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Wells Fargo &'s CEO Discusses Q2 2011 Results - Earnings Call Transcript

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Wells Fargo & (NYSE:WFC)

Q2 2011 Earnings Call

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Executives

Timothy Sloan - Chief Financial Officer and Senior Executive Vice President

John Stumpf - Chairman, Chief Executive Officer and President

Jim Rowe - Director of Investor Relations

Analysts

John McDonald - Sanford C. Bernstein & Co., Inc.

Paul Miller - FBR Capital Markets & Co.

Betsy Graseck - Morgan Stanley

Joe Morford - RBC Capital Markets, LLC

Moshe Orenbuch - Crédit Suisse AG

Frederick Cannon - Keefe, Bruyette, & Woods, Inc.

Christopher Mutascio - Stifel, Nicolaus & Co., Inc.

Nancy Bush - NAB Research

Keith Horowitz - Citigroup Inc

Matthew O'Connor - Deutsche Bank AG

Operator

Good morning. My name is Celeste, and I will be your conference operator for today. At this time, I would like to welcome everyone to the Wells Fargo Second Quarter Earnings Conference Call. [Operator Instructions] I would now like to turn today's call over to Jim Rowe, Director of Investor Relations. Please go ahead, sir.

Jim Rowe

Thank you, Celeste, and good morning, everyone. Thank you for joining our call today, during which our Chairman and CEO, John Stumpf; and 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'd also like to caution you that we may make forward-looking statements during today's call and that those forward-looking statements 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 in the 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 our website at wellsfargo.com.

I will now turn the call over to John Stumpf.

John Stumpf

Thank you, Jim, and good morning, and thanks for joining us today. The results we will review with you this morning are a product of our steadfast focus on 5 key priorities: helping customers succeed, growing revenue, reducing expense, living our vision and values and building strong relationships with our key stakeholders. The second quarter also reflected the strengths of Wells Fargo diversified business model and operating culture which continued to produce record high results in a tough economic business climate.

In the second quarter, all of our business fundamentals moved in the right direction, revenues, loans, deposits, expenses, credit and capital. This is how we delivered the highest earnings in Wells Fargo's history with net income of $3.9 billion, an increase of 29% from a year ago, and an EPS of $0.70, up 27% over the same period.

Our strong financial performance led to strong internal capital generation, producing an estimated Tier 1 common equity ratio under Basel III capital proposals of 7.4%. We grew capital even as we rewarded our loyal shareholders through dividends and with the reinstatement of our share buyback program during the quarter.

The second quarter also included many examples of the ongoing benefit of our merger with Wachovia, beginning with the successful completion of our largest state conversion, Florida. With Florida now operating under the Wells Fargo brand, we have 83% of our banking customers on a single system, a powerful advantage for the future. We have converted 2,215 Wachovia stores as well as 23.7 million customer accounts, including mortgage, deposits, trust, brokerage and credit cards.

Our success reflects the tremendous effort made by our entire team. For the conversions in Pennsylvania and Florida alone, team members in our banking stores completed over 217,000 hours of training and practice. To help support our stores during conversion, 2,360 bankers from stores in the West each spent more than a week in the converted states to ensure a smooth transition.

But the biggest benefit of the largest merger in our industry's history are revenue synergies, many of which we are already starting to realize. They reflect the payoffs that are possible when a team has a plan, follows it with discipline and doesn't allow headwinds to distract them.

Let me highlight just a few. Our continued strong growth in consumer checking accounts demonstrates our success at attracting new customers even during the integration. In our eastern retail banking stores, consumer checking accounts were up over 30% from a year ago. New credit card accounts also grew in the East, growing more than 140% from a year ago as we began to see a meaningful lift in credit card penetration rates in our converted markets, up from 13.2% at the end of 2010 to 14.5% at the end of the second quarter.

Wachovia had a well-run Auto business before the merger, and it has only become a more robust part of Wells Fargo, growing indirect auto loans by more than 50% since the merger. Our market share has also increased, and that has made Wells Fargo the largest used car auto lender and the second largest overall auto lender in the industry.

Wholesale Banking businesses have benefited from the merger as well, with more customers, a broader product line and higher cross-sell. For example, year-to-date, our investment banking market share for 2011 was 4.7%, up from 3.7% for the first 6 months of 2009.

Investment banking revenue with corporate and commercial customers also has increased, growing 53% during the first 6 months of 2011 versus the same period last year, reflecting continued success in cross-selling investment banking products to our wholesale customer base.

Foreign exchange revenue from wholesale customers is also up 24% during the first 6 months of 2011 versus the first 6 months of 2010. And trade fees in the second quarter from corporate and commercial customers were up 13% annualized in the first quarter.

In Wealth, Brokerage and Retirement, the benefit of converting to one system and greater scale in each of its businesses are reflected in a 27% increase in client assets since the merger. The retail brokerage business, which is the third largest full-service brokerage business, retail brokerage firm in the U.S., continued to grow with net flows of more than $50 billion into managed accounts since the merger. And by focusing on meeting all the financial needs of our customers, Wealth, Brokerage and Retirement's and deposits have grown 28%, and broker loan originations have grown by 47% since the merger.

Clearly, it was an outstanding quarter, and we aren't stopping here. As our CFO, Tim Sloan, will highlight in a few moments as he walks through the quarter's details, we think our opportunities to operate more cost effectively are just as promising as the growth opportunities that we believe lie ahead of us, and are important as we continue to help even more customers succeed financially in the future.

Now let me turn this over to Tim Sloan.

Timothy Sloan

Thanks, John, and good morning, everyone. My remarks will follow the slide presentation included in the first half of the quarterly supplement starting on Slide 2. I want to focus my comments today on 4 areas.

First, the drivers behind our strong business results this quarter, which included record earnings, up 5% from the first quarter, our highest ROA in 3 years; continued improvement in credit and linked-quarter growth in revenue, loans, deposits and pretax pre-provision profit.

Second, as I promised, I will discuss our focus on reducing expenses, including Project Compass and our $11 billion quarterly noninterest expense target by the fourth quarter of 2012.

Third, I will update you on our current mortgage issues, including the quality of our servicing portfolio, mortgage repurchases, securities litigation and consent orders and also highlight some of the actions that we've already taken.

Finally, I'll conclude with an update on our growing capital levels and capital actions.

Let me start by highlighting just how strong our results were this quarter and our many areas of growth. We achieved record EPS of $0.70, up 4% from the first quarter. Our revenue was up $57 million from Q1, with growth in both net interest income and noninterest income. Growth was broad based, with several businesses generating double-digit annualized linked-quarter growth, including corporate banking, commercial real estate, debit card, insurance, international, merchant services, retirement services and SBA lending.

Pre-tax pre-provision profit was $7.9 billion, up 4% from the first quarter. Our period-end loans were up $766 million, and average core deposits increased $10.7 billion from the first quarter.

The benefit of our continued focus on meeting our customers' lending needs throughout the past few years helped produce loan growth this quarter despite the continued reduction in our liquidating portfolio. Our core loan portfolio, which excludes the liquidating portfolio, grew by $5.8 billion from the first quarter. Loan growth in this quarter was driven by our commercial portfolio, which grew $7.5 billion or 2% from the first quarter. Growth was diverse across commercial businesses including linked-quarter growth in commercial banking, commercial real estate, corporate banking, capital finance, asset-backed finance and international.

Consumer loans were down 2% from the first quarter, driven by the liquidating portfolio runoff, partially offset by growth in auto, credit card and private student lending. The runoff of the liquidating portfolio continued as expected, down $5 billion from the first quarter and down $69 billion or 36% since the Wachovia merger.

Deposit growth remained very strong in this quarter, driven by new account and balance growth. Average core deposits were up $10.7 billion from the first quarter and up $45.7 billion or 6% from a year ago and were 107% of average loans. Average checking and savings deposits were up $735 billion, up 9% from a year ago and were 91% of average core deposits, up from 88% a year ago. Consumer checking accounts were up 7% from a year ago.

The strong growth we achieved throughout our banking states demonstrates our ability to both acquire and retain customers as we successfully complete the largest merger integration in the industry. While deposit rates are at historically low levels, we continue to bring down deposit yields, with average deposit cost declining to 28 basis points, down from 30 basis points in the first quarter and down 35 basis points from a year ago.

Turning to Slide 6. As I've mentioned, our revenue growth this quarter was driven by growth in both net interest income and noninterest income. Tax-equivalent net interest income increased $39 million from the first quarter. The increase was driven by the period-end balance of our available-for-sale securities portfolio increasing $18 billion, reflecting deployment of excess liquidity and the decline in our long-term debt expense from the maturity of debt and the redemption of high-cost trust preferred securities. These positives were partially offset by the decline in mortgages held for sale, driven by lower funding volumes and the fact that loan growth in the core loan portfolio was offset by expected runoff in the higher-yielding liquidating portfolio. These loans generally have higher charge-offs and cost more to service.

Noninterest income was up $30 million from the first quarter, with growth in deposit service charges, trust and investment fees, card fees, processing fees, insurance, equity gains and operating leases, more than offsetting declines in mortgage. The increase in card fees, up 46% or 5% from Q1 reflects an 8% increase in debit card volume and a 13% increase in credit card volume.

New credit card accounts were up 12% from the first quarter and up 63% from a year ago. Mortgage banking revenue was down to $397 million or 20% from the first quarter, reflecting a $20 billion decline in origination volume. As rates declined in this quarter, there was an increase in application volume and the unclosed mortgage pipe line increased $6 billion to $51 billion as of the end of the second quarter.

With the final Federal Reserve rules regarding debit interchange fees, we have lowered our estimate of the impact on our earnings to approximately $250 million quarterly after tax before any offsets starting in the fourth quarter of 2011. We expect to recapture at least half of this through volume -- half of this over time through volume and product changes.

Our second quarter results also benefited from lower expenses. Noninterest expense was down $258 million or 2% from the first quarter and down $865 million from the fourth quarter of last year, driven by lower commissions and incentive compensation, employee benefit cost and equipment expense.

Second quarter expenses included only $10 million of higher FDIC insurance assessments, which is lower than our previous guidance. Our assessment reflects the fact that deposits as a percentage of assets is greater than many of our peers.

Second quarter expenses also included $484 million of merger integration costs, up $44 million from the first quarter, reflecting increased integration activity. And finally, second quarter expenses included $428 million of operating losses, substantially all driven by litigation accruals for mortgage foreclosure-related matters.

As I promised last quarter, I'm going to spend some time on the call today talking about our expense initiative, Project Compass. This starts on Slide 9. Project Compass is a company-wide initiative focused on removing unnecessary complexity and eliminating duplication as a way to improve the customer experience and the work process of our team members. While Project Compass is focused on reducing expenses, we are using a bottoms-up approach to ensure revenue is not adversely affected. Wells Fargo is still a very -- very focused on growing revenue as we did this quarter. And we believe that if we do this right, we will have increased revenue and a more streamlined operating model.

Project Compass has 3 main areas of focus. First, staff and technology functions. As our company has grown, we have become more complex. We are focused on removing unnecessary complexity and eliminating duplication in our staff functions. Throughout the merger integration, we have been focused on IT consistency, one platform throughout our company to serve our customers seamlessly.

With Project Compass, we're focused on simplifying the technology environment across our company, particularly in such areas as data centers, help desk and application development and support. For example, we recently moved technology support for human resources, finance, corporate properties and Internet services under the corporate technology group.

Second, loan resolution, loss mitigation and foreclosed asset expenses should decline as the credit cycle improves. At the same time, process improvements can also be made in this area, such as automating asset tracking and payment processing and centralizing certain functions.

The third area of focus is business optimization, which consists of business efficiency and business portfolio reviews. Business efficiency is focused on ensuring team members are supporting revenue-generating activity as cost effectively as possible by removing unnecessary complexity and duplication. To date, we've consolidated our auto business and reorganized our wealth management business to improve business efficiency.

Business portfolio review is a continuation of our long-standing practice of reviewing all lines of business to ensure they are generating appropriate returns and work within our business model. As a result of these reviews, we've closed Wells Fargo Financial stores, exited the reverse mortgage business and announced the sale of H.D. Vest.

As a result of Compass initiatives and the completion of merger integration activities, we are targeting quarterly noninterest expenses to decline to $11 billion by the fourth quarter of 2012, down 12% from the $12.5 billion this quarter. The target reflects expense-save initiatives that will be executed over the next 6 quarters. However, quarterly expense trends may vary due to factors such as cyclical or seasonal increases, particularly in the first quarter when higher incentive compensation and employee benefit expenses typically occur. Our $11 billion target includes currently contemplated investments in our businesses and team members, such as hiring more team members in banking stores in the East.

Turning to our segment results, starting on Slide 13. Community Banking earned $2.1 billion, down 4% from the first quarter, reflecting lower mortgage banking results. Other businesses within Community Banking continued to grow. We had record retail banking cross-sell of 5.84 products, up from 5.64 a year ago. With cross-sell in the East at 5.29 products compared to the West at 6.25, we have plenty of opportunity to continue to grow across our franchise. Over the past year, we have added an incremental 1,500 platform banker FTEs in the East, up 16%, to better capture this opportunity. Core product sales in the West were over $8.3 million, up 16% from the prior year. Core product sales in the East grew by double digits.

Wholesale Banking earned $1.9 billion, up 17% from the first quarter, with revenue up 3%, expenses down 1% and continued improvement in credit cost. Linked-quarter revenue growth was driven by strong results across many businesses, including investment banking, Eastdil Secured, commercial real estate, international, corporate banking and insurance. These results also reflect strong loan growth, up 4% from the first quarter, which was broad-based across a number of the wholesale businesses. This growth reflects our commitment to meeting our wholesale customers' financial needs. We continued to meet with our customers and grew our customer base when the market was soft, and we are now benefiting from the relationships we both expanded and built during the past 3 years.

Wealth, Brokerage and Retirement earned $333 million, down 2% from the first quarter, driven by lower brokerage transaction revenue, reflecting lower market activity; while asset-based fees remained strong, up 3% from the first quarter. Expenses were down 3% from the first quarter due to lower personnel cost. Average loans were up 2% from the first quarter, with growth in brokerage lines of credit, margin loans and wealth. Managed account assets were up 3% from the first quarter, driven by strong net flows. Our continued focus on helping customers succeed financially drove cross-sell to 9.9 products, up from 9.7 a year ago.

Credit quality continued to improve, as shown on Slide 17. Charge-offs declined for the sixth consecutive quarter, down $372 million from the first quarter and 48% below the peak in the fourth quarter of 2009. Provision expense was $1.8 billion, down $372 million from the first quarter, including $1 billion reserve release. Absent a significant deterioration in the economy, we expect future reserve releases.

Other credit metrics continued to show improvement. Nonperforming assets were down $2.6 billion or 8% from the first quarter, driven by loans returning to performing status, loan payoffs, loan sales, improved success in home modifications and increased short sale activity. Nonaccrual loan inflows were down 15% from the first quarter. Loans 90 days past due declined for the sixth consecutive quarter, down $598 million from the first quarter or 25%. Early stage delinquencies, both balances and rates, also declined from the first quarter.

We believe our servicing portfolio is among the best in the industry. Our portfolio is fundamentally different from other large mortgage servicers. Starting on Slide 19, we highlight the quality of our portfolio.

The majority of our $1.8 trillion residential servicing portfolio, or 69%, is service for the agencies. Only 6% are private securitizations where we originated the loans. As a reminder, the characteristics of our non-agency securitization portfolio are different from our larger peers. 80% were prime origination, 58% are from pre-2006 vintages, there is an insignificant amount of home equity and there are no option arms. Approximately 50% of the private securitizations do not have traditional reps and warranties. 6% of the total servicing portfolio is non-agency acquired servicing and private home loan sales, with the majority having repurchase recourse with the originator. The remaining 19% are loans we hold on our balance sheet and losses are recognized through the loan loss reserves and the PCI-nonaccretable difference.

The quality of our portfolio is demonstrated by our delinquency and foreclosure rate. Once again, based upon the most recent publicly available data, our rate was the lowest among large bank peers and was over 300 basis points lower than the industry average. Total outstanding repurchase demands are down in both number and balances for the fourth consecutive quarter. Losses on repurchases also declined from $331 million in the first quarter to $261 million in the second quarter. Agency repurchase demands were up modestly from the first quarter due to an acceleration in the timing of the review of defaulted loans on older vintages. We do not believe this acceleration increases our future demand risk. Total non-agency repurchase demands declined for the third consecutive quarter. We added $242 million to the repurchase reserve this quarter, essentially flat with the $249 million we added last quarter.

Let me highlight a few other mortgage-related matters. We recently reached a preliminary settlement of $125 million to address Securities Law claims by buyers of private label mortgage-backed securities. This settlement should resolve pending Securities Law claims for most purchasers of our private label mortgage-backed securities. If approved, this settlement would have no future P&L impact since it has been considered in our litigation reserves.

As we discussed last quarter, we entered into consent orders with the OCC and the fed regarding foreclosure processing this year. We remain committed to full compliance and we are enhancing several aspects of our servicing, including single point of contact. We remain committed to helping our customers who are experiencing financial difficulties. And we have done approximately 695,000 trial and completed modifications since 2009, and we have forgiven over $4 billion of principal.

In addition to these actions to help our customers, we have continued to reflect our best estimates of potential costs surrounding mortgage-related issues in our financial results. We have reduced the value of our MSR asset by $445 million in the second quarter, and have reduced the value of this asset by over $2.5 billion over the past 2.5 years to reflect higher servicing and foreclosure cost. And as I previously mentioned, we also had $428 million of operating losses in the second quarter, substantially all from litigation accruals from mortgage foreclosure-related matters.

As shown on Slide 22, capital ratios continued to grow through strong internal capital generation. Our Tier 1 common equity ratio increased to 9.16%, up 23 basis points from the first quarter and up 155 basis points from a year ago. Under current Basel III capital proposals, our estimated Tier 1 common equity ratio grew to 7.4% this quarter. $3.4 billion of trust preferred were redeemed in the second order with a weighted average coupon of 7.44%. We expect to redeem additional trust preferred securities in the second half of this year. We restarted our open market common stock repurchase program and repurchased 35 million shares in the second quarter, and we will continue to opportunistically buyback our stock.

In summary, our strong results this quarter reflect strength throughout our franchise as we produce quarterly growth in revenue, loans and deposits. And our return on assets was 1.27%, our highest ROA in 3 years. The decline in noninterest expense from the first quarter is just the beginning of our efforts, targeting $11 billion in quarterly noninterest expense by the fourth quarter of 2012. The quality of our loan portfolios resulted in continued improvement in charge-offs, nonperforming assets and early stage delinquencies across our portfolios. Our capital levels continued to grow, and we returned more capital to our shareholders.

We're optimistic that the momentum demonstrated in our results this quarter will drive future growth as we complete the Wachovia merger integration, remain disciplined on expenses and continue to focus on meeting the financial needs of our customers.

I will now open the call up for questions.

Question-and-Answer Session

Operator

[Operator Instructions] Your first question comes from the line of Betsy Graseck with Morgan Stanley.

Betsy Graseck - Morgan Stanley

I just wanted to make sure. You said you were going to be doing a portfolio review, and you've mentioned that in the context of the expenses. Does that suggest that there would be any revenues impacted by a portfolio review or not?

John Stumpf

No. I wouldn't read that into it. We're always looking at our portfolios and what makes sense, but no, I wouldn't go -- that's not our intention.

Timothy Sloan

And Betsy, I would just reinforce that the $11 billion target that we set for the fourth quarter of next year assumes revenue growth. We believe that we can achieve that target by continuing to grow our revenues.

Timothy Sloan

And Betsy, just let me highlight that. Nothing -- revenues remains king around here. And we think that by becoming more efficient, we actually can grow revenue faster. We'll be more competitive on the Street, so -- and we have, as Tim mentioned in his comments, we have assumed in these numbers, adding more people, putting more feet on the street. And if we see some opportunity between now and the end of 2012, we'll even do more.

Betsy Graseck - Morgan Stanley

Okay. And then just separately on Page 6, you talked through the NII during the quarter. Can you talk about what kind of mitigating factors you have to deal with, the potential for further earning asset yield compression?

Timothy Sloan

Well, I think that the key for the business is to continue to grow loans. And we were able to grow loans on a sequential basis, particularly in our wholesale portfolios in the quarter, which was really exciting. We saw a decline in the rate of the drop off in the non-core, nonstrategic portfolios. I think in addition as we mentioned, we purchased about $18 billion of AFS securities, high-quality short-duration assets toward the end of the quarter. We'll continue to look for those types of opportunities. And it's also likely that we'll hold more mortgages that we originate on the sheet.

John Stumpf

Especially as the conforming caps come down.

Betsy Graseck - Morgan Stanley

Right, that's going to happen in September. So as you move into fourth quarter, is there -- can you give us any sense of how much you're expecting to retain relative to current run rate?

Timothy Sloan

No. We don't have a good estimate for that right now because we're not 100% sure what jumbo origination would be in terms of that mortgage class. But it's likely that we're going to hold more mortgages on the balance sheet than we did in the second quarter.

Operator

Your next question comes from the line of John McDonald with Sanford Bernstein.

John McDonald - Sanford C. Bernstein & Co., Inc.

Tim, a question on the noninterest expense side and the target. The foreclosed asset expense doesn't decline that much in your target by fourth quarter of 2012. And I guess, does that assume that you're still working through the cycle there, and there's more room to improve that particular line beyond the fourth quarter of 2012?

Timothy Sloan

That's a reasonable assumption, John.

John Stumpf

But I'd also say, John, there are some additional costs because of regulatory reform and some of the consent order that we had to build into our thinking there.

John McDonald - Sanford C. Bernstein & Co., Inc.

Okay. So some piece of that is still cyclically elevated, and some of it's just going to be structurally a little bit higher than it was historically.

John Stumpf

Correct. That's a good way of thinking of it.

Keith Horowitz - Citigroup Inc

Okay. Another question is you're not a huge International player, but you do have some businesses. Could you comment on your exposure to the troubled economies in Europe and how you think about risks there for your business?

Timothy Sloan

Sure. Right now, we have $3.2 billion of exposure to the countries affectionately called PIIGS. Most of it -- very little of that exposure is sovereign risk. Most of it's the corporates and bonds. Having said that, one of the real benefits from putting Wells Fargo and Wachovia together was growing our international presence. And our GFITS business is a terrific business. And we'll continue to grow Internationally, but we'd want to do it in a way where we take appropriate credit risk and deal with the right customers.

John Stumpf

And John, most of our international business, first of all, it's a very small percentage of our revenue. But as Tim mentioned, it's a business we like a lot. It's a correspondent business for central and international commercial banks. And it's highly biased or skewed towards foreign exchange, trade and those kinds of things, but it's a very small piece of our overall company.

John McDonald - Sanford C. Bernstein & Co., Inc.

Okay. Last question is could you give us any color on where you stand in terms of building reserves for litigation and regulatory matters, including the AG discussions? Is this process of building litigation reserves likely to go on for a while? Any of you?

Timothy Sloan

Well, here's how I think about that. First, I'm not going to speculate on the ultimate outcome of the discussion with the AGs and the Department of Justice. But the reserves, the litigation reserves we have today, reflect our best estimate of the estimable and probable outcomes of the discussions and conversations we've had. And remember in addition to that, we've also written down the MSR by $2.5 billion to reflect the future costs of servicing those mortgages. And we, of course, have a loan loss reserve that we believe is adequate considering all the discussions we've had. So think of it in those 3 ways. It's our best estimate for what we know today.

John McDonald - Sanford C. Bernstein & Co., Inc.

Okay. And then one quick follow-up, Tim, on Betsy's discussion around the NIM and the NII. So as you look ahead, how would you kind of summarize the puts and takes for the net interest income and the NIM going forward here?

Timothy Sloan

In terms of what the NIM might look like in future quarters?

John McDonald - Sanford C. Bernstein & Co., Inc.

Just positives and negatives, and where the key variables are. And what leverage you might have, and what environmental factors are going to influence whether you're able to grow NII and keep the NIM stable?

Timothy Sloan

Well, I think that the key leverage we have is just to continue to grow loans. I mean, we've got -- we've really grown relationships, we've talked about the success of the merger integration. And so that's number one. I think number two, as we talked about in the past, to the extent that rates rise a bit, we'll invest at a faster pace than we're investing our excess liquidity today. Having said that, as we mentioned in the second quarter, we took advantage of some short-duration assets that we found attractive. Again, these are high-quality, well-underwritten. We'll continue to do that.

John Stumpf

John, I think of it this way. We have a NIM around 4% now in probably one of the toughest environments I've ever seen. I mean, there's very tepid loan demand. We are winning new relationships, but you got to run pretty hard just to cover the runoff of some things that we'd like to see run off. And this wonderful deposit franchise we have is, I think, really undervalued in today's economic times. So these are pretty tough headwinds and we're doing pretty well in that. And we're also sitting on almost $90 billion of liquidity that's -- we're not even earning the cost of our deposits on that. So I mean, we have some real dry powder here, if you will.

Timothy Sloan

And John, just the final point, and that is when you look at one of the reasons that our liability costs came down, it was because we repurchased some drops. As I mentioned, we'll continue to repurchase drops in the second half of the year, as well as the fact that we've got about $20 billion of debt that's going to mature in the second half of the year. And I think we'll reduce our funding cost there too.

John McDonald - Sanford C. Bernstein & Co., Inc.

And can we assume the amount that you deployed this quarter, Tim, was pretty small relative to the $90 billion of liquidity? Can you tell us?

Timothy Sloan

Yes, that is correct. Yes, absolutely.

Operator

Your next question comes from the line of Matthew O'Connor with Deutsche Bank.

Matthew O'Connor - Deutsche Bank AG

Can you comment on the timing of the expense reductions as we think about getting from the mid-12s down to the 11% range over the next, I guess it's 6 quarters? Is that a straight line, front-ended, back-ended?

Timothy Sloan

Yes. It's not back-ended, and it's probably not going to be front-ended. I don't know if it's going to be at a straight line, but it's probably going to be closer to a continued quarterly reduction, like we've shown for the last couple of quarters, than anything else. Though again, I'd highlight that we could have some seasonal impacts. But the important thing, Matt, is you shouldn't expect the expenses to be flat and then all of a sudden, we'll just have a big drop in the fourth quarter next year. We're going to continue each quarter to reduce our expenses and work hard at doing that.

Matthew O'Connor - Deutsche Bank AG

And any related restructuring charges that we should expect?

Timothy Sloan

Not anything that's abnormal, no.

Matthew O'Connor - Deutsche Bank AG

Okay. And then just different topic. Among the regional and super regional banks, you have a bigger delta between your Basel I and Basel III capital ratios. I think it's about 1.8 % or so. One, can you remind us why there is such a big difference? I think part of it is deductions and part of it's the RWA inflation. And then two, what are some of the opportunities you have to narrow that 1.8% gap?

Timothy Sloan

Yes. Matt, I'll take you at your word that it's about 1.8%. But the way that we think about it is that historically, Wells Fargo has always felt that it's important to have adequate capital. That's one of the reasons why we got through the downturn as well as we did. So we've been competing against the regional banks, other smaller regional banks with more capital. And we don't believe that's a big issue. I think that the difference is specifically between our sheet, and each bank is just going to be kind of bank by bank.

John Stumpf

Matt, I'm little confused. I thought the big banks we compete with have a bigger delta between I and III, but...

Matthew O'Connor - Deutsche Bank AG

No, I'm sorry. I meant versus other regional. I guess I tend to think about you...

John Stumpf

No. On the regional side, I get it. But surely, not on the big side.

Matthew O'Connor - Deutsche Bank AG

Right. So your gap is less, but I think all things else being equal, you'd like it to be even less than it is...

John Stumpf

Yes. Less is good in this case.

Matthew O'Connor - Deutsche Bank AG

So are there opportunities to...

John Stumpf

If there -- we're always looking at that, but we're not going to do anything stupid or anything that doesn't make business sense. I don't worry about us getting to whatever our number will be. We're growing capital very quickly now, and we're going to do the right thing for the business and for our customers. And I wouldn't do something different just because I'm trying to figure out some way to narrow that gap or that we have a challenge getting to that number.

Matthew O'Connor - Deutsche Bank AG

Okay. And then just lastly, it's a little bit of an annoying, an accounting question on the accretable yield. But on Page 32, you showed the accretable yield balance coming down by about $1.1 billion or $1.2 billion, the weighted average life increasing. And I'm just trying to understand what drove both the accretable yield balance down much more than the accretion that came into earnings, and then why the average life. I assume it's related, but why that increased?

Timothy Sloan

You're right, Matt. When you look at the PCI accretable yield, it was down about $1 billion from the first to the second quarter. About half of that was reduction -- was the normal accretion which we recognized in NII this quarter. The other half was due to a decline in our expected cash flows. This decline was driven by, primarily by Pick-a-Pay. Again, we'll call these our lifetime estimates. We update these quarterly. They can be affected by interest rates, liquidation timing, loan modification activity. I think the important thing to remember is that the projected accretion is still significantly better than we had at acquisition. At acquisition, we thought this would be about $10.4 billion. We're at $14.9 billion this quarter. So even after netting out the $6.1 billion of accretion we've recognized since the merger, we're still higher.

Matthew O'Connor - Deutsche Bank AG

And the pace that, that accretes into earnings, we can think about the remaining balance of roughly $13 billion. That's 10 years, so it's going to be with us at a similar pace more or less for quite some time?

Timothy Sloan

Yes. It's been pretty steady, so I think that's a fair way to look at it, Matt.

John Stumpf

Good way of thinking of it.

Operator

Your next question comes from the line of Paul Miller with FBR Capital Market.

Paul Miller - FBR Capital Markets & Co.

There's been a lot of stuff -- earnings out as far as I'm all over the place. But did you address the loan demand? And also especially like, I think you had a big drive this year to drive small business loans. And I wonder, can you give us an update on that?

Timothy Sloan

Yes. We did address loan demand. Our loans were up sequentially from the first to the second quarter by $766 million. The core loan portfolio grew $5.8 billion from the first quarter. The loan growth was strongest in our commercial portfolio at $7.5 billion, which is up about 2% from the quarter. And then the runoff of the liquidating portfolio was down about $5 billion. And one of the areas that we grew -- I think we got an award actually, in the second quarter for the SBA who is our small business area. And those loans were up. Small business or SBA.

Paul Miller - FBR Capital Markets & Co.

There's been a couple banks out there saying that in mid-May, they saw loan demand kind of dry up due to some of the headlines from the debt ceiling talks in overseas. Have you seen loan demand consistent throughout the quarter and even into July?

Timothy Sloan

We saw loan demand consistent throughout the quarter. Overall. Every area is going to be a little different, but overall loan demand was pretty consistent. And I think that just -- that reflects the balance of our diversified model. We're not dependent on one specific area, which is pretty exciting.

John Stumpf

Not only -- but also by geography.

Timothy Sloan

By geography too.

John Stumpf

Yes. And by product type.

Paul Miller - FBR Capital Markets & Co.

So did you see consistent across geography? Was there certain areas that you saw better loan demand than others?

John Stumpf

It's not necessarily by geography different, but surely, difference based on the kind of business it is. Those who have commodities that they're selling, as commodity prices go up or down, you'll see more inventory financing. Agriculture, we're the largest U.S. lender to agriculture and people putting crops in and doing things and buying fertilizer, we're financing. That's just more, I would say, business-specific or industry-specific as opposed to geography-specific.

Operator

Your next question comes from the line of Fred Cannon with KBW.

Frederick Cannon - Keefe, Bruyette, & Woods, Inc.

I just wanted to follow up on the capital discussion. I mean, we are expecting to get some word this week out of the Basel committee on how they define global systemically important companies. I'm wondering, any thoughts in terms of where Wells falls into that? Your thoughts on that, number one. And number two, with 7.4% Tier 1 common under Basel III, that looks quite healthy relative to the 7%. Should we expect continued capital accumulation in the next year or 2, or can we expect that to level off at some point?

Timothy Sloan

Fred, we did get more information since the last call. And now the beta ask [ph] seems to be between the 1% and 2.5%. And they also shared, as you've all read, some of the criteria that gets you closer to the 1% or closer to 2.5% based on size, interconnectedness, complexity. On some of those measures, we don't even hit the scale. We're so -- whatever the opposite of interconnected is, not connected and not complex. So we've not been told our number, and we'll know more as you'll know more. But my expectation is that whatever the number is, I'm expecting it to be in the low to moderate side. And whatever you add that to the 7%, I just don't see this is an issue for us, as I mentioned in my comments. And we can't wait here to return more capital to our shareholders, our very loyal stockholders for a long time. And if you think of the kind of earnings we have today and the capital accumulation. I mean, you can just do your own math. This is just not a big issue for us as I see it today.

Frederick Cannon - Keefe, Bruyette, & Woods, Inc.

Great, okay. And just on that, John, once we get those numbers, would you like to operate any kind of strategic sense of where you'd like to operate, how much of above that or pretty close to it?

John Stumpf

Wells Fargo has always had this bias and view of strong capital. We even did that before Basel -- I even knew where Basel was or anything about the accords. And that's the history of the company, and what it gives you is the financial flexibility to do a Wachovia or do strategic things that really are important at a time when that capital really matters then. But we'll have to see what the numbers are and what the rules are and how it all comes down. So it's a little too early to comment on that. But again, just we've got another 6 quarters or so before the start of 2013, and I just don't see this as a big issue.

Frederick Cannon - Keefe, Bruyette, & Woods, Inc.

And just one more in terms of the loan growth, one thing I don't think you've talked about too much was credit cards. It looks like you got some pretty good fee growth quarter-over-quarter and year-over-year. It's still a relatively small portfolio compared to your peers. Any color on that, portfolio or opportunities?

Timothy Sloan

Sure. So we have something in the range of 28 million plus retail checking accounts, and the penetration of credit cards in the East is about 14.5% of our retail checking accounts have a credit card. It's 2.5 or 3x more than that on the West. We think there's huge opportunity here. And I can't wait to get a credit card in every one of our customers, our credit-worthy customers' wallets. And not only get in there, to be the dominant card or the primary card. So I think there's huge organic opportunity here. We like that business from a customer perspective, and not only for the transaction volume that they do. But it's a good -- it's another payments product. So we think there's big opportunity. And again, we're growing checking accounts also very quickly. So as we're catching the train, the train is also moving here, which is a good thing. Net checking accounts are up, on the retail side, 7% year-over-year. Those are big numbers because it's off a big base.

Operator

Your next question comes from the line of Moshe Orenbuch with Credit Suisse.

Moshe Orenbuch - Crédit Suisse AG

Could you expand a little bit in terms of your earlier comments, John, about capital deployment and how you see kind of the mix between further purchases of drops, stock buyback, you've done obviously some of both this quarter, and whether any acquisitions for cash also fit into that category?

John Stumpf

Okay. Again, so let's start with the idea that we like a strong capital position. It's part of our history. We have some instruments, some hybrids that are not going to fit into the capital regime going forward. And at an appropriate time, and it'll take a process, we will look to deal with those, eliminate some of those. And then the key will be how do you deploy your capital? And I think the first call on capital -- or one of the calls is to support the business. We think we're a growth business. And acquisitions are a part of that, but also organic growth is also part of it, adding people, adding distribution capabilities and so forth. I've said this publicly, the acquisitions that look most opportunistic or promising would be help build out our Wealth, Brokerage, Retirement area. We like that business a lot. We have opportunities to gain share there and have that share be more relative to the share we have in the business, compared to our deposit business. We have opportunities, I think, in the insurance distribution business. We could -- so there's just opportunities like that. With respect to -- and then the rest should be once you get to your numbers, should be returned to shareholders. It's their capital. It's your capital. And we'll do that through -- there's an annual process now to -- with our regulator. And then we'll also -- and part of that is dividends and part of that is stock repurchase, which we've done some in the first half of the year. And so you should expect that we have a strong bias to return capital to shareholders if we can't use it internally or don't need it.

Moshe Orenbuch - Crédit Suisse AG

Kind of on a separate question. When I think about that $125 million for the settlement, obviously, country-wide, there's something of an [indiscernible], but even just using their kind of loss expectations, we still would've come up with a higher number. Just can you talk a little bit about how that settlement was reached and what it encompasses?

John Stumpf

Well, I won't talk about how it was reached, but I'll talk about how it was -- first of all, think of that as securities. So you've got to separate reps and warranties kinds of settlements and litigation from securities law. This related to securities issues, and it's a settlement that involves most of the purchasers of those securities. You first have to think. So let's think about first of all, securities and then think about reps and warranties. But everything starts with the quality of the portfolio. So you go to Page 20 and look at that portfolio and look at the dichotomy, the differences. And remember, in our numbers, and the 7.2 is also some of the stuff that's on balance sheet. Pick-a-Pay, which is in that. So if you took that out, it'd even be a better number of what we sold. So how I think about the reps and warranties side, the portfolio is different than our competitors. Some of the riskiest or more problematic portfolios we have on balance sheet. And we've dealt with the rep and warranty cost through our PCI process. So we don't live that way. And in our $125 million, it's still a lot of money.

Operator

Your next question comes from the line of Joe Morford with RBC Capital Markets.

Joe Morford - RBC Capital Markets, LLC

Just following up on Paul's questions, I guess. CNI balances in particular were up nicely from the first quarter. And I just wonder if you could talk more about what was driving that. Any particular businesses? Was it more kind of large corporate or middle market? Did you see line utilization tick up at all? And any comments just in general on the competitive environment.

Timothy Sloan

Yes, a good question. I think the first point is that we do not see much line utilization, which makes the growth that much more impressive from my perspective, that's number one. Number two, it was really broad based across the entire wholesale platform. We saw it in commercial banking, real estate, corporate banking, capital finance, asset-backed finance and international. So it was good that it wasn't just based upon line utilization, and it was great that it was broad based.

Joe Morford - RBC Capital Markets, LLC

And then any comments on the competitive environment right now?

Timothy Sloan

You know what, it's competitive out there. I mean, it's always going to be competitive. I think that depending upon the business, it's probably a little bit more competitive than others. It's probably a bit more competitive at the high end in some of the large corporate when there's investment banking opportunities, but it's certainly a very reasonable environment. We like our chances in this environment, given how much we've grown customers over the last couple of years because we were there for people when things were a little bit tough.

Operator

Your next question comes from the line of Nancy Bush with NAB Research.

Nancy Bush - NAB Research

Three questions for you. On the Pick-a-Pay portfolio, do you continue to try to convert those loans to a "more normal" type of amortizing loan? Can you just speak to sort of ongoing restructuring efforts in that portfolio?

Timothy Sloan

Absolutely. Yes. I mean, we're trying to, any time we have an opportunity to modify a loan on a makes-sense basis for a customer and for us, we're going to do it. And we'll continue to do that. I think that's one of the reasons why the portfolio continues to perform better than our initial expectations because we got at it very quickly.

Nancy Bush - NAB Research

You have a sense of how -- I mean, at what point will that portfolio essentially disappear? I mean, is there still sort of a half life on it at this point?

John Stumpf

Yes, I would think of it that way. First of all let me just say, on the loans that have an option to them, about 56%. So less than 60% overall today has the Pay option, if you will. And that's down substantially from where it was when we started out. But some of these customers are -- these portfolios were built earlier. The average loan balance is in the 200 range for the ones that were not marked, if you will. And about 1,000 for the ones that were marked. So this will probably behave much like a real estate first mortgage portfolio as it is over time. So there will be a tail here.

Timothy Sloan

But it's a 10-year -- you should think about it as a 10-year portfolio, Nancy.

Nancy Bush - NAB Research

Secondly, I know it's very early on in the expense reduction, of the Project Compass, days. But do you have any sense very roughly at this point, how much of the expense reductions are going to come from sort of frontline branch activities versus non-branch?

Timothy Sloan

Well, most of it's -- very little going is going to come from frontline branch activity. And let me just go back, we've been working on Project Compass for a year. And one of the reasons why we started a year ago is because we wanted to make sure that it was a bottoms-up process. So it was focused on improving how our team members do their jobs and how they interact with our customers, right. It's not hard to reduce expenses at the expense of revenue, right. And we're just not going to do that. We want to continue to grow revenue during this time period. So when you think about Project Compass, I would think about in a reduction in merger integration expenses, we're nearing the tail end of the merger. It's costing us between $400 million and $500 million a quarter. Then you think about the reduction in loss mitigation expenses, and then it's going to come much more from staff and back-office type functions as opposed to the frontline. We want to continue to invest in our frontline bankers and stores as we've done in the East, in our relationship managers in wholesale and our financial advisors in Wealth, Brokerage and Retirement to take advantage of the opportunities we have out there.

John Stumpf

Nancy, I've been convinced for 25 years now that distribution matters. And we were convinced that when people were saying it didn't matter and it wouldn't be around anymore. And now you're having people -- then, everybody said this was just mere [ph], and now you're kind of getting some saying it doesn't [indiscernible]. We think it does. And you should expect more stores, net stores, we're still opening stores. And you should expect more people in the stores in the East. I mean, that's -- we wouldn't be growing the accounts that we are without it. So now that does not mean the store make up might not change. We continue to innovate. I mean today, we have about 5 billion retail transactions a year. And 2.5 billion, half of those, are online. Another 300 million or 400 million are on mobiles. I mean, so we continue to innovate and change. In the store design make up, what we do there, we continue to think about that. But distribution matters big-time.

Nancy Bush - NAB Research

And finally, just Tim, do have an estimate of the tangible book value per share for Wells Fargo? I know that's a metric you guys don't think that much about or really present that much, but do you have the number? And if so, can you just kind of walk us through how you come up with it?

Timothy Sloan

You know what Nancy, Jim will give you a call on that.

John Stumpf

We're so interested in Basel, we don't think of that.

Nancy Bush - NAB Research

Well, unfortunately, the market still does from time to time.

John Stumpf

Seriously, we'll get you that number. And I don't have it at the top. I mean, I...

Operator

Your final question will come from the line of Chris Mutascio with Stifel Nicolaus.

Christopher Mutascio - Stifel, Nicolaus & Co., Inc.

Two quick questions. Do your litigation reserves take into account the civil money penalties that could be coming about from the federal regulators and/or the AG settlements that may be coming?

John Stumpf

It's the best estimate we have for everything we know today.

Christopher Mutascio - Stifel, Nicolaus & Co., Inc.

Okay. And then as a follow-up, John, my fear is that the AGs will look at the penalties or fines, whatever they want to do, and they'll prorate it based on originations or based on servicing book and not based on the quality of the servicing book, which you showed in your slides, is much better than others. Is my fear justified? And if it is justified, do you balk and take your chances in court?

John Stumpf

I think what we should think about that is that our portfolio is different from others. And we're very proud of the prudence we had. We didn't do everything right, but the prudence we had. And we tell the Wells Fargo story in plain English when we have those kind of discussions.

Christopher Mutascio - Stifel, Nicolaus & Co., Inc.

Are they listening?

John Stumpf

We say it in plain English.

Thank you very much. Very much appreciate all of you on the phone. And we will see you next quarter at this time. Thank you very much.

Operator

Ladies and gentlemen, this concludes today's Wells Fargo Second Quarter Earnings Conference Call. You may now disconnect.

Comments (0)