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Texas Capital Bancshares, Inc.

Q4 2022 Earnings Conference Call

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CORPORATE PARTICIPANTS

Rob Holmes - *President, Chief Executive Officer*

Matt Scurlock - *Chief Financial Officer*

Jocelyn Kukulka - *Director of Investor Relations*

Operator

Hello, everyone, and welcome to TCBI Q4 2022 Earnings Call. My name is Nadia, and I will be coordinating the call today. I will now hand over to your host, Jocelyn Kukulka, Head of Investor Relations to begin. Jocelyn, please go ahead.

Jocelyn Kukulka

Good morning, and thank you for joining us for TCBI's Fourth Quarter 2022 Earnings Conference Call. I'm Jocelyn Kukulka, Head 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 and 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 earnings 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.

Our speakers for the call today are Rob Holmes, President and CEO; and Matt Scurlock, CFO. At the conclusion of our prepared remarks, our operator will open up a Q&A session. And now I'll turn the call over to Rob for opening remarks

Rob Holmes

Thank you for joining us today. This month marks my 2-year anniversary at Texas Capital and the fifth completed quarter since we announced our new strategy on September 1, 2021. Upon arrival to the firm and through the first several quarters of alluring the company, we systematically identified the previously unacknowledged depth of issues in each client-facing department and operational function, which were significant.

We were quick to return to the office Memorial Day of 2021 and immediately began facing reality and addressing problems. As we dissected the company in its early days, it became quickly apparent that 2021 will be spent defining, communicating and mobilizing to enable the strategy and that we would need all of 2022 to deliver the wholesale transformation required before we could begin to make meaningful progress towards acceptable financial outcomes.

The many identified challenges of the prior operating model and outlines for their planned remediation were described in detail in the strategic plan presented on September 1 of '21.

Consistent with our multiyear roadmaps, we acted to address each item in a rigorous and methodical manner. And I would like to spend the first portion of this call detailing the pace and magnitude of these actions to both provide context from where we are on the journey and share perspective on the opportunity that is in front of us. As of today, we have addressed every single rebuild, reorganization and restructuring that we said we would do at the outset of our plan plus much, much more.

When I arrived, fee income was limited and loan growth unfocused and represented an uncoordinated series of transactions without a comprehensive strategy as the only products available to serve our clients were basic credit solutions and very simplistic payment rails.

Achieving client relevance and earning our cost of capital was impossible under the prior model and our inability to serve clients in multiple ways led it to an overemphasis of the loan product rather than active consideration of the solution best fit for the client's current or prospective need.

In contrast, today, we have the tools and resources. We have a more durable and valued offering for our clients with over 20 new investment banking, treasury management and private wealth related services supporting our stated focus of being relevant to our clients throughout their life cycles. Fees across these areas of focus are up $32 million or 68% since full year 2020 and loan portfolio concentrations have been rightsized through proactive risk reduction and focused calling efforts on the best-in-class Texas-based clients.

In early 2021, we made the first of many difficult decisions. We exited correspondent lending and sacrificed revenue to derisk the balance sheet. Then in '22, we sold a disconnected national insurance premium finance business, sacrificing loan growth in order to refocus our business.

In aggregate, these 2 portfolio dispositions represented 10% of our starting loan portfolio composition. C&I loans now comprise 52% of the total portfolio, an increase of $3.3 billion or 48% since year-end 2020.

The implementation of the balance sheet committee into our routines has been an instrumental tool to ensure our capital is increasingly allocated to our target clients. 75% of commitments reviewed by the balance sheet committee during the last 3 quarters included treasury or ancillary product opportunities in addition to credit extension, evidencing our desired strategy is becoming increasingly ingrained in our daily client-facing interactions. We said we would fix revenue contributions and build a client-focused payments bank, and we did.

Sustainably earning a return greater than your cost of capital requires a stable and reliable funding base tied to the core clients that the firm exists to serve. However, the legacy funding strategy was also broken and characterized by an overreliance on disconnected, high-cost, high-beta national deposit verticals that created headwinds to earnings growth and volatility as interest rates change.

We knew at the outset that transitioning our funding base would be hard and take time. With that sustained emphasis on earning the right to be our client's primary treasury bank would ultimately be a foundational element of our future success.

Repositioning the deposit base consistent with our long-term strategy began in early '21 and the many subsequent actions have been directly aligned with this effort. Our first step was to rationalize a series of national deposit verticals, resulting in a $15 million reduction to annualized noninterest expense, which was reinvested in our focused strategy of supporting core Texas-based clients.

The proceeds contributed to doubling the number of client-facing treasury management professionals and a wholesale tech-enabled improvement in the treasury products platform. Overall, in '22, a significant portion of total technology project spend was allocated to an improved treasury solutions platform.

Projects both delivered and currently in flight are on time, on budget and meeting the expectations originally established. To further enhance the funding structure of the firm, the highest cost, highest beta and shortest duration institutional index deposits were deliberately reduced from 32% to 13% of total deposits from year-end 2020 to year-end '22.

Coupled with the 15% growth of full year average operating deposits in '22, this is a critical input into our stated plans to transition the model to one with structurally less rate sensitivity and improved balance sheet efficiency, both of which are required to deliver against our desired return targets.

By addressing the loan concentrations and the funding base, we're building a balanced company while establishing and now reinforcing cultural expectations that our success will not be marked by balance sheet growth, but instead by the relevance of our offerings and the quality of our advice. We said we'd fix the funding base. And as people and financial services well know, this is not easy. However, the foundation is established and the transformation is well underway.

To round out the balance sheet challenges, capital levels were also lower than peers, which both negatively impacted market perception and raised concerns with regulators and rating agencies. Anathema to this team's foundational commitment to financial resilience. This excess leverage also created an inability to proactively manage capital to take advantage of market opportunities in a manner consistent with long-term value creation.

During my first 15 weeks as CEO, we secured an improved outlook from one of our 2 rating agencies, then recapitalized the firm, another decisive action. The recapitalization added approximately 250 basis points of total risk-based capital through a $300 million preferred offering, $375 million of subordinated debt and a, first of its kind, mortgage warehouse credit risk transfer.

This demonstrated clear action against our stated commitment to building a business model not reliant on excess leverage for short-term returns, but instead operates from a through cycle position of strength, a core component of how we believe you create sustained long-term value.

Building upon these actions during 2022, the firm developed, implemented and began executing without a fully rebuilt internal capital planning and allocation framework. Delivering this analytic framework required addressing weaknesses in the cumbersome and outdated legacy data infrastructure that impacted everything from call centers to expense allocations, limiting the usefulness of legacy modeling tools. These are now rebuilt.

As a result of this disciplined approach and the resulting capital framework, further proactive measures during the year led to a higher and increasingly more focused capital position, well in excess of both our internally assessed risk profile and our externally communicated medium-term targets.

Our capital considerations extend beyond our regulatory ratios. And as we stated, we're also focused on high quality tangible book value growth through cycle. In Q1 '22, we took another crucial action. We transferred $1 billion of our lowest coupon, longest duration securities to held to maturity to appropriately hedge the balance sheet, should rates rise.

As of year-end, this reclassification allowed us to avoid additional unrealized loss positions by approximately $120 million or 4% of TCE contributing to our success in improving TCE ratios and supporting tangible book value during this volatile market period.

Tangible book value per share has grown over 5% since year-end 2020 compared to a decline of nearly 8% amongst the peer set. This outperformance further confirms our commitment to steadily improving the value of the franchise, even during a 2-year period where our focus was weighted more heavily towards building a bank than optimizing for short-term financial returns.

In addition to increasing both our absolute and relative capital levels, the firm both implemented and acted upon a wider range of previously unavailable tools to proactively manage the capital base.

In Q2 of this year, we put in place our first-ever share repurchase program, and over the course of the year, executed $115.3 million of repurchases, reducing total shares by 4% at a weighted average price equal to approximately 100% of the prior month's tangible book value. As of today, we have nearly completed the program and repurchased 5% of the shares since it began in Q2.

Finally, in November, we've closed the well-received and highly financially accretive divestiture of our National Insurance Premium Finance business BankDirect Capital. The 8% asset premium pulled forward 4 years of earnings for this business, generated approximately $165 million of capital reduced 100% risk-weighted assets by over $3 billion, which resulted in approximately 220 basis points of CET1. And importantly, it was accretive to earnings day 1.

We have worked tirelessly to be in this position of strength with solid conservative capital ratios, 2 investment-grade ratings, the first time since 2015; and a balanced business model. We have proven we prioritize a disciplined and professional approach to managing the firm's capital. During '23, we expect to hold north of 12% CET1 and with amounts in excess continue to be dynamically reallocated consistent with our well-defined strategy and observed risk appetite. We said we would fix the capital base, and we did.

Before the transformation, high leverage was paired with a misallocated expense base not tied to a strategy or long-term scale. The legacy investment agenda lacked a sustained focus, prioritized incompatible infrastructure and expensive build-outs for noncore businesses.

Now we successfully re-underwrote all of our expenses and over the last year, steadily repositioned the cost base to support consistent advancements in the businesses where we know we can compete and win.

During 2021, we undertook a series of actions to release unproductive expense to invest against the strategy stated. The corresponding lending business was wound down and MSR portfolio sold in the second quarter to both improve through-cycle earnings variability and to unlock $70 million of expenses that were directly reinvested into the strategy.

Under-used, inefficient and redundant software technology assets were written off for a total of $12 million in the third quarter, coupled with additional $15 million of deposit vertical rationalization and $40 million of other realized internal opportunities.

In the first year, we repositioned approximately $140 million of run rate expenses, enabling the transformational activities delivered in 2022. Additional savings through the divestiture of BankDirect in late 2022 allows for $36 million of annual expense to directly contribute to improved profitability. The go-forward run rate is a clean expense base directly matched to our strategic goals as we move to a period of more normal investment and improving performance.

Expense alignment is a foundational tenet of future scale, and we expect the proportion of noninterest expense directly attributable to our people, technology and operational infrastructure to remain a priority. We said we would fix the expense base, and we did. Since the previous operating model offered limited or a poorly functioning product suite and relied on excess leverage to deliver returns, the historical loan portfolio concentrations were cyclical and overweight.

This outsized risk profile, coupled with poor client selection in energy and leverage-lending led to substantial charge-offs. $273 million during 2019 and 2020, while large holds led to overexposure in the wrong sectors and suboptimal risk-adjusted returns. We are now providing capital discipline via the balance sheet committee, coupled with a new CEO-led enterprise risk culture ensures resources are more prudently directed towards achieving our goal of earning deep, long-term relationships.

Our entire credit risk management team and platform is rebuilt, aligning sector-specific credit expertise with a new set of business leaders focused on client selection and adherence to appropriately establish concentration and hold limits. Loan portfolio diversification has materially improved as the balance sheet is now a vehicle to support our clients' broad financial needs whether than an overemphasized internal growth metric providing a false sense or short-lived success.

New credit disciplines are supported by a complete overhaul of our underlying processes, systems and technologies. After $7 million of legacy spend associated with unsuccessful attempts to implement a credit onboarding process, the firm, on the other hand, delivered its first integrated loan management system named Alloscape, a significant contributor to reducing operational risk.

This loan management system enables onetime data capture standardized workflows for more efficient processing and improve client and stakeholder visibility, including foundational capabilities for future automation.

Finally, we continue to thoughtfully resolve legacy credit issues while building a reserve consistent with our objective of being appropriately conservative. Current reserve levels are now 49 basis points greater than CECL day 1 in the top 20% of peers as a percent of total loans and over 5.2x nonperforming loans.

We have said before that being appropriately reserved is both a metric and a mindset and when coupled with our strong capital position, a competitive advantage heading into this year. We said we would fix loan concentrations and focus on client selection, and we did.

Finally, the historical organizational structure of the bank managed with a siloed mindset did not allow for the ability to scale or provide adequate transparency. During my first year at the firm, we established organizational routines to ensure resources are effectively allocated against strategic priorities and our decision-making and execution is not hindered by inefficient processes with limited information.

All necessary parties are at the table to achieve our goals. Executive leadership also implemented an expectation of clear communication, execution, transparency and accountability throughout the enterprise. This was further emphasized firm-wide as functions were centralized and the operating committee restructured to directly align accountability against strategic and financial initiatives.

During 2022, we further reorganized our operating model around client delivery to emphasize client experience. Firm-wide, every process flow across credit delivery, onboarding, treasury services and deposits and payments was reconstructed to meet this objective and is now further grounded in solidified risk controls through our risk control self-assessments.

Detailed procedures are also now in place, serving to automate manual and error-prone processes while operational reporting dashboards now systematically measure and highlight opportunities driving continuous improvement and reduce operational risk. The organization is now structured within a more efficient, higher quality operating model, driving both client and employee satisfaction while supporting future scale.

We said we would reimagine the client journey by improving the organization structure and operational infrastructure, and we did. By addressing the legacy challenges of the previous operating model, we built the coverage, product and technology required to serve our target clients and are now poised to deliver the next phase of our multiyear transformation.

Our business banking, middle market and corporate coverage areas are well established and match each client set with the talent, products and offerings they need to succeed. Since I arrived, we have grown the number of client-facing professionals by 1.9x across our defined industry and geographic coverage.

By combining this coverage model with expanded treasury solutions, a holistic private wealth offering and unique investment banking capabilities, this construct allows us to serve clients through the entirety of their life cycle, with a delivery model and solution set tailored to support them at each step of their journey.

As we seek to be relevant to our clients each day, assisting them in addressing their day-to-day working capital needs, in an efficient and secure manner, we meaningfully improved our treasury and payments platforms, completely transforming operations, technology and product to build a real payments bank.

In 2022, the Treasury Solutions Group implemented a new enterprise payments platform and launched API connectivity significantly improving the quality and ease of digital banking for our clients.

Said simply, our cash management offering from basic wires on an antiquated platform to a best-in-class treasury solutions platform. Our Investment Banking division, Texas Capital Securities, is a Texas-based institution offering a full suite of investment banking products and services focused on delivering exceptional outcomes for our clients launched in mid-2022, well ahead of schedule.

We are now leveraging our deep knowledge of industry dynamics, complemented by our extensive network of capital sources to deliver results that are aligned to our clients' definition of success.

The Sales & Trading group now offers significant experience in mortgage securities and corporate fixed income convertible and equity markets. Leveraging our considerable network of domestic and international institutional relationships, our team is now providing clients with actionable insight and access to global markets.

In the year since we received FINRA approval, Texas Capital Securities has delivered the following first, our first swap trade, first, FX spot trade, first TBA trade, first specified MBS pool trade, first whole loan trade, first corporate bond trade, first corporate loan trade, first, equity trade, first buy-side advisory mandate and closed its first sell-side advisory success fee.

We onboarded 150 new clients and traded over $9 billion of mortgage and corporate debt and equity securities. And finally, Texas Capital securities partnership with mortgage finance has been critical in evolving the business from a warehouse-only platform into a differentiated industry vertical characterized by multiple new products and services to meet clients' needs in real time, resulting in incremental treasury and deposit relationships with top-tier national mortgage lenders.

The full life cycle of the client extends beyond their corporate profile and includes their personal, financial well-being. We are rebuilding and significantly enhancing our successful subscale private wealth business and are halfway through our project plan, which includes updating our go-to-market strategy, expanding our products, improving our back-office operations investing in our front end client experience and adding additional quality talent.

Completion of this wholesale improvement is targeted by the middle of this year. In total, we have launched over 20 new products and services in the last 2 years, and have detailed achievable roadmaps to deliver the over 25 new offerings targeted by 2025.

The improvements of our technology and operating platform are also significant. We are beginning to see our investments generate efficiencies and operations while uplifting the client experience through vastly improved onboarding times, straight through processing and reduced mean time to resolve client issues and incidents.

We internally developed and delivered a market-leading cloud native software named Initio, our proprietary account opening and onboarding solution, which has received praise from our beta clients, and we expect that over 50% of all treasury onboarding requests will be completed digitally by March. This means that existing and new commercial clients will be able to self-serve account opening, products and services will be attached automatically, and they can use the account same day.

This puts us at or above parity when compared to the most digitally forward banks in the country. Other transformational technology infrastructure builds include Cortex, our completely modern API-driven services platform, C360 across LOB operations management system and a completely modernized cloud-based data platform. Underneath these new platforms and applications, we increase transparency and efficiency of operations from front end to back office through a CRM overhaul.

Another legacy challenge relating to $20 million of legacy expense spent on something that simply did not work when I arrived. The implementation of corporate management information system for cascading metrics automation of infrastructure, network improvements, deployment of new hardware and the implementation of a new cloud-based call center platform.

I have often said the biggest risk to our strategy was a need to build each pillar of the platform simultaneously, which was an acknowledgment of both our opportunity and of the limited infrastructure in place.

Through 5 quarters of dedication and focused execution by people across the firm, this execution risk has been further mitigated as the businesses were built and the needed capabilities landed on a more scalable platform.

The accomplishments over the last 2 years resulted in a firm that is poised to begin delivering structurally higher and more stable financial returns for our shareholders over time. We are heading into 2023 operating for a position of strength. The expense and capital base are aligned directly to our strategic priorities.

We are recycling capital into new and profitable relationships and improving relevance with both existing and new clients. Our balance sheet is the best since the bank's founding. Portfolio concentrations increasingly match our desired composition, liquidity and funding are higher quality, and our institutional financial reliance is a true strategic advantage positioning us well for the potentially challenging operating environment ahead.

The significant investments and efforts to rebuild the firm are largely in the ground, and we are transitioning our focus towards leveraging the full breadth of the new platform to achieving first call status with the best clients and prospects in our markets. This thoughtfully and deliberately rebuilt client-focused

business model is designed to earn above our cost of capital through cycle and drive structurally higher, more sustainable earnings.

It is very important to appreciate that this transformation is the result of the tireless work of each of our 2,200 people across the entirety of the firm who truly brought into the strategy accepted that the rebuild is harder than status quo but believed it was worth it as we worked together to build a new company. Collectively, we make up the new Texas Capital.

I'd like to express my sincere appreciation for their continued efforts and dedication to our strategy, vision, goals and our core values. We have so much to look forward to in 2023 as we execute upon what we have established this year. I'll now turn the call over to Matt, who will provide the financial details for the fourth quarter.

Matt Scurlock

Thanks, Rob, and good morning. As Rob described, we're increasingly transitioning the firm's focus from a period of concentrated build to a state of purposeful execution as we begin to mature uniquely broad and client-centric offering into a scaling platform that delivers against our long-term objectives.

Today, with client coverage build-out largely complete and targeted capabilities now in place, we are positioned to accelerate delivery against our defined financial goals. Our value proposition continues to resonate.

And C&I loans increased again this quarter, finishing the year up $2.3 billion or 29% relative to the fourth quarter of 2021. We also delivered notable progress in our fee generating businesses in the quarter, which will, over time, grow in contribution as we improve our relevance within now consistently expanding client base.

Treasury product fees were up 27% year-over-year, reflecting increased adoption of our newly built cash management and payment capabilities. Wealth management income also rose materially year-over-year as AUM growth of 11% outpaced broad market declines resulting a 14% increase in wealth management and trust fee income during 2022.

Rounding out our noninterest income areas of focus, investment banking and trading income grew 43% this year, with the $11.9 million realized in the fourth quarter setting the high watermark since we launched the business earlier this year.

Taken together fee income from our areas of focus increased by approximately $19 million or 31% year-over-year, representing steadily improving client receptivity to the completely refreshed operating model and capabilities, as Rob described in his comments.

Turning to Slide 11. Total adjusted revenue was up $12.3 million or 19% annualized linked quarter and increased $51.2 million or 23% when compared to fourth quarter 2021. Quarterly results benefited from

an $8.5 million increase in net interest income, mainly attributable to the continued realized benefits for asset-sensitive balance sheet, modest improvements in the composition of our asset mix and continued reduction in our highest cost shortest duration deposit sources.

Additionally, investment banking fee income was up by $4.1 million on a linked quarter basis as syndicated loan fees doubled quarter-over-quarter and increased 56% year-over-year, a result of improved capabilities and stated client focus.

The divestiture of our insurance premium finance business closed in November, resulting in the recognition of a nonrecurring $248.5 million pretax gain. We stated clearly that while our long-term plans do account for continued investment, much of the initial lift to deliver the foundational talent, technology, products and capabilities was incurred over the past 2 years, and we do expect slowing expense growth in 2023.

Q4 expenses include several nonrecurring items related to both the divestiture and restructuring reserves associated with the continued implementation of our target operating model. These items include $13 million in legal and professional expense related to the divestiture, $9.8 million in restructuring expenses and $8 million to fund the newly created Texas Capital Bank Foundation.

Taken together, PPNR excluding nonrecurring items, increased 13% linked quarter to $94.4 million, which is a 20% increase relative to the fourth quarter of last year. As we indicated during our Q3 quarterly call, after achieving this important milestone in the last quarter, we do expect to maintain year-over-year quarterly PPNR growth moving forward, including throughout 2023.

Of note, the divested business unit contributed $8.3 million of revenue and $2.8 million of expense during the month of October, resulting in $5.9 million PPNR contribution during Q4 when applying our observed cost of funds for the month of October. As Rob mentioned, with the proceeds invested into cash, we recognized immediate PPNR accretion.

Adjusted net income to common was $44.3 million for the quarter, down 11% compared to the third quarter as a result of the $22 million increase in quarter-over-quarter provision expense.

Overall credit quality remains historically strong. Although we continue to prepare for an evitable normalization, which based on external factors appears increasingly likely this year. We recognized $15 million in net charge-offs during the quarter as expected losses on certain legacy credits moved closer to resolution, compared to net charge-offs of $2.7 million in Q3.

We've previously indicated that we closely monitor an identified list of legacy credits and the weighted average origination date of the charge-off recognized during the quarter was mid-2013. Criticized loans increased $29 million quarter-over-quarter to 2.66% of LHI primarily a result of continued migration in a small number of consumer-dependent C&I credits. This quarter's provision expense was impacted by both realized charge-offs and observed and expected portfolio trends.

Finally, on capital. We repurchased $65.3 million or $1.1 million of common shares during the quarter, equal to 2.3% of prior quarter shares outstanding at a weighted average price of $57.20. The modest

decline in interest rate outlook as of year-end resulted in a slight improvement in AOCI of $16.5 million. Considering the realized gain on divestiture, we ended the year with CET1 of 13% and tangible book value per share of $56.45.

Quarter-to-date, we have repurchased approximately 450,000 shares of common stock and have nearly completed our inaugural share repurchase program.

Turning to Slide 12. C&I loan growth moderated this quarter as the more cautious client sentiment described on the third quarter call resulted in period-end C&I loan growth of $143 million.

Even with the reduction in recent volumes, sustained loan growth over the past 4 quarters has driven C&I balances, excluding PPP and insurance and finance loans, $2.3 billion or 29% higher year-over-year, consistently delivering our improving value proposition to core Texas-based businesses as resulting in a balance sheet increasingly comprised of a client base who benefits from our broadening platform of available product solutions delivered within a rebuilt and enhanced client journey.

Growth continues to come primarily from new and expanded relationships as utilization rates moved down slightly in the quarter to 51% and remain in line with our pre-COVID average of low 50s.

Moving to real estate. Period-end real estate balances increased $183 million or 4% in the quarter as payoffs slowed, supported by a modest mix shift toward term over the last 12 months. This is one of the most mature businesses at the firm, and we take a through-cycle view grounded in client selection and managed portfolio using established and well-tested concentration limits.

New origination volumes slowed in the back half of 2022 and remains focused on multifamily, reflecting both our deep experience in the space and observed performance through credit and interest rate cycles.

Average mortgage finance loans declined by 19% in the quarter comparing favorably to the estimated 25% or greater levels of broader market contraction as our industry-specific product offerings are increasingly compelling in what is and is expected to continue to be historically challenged market environment. Full year industry originations declined by approximately 50% in 2022 compared to our full year average decrease of 34%.

As a reminder, while distorted by the rising rate environment experienced over the last 12 months, outstanding balances in this business reflect the typical seasonality associated with home buying activity, rising in the second and third quarter then following in the fourth and the first.

Assuming the current rate outlook remains intact, expectations are for total market originations to decline by 15% to 20% in the first quarter. We expect the same dynamic in Q1 as seasonality is paired with continued rate and industry-specific pressures. Near-term pipelines remain reflective of a more cautious client outlook and are comparable to the levels we saw at the beginning of Q4.

Moving to Slide 13. As Rob discussed, through a series of actions over the last 2 years, we are thoughtfully shifting our balance sheet to businesses where we believe multiple client touch points will, over time, result in a higher quality funding base, increasingly comprised of our clients' primary operating accounts.

While pleased with the observed progress and associated benefits relative to the last tightening cycle, we are realistic on our expectations for achieving target state. We remain in the early stages of our funding transformation and do anticipate deposit costs and betas to continue increasing as market pricing responds to the rapid pace of Fed tightening.

Total ending period deposits declined 7% quarter-over-quarter with changes in the underlying mix reflective of both a continued funding transition in a tightening rate environment and predictable seasonality exacerbated by market-driven trends. Noninterest-bearing deposits represented 42% of total deposits at period end and were down 16% linked quarter as mortgage finance deposits experienced seasonal fluctuations associated with tax payments from escrow accounts, coupled with moderate impacts from select client repositioning.

Tax-related escrow to profits will begin to rebuild in Q1 as they do every year. And if market conditions hold, we would expect average quarterly mortgage finance deposits to remain between 100% to 120% of average total mortgage finance loans throughout next year. Average full year commercial operating deposits increased 15%, reflecting our focused strategy to generate and sustain operating account growth.

Our highest cost most rate-sensitive deposit sources continue to be deemphasized in favor of more granular and modestly less rate-sensitive options, including Bask. Q4 ending period balances in high beta index deposits contracted $788 million and now represent just 13% of total deposits. These balances are down $3.7 billion or 55% year-over-year.

Due to our sound current and prospective liquidity position, this quarter, we also had $170 million of brokered CDs mature without replacement. Ending period brokered CD balances of $1.1 billion are expected to continue to mature throughout the year with $228 million of 1.2% coupon CDs rolling off in the first quarter. The remaining weighted average portfolio coupon is 2.5%.

Supported by the proceeds and accompanying flexibility created by the BDCF transaction, we will continue to use our balance sheet to onboard clients where we believe there are or will be meaningful treasury opportunities.

Continued reduction in our highest cost deposit sources is likely to persist as improving the quality of our liquidity is a prerequisite to establishing a more efficient balance sheet. Despite this focus, our current outlook anticipates sustained pricing pressure and we do expect continued upward trajectory for interest-bearing deposit betas alongside planned Fed rate increases.

Turning to NII sensitivity on Page 14. As expected, after decreasing materially in Q3, our asset sensitivity increased this quarter, up modestly to 8% or $77 million in a plus 100 basis point shock scenario on a static balance sheet as the underlying composition changed quarter-over-quarter. Proceeds from the 61%

fixed rate BDCF portfolio were invested in cash and the reduction in our most rate-sensitive deposits increased our overall exposure to changing rates.

Model-based net interest income depicted on the slide assumes the balance sheet remains constant in terms of size and composition, meaning the expected seasonality of various businesses is not captured nor is the anticipated evolution of our business over the defined time period. This is a potentially useful view for comparing point-in-time earnings at risk across firms, but should not be viewed as a forecast.

Following a brief pause in early Q4, subsequent to the closing of the BDCF transaction, actions resumed to reduce the amount of future earnings exposed to changes in forward interest rates with the addition of $255 million of securities to the investment portfolio.

The core component of our asset sensitivity profile is a large portion of our earning asset mix that reprices with changes in short-term rates. Exiting the year, 93% of total LHI portfolio, excluding MFLs is a variable rate, with 86% of these loans tied to either prime or 1-month index.

Net interest income produced by our mortgage finance business is not as sensitive as the rest of the portfolio to changes in index rates due to the pricing dynamic of the associated escrow deposits held in noninterest-bearing accounts. which, in some cases, receive compensation in the form of interest rate credit. The asset sensitivity figures depicted on the slide account for the behavior of pricing relative to both mortgage finance loans and deposits.

Moving to Slide 15. Net interest margin increased by 21 basis points this quarter, while net interest income rose $8.5 million, predominantly as a function of higher loan yields and increased income from significantly larger cash balances from the divestiture proceeds, partially offset by an expected increase in funding costs.

Similar to the last several quarters, timing associated with the late quarter's Fed move, coupled with quarter-end spot rates, suggest a full impact of the 125 basis point Q4 rate increase will be more fully realized in Q1. The investment portfolio grew this quarter as we reinvested $65 million of cash flows and began the multi-quarter process of remixing excess cash balances by purchasing in Agency MBS and U.S. Treasury securities. The purchases came on the book at 4.7% yield versus those rolling off around 1.5%.

As the characteristics of our deposit base continue to improve, we will be actively looking to prudently bring our excess liquidity levels closer to our published targets while also taking advantage of market opportunity to more efficiently balance our liquid asset composition with additional securities purchases.

Noninterest expense adjusted for nonrecurring items benefited in Q4 from 2 months of cost savings associated with the insurance pay and finance divestiture. In addition to the previously discussed nonrecurring expenses, legal and professional expenses rose in part due to noninterest expenses associated with deposit compensation. This expense is expected to increase in 2023 and is included in our full year noninterest expense guidance.

Year-over-year adjusted noninterest expense grew 16% or 13% when compared to the $600 million starting point referenced in our 2022 full year guidance. Expense priority established over the last year remains intact, and we continue the disciplined process of systematically aligning our expense base with our published strategic priorities.

Turning to Page 16. Criticized loans increased $29.2 million or 6% in the quarter to $513.2 million or 2.66% LHI. As early grade migration in these categories continues to be primarily driven by commercial clients reliant specifically on consumer discretionary income.

While criticized loans are down 12% since year-end 2021, we do expect the breadth of industries and client types experiencing great migration to expand in the coming quarters as the economy slows and are pleased to be entering the year with reserve levels at 1.31% of total LHI and 5.2x nonaccrual loans both at or near cyclical highs.

Capital levels are also strong, and we remain committed to managing the hard-earned capital base in a disciplined and analytically rigorous manner focused on driving long-term shareholder value. As Rob mentioned, the gain on the insurance brand finance divestiture bolstered our already strong capital position, and we ended the year in the best capital position in firm's history.

CET1 and total risk-based capital finished the quarter at 13% and 17.7%, respectively, and the top 10% of peers and well in excess of both short- and longer-term targets. Finally, as we near completion of our inaugural share repurchase program, the Board has authorized a new $150 million program.

As we did in 2022, we will consider the array of capital uses as we make capital allocation decisions to enhance long-term shareholder value. Consistent with our previously disclosed framework, our preference remains reinvesting capital into the value accretive growth of our Texas-based franchise, and we are pleased to be operating with a strong hand heading into a potentially more challenged operating environment.

Looking ahead at 2023, consistent with the methodology disclosed last year to better highlight the impact of our potential financial performance, our guidance accounts for the forward rate curve assumes a peak Fed funds rate of 5.25% in mid-2023 and with a year-end exit rate of 4.75%.

We expect total revenue to increase year-over-year in the mid-teens percent range as full year impacts of the balance sheet transitions are paired with increasing contribution from recently added coverage and capabilities.

As Rob and I both indicated earlier, a large majority of the expense growth related to the wholesale transformation and infrastructure build is behind us. We, of course, have additional investments already in flight, but we expect to begin realizing operating efficiencies as we enter the year executing within our target model. As a result, we expect full year noninterest expense growth of low double digits. Together, these expectations should result in the maintenance of operating leverage, as defined as year-over-year quarterly PPNR growth.

This metric is important given the aforementioned seasonality associated with our business. We expect a predictable decline in linked quarter performance moving into the traditionally slower first quarter, which is why measuring PPNR relative to the same quarter in the prior year is a more appropriate metric by which to assess progress.

Moving to the balance sheet. Market expectations call for further decline in mortgage originations during 2023 with full year volumes anticipated to be down by more than 25% from 2022 levels.

Given our market positioning and expanded product suite, we do expect to maintain modest outperformance remain cautious given the wide range of potential rate and market outcomes. As we continue to deploy cash proceeds from the divestiture, we will prioritize actions that reduce our asset sensitivity and help stabilize the earnings power of the bank through cycle.

Over the course of the year, we will look to bring our published sensitivity down to a mid-single-digit level as measured in an up 100 shock scenario with the pace and levers used ultimately dictated by our own strategic progress and market conditions.

At this point in our transformation, we remain committed to holding greater than 20% of our total assets in cash and securities, but do expect the absolute level to come down through the year and the composition to change consistent with our goals to reduce interest rate sensitivity. When we set forth the strategic plan, we accounted for an economic downturn over our planning horizon and the path to reach our 2025 goals does account for a more normalized level of provision.

Lastly, we are committed to conservative capital levels. And as Rob mentioned, we'll maintain a CET1 capital ratio of 12% throughout 2023, as we earn the right to operate at a lower level in the future. With that, I'll hand the call back over to Rob

Rob Holmes

Thanks, Matt. (Technical Difficulty) Available to answer any questions. Operator?

Operator

Our first question today comes from Brett Rabatin of Hovde Group.

Brett Rabatin

I wanted to first ask, Rob, I'm curious about how you view the environment where in the past, it was really hard to hire talent or it was a competitive landscape, and it seems like that's eased. And so I was curious in thinking about the expense growth this year, if you're expecting maybe the acceleration of hires just given the environment with the pullback from some competitors on that front?

Brett Rabatin

Sure. Thanks. It's a good question. Just the broader Texas economy, I'd say, manufacturing output to decline as it did in the fourth quarter. Other firms are not hiring as aggressively in the past for the summer months. The year-over-year employment growth in Texas fell, but not as much as the national average, so as just kind of the macro, if you will.

We, as a firm, as we stated in our comments, the majority of the spend is behind us in the transformation. That includes wholesale hiring as well. We've built the businesses. They're largely in place, and they'll grow as they grow organically.

We do have different opportunities to add select talent on a select basis as we move forward, but we feel really, really good where we are. The good news is, as you said, the hiring across the board has slowed the competition for talent, I think, has peaked. But that's just a coincidence of where we are in the transformation. So I think we're going to slow hiring, but it's not because of the environment necessarily, it's because of where we are in the journey.

Brett Rabatin

Okay. That's helpful. And then Matt, a question for you. I want to make sure I understood the balance sheet management going forward. You mentioned buying securities. I wanted to make sure -- or maybe get a little better color on the magnitude of securities purchases, managing the cash position and then just thinking about the overall balance sheet management into '23 in terms of thinking about the liquidity on the balance sheet. Maybe you can keep the balance sheet fairly flattish or if you intend to grow it if the deposits are successful and growing from here.

Matt Scurlock

Yes, happy to take that, Brett. So it's fairly complex calculus as you would expect. But like everything else we're doing around here, really thinking about our aggregate ability to steer the place to a point where we can sustainably earn a return in excess of the cost of capital. So we look at the impact of changing rates on the balance sheet and business model, we generally let that guide our positioning.

So stated in the comments that we would like to take the earnings at risk in an up 100 scenario down into the mid-single digits this year while keeping liquidity assets above that 20% threshold. You will see the mix likely shift from heavier weighting toward cash into securities as we do that. But of course, we'll balance the securities and swap portfolio depending on where we see forward rates going.

Brett Rabatin

And just to be clear, Matt, what -- is there a targeted cash position you think you would want to get to or lined up at?

Matt Scurlock

Yes. I think again it's pretty dependent on the rate environment. But if you look at the portion of our total liquidity assets today that's sitting cash versus securities, there's certainly a scenario where that could slip and be heavier weighted to securities.

Operator

And the next question goes to Matt Olney of Stephens.

Matt Olney

I want to drill down on deposits and specifically on the DDAs. Matt, you provided a disclosure around mortgage finance DDAs, I think, as a percent of mortgage finance loans. Can you just kind of clarify what that disclosure was for the year?

Matt Scurlock

Yes, you bet that, Matt. So in general, the mortgage finance DDAs are going to equal about 120% mortgage finance loans. And that's going to depend on where you are seasonally. There's, obviously, end of the year outflow as people pay their taxes and then you start to see that build back up into the first quarter. But generally, you can think about 100% to 120% deposits relative to loans (inaudible).

Matt Olney

Got it. Okay. That's helpful. I appreciate that disclosure. And then, I guess, kind of looking at the DDAs from the non-mortgage finance clients. I think they were in year-end. And I know the bank is adding new commercial operating accounts assuming [this higher], but on the other hand, with higher rates, we're seeing borrowers move deposits into interest-bearing accounts. So I would love to hear any kind of commentary about expectations of the non-mortgage finance DDA balances from here?

Matt Scurlock

Yes, Matt. We've been really pleased with success in adding commercial operating accounts over the last 2 years. You noted that average deposits in that space up 15% year-over-year. We expect, candidly, an acceleration in our ability to add clients.

Some of the balance sheet and income statement impact could be muted by changes in earnings credit rate as rates rise, but both our ability to attract those clients and their deposits along with continued penetration for the new treasury products and services to Rob's comments are right on track. We expect a continuation of that trend for the duration of this year.

Matt Olney

Okay. I appreciate that, Matt. And then just lastly around the strategy, good to see you iterate the guidance around the positive operating leverage. And I guess from our perspective, it's clear the bank has a good tailwind right now from higher rates and the bank's sensitivity to higher rates. But assuming that that takes the pause here in the near term, it feels like there could be some pressure as you move in the back half of next year or this year on the margin.

So just to give us any kind of commentary that can get us more comfortable with maintaining that positive operating leverage the back half this year and into the next year with rates that may be not as cooperative.

Matt Scurlock

Yes. Thanks, Matt, for calling out the importance of that year-over-year quarterly PPNR. So I just want to reemphasize as we did in the comments, the seasonality associated with the balance sheet and the ability to generate earnings, so we've said all along that we're trying to build a business model that is less dependent on rates.

And as we continue to accelerate progress across the new capability build, in particular, private wealth and notably the investment bank, our ability to generate earnings from sources other than margin is going to improve, which does give us confidence that despite the rate outlook, we'll be able to achieve guidance this year.

Operator

And the next question goes to Jennifer Demba of Truist.

Jennifer Demba

Curious on asset quality, your higher level of net charge-offs this quarter as you take some losses on some legacy loans. How much more loss content do you see in this legacy portfolio that maybe you could be realizing in '23 or '24?

Rob Holmes

The legacy issues that we've talked about in the past ever that I think was pretty vocal for a while about the amount that we saw has worked its way down to about $130 million left in the portfolio, and that's -- those are loans and clients that we would like to work off the balance sheet over time, but it's down to a very manageable number.

Jennifer Demba

Okay. Okay. That's not too much left. And is that $130 million concentrated in any one industry or type of loan or...

Rob Holmes

No, it's the -- you know what, I'll let Matt correct me. But what I understand is the majority of it is 4 sponsors across the country without a sponsor relationship. Some of the same sponsors that the firm had trouble with in the past, and we're working our way through those. The rest is pretty distributed.

Matt Scurlock

Yes. I think that's entirely accurate, Jennifer. Their legacy credits wholly inconsistent with how we underwrite today. And we commented in the script that the weighted average origination date of those charge-offs was 2013. So we'll continue to work our way through those as we get opportunity for resolution, but wholly inconsistent with underwriting since route arrival.

Jennifer Demba

And what are you seeing in terms of credit trends in the rest of the portfolio other than what you noted in terms of nonaccruals being up from businesses more dependent on discretionary -- on consumer discretionary.

Matt Scurlock

Yes, Jennifer, I mean, the Fed has been on the path now for nearly a year to try to increase unemployment and lower consumer spending. Over that same period, we've been consistently conservative in our view and our approach to how we manage the reserve, adding nearly 40 basis points over the last 12 months.

So while all the later-stage indicators of credit health have actually improved year-over-year. So criticized down 12% and NPAs are down 33%. We are seeing some downgrades in the pass rated book, which we would honestly expect, so when coupled with our conservative outlook, that's what drove the provision expense. There's no real trends to highlight there other than just we're going to continue to take a conservative approach and be timely in our changes in underlying credit grades.

Operator

And the next question goes to Brady Gailey of KBW.

Brady Gailey

I want to start with the share buyback. If you look at -- I wanted to start with the share buyback. If you look at last year, so 2022, you repurchased about $115 million of stocks, about 4% of the company. And despite doing that, your common equity Tier 1 increased from 11% to 13%. So it feels like the buyback could be a lot larger in size this year versus last year. Is that correct? Is there any way to help us size how big the share buyback could be this year?

Rob Holmes

Yes. Thanks, Brady. I thought you'll be happy with our first share repurchase program, but you want more? I'm kidding, Brady.

So I thought on a serious note, we talked about before, we have a highly disciplined framework that we go through on share repurchase. As you know, much to your frustration and some others we look at organic growth, other opportunities. There's a whole metric of framework that we work our way through before we decide on capital actions.

Before 2 years ago, we weren't in a position to do any capital actions whatsoever. Now as you know, we're still balancing that against business opportunities. And as you know, my preference is to invest in the business, inorganic growth and projects across the firm. But the fact of the matter is when you can buy back $150 million of shares at tangible book, that's pretty good, and you can't ignore that.

And we could afford to do both at this period in time with very conservative capital liquidity levels and still reinvest in the business, so we felt good about it. And we will continue to be disciplined and opportunistic in the buybacks as opportunity presents itself. So to project, how much this year, I can't do that.

Brady Gailey

And then...

Rob Holmes

But to tell you will -- sorry. Sorry, Brady. Go ahead.

Brady Gailey

Yes, I'll just -- my follow-up question is just kind of a bigger picture question on the ROA. I know we have the 1.1% target out there for 2025. As I look at the core ROA for last year, it was about 50 basis points. That is down from 65 basis points in 2021. I know you guys are investing a lot in revenue-producing activities. But when should we expect to start to see the ROA really inflect higher? And do you guys still feel good about the 1.1% in 2025.

Matt Scurlock

We definitely feel good about our ability to achieve the longer-term targets for ad, and you'll see material progress throughout the course of the year. So seasonal step back in the first quarter which will include most performance metrics as you have seasonally slow warehouse. But then for the duration of the year, you'll see a steady build as we continue to make progress against those targets.

And you think of the guidance we've given you a lot of components to assess what that progress looks like this year, including how we're thinking about capital and liquidity levels. So in one of the slides, (inaudible) has a comment we've made quite often, we fully realize that this is the year to transition from capability build to financial performance and the company is oriented to go do so.

Operator

And our final question goes to Brad Milsaps of Piper Sandler.

Brad Milsaps

Matt, I joined a few minutes late, but I think I heard you mention that the increase in professional fees after making the adjustments the last couple of quarters, primarily related to maybe ECR costs.

I was wondering if, in fact, that is correct. And then can you give us a sense of as we see further rate increases, how much more that could go up. It would almost seem that if you have a roughly $80 million year-over-year increase in expenses, maybe half of it is coming from that if professional fees sort of hold here, but just want to make sure I'm understanding that relationship correctly as you kind of move forward?

Matt Scurlock

Yes. Thanks, Brad. Just a couple of points to call out. So there's a lot going on with noninterest expense this quarter and this year. The $680 million adjusted noninterest expense is what we're building full year guidance off of.

And then if you're thinking about run rate for those who may have interest in building models, that 182.3 is a pretty good fourth quarter number, although the underlying composition is going to shift a bit. There's some somewhat unusual or exotic items that inflated what we'd call sort of other noninterest expense and then decrease some of the salary benefits expense as we reset accruals.

So if you look through that legal and professional line, I think you could keep about $2 million of that increase. And then there will be some sensitivity in that line on the income statement as we see or don't see rates move up. So disclosing individual or incremental move is probably not what we're willing to do at this point, given some of the competitive nature of how we compensate folks. But you're right that, that will be an area that's going to be sensitive to interest rate changes.

Brad Milsaps

Got it, Matt. And if I look at it bigger picture, although you guided to low double digit, if I sort of annualize the fourth quarter really only represents maybe 4% or 5% growth over the fourth quarter. Is that a level that you guys kind of hope to aspire to you going forward? I know you've got a lot of investments, a lot of things going on. But looking at it through that lens, it seems a little better than what double-digit might (inaudible).

Matt Scurlock

I appreciate the question, Brad. I mean, we then, I think, pretty clear that the volume of investment is absolutely slowing. But the number of people, the amount of infrastructure build and the capabilities that come along with it that we incurred over 2022 is going to bleed into 2023.

So we're highly focused on sustaining expense discipline, which as you know, we view as just matching expense directly against the strategy and do feel good about the implied operating leverage, but it's certainly way too early to call if we're going to be able to come in inside of our published expense guidance.

Operator

We have no further questions. I'll hand back to Rob for any closing remarks.

Rob Holmes

Highly appreciative of the interest by everybody. And I'm sure Jocelyn, Matt will make themselves available as well as necessary. Have a great day. Thanks for your time.

Operator

Thank you. This now concludes today's call. Thank you so much for joining. You may now disconnect your lines.