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Texas Capital Bancshares, Inc.

Q3 2019 Earnings Conference Call

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CORPORATE PARTICIPANTS

Keith Cargill - *President, Chief Executive Officer*

Julie Anderson - *Chief Financial Officer*

Heather Worley - *Director, Investor Relations*

PRESENTATION

Operator
Welcome to the Texas Capital Bancshares' Third Quarter 2019 Earnings Conference Call. All participants will be in listen-only mode during the presentation. Please note this event is being recorded. If you need assistance, please signal a conference specialist by pressing the "*" key followed by "0."

I would now like to turn the conference over to Heather Worley, Director of Investor Relations. Please go ahead.

Heather Worley
Good afternoon and thank you for joining us for the TCBI third quarter 2019 earnings conference call. I'm Heather Worley, Director of investor relations. Before we begin, please be aware this call will include forward-looking statements that are based on our current expectations of future results or events. Forward-looking statements are subject to both known and unknown risks and uncertainties that could cause actual results to differ materially from these statements. Our forward-looking statements are as of the date of this call, and we do not assume any obligation to update or revise them.

Statements made on this call should be considered together with the cautionary statements and other information contained in today's earning release, our most recent annual report on Form 10-K and subsequent filings with the SEC. We will refer to slides during today's presentation, which can be found along with the press release in the Investor Relations section of our website at texascapitalbank.com.

Our speakers for the call today are Keith Cargill, President and CEO, and Julie Anderson, CFO. At the conclusion of our prepared remarks, our operator, Andrea, will facilitate a Q&A session.

And now I will turn the call over to Keith, who will begin on slide three of the webcast.

Keith Cargill
Thank you, Heather. I will open and then Julie will give her assessment for Q3. I will close before opening the lines for Q&A.

Let's begin on slide three. In summary, we delivered a strong quarter in multiple key areas. Deposit growth was excellent. Credit improved. Controllable core expenses were up only modestly. Mortgage finance was strong. Core LHI grew on average despite the significant pay downs we accomplished in leveraged loans. Net revenue grew linked quarter and year-over-year. Earnings per share grew 13% linked quarter and 3% year-over-year.

Outstanding results from an extraordinary effort by our truly talented team across Texas Capital Bank. And these excellent financial results were accomplished through executing our strategic initiatives to drive continued improvement in deposits, fees, efficiency and an even more differentiated premier client experience. I'm a fortunate CEO indeed to work with amazing talents,

who wake up each morning excited to build the premier business and private bank in America. It is an aspiration we all own and expect to achieve in time. Julie…

Julie Anderson
Thanks, Keith. My comments will cover slide six through 13. Net interest income increased $8.6 million or 3.5% from the second quarter and is up $20 million or 8.6% from the third quarter last year continuing to demonstrate the resiliency of our balance sheet in the existing rate environment. Mortgage finance has acted as a very effective hedge in an inverted or close to inverted yield curve scenario. Despite the fact that our NIM decreased on a linked quarter basis, it's important to understand that it was primarily related to the earning asset shifts, specifically mortgage finance and liquidity. Honestly, we don't believe NIM is the best metric to assess relative profitability or future revenue generation in this rate environment.

Traditional LHI yields were down, which is reflective of the continued decline in LIBOR. These were slightly higher in the third quarter and are comparable to Q1 levels, but remain at levels meaningfully lower than we experienced in most of 2018.

Our mortgage warehouse yields were down on a linked quarter basis and similar to last quarter the decline is not related to any shift in competitive pressures, but rather resulted from volume pricing that was already in place. And when we refer to volumes; that means loan volumes as well as deposits, both of which are positive for net interest income. Our MCA yields continue to be pressured, which was expected compared to actual mortgage rate.

We continue to have growth in deposits with growth in interest bearing as well as non-interest bearing. Overall deposit cost decreased by eight basis points from 129 basis points in the second quarter to 121 basis points in the third quarter. The decrease resulted from continued growth in DDAs as well as meaningful decreases in interest bearing deposit cost.

Our total funding costs were down 15 basis points with decreased usage of FHLB borrowing. We continue to have a solid deposit pipeline with some of the verticals getting traction, the launch of our escrow vertical went public during the quarter and more to come in the next few months of our other high-potential verticals.

Reset sensitivity simulations indicate that net interest income would decline approximately 6% to 9% assuming 75 basis points of additional rate cuts over the next 12 months. This assumes that certain floors would kick in as well as assumptions related to continued elevated mortgage finance volumes over the forecast horizon. We have a slight increase in average traditional LHI during the quarter, but balances were down as of period end that’s consistent with the continued runoff in our leveraged portfolio.

Traditional LHI average balances were down 1% from second quarter and up 3% from this time last year. The level of overall payoffs continue to be high primarily in CRE where we're continuing to replace runoff with fundings on existing commitments and some new originations. In contrast, the C&I leverage runoff is not being backfilled.

Payoffs and C&I leverage are in line with what we expected and we would expect to see further reductions in the fourth quarter. Again, we had a strong average total mortgage finance balances including MCA driven by the seasonally strong quarter, which similar to the second quarter was even stronger with lower mortgage rates. Average balances are up from this time last year about 54%. We would expect fourth quarter volumes to be strong with the continued loan rate.

We continue to experience good growth in linked quarter average total deposits with the mix of interest bearing as well as non-interest bearing. Our slower core loan growth is and will continue to be beneficial to our marginal cost of funding. We continue to see improvements in deposit mix with some contribution from verticals as well as from existing clients including mortgage finance escrow accounts. We would expect that to continue with meaningful improvement more evident in 2020 as verticals get more traction and we continue to deepen existing relationship. Overall, 8 basis points linked quarter improvement in our deposit cost and 15 basis points improvement in total funding costs with less reliance on FHLB borrowings.

Our interest bearing deposit costs were down 6 basis points, but excluding CDs, which are mostly brokered CDs, our interest bearing deposits were down 9 basis points on a linked quarter basis. As we've mentioned, index deposits have an assumed 100% beta while all other interest bearing is assumed to be closer to 65%.

Our playbook for stepping down rates was in place prior to the July moves. We're being cautious, but very proactive in applying rate reductions across the board. We expect re-pricing to remain at a similar level or perhaps faster for the next one to two Fed moves and for broker deposits they remain at $2.1 billion. With increasingly favorable pricing, the selective use of brokered CDs remains an option to supplement the funding stack as we gain traction in the new deposit focused vertical.

We continue to show positive trends in our core operating expenses, specifically looking at the changes in salaries and employee benefits, which represents over 50% of our total non-interest expense. Third quarter salaries and employee benefits were up less than 4% from the third quarter last year and year-to-date the increase is a little over 5%, levels that are unprecedented in our history. And we're doing it at a time when we are focused on transformational changes in how we think about efficiency and client experience.

We're being very deliberate with revenue-generating hires and are continuing to attract exceptional talent as our story continues to be extremely compelling. We've discussed marketing expenses and the variable portion tied to deposit. About a third of the increase in that category, this quarter, was related to the variable portion. That expense peeked in Q3 as we're not focused on growth in that category of deposit. The remainder of the increase was normal business development, which can fluctuate from quarter-to-quarter, but is not a significant part of the total expense.

Third quarter included an MSR impairment of $2.6 million and that's compared to $2.8 million in the second quarter and $2.9 in the first quarter, so a total of over $8 million of non-run rate expenses negatively affecting total non-interest expense for the year. We are in the process of

putting instruments in place that will protect us from future downside risk with the MSR portfolio assuming rates continue to fall.

Our efficiency ratio for the third quarter was elevated to 54.8% and was really related to a couple of MCA items, all of which are rate related and have been offset in net revenue, either this quarter or in prior quarters. The classifications of several of the MCA items as well as the marketing cost related to deposit have been punitive to our efficiency ratio.

If servicing costs were netted in non-interest income against servicing revenue and the related marketing fees were moved to interest expense, our efficiency would have been consistently in the 50% to 51% range, and would show an improvement year-to-date 2019 compared to 2018. We believe a more representative measure to focus on in evaluating our non-interest expense trend is non-interest expense to average earning assets, which has improved from 2.15% in the third quarter of 2018 to 1.86% in this quarter.

We are pleased with our improvements in our credit in the third quarter, namely a lower provision level as well as a decrease in total criticized net of the charge-offs. Our non-accrual levels are still at a relatively low level of 0.49% of total LHI.

Net charge-offs for the quarter are primarily related to energy and leveraged, specifically $17 million in energy and $20 million in leveraged. Similarly, year-to-date charge-offs of $61 million are comprised of $32 million in energy and $24 million in leveraged. All of the quarter's charge-offs were related to existing problem credits that we've discussed in previous quarters.

Additionally, we experienced a meaningful decrease in total criticized levels in the third quarter and that's directly reflective of the actions taken over the past few quarters in actively managing each of these credits. Our total criticized as a percentage of total LHI remains low and dropped to 2.2% this quarter, compared to 2.6% in the second quarter. For all criticized loan relationships, we continue to be engaged and are forecasting additional pay downs in the fourth quarter.

We had a meaningful drop in provision to $11 million from $27 million in the second quarter. Loans being charged off already had certain reserves allocated. Earlier in the year, we expected a larger portion of provision in the first half of the year and our actions have translated into achieving that. There will still be revolutions to existing credits and there could be migration within the criticized book, but we do believe there are enough offsets in those forecasted recoveries of provision for us to lower our full year guidance. We continue to be focused on crisp management of the problem credits, primarily in leveraged and energy to minimize downside impact. And we're actively monitoring all portfolios in light of macroeconomic factors.

Turning to the quarterly highlights, our continued strength in linked quarter net revenue despite the punishing rate environment, that's resulting from our strong volumes in mortgage finance which have continued to contribute in a meaningful way to the increase. First quarter and second quarter non-interest income had $8.5 million and $6.5 million related to a legal settlement, which was not recurring in the third quarter and that was the main driver of the decrease on a linked quarter basis.

We continue to have some noise in the loss on sale of loans line in non-interest income, which has primarily resulted from holding MCA loans longer, which increases the hedging cost and is offset in additional spread income. This quarter that line also included an additional increased reserve component related to a spike in early loan payoffs resulting from refinance activity.

We're continuing to improve run rate on core operating expense items. Year-over-year 8% increase in non-interest expense compared to prior year Q3 excluding OREO recoveries last year. Excluding the increases in marketing related to deposit cost and the increases in servicing related to impairment, the year-over-year, as well as year-to-date comparisons are 4% to 5%, which again is unprecedented in our history and represents a significant improvement in managing our core operating expenses.

ROE and ROA levels were improved in the third quarter as a result of the lower provision for loan losses. Our ROA levels will continue to be negatively impacted by the higher mortgage finance and liquidity balances. Loan loss provision levels will continue to be key to driving improved ROE.

Now, we will turn to the outlook for the remainder of 2019. We're maintaining our guidance for average traditional LHI growth at mid-single-digit percent growth. This is reflective of the growth we experienced earlier in the year and incorporates our current focus of positioning our balance sheet to be as strong as possible as we head into what could be a challenging point in this cycle.

We're increasing our guidance for average mortgage finance growth to mid-to high 30s from low-to-mid 20s percent. That's takes into consideration the additional growth so far this year and an expected strong Q4. Obviously, this is the lowest risk category for us, so we're happy to explore the opportunities available with lower mortgage rates, even if it means temporary dilution to some of our performance metrics. No changes to our MCA guidance of $2.5 billion for average outstandings, MCA will continue to benefit from the additional volumes with lower rates.

We're increasing our guidance for average total deposit to high-teens percent growth from low double-digit percent growth, reflective of the DDA growth that we experienced in the second and third quarters.

Decreasing our guidance for NIM to 3.2% to 3.3%, that's down from 3.5% to 3.45%. The decrease is driven primarily by the earning assets shift we've experienced and will continue to have from the total mortgage finance, which is relatively lower yielding asset. While punitive to NIM, the added growth is very positive to net revenue and offset some of the impact from rate decreases.

Our guidance assumes no Fed changes in rates as the probabilities for those continue to move dramatically from week-to-week. However, it's important to understand how we believe rate cuts will affect us. And we're focused on it in terms of net interest income, which will be negatively affected our future rate decreases. As I noted earlier, the decrease to net interest income could be 6% to 9% over the next 12 months, assuming 75 basis points of additional rate cuts.

Our guidance for net revenue remains at high single-digit percent growth. Because of the lower level of provision in third quarter, coupled with continued relationship specific strategies, our leveraged lending and energy portfolios, we're reducing our guidance for provision expense to high 60s to high 70s and that's down from mid-to-high 80s.

Our guidance for non-interest expense remains at mid-single-digit to high-single-digit percent growth. As we've noted, we continue to feel very good about the slowing of our core operating expenses, but the impact of MSR impairment charges, as well as the variable marketing costs have driven upward pressure on the range. Our guidance for efficiency ratio remains in the low 50s.

Lastly, we'll turn to our longer-term outlook. These are the right goals and we're committed to achieving them, but the timeline will be more challenging in the existing rate environment. As you know, the initiatives we have in place are focused on repositioning our balance sheet to be more stable through rate cycle, but certainly there can be variability at different points in that cycle. We are confident that we have the right initiatives underway for the long term. Historically, we have been very successful at repositioning as needed and we expect similar success this time. Keith…

Keith Cargill
Thank you, Julie. We are committed to delivering an even more premier, differentiated client experience to our current business and private clients, while developing new best-of-class specialized industry verticals. Elevating our client experience delivery and opening new specialized industry businesses will create untapped opportunities to attract clients in a more favorable ROE and self funding categories, helping us overcome with growth some of the shrinkage we continue to experience deliberately in our leveraged lending.

Mortgage finance continues to give our company a high performance growth engine with essentially U.S. government credit risk, this business allows us to grow net interest income despite the late cycle challenges in pricing, and structure and other core LHI categories. It also provides significant self funding through the mortgage finance, treasury management deposits. And the fee income from the mortgage finance business covers our cost of operating the business. Beyond the success of the mortgage finance deposit growth, we have seen strong growth in core CNI treasury management deposits, as well as early growth in some of our new deposit verticals.

In combination, the core treasury deposits and new deposit vertical funding has grown by over $1 billion so far in 2019. Our final two deposit verticals launching in the first quarter of 2020 are expected to be the most significant new deposit growth initiatives of all. We're bullish on our deposit growth prospects for the next few years as these verticals mature and our bankers and treasury management partners drive increased core treasury growth, as well as cross sell new deposit vertical products.

It was most encouraging to see not only loan loss provision decline meaningfully, but also to see a significant decline in criticized classified loans. The credit team, loan review team, relationship managers and their group heads have all worked as one team for the past year to understand the loan portfolio at a deep, granular level and de-risk the portfolio before an eventual economic

slowdown sometime in the future. Their hard work continues and we expect to deliver an improving trend for several quarters ahead.

We're seeing significant improvement in process efficiencies and the resulting improvement in more responsive client service and lower core operating expense growth. We are working diligently and with confidence to deliver a great long term investment for our shareholders and premier service and products for our clients.

Operator, if you would let's please open the lines for Q&A.

QUESTION AND ANSWER

Operator
To ask a question, press "*" then "1" on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys, to withdraw your question, press "*" then "2." At this time, we will pause momentarily to assemble the roster.

And our first question comes from Ebrahim Poonawala of Bank of America, Merrill Lynch. Please go ahead.

Ebrahim Poonawala
Good afternoon, guys. I think the first question Keith, just based on feedback I've received over the last one hour, would love to get a little more color on credit and how we should read you lowering the provisioning guide, would love to get in terms of your comfort on migration chance in the leverage lending, the energy book and just the risk of like things again surprising to the downside to your six months of now. If you could talk to that, that would be helpful.

Keith Cargill
Well, we're encouraged. It's early to declare victory, but we really believe we have a much deeper understanding, Ebrahim, of our portfolio and not just leveraged lending and energy than certainly, we had a year ago and it's taken a tremendous amount of work by all the groups. I mentioned, our loan review team, credit team, our bankers, our group heads, everyone is really pitched in and it is most encouraging to me that we're seeing this trend is tipping down that's meaningful link quarter, but we need to put two or three of these together and I believe we will. It's taken a while to be confident that we really have our arms around the portfolio, but I believe we are in that kind of situation and things can happen on a given credit and a given 90 days. So again, I'm not here to declare victory, but I do believe we're on the right path and we're going to see, hopefully multiple successive quarters with the right trends, not just one.

Ebrahim Poonawala
Got it. And is it fair to assume that the quarter-end included other banks I've talked about the SNIC [ph] exam having an impact, is all of that reflected?

Keith Cargill
It did include that, in fact, we had no surprises on the SNIC exam. Our team was on top of it and so that came out just fine for us.

Ebrahim Poonawala
Perfect. And just moving on, in terms of capital when we look at TCE, in the high sevens, just talk to us in terms of, how you're thinking about how low can capital ratios go just your…strategy around participation of the mortgage warehouse loans. And how CECL if at all may impact capital ratios towards the end of the year?

Julie Anderson
Ebrahim, we talked about earlier in the quarter that we're comfortable with taking advantage of what we're getting with the warehouse growth. And so, we're comfortable with doing additional participation. We ended the quarter participations commitments were a little over a $1 billion. So we're comfortable with that. We want to make sure that we can continue to take good care of our clients. So we're comfortable with that TCE ratio, that's comfortable for us. We're very comfortable with that.

CECL, we're not saying too much about CECL, what I would say is, what we have said in the past that for commercially focused institutions like ourselves. We don't expect a material change in our overall provisioning. So I think that we're comfortable with that.

Keith Cargill
By the way, Ebrahim, that move and what we had in actual funded participations at second quarter end versus third quarter end was close to a $0.5 billion. So we could have taken that on balance sheet, but we're being very disciplined to take care of clients without putting it all on balance sheet and I think that's the right move. Had we put it on balance sheet, it would have been about a 23% growth link quarter. But I think, we're doing the right thing to have a strong business, but also to manage it and not let it all grow on balance sheet.

Ebrahim Poonawala
Got it. And if I can sneak in one last question, demand deposit growth was extremely strong. Is that sustainable like do you expect to hang onto these balances as we look into the fourth quarter and have we seen any early results from the one or two big deposit verticals that are either online or in the process of coming online?

Keith Cargill
Yes, we're very encouraged about what we're doing with our deposit verticals and our core treasury efforts. Our bankers have done just as we ask and really taking their treasury partners out far more on calls and we're filling in some of the gaps and relationships where we only had loan relationships and that's really contributing along with our new deposit verticals. As I mentioned, just this year and nine months we're up over $1 billion in those two categories. We don't want to drill down a lot at this point, but I think you can tell, there's always seasonality that comes from our mortgage warehouse deposits and we experienced it in the second quarter and again in the third, but I wanted you to also hear about that north of $1 billion growth that came

from verticals and also just core treasury growth which is awesome to have alongside those seasonal balances.

Julie Anderson
Hey, Ebrahim, typically, we can see some seasonality in some downward impact from seasonality in our deposit in the fourth quarter and the first quarter.

Ebrahim Poonawala
Got it. Thanks for taking my questions.

Operator
Our next question comes from Brady Gailey of KBW. Please go ahead.

Brady Gailey
Hey, good afternoon guys.

Keith Cargill
Hello, Brady.

Julie Anderson
Hey, Brady.

Brady Gailey
So the mortgage warehouse and MCA combined continued to perform really nicely here, it's up again of a strong 2Q. It feels like, we're getting close to the levels where you start hitting concentration limits, I forgot exactly how you all look at it, but I know you have a limit out there. I mean, as MCA and the warehouse continues to be robust and potentially grow from here, will most of those balances move into the participation program you have through other banks or is there still capacity to let the balances grow on Texas Capital's balance sheet?

Keith Cargill
Well, as we moved into the fourth quarter, well the volumes will be very good compared to most seasonally softer fourth quarters. I don't anticipate it being higher. And so, I don't believe that's going to impact this Brady in the fourth or first quarters. And as we grow the overall balance sheet between now and the second quarter next year, I think, we'll be fine and in good shape and not have to lay off all of the growth once we get a couple of quarters down the road.

Brady Gailey
Alright. And then one more on credit, if you look at non-performing loans, they're pretty much stable or up a little bit linked quarter. The net charge-offs obviously would naturally reduce that. So maybe just talk about any sort of inflows into the NPL bucket in the quarter?

Keith Cargill
There was one energy deal and that was the bogey that got us slightly over. I think it was like two million hires I recall from prior quarter overall on NPA, still quite modest NPA stuff.

Brady Gailey
Okay, great. Thank you guys.

Keith Cargill
You're welcome.

Julie Anderson
Thanks.

Operator
Our next question comes from Brett Rabatin of Piper Jaffray. Please go ahead.

Brett Rabatin
Hey, good afternoon everyone.

Keith Cargill
Hello, Brett.

Julie Anderson
Hi, Brett.

Brett Rabatin
I wanted just to go back to Julie, the NII guidance and the 69% downside for 75 basis points. Can you just talk about how you're modeling that in terms of the verticals for growing deposits, how the mortgage warehouse factors into that is as presumably declines, it would seem like you have a net benefit to the margin. Can you just walk through the modeling for how you're doing downside for fed cuts?

Julie Anderson
Sure. So we're focused on net interest income because you're right, there can be some variability in NIM with mortgage finance balances. I said, we're assuming 100%, beta on the index deposit and 65% on the other interest bearings, but that also assumes that mortgage finance growth still continues to be pretty strong, not elevated, but certainly still strong over that four quarter horizon.

Brett Rabatin
Okay. And then wanted to talk about the LHI growth for a second, as you overcome the declines in leverage lending, I'm just thinking about the growth file for the next year or so. I mean does that improve notably or can you give us any additional color on how you see that trending once you've got...running down some of the leverage book and then obviously, it's not going energy as well?

Keith Cargill
We're really encouraged about a couple of new corporate verticals that we're looking at, that are full blown lending and deposit verticals. So these would be separate from the deposit vertical initiatives we launched year and a half ago. And we have a team that's close to us announcing that will launch the first of those verticals. So we will be able to talk about that in January. And I'm very optimistic with that new vertical, with our some new talent we've been able to bring to the company and our overall C&I business both in Houston and Dallas that we're going to be able to more than backfill, it is just too early to give you that guidance for next year, but I'm very encouraged that will be even more diversified certainly with lower risk growth than what we experienced the last few years when we were growing leverage lending. So I will have more for you in January, but we have yet another two corporate verticals we're contemplating to launch at some point in 2020 and between those three, I believe that we're going to have some good solid diversified appropriate risk growth in our book.

Brett Rabatin
Okay. Great. Appreciate the color.

Keith Cargill
You're welcome.

Operator
Our next question comes from Steven Alexopoulos of JP Morgan. Please go ahead.

Steven Alexopoulos
Hi, everybody.

Keith Cargill
Hello, Steve.

Julie Anderson
Hey, Steve.

Steven Alexopoulos
I want to start on the new margin guidance. Is my math correct, because the midpoint of the new guidance seems to imply a NIM in the 270 range for the fourth…

Julie Anderson
No, that we do expect NIM, that's all we try to focus on net interest income obviously. But we do expect NIM with the continued success in mortgage finance, it could take down, it would take down in the fourth quarter compared to the third quarter, that would also factor in the full extent of the September move. So but not that low.

Steven Alexopoulos
So what is…just so we're clear? What is the range that you're expecting NIM to come down in the final quarter?

Julie Anderson
The range that we updated was the...was the 3.20% to 3.30%. That's the update for the full year, 3.20% to 3.30%.

Steven Alexopoulos
Okay. Just looking where you started 2019, it seems to imply a pretty dramatic reduction in NIM coming again in 4Q. Do you expect the pressure to be pretty consistent with what you reported this quarter?

Julie Anderson
I obviously expect the fourth quarter to still be in the low 3%.

Steven Alexopoulos
Okay, got you. Okay. Can you remind me, for your mortgage finance loans, they carry a lower yield in peers which are just in the mortgage warehouse business rate, First Horizon reported 5.3% yield. Just wondering why your yield is so much lower with just the mortgage warehouse business.

Keith Cargill
We really focus, Steve, on the QM business. Now, we have a little non-QM, but other competitors are more comfortable with non-QM than we are. And so, that's the primary difference.

Steven Alexopoulos
Okay. Got you. Okay, and then just finally, I'm trying to make sense of this very strong deposit growth. I know Ebrahim asked the question, but when we look at non-interest bearing and savings deposit growth, why were they both so strong this quarter, it was really off the charts growth.

Julie Anderson
It is primarily from existing client, some related to mortgage finance and then some related to some of our core clients. Keith mentioned there was some impact from some of the vertical, but most of it was from existing clients.

Steven Alexopoulos
Got you, and you said...

Keith Cargill
You said, Steven we grew so fast the last five years, we had some gaps, but we did not gather up the treasury relationship. And so, we've really been focused on that and it's bearing fruit. And it's really helping us along with the new verticals.

Steven Alexopoulos
Okay. And now that you have this liquidity, do you plan to keep the loan to deposit ratio below 100%?

Julie Anderson
Yes, we'll assess the liquidity levels that we have obviously we had some outside success in the last couple of quarters in deposit generation. We've reduced what we're borrowing. That's still leaves us with quite a bit of liquidity so we will assess that. There will also be some seasonality and some of our deposits primarily DDA will see some seasonality in the fourth quarter. So we'll take all of that forecasting into assessment on what we're going to do with liquidity levels.

Keith Cargill
And we're really looking anyway we can at replacing higher cost funding too Steve. So like the brokered deposits over time, we're going to be in a better position to take that out and improve our NIM.

Steven Alexopoulos
Okay, terrific. Thanks for taking my questions.

Keith Cargill
You're welcome.

Julie Anderson
Sure. Thank you.

Operator
Pardon me. This is conference operator. If you were currently in the question queue, could you please re-queue, I have accidently cleared the queue? So if you would like to ask a question, please press "*" then "1" at this time. And we will pause for a brief moment to reassemble that roster.

And our next question will come from Matt Olney of Stephens. Please go ahead.

Matt Olney
Hey, thanks for taking my question. I want to stick with the deposit discussion. And Julie, you mentioned downward pressure on deposit balances due to seasonality in the fourth quarter. If I look at the full-year guidance, I think it implies that the balances in the fourth quarter will drop pretty considerably by 9% or 10%. Can you just confirm that I'm thinking about that right for the fourth quarter deposit balance?

Julie Anderson
Yes, we try to be conservative with our guidance. So we do expect some seasonality impact on deposits. We try to set that guidance so that it is conservative, that's how I would leave it.

Keith Cargill
And Matt, with the continued strong volume and warehouse along with that, it does help offset the normal seasonality on the deposit side too because they're building their mortgage servicing book, and so that helps keep it a little higher and more stable. But we also look at historical seasonality

and we try to take what we know today, along with historical and give you a more conservative guidance.

Matt Olney
Got you. Okay, I think going back to…I think it was Brady's question previously, on the migration of loans from criticized into non-accrual. I think I see the migration that you mentioned Keith on the energy portfolio, but it also looks like there was some negative migration in the leverage lending book. Non-accruals were flat there, but there were still some higher charge-offs in the third quarter. Any color you could tell us about that book?

Keith Cargill
Yes, we really have…been able to address those charge-offs in prior quarters and built that provision which we all know was pretty hard on us in the first half of the year, but we are seeing the overall criticized classified tip down. And then within that, I really think we are seeing improvement in the classified. So it's not simply a matter of the criticized which we got on the radar in the first quarter with these deep dives we've been taking on our loan portfolio over the last four quarters, it's also the actual classified component that's very encouraging at this point. So yes, there were a couple at it [ph] toward quarter end, but the overall trend of migration we think is favorable going into the fourth.

Matt Olney
Got it. Thank you.

Keith Cargill
You're welcome.

Operator
Our next question comes from Michael Rose of Raymond James. Please go ahead.

Michael Rose
Hey, thanks for taking my questions. I wanted to go back to something you said earlier in the call around expenses. Julie, I think you said the way you guys are looking at it now is expenses to average assets. Is that correct? And if so, do you have kind of thoughts, it's obviously come down, but you have thoughts kind of around, how we should think about that moving forward?

Julie Anderson
No, I'm mean, we have been giving guidance on that. Michael, that's a thoughtful question and we will certainly think about that. As we struggle with trying to explain how we really are doing a much better job on our core operating expenses which is non-interest expense to average earning assets, it just seems like a more representative metric of our progress. We haven't given any guidance on that, I think we feel comfortable that that's going to continue to improve. But we haven't given any specific guidance on it.

Keith Cargill
Excuse me, Julie.

Julie Anderson
Sure.

Keith Cargill
I might add, Michael, over time this gap between efficiency ratio as Julie's described measuring it and the traditional way we measure it, those lines will cross or meet and that will be as we replace some of these marketing expense deposits. Those marketing expenses are what really throw us and make it hard to give you metrics that are comparable that of peers. But again, that's one of the key things we're working on, is lowering overall cost of funding including those marketing expenses.

Michael Rose
Okay, that's helpful. And then maybe just going back to the margin, not to beat a dead horse here, but I think the guidance you said does include any future rate cuts this year. Looks like the futures are implying we get one month LIBOR is already down 14 basis points this quarter. Is that kind of all...at least the drop in LIBOR, is that contemplated in the outlook and why perhaps the range is so big, and then if we do get a rate cut in October-December, would the dynamics around the stats that you quoted before in terms of the impact on NII, would that shift at all? Thanks.

Julie Anderson
So what would already be factored into the guidance is where we ended the quarter, right. The loans how they had re-priced this level at the end of the quarter that's [indiscernible] included in the guidance. And then what we've assumed in that…the sensitivities that I gave you what we've assumed is that there is another 75 basis points we've assumed that could be in October, move, December and then again in June for that 12 months of sensitivity [ph]?

Michael Rose
Okay, that's...

Keith Cargill
And then as we mentioned, of course, you have 100% beta on the institutional funding and then we are projecting a 65% beta on our other interest bearing.

Michael Rose
Okay. Maybe just one more separate question on energy, I know it's been a topic of a lot of calls. So far you guys spoke last summer that you guys had seen some issues back then and the thought process was you were getting ahead of it and we're going to be perhaps first out of the shoot. Do you still kind of feel that way, and maybe just as it relates to energy, why do you think we're seeing the issues that we're seeing now when oil prices are still pretty healthy? Thanks.

Keith Cargill
I do think we're ahead of it as anyone. And I say that because the capital market is just kind of locked up right now, and that is causing some of the stress on some of the energy companies

that were not geared to be full blown operating energy companies. So it was more of a acquisition play when they thought prices were low and new capital came into that space with the intention of proving up some of the unproven property that they acquired with drilling programs. And now, they realize they're going to have to be generating drilling programs that are cash flow positive, because the capital markets aren't active. And so, they don't have access to the capital. They have robust drilling programs.

So I think it's just in that state where it's difficult to call, how long we might be in this mode of them working their way through it. But I do think we are more on top of the portfolio certainly than many banks and we had to be, because it's something we've done in Texas Capital our entire history, but most of us are involved in the credit process that the company have done this 35 years, 40 years. These cycles every single one is unique and you learn from each one, but you have to be so aggressive and looking at each deal and each operator. We're much more thoughtful now about looking more carefully at drilling plans, Michael because some of the...again operating knowhow with all that capital flowing in was getting pushed to do some outlying drilling to try and elevate the price of the overall property, and by doing that, they took some more risks than they should have.

I think, we've identified who those are and it's more a matter with the rest of the portfolio of just grinding through this period where they have challenging access to capital. And I mean challenging access to any capital because as banks were looking so carefully at our borrowing basis that we're taking a lot of the cash flow that they had hoped, they'd be able to deploy in new drilling activity, but in order to be sure we keep our borrowing basis in line, more of that cash flow on debt pay downs. So it's not simply a matter of equity capital that's kind of in a wait and see mode, but also debt capital that they're having a challenging time to find it.

Michael Rose
Very helpful. Thanks for all the color, Keith.

Keith Cargill
You're welcome.

Operator
Our next question comes from Jon Arfstrom of RBC Capital Markets. Please go ahead.

Jon Arfstrom
Hi, thanks. Good afternoon.

Keith Cargill
Hello Jon.

Julie Anderson
Hi Jon.

Jon Arfstrom
Hi, couple of near term and then longer-term question. But earning assets have been up quite nicely in Q2 and Q3 and I am just curious if you feel like Q4 earning assets can be up again?

Julie Anderson
No, it depends on warehouse volume. And so we think they will be good, I don't know that they're going to be up because fourth quarter is seasonally a little slower. So, I don't want to keep...I wouldn't say that it'd be up.

Keith Cargill
We're still overcoming on the net growth side, Jon, the bleeding down the shrinking and de-risking of our balance sheet with the leveraged lending portfolio. And so actually we're really quite optimistic that we'll have an even bigger pay down in leverage lending than we had on average the last three quarters. So, if that occurs, then you just have to make up that $100 million plus roughly in order to get back to zero. And so, it'll be a modest growth, if any growth in the fourth quarter, but I don't think you have to drill down to see if that's good, I think it may be good because we are de-risking our balance sheet.

Jon Arfstrom
Yes. Okay. Okay. That makes sense. It's just another way to think about the margin, NII equation. And my assumption would be flat to down and I just want to make sure I'm thinking about that correctly.

Julie Anderson
I think that's…

Keith Cargill
I think you are.

Julie Anderson
Yes.

Jon Arfstrom
Okay. On the provision, I appreciate the fact that that came down, but there's still about a $10 million swing factor in terms of a high and low level of range. Just curious if you're leaning one way or the other. I know that's a lot of this kind of depends on what happens at year end, but how are you feeling about it right now?

Keith Cargill
Well, I can tell you I'm leaning more to the low and some of my cohorts a little more to being safe on that, but I think collectively we agree on this range and I'm still hopeful, we will come in the high 60s or low 70s, but I think our team feels like we certainly can come in within the range.

Julie Anderson
There's a small group in the room and it's probably 50:50. So, we all agree. Again, we all agree that we feel comfortable with the range.

Jon Arfstrom
Okay. Alright. And then I hate to go back to this, but the 6% to 9% decline in NII on the 75 basis points. The first part of the question is what are you assuming in terms of growth, is this just a static balance sheet, are you assuming like a normal course of business to get to that number?

Julie Anderson
Our normal forecasted 12 month balance sheet, so it would assume that warehouse is still pretty strong because you wouldn't see any reason why it stays strong. Again some of the continued pay down in leverage, but as Keith said in a couple of quarters from some of these new areas of growth, we would expect some growth. So it's our normal 12-month forecast.

Keith Cargill
And again even if the market and we anticipate the market next year, Jon, being somewhat softer than this year, we won't be doing linked quarter laying off of a $0.5 billion of the warehouse volume. And so that gives us that shock absorber capability as we manage, how much we take on balance sheet, so that if we do see some backing off slightly next year on mortgage warehouse volumes, we still feel good about being able to take market share and grow it slightly.

Julie Anderson
And on the deposit side, it does include some more deposits from some of the new verticals, more meaningful than we've seen in the last couple of quarters.

Jon Arfstrom
Okay. And then the last thing, maybe this is an obvious question, but I'm assuming that the last cut would take the biggest bite. So, for example, if we get only 25 when the Fed is done that's not a terrible outcome for you, but when we get to 50 or 75, that's where the biggest bite comes in terms of the NII guide.

Keith Cargill
I don't necessarily think so.

Julie Anderson
Yes.

Keith Cargill
I'm very optimistic about our deposit trends and our new verticals, but also just our core treasury trends it won't be easy, and we're going to have to be better than we've ever been, even though we've been really good this year on core expenses. I really feel good about what we can do overall on our expense and efficiency next year. So yes, on the spread, it won't be easy, but I don't think it'll be as challenging as certainly if we hadn't done these initiatives two years ago and be into the process now with launching these biggest deposit initiatives in the next quarter or so.

Julie Anderson
Hey Jon, something else that's important to remember is what happened with our deposits on the way up. We moved up really fast with a really high beta, which means we have a lot more to come down. So the index deposits alone will continue to come down, and then in addition, if we continue to replace some of the higher cost deposits with some of these new verticals. So we feel like we have a lot more runway on the deposits coming down.

Keith Cargill
But we're not naïve. I mean, it's a meaningful headwind and we're certainly doing our planning around the expenses and all accordingly.

Jon Arfstrom
Okay, alright. Thank you.

Keith Cargill
You're welcome.

Operator
Our next question comes from Brad Milsaps of Sandler O'Neill. Please go ahead.

Brad Milsaps
Hi, good evening.

Keith Cargill
Hello Brad.

Julie Anderson
Hi Brad.

Brad Milsaps
Hey Julie. Just to follow-up on the warehouse. I'm just curious of the 26-basis point decline in the yield on the warehouse this quarter, how much of that relates to volume discount versus just the move in LIBOR. I just want to get a sense as volumes may weaken; as you move into 2020 a little bit versus the high this quarter kind of can you recover any of that lost yield on the warehouse?

Julie Anderson
[Indiscernible] to answer that. I mean…

Keith Cargill
Some of it's driven by volume discounts with these top clients. And so, they've been coming in with such robust volumes that certainly has contributed, but it's mostly LIBOR.

Julie Anderson
Yes.

Brad Milsaps
Okay. That's helpful. And then, I'm sorry if I missed this, but relatively small numbers, but there was also an uptick in the loans 90 days past due kind of ex the impact of premium finance customers. That's just kind of curious to me, any additional color there on kind of what the driver was?

Julie Anderson
No. Just a couple of the bigger deals, but not ones that we feel uncomfortable with, just some documentation things that didn't get done. So nothing that was of any consequence that we're concerned about migrating to loan growth category.

Keith Cargill
But we're not happy that it didn't get done on the documentation.

Julie Anderson
That's correct.

Keith Cargill
But we don't have concern about the credits.

Brad Milsaps
Got it. Alright. Thank you, guys.

Keith Cargill
You're welcome.

Operator
Our next question comes from Peter Winter of Wedbush Securities. Please go ahead.

Peter Winter
Hi, I just want to follow-up on the expense question. I know you're not going to give specific guidance, but can you just talk about big picture, maybe some opportunities to maybe lower the expense growth rate next year?

Keith Cargill
We're looking at all things that we can leverage, including the technology investing we've been doing here for the last three years. And that is beginning to you know show some opportunity where we can in fact hire fewer new people that's been the case this year. I think it'll continue to give us opportunity to leverage that technology as we go onto the New Year. We're doing some really incredible work around process reengineering and finding again that we can lift the value of our people that have been doing work not as valuable as they are capable of doing by automating some of the things that are more rudimentary. And we're looking at deploying you know bots to

give us 24/7 capabilities to do some of that rudimentary work and looking at a number of different opportunities. So thankfully we have worked hard to get our technology grid in good shape, up-to-date over the last three years and now we're able to begin to do things that are more of a contributor to really giving tools to our people that'll substantially help their productivity. And I'm encouraged, we'll be able to take yet another really good step this next year on being able to hire fewer and continue to hire even higher quality people each year. And we've hired the finest quality people we've ever hired this year. So the company is still just an amazing place on the ability to attract great talent and I think as we give our people more technology tools to use, that's going to improve productivity.

Peter Winter
Okay. And then just on this long-term outlook, I was just wondering what type of timeframe are you thinking about reaching these goals? And secondly, with that net charge-offs of 20 basis points to 25 basis points, is that kind of the average through a cycle?

Julie Anderson
Yes, absolutely. That's through a cycle and so obviously year-to-date this year and last year those were higher. But, if you look at some of our previous years, we had 7 basis points, 8 basis points that they were seemingly low. So that's through a cycle. Peter when we put these out in January we were talking about a three year, it was under our three year planning horizon. I think what has happened with rates was not what we thought in January. So that's when I said I think it's going to take a little bit longer and I don't know exactly what that looks like. We're in the midst of our updating our three year planning cycle and so we'll try and give a little bit more color on that in January when we do 2020 guidance and kind of update for the three years.

Keith Cargill
And obviously we'll have some better visibility on this rate situation.

Julie Anderson
Right, exactly.

Keith Cargill
That's what's primarily is driving this timing.

Julie Anderson
Absolutely.

Peter Winter
Okay. And then just my last question, just you had mentioned on CECL there shouldn't be much of a change given the commercial short-term nature of the portfolio. I'm just wondering does that include I guess a fairly positive economic outlook as well?

Julie Anderson
Yes. One of the things I've said is that while commercially focused banks are not going to have dramatically different reserve levels. I think that the introduction of forecasting into that is going

to drive more volatility. So, I don't know that it's going to be overall higher levels, but certainly it could drive more volatility on a quarter-to-quarter and year-to-year basis.

Peter Winter
But, right now you guys still have a fairly positive economic outlook?

Keith Cargill
We do. Texas is doing quite well and there are lots of mixed signals, but overall we're positive on the economy.

Peter Winter
Great, thanks for taking my questions.

Keith Cargill
You're welcome.

Operator
Our next question is from Jennifer Demba of SunTrust. Please go ahead.

Jennifer Demba
Thank you. Keith, do these results include…sorry back to credit for just a second. Do the results you reported include a redetermination period for the NP loans?

Keith Cargill
That is underway and so it is something that takes 60 days or so, Jennifer. So some of that has been incorporated, but it's not been completed. We don't anticipate any significant change, but that is not put to bed.

Jennifer Demba
Okay, okay. And you're still contracting your leverage loan book through the end of this year. What does leverage lending look like for TCBI going forward? What will you be doing differently than previously?

Keith Cargill
Well, before we started this process I talked and had many meetings to talk about the business we want for the long run and the business we want in this space for the long-term are, what we call our trophy sponsored clients. And of course high quality, single run enterprises that happened to also fall into that leverage lending bucket. So, we're not inclined to take on new sponsors at the pace we did over the last five years. We like the sponsors that we've had a history of 10 or 15 deals with over the years, understand how they behave when portfolio companies don't go exactly as due diligence and plans suggest. And so, we do like the business. We just believe we were too successful and brought in and took too much market share with some sponsors that we just didn't have the history with. And some of the hiccups we had on deals were with these newer sponsors we have not had the history with. So that is the approach we're taking. We certainly

want to take great care of our long-time quality clients are in the PE space and have a great track record, think like operators, not just financial engineers and we have a wonderful core client base. Over the course of the next year or so, we likely will still tip it down some. It won't be at the same pace. We're not shooting for a 30% type runoff in 2020. It might be something closer to 10, but just fine tuning it. We are not ready to give all that detail until January, but that's directionally where we're headed at this point.

Jennifer Demba
Last question Keith. Did the escrow team have any impact on third quarter results?

Keith Cargill
I'm sorry, Jennifer. I was reading a note someone gave me. The escrow team, will they have any…do they have any major impact? No.

Jennifer Demba
On third quarter results.

Keith Cargill
No, they haven't. And they won't have their special black box that they've been working with our IT team on for the larger, more complex clients that we'll be bringing onboard until the first quarter. So they have several clients that we can take on and handle very capably but those that are in more complex businesses where we need to have the best piece of technology, much like we understood 13 years ago, we needed to build in mortgage finance, mortgage warehouse, we're doing the same type of thing where we're really listening to their clients and building something that'll be a great tool for us and the client, in those cases where we have larger more complex clients in escrow. So they'll have some impact in the fourth quarter, but it should be significantly accelerating as we get into next year.

Jennifer Demba
Thank you.

Keith Cargill
You're welcome.

Operator
Our next question comes from Brock Vandervliet of UBS. Please go ahead.

Brock Vandervliet
Thanks. I was just wondering if you could kind of clarify the math on the energy credit flows. So energy NPA is $61 million Q2, energy net charge-off s $16.5 million Q3, I would think that would get to therefore NPAs say $46 million. Your NPAs at the end of Q3 were $63 million, and does that…does that imply a new energy NPA of $17 million or 18 million or no?

Keith Cargill
That's exactly what it was Brock.

Julie Anderson
Yes, we mentioned that earlier on the call that the uptick in total nonaccruals with one energy deal.

Brock Vandervliet
Okay. Got it, alright. And has that been reserved or is that a new credit?

Julie Anderson
Anytime a loan goes to non-accrual, there's enough impairment analysis done and the appropriate reserve would have been put on it.

Brock Vandervliet
Okay. Alright, got it. I understand the math now. Thank you.

Keith Cargill
You're welcome.

Operator
This concludes our question and answer session. I will turn the conference back over to President and CEO, Keith Cargill for closing remarks.

CONCLUSION

Keith Cargill
I would like to thank all the call participants for tuning in and we appreciate your interest and your support. Have a good evening.

Operator
Thank you for your participation in TCBI's third quarter 2019 earnings conference call. Please direct requests for follow-up questions to Heather Worley at heather.worley@texascapitalbank.com. You may now disconnect.