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FINA6280
REGIONS FINANCIAL

INTRODUCTION

Regions Financial Corporation was formed in 1971 as First Alabama Bancshares Inc., Alabama 's first multibank holding company. A combination of three banks, the holding company began operations with a total of $543.0 million in assets and 40 banking locations in Birmingham, Huntsville and Montgomery. We have chosen to draw monthly and yearly data to analyze Regions Financial and Regions Bank over the term 12/31/2002 to 12/31/2012 to capture the past, present, and future environment.

REGIONS FINANCIAL CORPORATION: Moody rating: Bb1

Value

The firm's stock price closed at $33.36 and $7.13 on 12/31/2002 and 12/31/2012 respectively. Over the time horizon, price fluctuated around a mean of $20.85 with a standard deviation of $13.71. Owner's Equity grew from $4.2B in 2002 to just under $20.0B in 2007 before shrinking to $15.5B in 2012. Though stock traded at a P/B ratio of 2.18 in 2002, market sentiment regarding firm growth prospects waned as P/B declined to 0.83 in 2007 and finally to 0.67 in 2012. Applying the CAPM model[1], we estimate the cost of equity as of 12/31/12 to be approximately 10.1% for the firm. As of 2012, with the stock trading at a discount and a book return on equity of 7.6%, the firm is destroying value for shareholders.

Dividends

Dividends rose from $0.94 in 2002 to a peak of $1.76 in 2006 before being cut to $0.04 in 2012. The dividend yield was maintained at a range of 3%-6% over the growth years before dropping to a minimum regulatory level. The payout ratio also grew from

[1] CAPM model assumptions: 20 Yr TNote = 2.68%, Beta = 1.35, MRP = 5.50%

43% in 2002 to 75% in 2007 before the firm realized negative earnings over the financial crisis period. Applying the dividend growth model and an estimated Cost of Equity of 10.1%, the implied dividend growth rate to support a price of $7.13 is about 9.5%. Growth of the dividends was not aptly supported by quality earnings as the sustainable growth rate is estimated at 7.2%. This suggests that the market is pricing the firm on growth potential to future earnings.

REGIONS BANK: Moody rating: Baa3

Capital Adequacy

As of 2012, the bank's Total Equity Capital was $16.5B, increasing from $14.2B in 2008. Over the same term, the bank's Long Term debt has been retired at a meager rate, maintaining a relatively stable leverage ratio. As a percentage of Equity, the bank holds 5-6 times the Long-Term Debt held by peers, raising serious solvency risk concerns. Net Loss to Average Total LN&LS reveals that Regions experienced more than twice the average losses of peers in recent years. Furthermore, dismal Earnings Coverage of Net Losses exacerbates the net effect upon ROA. The bank's Tier I Capital has remained on par with peers historically; recently growing to 10.65% of Avg Assets as of 2012 placing in the 73rd percentile. Given stable yearly estimates of Goodwill (approx. $4.2B net of Ineligible Def Tax Assets), increases to Tier I Capital has been propelled by growth to Equity Capital. Using the risk index to analyze quarterly ROA calculations for 2002-2012, we estimate there to be a 1.2% probability that Tier I Equity Capital ratio will decline below 5% and 0.6% probability that it will decline below 2%. The bank's

Mean ROA	0.6820	Threshold	Risk Index	Probability
Std Dev ROA	0.9818	2%	9.5045	0.0055
Tier 1 Capital 12/31/12	10.65	5%	6.4491	0.0120

Tier II Capital has declined over the trailing 5 years from $3.6B in 2008 to $2.6B in 2012. The Allowance for Loan Losses has shrunk from $1.4B to to $1.2B over the same term. Subordinated Debt(Qualif Debt and Redeem Pfd) saw a larger decrease from $2.0B to $1.2B due to debt retirement. The bank appears to be shuffling its balance sheet in adherence to Basel III requirements.

Risk Weighted Assets

Total On-Balance Sheet Risk Weighted Assets have declined from $97.6B in 2008 to $79.2B in 2012. While the Category Two Asset balance remained relatively flat, Category Three and Four Assets shrunk by 18% and 20% respectively over that term. One can infer that the motivation driving reductions to these higher risk weight classes is to decrease the denominator to Risk Based Capital Ratios to magnify the metric. As of 2012, the bank had a Tier I Capital Ratio(Tier I to TA) of 10.65%, which exceeds the Basel III "Well Capitalized" lower threshold of 5%. Total RBC (Tier I+II to RWA) was 16.04% while Tier I RBC (Tier I to RWA) was 13.25% in 2012. These measures have aligned with peers in recent years, though management must remain cognoscente that the cost of conformity may be at the expense of growth to quality earnings and assets.

On-Balance Sheet	12/31/2012	12/31/2011	12/31/2010	12/31/2009	12/31/2008
RWA (billions)					
Category Two - 20%	$ 4.5	$ 4.3	$ 4.3	$ 4.7	$ 4.4
Category Three - 50%	8.9	9.5	11.1	11.2	10.8
Category Four - 100%	65.8	66.5	68.9	74.9	82.4
Total On-Balance Sheet	**79.2**	**80.3**	**84.3**	**90.8**	**97.6**
Memo: Category One - 0%	10.5	13.2	13.2	12.0	11.8

Asset Quality

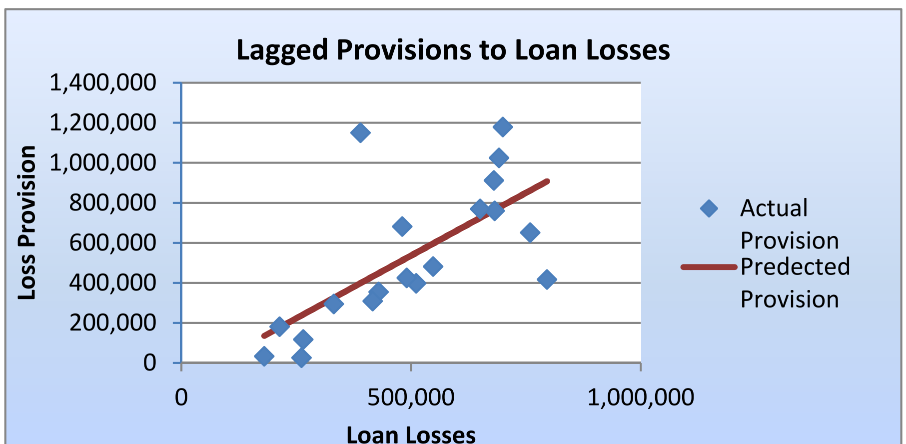
Management has been shrinking assets each quarter since 06/30/2009 from $140.5B to $120.6B as of 12/31/2012. The bank's percentage of Earning Assets to Average Total Assets has lagged the peer group by 3%-4% over the past 5 years. In part, this is due to the On-Balance Sheet shift from higher yielding, higher risk weighted assets. Loan quality has restrained profitability and begs to question Regions' ability to screen and assess risk. Though loans are concentrated heavily to 1-4 Family Residential, Commercial & Industrial, and Non-Farm/Non-Residential Loans, Net Losses to these types (standardized by portfolio size) are 3-5 times those of peers, resulting in realized yields consistently lagging by more than 1%. Slow (90days past due) and Nonaccrual loans have become an increasing burden. Though the bank achieved parity with the peer group in 2008, 3% of the Loan portfolio earned this designation in 2012 placing the bank in the 75th percentile. Loans related to Real Estate, Single & Multi Mtg, and Credit Card Plan are primary drivers to delayed payment. The percentage of problem loans (Rest+Nonac+RE Acq) to [Equity Capital plus the Allowance for Losses] has also exceeded that of the peer group, placing the bank in the 82nd percentile as of 2012.   Restructured loans as a percentage of Non-Current LN&LS exceeded industry peers by nearly a factor of 5 in recent years. Realized Gains/Losses on securities has slightly outperformed peers with nearly 80% of securities mix composed of Pass-Through or CMO&REMIC Mortgage Backed securities.

Remaining Non-Earning Assets have exceeded the peer group by 3%-6% over the same period. While Total Overhead and Efficiency metrics are in line with the industry, the bank's non-earning assets are weighted most heavily to Premises, Fix Assts & Cap Leases and Acceptances & Other Assets, which in turn has placed a strain on ROA. The Occupancy Expense appears to be a fixed burden at 0.5% of Average Assets, while the average peer expenses 0.3%.

Management Analysis

Retained Earnings (as a % of Avg Assets) has trailed peers by 1%-3% through 2012, at which point management issued a Cash Dividend of 71% of Net Income. The Loss Provision floated between 1.25%-2.50% of Assets from 2008 to 2011 before dropping to 0.18% in 2012. One should question the quality of earnings increases in concert with a drop to the Loss Provision if the deltas are similar in magnitude. While the LN&LS Allowance has habitually covered Net Losses, the balance (as a percentage of Total LN&LS) is historically 50%-60% larger than peers. From 2011-2012, Retained Earnings saw a small increase, while Total Assets and Net Interest Income both decreased. This dividend appears to be driven by a strategic reduction to the Provision for Loans Losses.

Management must be forward-looking when estimating the provision for loan losses. To determine their predictive power, we regressed one quarter lagged provisions on net loan losses to examine management's success in predicting losses for the next quarter. The results are statistically significant and the regression explains 46% of variation of Loans Loss Provisions, thus management does display an ability to predict future loan losses.



Output	Coefficients	Standard Error	t Stat	P-value
Intercept	-90847.54	177249.77	-0.51254	0.6148683
Loan Losses Beta	1.2544522	0.3324321	3.7735588	0.0015154

Regression Statistics	
Multiple R	0.6751455
R Square	0.4558214
Adjusted R Square	0.4238109
Standard Error	272274.45
Observations	19

Earning Analysis

The bank is earning lower interest income while concurrently paying a lower interest expense. Although between 2011- 2012, the magnitude of the decline in interest income (-$333M) is larger than the decline in interest expense (-$240M). Interest income as a percentage to assets has been declining steadily for the past 5 years. A downward trend also realized by peers, we can attribute this to the state of the economy and the low interest rate set by the Federal Reserve. Regions' interest income has been consistently lower than the peers as the Bank holds interest earning assets of 88% compared to 92% for the peer group, with an average yield on said assets consistently lower than competitors. Nonaccrual loans to total loans has driven down interest income with Regions and peers averaging 3.3% and 2.5% respectively over the past 5 years . High nonaccruals and larger losses have decreased the effective yield on Regions' assets. These figures could imply that Regions may have lowered its aversion to risk but was not sufficiently compensated.

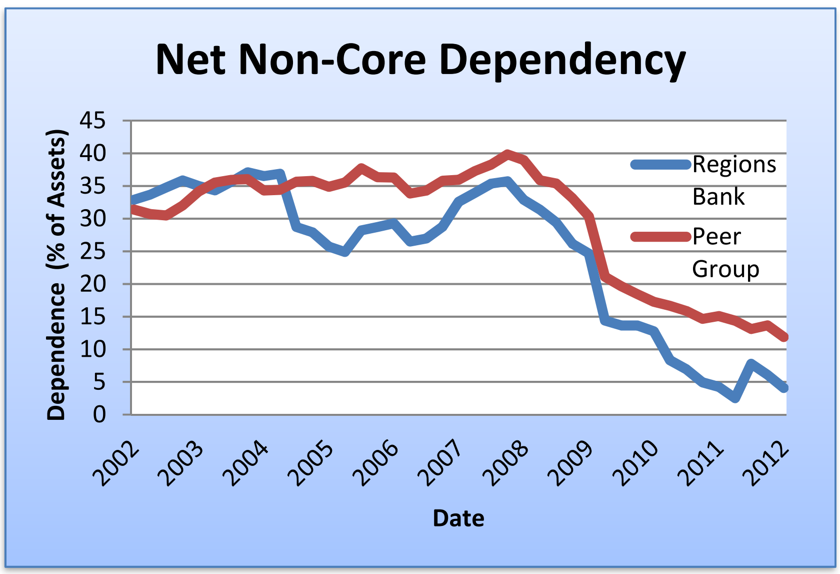
Over the past 5 years, the bank has been paying a lower interest expense except for 2009, as a result of lower cost of funds and retirement of debt. Looking at the average cost of deposits, we note that over the five-year period Regions' has averaged 1.0% while the peer group has been paying 16 basis points higher. This suggests Regions is offering lower deposit rates in order to shrink their assets. This will boost ROA and reduce reliance on non-core funding to increase its liquidity.

Noninterest income of Regions has been consistently higher than the peer group, hinting of a prowess with respect to fee-based revenues, perhaps a strategy to combat falling yields. Noninterest Income is earning 1.7% of assets compared to the 1.1% for their peer group, placing in the 75th percentile.

Noninterest expense has been flat in recent years, having no noticeable impact on Regions' earning performance relative to the peers, save 2008 when the noninterest expense was 6.8% of assets compared to 2.9% for the peer group. Provision for loan losses of Regions is at 0.18% of assets; almost half of that of peers. With such a departure from the peer Provision norm, the Net Income boost and earnings comparison to peers should be viewed with a grain of salt.

Liquidity Analysis

Liquidity is a crucial measure of a bank's financial health, and can be easily affected by factors ranging from asset allocation to market sentiment. One of the most common metrics for assessing a bank's ability to meet short-term debt obligations is the Net Non-Core Funding Dependence ratio. This conveys how dependent a bank is on funding that is uninsured by the FDIC, and likely to move to another bank at the first sign of higher yields. A value above zero means the bank may have to sell some long-term assets, in addition to its short-term investments, in order to repay all non-core liabilities if such an event were to occur. As illustrated in the "Net Non-Core Dependency" Chart, Regions has a quarterly dependency ratio above zero, but it has decreased steadily over the last 10 years, suggesting an increase in liquidity. In addition, since mid-2004 the bank has outperformed



its peer group in terms of the dependency ratio. The continued decrease in non-core dependency is encouraging for the future of Region's liquidity health, as it suggests that the bank has not depleted its source of core depositors in the respective areas of its branch banks.

Another key determinant of liquidity is the proportion of pledged securities to total securities. Pledged securities are securities posted as collateral for various liabilities and are thought to be highly illiquid. With over $11.7B in securities pledged as collateral, around 44% of Regions' securities are not available for sale in the event of a liquidity crisis. The ratio is down from 60% 2011 and considerably better than the 90% level during the peak of the recession. Currently, the bank is in a better position than most of its competitors in this category with the peer group averaging about 50% of securities tied up as collateral. Finally, one metric that is not as common but perhaps equally as important is the relationship between net loan & leases to core deposits. With this metric, one can gauge Regions' ability to support new loan growth with their insured deposits. With a ratio of 0.8, we can deduce that the bank has a healthy amount of deposits that could potentially fund new loans, which reiterates the soundness of Regions in terms of liquidity. In addition, the ratio has improved significantly since the crisis, when the bank charted a 1:1 ratio between net loans & leases and core deposits.

Basel Accord Liquidity Requirements

After the Financial Crisis took a heavy toll on economies across the globe, the Basel Committee installed several rules for international banks to adhere to in order to prevent a similar meltdown in the future. As a result, banks must meet the accepted levels of two liquidity ratios: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio

(NSFR). The LCR is calculated as Total High-Quality Liquid Assets/Total Net Cash Outflows over the next 30 days. When initiated in 2015, the LCR requirement will be 60%, but it will evolve to 100% by 2019. While we don't have the projected cash outflow for Regions over the next 30 days, the bank's large number of High-Quality Liquid Assets should be sufficient to cover standard cash outflows in the forthcoming 30-day stretch. The NSFR requirement, however, does pose a potential issue to the bank's overall health. The ratio is defined as Available amount of Stable Funding/Required amount of Stable Funding, and will eventually be required to meet or exceed 100% for loans over one year. The issue is not whether Regions can meet this requirement, but how it will affect its profitability. Specifically, the impact of the Basel requirements will force the bank to fund long-term liabilities with short-term, low yielding assets. The bank holds over a $1B in FHLB Borrowings maturing in more than a year, which would result in a need for $1B in liquid assets to cover this long-term liability. It will be important to monitor the impacts of the regulation closely over the next few years, and make necessary adjustments where applicable.

Rate Sensitivity Analysis

Gap Analysis			
Regions Bank			
	Summary Interest	>1yr	<1yr
Assets Earning Interest	88.12	42.55	45.57
Liabilities Bearing Interest	77.16	4.93	72.23
Gap (% Total Assets)			**-26.7**
Peer Group			
Assets Earning Interest	91.89	51.69	40.20
Liabilities Bearing Interest	77.80	6.50	71.30
Gap (% Total Assets)			**-31.1**

The impact of fluctuating interest rates can be damaging to any financial institution, regardless of its size, if rate sensitivity is not addressed. Re-pricing risk is one of the most important risk types to screen for when conducting an analysis on rate sensitivity. Repricing risk arises from a change in interest rates when a rate-sensitive investment matures, and is most commonly measured through gap analysis. Doing a simple gap analysis, without accounting for prepayments or calls, we witness a negative repricing gap for Regions. The gap analysis chart highlights the banks penchant for earning a spread by funding long-term assets with short-term liabilities, which is not uncommon for most banks. The short-term gap is worth noting as the Federal Reserve contemplates shifting monetary policy within the next year, which could result in the rates of the bank's liabilities increasing. Generally a negative gap implies the bank is liability sensitive, and suggests that as rates increase net income will decrease. However, observing the positive correlation between short-term T-bill rates and Regions' net income margin, we can deduce that the reverse is true on a short-term basis. In fact, we find that as 3 month T-bill rates increase, Net Income Margin increases almost one-for-one. This is likely due to the bank's hedging strategy, which includes interest rate derivatives contracts totaling more than $100 billion in notional amounts. Still, the bank's long-term repricing risk is worth noting, as the inverse relationship between interest rates and net interest

Interest Rate Correlation

	Int Inc Δ	Int Exp Δ	NIM Δ
3m T-Bill Δ	98.4%	65.2%	96.4%
10yr T-Note Δ	-22.0%	-80.6%	9.9%

Interest Rate Correlation

	Int Income	Int Expense	NIM
3m T-Bill	97.0%	83.6%	50.3%
10Yr T-Note	73.6%	84.8%	-23.0%

income seems to hold true when analyzing the correlation between the 10 year T-Note. Long-term rates are increasingly difficult to forecast, especially with changing Federal Reserve Policy on the horizon, and derivatives contracts can get expensive beyond the 5 year maturity boundary.

Concluding Remarks

With Regions bank's strategy of decreasing assets while increasing capital, the return on the bank's assets has increased over the last few years. As a result of management's actions, the leverage multiplier for the bank has decreased significantly, likely stemming from retiring long-term debt. Perhaps most important is the effect all of these policies have had on the return on equity for Regions. With ROA(1.1% in 2012)increases outpacing the decline in leverage multiplier(7.3 in 2012), the bank's ROE has increased to a solid 8.1% after turning the corner on a double-digit negative return during the peak of the recession. This justified a Baa3 rating from rating agencies, and propped up the rating and earnings of Regions Financial Corporation. As RFC's return on equity makes similar improvements, the market is looking at the company in a favorable light. The company is still selling at a price-to-book discount, but the share price has improved 35% since the downturn. Although RFC seems to trade at a per share valuation that assumes over-ambitious dividend or earnings growth, we believe the company is poised to make sizable improvements in the coming years.