decades, to satisfy our customers' financial needs. Rates rising for the right reason, an improving economy, is beneficial for our customers, which then in turn benefits Wells Fargo.

Tim will now provide more details on our second-quarter results. Tim?

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

Thanks, John, and good morning, everyone. My comments will follow the presentation included in the first half of our quarterly supplement starting on page two. John and I will then take your questions.

As John mentioned, Wells Fargo had another outstanding quarter with record earnings of $5.5 billion, up 19% from a year ago and up 7% from the first quarter. Earnings per share grew to $0.98, up 20% from last year and up 7% from the first quarter. We have now achieved 14 consecutive quarters of EPS growth and nine consecutive quarters of record earnings per share.

As John just mentioned, the rate environment this quarter looked very different from last quarter. In fact, the economic housing and rate environment has differed significantly over the past 14 quarters of our earnings growth. While the drivers of our growth have varied, our consistent risk discipline and diversified business model have remained the same.

Our results this quarter compared to the first quarter clearly show the advantage of our diversity with our bottom-line results benefiting from strong broad based trends including net interest income growth as we grew loans and investment in securities, fee growth across a variety of our businesses, reduced expenses generating positive operating leverage, and improved credit and capital levels. As you can see on page three, our year-over-year results were also strong with growth in pretax pre-provision profit, net income, EPS, both total and core loans, core deposits, ROA, and ROE.

Our revenue diversification is highlighted on slide four; a 50/50 split between spread revenue and fee revenue from our diversified businesses and cross-sell activities. Trust and investment fees were once again our largest fee category and it has been for the past five quarters. We achieved positive momentum across many of our businesses, which I will highlight throughout the call.

Let me start by highlighting some of the key drivers of our second-quarter results from a balance sheet and income statement perspective. On page five you can see we had good balance sheet growth this quarter growing loans, deposits, and securities. I will provide more detail on the securities we purchased later on the call. The decline in our provision expense this quarter reflected improvement in home prices and our overall credit performance.

Turning to the income statement on page six, mortgage revenue was stable in the quarter and revenue growth was driven by stronger trusts and investment fees and higher net interest income. Our expenses declined, as we expected, primarily reflecting seasonally lower employee benefit costs. Let me now cover our business drivers in more detail.

As shown on page seven, we continue to have solid loan growth with period-end loans up $26.8 billion, or 3%, from a year ago and up $2 billion from the first quarter. Loans grew even after the continued run-off of our liquidated portfolio. This portfolio has declined by over 50% since 2008 and the headwinds to overall loan growth caused by this run-off has continued to slow.

In the second quarter, the liquidating portfolio declined $15.5 billion from a year ago and $3.2 billion from the first quarter. Excluding these liquidating loans, our core loan portfolio grew by $42.3 billion, or 6%, from a year ago and was up $5.2 billion from the first quarter.

Commercial loans grew $1.8 billion in the quarter with broad-based growth in C&I and foreign loans. Consumer loans grew $250 million with growth in nonperforming first mortgage loans, auto, and credit card, partially offset by the expected run-off from the liquidating and core home equity portfolios.

Deposit growth remains strong with period-end deposits up $10.9 billion from the first quarter. Average deposits were up $23.6 billion from the first quarter and up $85.8 billion, or 9%, from a year ago. Average core checking and savings deposits were up 8% from a year ago.

We grew our primary consumer checking customers by a net 3.5% from a year ago, up 2.1% from last quarter. These are active checking account customers who transact with Wells Fargo regularly. The growth we have achieved with these relationship-based customers demonstrate the strength of our deposit franchise and should generate future growth as we focus on remaining their primary bank and meeting more of their financial needs.

We continue to lower our deposit costs with average deposit costs of 14 basis points in the second quarter, down 1 basis point from the first quarter and down 5 basis points from a year ago. We've successfully grown deposits while reducing our deposit cost for 10 consecutive quarters.

As shown on page nine, we grew taxed equivalent net interest income by 3% from the first quarter. The growth in NII was driven by securities purchases, lower funding costs, loan growth, higher variable income, as well as the benefit from an extra day in the quarter.

Average earning assets grew $31.1 billion from the first quarter, reflecting increases in short-term investments, loans, and AFS securities. We purchased $21 billion of AFS securities during the second quarter, primarily agency MBS, and we purchased an additional $6 billion of securities in the first two weeks of the third quarter.

We remain disciplined during periods of lower rates and we were prepared to deploy liquidity as rates rose. We benefited from this disciplined approach in the second quarter by investing in higher yielding securities.

While higher rates driven by an improving economy will be positive to our results over the long-term, including higher-yielding earning asset growth and improving credit quality, there are also some short-term effects such as lower mortgage refi volume and reduced OCI that I will highlight throughout the call. Higher rates impact our businesses in different ways and at different times, which reinforces the benefit of our diversified model.

Our net interest margin declined by 2 basis points from the first quarter to 3.46%. This decline was driven by three primary factors. First, our continued deposit growth caused cash and short-term investments to increase, reducing the margin by 6 basis points.

As I have highlighted in the past, our deposit growth has little impact on net interest income but it is dilutive to the net interest margin. Offsetting this declined by 2 basis points was higher variable income, including higher PCI loan resolutions and periodic dividends. This variable income is obviously lumpy and it can increase or decrease in any quarter.

Finally, the net impact of repricing and balance sheet growth improved the margin by 2 basis points, largely due to the benefit of the growth in the AFS portfolio and reduced funding costs. While margin was relatively stable this quarter, it is still reasonable to expect continued net interest margin pressure.

Despite a decline in total fee income in the quarter, many of our businesses demonstrated strong momentum, including deposit service charges up $34 million from the first quarter, benefiting from seasonality and account growth; trust and investment fees up $292 million on strong investment banking fees and higher retail brokerage asset-based fees; card fees grew $75 million on credit and debit card account growth and higher purchase volume; commercial real estate brokerage commissions grew $28 million with strong activity from both private and public deals.

Overall, noninterest income was down slightly from the first quarter on lower gains from deferred compensation plan investment income, which is P&L-neutral, weaker customer accommodation trading, and lower fees including a lower gain on sale of the PCI loans.

Our mortgage business continued to generate strong results in the second quarter with revenue up modestly from the first quarter, as highlight on page 11. Mortgage originations were $112 billion, our seventh consecutive quarter of more than $100 billion in originations, reflecting the benefit of the housing market improvement and low interest rates.

As rates rose late in the quarter, applications for home purchases remained strong but refi application volumes declined as expected. We still had a relatively large unclosed pipeline at the end of the quarter, but refi volume is obviously very sensitive to rates. Refis were 56% of originations in the second quarter, down from 69% in the first quarter.

We've managed through many refi cycles in the past and we will adjust the size of our business based on production volumes through this cycle.

Gain on sale margins declined from 2.21%, and with the increase in mortgage rates, we would expect further declines in our margins and origination fees.

Expenses declined from seasonally high first-quarter levels as shown on page 12. This decline was driven by a 4% reduction in personnel expenses reflecting lower employee benefit expenses due to the first quarter seasonally high payroll taxes and 401(k) matching. These declines were partially offset by higher salaries reflecting annual merit increases and higher revenue-based incentive compensation expense from strong results in capital markets, WBR, and mortgage.

We also had increases in other expense categories, primarily driven by our continued investment in our business to drive future growth, including project spending for product improvement and system enhancements, higher advertising and promotion expense driven by seasonality and a new campaign launched in the second quarter.

Operating losses increased $131 million in the second quarter, primarily from litigation accruals related to various legal matters. And we also experienced increased costs associated with regulatory and compliance requirements.

Our focus on reducing expenses while investing in our businesses to generate revenue growth is reflected in our efficiency ratio declining to 57.3% in the second quarter. We expect our efficiency ratio to remain within our target range of 55% to 59%.

As John mentioned at the start of the call, the recovery in the housing market is driving significant improvement in a number of areas, including some of our environmentally-elevated costs. As highlighted on page 13, in the second quarter most of these costs were significantly below what they had been over the past few years. We had a nominal amount of costs associated with the independent foreclosure review this quarter from customer call volumes following the distribution of remediation checks.

The improvement in real estate values helped reduce foreclosed asset expenses by $49 million compared to the first quarter and by $143 million from a year ago. Mortgage revenue this quarter was reduced by $25 million for additions to our repurchase reserve not related to current originations, which is the lowest build we have had since prior to 2008. Outstanding repurchase demands were relatively stable compared with the first quarter and new demands emerged consistent with our expectations.

However, not all elevated costs are behind us. Mortgage revenue is reduced by $82 million to reflect higher servicing and foreclosure costs as foreclosure timelines continue to extend, especially in judicial foreclosure states.

Turning to our segment results starting on page 14, Community Banking earned $3.2 billion in the second quarter, up 28% from a year ago and up 11% from the first quarter. Retail banking achieved a record cross-sell of 6.14 products per household, up from 6 products a year ago. To support sales and household growth, we grew platform banker FTE by approximately 1,900 from a year ago.

Our credit card business continued to have strong account growth with a record 594,000 new accounts in the second quarter, up 16% from a year ago. Our household penetration increased to 35%, up from 31% a year ago. Credit card balances were up 3% from the first quarter and up 9% from a year ago due to strong transaction volume and account growth.

We also had momentum in our auto business with record originations in the second quarter of $7.1 billion, up 4% from the first quarter and up 9% from a year ago. Our continued focus on serving our small business customers generated a 2.7% growth in business checking accounts from a year ago. And we extended $9.3 billion of new loan commitments to small business customers during the first half of the year, up 25% from a year ago.

Wholesale Banking earned $2 billion in the second quarter, up 7% from a year ago and down $41 million in the first quarter. Wholesale Banking generated record revenue of $6.1 billion.

Investment banking fee growth was strong, driven by higher equity underwriting, credit originations, and loan syndication fees. Investment banking results included a 34% increasing in year-to-date revenue from commercial and corporate customers. This relationship focus also benefited treasury management as revenue grew 12% from a year ago, benefiting from better penetration of our existing customers.

Wholesale Banking's cross-sell reached 6.9 products per relationship, up from 6.8 a year ago. Wholesale Banking results continued to benefit from steady loan growth with loans having grown for 11 consecutive quarters. Average loans increased 6% from a year ago with growth in nearly all portfolios, including asset-backed finance, capital finance, commercial banking, commercial real estate, corporate banking, and government and institutional banking. Credit quality remains strong with net recoveries in the second quarter reflecting the improvement in our economy and our risk and underwriting discipline.

Wealth, Brokerage, and Retirement earned a record $434 million, up 27% from a year ago and up 29% from the first quarter, reflecting the success of our core business strategy of growing asset-based relationships and the benefit from the improvement in the markets. Revenue grew 10% from a year ago, reflecting strong growth in asset-based fees and higher brokerage transaction revenue.

Retail brokerage managed account assets reached a record $331 billion, up 19% from a year ago, driven by strong net flows and market performance. WBR had strong loan growth with average loans up 4% from the first quarter, driven by nonconforming mortgages. WBR continue to effectively partner with retail banking to meet the financial needs of our customers, increasing the cross-sell to 10.3 products per household.

Assets referred from Community Banking to WBR grew over 25% from a year ago based on first-quarter results. This partnership is a great example of how our businesses work together to meet the financial needs of our customers.

Turning to credit quality on page 17, we have continued improvement across our commercial and consumer portfolios. Second-quarter net charge-offs declined to 58 basis points of average loans. Losses in our commercial portfolio were only $44 million, or 5 basis points of average loans. Consumer losses declined to 101 basis points.

We have had especially strong improvement in our commercial and residential real estate portfolios. These portfolios are now providing a tailwind for our credit performance compared to the headwind they provided when the real estate market was weaker. Reflecting these improvements, our provision expense declined $567 million from the first quarter and included a $500 million reserve releases compared with the release of $200 million in the first quarter and $400 million from a year ago.

We continue to expect future reserve releases absent a significant deterioration in the economic environment, and while we don't know what our release will be in the third quarter, the favorable conditions that drove this release this quarter have not dissipated.

The recovery in the housing market also benefited our expected losses in the PCI portfolio. This quarter the accretable yield balance increased by a net $2.1 billion, which included a $1.6 billion increase in expected cash flows and an $876 million reclassification, primarily from our pick-or-pay portfolio. This request did not impact second-quarter results, but will be accreted into income over the remaining life of these loans.

In addition to lower charge-offs and provision expense, nonperforming assets also improved with NPAs down $1.8 billion from the first quarter and down $3.8 billion, or 15%, from a year ago. Loans 90 days or more past due decreased $206 million from the first quarter and were down 15% from a year ago with improvement in both commercial and consumer loans. Early-stage consumer loan delinquency balances and rates also declined from the first quarter and from a year ago.

Earnings are the primary driver of capital growth for Wells Fargo. As shown on page 19, our Tier 1 common equity ratio grew to 10.73%, up 34 basis points from the last quarter. Our estimated Tier 1 common equity ratio under Basel III, which reflects our interpretation of the Basel III capital rules adopted July 2, increased to 8.54% in the second quarter.

OCI negatively impacted the ratio by 24 basis points in the quarter due to the increase in interest rates. Because of our strong earnings growth, we grew capital even with the impact from the increase in rates. We expect reductions to unrealized securities gains when rates rise and this is one reason why, as we discussed over a year ago, we are targeting a capital buffer of approximately 100 basis points.

Just this week, as John mentioned, US regulatory agencies issued a supplemental leverage ratio proposal. Based on our initial review, we believe our current levels -- leverage levels will exceed the well-capitalized requirements in both the bank and the holding company.

We increased our second-quarter dividend to $0.30 per share, or 20% increase over the first quarter dividend, and purchased 26.7 million shares in the second quarter and executed a $500 million forward contract that is expected to settle in the third quarter for approximately 13 million shares. Including the shares under the forward contract, our share count would have been relatively flat for the quarter, offsetting 40 million shares issued during the quarter, primarily related to profit sharing and match contributions to the 401(k) plans and team members exercising option.

We have many opportunities to generate growth at Wells Fargo. On slide 20, we summarized the demonstrated momentum we have throughout our businesses that I have highlighted on the call. In each of our businesses we have opportunities for growth, reflecting the expanding needs of our customers. This customer, account, and balance growth, along with increased cross-sell, will help drive our future results and reflects the benefit of our diversified model.

In summary, we had a very good quarter with strong broad-based improvement and demonstrated momentum across many of our businesses. This included growth in loans, deposits, net interest income, and fee growth across many of our businesses. We reduced expenses and benefited from a continued improvement in credit quality that reflected our conservative underwriting and the strengthening economy, especially the rebound in housing.

Our ROA and ROE continue to grow and we grew capital levels while returning more capital to shareholders. We will now open up the call for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) John McDonald, Sanford Bernstein.

John McDonald - *Sanford Bernstein - Analyst*

Good morning. Tim, question on liquidity. Could you tell us where you are on the liquidity coverage ratio relative to your understanding of what will be required of you in the new regulatory rules?

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

John, it's a good question. One of the challenges is that the rules haven't been finalized, and similar to the Basel III capital rules, from the point at which they were originally proposed to where they were finalized there was a fair amount of discussion and change. I would tell you that we have adequate capital to operate Wells Fargo.

Having said that, we are going to continue to work with regulators in terms of those interpretations. There may be some incremental amount of liquidity that we need to raise, but it's certainly something that we are focused on because liquidity risk is a key risk for the Company. But given the over $1 trillion of deposits we have and given the experience we have in terms of operating in different environments, again we think we've got adequate liquidity. We may need to raise a little bit more, but it should be material for the Company.

John McDonald - *Sanford Bernstein - Analyst*

Okay, so it's a factor. And as you think about the pace at which you deploy your cash -- you mentioned buying some securities here today -- is that a factor in how you think about deploying your liquidity?

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

No, it's not a big factor at all, John. Again, to me it's much more important to think about the liquidity needs for operating the business as it relates to how much we want to invest in securities, because the first call for any of our liquidity has always got to be to our customers in terms of loan demand. But it's not a primary driver in terms of the pace of activity. The primary driver in terms of the pace of our investment activity has been that over the last year we have been in this very low-rate environment.

Turn the clock back a year ago; we had a lot of excess liquidity. There was a lot of concern that we were going to be low rates for awhile and there was this view that we weren't investing fast enough. We wanted to stay disciplined, that was the primary driver. Just like today one of the primary drivers for why we are investing more in our securities portfolio is because we think, given the rate backup, that returns are much more attractive.

John McDonald - *Sanford Bernstein - Analyst*

Yes, we did see a benefit there in the degree of net interest margin compression, but you still have an expectation for some continued margin compression. What are the drivers there, Tim? Then in terms of NII dollars, do you still expect to grow the NII dollars from the current level?

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

So on the net interest margin I don't think the drivers have really changed that much. As you recall, if you look at our net interest margin decline, which we have had one over the last 14 quarters, the primary driver for the decline has been the fact that we have been growing deposits, which long-term (technical difficulty) for the Company.

Within a quarter we can have some variability based upon the variable income, which was positive this quarter but last quarter it was negative. The balance sheet continues to reprice a bit. So the factors really haven't changed because we haven't gotten to a point that the balance sheet has completely repriced.

So we could continue to see some continued compression in the net interest margin. The underlying factors really haven't changed.

In terms of net interest income, our goal is to grow net interest income over time. What happens on a quarter-by-quarter basis I just don't know for sure because there are a lot of factors. We had a lot of positive factors that drove our net interest income this quarter, which I think was absolutely terrific.

Again, I don't know if that means we are going to grow net interest income in the third quarter, but over time I believe that we can grow net interest income. And this quarter I think we've demonstrated our ability to do that.

John McDonald - *Sanford Bernstein - Analyst*

Okay. And switching gears over to the mortgage revenues, did the gain-on-sale margin of the 2.21% you mentioned hold up better than expected? What were the factors there? Is there any framing you can do for us of how much pressure that margin could experience as you move through the next couple quarters?

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

John, I think that's a very fair observation and, candidly, I think the mortgage gain-on-sale margin has held up better, not just for the last quarter but for the last year, than I think anybody in the business or in the industry would have expected. That said, it has come down and it came down over 30 basis points in the quarter. Our best guess is that we are seeing pressure in the gain-on-sale margin and the gain-on-sale margin is going to decline.

Recall that last quarter we framed the gain-on-sale margin variability over the last few years at a -- if you annualize it, at the low end was 1.60% and the high end, again on annualized basis, was to 2.20%. We have been at the high end. We think we are going to start to move down from there.

So I think there is going to be pressure. I do not believe you are going to see a 2.21% gain on sale margin. I think it's more likely to be lower.

But, again, it's really a function of the competitive environment, which we think has been very rational as we have gone through this cycle, as well as the rate environment. Recall that our best guess in the second quarter was that origination was going to be a little bit lower than the first quarter, but in fact originations were up in the second quarter because rates stay low for a longer period of time. Rates are now up and that's going to affect originations for sure.

So there's a lot of variability, but to put it very bluntly, we think that the gain-on-sale margin is going to decline and it will decline somewhere in the range of what we've seen over the last few years. But it is going to decline.

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

John, as you know, and Tim is absolutely right, it will decline and margins will be under some pressure, but we have this wonderfully balanced business within the business. In other words, when rates increase -- if refis drop, margins come in because there's more competition. But then you have a servicing portfolio, and that does better.

So there's balance within this business, not only -- and there's also, of course, balance in the broad distribution and diversity within the Company. So some businesses do better, some do not as well when rates rise.

John McDonald - *Sanford Bernstein - Analyst*

Okay. Thanks, John. Tim, one follow-up on that. Could you remind us of the mechanics by which the higher servicing income can work its way through the income statement?

It didn't seem like we saw any of that start this quarter with the big move in the 10-year. What will trigger the kind of offsetting balance on the servicing side where the income there we will see that start to rise?

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

John points out over time I think that there is some balance in the business on the revenue side, because of the fact that servicing income tends to be a little bit less volatile. We should see some benefit in terms of servicing income increasing as the housing industry continues to improve.

As we pointed out, we did reduce the value of this servicing for some elongation of some foreclosure timeline. Over time that will dissipate and then we will continue to get the carry and the underlying servicing income.

Our hedge ratio is pretty high, so it's not like we are betting the farm on or the stagecoach on an increase in rates in the servicing portfolio. We will see some benefit there, but I think it's also really important to remember that there will also be some expense trade-offs in the mortgage business itself. If it turns out that originations are down, then it's -- immediately in the quarter you get a benefit from the revenue-based compensation, the commissions coming down.

And then, to the extent that that volume continues, then you also make adjustments that tend to be on a lag basis, on a quarterly basis in terms of some of your other expenses.

John McDonald - *Sanford Bernstein - Analyst*

Are you starting to make those adjustments based on what you are seeing in the pipeline and the outlook given rates?

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

John, we are making adjustments all the time. The fact of the matter is we entered the quarter with actually a pretty strong pipeline of $63 billion, which was only down 10%, 15% from the end of the quarter. But there's no question that, to the extent that we continue to see a decline in the pipeline, that we will make adjustments. And so you can assume that we will begin to make some of those adjustments this quarter.

John McDonald - *Sanford Bernstein - Analyst*

Got it. Okay, thanks.

Operator

Erika Penala, Bank of America.

Erika Penala - *BofA Merrill Lynch - Analyst*

Good morning. My first question is a follow-up to John's last. We heard another mega-bank today say that if loan rates stay where they are that the mortgage market could shrink 30% or 40% in the second half of the year. Do you agree with that statement for your company, given what you are seeing in purchase trends?

Additionally, could you quantify, if that number is correct, how much of the expenses can come up proportionate to that 30% to 40% decline?

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

It's a fair question. I don't think anybody really knows what the volumes in the mortgage business are going to be. I think one of the challenges for anybody in making that estimate today is that the complexion of originations is really changing.

When you look at the percentage of refi volume versus purchased money volume that we had in the first quarter of this year, for example, it was about one-third purchase money and about two-thirds refi volume. As the housing industry continues to improve, and as we went into the spring selling season, you saw that mix shift and so it was more like 55%/44% or 45% or whatever. And what that means is that a larger portion of your originations are coming from the purchase portion of the business.

So I think it is a fact that refinance volume is certainly very much impacted by rates, but also we have seen now rates at the long end start to come down 10 basis points just in the last few days. And so we don't think -- we don't know for sure where volume is going to be. We believe it's going to be lower in this quarter.

One of the things that we've learned in the mortgage business is it's probably not a good thing to think six months out or nine months out, because there could be so much variability. We think volume is going to be down, but whether it's going to be 30% or 40% I just don't know.

As it relates to expenses, again, the timeline generally is that the revenue-based compensation declines immediately and then, to the extent that you have continued origination reduction, then you start to reduce some of your expenses. That tends to occur on a lag-quarter basis, but at the end of the day we still believe that we can continue to have good margins in the business and to keep the efficiency ratio about where it is.

Because also, remember that one of the important things that's going on in the business is you've got an improvement in the underlying housing industry so that your environmental-related costs, hopefully, will come down, including foreclosures, at the same time.

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

Erika, one other thing that I know that we should not forget, not only have we been through this many times but we have 6,200 stores, 30,000 or 40,000 personal bankers that refer business in. So when rates rise and it's more of a purchase money business, we have all folks on deck helping serve customers.

And we still have tons of our customers who are interested in buying homes and moving and so forth who are our customers but do their mortgage business other places. So we have still lots of opportunity to capture purchase money business, which is still not at the levels it was pre-crisis. So there's lots of activity going on there.

Surely, the refinance volume is going to come down significantly if rates continue to stay high, but as Tim mentioned, I don't know what rates will be. 90 days ago we wouldn't have talked about what we're talking about today. Things change very quickly in this business.

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

Erika, let me just reinforce again, as you think about the third quarter and you think about the volume that we've seen over the last couple of years, we've been very fortunate to see quarters in which volume has been above $100 billion. We just don't think that we are going to see $100 billion of mortgage volume, given the current rates today, in the third quarter.

Erika Penala - *BofA Merrill Lynch - Analyst*

Got it. Speaking of how Wells benefits as housing recovers, I know that you are frustrated by the obsession on your margin. But as I think about slide 26 in your deck, it seems like you have $876 million of reclassification to accretable yield and $1.6 billion of additional expected cash flows that could be helpful to your margin over time.

Should we think of the pick-a-pay portfolio similar to how we think about reserve relief for the entire company in that, as housing gets better, you could release some of the marks into net interest income, which would benefit or alleviate some of the concerns on margin?

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

There's no question that the key drivers for the improvement in the or the reclassification for housing prices as well as the underlying credit performance within that portfolio. And those are very similar to the drivers for the improvement that we've seen in our first mortgage portfolio and our home equity portfolios.

In terms of the impact, I would love to tell you that when you request the $876 million we get an immediate impact. That's not the way it works. It's occurs over the life of the loan.

There will be some positive impact, and you have seen that. And I'm hopeful, if the current trends continue, that this isn't the last time that we see a reclassification. I can't promise you that's going to be the case, but it will provide some positive benefit over time. But, again, we've got make sure that we put it in the right context because our best estimate is the weighted life of that portfolio is still about 14 years.

Erika Penala - *BofA Merrill Lynch - Analyst*

Okay, got it. Just if I could sneak one more in, just a clarification follow-up to John's question on the LCR.

Cash balances keep growing but in other calls you've mentioned that you have something like $50 billion of excess cash. Is that true still, relative to how we should think about Basel III LCR compliance? And I guess if the main message is potentially the cash balance will continue to build from here?

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

I think that the challenge we all have, including where we are in terms of the liquidity coverage ratio, is the rules haven't been finalized. If you would tell me what the final rules are, then I can tell you whether or not we have too much or not enough or the right or whatever.

What I do know is that we believe that we have additional ability based on how we are running Wells Fargo, based on our interpretations of LCR to invest some of our liquidity in securities. But, more importantly, we have it ready for our customers when they want to borrow money.

That doesn't mean that we may not raise liquidity if -- when some of the rules are finalized. But we don't believe -- and we believe that that is impossible to do without a significant impact or a material impact in terms of running the Company. But, again, I think it would be premature to conclude what the final rules look like because they haven't been finalized.

Erika Penala - *BofA Merrill Lynch - Analyst*

Okay. Thanks for taking my questions.

Operator

Matt O'Connor, Deutsche Bank.

Matt O'Connor - *Deutsche Bank - Analyst*

Good morning. Hopefully, just a couple of quick ones here.

You mentioned the trust investment fees. Good strength in both the brokerage and investment banking, which of course you now split out. On the broker side, is that just the higher market levels or are you seeing some inflows there as well? I did notice the deposits in that segment were down a couple of billion, so I'm just wondering if there's some flows coming into the brokerage area.

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

I think it's all of the above, Matt. There's no question that we have been benefited, as everybody in the industry has been benefited, by the improving markets -- the improving equity markets and the fact that retail investors want to be part of that business.

We did see some movement from deposits to investing in the market. We think that's a good thing. We've been waiting for that for a while, but we also grew our customer levels too.

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

Matt, the other thing, is this is a big emphasis for the Company. David Carroll and his great team are working with Carrie Toldstedt and her team and Dave Hoyt and within the Company -- this is that One Wells Fargo working together. So not only the markets help us, we are also putting a big emphasis on this. I think this is a big growth opportunity for this company.

Matt O'Connor - *Deutsche Bank - Analyst*

Then, just separately, on the mortgage servicing rights, I know you've talked about potentially testing the waters to sell. And sorry if I missed it, but did you sell any this quarter and thoughts going forward in terms of potentially selling them? I would think they are worth a little bit more now that a few months ago.

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

We hope that's the case, Matt. I think that, as you know, we entered into a transaction to sell our -- a portion of our reverse mortgage portfolio in the first quarter. We didn't have any sales of MSRs this quarter, but we will continue to look at selling MSRs. We think that that's prudent risk management. The primary driver for doing that is not because we feel like there's pressure as it relates to capital, but I wouldn't be surprised if we move forward and executed a sale of MSRs this quarter or next.

Matt O'Connor - *Deutsche Bank - Analyst*

Okay, that's it for me. Thank you.

Operator

Scott Siefers, Sandler O'Neill.

Scott Siefers - *Sandler O'Neill - Analyst*

Good morning. John, I guess I was just hoping you could expand kind of generally on the comments you made in your prepped remarks early on about the housing market. I guess what I am thinking about is high rates impact affordability, but you certainly seem pretty optimistic about the prospects for the housing market and continued improvement. So what trends are you seeing generally? Particularly I guess most recently, just since you guys see so much of the mortgage and consequently the housing market, that makes you keep this sustained optimism?

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

Sure. So, first of all, I think I have mentioned before that we look at 400 or so MSAs, metropolitan statistical areas, and we have a unique and pretty grounded way of seeing real estate across the country. The view is it's better everywhere. It has been better everywhere for going on, in some cases, two years, surely in the past year.

And it has been stronger in some places than even probably we had expected. Some of the states that were hardest hit -- Nevada, Florida, Arizona, California -- are showing huge or very large price appreciation kinds of numbers.

Also, if you look at -- and, yes, rates have gone up. But, if you were in the mortgage market before 2000, you know that these are unbelievably good rates. My first mortgage was at 8.5%, my second one was at 11.5%, and I thought those were great rates at those times.

So affordability still is there. Household formation has continued to happen the last four or five years where people weren't buying, so there's a lot of pent-up demand.

The three important issues to a home purchase -- what you make, what the house costs, and what the financing costs -- one of those is still at close to 40-, 50-year record lows. Compared to rental, owning a home is -- makes economic sense. Sure, it depends on where you want to live and how long you want to live there and so forth. So there is just strength there and it improves customer confidence.

The thing I hear most about when I'm out in the marketplace is the lack of inventory. So we are expecting that prices will continue to improve, probably not at the level they have in the past, but housing sure has strength to it.

So I don't know what's going to happen to rates over time, but when housing improves it's good for Americans, it's good for confidence, which in turn is good for financial services industry and Wells Fargo.

Scott Siefers - *Sandler O'Neill - Analyst*

All right, I appreciate the color there. Then I guess, Tim, sort of along the same lines, your consumer credit improvement -- I guess we kind of knew it would improve, but I think the magnitude was probably a little better than I would have anticipated.

If we kind of just -- if we were to say stay at this sort of level of housing, is there a point where you'd need continued improvement to impact the sustainability of such strong consumer trends, or are we there yet? How are you thinking about that dynamic?

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

I think it's a fair question, Scott. The underlying trends and factors the John has alluded to are still improving and so it's hard to imagine improvement not continuing. Whether it continues to improve at the same rate, I don't know. I think we have continued to be surprised by how housing has positively impacted our results.

I think it's also important to remember that particularly when you think about the reserve release that there were some overriding factors that impacted the reserve release over the last few quarters, including the fact that we had the OCC guidance that impacted the third and fourth quarter of last year and also the potential for the impact from the damage of Hurricane Sandy that has been working its way through the system.

But again, I think the fundamentals for housing are strong. We have a large first-mortgage and second-mortgage portfolio that tends to be the portfolio where we have a disproportionate share of our losses, even though they improved -- the consumer losses improved to just a touch over 1% this quarter. So we are feeling pretty good about the improvement.

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

Scott, if I could just add one more thing, housing is uniquely different than any other consumer asset class. When housing improves, people feel better. I mean two-thirds of Americans or so own a home. When housing improves, it improves confidence. People spend more. The multiplier effect on buying washers and dryers and other consumer goods, it's just very special around housing. So when housing gets better, it really lifts all boats on the consumer side.

Scott Siefers - *Sandler O'Neill - Analyst*

Well, guys, I definitely appreciate the help. Thank you.

Operator

Ken Usdin, Jefferies.

Ken Usdin - *Jefferies & Company - Analyst*

Thanks. Good morning, guys. First question, Tim, that other income line that you talk about, the equity method and less PCI loan sales gains, that line was in $450 million to $500 million for last several years. Is there anything in particular that happened this quarter, and is there anything that would prevent it from kind of going back to that more normal run rate?

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

Good question. It's really not what happened; it's what didn't happen this quarter. The comparison to the first quarter and the primary drivers for the decline were we had an equity investment that we accounted for under the equity method, and as you know, when those appreciate in value, as opposed to the cost method, you have to go ahead and write off the value, which we did in the first quarter.

Just so you know, we actually sold that equity investment so we got the cash in the second quarter.

Then, secondarily, we had a $151 million gain which we had called out in the first quarter, from the sale of some PCI loans that -- again were in the first quarter that we just didn't have in the second quarter. So I think it's more of what was missing in the second quarter than what was -- what occurred. So I don't know what's going to happen in the third quarter, but I think if you look over a long period of time the income from that line item being as low as it has been is not typical.

Ken Usdin - *Jefferies & Company - Analyst*

Right, okay. Then, secondly, the share count again was up, and you guys have talked about that we might be getting towards the point where we finally start to see it reduce. And I'm just wondering are we at that point and what needs to happen just with the math to finally start getting the share count down.

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

Well, we were almost at that point this quarter. That's one of the reasons why I called out the fact that the timing of the settlement from structured sale, had that occurred in the second quarter and it's going to occur relatively early in the third quarter, we would have been about flat, notwithstanding the second quarter tends to be a quarter in which there's more share issuance as we called out. I don't know exactly what's going to happen, but my guess is that we are very close to the point at which we will start to see share reductions.

Ken Usdin - *Jefferies & Company - Analyst*

Okay. Then just on the mortgage business, the pipeline was down but you guys have mentioned last quarter that your closing times had gone down from 90 to 60. I'm just wondering just how much of a market share opportunity is this, because it doesn't sound like you've really cut capacity yet?

So could you just walk us through originations versus pipeline and how much more you're actually just pumping through the channel regardless of what's happening with the overall origination volumes in the marketplace?

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

Yes, one of the reasons why we haven't made a lot of changes in terms of underlying business is that the increase in the rates only happened a few weeks ago and we had a large pipeline that we were working through. As you saw, originations in the second quarter were a lot stronger than I think anyone would have imagined. So I think that's going to naturally begin to change, because even though $64 billion is a great place to start, it's -- or $63 billion, it's definitely less than $79 billion.

And so our guess is that volume and originations will be under the $100 billion mark and we will need to go ahead and make some adjustments. But, again, I think the competitive atmosphere is very fierce, but it's very rational.

Ken Usdin - *Jefferies & Company - Analyst*

My last question, Tim, just with regard to your favorite slide, you had big delta in provision this quarter and you're talking about the mortgage banking revenue now starting to turn from here. I know it's hard to say in any given quarter if you're going to actually be able to grow EPS in the quarter ahead, but can you just talk us through -- again, it's hard to see the provision move much more and we know that mortgage is kind of tailing. So what do you expect to be the biggest drivers, other than maybe the other income reverting back up, to kind of continue to get that net income moving the right way?

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

It's a very fair question given the potential decline in mortgage revenues, but, again, let's make sure we put that in perspective. Mortgage revenues are a little over 10% of our total revenues for the Company. That's number one.

Number two, when you look at the breadth of the growth in the Company in terms of net interest income growth, you saw loan growth. You saw us take advantage of the fact that given the rate backup we invested more in securities. We haven't invested this much in securities in a long time, not even when we saw the backup in the first quarter.

When you look at the noninterest or the fee revenues, really across the board we saw growth with the exception of some of those areas that were affected by the backup in rates. So there was a good story there. I don't necessarily think this is the end of the improvement in credit, because the factors continue to -- that are driving the improvement in credit haven't bottomed out. And then I think it's likely that we will continue to see some improvement in expenses.

So when you put it all together I don't think it's just one item. If it was, I'd tell you and you could decide whether or not it would make sense, but the good news for us, because of our diversified model, we don't have to rely upon one or two specific areas to be able to make up a decline in any business. We have seen declines in some of our businesses each quarter now for the last 14 quarters and we still have been able to grow. Whether or not we can do in the third quarter I can't promise you that, but I sure do like our chances to continue to grow earnings over time.

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

Tim is absolutely right on that. We are absolutely focused around here on growth, and it comes from our basic operating philosophy around helping customers succeed financially. And when you are in 90 different businesses, as Tim mentioned, not every quarter would be a complete offset to another one, but over time we believe we have the right business model, the right leaders, the right markets to continue to grow this company. And we sure like our chances on that.

Ken Usdin - *Jefferies & Company - Analyst*

Thank you very much, guys.

Operator

Paul Miller, FBR.

Paul Miller - *FBR & Co. - Analyst*

Thank you very much. How are you guys doing? Just one follow-up question on the MSRs; you talked about you could see some sales. Would these be material sales of MSRs? What level of MSRs would you like to hold?

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

We are very comfortable with the level of MSR that we have today. Having said that, from a risk management standpoint it's prudent to investigate the sale of any of the assets that you have on the books, whether it's MSRs or otherwise.

I think to the extent that we would move forward to sell MSRs, we would focus on those MSRs that tend to be to a customer that only has one product, that mortgage that we service with the company. That would be where the primary focus would be.

I don't necessarily think it would be material because we don't think we have to do it. But it sure does make sense, given the volatility in interest rates, to look at all your assets and make sure that you know how to and can execute on sales before you'd ever get to a position that you would have to do it.

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

Paul, think of it this way. I wouldn't make more of this than it is. We have a very large and important servicing business. We love that business. From time to time opportunistically we will sell something and reposition, but we like the balance and we like that business a whole lot.

Paul Miller - *FBR & Co. - Analyst*

Then on the credit side, I believe your reserve ratio is down around 2%. What do you think you can take that down to with your improvement in credit and improvement in HPI?

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

We don't have a target. It's a fair question, but we don't have a target. It was 2.01% at the end of the quarter. It's going to be what it's going to be based upon the improvement in the underlying credit trends.

I wouldn't be surprised if it was below 2% next quarter. That's a possibility. It could be a little bit higher, it could be a little bit lower, but there's not a specific target that we have because it's really just a result of their underlying credit performance.

Paul Miller - *FBR & Co. - Analyst*

Okay, guys. Thank you very much.

Operator

Joe Morford, RBC Capital Markets.

Joe Morford - *RBC Capital Markets - Analyst*

Thanks. Good morning, guys, and congrats on a solid quarter.

I guess, as you mentioned, the economic data continues to improve. With last week's employment report and the strengthening housing recovery and why you talked about the multiplier effect, are you seeing much of a pickup in activity yet at the customer level as well? When might we see this translate into stronger loan growth, particularly on the commercial side?

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

The primary areas that we are seeing it take hold is on the consumer side. You saw our consumer loans. Again, you need to back out the impact of the liquidating portfolio.

But we saw auto growth; we saw credit card growth, which was very nice. We are continuing to see growth in terms of just household formation that's out there, and that allows us to continue to grow deposits. So all those are good trends.

There's no question there's going to be a bit of a lag effect as it relates to stronger commercial loan growth. Our commercial loan growth again has been pretty strong.

This is now, I think, the 10th consecutive quarter that wholesale in total has grown. And it's certainly in certain segments and industries within the wholesale portfolio we are seeing some good growth. But my guess again it will be a quarter or so before we start to see a big pickup.

Joe Morford - *RBC Capital Markets - Analyst*

So you are not really seeing customers drawdown cash yet or really make more investments?

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

No, no. I wish they were, but unfortunately not. When you look at line usage in the commercial side, it has been pretty stagnant for a bit.

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

And you're right, Joe. That happens first. That is typically the first thing that happens.

Joe Morford - *RBC Capital Markets - Analyst*

Then just on investment banking, revenues up strong from the first quarter. Can you just talk a little bit more about the drivers there? And maybe, if you could, just an update on the business in general and how it's progressing and market share gains and things like that?

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

Overall, the business is performing very well. The primary drivers for the growth wasn't necessarily in any one specific product type within the business and it was very, very much focused on our existing customer base.

The fees were up 40% year-over-year. Most of that, again, was with our existing commercial and corporate customers. I think our market share at the end of the quarter ended up at about 5.8%, which was fine.

We are not running that business for any sort of market share. We are running that business to be able to be there for our customers when they need us. And when you look at the growth in the business and the fact that it's primarily focused on those customers, it's performing quite well.

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

Joe, to add something to that, I make a lot of calls in that area on behalf of our team and these are existing customers for the most part. They appreciate the skill set and the abilities we have in that business, especially as we partner with our retail distribution platform. So we make a compelling offer and our long-term customers appreciate that added service that we have for them.

Joe Morford - *RBC Capital Markets - Analyst*

Okay, thanks very much.

Operator

Mike Mayo, CLSA.

Mike Mayo - *CLSA - Analyst*

I am trying to get just a real simple answer and that is -- I heard what you said, John, about the improving housing market, and that was helpful. But the question is are the benefits in the improving housing market already in the numbers of Wells Fargo?

My column A, based on what you said, are some headwinds. The origination pipeline down 10% to 15%. Repurchase reserves are all pretty low. Gain on sale going down.

And the column B are, perhaps, some tailwinds. Expenses perhaps going down from the workout costs and the mortgage platform, the MSRs, and the credit. So which is greater, column A or column B?

And, John, in your opening remarks you said Wells benefits -- your grammatical tense was the present tense and I think Ken at one point said Wells Fargo benefited, the past tense. So does Wells Fargo still benefit in their bottom-line results from the improving housing market or is it all in the numbers?

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

Here's the way I look at that, Mike. When housing gets better, it's better for Americans, it's better for the country, and that improves for us. You know, we have a commitment to residential real estate and commercial real estate, for that matter, in this company because that's what our customers want us to buy.

I can't tell you what's going to happen in the next quarter, but I can tell you this. And improving housing market will benefit customers and us, because we are, at the end of the day, a reflection of our customers. So the benefits are yet to come.

It might come in different line items. You're right, if rates rise there will be less refinances. We've been there before. But it also means improved credit. It means improved confidence. Customers start small businesses. We are a big small business bank. Environmental costs go away.

So I would take that trait all day long. An improving housing market, even if it means less refinances because rates are rising at the same time, that's fine.

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

Mike, the only other thing I would add is I don't think you have enough columns on your sheet of paper. We have 90 different businesses. We are not just a housing -- if we were just a mortgage company, then I think the columns and the items that you pointed out would have been absolutely spot on.

But this is a portion of our business. It's a great business, terrific people. We are helping customers succeed all the time in that business, but we have 90 other businesses or 89 other businesses in this company that are continuing to grow. And you see, not only this quarter, but over the last year that many of the businesses have been growing, not only as it relates to net interest income, but also to noninterest income.

So, again, who knows what's going to happen in the third quarter, but over time this diversified model is very helpful when you have one business where revenues might be coming down.

Mike Mayo - *CLSA - Analyst*

If I can speak your language, so I guess you would say there's 90 horses pulling the stagecoach. And as the mortgage horse is slowing down, or potentially slows down, although it has certainly been stronger for longer, which of those other 89 businesses do you think are most able to pick up the slack?

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

All of them. It's not just one, Mike, and that is what's exciting. If it was just one, actually we would be worried about it, but -- it's a nice analogy. That would be quite a stagecoach that we would have. But the mortgage horse has been a big, strong horse. We've got 89 other horses that are going to be able to grow.

Again, just look at the numbers this quarter to get a feeling for -- we call out 10 to 12. There's even more as you pore through the numbers in terms of performance.

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

We talked the last couple of quarters about how we think we have an opportunity in credit card. We are seeing great increases there. Look at the Wealth, Brokerage, and Retirement side of the business.

Now these are not all one horse offsets the other horse, but when you have a whole team out there, the key is keep the coach running. And we like that diversity.

Mike Mayo - *CLSA - Analyst*

Last follow-up, just in case the other 89 businesses don't pick up the slack right away, as Jake Morgan said on his call earlier that you can have a slowdown in mortgage but a lag in the expense take out, can you just remind us of the expense flexibility that you have outside of mortgage?

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

We still think there's opportunity on expenses here and I think Tim mentioned that earlier in the call. So as you mentioned on the mortgage side, first of all, there is the commission base, so that happens immediately, and then we are very good at sizing the business based on what's going on. We've done that many times.

But in other businesses, for example, we started something called the neighborhood store with 6,200 stores. We opened our first one in Washington, DC, and that operates at 40% less cost but the same functionality. There are tons of opportunities like that -- paperless ATM receipts, nickels and dimes in the corners that all add up at the end of the day, in addition to the environmental costs.

Mike Mayo - *CLSA - Analyst*

All right, thank you.

Operator

Nancy Bush, NAB Research LLC.

Nancy Bush - *NAB Research - Analyst*

Good morning, guys. I promise I'm not going to ask a mortgage banking question.

There has been a lot of press around this issue of the kiosk branch that you're introducing I think into New York City. Could you just talk about that a little bit and whether this signals some sort of broader experimentation with branch types throughout the network, or is this something specific to New York?

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

It's actually Washington, DC. Let me tell you, first of all, we have about 6,200 stores and the stores have been relatively flat in numbers. There is a lot of discussion today about -- in our industry whether stores are still relevant. We think they are enormously relevant, even to our millennial customers. And store usage and channel usage, frankly, is based on many times age, affluence, and activity.

When we talk with our customers, even the Millennials visit our stores once every year or six months or some time. It's places where they go to open their first account. It's where people go if they can't [sell a product] any place else and it's the place they take their money if they come into a trust fund that funds out or whatever the case may be.

But here's the key. As long as our customers tell us that destination distribution like a store is important, we are going to build it for them. We are going to have stores where they need them, where they want them. That's important to growing deposits, to selling products and services to them.

If we ever get a time where they say it's not important, then we will adjust that way also. So since stores are important, how do you make them more efficient? And how do you build them in a way that allows for the convenience they want, the availability they want, but also under the cost structure that makes sense?

The neighborhood store we have is about 1,000 square feet. During the daytime it's a full-functioning store. It happens to be paperless. It happens to have -- the cash there is contained within machines that can cash a check down to the dollar. And then after-hours the walls fold in and it's an ATM vestibule, so you kind of get the best of both.

This is a test-and-learn. We've done a lot of testing and learning around here, and in many of those densely populated marketplaces you can't rent a facility of 5,000 square feet. 1,000 is all you can get. So that makes it available to you.

So if this works, we will do more. If it doesn't work, we have got -- this is not the only test we have going on. We have lots of tests going on.

Nancy Bush - *NAB Research - Analyst*

But at this point it's an additive strategy. It wouldn't be where you would take existing branches that are sort of, quote, more normal branches and change them? It's just an additive strategy at this point?

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

Yes, it's additive, but it might be a replacement strategy for certain stores. In fact, some of what we are doing today is taking in two stores and building a new one and consolidating the two. Depending on customer flows, depending on customer needs.

We are a retailer, so most retailers that I respect are always looking at their distribution footprint and model. But the long and the short of it is we believe in the store concept. When I first got in the industry we had the operation from the second floor and the Board room on the bottom floor, in the basement. We had -- and it has changed since that time. It will continue to change.

Nancy Bush - *NAB Research - Analyst*

Am I right in assuming that the breakeven on these things is like weeks or a few months?

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

Well, it depends on the activity in the store and the activity of the customer. Five years ago the breakeven was very different than it is today. Customers borrowed more. There's a different margin on borrowing versus depositing.

But I wouldn't say it's in weeks and months, but it's about 40% reduction in cost with the same functionality. That's a big deal.

Nancy Bush - *NAB Research - Analyst*

All right. Second question is this; your improvement in cross-sell from 6 to 6.14 and your ongoing improvements in cross-sell, is this merely one product, two products? Is there sort of still a, quote, lead product you guys have that sort of leads cross-sell?

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

Yes, it's checking accounts. That's why when I wake up in the morning, I get here and the first thing I look at is the checking account report from the day before. I love checking accounts. I dream about them. I just -- because (multiple speakers)

Nancy Bush - *NAB Research - Analyst*

John, you've been in the business too long. I'm sorry.

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

Because it's a formational account for a consumer. And the second probably most important is mortgage and that's why we are almost -- we are obsessive about that, about serving customers.

Nancy Bush - *NAB Research - Analyst*

Yes. And just finally one quick thing, and I probably already know what the answer is but I've got to ask it anyway. Given that there has been yet one more attempt at Glass-Steagall, break them up. You are all too big. You are bigger now than you were before the financial crisis, blah blah, blah.

Are you -- I would assume that you would be in this group of break-them-up banks and I guess my question is what could you be broken up into?

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

You know, Nancy, this is America. People are free to express their opinion, that's one of the beauties of this country. From my perspective, we are solidly in the real economy.

What we do is to serve customers -- small business, large business, commercial real estate customers, consumers. And virtually everything we do has a customer on the other side of it.

When we take a deposit in, we don't put it into a vault and (inaudible). We put it to work. We make consumer loans, commercial loans, small business loans. Loans to ranchers and farmers and energy companies and renewable -- that's what we do.

And that's proprietary. That's putting -- because we have to manage those kinds of risks. I understand that.

I don't understand how serving customers broadly and deeply, including helping them with a public offering, whether it be debt or equity, somehow makes us riskier or weaker or puts depositors at risk more so than banking alone. But I understand that's the dialogue.

You've got to realize the capital that is been raised, the discipline around risk of all kinds is far different than it was just a few years ago. I am proud of this company and proud of what we do. I know that we are helping this economy to recover, to heal, and we do all we can to do that.

Nancy Bush - *NAB Research - Analyst*

Thank you.

Operator

Andrew Marquardt, Evercore.

Andrew Marquardt - *Evercore Partners - Analyst*

Morning, guys. Just a couple [TIKI TAK] questions. First on expenses, environmental costs have come down significantly the last couple of quarters. Is there a lot more room to go from there?

I know you had mentioned that they were not all behind us, but I assume that we won't go to zero on a lot of these. Some of these will be ongoing costs when I'm looking at your page 13 on your slide. How much room should we really think about is left to go?

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

I don't know the exact answer to your question, Andrew. I think it's a fair question because, as you point out, we've made a tremendous amount of progress over the last few quarters. I don't think -- so if you just pick two items, for example, foreclosed asset expenses, which were $146 million in the second quarter, that doesn't feel to me to be the run rate that we would settle in.

Could it go up? It could go up, it could go down, but I think over time there still is some room for that to decline.

Then also I think the contra revenue item that we had, which is the MSR servicing and foreclosure cost impact, again the primary driver there is continued foreclosure timelines in certain judicial foreclosure states, primarily New York and New Jersey. And over time that will, I think, begin -- will continue to moderate. So I think those in particular there is probably a little bit more room to run. But you are correct; the rate of increase is going to slow down.

Andrew Marquardt - *Evercore Partners - Analyst*

Okay, okay. That's helpful, thanks. Then, secondly, back to liquidity. Just want a clarification, because you had mentioned in an earlier comment about how you may need to raise some additional liquidity, is that related to the LCR or is that related to the consideration of other things in terms of the OLA additional bailing debt considerations that are out there?

Because when we look at LCR, we have you guys in a pretty healthy range of [120] to [140] depending on how you calculate it. So I was just a little surprised by that comment.

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

I think that is the -- you hit the nail on the head with your last comment and that is it's hard to calculate the answer when you don't really know what all the variables are going to be. We think we have more than sufficient amount of liquidity to be able to operate Wells Fargo. We've been able to demonstrate that through some pretty significant downturns.

The rules might change a little bit. If that's the case, will we have to make some adjustments to the balance sheet if we do that? That's fine. We'll adjust to that.

But it's not -- the onset of finalizing the Basel III LCR and any of the interpretation that might occur from our domestic regulators is not impacting the way that we are running the business today. Meaning that we are not -- we don't have some money set aside that we can't lend to our customers or we can't invest in securities because we are too concerned about that.

There's a lot of moving parts and, again, we are going to -- we will comply with whatever the final rules are. We will do that in an appropriate timeframe, but it's not a limiting factor for the Company today.

Andrew Marquardt - *Evercore Partners - Analyst*

Got it. And what is the constraining factor when we should think about excess liquidity and the ability to deploy more into securities or loans or what have you? What is the sense that --?

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

It's the rate of economic growth and the rate of loan growth. When we think about the recovery, as we have talked about, we continue to be in a recovery that has had to adjust to a tremendous amount of headwinds. It has been, from our perspective, remarkably resilient.

But our loan growth would be a lot stronger if we were at a 3% GDP level or a 4% GDP level, which is about what I think everybody expected a few years ago when we started to come out of the downturn is primarily loan growth. Less today -- in terms of investments, less today rates. That was a big limiting factor for us a year ago and nine months ago and three months ago, for that matter. Less today for sure rates because rates are more attractive today.

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

And the beauty of it, if borrowing does start, those costs are already embedded. We already have those approved. That's just all revenue then.

Andrew Marquardt - *Evercore Partners - Analyst*

Got it, that's helpful. Thanks.

Operator

Betsy Graseck, Morgan Stanley.

Betsy Graseck - *Morgan Stanley - Analyst*

Good morning, a couple questions. One on page 26 you got the PCI accretable yield slide and you indicated the weighted average life is 14.5 years there. So that's up from last quarter where I think it was like 12.3 or something like that. I am just wondering what is behind driving that up.

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

A couple of things. One is just that we have a general improvement in the underlying portfolio and the delinquency in the portfolio has come down a little bit so that the expectation according to the model is that customers are going to stay in their homes longer.

We could be -- it could be, though, that you could reach a point whereas you continue to see home values increasing that it could reach a point where those customers may be more comfortable and able to sell their homes or even to refinance. And that would begin to bring the average life down. But I wouldn't read into that change any big change in our assumptions or anything like that. It's very variable on a quarter-to-quarter basis.

Betsy Graseck - *Morgan Stanley - Analyst*

Okay, but you're basically saying credit quality is improving and that's why the weighted average life is extending?

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

Correct.

Betsy Graseck - *Morgan Stanley - Analyst*

Do you have anything at all in there for prepays, or it's not rate related at all?

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

Yes, we definitely do. That's part of the -- that is one of the important variables in the model. But, again, personally I think that prepays are going to accelerate over time as values continue to go up. We haven't seen that yet in the performance level, but I think logically it could occur.

Betsy Graseck - *Morgan Stanley - Analyst*

Okay. Then -- which would short duration and pull in the PCI a little bit faster?

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

Correct.

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

Correct.

Betsy Graseck - *Morgan Stanley - Analyst*

Okay. Then, separately, HPI going up significantly in the most recent quarter. If this level of housing value held for the rest of the year, how much is that going to be impacting your loan growth?

I know this question has been asked a couple different times. But I guess the real question is do you feel that the current value of housing price is in 2Q's numbers, or is there more to come from the HPI improvement that we've seen this quarter?

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

We tend to use a lag assumption and we tend to be a little bit more conservative. We're not going to take, for example, the housing price, the 13% that John mentioned what we have seen year-over-year, and assume that is going to continue forever. And so you've got to be very careful with that.

I think we have been, and I think the entire industry and the market has been, positively surprised at the level at which housing prices have -- how resilient they've been, how much they've grown, and the percentage that they've grown. So, again, I think that we've seen some nice improvement. Our expectation is that we are very positively leveraged to home prices and so we could see some improvement from the results that you see here in the second quarter.

Betsy Graseck - *Morgan Stanley - Analyst*

Just thinking in particular about home equity, because that to me seems like the area where you should have some of the sharpest swings as HPI has gone up so much recently over the next couple of quarters. But I don't know if that's a fair assessment given (multiple speakers)

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

Betsy, I think you are absolutely right in that maybe using the word leverage is maybe even more appropriate there. When you think about the impact to a home equity portfolio, which the majority of our home equity portfolios our junior liens, to the extent that you've got a portion of that that is above 100%, home -- increasing home values really, really impact that portfolio.

Betsy Graseck - *Morgan Stanley - Analyst*

So are you seeing much in the demand and the origination pipeline for that product yet, or is it too early?

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

I think our home equity originations were up year-over-year, but I don't that they were necessarily up significantly from the first quarter. It's a good product. It's underwritten very well today. It's one of the many products we provide. It's a slight uptick, but it wasn't one of the drivers for the home equity or our loan growth or we would've called it out.

Betsy Graseck - *Morgan Stanley - Analyst*

Got it, thanks.

Operator

Chris Mutascio, KBW.

Chris Mutascio - *KBW - Analyst*

Good morning, John. Tim, I had a quick question for you. I'm going to go all the way back to the first question today and I can't promise what Nancy promised. It will be a mortgage question.

When you look at the servicing side of the business and how it flows through the income statement, the servicing asset has -- the MSR has been written up about $3 billion in the last couple quarters and yet the servicing income is still kind of stuck in that $300 million to $400 million range per quarter. So in order for that natural hedge to fully take hold, if indeed we see a material -- and that's my assumption -- a material decrease in refinance activity, do you have to start lessening up on the hedge on the MSR for that to flow through to the income statement more so than it has?

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

If you wanted to create a natural hedge, you would have to reduce your hedge percentages, and in doing that, you would potentially create a lot more interest rate risk. Not potentially, you would create a lot more interest rate risk for the Company. We just don't think that that is a prudent thing to do.

So I think, historically, when the business was smaller than it is today, it might have been a little bit more -- we might have more flexibility to do that. That doesn't really make sense to us today. So our hedge ratios are relatively high, which is one of the reasons why you are not seeing a one-for-one offset.

There will be some benefit, there's no question about that. And I think one of the key benefits of the servicing portfolio over time is that the quality of what you are servicing continues to increase because you continue to originate better quality mortgages that are going to pay for a longer period of time and you don't have as much foreclosure impact.

I think that in terms of comparing our servicing results over the next few quarters with what we've experienced in the last few quarters, most of the reduction that you have seen has been related to foreclosure elongation and things like that. And we are hopeful that that's going to dissipate. But I would not look for the MSR to dollar-for-dollar offset any reduction in revenues from the origination side of the business. There's some natural relation, but it's not one-for-one.

Chris Mutascio - *KBW - Analyst*

Just one quick follow-up. I think John had mentioned, or I think both of you mentioned, potential MSR sales going forward. And I think, John, you had mentioned -- I don't want to put words in your mouth, but maybe there would be kind of one-off type portfolio similar to the reverse mortgage sale recently. Would the Pick-a-Pay portfolio be included as a one-off potential sale in terms of MSRs?

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

Well, that when we own. We own the assets there, so I wouldn't look for that area, per se. And I don't want to give guidance here, but I think what you should take away from this is that we like the MSR business. We think it's critical to -- well, we not only like it because of the business itself but because of the cross-sell we do out of it and that we will sell from time to time opportunistically.

I think Tim mentioned that we might look at something that has a single-product household kind of dynamic here. But we are always looking at all of our businesses as is an opportunity here to monetize something that might be more valuable to someone else than to us? Sure, we will look at that. I wouldn't look for a big change here.

Chris Mutascio - *KBW - Analyst*

Right, thank you very much.

Operator

Chris Kotowski, Oppenheimer.

Chris Kotowski - *Oppenheimer & Co. - Analyst*

My question was asked, thanks.

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

Okay, thank you.

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

Hi, Chris. Okay, thank you much. I know we went over time a little bit, but thank you all for joining our call. We appreciate your interest and your coverage of Wells Fargo.

See you next quarter. Thank you much.

Operator

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

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