REFINITIV STREETEVENTS

PRELIMINARY TRANSCRIPT

FITB.OQ - Fifth Third Bancorp at BancAnalysts Association of Boston Conference (Virtual)

EVENT DATE/TIME: NOVEMBER 06, 2020 / 3:30PM GMT

CONFERENCE CALL PARTICIPANTS

James Leonard - Senior Key Executive

PRESENTATION

Unidentified Analyst

And before we get started with the Q&A, I just want to remind everyone for those that would like to ask a question, you could do so at the bottom of your screen. I'll do my best to get to those questions throughout the presentation.

So let's just get things started. First off, I mentioned the geographic footprint on the brand side. Within Corporate Banking, the footprint does expand in other parts of the country, and I'm thinking Texas. So can you speak to the macroeconomic kind of observations, what you're seeing as well as expectations across the different markets in which you operate?

Unidentified Company Representative

Thanks for having us, Terry. With 1 year gap, we're glad that we're participating in this conference. Look, I think we cover a lot of space from Michigan to Florida, as you mentioned, Texas and California, where we have now commercial loan origination capabilities.

The way I would describe the environment is stable. Clearly, the second round of COVID data does not look very encouraging, but we're not yet seeing much signs. On the commercial side, we continue to experience paydowns on commercial lines. But pipelines are actually showing some signs of improvement. I think the election was an important event, and people paused a little bit as we approach November

(technical difficulty)

soon such that economic activity can continue. On the consumer side, I think today's implemented report is pretty descriptive of the environment. We are seeing on the credit side, and Jamie will get into that. Pretty stable results. Clearly, much better than what we expected back in April and May. But there's also some level of anxiety both on the commercial side and the consumer side related to further fiscal support, the timing and the size. And the Fed's concerns are very clear, and they've made some very allowed statements. And I think the market is taking notice of that.

But overall, I should say, continued liquid environment. We are still seeing growth in deposits in October. And we suspect that the environment will remain about the same through the end of the year. And then obviously, the election results and subsequent decisions in D.C. will have an important impact on the direction of economic activity.

Jamie, I don't know if you want to add anything?

James Leonard - Senior Key Executive

I think that's a good summary. And I guess we'll get into credit a little bit later in the questions.

Unidentified Analyst

Perfect. Just going back to the theme of this year's conference, which is, how will banks combat the structural challenge of low interest rates into the foreseeable future? Assuming the Fed sticks with its strategy of keeping short-term rates basically low until 2013. What strategies have you employed? And I know they're pretty extensive. What strategies can you employ to really counter the negative effect of the low interest rates on net interest income?

Unidentified Company Representative

So as you know, we've discussed this many times over the past couple of years. At the end of 2018, we took advantage of a sell-off in the market in October and November of that year. And with the conviction that we would be seeing a lower rate environment. Compared to the environment then, we executed a large portfolio of swaps, $8 billion in swaps and $3 billion in interest rate for us at the time.

Now we clearly were not expecting to be where we are today, especially the trigger was not one we would have anticipated. But we did expect significant weakening in the economy and ensuing action by the Fed to lowered interest rates. So those actions clearly are helping out. And we also have emphasized that those were 5-year -- some forward starting, some spot starting 5-year transaction. So we have a good amount of protection now until -- the market is expecting, obviously, the current interest rate environment to persist 23 and 24. We feel very good about the protection we were able to put on our balance sheet.

On top of it, our perspective was that the derivative portfolio alone was not going to be enough. And we -- over the past, I should say, 5-plus years, we've significantly changed the composition of the investment portfolio in light of the composition of our loan portfolio. Because our loan portfolio is predominantly floating. 2/3 of our commercial book is floating. And so we manage the investment portfolio overall to protect the entire balance sheet.

So the lockout cash flows are significantly helpful today. In the third quarter, when we looked at our data and data from the peers, the annualized cash flows that came back in the third quarter, relative to the portfolio size, was 10% for us. The median for the peer group was close to 40%. So that -- we were already ahead of competition in terms of the portfolio yield by almost 1%. So the ability to preserve that advantage and provides as significant protection as a derivative portfolio.

And we sort of said that, under normalized conditions, if you exclude the PPP portfolio and the overwhelming impact of the liquidity on our balance sheet, we think that our natural sort of margin at this point is about 3%. And we think we're pretty comfortable with that for the next couple of years.

Obviously, there's a lot of adoption that goes into that, but I think we feel very good. Now that's only the interest rate side. But as you know, we are also taking action on the expense side in light of revenue pressures, and we can talk about that as well.

Unidentified Analyst

And then just a follow-up there. Based on the duration of your securities and loan portfolios, how long will it take for the portfolios to reprice? So the yield in the portfolios is equal to the reinvestment rate, assuming rates stay unchanged for the next few years?

Unidentified Company Representative

So I think as we look forward for the next 2-plus years, I think we will be able to preserve the yield above 2%. We were at a little over 3% in the third quarter. So we think that we can maintain a portfolio yield over 2% with sort of the expectations around prepayment rates, et cetera, at this point.

Unidentified Analyst

Great. And then over to Jamie. The industry, along with Fifth Third, is derisked its balance sheet relative to the prior period ahead of the last recession, I was wondering if you could expand on the specific actions at Fifth Third? How much has that helped you navigate through prices better or worse so far this credit cycle?

James Leonard - Senior Key Executive

So obviously, Fifth Third is a much better positioned company today than it was prior to the Great Financial Crisis. Since then, we've completely overhauled credit underwriting, centralizing, implementing best practices and improved governance, immediately following the Great Financial Crisis.

And then when Greg assumed the duties and responsibilities of being the CEO in 2015, our goal transformed to one of being good through the cycle. And so that's been the principle by which we based our loan origination activities over the last 5 years. And as part of that decision to make sure that we would perform well through all credit cycles, we did derisk the balance sheet, about $5 billion, half of that due to credit shortly after Greg took over as CEO. Since then, we've continued to derisk with pulling back from the indirect leasing portfolio. And frankly, you see it playing out in the numbers today. We talked a little bit about it on the earnings call that we would expect our losses to be a fourth or so of what we experienced in the Great Financial Crisis.

So from that standpoint, we feel very good about the work we've done to position the company for what actually has transpired in 2020, but still a lot of uncertainty. What's been surprising, I would say, to the bad, I will take that first. To the bad, the velocity at which things transpired and clients went from performing to doors closed and 0 revenue was incredibly swift and severe. But to the good, I guess, I would say, one, idiosyncratic item related to Fifth Third is that our client selection and all of that derisking that you mentioned leading up to 2020 is certainly paid footings for us.

So the client selection and the ability of our clients to work with the bank to maintain performance has been very good. And then as Tayfun touched on with the macro environment, I guess the other surprise to the good is the combination of federal government support, along with Fed support to provide as much stimulus as well as unemployment benefits. And so the liquidity levels in the market have been a big bolster to bank credit performance thus far in 2020.

Unidentified Analyst

And let's talk about loan forbearance. It's been utilized by the banking industry to help borrowers just weather the economic downturn. What's been the latest trends in loans coming off of forbearance? How are you approaching commercial credits in forbearance? And have most of these been re-rated?

James Leonard - Senior Key Executive

So the first part of the question is the easy one. The stats on forbearance hardship deferrals, at the end of the second quarter, we were at 6%. Our loan portfolio was at 2% at the end of September, and that's 1%, excluding mortgage. Mortgage, obviously, going to take a little bit longer with the CARES Act with 6 months initial forbearance, and then the option by the borrower to take another 6 months. So we'll see mortgage play out into 2021.

But for the activity on commercial and consumer that has been under hardship programs, it's actually been a pleasant surprise that folks have migrated out of forbearance and out of the hardship and into paying current.

On the consumer side, we were at 93% of borrowers exiting the initial hardship program are current and 96% or so on the commercial side. So that would be the positive. The negative would be in what we're seeing with borrowers as you come out of the initial deferral program, if you are opting for a second program, we are seeing signs of stress in those portfolios, predominantly card being the one where we have the lower payment rates, that's at about a 70% current level.

However, the upside here would be that only 15% of our consumer portfolio coming out of hardship has elected for that second deferral. But there's signs of stress with the borrowers are those that have taken the 2 hardship deferrals.

And then, I guess, the second part of your question, regarding commercial. The vast, vast majority of any commercial borrower that took hardship relief, commercial borrower that took hardship relief, whether it's in the form of covenant relief or in the form commercial borrower that took hardship relief, of principal and interest deferral, we did re-rate. And we believe that's part of being accurate and finally in our risk ratings. And perhaps that's a driver of our criticized assets relative to peers.

Unidentified Analyst

Shifting gears. Deposit growth has been very strong for the industry and Fifth Third, just up $30 billion at Fifth Third year-to-date. Growth has been primarily driven by just policies from the government, from the Fed. The question is, can you share with us your view on deposit growth over the next 12 months? It sounds like through October, it continued to move in the positive direction. Do you think your balance sheet can shrink as customers' liquidity is utilized? Or do you think that's unlikely if the Fed's balance sheet continues to grow?

James Leonard - Senior Key Executive

Clearly, deposit growth surprised us similar to where we are in credit. But very reasonably supported by the fiscal and monetary policies. We do expect this environment to continue to keep our balance sheet fairly liquid. And I'm saying that with some amount of uncertainty because this environment is new to all of us. We have a diverse set of clients in terms of that the deposit growth to these levels, very granular. We're not talking about a handful of large corporations, deposit growth on the middle market side has been very strong. And we suspect that will continue into '21, at least through the first half of '21.

And clearly, we're not complaining about it because it gives us an opportunity to talk to the clients, to talk to them about their cash management options and not having to worry about liquidity in this environment is a good luxury compared to the 2008, 2009 crisis. And it enabled us also to be very aggressive in deposit rates. But we do expect this environment to be with us for at least a 6-month period.

Unidentified Analyst

And then just as a follow-up on this topic. Certain banks have invested a portion of the excess liquidity on the balance sheet into securities. Period end security balances at Fifth Third, if I look here, we're actually lower year-over-year last quarter, with short-term investments up. I'm just going to eyeball about $28 billion.

So I guess my question is what would cause you to extend out the duration of the assets you're investing in

(technical difficulty)

these days. And as we said during the earnings call, taking duration risk at this point does not seem like a good risk return trade-off. And we are choosing to be on the sidelines. I think what may change that is not just the duration of this deposit book, and it clearly is lengthening more so than we originally thought.

But as we think about the world, we are getting used to living in this low rate environment as it is. But there is clearly a chance that we may move on to a negative interest rate environment. And we are looking at all of our options because, ultimately, that downside risk for banks is significant.

So

if the economy and the world moves in a direction with less fiscal support and more aggressive monetary actions, which could potentially lead to a worse rate environment, if we are becoming convinced that's the case, then we may take some action. But at the same time, those are limited because you still are exposed to a pretty volatile sort of prepay environment given the options that we have. So we will be very selective, whether that would be in the portfolio or in the derivative book. We're just going to have to decide what the best way is.

But that's the environment where we may choose to sort of take some steps. We're not there yet. And at the margin, we're looking at some windows of opportunities if the market provides us. We will put some money in use.

But again, at this point, I mean, as we've seen this week, the market is quite jittery. And we'll just have to wait and see more signs -- more directional signs before we can act with conviction. I mean, instead of that, we're sort of potentially thinking about maybe looking at some mortgages, originated mortgages. If we're convinced that that portfolio gives us a big protection on the defined risks, we may choose to add a little bit more residential mortgages, but we are still being very careful in terms of the prepayment risk associated with those assets as well.

Unidentified Analyst

Let's move on to capital. Fifth third is actively returning capital to shareholders, dividends have gone up and share repurchase activity has been active until recently, as we all know, the Feds put share repurchase programs on hold for the larger banks.

So I guess my question is assuming they lift the suspension next year, what is Fifth Third's plan around returning excess capital to shareholders? And I would note, CET, a very healthy 10 plus percent, and plus you always have that RA income gain that comes into the fourth quarter that helps capital.

James Leonard - Senior Key Executive

Yes. I think we're going to be fairly close to 10.5% by the end of the year, which is one full point above our elevated targeted capital level. We -- originally, we were targeting 9%. And even then, we said we can operate this company with an 8 handle. But recognizing where the peer group distribution was, at the time, we said 9% is a good target. Then we elevated it to 9.5%. Now we are a full point above that.

Look, I think clearly, if the Fed does change their mind, then that opens up the possibility for buybacks. But as always, we will maintain a very risk cognizant approach to capital management. We need to make sure that, from the credit side, from the risk side, we have a clear expectation that the economy will not get worse. But under those circumstances, again, we have 1% of capital to potentially return to the shareholders. But it's not an automatic decision. It's one that I'm sure the Board will spend a considerable amount of time evaluating. We just submitted, obviously, the new CCAR filing. And the Fed had a fairly stressful scenario.

We believe that the risk profile of our balance sheet and also the nature of our income statement continues to perform well. So we'll see -- we'll pin out the results at the end of the year. But I think we feel good that we have a significant amount of flexibility when it comes to capital.

Unidentified Analyst

A question for Jamie. Within the commercial real estate portfolio, what sectors are likely to give you the most challenges over the next couple of years? And maybe if you could comment on 2 areas specifically, hotels as well as retail-related CRE?

James Leonard - Senior Key Executive

Yes. So thanks for helping to answer the question because I would say, definitely, hotels would be high on our list of areas with concern. Parking structures would probably be second, and then nonessential retail, where you're really not anchored by a grocery tenant within a strip center. Those will be the 3 areas that we're most concerned about.

Within the hotel book for Fifth Third it's about $2.3 billion, $2.4 billion, of which casino hotels are about $900 million. So when you remove those, we're left with about $1.3 billion, $1.4 billion of hotels, of which about 1/4 of those are tied to central business district, seminars conference and other business activity dependent.

And so within the portfolio, that is the portfolio that we think will have a longer tail and perhaps higher loss content than the entertainment or destination hotels as we see travel had picked up for a bit in the third quarter.

So within hotels, that subset is where we're focused. And then parking is a smaller allocation of the portfolio, less than $500 million there. But certainly, a consistent theme with all 3 of these with nonessential, retail with parking and with the business district hotels is that all are really reliant on people congregating. And those types of businesses are just going to have a slower recovery, and it's going to be dependent upon the path of the virus and the vaccines.

Unidentified Analyst

And if I go back to last quarter, Jamie, Fifth Third made no changes to the composition or definition of what you call kind of COVID-19 high-impact industries? So within that $12 billion portfolio, what areas are you feeling better about today that maybe have the potential to come off that list?

James Leonard - Senior Key Executive

Yes. We try to be transparent and incredible in the disclosures and not pull things in and out based on the flavor of the day. So we've kept those sectors consistent throughout. And we had some debate internally in terms of where the less stress has evolved. And within the C&I book, within the retail portfolio and then as well as with some of the hotels, why we're concerned, but regional gaming as well as the entertainment destination hotels have certainly been performing better. And we're just seeing improved results in a lot of our ABL and leverage structures. And so we feel good about those portfolios.

But again, we're a long way from resolution and with the virus. And so we're trying to be conservative as well as consistent in how we're classifying these.

Unidentified Analyst

Then over a year since you closed the MBE Financial acquisition in Chicago, how has the integration proceeded versus expectations? Can you give us some examples of what went better than expected? Where did you run into any challenges? And where do you expect this acquisition to add the most value for Fifth Third over time?

Unidentified Company Representative

Yes. I think let me start with the latter part of your question. Clearly, Chicago is -- was and is an important market, and it will continue to be a healthy commercial loan market. And combining the 2 companies gave us a pretty good leg up in Chicago. And the future of the transaction will be clearly largely based on that economic and financial advantage. But beyond that, MB had a couple of business lines that we did not have. One was a stronger

(technical difficulty)

lease banking and leasing business. And ABL was the other one. And both of those business lines are prospering well. And then it just turns out that those 2 business lines are actually pretty good business lines.

(technical difficulty) well. So we are clearly expanding those 2 in our footprint, which is giving us a very good advantage in broadening the relationships that we have with commercial customers.

In Chicago, things are going very well. We actually -- I think our production in Chicago in the third quarter was like 30% above last year's third quarter and household growth on the retail side, I think it was 3% or so, which is above the broader footprint. So we are now seeing the impact of our operations, the lineup that we have in products and services in retail. We have very good network coverage there. So all of that is looking very good. We're continuing to make progress in wealth and asset management.

Look, I mean I think no transaction integration goes perfect. And at the beginning, we had some issues, especially on the treasury management side. This is back in 2019. But all of those are over yet, they are now operating with our system. So that's behind us. The transaction looks great. As you know, we hit the cost savings target on time and at the level that we anticipated. We were able to maintain the talent level. We have good, stable leadership in the market for the combined entity. And so we are optimistic, obviously, these are not necessarily normal typical times. But once we get beyond this, I think the momentum will continue to help the company.

Unidentified Analyst

And then just a follow-up question that came in on this topic. What kind of M&A opportunities, if any, would Fifth Third be open to in the future?

(technical difficulty)

organic growth. We've always been very keen on being clear on our desire to add to fee businesses. They mostly have been either on the commercial side or wealth management, and those 2 areas will continue to be high priority areas in capital markets. We continue to seek expanding the breadth of the products and services that we have. So that will continue.

In terms of -- so obviously, in the market today, there are a number of sort of portfolio type or business -- some entities are parting with certain business lines. I mean, we'll look at those, but there is so much demand on either earning asset or some of the larger fee producing businesses and pricing is quite high, and we are not going to do anything that is economically not going to be feasible.

And lastly, in terms of full bank acquisitions, we do expect independent of our current lack of interest in pursuing a bank acquisition, we do expect

(technical difficulty)

Look, I mean this revenue weakness in general is putting a lot of pressure on all kinds of facts. And -- but we're going to have to wait and see. The industry, in general, predicted a better M&A environment every year since 2010, and it has not materialized for various reasons. And that sort of remains to be seen whether or not that will present opportunities, but I think that's way down the road. And we have a good set of businesses, a great footprint. And we are, as you know, organically expanding our retail footprint or growing our retail footprint in the Southeast in very good economies and markets. So we'll continue to do that. Those are our priorities at the point -- at the moment.

Unidentified Analyst

Then moving on. You took your foot off the gas and growing your indirect auto business a few years back. But today, Fifth Third is back again growing that business. And I apologize for the pun. What's changed in that business? And really, how do you measure profitability within the indirect auto business?

Unidentified Company Representative

Yes. Look, I mean, that's been -- for decades, the industry has gone back and forth on that business. I -- actually, when I started my career back in the early '90s, that was the first analysis that was handed to me. The business has gone through an up and down since the crisis. Spreads have reached 350, 400 basis points right after the crisis. But then they retracted all the way down to close to 100 basis points.

And at that point, given our high prime, super prime focus, we just decided in 2015 or so that we had better use for that capital. We took a step back at the moment. At the time, we were originating about $5.5 billion on an annual basis. We took that number down to close to $3 billion. And that gave us the opportunity to recycle that capital into other assets.

But business has come back over the past sort of 12 to 18 months. They're not quite -- spreads are not quite at 350 basis points, but they are in the high 200s. They were actually -- were a little bit above 300 earlier this year. And the credit profile continues to be extremely strong. And the duration is one that gives us comfort.

So we will continue to grow the portfolio. But again, recognizing that we are on top of it on a weekly basis. The business line as well as my treasury team are very closely monitoring pricing in the market. It's an easy one to turn on and off or to slow down and speed up, because it's an indirect business. But for now, we believe that it's good use for capital, lack of consumer -- other consumer assets clearly is also a contributor to that decision.

Unidentified Analyst

And then just for the sake of time, I'm going to combine 2 questions that have come in. Can you discuss some opportunities to adjust expenses if revenue headwinds persist? And then as a follow-up, can you still achieve positive operating leverage in light of the current interest rate environment?

Unidentified Company Representative

So on the expenses, in September, we announced an expense reduction effort that we said we'll reduce our run rate expenses by $200 million. We're very comfortable with that most of that action. Action Package is well underway. And during our earnings call in October, we said that the full run rate will be achieved in the first quarter of next year. So that $200 million will come off our base on an annualized basis.

And then on top of it, we also announced a second expense reduction plan, which is a little bit longer term. We are now undertaking a study on a sort of a Six Sigma lean type approach to a significant number of processes at the bank, middle office, back-office and other processes.

And we set a target somewhere between $100 million and $150 million. That will hit the income statement starting in 2022. And we have very good history in terms of managing the expenses. I mentioned a bit ago that the MB expenses were hit on time and at the level that we predicted. And we feel comfortable with these 2 plans, and we will continue to keep an eye on the environment.

It's difficult. Look, I mean, I have to be honest with you, the interest rate environment is very challenging, but cushioning some of that is a healthy fee income distribution, which is going to help us.

As to the operating leverage question, we're going to probably address that in January when we actually will share the actual 2021 expectations. So I'd rather table that question and come back to it. But we are doing -- we're very focused on it. We will continue to invest in the company. And I think those investments will continue also, in the long term, to help with expense reduction. Digital investments have proven to be extremely on point and helpful, for example, in our retail business, in front lines. And we are turning our attention to automation inside the company.

So we took expenses down. Obviously, we will continue to invest regardless, but we'll hopefully we'll be able to give you a clearer picture here for the next 12 to 18 months when we get to January during our earnings call for the fourth quarter.

Unidentified Analyst

One of the fee businesses that's been very strong is residential mortgage, just recognizing there's some seasonality in the fourth quarter. What's your outlook for mortgage over the next 12 months?

Unidentified Company Representative

So we expect 2021 to continue to be a strong year. May not be as strong as some of the heights that we achieved this year in refi boom, but I think a large chunk of the existing mortgages are still subject to refi. The purchase environment should be healthy, and we're doing everything that we

REFINITIV

can also to make our business, the back end of the business, more efficient. We have introduced a more digital customer-facing tool in the summer, which now is going to go into full force in 2021.

And so the one unknown is always again on sales spreads. As banks continue to increase capacity in mortgage, those spreads and the primary secondary spreads, have been wide. Those spreads may come in next year. But I think it's a bit too early to predict what the scale would be.

The one area that clearly all banks and all mortgage originates and services have suffered is prepayments and the impact on servicing fees. We'll go through this. And I think as you look forward on the servicing side, I think the future of it is going to be a lot more stable as we sort of take care of the refi boom, and we're a very sort of low-cost servicer.

So although it may be a little bit of a headwind today, I think it will continue to support returns once we get through this current phase of the mortgage refi boom.

Unidentified Analyst

And then just one last question. We have 2 minutes left. It came in. Can FITB get to a low 50s efficiency ratio with higher rates and lower credit costs, as was suggested in 2018? So we'll finish on that question.

Unidentified Company Representative

Yes. So normalized, when we -- I think at the end of 2019 our efficiency target was mid-50s, including the gains. And actually -- I mean, we have said we will fall maybe potentially below 55%. In a normalized rate environment, it is possible. And -- but it's going to take a while before we can move the efficiency ratio towards that 50 target. In the current environment, I don't expect us to be in the low 50s anytime soon.

Unidentified Analyst

Okay. And with that, I want to thank you both and Fifth Third for your participation this year. We look forward to seeing next year. And both of you, thank you and enthe

weekend.

James Leonard - Senior Key Executive

Unidentified Company Representative

Thanks for inviting us.

James Leonard - Senior Key Executive

Thanks, Perry.

I.
