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Huntington Bancshares Incorporated's (HBAN) CEO Steve Steinour on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-24-19 Earnings Summary

Press Release   SEC *10-Q*   *Slides*

EPS of $0.34 beats by $0.01 | Revenue of $1.19B (3.85% Y/Y) beats by $14.69M

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Huntington Bancshares Incorporated (NASDAQ:HBAN) Q3 2019 Earnings Conference Call October 24, 2019 9:00 AM ET

Company Participants

Mark Muth – Director-Investor Relations

Steve Steinour – Chairman, President and Chief Executive Officer

Mac McCullough – Chief Financial Officer

Rich Pohle – Chief Credit Officer

Conference Call Participants

Erika Najarian – Bank of America

Ken Usdin – Jefferies

Jon Arfstrom – RBC Capital Markets

Brian Foran – Autonomous Research

Scott Siefers – Sandler O'Neill & Partners

John Pancari – Evercore ISI

Matt O’Conner – Deutsche Bank

Ken Zerbe – Morgan Stanley

Steven Alexopoulos – JPMorgan

David Long – Raymond James

Marty Mosby – Vining Sparks

Brock Vandervliet – UBS

Peter Winter – Wedbush Securities

Operator

Greetings and welcome to the Huntington Bancshares Third Quarter Earnings Call. At this time all participants are in a listen-only mode. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Mark Muth, Director of Investor Relations. Thank you. You may begin.

Mark Muth

Thank you, Sherri. Welcome. I'm Mark Muth, Director of Investor Relations for Huntington. Copies of the slides we'll be reviewing can be found on the Investor Relations section of our website, www.huntington.com.

This call is being recorded and will be available as a rebroadcast starting about one hour from the close of the call.

Today's presenters are Steve Steinour, Chairman, President and CEO; Mac McCullough, Chief Financial Officer; and Rich Pohle, Chief Credit Officer. As noted on Slide 2, today's discussion, including the Q&A period, will contain forward-looking statements. Such statements are based on information and assumptions available at this time and are subject to changes, risks and uncertainties, which may cause actual results to differ materially.

We assume no obligation to update such statements. For a complete discussion of risks and uncertainties, please refer to this slide and materials filed with the SEC, including our most recent Forms 10-K, 10-Q and 8-K filings.

Let me now turn it over to Steve and he will start on Slide 3.

Steve Steinour

Thanks, Mark. And thank you to everyone for joining the call today. As always, we appreciate your interest and support. We had a solid third quarter and we're pleased with the continued momentum across the bank despite a challenging operating environment.

Overall, our businesses are performing well with disciplined organic growth. Credit quality remains strong and we continue to build capital while supporting organic growth. We've been positioning the bank for a weaker economy and for a lower interest rate environment throughout the year.

Our efforts are consistent with our strategies of creating a high-performing regional bank delivering top quartile through the cycle shareholder returns. We were being cautious with our capital and liquidity given mixed global economic signals as well as increased global risks and volatility.

Please remember our board and management collectively are among the top 10 shareholders of the Company and we're required long-term shareholders. Across our footprint consumers continue to perform well with strong labor markets, driving wage inflation.

In the 12 months ending August 2019, unemployment rates declined in 14 of the 20 largest MSAs in Huntington's footprint states. Job openings exceeded unemployment levels in most of our markets. Home prices continue to appreciate with especially solid increases in Michigan, Indiana, and Ohio.

Additionally, consumer confidence in our region has generally stayed at the highest levels since 2000. On the business side, we've adopted a slightly more cautious view of the local economies recognizing that economic growth has slowed.

We've recently seen a slowdown in commercial loan activity consistent with the more measured tone from some of our commercial customers primarily in the manufacturing sector. Near-term uncertainty around trade and the national and global economic outlook has impacted investment. The uncertainty along with the tight labor markets is constraining economic growth in our footprint.

Our customers are generally confident about their performance this year. Fundamental long-term improvements are evident in virtually all footprint state economies. Michigan for example, is benefiting from a growing services sector with strong recent employment growth occurring in financial, business and professional services. Ohio has multiple industries in which long-term growth potential is high, including technology, financial services, healthcare and research.

The visibility in the pipeline for the fourth quarter commercial loan growth remains good, though we are more cautious about 2020. In light of the more challenging current operating environment and the prevailing outlook for additional interest rate cuts, we’ve taken action in the fourth quarter to reduce our future expense growth.

We've recently completed an internal reorganization including the elimination of about 200 existing positions to better drive productivity. In addition, the build out of our agile development capabilities have allowed us to become more efficient and more effective in our technology investments, which are focused on enhancing customer experience.

These actions position the bank to continue to perform well and further invest in digital technology despite an expectation of additional rate reductions. We are projecting positive operating leverage in 2020. As we've stated several times this year, we do not foresee a recession in the near-term.

Our core earnings power, strong capital aggregate moderate-to-low risk appetite and our long-term strategies position us to withstand economic headwinds. Our strategies are designed to drive more consistent performance across economic cycles. And while we, as I've said, we do not foresee a near term recession, it's important to recognize the downturns do not only bring challenges, they also bring opportunities. And we have a strong record of taking advantage of these situations.

For example, in 2009 and 2010 when others were pulling back from auto and small business lending, we stepped in and expanded these businesses and 10-years later these two groups are key drivers of Huntington's success.

Huntington was the largest SBA, 7(NYSE:A) lender in the nation last year for the second year in a row and we've now been number one in our footprint for more than a decade. Similarly, our auto finance business now operates in 23 States and we're the tenth largest bank auto lender.

Also in 2010 we introduced Fair Play banking, which was quite controversial and disruptive at the time, but has fueled our consumer banking growth over the past decade. We're positioned for a more challenging economy and I'm confident in our ability to continue to build long-term shareholder value.

Now, before I turn it over to Mac, I want to highlight our announcement last week that Zach Wasserman will be joining us in early November from Visa as our next CFO. As you all know earlier this year Mac announced he'll be retiring at year-end. So this is Mac's final earnings conference call before his retirement. I wanted to take a moment to thank him for his many accomplishments and enormous contributions to Huntington.

Mac heightened the culture of financial discipline throughout the organization. He was instrumental in our acquisition of FirstMerit and was the executive co-lead for the integration which successfully delivered the largest acquisition in our history. Under Mac's strategic leadership, we've established our long-term financial metrics and exceeded the original set in 2014 and are now working on a current set.

He has positioned the bank to perform well through all economic cycles. So on behalf of our board, our shareholders and certainly our colleagues like to thank Mac as we're extremely grateful for his contributions to the company.

So Mac with that halo, let me now ask you to provide the overview of financial performance.

Mac McCullough

Very good. Well thank you for those kind words, Steve. And let me say, welcome to Zack, who I'm sure is listening to the call today. Good morning to everyone on the call. And I just want to let you know how much I've enjoyed the relationship with the investment community over the last three decades.

I've appreciated the friendships that we've developed and I appreciate the learning opportunities as well. So thank you very much. Let's turn to Slide 4 and take a look at the third quarter.

So we have reflected strong earnings momentum with solid growth of revenue and earnings per share and a double-digit growth rate in tangible book value per share. We recorded net income of $372 million, a decrease of 2% versus the year ago quarter. We reported earnings per common share of $0.34 up 3% year-over-year.

Tangible book value per common share was $8.25 a 17% year-over-year increase. Return on assets was 1.4%, return on common equity was 13% and return on tangible common equity was 17%.

Our efficiency ratio for the quarter was 54.7% down from 55.3% in the year ago quarter. Total revenue increased 4% year-over-year. Average loans increased 3% year-over-year and average core deposits increased 2% year-over-year. Net charge offs modestly increased this quarter as a result of two commercial credits, which Rich will provide more detail on later in the call.

Overall credit quality remains strong. Even with these items, net charge offs were near the low-end of our average through the cycle target range of 35 basis points to 55 basis points. As we have previously noted, we expect some quarter to quarter volatility given the very low loss in problem loans levels at which we are operating.

Turning now to Slide 5, average earning assets increased $2.9 billion or 3% compared to the year ago quarter. Average loans and leases increased to $2.3 billion or 3% year-over-year including a $1.5 billion or 4% increase in commercial loans and a $0.8 billion or 2% increase in consumer loans.

Average commercial and industrial loans increased 6% from the year ago quarter and reflected the largest component of our year-over-year loan growth. C&I loan growth has been well-diversified over the past year with notable growth in corporate banking, dealer floorplan and asset finance.

We also continue to see good traction in our new specialty lending verticals of mid corporate lending, technology, media and telecom and practice finance, which we announced as part of the 2018 strategic plan. Alternatively, we continue to actively manage our commercial real estate portfolio around current levels, with average CRE loans reflecting a 3% year-over-year decrease.

The decrease is an output of pay downs as well as our strategic tightening of CRE lending to ensure appropriate returns on capital and to manage risk. Consumer loan growth remain centered in the residential mortgage and RV and marine portfolios reflecting the well-managed expansion of these two businesses over the past two years.

Average residential mortgage loans increased 10% year-over-year. As we typically do, we sold the agency qualified mortgage production in the quarter and retained jumbo mortgages and specialty mortgage products.

Average RV and marine loans increased 17% year-over-year as we continue to gain traction and market share across the 34 state footprint for this business. Average auto loans decreased 2% year-over-year as a result of the auto loan pricing optimization strategy we executed in 2018 and the first half of 2019.

Pricing optimization has helped us maximize revenue while minimizing balance sheet impact. However, given the changes in the interest rate outlook, we intentionally lowered our auto pricing in the third quarter to drive increased production. We are locking in short term duration, fixed-rate assets that are current higher yields before anticipated future rate cuts push auto loan yields lower next year.

It is important to note that we are driving the increased production while maintaining our super prime customer focus and our consistent underwriting discipline. Auto originations in the quarter totaled $1.6 billion up 17% versus the year ago quarter and had an average FICO score above 770.

Turning now to Slide 6, average total deposits increased 1% year-over-year, while average core deposits increased 2% year-over-year. Note that we sold approximately $725 million of core deposits as part of the sale that was constant retail branch network in June of this year.

Average money market deposits increased 13% year-over-year, primarily reflecting the shift in promotional pricing away from CDs to consumer money market accounts in mid-2018.

Core certificates of deposits increased 15% from the year ago quarter, primarily reflecting the consumer CD growth initiatives during the third quarter of 2018. Average interest-bearing DDA deposits increased 1% year-over-year, while average noninterest-bearing DDA deposits decreased 2%. Average total demand deposits were flat year-over-year.

As shown on Slide 30 in the appendix, we are very pleased that our consumer noninterest-bearing deposits increased 3% year-over-year. We continue to see our commercial customers shift balances from noninterest-bearing DDA to interest-bearing products, primarily interest checking, hybrid checking and money market. Average savings and other domestic deposits decreased 15%, primarily reflecting a continued shift in consumer product mix.

Moving on to Slide 7. FTE net interest income decreased $5 million or 1% versus the year ago quarter, primarily driven by the 12 basis points decline in net interest margin, partially offset by the 3% increase in average earning assets. Net interest margin was 3.20% for the quarter, down 12 basis points from the year ago quarter and down 11 basis points linked-quarter.

Moving to Slide 8, our core net interest margin for the third quarter was 3.16%, down nine basis points from the year ago quarter. Purchase accounting accretion contributed four basis points to the net interest margin in the current quarter, compared to seven basis points in the year ago quarter. Slide 26 in the appendix provides information regarding the actual and scheduled impact of FirstMerit purchase accounting for 2019 and 2020.

Turning to the earning asset yields. Our commercial loan yields decreased five basis points year-over-year, while consumer loan yields increased 18 basis points. Security yields increased one basis point. Our deposit costs remained well contained with the rate paid on total interest-bearing deposits of 98 basis points for the quarter, up 25 basis points year-over-year and up only one basis point sequentially. Our total interest-bearing deposit costs peaks in July and have moved lower every month since.

Slide 9 summarizes the incremental hedging strategy we have implemented to reduce the downside risk from lower interest rates. The incremental hedges include both asset swaps and floors. We have now substantially completed implementation of the incremental hedges. However, as you should expect, we will continue to fine-tune the overall hedging program as the interest rate environment, balance sheet mix and other factors necessitate. It's also important to remember that the cost of the hedging program has been fully reflected in our guidance since late 2018.

The graphs on the bottom left of the slide provide detail and the mix of our loan portfolio as well as the significant consumer deposit balances with repricing events in the second half of 2019 and the first half of 2020. This provides an opportunity for the bank to reduce the cost of deposits as these well-timed, higher priced CDs and promotional money market accounts repriced lower.

Through September, the deposit repricing activity is on track, although the maturing balances pick up in the fourth quarter, given this timing, we expect to see the impact of the lower consumer deposit costs beginning in the fourth quarter of 2019. On the commercial side of the business, we've developed tactics to quickly react to any rate cuts with client-specific rate reductions, particularly among our highest cost deposits. We were very pleased with the results following the July and September rate cuts and are ready to implement the same strategy for any future rate cuts.

Slide 10 provides detail on our noninterest income which increased 14% from the year ago quarter. Mortgage banking income increased 74%, primarily reflecting higher secondary market spreads and favorable origination volume as well as an $8 million gain on net mortgage servicing rate, risk managements in the current quarter.

Capital markets fees increased 38% versus the year ago quarter, primarily reflecting the acquisition of Hutchinson, Shockey and Erley in the fourth quarter of 2018 and continued core business growth. We continue to see positive momentum within our two largest contributors to noninterest income as deposit service charges and card and payment processing fees both posted year-over-year growth.

Slide 11 provides the components of the 2% year-over-year growth in noninterest expense. Personnel costs increased 5%, primarily reflecting a shift in the composition of colleagues, including the addition of nearly 200 colleagues in our digital and technology areas related to the 2018 strategic plan initiatives and the hiring of experienced bankers in our new lending verticals.

Further increasing personnel expense year-over-year with the implementation of annual merit increases in May of 2019 and increased benefit costs. Outside data processing and other services increased 26% year-over-year, driven by ongoing technology investment costs. Partially offsetting these increases, deposit and other insurance expense decreased 56% due to the discontinuation of the FDIC surcharge in the fourth quarter of 2018, while other expense decreased 16%.

We remain focused on driving positive operating leverage in 2019 and 2020. Slide 12 illustrates the continued strength of our capital ratios, the tangible common equity ratio or TCE ended the quarter at 8%, up 75 basis points from a year ago quarter. For the common equity Tier 1 ratio ended the quarter at 10.02%, up 13 basis points year-over-year and up 14 basis points linked-quarter. We continue to manage CET1 to the high-end of our 9% to 10% operating guidelines. During the third quarter of 2019, we repurchased 5.2 million common shares at an average cost of $13.02 per share or a total of $68 million of common stock.

Slide 13 provides a look at our current thinking around CECL. We continue to progress towards CECL implementation in 2020. At this time, we estimate our allowance for credit losses or ACL will increase in a range of 40% to 50% from current levels. Given our 50% mix of relatively longer dated consumer loans, the CECL lifetime loss methodology results in a much higher allowance than the current expected loss methodology. The increase in reserves has predominantly correlated to the consumer loan portfolio.

We reduced our buyback this quarter as we worked through the expected impact of CECL. Going forward, we plan to use the share repurchase to manage our capital costs, our capital post-CECL back to 10% CET1 level, but a fully implemented basis by the end of next year. These actions reinforce our commitment to maintaining our strong capital ratios which we see as a position of strength for the organization.

As we have previously communicated on many instances our capital priorities are: first, to fund organic growth; second, to support the cash dividends and finally, all other capital uses including the buyback and selective acquisitions. These capital priorities have not changed.

Let me now turn it over to Rich to cover the credit trends for the quarter. Rich?

Rich Pohle

Thanks Mac. Slide 14 provides a snapshot of key credit quality metrics for the quarter which remains strong. Consistent prudent credit underwriting is one of Huntington's core principles and our financial results continue to reflect our disciplined approach to risk management and our aggregate moderate-to-low risk appetite.

We booked loan loss provision expense of $82 million in the third quarter and net charge-offs of $73 million. Net charge-offs represented an annualized 39 basis points of average loans and leases in the current quarter, up from 25 basis points in the prior quarter and up from 16 basis points in the year ago quarter. The increase was centered on two specific energy credit relationships which made up nearly three-fourth of the total commercial net charge-offs.

These relationships were upstream companies operating in the same reserve basin. One of the credits was moved to held-for-sale, which accounts for the increase in other NPAs for the quarter. We expect the sale to close in the next couple of weeks. The loss exposure in these two credits was completely recognized in the third quarter.

We have a relatively small energy portfolio representing less than 2% of total loans. Consumer charge-offs have remained consistent over the past year. There is additional granularity on charge-offs by portfolio in the analyst package and the slides. The allowance for loan and lease losses or ALLL, as a percentage of loans remained relatively stable at 1.05%, up two basis points linked-quarter. The nonperforming asset ratio increased three basis points linked-quarter and nine basis points year-over-year to 0.64%. The year-over-year increases was centered in the C&I portfolio and other NPAs, partially offset by decreases in the residential mortgage, commercial real estate and home equity portfolios.

Note that these metrics include the results from the most recent shared national credit exam. The increase in commercial delinquencies this quarter as seen in the appendix on Slide 54 was related to a leasing system conversion, not underlying credit deterioration. Overall, asset quality metrics remain near cyclical lows. And as we have noted previously, some quarterly volatility is expected given the absolute low level of problem loans.

Let me turn it back over to Mac.

Mac McCullough

Thank you, Rich. Slide 15 illustrates our updated expectations for full year 2019. We expect full year average loan growth of approximately 4% with continued growth in our consumer business, including home lending and auto finance. We expect more measured commercial loan growth consistent with recent economic data.

Full year average deposit growth is expected to be approximately 3% as we remain focused on acquiring core checking accounts and deepening customer relationships. A number of you have asked for us to provide guidance on net interest income as opposed to NIM, which we are now providing on the slide.

We expect full year fully taxable equivalent net interest income growth of approximately 1% for 2019. This is consistent with a full year 2019 margin guidance we provided at the Barclays conference and includes the impact from purchase accounting and the cost of our hedging strategy.

Also, as I mentioned at the Barclays conference, we remain comfortable with current Street consensus expectation for full year 2020 NIM of 3.21%. We expect full year noninterest income growth of 9% to 12% on a GAAP basis. As we have told you previously and are demonstrating with our actions, we've remained committed to delivering annual positive operating leverage. Full year noninterest expenses are expected to increase 2% to 2.5%.

This includes approximately net $15 million to $20 million of unusual expense resulting from the previously mentioned expense actions we are taking in the fourth quarter. As we have done in the past, we are also evaluating our branches and other real estate. We anticipate that full year 2019 net charge-offs will remain below or average through the cycle target range of 35 to 55 basis points. Our expectation for the effective tax rate for the remainder of the year is in the 15.5% to 16.5% range.

So with that Sherri, we will now take questions. We ask that as a courtesy to your peers each person ask only one question and one related follow-up. And then if that person has additional questions, he or she can add themselves back into the queue. Thank you.

Question-and-Answer Session

Operator

[Operator Instructions] Our first question is from Erika Najarian with Bank of America. Please proceed.

Erika Najarian

Hi, good morning.

Mac McCullough

Hi Erika.

Erika Najarian

Thank you so much for reiterating your outlook on that net interest margin for next year. And I'm wondering if we could put it in context of balance sheet growth as well. The loan growth momentum continues to be solid. And I'm wondering, how should we think about, how you're thinking about A, your resi growth strategy in a post-CECL world and B, how earning asset growth will trend relative to loan growth from here?

Mac McCullough

Yes, thanks, Erika. We're not going to give 2020 guidance until later this year at a conference in December. But happy to answer your questions around resi growth and how we're thinking about going forward. We will be cautious with resi growth on the balance sheet. I mean, obviously we have a number of our customers who have the need for that product. A number of the balances that we've been putting on in 2019 have been private plan relationship that we have a deep relationship with and that's how we're thinking about mortgage product going forward.

Just given some of the changes in CECL work, we're looking for that to be more of a relationship product from a relationship pricing perspective. But still like the asset class but that might be the one change that we think about going forward.

Erika Najarian

I guess just in net-net, if we take a step back, unless you tell us something more dramatic in terms of how you're managing the securities portfolio. If I combine your outlook on margin with, let's call it 3% to 4% loan growth, then it seems as if the net interest income growth would be sort of greater than the flat trend than what consensus is expecting.

Mac McCullough

Clearly, the net interest income growth in 2020 will be driven by earning asset growth. We are seeing growth switch from the commercial categories to the consumer categories in the fourth quarter. We will likely continue to be more aggressive of consumer lending in 2020 as we like the dynamics of those portfolios, if you think about some of the fixed rate nature of the portfolios as well as the credit quality. We continue to super-prime consumer portfolio, so that's one change, just given some of the comments we made about the outlook for commercial lending and what we're seeing now that you could expect to see in 2020.

Erika Najarian

Got it. Thank you and congratulations, Mac.

Mac McCullough

Okay. Thank you, Erika.

Operator

Our next question is from Ken Usdin with Jefferies. Please proceed.

Mac McCullough

Hi Ken.

Ken Usdin

Hi good morning. Hey, good morning and then best of luck to you again, Mac. On the deposit side, you mentioned that you'd expect the deposits to start coming down in the fourth. They were up a touch in the quarter. Can you just walk us through the dynamics of the rolling off legacy CDs and how much impact you can see that have on total interest-bearing cost as you do roll forward? Thanks. And beta – just kind of your underlying beta expectations. Thank you.

Mac McCullough

Yes, thanks Ken. So the opportunities we have with the CD book that’s repricing and some of the money market specials that are also coming up for re-evaluation. I mean, it actually presents a really nice opportunity for us. I think Slide 9 actually has the mix of what's repricing from a deposit perspective and you can see that we're actually entering into some of the bigger balance changes in the fourth quarter into the first quarter of 2020.

As I mentioned in my opening comments, we've seen really good execution against being able to reprice those deposits. I would say, it's ahead of our expectations. We are seeing some of the CDs move into money market, because of just some late specials that we have in the money market space. But we still like that activity as it retains those deposits and allows us to reprice lower.

The one good trend that continues to play out well for us is the continued growth in noninterest-bearing on the consumer side, still really good activity there. And we don't see that slowing down. So, all in all, I think the timing of when we put some of these deposits on our books in 2018 and the opportunity as we see the declining rate environment is what really gives us some confidence as we move into the fourth quarter with our ability to reprice these deposits and help to stabilize the NIM.

Ken Usdin

Got it.

Steve Steinour

I think the sale of Wisconsin was little over $100 million of DDA as well, so the year-over-year numbers even more impressive.

Mac McCullough

Yes, good point. So the $725 million that we sold with Wisconsin those were our core deposits as Steve called out the DDA portion. So our performance needs to take into consideration that $725 million that we sold as a part of the Wisconsin branch sale.

Ken Usdin

Yes. And just one clarification, you always do guide on GAAP. So I'm presuming that the $15 million to $20 million of non-core stuff in the fourth quarter, that's in the full-year guidance?

Mac McCullough

Absolutely Ken. That's a good call-out and a good margin of what the guidance…

Ken Usdin

All right. And we should see the benefits of that next year then?

Mac McCullough

That's correct.

Ken Usdin

All right, thank you.

Mac McCullough

Okay. Thanks Ken.

Operator

Our next question is from Jon Arfstrom with RBC Capital Markets. Please proceed.

Jon Arfstrom

Good morning.

Mac McCullough

Good morning, Jon.

Jon Arfstrom

Mac, I wonder what you're going to be doing in mid-January not thinking about margin guidance?

Mac McCullough

I will be lonely.

Jon Arfstrom

Your last chance to do what's right.

Mac McCullough

Now what does that imply, Jon?

Jon Arfstrom

Yes. Noninterest income growth, it's a pretty wide range that you have for the full year. And I'm thinking if mortgage is the variance there but can you just help us understand the wide range and what would drive us – drive you to the lower, higher end of the range?

Mac McCullough

Yes, that's absolutely correct, Jon. I mean, we continue to see good mortgage origination volume and the favorable spreads are holding up nicely. So we don't know exactly how strong the quarter is going to be, but we do think there could be some upside there. And that's why we gave it.

Jon Arfstrom

Okay. And is the origination strategy I understand a lot of it is this quarter was MSR and maybe some refinance, but the origination strategy is still more Chicago focused or is there something more than that driving it?

Mac McCullough

Well, it is broadly across the franchise, but I do think some of the changes that we made in Chicago and particular as we acquired FirstMerit and built out the mortgage origination capabilities in the Chicago market, a lot of the growth has been coming out of Chicago since FirstMerit.

Jon Arfstrom

Okay, all right. Thank you.

Mark Muth

We also do a lot of strengthen both here in Michigan – in Ohio and Michigan post-FirstMerit. So don't want to downplay that impact either.

Jon Arfstrom

But it's safe to say that it's just – it's refinancing volume that's going to drive you to the higher end or lower end that's really it?

Mark Muth

Yes, that's exactly a way to look at it.

Jon Arfstrom

Okay, thank you.

Mark Muth

Okay, thanks Jon.

Operator

Our next question is from Brian Foran with Autonomous Research. Please proceed.

Brian Foran

Hi, good morning everyone.

Mac McCullough

Good morning, Brian.

Brian Foran

I guess, Steve, you mentioned you don't see a recession on the horizon, but you also kind of made some cautious comments on the commercial side. I mean, you've seen several cycles. I'm just wondering, is that something that can persist or is it kind of like one or the other has to win, i.e., can we have a prolonged period of a slump in commercial lending without a recession or is it kind of like if C&I stays weaker for longer eventually that tips in a recession, and if we don't tip in recession, then eventually C&I recovers?

Steve Steinour

Right. In the commercial context, there are a lot of avenues for financing in addition to banking. Historically, it would have said reduced bank lending would naturally translate into slower economic growth, but you do have many other options out there today for different levels of commercial customers.

I think what we're trying to suggest is that the combination of factors that have occurred somewhat more in the late first half and certainly the second half of the year have compounded the outlook a bit. So whether it's global slowdown, trade and tariffs, we have a big manufacturing sector and an export sector here in the Midwest states we're in.

Just as we mentioned in the last call, we're almost talking ourselves into this. So I think a number of factors are contributing to a slowdown and we still see it as a slowdown. Many of our customers continue to suggest their number one issue is they can get qualified employees. And so this is a labor constrained recovery that has lost a little steam but we think it continues.

Brian Foran

And then maybe one follow-up on the expense side. Can you remind us in kind of a normal year, how much expense flexibility do you have? So I'm not trying to get into a number for 2020. But just if you're trying to ramp up or ramp down expenses based on the environment, but also trying to make the core investments you want to make in the franchise. As the year progresses, is the range plus or minus 2% or 200 basis points, 400 basis points? How much ability do you have to react in a typical year?

Mac McCullough

Yes, Brian, this is Mac. So we do believe that we have expense flexibility and I think we've proven that as we move through what's important with the economy and the interest rate outlook. We still have some flexibility. We go through the process every year of taking a look at just different levels of productivity improvements that we put in place before the year ends, so that we know where we're going to go in case we have to think through some changes in the environments and how we want to manage things like operating leverage or EPS or investment back into the franchise.

So it's important that as we think about what opportunities we have on the expense side in 2020, as we manage for positive operating leverage. We're also investing back into the franchise. And I think that's really important for us to recognize in terms of the activities that we're going through and some of the important investments that Steve has spoken to that we're going to continue to make in 2020.

So confident that we've got flexibility, in addition to what we've already done. But we're going to be careful about the overall health of the franchise and we're going to continue to make those important investments that we think will drive the top line and our competitive position going forward.

Brian Foran

Thank you both, and Mac, congratulations.

Mac McCullough

Yes. Thank you, Brian.

Steve Steinour

Thanks Brian.

Operator

Our next question is from Scott Siefers with Sandler O'Neill & Partners. Please proceed.

Scott Siefers

Good morning, guys. How are you?

Mark Muth

Good morning, Scott.

Scott Siefers

Hey, Mac, I guess first question, just sort of on kind of a qualitative one on the balance between the margin and the overall dollars of NII. Do you guys sort of have one that you kind of prefer to manage to over the other? So I think in the past as you guys have looked at some of the levers you have to pull on the margin, you've alluded to some of the – some marginality in the securities portfolio for example. How do you sort of weigh that balance between preserving the dollars and preserving the margin rate?

And then I guess, along those lines, as we look at the mix shift into next year, relatively more consumer-driven vis-à-vis commercial. Is that going to have any discernible impact on the margin trajectory from you guys' standpoint?

Mac McCullough

Yes. Thanks, Scott. So in this environment and just based upon feedback we've gotten from analysts and investors, we did make the switch over to net interest income in terms of providing guidance in this quarter. Obviously, with some of the volatility in the marketplace as well as some of the actions that we can take to drive net interest income that will have an impact on NIM, that might necessarily tell the whole story by us just giving you the NIM guidance.

Yes. So to your point, Scott, you alluded to the levers that we have in terms of how we think about driving net interest income and that would be things like the securities portfolio, optimization of the balance sheet. There are many players that we've run over the years that we still have in our pocket that we can take a look at and those actions have an impact on NIM obviously.

So going forward, we're managing net interest income and we're managing the revenue profile of the company. NIM is a bit of an output from that as we move through what is increasingly more volatile period. But we think that gives you the best information you need to understand where we think the organization is going.

Scott Siefers

Okay, perfect. Thank you for that. And then I think I'm effectively going to repeat one of the other questions here but just so I understand it perfectly. On the cost side, all of that difference in the guidance today versus what you gave a month or so ago at the Barclays conference, that's simply a function of the sort of one-time costs that we're going to have in the fourth quarter as opposed to any change in the core trajectory, right?

Mac McCullough

Yes. That is exactly correct.

Scott Siefers

Okay, terrific. All right. Well, thank you again. And then Mac, good luck and congratulations.

Mac McCullough

Thank you, Scott.

Operator

Our next question is from John Pancari with Evercore ISI. Please proceed.

Mark Muth

Good morning, John.

John Pancari

Good morning. On the expense topic again for, I know you're not giving formal guidance for 2020, but you did indicate that you're confident and positive operating leverage or you're projecting it for 2020 as well. Is there any way you can help us with the magnitude and – or at least a little bit of color that – could operating leverage actually accelerate off of the 2019 amount that you're going to see because of the headcount reductions in the hedging that's in place? Thanks.

Mark Muth

Yes. Thanks for the question, John. So the way we think about expense growth and what we're trying to accomplish is we understand the revenue environment that we're moving into. And once we get some confidence around a range of revenue expectations then we decide what we can do from an expense perspective including investment back into the franchise.

So, well, I can't and won't give you any guidance around expense for 2020. We are targeting positive operating leverage as Steve mentioned in his comments. We're also looking to reinvest back in the franchise as I mentioned in my comments and Steve's comments.

So the activity is underway and what we've done up to this point in time, give us a path to both of those objectives, making the right investments back into the franchise and achieving positive operating leverage.

If we get ahead in 2020, it's more likely we're going to invest back in the franchise taking everything else into consideration, the revenue outlook obviously where the economy is and where we think its heading and what we think our performance is going to be in those scenarios. But we've got some investments underway that we think are differentiating and important and we're going to continue to make those investments.

John Pancari

Got it. Okay, that's helpful. And then separately on the credit side, I know you mentioned that you implied that one of the energy credits had impacted other NPAs, so that accounted for some of the increased in non-accruals, but – in NPAs. But non-accruals also saw, it looks like an additional increase. So I just want to get a little bit of color about what may have driven that and also your criticized assets were up a bunch. Is that all the NPA increase or is there something else there that's driving them higher? Thanks.

Mac McCullough

Yes, I mean the quick class number is up. It's not at a level that, we haven’t operated at before, we've been back at this level in the 2016, 2017 timeframe. The current quarter does have some energy impacts in there as well. As it relates to the NPAs, we did move the one deal into held-for-sale and then we had a couple of additional NPAs added, one in energy and then one, a couple of others outside of energy more on the C&I side.

John Pancari

Okay. Thank you. And the other stuff on the C&I side, was that in any specific sector outside of energy?

Rich Pohle

No, it was pretty broad based, a couple of middle market credits and we're in there.

John Pancari

Okay. So no other deterioration non-energy to flag that you're starting to see developed in the portfolio?

Rich Pohle

No, I mean, the energy represented a significant amount of the charge-offs for the quarter. If you were to exclude the energy losses, which you can't do, but the rest of the book on the commercial side, the charge offs were pretty de minimis.

John Pancari

Got it. All right. Thanks Rich, and Mac good luck.

Mac McCullough

Thank you.

Operator

Our next question is from Matt O’Conner with Deutsche Bank. Please proceed.

Matt O’Conner

Hey guys.

Steve Steinour

Good morning Matt.

Matt O'Conner

I was wondering if you could talk as far as you could talk a bit more about the drivers of the good growth in both service charges and card fees as we look year-over-year. I mean, you addressed kind of continued growth from a more activity, but they're obviously both for us, rates are quite high and maybe give us a little color on, on the service charges, how much is commercial or consumer and again, the sustainability of both of those growth rates. Thanks.

Mac McCullough

Yes. Thanks, Matt. So the good news here is that I can't really call it anything unusual that's driving the growth, other than just good execution and organic growth. When you take a look at deposit service charges, we are seeing growth in consumer because we continue to add new households to the organization.

Commercial is probably being driven by treasury management to a large degree and some of the new products and services that we've implemented. In particular, we've added some new capabilities in the business banking, our small business side, that have had a nice lift and kind of a pipeline for treasury management revenue as well as close one referrals.

So that is a very, very nice developing trend that we think is going to continue into 2020. And payment processing, I would just tell you that's a good core organic growth in terms of new customers coming into the bank, new card, debit and credit opportunities, And it's just basically the growth of our customers organically.

Capital Markets is another item to call out, which again we continue to see really, really good growth, good execution. We continue to add up the products out there. We bought the broker dealer, municipal broker dealer last year and that has really been very complementary to our Capital Markets business. We've been able to leverage that acquisition into some of our other capabilities and business lines to actually see additional growth coming out of that opportunity.

So we've got some good performance in fee products in 2019. I think there are some good reasons to believe that's going to continue in 2020.

Matt O'Conner

Just back on the service charges. Have you guys disclosed what the mix is between the consumer and commercial? And I guess does a commercial benefit from the declining rate environment here on the earnings credits the way it works versus your fees versus your earnings credit on deposits?

Mac McCullough

Yes. So the mix is probably slightly more toward the consumer side, but we haven't really disclosed the exact breakout between the two. And I'm sorry, the second part of your question?

Matt O'Conner

Just the outlook on the commercial. Is there some benefit from the lower rates there as the earnings credit on deposits are less and you've picked up in fees that one is the driver as you think about next year?

Mac McCullough

Yes, I wouldn't think that earnings credit is going to be a big addition to that line going forward in 2020. I mean we manage earnings credit pretty tightly. But I don't think that's going to be a big driver.

Matt O'Conner

Okay, all right. Thank you.

Mac McCullough

Okay. Thanks, Matt.

Operator

Our next question is from Ken Zerbe with Morgan Stanley. Please proceed.

MarkMuth

Morning, Ken.

Ken Zerbe

Great, thanks. I guess maybe Steve, I know in your initial comments, it sounds like you're pretty negative on commercial loan growth. I just want make sure we get the right message that is it that commercial loan growth in 2020 could slow, but you're going to more or at least make up the slowness with better consumer growth, is that the right message?

Steve Steinour

Well, I want to imply a cautiousness. The economy has slowed significantly year-over-year. We were running around 3.5% to 1.5% most recently. We've done 6% year-over-year commercial growth, and I think we need to be a little more cautious. We're just trying to flag that for you in line with the outlook that we're hearing from our customers. We expect to be able to grow commercial next year and at the same time, we will grow the consumer side as well.

Ken Zerbe

Got you. Okay. And then I guess just one small question in terms of your guidance for positive operating leverage in 2019, is that on a full GAAP basis? Are you excluding the unusually high expenses in fourth quarter?

Steve Steinour

Yes. It's all on a GAAP basis.

Ken Zerbe

Okay, all right, great. Thank you.

Steve Steinour

Thanks, Ken.

Operator

Our next question is from Steven Alexopoulos with JPMorgan. Please proceed.

Steven Alexopoulos

Good morning, everybody.

Steve Steinour

Hi, Steve.

Steven Alexopoulos

I wanted to drill down a little bit on CECL. How much is the reserve for auto loans expected to change under CECL?

Mac McCullough

So Steve, we're not going to give that level of guidance at this point in time. We'll disclose those stats, obviously in the future, but I'm not going to disclose them here.

Steven Alexopoulos

Okay. Is it material enough to change your appetite to want to add auto loans in 2020?

Mac McCullough

No.

Steven Alexopoulos

No. Okay. And then separately for Steve. In terms of the tone-shift you're talking about from your manufacturing customers, is this more coming from the macro noise right trade wars, etcetera. Are you starting to actually see pressure start to show up in financial statements for these customers?

Steve Steinour

We're total at this point, Steven we, again, I think there is an element of we're talking ourselves into something but certainly for these manufacturers, the trade tariff issues are real, for some of them.

Steven Alexopoulos

Okay. And what percent of your loans are to manufacturing companies?

Mac McCullough

Commercial loans of about 25% to ballpark.

Steven Alexopoulos

That's of commercial.

Mac McCullough

Yes.

Steven Alexopoulos

Okay, thanks and best of luck, Mac. Thanks very much.

Mac McCullough

Yes. Thank you. Take care.

Operator

Our next question is from David Long with Raymond James. Please proceed.

Mark Muth

Hi, Dave.

David Long

Good morning everyone. Mac, I think you said that you were comfortable just maybe confirm if this is accurate, but I thought I heard you say you're comfortable with the Street NIM forecast of 321 for 2020. Is that accurate?

Mac McCullough

That is correct.

David Long

Okay, just when you say that, what type of rate backdrop do you have in mind? How many rate cuts do you have in or what are your expectations when making that comment?

Mac McCullough

Yes, it's great, great question, Dave. So we have a assumption of three rate cuts, October, January and September.

David Long

Got it, got it. Okay, great, that's all that I had.

Mac McCullough

Okay, thanks Dave. Thanks.

Operator

Our next question is from Marty Mosby with Vining Sparks. Please proceed.

Marty Mosby

Thanks.

MarkMuth

Good morning, Marty.

Marty Mosby

I wanted to ask – hey, good morning. I wanted to ask a question about the return on tangible common equity and how you're looking at the different stacks of capital. Your CET1 ratio is relatively flat but your TCE to TA ratio has been increasing over the last year pretty substantially.

I know that some of that's related to mark-to-market on the securities portfolio. But I wouldn't think that all of that was the difference there. So, we're just curious because that increase in TCE to TA ratio was causing the ROTCE to fall off a little bit.

Mac McCullough

Yes, Marty. It's a great, great question. So we're up about $1 billion year-over-year in tangible common equity. About 75% of it is OCI related to the securities portfolio and other pension, things like that. So that is the primary driver of the improvement in TCE.

Marty Mosby

And then could you give us a little bit of color on the mortgage servicing rights? We've had several banks report these gains in the mortgage servicing rights with the hedging given that interest rates were coming down and prepayments were kicking in. It's one of two things. Either the assumption on the prepays was over exaggerated, which I think is built into the models all the time in the or you are over-hedged. So I'm just curious how the dynamics were playing out. So this particular quarter, we had these gains on mortgage servicing rights hedging.

Mac McCullough

Yes, Marty. It's obviously been a pretty volatile environment. Then I would say it's a little of both in terms of the two suspects you threw out there. But volatility has been pretty, pretty high as you, as you know, but I think the team has done a great job of making sure that we are hedged appropriately and some of that volatility is going to mean that you are over hedged, under hedged at any point of time.

But it's obviously something we look at very carefully, spend a lot of time with and I think we've done a good job.

Marty Mosby

Well, thanks and best of luck where you'd go forward, it's been great working with you.

Mac McCullough

I appreciate it Marty. Thank you.

Operator

Our next question is from Brock Vandervliet with UBS. Please proceed.

Mark Muth

Hi, Brock.

Brock Vandervliet

Great, good morning. On the credit picture and I know you provide a lifetime net charge-off over the cycle guide, I guess over the cycle guide. I'm a little surprised that some of the credit friction this quarter, what kind of confidence do you have based on what you can see right now that you can hold net charge-offs and kind of the level that we saw this quarter as opposed to having them move higher in the intermediate term?

Rich Pohle

This is Rich. Like I said, the charge-offs in this quarter were really isolated to the energy book. The balance of the portfolio, we believe is performing well and we have expectations that it will continue to perform well. So if you're trying to, are you trying to tie that into the CECL estimate or …

Brock Vandervliet

Not so much around CECL, just trying to get a sense of, I felt like Huntington has been kind of battened down for quite a while on credit and just it sounds like there is more a tone of slowing and I just want to make sure I'm attuned to that. That's all.

Mac McCullough

Yes. So I think it's important to differentiate the slowing with the credit discussion. We talked about energy be less than 2% of our loan portfolio and that really is where the problems have been centered. Outside of that, we really don't see anything of concern as we take a look at the portfolios on the outlooks.

So it's different, I think a different, different discussion on what we see in the economy and what we hear from our customers and a little bit of caution around some of the feedback we're getting in, some of what we're seeing take place on the ground. But that's how I would think about the credit question versus what we see it and from a growth perspective.

Rich Pohle

And to be clear Brock, we're not making a call on a recession, we don't see it. I think we reiterated that twice in the prepared comments. So this is a 1.5% which, you roll the clock back six years ago would have been a reasonably good year. So we're just coming off of 3.5% and it's a percent GDP growth. So we think this we could be, we could be running at this level for a while.

Mac McCullough

And to your earlier point Brock, I mean, look, we're not going to put question of assets on the balance sheet at this point of the cycle. So we've been consistent in talking about the discipline of our underwriting process. I think we're even more cautious in environments like this based on what we're hearing from our customers. So we put a note of caution out there and we've talked about the pipeline still being higher than they were at this time last year, but we're just reflecting what we hear from our customers and letting you know what we're thinking.

Brock Vandervliet

Okay. I appreciate the color.

Mac McCullough

Okay, thanks Brock.

Operator

And our final question is from Peter Winter with Wedbush Securities. Please proceed.

Peter Winter

Good morning.

Mac McCullough

Hey Peter.

Peter Winter

I had a question on capital. And I heard you with the share buybacks being at the bottom of your packing order. But I'm just curious, are you planning on completing the share authorization under the 2019 CCAR?

Mac McCullough

Peter, it's going to depend on balance sheet growth from here and outlook for 2020. We are committed to getting our capital levels back to the pre-CECL levels by the end of 2020 which could mean that we curtail the 2019 share repurchase authorization a bit but it's all going to come down to a balance sheet growth and what it's going to take you back to those levels at the end of 2020.

Peter Winter

Got it, okay. Thanks and Mac I've enjoyed working with you over the year. So, best of luck.

Mac McCullough

Thank you, Peter.

Operator

I would like to now turn the conference back over to Steve for closing comments.

Steve Steinour

So, I'm pleased with our solid results through the first three quarters of 2019, particularly given the significant movement in the yield curve and the amount of market volatility we've witnessed. I remain confident about our prospects for the remainder of the year in 2020 as we manage through what we expect to be a challenging environment.

Our top priorities are executing our strategic plan and thoughtfully investing in our businesses for continued prudent organic growth while delivering the annual positive operating leverage. We're building long-term shareholder value by focusing on customers and top quartile financial performance with consistently disciplined risk management.

And finally, we always like to end with a reminder to our shareholders that there is a high level of alignment between the Board, management, our colleagues and our shareholders. The Board and our colleagues are collectively at top 10 shareholder of Huntington and all of us are appropriately focused on driving sustained long-term performance.

So with that, thank you for your interest in Huntington. Mac many thanks to you, and congratulations. We appreciate all of you joining us today. Have a great day.

Operator

Thank you. This does conclude today's conference. You may disconnect your lines at this time, and thank you for your participation.