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## Sovereign Bancorp, Inc. Q3 FY07 Earnings Call Transcript

### Question-and-Answer Session

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#### Operator

[Operator Instructions]. Your first question comes from James Abbott with FBR Capital Markets.

#### James Abbott - Friedman, Billings, Ramsey & Co.

The auto portfolio; could you tell us, where the reserve to loan ratio stands on that particular piece of the portfolio? And then where it was last quarter, trying to understand through the directional magnitude of how much the increase was there?

#### M. Robert Rose - Chief Risk Management Officer

Yes James, this Bob Rose. The reserve at the end of September on that portfolio was approximately 135 basis points and that is increased from approximately 88 basis points, at the end of June.

#### James Abbott - Friedman, Billings, Ramsey & Co.

Okay, Thank you. And then as you look through that portfolio, what was the main driving factor behind increasing reserve, was it the early payment defaults that caused a substantial increase and then maybe if you could put some color around that, and then also if you could look down through the FICO spectrum, where are you seeing... are you seeing the falls at the 700 FICO core level or above? Or is it all occurring down in the low 600 or what can you tell us on that?

#### M. Robert Rose - Chief Risk Management Officer

Well, I think you have several questions there. What we did was, we went through this portfolio and examined in the usual ways delinquency roll rates, FICO analysis, where the losses were coming from, even down on a dealer-specific basis. And the losses are as Mark has indicated, had been skewed more to our expansion market where we are undertaking new business, and as you expand into a new business, you do experience slightly higher losses. Going back through the FICO band, overall the FICO... pardon me, profile of this portfolio is about 62% of it would be over 700 and that varies according to the sector that we're in. In the Northeast it's somewhere around 64%. But in some of the expansion markets, it's a little lower as we were working, some of the second tier and third tier credits there. The defaults are coming from a fairly broad range of the FICO scores James, not concentrated in any one sector in the FICO range.

#### James Abbott - Friedman, Billings, Ramsey & Co.

Okay

#### M. Robert Rose - Chief Risk Management Officer

Does that answer all of your questions?

#### James Abbott - Friedman, Billings, Ramsey & Co.

I think so and maybe one last one and then I'll get jump back into the queue; but on severity as you are repossessing cars and selling them into the secondary market. I don't know if you have statistics on what the third quarter's severity was, loss given the fall compared to second quarter, that is really what I am interested in but if you don't have the exact number may be if you can give us a sense as to whether you are experiencing any changes there were relative to historical trends.

**M. Robert Rose - Chief Risk Management Officer**

Well I think that I do not have those specific numbers, but there is an increase in severity of default across the auto business. I think that higher gasoline prices have caused SUVs to bring less money today than they did in the first quarter. I think also that there's just a general sort of malaise in the consumer business, where people are not wanting to buy new cars as much as they were and if you have a slight decline in demand for vehicles, it affects prices across the board.

**Joseph P. Campanelli - President and Chief Executive Officer**

Jim it's Joe Campanelli, we did adjust that issue in anticipation of continued weakness in used car prices. We just do try to underwrite terms, lower advanced rates, shifting more towards new vehicle financing instead of used and shifting on the higher FICO scores as Mark mentioned.

**James Abbott - Friedman, Billings, Ramsey & Co.**

Okay. Thank you very much. I'll step back. Thank you.

**Joseph P. Campanelli - President and Chief Executive Officer**

Thanks Jim.

**Operator**

Your next question comes from Rich Weiss with Janney Montgomery.

**Richard Weiss - Janney Montgomery Scott**

Can you hear me?

**Joseph P. Campanelli - President and Chief Executive Officer**

Yes we can Rich.

**Richard Weiss - Janney Montgomery Scott**

Okay. I was just wondering... phone problems today I think. I just want to go back to the indirect auto lending, just kind of ask why are you increasing them so rapidly it's a charge offs are ramping up and also what kind of limit do you have in portfolio or in the indirect portfolio as a percentage of the total portfolio?

**Joseph P. Campanelli - President and Chief Executive Officer**

Yes, you could anticipate slower growth now as when you answered your Mark and basis Joe [ph] obviously it has more proportionate impact on our growth rates. But through a combination of things the growth is moderating to more normalized basis that are looking that as more like mature markets. So we anticipated by the single-digit growth based n where we are today and where we see the economy going both in total car sales within the country and the concerns of the consumer credit being much more conservative.

**Richard Weiss - Janney Montgomery Scott**

Okay, when you are saying single-digit growth rate that's on an annual basis?

**Joseph P. Campanelli - President and Chief Executive Officer**

Yes.

**Richard Weiss - Janney Montgomery Scott**

Okay. And also on the correspondent home equity low, how do you value the sub-prime loans today since, it's just a pretty difficult for everybody and Fed reserves against that?

**Joseph P. Campanelli - President and Chief Executive Officer**

Yes, I think it was very difficult from a year ago, where I think we are one of the first to decide that that's the business that we don't want on our balance sheet. It had been at discontinued business it starting from I guess the late '05 to early '06 periods but was just in run off mode. We went to market very early on and received the variety of goods. Spread at that time is that more recognize the market start to deteriorate. I think a lot of people still having great deal of difficulty in establishing with the range who would be based on our payment history and this is your portfolio. Some of the stats

flows we've looked at the positive of the fall was variable above growth in this team came up with a methodology that we felt was appropriate to apply the portfolio to corresponding write-down. Bob do you want to add.

**M. Robert Rose - Chief Risk Management Officer**

Well the benefit unfortunately in parts of this portfolio. We have lost a fair percentage of the principle balance so if 1 goes back and adds back in, in the second mean portion in particular add back in the charge offs that have been taken since we brought it back on our books and add that to reserves that have been placed on that second mean portfolio we've in access of a 46% reserve and you know unfortunately in this business for losses of binary you need to lose it all in the case of second lien loans in this quality range or you lose a little there's not a lot of middle ground. But we think the second past through this portfolio through our analysis of the previous of falls we stressed the property value quite a bit off of their current values and we think that the amount of money that we have here is adequate to see it through to its conclusion.

**Richard Weiss - Janney Montgomery Scott**

Okay and one final question I guess Mark this for you. What sort of tax rate would be appropriate to use going forward from modeling purposes?

**Mark R. McCollom - Chief Financial Officer**

Yeah, going forward, I think you should expect us to be some where just out of 20% into the fourth quarter going into next year, then if you go back and look at our K, where we do a reconciliation to your statutory rate there is about 3% impact from our Section 29 credits, which were the synthetic fuel credits. That part of the other tax law actually goes away as a 1231. So we won't have investment on our books next year. So when you think the next year all other things been equal you would expect our tax rate in a sort of low to mid-twenties range.

**Richard Weiss - Janney Montgomery Scott**

Okay. Thank you.

**Operator**

Your next question comes from Collyn Gilbert with Stifel Nicolaus.

**Collyn Gilbert - Stifel Nicolaus & Company, Inc.**

A couple of questions, starting with capital. Mark you had said assuming cleaner quarters ahead that your capital levels should rebound, I mean can you give a little bit more color as to what the goals are there and I mean obviously given the constraints that are happening there, I wouldn't anticipate much in the way buybacks for you guys? Is that true?

**Mark R. McCollom - Chief Financial Officer**

I think that's fair Collyn for at least in next several quarters. I mean we have... we had always put out some interim capital targets to achieve that we wanted to get back to where we were... sort of free the acquisition of Independence, so go back and look at our numbers in September of '05, which back then one of the numbers with tangible capital was 4.54. We have always said that we wanted to get back there by the end of this year. We were on track to do that until the charges that we had to take this quarter. I think that interim target might be delayed a quarter or so, but then once we even get back to that level, I know I have also said that we need to then evaluate once you get back to that interim stage, how your balance sheet has shifted and with the moves that we have made over the past year, we have come decidedly more commercial and as that commercial exposure increases, so should your capital, particularly in the light of what I think everyone views as a weakening credit environment. So, I think you can anticipate for Sovereign that we are going to be building capital for several quarters to come.

**Collyn Gilbert - Stifel Nicolaus & Company, Inc.**

Okay. And then on the C&I side, what is driving and if you said this in your opening comments, I apologize, but what's driving a lot of that growth and is it sustainable?

**Joseph P. Campanelli - President and Chief Executive Officer**

Yes. I think it's and there is two things going on. One is we will take much more disciplined approach in risk adjusted returns, so in certain areas where we don't feel we are getting adequately compensated, we are not renewing credits and the other side we are adding resources in market to better service commercial clients through our Pennsylvania, New Jersey and in to New York market. You may recall that Independence several years ago was primary a thrift under Brendan Dugan and his team, he has able to add experience commercial lenders into that marketplace to complement the branch network and small business. So I think its better servicing the needs of small businesses and middle market companies residing in our franchise.

**Collyn Gilbert - Stifel Nicolaus & Company, Inc.**

Okay and then would you characterize it's still more as small business focus, are you moving upscale in terms of credit?

**Joseph P. Campanelli - President and Chief Executive Officer**

There is some opportunities for end market companies to provide better services but I think the focus is really going from the small business all way up to the mid-tier middle market company, where we can add some value.

**Collyn Gilbert - Stifel Nicolaus & Company, Inc.**

Okay, okay and then, Mark can you just give a little bit more detail again for us on that credit default swap and exactly how that... how you covered on that?

**Mark R. McCollom - Chief Financial Officer**

Yes, it was a deal that we did in the second quarter of '06, there was a reference pool at that time of about \$6 billion of residential mortgage loans which what it does is that it caps the life losses that can incur under that portfolio to 10 basis points. So in other words then if losses in that reference pool would go above 10 basis points, we would then get paid on the credit default swap because some of the loans that were, that we were pointing that against in the reference pool were loans that we sold as our restructuring in the fourth quarter, a combination of that plus just normal amortization, there is now the remaining reference pool of \$3.6 billion. And so the point is that on our \$14 billion or so of residential mortgages, a little more than a quarter of them, we have protection against for life to date loss... life losses of only 10 bps.

**Collyn Gilbert - Stifel Nicolaus & Company, Inc.**

Okay. Great, okay that was it. Thank you.

**Operator**

[Operator Instructions]. Your next question comes from Ken Usdin with Banc of America Securities.

**Kenneth Usdin - Banc of America Securities**

Mark, you made the point... we know that there are these one time charges extra provisions that you had in the... on the credit side. So if you back them out, you are kind provided in the kind of mid 70s or so and I'm just wondering if you can kind of help box for us either how much ahead of future provisioning you got this quarter or if this is more of that kind of normal run rate of provisioning, if not higher; going forward to your points about your credit continuing to deteriorate going forward.

**Mark R. McCollom - Chief Financial Officer**

Right. I assume that was a trick question, Ken because we never get ahead of ourselves in provision, you provide what's required under GAAP. But when you strip those two items, the other components that I did mention is what we have seen is an increase in criticized and classified assets, which takes... if you have a commercial loan, that typically you're reserving a 100 basis points against;

as you see that it goes through the credit cycle, you may now need to reserve 2.5% or 5% if that becomes either criticized or classified. And then ultimately if it becomes a doubtful asset then you are required to reserve 50% against the asset. So as we have seen in some of those migrations through our credit portfolio that's requiring some of that additional amount. And I would anticipate for the next several quarters that you could see increased or higher levels of provisioning relative to charge offs, until that sort of front-end credit process stabilizes itself. I mean is it going to be in the \$77 million range, I not prepared to forecast to that level of detail today, but I would anticipate you to expect to see continued weakening in terms of charge offs in the portfolio for the next couple of quarters certainly.

**Kenneth Usdin - Banc of America Securities**

Right and then on that basis I mean can you talk about where you are in your expectation of charge-off normalization or moving towards peak even and what inning are we in of that deterioration of credit as far as you see it?

**Mark R. McCollom - Chief Financial Officer**

Sure, I mean as far what inning I guess I will leave the folks from the baseball town in Boston to answer that question. Bob Rose can comment on that, but from my perspective I do believe that for significantly into 2008 I expect there to be continued credit weakness I think exactly how weak it gets is exactly what we as well as the folks who cover us I think all trying to get our arms around. Bob.

**M. Robert Rose - Chief Risk Management Officer**

Well, the areas that we are paying attention to are those same ones that you are reading about in the newspaper and that we are seeing some downgrade activity take place in, in anticipation of and in recognition of actual deterioration and those are in the for sale housing sectors of the portfolio and in some building related areas and so the inning there it varies according to the individual developer and the situation. Some are very well capitalized and are able to put additional capital into situations, and some are not so well capitalized and are more collateral reliant. So we are going through all of those assets in our portfolio in making those determinations.

**Kenneth Usdin - Banc of America Securities**

Okay and --

**Joseph P. Campanelli - President and Chief Executive Officer**

And we are fortunate, Ken to be in the highly concentrated Northeast where we have haven't experienced a great boom over the last five years, especially in some of the housing growth in the Southeast and in other areas, so we are not anticipating a big bust either.

**Kenneth Usdin - Banc of America Securities**

Okay and Mark one further question, just on the margins side. You did have a little bit of... little increase this quarter, but then you are talking about you maybe moving upscale in the Auto bucket and your talking about some of the other loan growth areas being okay. But slowing in some areas and deposits kind of being tough out there I mean, can you just give us some color on what you think directionally the margin should head from here and also what impact if anything the Fed cuts have on you guys.

**Mark R. McCollom - Chief Financial Officer**

Yes, the Fed cuts benefit us a little bit, but not enough to move the needle over the kind of credit weakness that we are seeing on the credit side of things. But in terms of margin, I only anticipate for the fourth quarter it to be more flattish, I say plus or minus 5, I mean it could be plus or minus 5 again this quarter, although I only anticipate it to probably be fairly range beyond to the 274 we reported this quarter. And you are right, Ken, that I mean some of the things we are doing to clamp down from a

credit perspective, are going to have a little bit of an adverse impact on loan yields, but again we think that's going to be more than made up for in terms of credit cost.

**Kenneth Usdin - Banc of America Securities**

Okay, thanks a lot.

**Operator**

Your next question comes from Bernard Horn with Polaris Capital.

**Bernard R. Horn Jr. - Polaris Capital Management**

Just like to ask another question on kind of corresponding home equity and indirect auto loan business. I'm wondering if you have any contractual obligations to continue to accept loans that are originated by others in that area and that doesn't necessarily... the contractual obligation question doesn't really apply just to those two loan categories. I am wondering if you have obligations to do that from distribution systems elsewhere and other parts of your loan portfolio.

Second question I had is I know that Independence had quite a lot of competition on at least on multi-family housing business from other kinds of non-bank lenders like hedge funds, indirect insurance conduits and so forth, and I am wondering if that has subsided or if they have noticed any difference in there, both the competition and the spreads that they are seeing in the market?

**Mark R. McCollom - Chief Financial Officer**

I am sure. The first question on the contractual obligation, Bernard, corresponding home equity business we had... we had shut that business down in the early 2006. So we have not been taking any corresponding home equity paper for several quarters. On the indirect auto side, while that business is still open and running and growing, we underwrite every credit that comes in to us. So we always have the ability for credit reasons or otherwise to reject any application that will come in to us. Then with respect to I think you said on Independence and specifically I think you are asking about the multi-family business. Independence had a strategy of putting more of those loans on the balance sheet. Historically, Sovereign in the time that we have owned the business, we liked the business and we want to grow that business and continue to partner with Meridian Capital on that business, however with this kind of interest rate environment it made more sense for us to focus on the originate and sell portion of that business as opposed to the portfolio piece of the business. So we have been running the portfolio side of that business down from about \$6 billion to \$4 billion, but our goal and intent is still to grow the originate and sell side of that business, whether it's through direct sales to Fannie Mae or whether it's through a CMBS conduit, as robustly as we can.

**Bernard R. Horn Jr. - Polaris Capital Management**

So it sounds like on the multi-family business is because Fannie or Freddie you are getting very aggressive in trying to enter that market, I know that was a threat due to lot of the multi-family vendors have seen that would likely reduce margins in the business, is that... is that the reason that you are not bringing it on to the portfolio, those are generally speaking pretty good loans with decent yields and so forth but of course the yields were beaten down by this kind of extra competition?

**Mark R. McCollom - Chief Financial Officer**

Yes, yes that is right and I would say that if you look to where we source a lot of our loans in multi family through our relationship with Meridian and as do some other banks who have, who are... who take Meridian's production and in recent quarters I would say that some of those other banks have been more aggressive on the portfolio side than we have and you are right, the credit quality is really strong but for us it is always a balance of profitability versus just a balance sheet in earnings growth and for us right now, we think the right thing to do is to selectively put loans in portfolio for certain relationships but to instead focus on the for sale portion of that business.

**Bernard R. Horn Jr. - Polaris Capital Management**

Okay and just getting back to my other question on the contractual obligations. I wasn't quite sure if you were saying that you have no contractual obligations or you do, but you are able to kind of moderate the inflow. Is... do you have like obligations to take or not take certain loans from the various distributions systems that you are in?

**Joseph P. Campanelli - President and Chief Executive Officer**

Yes, just to be clear, Bernard, this is Joe Campanelli. We have no contractual obligations to purchase loans. Every loan we have put on our books is our sole underwriting discretion and underwriting standards and pricing on every business line.

**Bernard R. Horn Jr. - Polaris Capital Management**

Okay, Thanks. That's all from me.

**Operator**

Your next question comes from Gerard Cassidy with RBC Capital Market.

**M. Robert Rose - Chief Risk Management Officer**

Hello, Gerard, are you there?

**Operator**

Please hold sir.

**M. Robert Rose - Chief Risk Management Officer**

Yes, thank you Tracy.

**Gerard Cassidy - RBC Capital Market**

Hello?

**Operator**

Mr. Cassidy, you may proceed with your question.

**Gerard Cassidy - RBC Capital Market**

Yes. Can you hear me now guys?

**Mark R. McCollom - Chief Financial Officer**

Yes, we can, Gerard.

**Gerard Cassidy - RBC Capital Market**

I apologize. I have been jumping on and off the call. And I apologize if you have addressed this, but in your commercial --

**Mark R. McCollom - Chief Financial Officer**

Gerard, we just lost you midstream on your question. Don't know if you hit a mute button or if your phone was disconnected. Tracy, can we try to get him back or if not we will go to our next question please.

**Operator**

Yes. Hold one moment.

**Mark R. McCollom - Chief Financial Officer**

Thank you.

**Operator**

Mr. Cassidy, you may proceed.

**Gerard Cassidy - RBC Capital Market**

Will try one more time and if I get lost I will just call you on the outside. In regards to your commercial real estate portfolio can you guys give us some color of the trend you are seeing there and second what percentage of the commercial real-estate numbers are in construction loans and once you give us that number, can you give us some color of what's in residential real estate market versus the non-residential real estate market. Thank you.

**M. Robert Rose - Chief Risk Management Officer**

Sure this Bob again. The commercial real estate portfolio is about \$11.8 billion... \$12 billion and of that \$2 billion is construction and \$10 billion is permanent. Within the construction portfolio, the home builders would be approximately \$472 million, the conduit [ph] builders would be about \$457 million. The balance of the portfolio is split the largest next sector would be retail, then office, then warehouse space multi-family hospitality and other so that gives you the spectrum of that. The parts of it that we believe retail and it is performing fine, office is performing well, the warehouse multi-family hospitality etcetera all the other sectors are performing fine. The sectors that have our attention again are for sale housing and we are approaching that with a very careful management approach and we escalated all of our reporting and all of our discovery and all of our action steps to manage through any imbalance in supply/demand that makes it.

**Gerard Cassidy - RBC Capital Market**

Thank you.

**Joseph P. Campanelli - President and Chief Executive Officer**

To see the conservative underwriting over the past three to five years is maintained is resulting in some ability in the portfolio?

**Gerard Cassidy - RBC Capital Market**

Great. Thank you.

**Operator**

Your next question comes from James Abbott with FBR Capital Markets.

**James Abbott - Friedman, Billings, Ramsey & Co.**

Just another question but just a follow up on construction loans the home building and the condo, what's the typical loan-to-value for the firm and are you seeing a lot of deterioration in the markets that you are in. I don't know how much exposure do you have to various different markets there and maybe just to get the opportunity to ask that question as well?

**M. Robert Rose - Chief Risk Management Officer**

I'm sorry, you were coming through a little weak; could you repeat those again please James.

**James Abbott - Friedman, Billings, Ramsey & Co.**

Sure, just looking at the construction, the residential construction, just a piggyback offer to earlier question. The homebuilder, loans and the condo loans; what the loan-to-value ratios are on those projects in general and then also geographic dispersion on that?

**M. Robert Rose - Chief Risk Management Officer**

Yes, the loan-to-value in those two sectors range at some of them as low as 35% and 40% and some is high as 80%. Again that would be of cost of the structure not the retail price. So that can stand some marking down in the process. As to sector, the majority of these are in our area, I would say there is approximately \$250 million out of area in these sectors; and our footprint would include the Northeast and when we do leave the area, we are often times following a developer who is headquartered in one of our main markets here and we have a relationship with them and we're helping them out in some out of area projects.

**James Abbott - Friedman, Billings, Ramsey & Co.**

That's helpful. And when you say out of area, can we isolate, do we know how much is in for to California, Nevada, Arizona areas?

**M. Robert Rose - Chief Risk Management Officer**

Yes, there is no Nevada exposure, there is one Arizona project that we've done, that's... its such a low loan-to-value we did for a very deep and large relationships that represents little opening in terms of total exposure that customer. Florida I don't have an exact number with me but Florida would represent I mean to say in the 150 a range little less than that. We actually exited the credit two

days ago with \$21 million credit that had a fair out of area exposure and I need to include that in the outstanding because they were just reduced by in excess of \$20 million.

**James Abbott - Friedman, Billings, Ramsey & Co.**

Okay, well that's helpful. Then my main question that I was asking and so I switched back to the auto portfolio just as a follow up, of the charge offs of the roughly \$20 million of charges offs in auto loan this quarter, how much of that came from loans that were less than a year old and how much of it was from loans that were loans that were more than a year old. Trying to get a sense of seasoning on these?

**Mark R. McCollom - Chief Financial Officer**

Well James, I think as I had mentioned before I mean particular in the South East are the one of the disproportionate amount of first payment of falls was to triggered a lot of changes that we're making. If you look to the end-market portion of our portfolio, you'd expect to see that these losses attract what a normal season curve would show.

**James Abbott - Friedman, Billings, Ramsey & Co.**

Okay. Alright, thanks again.

**Operator**

[Operator Instructions]. Your next question comes from Michael Cohen with Sunova Capital.

**Michael Cohen - Sunova Capital**

My questions have been asked and answered. I apologize.

**Mark R. McCollom - Chief Financial Officer**

Okay thank you. I believe we are at the end of our allocated time. So I thank everybody for listening in on our call this morning. If you have any follow up questions please feel free to call myself Mark McCollom, Stacey Weikel, Head of Investor Relations or certainly, you can call Joe Campanelli, our CEO at any time. Thank you very much. Bye-bye.

**Joseph P. Campanelli - President and Chief Executive Officer**

Thank you a lot.

**Operator**

Thank you for participating in today's conference call. You may now disconnect.

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