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Texas Capital Bancshares, Inc.

Q3 2023 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. And welcome to TCBI's Third Quarter 2023 Earnings Call. (Operator Instructions) It's my pleasure to now hand you over to your host, Jocelyn Kukulka, head of Investor Relations. Please go ahead when you are ready.

**Jocelyn Kukulka**

Good morning. And thank you for joining us for TCBI's Third Quarter 2023 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 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 and 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](http://texascapitalbank.com). 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. I'll now turn the call over to Rob for opening remarks.

**Rob Holmes**

This quarter marks 2 years since we announced that we would transform Texas Capital into the first full-service financial services firm founded and headquartered in our state. Our work over the last 2 years has focused on ensuring Texas has a financial partner capable of providing clients the widest possible range of differentiated products and services on parity with those of the largest Wall Street firms with high-touch, locally based execution from an experienced team of bankers invested in the success of this state's economy and our clients. We are both committed and equipped to serve the best clients in all of our markets throughout the entire country while ensuring our firm is a relevant, trusted partner throughout our clients' corporate and individual life cycles.

And we know that the success of our clients will define our firm. With the strategy risk and build risk behind us and all critical roles now filled with top requisite talent, we have a solid and financially resilient foundation from which to execute.

Our industry-leading liquidity and capital position afford us a competitive advantage in this unique operating environment. CET1 of 12.7% ranked fourth amongst the largest banks in the country. TCE of 9.4% ranked first among the largest banks in the country and liquid assets of 28% allows our bankers to be front-footed in our clients' offices as we are well prepared to support the diverse and broad needs of our clients in what continues to be a challenging operating environment for all industries. We saw the emerging power of the platform on display again this quarter. In the current environment, which is putting material pressure on the industry's ability to grow net interest income, the firm was again able to deliver

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financial results through resolution of critical client needs with new products and services purpose built over the last 2 years.

We are no longer a loan-only bank, unable to holistically serve our clients' needs, which, by definition, makes our capital less of a commodity. Our continued success is supporting clients across our platform has solidified our positioning as a full-service financial services firm. This quarter's financial results -- but more importantly, market momentum earned through strong execution, suggests continued progress on the core components of long-term value creation. More than 3/4 of clients to whom we have made credit commitments since we launched our strategy, have expanded their engagement with our treasury business or other services. We continue to add clients and operating accounts at a pace consistent with our long-term plan.

September was the highest month on record in the last 2 years for a new treasury business, including new operating accounts, indicative of becoming our clients' trusted financial partner. The treasury business 1 today will generate balances, payments and revenues in the next 6 to 18 months, as the account activity ramps to full potential. Gross segment revenues were up 14% year-over-year, the highest growth since the first quarter of 2022 and a result of realized treasury business awarded in prior quarters.

Additionally, as I've detailed in the past, our clients' response to our proprietary outboarding tool into that provides significantly improved client journeys through faster and automated account opening and onboarding has exceeded expectations. For some specialized client types, we have been able to open several hundred accounts per client per day, including during March, when clients needed expedited onboarding.

Our broad platform continues to avail itself to clients in need of alternative cash management solutions. In the current rate environment, clients are actively seeking options for those deposits and excess other daily operating needs. And we remain active in advising them on how to best position their liquidity given their own unique circumstances. Our platform can now provide alternatives such as interest-bearing deposits automated insured suite programs, money market options or, in some instances, liquid investments like treasuries. The firm's constant focus on a financially resilient balance sheet is enabling a consistent market-facing posture, ensuring we can confidently approach clients and prospects based on their needs, not ours.

In my many interactions with current and especially new clients, this is frequently cited as a reason why clients are choosing to do more with us or bank with us for the first time. As we continue to build this franchise, we are and will remain materially more focused on ensuring client needs can be met with our offerings than on our own near-term financial outcomes. Clients are also increasingly benefiting from our still emerging investment banking capabilities.

Investment banking and trading income had a fourth consecutive record quarter with revenue up 6% quarter-over-quarter to \$29.2 million, which is comprised of revenue from all areas of the Investment Bank. Each of the past 4 quarters had significant contributions from a different part of the platform.

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This quarter, our Capital Markets group saw a material financing need outside the bank markets for a marquee client, that a renowned money center bank attempted to solve, took to market but failed to complete. We successfully arranged a comprehensive financing solution, including serving as Sole arranger on the \$1.2 billion term loan which was the largest transaction of its type this year and one of the largest sole managed term loans ever plus acted as a financial adviser on the \$155 million equity follow-on for the same client. This transaction was executed with a global reach and a wide variety of investors, including leading alternative asset managers, energy specialists, insurance companies and family offices. The majority of whom opened new institutional accounts with Texas Capital Securities if they didn't already have one. These are types of transactions that create real market momentum and the amount of opportunity that is created from that institutional growth is and will be significant.

It is important to once again note that this was not syndicated in the traditional bank market, as such, we do not hold any part of this financing transaction on our balance sheet. Since we launched the strategy, we acknowledge that revenues generated by the newly formed investment bank would not be linear and that it would take several years to mature the business with a solid base of consistent revenues.

Despite broad-based early success, we expect revenue trends to be inconsistent in the near term, the same as all firms, as we work to translate early momentum into a sustainable contributor to future earnings. The substantial investments made over the last 2 years to deliver a higher-quality operating model, supporting a defined set of scalable businesses is resulting in the intended outcomes. The entire platform contributed to our now fifth consecutive quarter of positive operating leverage as year-over-year quarterly adjusted PPNR grew 18% in the third quarter.

Noninterest income as a percentage of total revenue increased to 16.8% this quarter and stands at 15.7% year-to-date, in-line with the bottom end of our full year 2025 goal to generate 15% to 20% of total revenue from fee income sources. As you know, a foundational tenant, the financial resiliency we have established and will preserve its continued focus on tangible book value, which finished the quarter up 12% year-over-year, ending at \$57.82 per share, which continues to be near an all-time high for our firm. As we enter the fourth quarter from a position of strength and fully committed to improving financial performance over time, we do recognize that we have made strategic capital decisions that suppresses near-term profitability.

But as you have heard me say in the past, maximizing near-term returns is not the immediate goal of the transformation. We will drive attractive through-cycle shareholder returns with both higher quality earnings and a lower cost of capital, as we scale high-value businesses through increased client adoption, improved client journeys and realized operational efficiencies and all objectives that we made significant headway on this year.

Thank you for your continued interest in and support of our firm. I'll turn it over to Matt to discuss the quarter's results.

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**Matt Scurlock**

Thanks, Rob, and good morning. Starting on Slide 5. Progress against our 2021 strategic performance drivers continued this quarter, with the revenue base increasingly balanced toward noninterest income targets and capital and liquidity in excess of both medium and longer-term guidance. Year-to-date, noninterest income to total revenue was 15.7%, in line with our long-term target of 15% to 20% and reflective of our increased ability to support a broad range of clients' financial needs. Treasury product fees increased 5% quarter-over-quarter as client onboarding continues to accelerate.

Near-term pull-through to earnings from sustained momentum in our cash management and payment businesses is being offset by increased deposit compensation at this point in the rate cycle. We remain less focused on current quarterly fluctuations in revenue from this offering and we are ensuring we are adding primary banking relationships consistent with our long-term plan. Wealth Management income decreased 3% year-over-year, in large part due to continued client preference from managed liquidity options given market rates. Similar to the treasury offerings, we are, at this point, more focused on client growth and platform use than on quarterly changes in revenue contribution. Year-over-year growth in assets under management and total clients of 22% and 16%, respectively, is on pace with plan.

This connectivity between private wealth and commercial banking continues to mature. Investment banking and trading income of \$29.2 million increased 6% linked quarter, which is our fourth consecutive record quarter since launching the investment banking business last year. Rob described one marquee transaction that occurred during the quarter. However, we continue to see early success across the breadth of that platform, both in transactions executed year-to-date and in the broad and granular medium-term pipeline. Fee income from our areas of focus more than doubled year-over-year.

as each individual offering continues to advance against our expectations and their collective benefit further differentiates our value proposition in the market. Total revenue increased modestly linked quarter to \$278.9 million as both net interest income and noninterest revenue improved slightly over previous year-to-date highs experienced last quarter. As expected, further net interest income expansion was pressured by industry-wide trends related to rising deposit costs and slowing credit demand. Total revenue increased \$14.5 million or 5% when compared to Q3 2022. With year-over-year results benefiting from an 85% increase in noninterest income, coupled with disciplined balance sheet repositioning into higher earning assets associated with our long-term strategy.

Total noninterest expenses declined 1% linked quarter after a 6.4% reduction during the second quarter, as structural efficiencies associated with our go-forward operating model are improving near-term financial performance while enabling select investments associated with long-term capability build. Taken together, quarterly adjusted PPNR increased 18% year-over-year to \$99.1 million, the high point since we began this transformation in Q1 of 2021. This quarter's provision expense of \$18 million resulted primarily from continued resolution of select legacy problem credits and a modest increase in criticized loans. Net income to common was \$57.4 million, an increase of 15% from Q3 of last year when adjusted for the divestiture of our insurance brand finance business. Our balance sheet metrics remain exceptionally strong.

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Cash balances grew \$1.3 billion this quarter as clients deposit growth broadly outpaced credit needs. Ending period gross LHI balances declined by approximately \$700 million or 3% linked quarter, driven predominantly by predictable seasonality in the mortgage finance business, whereby average balances grew, but end-of-period balances declined, reflecting the end of the summer home buying season. Deposit balances increased 2% or \$560 million in the quarter resulting in period end loan-to-deposit ratio of 86%, down from 91% at the end of the second quarter. Finally, the nearly 50 basis point increase in 5-year treasury yields during the quarter resulted in AOCI decline of \$66 million, which is nearly offset by net income of common and resulted in tangible book value per share of \$57.82. Total LHI, excluding mortgage finance, decreased \$43 million for the quarter but remains up \$1 billion or 6.5% for the year.

During the quarter, we executed a \$164 million pooled sale of nonstrategic C&I loans sold at par. \$36 million was delivered in September and a related \$127 million were moved to held for sale and subsequently sold in early October. Both our market-facing posture and capital priorities remain unchanged as we continue our multiyear process of recycling capital into a client base that benefits from our broadening platform of available product solutions delivered within an enhanced client journey. Commercial loan balances continue to moderate this quarter, declining \$94 million or about 1%, which while marginally unfavorable to near-term earnings expansion obscures continued strong underlying momentum in the commercial business. New relationships onboarded year-to-date are up nearly 10% relative to elevated 2022 levels.

With a portion of new activity that includes more than just the loan product remaining over 95% for the first 9 months of the year, the noted progress on winning clients treasury business is highly correlated with the increasing percentage of commercial relationships in which we are the lead bank. For commercial syndicated transactions that meet the definition of a shared national credit, the portion of we get has increased to 30% from 12% in Q3 of last year.

For other syndicated loans on our balance sheet, we now act as agent on over 2/3 of existing credit facilities, which is consistent with our desired value proposition and stated balance sheet priorities. This manifests in the fee income trends Rob noted in his commentary, as we are increasingly the primary operating bank providing value in multiple ways for those clients for whom we choose to extend balance sheet. Period-end real estate balances increased \$50 million or 1% in the quarter.

We continue to experience the expected but still material slowdown in payoff rates of recent record highs. Despite a modest increase in the third quarter, we are positioned for continuation of year-to-date payoff trends in the medium term. Our clients' new origination volume also remained suppressed. With new credit extension largely focused on multifamily, reflecting both our deep experience in the space and observed performance through credit and interest rate cycles. Approximately 36% of the real estate portfolio has a maturity date in 2023 or 2024.

And while over 64% of the portfolio matures in 2025 or later. Our office exposure is \$459 million or approximately 9% of the total commercial real estate book. The office portfolio has solid underwriting with the current average LTV of 57% and 90% recourse as well as strong market characteristics as over 73% is Class A properties and over 71% located in Texas. Average mortgage finance loans increased \$321 million or 7% in the quarter, as the seasonality associated with summer home buying partially offset rate-

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driven pressures that continue to drive down estimates of next 12- to 24-month activity. Year-over-year, the industry has contracted from \$3.4 trillion to \$1.5 trillion in trailing 12-month originations.

Overall, market and volume estimates from professional forecasters suggest total originations to decrease approximately 20% in the fourth quarter, with full year expectations showing a decline of nearly 35% in total origination volume. As you know, Q4 and Q1 are the seasonally weakest origination quarters from a home buying perspective, and we expect the next 6 months to be amongst the toughest the industry has seen in the last 15 years.

Total ending period deposits increased 2% quarter-over-quarter with changes in the underlying mix reflected on both the continued funding transition in a tightening rate environment coupled with predictable seasonality and a sustained focus on leveraging our cash management platform into deeper client relationships. Total noninterest-bearing deposits remained stable quarter-over-quarter with a portion to total deposits decreasing modestly to 39% from 42% at year-end. Mortgage finance noninterest-bearing deposit balances increased \$363 million or 7% quarter-over-quarter.

As we remain focused on holistic relationships with top-tier clients in the industry. Average mortgage finance deposits were 128% of average mortgage finance loans at the high end of our guidance and up from 108% last year, due to both continued success in capturing more of our clients' treasury business and the impacts of system-wide contraction in mortgage origination volume on their short-term credit needs.

As a reminder, Q4 is a seasonally weak quarter for mortgage finance deposits. As escrow balances related to tax payments are remitted beginning in late November and run through January. However, given the previously mentioned client level trends, we expect the ratio of average mortgage finance deposits to average mortgage financial loans to increase in the fourth quarter, further pressuring the firm's net interest margin.

As expected, other noninterest bearing deposits declined \$440 million or 11% this quarter. As previously described, trends or by select clients shifted excess balances to interest-bearing deposits, which to other cash management options on our platform has slowed. Noninterest-bearing deposits, excluding mortgage finance, is now 15% of total deposits, down from 18% last quarter and 26% in Q3 of last year. Our expectation remains that the portion of our total deposits comprised of noninterest-bearing excluding mortgage finance, will continue to decline but at a decelerating pace in the near term. Our repositioning away from reliance on index deposit sources is complete, as balances are now aligned to clients consistent with our strategy and paired with bankers equipped to effectively serve their specific needs.

At 7% of total deposits well inside our published 2025 threshold of 15%. We now consider these relationships as part of the target client base, and we'll report them as interest-bearing deposits moving forward. Broker deposits declined \$86 million during the quarter as growth in client-focused deposits consistent with our long-term strategy remains sufficient to satisfy the desired near-term balance sheet positioning.

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We maintain ample brokered capacity and while always evaluating future liquidity composition consistent with established balance sheet management priorities, do anticipate that brokered CDs will decline during the fourth quarter as \$124 million will mature without replacement. As expected, our modeled earnings at risk was relatively flat quarter-over-quarter at 3% or \$29 million and a plus 100 basis point shock scenario and negative 4.3% or \$42 million and a down 100 basis point shock scenario.

Proactive measures taken earlier in the year to achieve a more neutral posture at this stage of the rate cycle, coupled with an increase in quarterly cash balances have produced the intended outcome. There were no new securities purchases in the quarter, and we continue to believe current levels to be an efficient and prudent portion of our liquid asset composition at this time.

The core component of our naturally asset-sensitive profile remains the large portion of our earning asset mix that reprices with changes in short-term rates. 93% of the total LHI portfolio, excluding MFLs is variable rate with approximately 90% of these loans that tied to either prime or a 1-month index. Net interest margin decreased 16 basis points this quarter and net interest income was flat at \$232.1 million, predominantly as a function of the deposit mix shift into interest-bearing deposits and higher quarter-over-quarter deposit costs, partially offset by improved loan yields and increased cash balances.

Our multiyear business model transformation and associated platform build is directly intended to lessen our dependence on these inevitable fluctuations and rate driven earnings. Sustained execution on noninterest income initiatives will, over time, enable revenue stability even as near-term net interest income expansion moderates. Further, the systematic realignment of our expense base with strategic priorities continues to deliver the expected efficiencies associated with a rebuilt and more scalable operating model.

We expect to see another contraction in quarterly year-over-year noninterest expense, which when coupled with maturing revenue generation capabilities, enables the foundation for future earnings expansion despite the market backdrop. Criticized loans increased \$58.1 million or 9% in the quarter to \$677.4 million or 3.3% of total LHI.

As increases in special mention of both commercial loans and real estate loans were only partially offset by \$17.9 million reduction in nonaccrual loans as a result of both realized net charge-offs of \$8.9 million in selected payoffs and upgrades. Nonperforming assets are at 0.21% of total assets, which continues to be near all-time industry lows. As in prior quarters, the composition of criticized loans is weighted towards commercial clients with dependencies on consumer discretionary income plus a handful of well-structured commercial real estate loans supported by strong sponsors.

We continue to believe our client selection and underwriting guidelines provide adequate protection against realized loss. Preparation for an inevitable normalization and asset quality began early in 2022, as we steadily built the reserve necessary to both address known legacy concerns and align balance sheet metrics with our foundational objective of financial resilience.

Total allowance for credit loss, including off-balance sheet reserves increased \$9 million on a linked-quarter basis to \$291 million or 1.41% of total LHI at quarter end, up nearly \$35 million or 11 basis points

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year-over-year in anticipation of a more challenging economic environment, while our ACL to nonaccrual loans improved to 4.6x. We have previously commented on the portion of legacy loans still on the balance sheet and consistent with current client selection or underwriting principles. That will be resolved in maturities, workouts or select charge-offs. During the quarter, we recognized gross charge-offs of \$7.5 million against this identified portfolio and exposure to this client set is now approximately \$60 million of book balance. As Rob described in his commentary, capital levels remain at or near the top of the industry.

Total regulatory capital remains exceptionally strong relative to the peer group and our internally assessed risk profile. CET1 finished the quarter at 12.7%, a 50 basis point increase from prior quarter. Intangible common equity to tangible assets finished the quarter at 9.4%, which ranks first relative to second quarter results for all large U.S. banks and in the top quartile of the peer group. We remain focused on managing the hard-earned capital base in a disciplined and analytically rigorous manner focused on driving long-term shareholder value.

Our guidance accounts for the market-based forward rate curve, which assumes Fed funds of \$550 through the remainder of the year. The recognition of system-wide funding cost increases has resulted in net interest income pressure as we anticipated earlier this year. Our outlook for low double-digit percent full year revenue growth remains unchanged. As recognized fee income year-to-date has partially offset net interest income pressure associated both with market events and chosen balance sheet positioning. As detailed above, the significant investments made over the last 2 years are yielding expected operating and financial efficiencies that will continue contributing to profitability of the firm.

Our noninterest expense guidance remains unchanged, and we believe that current consensus, expense estimates are achievable with flat total noninterest expense in Q4 before accounting for an FDIC special assessment. The same commitment to our long-term strategy, coupled with a historically challenging environment for our mortgage clients, resulted in us lowering PPNR expectations in Q4 to below Q4 2022 levels. Finally, we remain committed to maintaining our strong liquidity and capital positions, and our intent remains to hold greater than 20% of our total assets in cash and securities and to exit the year with CET1 ratio of greater than 12%. And now I'll turn the call back over to Rob for closing remarks.

**Rob Holmes**

Thank you, Matt. Operator, you want to have questions?

**Operator**

(Operator Instructions) And our first question comes from Michael Rose from Raymond James.

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**Michael Rose**

Maybe we could just start on just the increase in CET1 levels in your guidance in the intermediate term. I think the question that I think we've gotten now for the past year, perhaps longer is how do you meet the targets in 2025, particularly when it seems like there's going to be some further pressure on margin and especially in the warehouse, just given kind of a challenge outlook, Matt, just sort of your commentary on PPNR levels being a little bit lower year-on-year in the fourth quarter. I think that's a big question that everyone is trying to get at.

You continue to reiterate these targets, but consensus continues to reflect something in some cases, much lower than that. So if you could just try to help us bridge the gap now that we're a couple of quarters closer than another quarter closer than where we were.

**Matt Scurlock**

I appreciate the question, Michael, capital priorities remain the same for us. So we said since September 1, '21 that we wanted to run the place based on our principle of financial resilience, which for us means the ability to access markets for clients and serve communities through any cycle, and we do that as a competitive advantage always, and certainly right now. Rob mentioned in his comments that our market-facing posture remains the exact same, which is having a clear benefit in terms of new client acquisitions, mentioned in my comments that we've onboarded 10% more new C&I relationships than new C&I relationships last year and other coming with materially more new business. Those are, in our view, the things that drive long-term value. We're going to continue to bias the capital base in that direction.

**Rob Holmes**

Yes, I would just add, Michael, let me give you an example of that. I kind of feel -- we all feel like that capital it is really equity for us and as it relates to the new client acquisition and maintaining clients. So quick story. There is a new client. We onboarded kind of February of last year.

They came on the platform, what they'll tell you is they came on the platform due to our treasury platform, our advice in treasury and technology, which is a pretty cool story. We do not lend to this client. This is a great company, great people, when fully were (inaudible) at a substantial amount of payments will run through this bank, like over \$1 billion in a year. And so it's a great client. I went to see the CEO and his team last month.

And after I got back, the CFO wrote me a note and said, "Hi, I didn't say this at the meeting, but you need to understand exactly how this happened. And the difference between Texas Capital and our incumbent bank, which was a super regional. I said we did all our diligence on your capital structure and your financial resiliency before we came to your platform but for your banker to come out the day after the events of March and then your CFO get on a call with us after that and explain your capital position. There's just -- there's no comparison in your technology, your service in (inaudible), but your capital and financial stability gives us the comfort to stay with you." So it has a huge benefit to attract and maintain clients.

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And these are great clients running. That client will have -- I think, over 30 lockboxes with us and do, like I said, approaching \$2 billion in payments through our system. That's pretty valuable.

**Michael Rose**

Okay. But I guess, the latter part of my question is just -- can you help us try and bridge the gap to kind of get to some of the targets now that the capital levels are continuing to climb higher. I think that's the real question. And -- just a follow up -- as my follow-up, the investment banking trading line continue to move higher again this quarter. Obviously, really hard to predict, but it seems like we're getting a greater confidence in the durability of the business model here.

So maybe if you can kind of encapsulate that all, which I think is the question that most investors are asking.

**Matt Scurlock**

Michael. So keeping our average assets was north of \$130 million for 1.3% for the second straight quarter. We've got to get back to [\$165] million to \$170 million, which on the same size balance sheet is \$20 million to \$25 million of additional PPNR per quarter. There's a multitude of levers that will be dependent on the environment, which we find ourselves in '24 and '25 as we continue to warehouse liquidity, that's certainly an available lever, if you simply move the loan-to-deposit ratio back to 90% through repositioning of cash into loans, that's going to drive another \$7 million or so of quarterly PPNR and then to your comment, the fee-generating businesses, while we've seen material progress this year, they're in their infancy -- they're brand new.

So for example, we've got a pretty robust at this point, M&A offering the M&A bankers landed in the second quarter. So they had over 80 conversations with clients this quarter. So any conversations in the last 90 days about prospective M&A transactions over the next 2 years. But those are brand-new businesses, so if we were to look into the crystal ball and look forward, you would continue to prospect the recycling capital from low-return relationships and to those, where we can be more relevant, drive higher risk-adjusted return on the allocated capital, start to reduce some of the excess liquidity as the deposit base continues to improve. That provides us with \$6 million, \$7 million supporting PPNR right there. And then the expense outlook and probably too early to detailed into 2024. So we continue around the same playbook that we have on a non-interest expense stage, where we're focused on making technology investments that lead to structural improvements in how we show up for our clients, while reducing risk and increasing efficiency.

**Operator**

Our next question comes from Matt Olney of Stephens.

**Matt Olney**

On the mortgage finance, great to see those balances of loans and deposits outperform in a difficult backdrop in the third quarter. Any more color on that outperformance that we just saw -- and then, Matt, you mentioned industry expectations for originations down 20% in the fourth quarter. Can you just talk about the ability or potential to add before that?

**Matt Scurlock**

Yes. The mortgage market, we also said in the comments in the next 6 months can be the most challenged in the last 15 years. I mean, just yesterday, you saw home affordability at a 25-year low, just as 30-year of fixed rate mortgages had a 25-year high, which is certainly pressing industry-wide originations as you know, Matt, and we will generally move at about 75% beta relative to change in overall mortgage originations.

So professional forecasters are now calling for originations to be down about 35% across the industry for the year, which would suggest we'll be down by about 25% for the year, to look for a full year average balance somewhere in the low-4s, off about \$5.3 [billion] full year average balance last year. We continue to successfully executing against the strategy, Matt, of moving upmarket and serving stronger and larger clients with the strategy similar to what we have across the commercial franchises that we want to be relevant to those clients through a wide range of products and services, have done so originally through the capture of more of the treasury wallet as well as the deposit wallet.

So that ratio generally for us has been 100% to 120% self-funding in a seasonally and certainly cyclically slower fourth quarter. We think that ratio could go up to about 150% from that, which has some near-term negative impact on margin. We've got some material set of new capabilities that are coming online with those clients and over time, we think are going to drive a higher and less volatile return on capital, but there's certainly going to be near-term pressure as we continue that build.

**Matt Olney**

Okay. That's great, Matt. And then just as a follow-up on the positive operating leverage in the near term, I appreciate the updated guidance around the challenges of achieving kind of your goals in the fourth quarter. Can you speak just more broadly about operating leverage in 2024? What are just the puts and takes around the challenge of achieving the operating leverage in '24 versus '23? Thanks.

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**Matt Scurlock**

Yes, Matt, the update to the guidance certainly incorporates seasonality associated with that mortgage business in the fourth and the first quarter. I'd say the other item that was included in our comments, it's important to call out is that we continue to be quite aggressive on capital recycling, which has obviously been a core part of our playbook, since Rob got here. So between the noted loan sale at par, which was a set of consumer-facing C&I credits that were loan-only, which is about \$160 million reduction in balances and then exceeding expectations on our ability to reduce capital committed to relationships, where we don't see a path to being relevant. And we pulled down about \$300 million of C&I loan balances this quarter and then parked it in cash, in preparation for the ability to be able to redeploy at much higher risk-adjusted returns moving into 2024.

So we're obviously extraordinarily committed to delivering on the 2025 targets. We see all sorts of leverage to get there, which again would include continued maintenance of non-interest expense, delivering on the fee income target and then a lot of opportunity to reposition within the asset base. I won't -- I certainly appreciate the question. We're not going to give the detailed guidance on '24 yet, but that's how I would think about -- that's how we are thinking about balance sheet positioning as we get closer to achieving those '25 targets.

**Operator**

Our next question comes from Zachary Westerlind of UBS

**Zachary Westerlind**

It's Zack on for Brody. Just had a couple of quick ones. On the consumer-dependent commercial loans that are got moved to criticized and classified. Are those oriented towards sub-prime consumers? Or just any color you can provide on what's driving the move into criticized -- classified for those?

**Matt Scurlock**

Yes, they're not oriented towards subprime consumer back. So -- and we called out, I guess, the core call last year, so a year ago. That we expected to see some downgrades across certainly C&I, but CRE as well as we move into the middle part of this year. Those have materialized largely as expected. There's nothing that's unique enough about these consumer-dependent C&I credits to go into a whole lot of detail around them. There's some franchise finance that sits in there, but there's nothing that we'd call out as sort of systemic across the portfolio and it needs additional color beyond what we've provided.

I would note just generally on credit, we're quite pleased with the progression this quarter. So we've been pretty public doing Rob started. We had about \$200 million that we identified as legacy problem credits that we needed to work down. That's now down to \$60 million. So we reduced that by \$40 million this quarter. \$20 million of that was through sales or payoff. We had about \$10 million restructured and upgraded, and then we charge down \$10 million, which is part of how you get the \$17.9 million reduction

in nonaccrual. So sitting down at \$63 million of nonaccrual off of highs of mid-90s earlier this year. Feel like we're making material progress on the credits that were most concerning for us.

**Zachary Westerlind**

Understood. Appreciate that. And then just on the shared national credits, Apologies if I missed this. What percentage of the loan portfolio are SNCs? And then of that, what amount are you guys will lead to underwrite it on?

**Matt Scurlock**

Yes. Great question. 23% of the total loans, we lead 30% of that, Zack. It's not all syndicated credits are SNCs. So there's certain criteria that classify as syndicated credit, SNC north of \$100 million, 3 or more banks. We lead a large portion of syndicated credits across the middle market, so we were in the ninth rank middle market book runner through the first 2 quarters of this year, which means we originated and distributed more middle market credit than all, but 8 banks in the country.

So we noted in the comments that across syndications that are not SNCs we are the lead on north of 2/3 of those relationships, which is a critical part of our strategy as a key driver of why we're driving increased fee income, which obviously improves return on equity or return on allocated balance sheet.

**Zachary Westerlind**

Got it. That's very helpful. Sorry.

**Matt Scurlock**

Yes, one more quick color on, Zack, I think is helpful. We've said since Rob got here that our approach to any sort of participation in our credit facility, whether it was a SNC or otherwise, was based on the same client selection underwriting principles that we use, when it's a participation or we lead and that oftentimes if there was a target client, where we need the management team and the development strategy, we would be willing to move into a credit facility with the desire to move left or desire to capture more of the wallet you're now seeing us going back to Matt's question, you're now seeing us start to rotate out of some of those relationships, and we don't see a path to being more relevant to that client. So just I think it's important to note this is all entirely consistent with the messages that we've been trying to communicate for the last couple of years.

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**Zachary Westerlind**

Got it. I appreciate that. And then if I could just sneak 1 more quick one in, the office portfolio? Are you able to share what the reserve is on that?

**Matt Scurlock**

No. We generally don't disclose that. I mean, we have \$460 million of office and we've got \$4.2 billion of cash, 2% of total loans. So generally don't describe the asset class or property type specific reserve.

**Operator**

And our next question is from Brady Gailey of KBW.

**Brady Gailey**

I think 1 of the most difficult things to -- I think 1 of the most difficult things to forecast is just this investment banking line. I mean it's been so strong recently. I mean, \$29 million this quarter, that's up from only \$8 million a year ago. And I know it's volatile. I know it's tough to forecast. But I mean, over time, should the trend even off this 3Q base still be to drift higher? Or do you think you're at a level, like I think you guys targeted about 10% of revenue, which I think you're almost there. Is this kind of the level that we should think of as a kind of good run rate for the next couple of years from here?

**Rob Holmes**

Let me just comment on the business, then Matt can comment on guidance, if that's okay, Brady. I think it's a great question and obviously, a very fair question. As you know, I think we've had this conversation before, when Matt and I were coming up with the strategy I told Matt, that when we say we're going to start an investment bank. Everybody is going to think we're crazy. Then what we're going to do it. We're going to be successful. We're going to have great revenues and a great practice and then everybody is going to complain about the ability to model go-forward earnings and I think that will be a great problem to have.

So first on whatever having a conversation and a problems for the business and the team and the broader business, because remember, we're not doing investment banking business with other clients, they are clients of our commercial bank and corporate bank and real estate banking franchise. So it's 1 firm, which I think is really, really important. The big transaction this week that we talked about this quarter is a great example of how the platform works.

So we went in on committed on 3% of a credit facility to a big public company and has started to hammer them with advice. And we launched they went with another money center bank to address '24 maturities that they had to address is a strategic imperative. And they took on the market they failed to get it done. They called us back half as if we could get it done. So our strategy, we said yes, remember, the bank market has substantially closed, everybody has our capital liquidity in our calls on their clients right now like we are. So we went to a market that was nonbank. Like I said in my remarks, it was a global investor base, energy specialists, alternative asset managers, insurance companies, family offices, et cetera.

When you do that and you get a transaction that's the largest sole-managed transaction in the country year-to-date then everybody in that industry and frankly, other industries wants talk to you about the market and market receptivity. And so that opens doors and credibility for new business. The principle of the company is part of the private wealth business. And then when you distribute the allocations to these different investors, we had over 30 -- I forget the exact number, but well over 30 investors that opened accounts for their sales and trading floor that we weren't doing business with before. So that helps sales and training, helps further wealth, that helps further dialogue with other clients. And then when you allocate the right amount of demand to that investor, it creates an unwritten IOU with that investor.

And so that's another way of generating more business. And then when somebody wants to trade the debt, they come to us because they know we know where the debt is. So then you have secondary trading. So it's very granular and broad line Matt talked about, the go-forward pipeline in investment banking. And I just want you to kind of know how it works. So a lot of people that follow us haven't followed investment banks in the past. And so that was an important note, but not much of our guidance.

#### **Matt Scurlock**

Yes, back to back quarters of landmark transactions, Brady, near-term pipeline is materially more granular. We suggested to you and the rest of the investor base to model this is trailing 4 quarter average. We point to that guidance and suggest that some quarters were going to be in excess, the last 2 quarters being examples of that. In some quarters, we're going to be below. And our current outlook would suggest we'll be below a 4-quarter trailing average in the fourth quarter. As we think about the long-term prospects for that business, we need to sustainably hit 10% of total revenue, which is the guide until we offer that guide. I think that the platform to date has proven to be 1 that clients certainly value and 1 that we're quite optimistic is going to be able to achieve the growth targets that we've set out is moving at '24 and '25.

#### **Brady Gailey**

Okay. And sorry if I missed it, but did you guys quantify the fee from that marquee big transaction?

#### **Rob Holmes**

No, but the quarter would have been -- I'll just say the quarter would have been good without it. But it was a solid win.

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**Brady Gailey**

All right. And then my last question. I mean if you look at Texas Capital today versus pre-Rob, I mean the capital is a lot higher, the liquidity is a lot greater. The credit is a lot cleaner. It's just a much stronger institution, but you still have a stock that trades at like 1x tangible book value. I know you guys have done buybacks in the past, but I know there's a lot of uncertainty in today's backdrop. So when do you it seems like you're a perfect candidate for the share buyback. But when do you more seriously consider getting more involved there?

**Rob Holmes**

We seriously consider getting involved there every day. And as you know, we had a very disciplined capital allocation framework. We've proven in the past that we can repurchase shares responsibly and very efficiently most recently. We do believe we're -- I appreciate, with your words. Those were that imperatives for us. And our commitment to view and all of our constituents that we would do that. We still believe that we're in the build mode, we are onboarding clients at a pace that we are all very happy with.

The pipelines continue to be strong receptivity of the strategy by the client base is good. A lot of banks right now, frankly, are out of business. So to invest in the organic growth is a much higher return for this franchise over the longer term. However, having said that, you're right, we will need to consider buybacks and we do and it will and -- but it's not our first preference.

**Operator**

We have no further questions at this time. So I'll turn the call back over to Rob for any closing remarks.

**Rob Holmes**

Just thanks everybody for their interest in the firm and look forward to talking to you next quarter.

**Operator**

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

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