Seeking Alpha
Transcripts | **Financial**

The PNC Financial Services Group, Inc. (PNC) CEO William Demchak on Q3 2019 Results - Earnings Call Transcript

Oct. 16, 2019 4:14 PM ET
by: SA Transcripts

Q3: 10-16-19 Earnings Summary

Press Release SEC *10-Q* *Slides*

EPS of $2.94 beats by $0.14 | Revenue of $4.49B (3.12% Y/Y) beats by $78.62M

Earning Call Audio

Subscribers Only

00:00 -58:23

The PNC Financial Services Group, Inc. (NYSE:PNC) Q3 2019 Earnings Conference Call October 16, 2019 10:30 AM ET

Company Participants

Bryan Gill - Executive Vice President and Director of Investor Relations

William Demchak - Chairman, President and Chief Executive Officer

Robert Reilly - Executive Vice President and Chief Financial Officer

Conference Call Participants

John Pancari - Evercore ISI

Erika Najarian - Bank of America Merrill Lynch

Betsy Graseck - Morgan Stanley

Scott Siefers - Sandler O'Neill & Partners L.P.

John McDonald - Autonomous Research LLP

Matthew O'Connor - Deutsche Bank AG

Kenneth Usdin - Jefferies LLC

Michael Mayo - Wells Fargo Securities, LLC

Kevin Barker - Piper Jaffray

Gerard Cassidy - RBC Capital Markets

Saul Martinez - UBS Investment Bank

Operator

Good morning. My name is Tina, and I will be your conference operator today. At this time, I would like to welcome everyone to The PNC Financial Services Group Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] As a reminder, this call is being recorded.

I will now turn the call over to Director of Investor Relations, Mr. Bryan Gill. Please go ahead.

Bryan Gill

Thank you and good morning, everyone. Welcome to today's conference call for The PNC Financial Services Group. Participating on this call are PNC's Chairman, President and CEO, Bill Demchak; and Rob Reilly, Executive Vice President and CFO.

Today's presentation contains forward-looking information. Cautionary statements about this information as well as reconciliations of non-GAAP measures are included in today's earnings release materials as well as our SEC filings and other investor materials. These materials are all available on our corporate website, pnc.com under Investor Relations. These statements speak only as of October 16, 2019, and PNC undertakes no obligation to update them.

Now, I'd like to turn the call over to Bill Demchak.

William Demchak

Thanks, Bryan, and good morning, everybody. As you saw this morning, PNC reported third quarter net income of $1.4 billion or $2.94 per diluted common share. Overall, I think we had a really good quarter. We generated solid growth in loans and deposits. We grew total revenue by 1%, as both NII and non-interest income increased.

You saw we managed expenses well even as we continue to invest in our businesses and infrastructure, and we improved our efficiency ratio. Overall, credit quality also remained strong, and we increased the capital we return to shareholders in the third quarter through share repurchases and the dividend.

We continue to execute on our strategies to extend the reach of our middle market corporate banking franchise into new markets and to expand our retail banking brand nationally.

We delivered these results despite uncertainty in the market related to everything from slowing economic growth, trade restrictions, geopolitical concerns and the interest rate environment.

As we look toward the remainder of the year and ahead to 2020, there are obvious unanswered questions about the environment we are operating and along with the intensity of entering the Presidential election year.

However, we will not be distracted by things that are beyond our control. Rather, you will see us continue to invest and work to improve the customer experience to reach more customers with our products and services and to offer superior solutions to our customers evolving banking and investment needs.

Last week, you would have seen the Federal Reserve voted on the final rules for the tailoring proposals, and the rules are essentially in line with what we expected and Rob is going to walk you through the details, but this is a positive outcome obviously, as it gives us a degree of capital and liquidity flexibility beyond what we already have today.

As always, I want to thank our employees for their hard work in the third quarter and their continued focus on serving our customers, the communities that we live in and our shareholders.

Now, I'll turn it over to Rob for a closer look at our third quarter results, and then we'll take your questions. Rob?

Robert Reilly

Thanks, Bill and good morning, everyone. As Bill just mentioned, we reported third quarter net income of $1.4 billion or $2.94 per diluted common share. Our balance sheet is on Slide 4 and is presented on an average basis. Total loans grew $2.8 billion or 1% to $238 billion linked quarter. Compared to the third quarter of 2018, growth was $14.4 billion or 6%.

Investment securities of $85.2 billion increased $1.5 billion or 2% linked quarter, primarily due to purchases of agency residential mortgage-backed securities. Year-over-year, total securities balances increased $4.4 billion or 5%.

Our deposits – the Fed averaged $15.3 billion for the third quarter, up $2.1 billion linked quarter. Deposits grew $6.2 billion or 2% linked quarter, and $16.6 billion or 6% year-over-year.

We continue to maintain strong capital ratios. During the quarter, we returned $1.5 billion of capital through dividends of $516 million and share repurchases of $1 billion. Since the third quarter of 2018, we've reduced our shares outstanding by $23 million or 5%. As of September 30, 2019, our Basel III common equity Tier 1 ratio was estimated to be 9.6%, down slightly from 9.7% as of June 30, 2019.

As Bill mentioned, the Federal Reserve released the final regulatory tailoring rules last week and as expected, the rules are largely unchanged from the original proposals and are generally favorable to our liquidity and capital ratios.

There are three significant impacts from a financial perspective for PNC. One, we will get relief on threshold deductions in our CET1 capital calculation, two, we will have the choice to opt out of the inclusion of AOCI and capital, and three, our LCR requirement will be lowered to 85% from 100% currently.

If the rules were effective on September 30, we estimate that the threshold deductions changes would generate a benefit of approximately 70 basis points to our common equity Tier 1 capital ratio, while the impact of opting out of AOCI would reduce that benefit by approximately 15 basis points.

Through LCR relief, we would have flexibility to potentially increase net interest income between $20 million and $50 million annualized by reducing debt, redeploying excess liquidity in loans and securities, or a combination thereof.

Our return on average assets for the third quarter was 1.36%, our return on average common equity was 11.6%, and our return on tangible common equity was 14.6%. Our tangible book value was $82.37 per common share as of September 30, an increase of 13% compared to a year ago.

Slide 5 shows our average loans and deposits in more detail. Loans grew $2.8 billion or 1% over the second quarter, with growth in both commercial and consumer lending. Commercial lending balances increased $1.3 billion or 1%, primarily in our real estate and corporate banking businesses. Included in this growth, with an increase in our average, multi-family warehouse balances of approximately $700 million.

On the consumer side, balances increased $1.5 billion or 2% linked quarter, driven by growth in residential mortgage, auto and credit card, somewhat offset by runoff in our home equity and education loans.

While not shown on the slide, spot loans increased approximately $200 million quarter-over-quarter. Consumer balances increased $1.6 billion, while commercial balances declined $1.4 billion, which was primarily driven by a decrease in our multi-family warehouse balances of $1.1 billion.

Compared to the same period a year ago, average loans grew 6% or $14.4 billion, commercial lending balances increased $11.6 billion or 8%, and consumer balances were higher by $2.8 billion or 4%.

Average deposits increased $6.2 billion or 2% in the third quarter compared with the second quarter driven by seasonal growth in commercial deposits. Growth was primarily in interest bearing deposits. However, non-interest bearing deposits posted a modest increase as well.

It's worth noting that spot deposits increased $12.3 billion or 5%, compared to June 30, 2019 and included approximately $4 billion of balances related to a sweep deposit product we began offering our asset management clients in September. Compared to the same quarter a year ago, average deposits increased $16.6 billion or 6%.

As the slide shows, the yield on our loan balances declined primarily as a result of lower LIBOR rates during the third quarter. And importantly, our rates paid on deposits reached an inflection point having declined 1 basis point linked quarter.

As you can see on Slide 6, third quarter total revenue was $4.5 billion, up $54 million linked quarter and $136 million compared to the third quarter of 2018. Net interest income, non-interest expense, and provision were all relatively stable compared with the second quarter.

Total non-interest income increased $48 million or 2% linked quarter, reflecting higher fee income, partially offset by an expected decline in other non-interest income. Our effective tax rate in second quarter was 17.5%. For the full-year 2019, we continue to expect the effective tax rate to be approximately 17%. Now let's discuss the key drivers of this performance in more detail.

Turning to Slide 7. Net interest income of $2.5 billion was up slightly by $6 million compared with the second quarter. The growth reflects higher interest earning asset balances and an additional day, partially offset by the impact of lower rates. Net interest income grew $38 million or 2% year-over-year, driven by higher earning asset balances and yields, which were partially offset by higher funding costs and balances.

Net interest margin decreased to 2.84% in the third quarter, mostly due to the net effect of lower interest rates, primarily LIBOR. Although lower rates reduced our borrowing costs that was more than offset by the impact of LIBOR on our commercial loan yields.

Separately, deposit rates began to decrease during the quarter, and we expect that decline to continue during the fourth quarter at a faster pace.

Non-interest income of $2 billion increased $48 million or 2% linked quarter as higher fee income was partially offset by lower other non-interest income. Importantly, fee income grew 5% over the second quarter.

The main drivers of the increase were asset management revenue, increased $19 million due to higher earnings from our equity investment in BlackRock. Consumer services increased $10 million attributable to higher brokerage revenue and seasonally higher debit and credit card transaction volumes.

Corporate services declined $15 million primarily due to a lower benefit from commercial mortgage servicing rights and M&A advisory fees. Residential mortgage non-interest income increased $52 million due to RMSR hedge gains as well as higher refinancing volumes, and service charges on deposits increased $7 million, reflecting a seasonal increase in consumer spending.

Finally, other non-interest income was $342 million, the $25 million linked quarter decline reflects lower asset sales related to the second quarter gain on the sale of the retirement record keeping business, partially offset by higher revenue from private equity investments.

In the fourth quarter, we expect other non-interest income to be in the range of $300 million to $350 million, excluding net securities and Visa activity. This includes the estimated gain for the previously announced sale of our proprietary mutual funds, which is expected to close in the fourth quarter.

Turning to Slide 8. Third quarter expenses remained relatively flat linked quarter with an increase of $12 million. Personnel expense increased $35 million, largely as a result of higher compensation related to business activity and an additional day in the quarter. Importantly, every other expense category declined quarter-over-quarter. Compared to the same period a year ago, expenses increased minimally by $15 million.

Our efficiency ratio was 58% in the third quarter, improving from 59% for last quarter, and 60% a year ago. And importantly, we continue to generate positive operating leverage.

Expense management continues to be a focus for us and our expenses have been well controlled due in large part to our continuous improvement program. Through the first three quarters of the year, we are on track to achieve our annual target of $300 million in expense savings, which as you know, contributed to funding our technology and business investments.

Turning to credit quality. Our metrics are presented on Slide 9 and remained strong. Provision for credit losses was $183 million, a $3 million increase linked quarter, as a lower provision for commercial loans was slightly offset by a higher provision for consumer loans, principally in auto and credit cards.

Net charge-offs increased $13 million to $155 million linked quarter and our annualized net charge-off ratio was 26 basis points. Overall, our allowance for loan and lease losses to total loans was 1.15% as of September 30, 2019, virtually unchanged for the previous five quarters.

Non-performing loans were up $4 million, essentially flat linked quarter. Non-performing loans to total loans represents 73 basis points consistent with the previous quarter, but down from a year ago. Total delinquencies were up $39 million or 3% linked quarter, primarily reflecting an increase in auto and credit card delinquencies partially due to seasonality.

As you know, we are approaching the adoption of CECL, the new accounting standard for credit losses, which will go into effect January 1, 2020. We've been in parallel run since the beginning of this year and based on our expectation of forecasted economic conditions and portfolio balances as of September 30, 2019, we estimate that CECL could result in an overall allowance increase of approximately 20% as compared to our current aggregate reserve levels.

We continue to expect the increase to be driven by the consumer loan portfolio as longer duration assets require more reserves under the CECL methodology. Importantly, this remains an approximation and we'll further refine this estimate through year-end.

In summary, PNC posted very good third quarter results. For the balance of this year, we expect continued growth in GDP, albeit at a slower pace. We continue to expect one 25 basis point cut in Fed funds rate in October.

Looking ahead to the fourth quarter 2019 compared to third quarter 2019 reported results, we expect average loans to be up approximately 1%. We expect net interest income to decline approximately 1%. We expect fee income to be stable to up 1% as growth in our fee-generating activities is expected to more than offset the elevated RMSR hedge gains in the third quarter.

We expect other non-interest income to be between $300 million and $350 million, excluding net securities and Visa activity. We expect expenses to be up approximately 1%. Importantly, given our expense management efforts, we remain well positioned to deliver positive operating leverage for the full-year 2019, and we expect provision to be between $175 million and $225 million.

And with that, Bill and I are ready to take your questions.

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] And our first question comes from John Pancari of Evercore ISI. Please go ahead.

John Pancari

Good morning.

William Demchak

Hey. Good morning, John.

John Pancari

Bill, I think at a conference presentation in the quarter, you had talked about 2020 net interest income and thought that it could be potentially flat or maybe down 1% or so given the backdrop and given what you're looking at for rates. Can you just give us your updated thoughts there based upon how the curve is looking right now and Fed expectations or anything? What we can think about for NII for the year? Thanks.

William Demchak

I don't want to spend a whole lot of time on 2020, but since I talked about it before, we haven't seen a dramatic change. So we talked about kind of down 1% I think on forwards. It's maybe a little bit worse than that today, but not a whole lot.

John Pancari

Okay. All right, thanks. It's helpful. And then separately on the – in terms of the newer market expansion, I wanted to get an idea if you have any indication on the returns that you're beginning to see in some of these newer markets where you've entered with both a lending product as well as your deposit gathering, but you've gone in branch-light. So some of these newer markets, are you starting – are you able to assess the profitability for some of these markets and how they are comparing now to some of your traditional brick and mortar markets?

William Demchak

Yes. I mean, two separate thoughts. So the middle market expansion, we've kind of talked about a three-year breakeven per market and if anything, we're kind of running ahead of that. And of course is we go through the aging of the markets we've entered a handful of years ago, they start coming online on an accelerated basis, which is one of the things you're seeing show up I guess in some of our loan growth.

On the retail side, at this point, it's clearly a net investment, but what we would tell you is that the solution centers we're building are breaking even probably a bit faster than a traditional de novo branch, even though they are paying, in effect market-leading rates.

So the deposit growth rate is 3x and 4x and 5x higher in some cases than what we would typically see. But that whole investment on the retail side at this point is an investment and is a net drain. But it is something long-term that I think is important for our franchise.

Robert Reilly

And we are encouraged by the early results.

William Demchak

Yes. It's kind of – it's all going to plan thus far.

John Pancari

Okay, thanks. And if I could just ask one more. On the expense side or at least the operating leverage side, I know you expect – you're still confident in positive operating leverage for the year, for 2019. Can you just talk about your expectations for 2020 in terms of the magnitude you maybe looking to achieve for the year?

Robert Reilly

Hey, John, it's Rob. Yes, absolutely. For 2019, we feel very good. We've run with positive operating leverage all year and we expect to complete that for the full-year. 2020, it's premature. We haven't started our budgeting process yet, so we haven't worked through at all. So don't have anything for you this morning on that, but we'll get to it later in the year, and certainly in our fourth quarter earnings call.

John Pancari

Okay. Thanks. Understood.

Operator

Thank you. Our next question comes from Erika Najarian of Bank of America. Please go ahead.

Erika Najarian

Hi, good morning.

William Demchak

Good morning.

Erika Najarian

My first question is just a follow-up on the tailoring rule and we really appreciate all the detail that you've provided. As we think about the 70 basis point impact to CET1 on a net 55, should we think about that as the amount allocated to an additional buyback? And if so one of your peers mentioned going back to the Fed, during the CCAR year end asking for that. So just wanted a little bit of color on that.

Robert Reilly

Yes. Sure Erika. This is Rob. So yes, so the tailoring rule is largely favorable from a capital perspective. The threshold sort of relief adds 70 basis points. As of now, you have to subtract 15 for AOCI presuming that you opt out, which is a fairly good assumption. But we haven't made that decision yet.

I think in regard to what our plans are for that capital, once the rules are finally implemented, which we expect to be somewhere in the early part of 2020 that would coincide with our CCAR process. So we would take it up then in terms of what we would do from that new – at that time official higher capital position.

William Demchak

Yes. The one thing I'd mention, we obviously have a large buyback ongoing today and part of what we will need to do work on in the 2020 CCAR is to look at the actual impact post stress of some of these changes. So we have a benefit on a spot basis as Rob said net 55 including AOCI. But we actually benefit a bit more in a severe stress because of the larger bucket in the sin bucket effect, but we need to work that through.

Robert Reilly

That as you know that's just becomes more punitive in a severe scenario.

William Demchak

Yes. So in effect, our target ratio has the opportunity to decline from what we've said historically, but we'll have guidance on that as we get into the new year.

Erika Najarian

Got it. I see. And just a follow-up, taking a step back. Obviously, the curve, the forward curve has been completely unpredictable. The October percentage in terms of rate cut has increased just in the past few hours. But as I just think about the business opportunities in terms of actually just executing strategy, the pace of business growth and lending growth as we think out to 2020 fully acknowledging all the different that the economy could be slowing down, there is a volatility of Presidential election. Does it feel like this piece of business growth can continue in 2020?

William Demchak

I think it can. I mean part of what gives us the degree of confidence we have is just the market expansion that we've done. So we've been able to grow in effect by pulling share in newer markets without having to push on credit risk or other levers. And importantly we've been able to grow fees concurrent with growing clients. So I think that's – I think that will continue. For the overall economy, the consumer is holding it up today as manufacturing weakens and we'll see how long that is sustainable.

The final comment I'd make and I appreciate your comment on the fact that the forward curve swinging all over the place. We put a NII guidance and part of the issue of course is in the course of the last week, we've seen a Fed move get taken off the table, put back on the table, taken off.

And so when I get a question as to what NII is going to do next year, the best way I'd answer it is to say that no matter what happens here, it's not a big move from where. We're not dependent on it. On a given day last week, I would have told you that it would have been down less than 1%, but the day after that it was going to be more.

Robert Reilly

1.5%.

William Demchak

Yes. So it isn't critical to our business model at this point. We can obviously survive it. We feel really comfortable about growing clients and the related portfolio of products that we serve those clients with which gives us good fee momentum.

Erika Najarian

Great. Thank you.

Operator

Thank you. Our next question comes from the line of Betsy Graseck of Morgan Stanley. Please go ahead.

Betsy Graseck

Hey, good morning.

Robert Reilly

Hi, Betsy.

William Demchak

Good morning.

Betsy Graseck

Just one quick follow-up on that, when you think about the NII. Look, I understand it's not really a major driver of what you're going to be able to do, but just wondering the 1%, does that include the LCR benefit you talked about, it's like 30 bps to 80 bps or something like that?

William Demchak

No.

Robert Reilly

No.

Betsy Graseck

No. Okay. All right. Yes, so LCR would be ameliorating that outlook. Okay, got it. And then I guess the other thing I get questions on more from like cross-asset class investors is we're seeing some little, I don't know, I don't even want to call it stressed, but we're seeing a little bit of cracks in like maybe CLOs or leveraged loans, spreads are beginning to widen. But then I look at your results and others and corporate just looks fantastic.

So why do you think that is, why do you think we're in some parts of the markets seeing a little bit of stress, but in other parts of the market we're not seeing delinquencies go up meaningfully? And I know you got a big C&I book. So I thought it would be a good question for you.

William Demchak

I'm trying to figure out how to answer that question without being critical of non-bank lenders.

Robert Reilly

Good luck.

William Demchak

I think that people who – participants who pushed on credit to get deals struggle when there is any slowdown at all, and of course, we've seen that in manufacturing. So it's starting to show up in some of the credit stats. We didn't push on that box to the extent that the economy slows and our clients get downgraded, we will have elevated provision through time, but we just really haven't seen a crack with systemic risk across any part of our portfolio.

Robert Reilly

I guess, but it's – because deliberately we are not at the line or at the edge. These are bizarre.

Betsy Graseck

Yes. And then with the quality of your book, obviously we see coming through like delinquencies and NCOs and things like that and I don't know if there's any other details you could give maybe in the 10-Q or 10-K or something like that around ratings and rankings. I suppose you do already and I just need to find it, but that would be helpful just given your scale.

William Demchak

You know our criticized and classified stuff is out there, it's probably what we disclosed to you. But bizarrely our corporate guys would probably – or not probably, they would definitely tell you that a slowdown ultimately helps that business, might hurt in the immediate term, but asset-based lending spreads increase business volumes.

Robert Reilly

Less competition.

William Demchak

Yes, less competition across the whole space. So we're fine with where we sit. It's the same book we've had for the last 15 years.

Betsy Graseck

Yes. Got it. Thank you.

Operator

Thank you. Our next question comes from the line of Scott Siefers of Sandler O'Neill & Partners. Please go ahead.

Scott Siefers

Thank you. Good morning, guys.

William Demchak

Hey, Scott.

Scott Siefers

I just wanted to – hey, I just wanted to ask on the other non-interest income guide. So the $300 million to $350 million in the fourth quarter is higher than the typical $250 million to $300 million and it includes that business sale gain that you guys will close hopefully in the fourth quarter. So I guess I'm just curious if you – either one give sort of order of magnitude of that than anticipated gain or two. Are we getting to a point where you have enough of a confidence that we sort of stay in this more elevated range?

Robert Reilly

I think, Scott, it's a good question, and you're right. Historically that we had some volatility in that category quarter-over-quarter, but it tends to average out at around $300 million. So if you look at the last three quarters of 2019, and then the previous four quarters in 2018. You do that average, it's around $300 million. Our low I think was first quarter of 2018, which was $249 million, and our high was second quarter of 2019, which was $364 million.

So that just gives you a sense of the order of magnitude, but it averages out around $300 million. I'm guiding up for the fourth quarter above that because of the announced sale of our proprietary mutual funds, which is about that magnitude. So we're going up about $50 million, yes that $300 million to $350 million, and that's why, everything else is, as we would expect.

Scott Siefers

Okay. That's perfect. I appreciate the clarity on that. And then I was hoping if I could switch gears just a second to just the competitive dynamic on overall deposit cost. Sounds like you guys are pretty confident about an acceleration in decline in deposit costs in the fourth quarter, maybe just some broad thoughts on what you see going on. Are these just natural longer term stuff sort of rolling off or are you – you are having some success in taking down rates et cetera?

William Demchak

I'll start right, you can jump in. I think and you've heard us talk about this. We aren't fighting for deposits per se today. So in our loan to deposit ratio, it's kind of around the level it's always been, in the low 80s. We have taken down our rate on the national digital strategy, so we're not one of the top posters there. We have been able to lower consumer promo rates and still grow deposits in households the way we want to. So it seems to be working.

The one thing I would tell you is that the one place where we see a lot of competition. We saw it throughout the third quarter and continuing, is in small business banking where rate paid for small businesses, which give rise to a big chunk of deposits that are sort of retail like is really high. And that's one of the reasons our deposit cost didn't decline as much as they otherwise would have in the third quarter. But that's the one spot I can think of.

Robert Reilly

Yes. Well, I think that's – yes, that's clearly an impact. It's also – just a lot of the moves that we made following the July rate cut are starting to take hold. So on the consumer side, you're just going to see rates that – actions we've already made now show up in full force in the fourth quarter.

William Demchak

Yes.

Scott Siefers

But it's not – it hasn't affected our flows.

Robert Reilly

No, no.

Scott Siefers

Yes. Perfect, all right. That's terrific. Thank you, guys.

Operator

Thank you. Our next question comes from John McDonald, Autonomous Research. Please go ahead.

John McDonald

Hey, good morning.

Robert Reilly

Hi, John.

John McDonald

Rob, I was wondering if I could just ask you about the dynamics around the outlook for NII next quarter. You've got the average loans up and NII down a little bit. I guess with the deposit pricing maybe inflecting down. Could we see the NIM decline a little bit less next quarter – there are some other factors that play there?

Robert Reilly

Yes, maybe John. I mean you're on it. That's the calculation. I think the biggest variable would be one month LIBOR and how that affects our commercial loan yields. I think that's the biggest sort of unknown variable, and we'll have to see.

John McDonald

Yes. Yes, so you've got the loans up, so you're expecting some degree of margin compression, I'm not sure how much, but overall guess is NII down a little bit.

Robert Reilly

Yes. That's right.

William Demchak

The other thing that's rolling through everybody's income statement to one degree or another is amortization cost on mortgage-backed securities, so the premium amort. And we actually benefited a little bit in the third quarter versus what we thought we would have because rates sold off. So that I think that's going to drive a lot of people and that will impact us at the margin as well, which is of course longer-term rates, the 10-year more so than what's happening in the front-end.

John McDonald

Okay. Is that a little bit of a delayed impact of what happened already in the 10-year, Bill?

William Demchak

No, I mean at the end right, if the 10-year trades around 150 for the – I'm making up a number for the quarter, prepays are much higher, if it's up in the 70s, they're much lower. We put a forecast out there, it was somewhere in between, so that that swings around $5 million or $10 million either way. And we have a small mortgage book relative to others. So I think that's an industry phenomenon right now that's causing –forecasting this number would be a little tough.

Robert Reilly

Right.

John McDonald

Got it. And then just on the 2020 outlook, understanding it's too early to get too precise there, but assuming in that outlook, which is generally reassuring about the ability to kind of grow with the forwards – keep NII relatively to a small decline. Rob, you're kind of assuming in that – those simulations loan growth in the same ballpark that you've had kind of mid single-digit-ish type of thing in that simulation?

Robert Reilly

Yes, a little. Yes, still loan growth, more in line with our strategic plan, which is lower mid single-digits.

William Demchak

So it's a little less than we've done this year.

Robert Reilly

Yes, a little less, so far 5.5, 6 a little less than that.

John McDonald

Lower end of mid.

Robert Reilly

Lower-end of mid, yes. Higher-end of low.

William Demchak

But nothing heroic.

Robert Reilly

Yes, nothing heroic. That's right.

John McDonald

Got it, okay. Thank you.

Operator

Thank you. Our next question comes from Matt O'Connor, Deutsche Bank. Please go ahead.

Matthew O'Connor

Hey, guys.

Robert Reilly

Hey, Matt.

Matthew O'Connor

I tend to focus more on the average loans and deposits, but you did referenced the period end jump in deposits in part driven by the new sweep strategy in asset management?

Robert Reilly

Yes, right.

Matthew O'Connor

And obviously, period end loans were flat. So I guess the first question is should we be thinking about the jumping-off point more using the period end than average. And then, if so, what do you do with all those extra deposits both that you got this quarter and then I'll come in from the sweep effort that you have.

Robert Reilly

Well, so I'll jump in on some of that and see if that answers your question. I think on the loans – the spot being below the average was entirely due to the multifamily sort of seasonal spike and some activity spike that we saw in the third quarter. So our loan guidance for the balance of the year, the fourth quarter is up approximately 1%. So we account for that, we see good activity coming up off those spot numbers in the fourth quarter. And then on deposits, we like deposits, more deposits are good. The AMG sweep was a bit of a one timer, but everything else is in line with what we would have expected.

William Demchak

Hey, Matt that loan growth guidance is off of average balances…

Robert Reilly

Yes. Yes, I'm sorry. The loan guidance is off average, believing with the spot, we will make the average.

William Demchak

Yes.

Matthew O'Connor

Okay. And the asset management sweep is just a one-time $4 billion versus the…

William Demchak

It will vary around there. It was just – it's something most of our peers have done in the past. We just kind of moved it over and offered it to our clients. So maybe it will grow with our client franchise, but not beyond that.

Robert Reilly

Right.

Matthew O'Connor

Okay, helpful. And then just separately, the proprietary mutual fund business that you're selling, should we be mindful of the revenue and expense kind of impact going forward, have you provided any of those numbers?

Robert Reilly

No, we haven't, and they are immaterial.

Matthew O'Connor

Okay and then just remind us what's left with kind of the PNC? I guess you used to call like advisor and the strategy there?

Robert Reilly

Well, so it's – within our asset management group, we have three segments: PNC Wealth Management, our Institutional Investments and Hawthorne, which collectively we manage in excess of $300 billion in assets for our clients.

So the sale of the proprietary business, Matt, was really something that was a return to our past, prior to a lot of the acquisitions that we made. When I ran the business, we didn't have proprietary mutual funds. We were committed to open architecture, which we still are.

Through the acquisitions that we made and maybe this is more than you want to know, through the years we pick those up and they were – they were good, but our core philosophy is advisory and the open architecture is much, much more conducive to that.

William Demchak

Yes. And they own the monies – another way to answer the question, we basically won't be in the manufacturing business except for some small short-term liquidity funds that we ground for corporates in the institutional side.

Matthew O'Connor

Okay, perfect. Thank you.

Operator

Thank you. Our next question comes from Ken Usdin of Jefferies. Please go ahead.

Kenneth Usdin

Hi, thanks. Good morning guys. On the fee side, it's good to see that the outlook is stable to plus one, especially given that you had that pretty healthy MSR gain this quarter of $40 million. So, I know there's some normal seasonality, but can you kind of talk us through just what your expectations are, especially given your prior answer that there is not immaterial loss from the sale of the mutual fund business. Just how you expect things to trend within where the leaders and laggards are? Thanks.

Robert Reilly

Sure, sure. Just on the fee side by category, for approximation, in asset management we'd expect to be sort of stable, maybe up a little bit. Consumer services up a bit, consistent with what they've been doing for some time on a quarterly basis.

The big driver for the fourth quarter in terms of our increase will be on the corporate services side, which typically has a higher fourth quarter and our pipelines would indicate that. And then mortgage is probably stable to down a little bit just because of the – our MSRs and maybe some margin compression.

Kenneth Usdin

Great, understood. Okay. Thanks, Rob.

Robert Reilly

Yes.

Kenneth Usdin

And as a follow-on on the commercial side, just bigger picture, the state of the commercial customer, you just mentioned you have still good pipelines on Harris Williams. Any changes to what you're seeing in the conversations and dialogues with commercial customers willingness to do deals, invest in plant and equipment, et cetera, just given the big picture points that Bill made in his intro. Thanks.

William Demchak

The only – I mean look, it's been muted and we're hearing that from our customers is they're cautious in this environment the way you would expect them to be. And we have seen for what it's worth, given the recent rate rally a lot of hedging activity.

One of the things, it's inside of our other line, Rob is our capital markets, FX and derivative activity and that has picked up a lot, which is a big driver fees inside the other line. But no, there hasn't been a turnaround in sentiment on the corporate side, small business is different. They are still bullish, the consumer is still bullish. But the larger corporate is holding back and we're seeing that.

Kenneth Usdin

And one more thing, just on the commercial side. Rob, your point on commercial fees, is that both the CMBS business and Harris Williams? Or are they both acting pretty well?

Robert Reilly

Yes. Yes, they're both acting pretty well, and yes, treasury management of course. Yes, so there is – treasury management is the largest component. But sometimes seasonal or quarterly variances come more through Harris Williams than M&A advisory and capital market.

Kenneth Usdin

Okay, thank you.

Robert Reilly

Sure.

Operator

Thank you. Our next question comes from Mike Mayo, Wells Fargo Securities. Please go ahead.

Michael Mayo

Hi. So your efficiency improved 60% to 58% year-over-year. My question relates to how much of that is driven by what you're doing in the back-office with technology? And could you just give us some more information about kind of what you're doing behind the scenes with tech like, I don't know, number of data centers at the peak, number of data centers you have now and where that might go or how much you've enabled to go to the public cloud? Or how far along you are with that or some other metrics that show kind of what you're doing with your technological infrastructure?

William Demchak

I don't know how to answer that question inside of four hours. Mike, I think, what technology has enabled us to do is to continue to grow the franchise without growing the kind of core cost base. And you're starting to see that show up on the positive operating leverage we have.

There is a million little benefits that we get that are too numerous to name from everything on how fast it is to spin up a server to how quickly you can change an app and release it to the offerings we have for our commercial clients and Pinnacle on our TM side on – all of these statements at the margin make a difference.

The savings we are getting, finally, out of the mortgage business have been replaced the servicing and origination platforms there and the digital experience we're offering to customers. So technology is showing up everywhere in the way we service our customers, and it's showing up in our operating leverage simply because it's allowing to scale without a commensurate in cost.

So maybe that's the simplest answer I can give you. I know you're asking what your technology had on. So I'll spend a second on what we're doing in core data center and cloud and cloud hybrid.

We have chosen for the time being to basically run a hybrid model. So we have an internal cloud, we have the capability through a container layer to burst through to public cloud when we need it for excess compute, for test environments and other things where it's efficient to do so.

We will run that hybrid model. Our plan is into the future. We do not see a benefit in cost savings by going to pure cloud at least in an environment that we think we want to operate in, as it relates to security and soundness and safety in cyber and so forth.

And we are – as you know we are – we've been at this for the better part of probably seven years now. So most of those investments are kind of behind this and you're also starting to see that show up with the decrease in the acceleration of our equipment point.

Robert Reilly

And our high data centers was 13 and now we're three.

William Demchak

Yes. Is that enough?

Robert Reilly

Yes.

Michael Mayo

Yes. No that's good. No, look, I think you summed it up. Tech allows you to grow without growing expenses, 13 data centers down to three. So kind of, I'm just – one more attempt. I think you guys have done a little bit more with the cloud or cloud enabling your app, how many apps do you have and how many might eventually go to the cloud. I know that's very tactical and specific, just a little bit more meat on the – the bones?

William Demchak

Mike, apps don't run in the cloud. I'm thinking of an app as a digital app and application runs in a cloud, virtually 100% of our applications to date are cloud enabled. So we're cloud native for everything. Our choice to put it in a public cloud is our choice. It is not a decision to – or works that we have to do to enable that application to then run in a cloud.

Robert Reilly

Every system that can be cloud enabled has been cloud enabled at this point.

William Demchak

Yes.

Michael Mayo

And that's what you mean about having done the hard work. So you've cloud-enabled. So now that you have a choice, what percent do you think you might eventually transition to the public cloud?

William Demchak

I think it will be a small percentage. We'll certainly use it for some of our test environments where we need compute and test tend to have the potential to take service time…

Robert Reilly

Right.

William Demchak

And there are certain of our non-critical information applications that we could choose to run in the cloud, and of course we have vendors who run in the cloud. And I should clarify, Mike, we still are dependent for certain applications on mainframe and that is the last not to crack for banks to get some of their core operations off of mainframe and we are not entirely there yet.

Michael Mayo

Sure. Well that's helpful. All right, thank you very much.

William Demchak

Yes.

Operator

Thank you. Our next question comes from Kevin Barker of Piper Jaffray. Please go ahead.

Kevin Barker

Good morning. Just in regard to – regarding the consumer, you know some of the consumer lending picked up quite a bit in the third quarter and I'm assuming some of the seasonality, but you also saw quite a bit of pickup in auto and residential real estate. So anything in particular that's occurring in the consumer that you're seeing a pick up, whether it's internally a PNC or just in general with seasonality?

William Demchak

The only thing that I think is perhaps different is on the mortgage side, the residential side, just the volume that we're doing through the new technology. So our volume is up, I don't know what the percentage is quarter-on-quarter or year-on-year.

But high percentages and frankly without kind of the new system running in the background, we wouldn't have been able to do that volume. So that's probably the only real change. We've been at the credit card game largely converting our existing clients to our lending products, we've been at that for a long period of time and continue to have success.

Robert Reilly

That's the biggest driver. We've had a strategic objective to grow our consumer loan book, which was and still is under penetrated relative to what we can do, so strong growth in card, auto, residential mortgage reflecting that.

Kevin Barker

Now we've seen some headwinds on delinquency and loss rates on the auto side. Would that change any of your appetite in the near-term given you've been growing our portfolio quite a bit in the last year?

William Demchak

Yes, delinquencies are up at the margin, partly due to seasonality, but also partly due to some vintages a year or so back and inside of our risk band, but at the lower end of prime and it's likely we'll dial that back in terms of originations.

In truth, we've already done that also. I don't know that you're going to see that slowdown our growth. It's just we won't be in the bucket that's causing the roll forward in the spike of delinquencies you're seeing.

Kevin Barker

Okay. So we should see a little bit of a settling down just because of the mix of the back book versus the front book, is that a way to think about it?

William Demchak

I think so. Yes.

Kevin Barker

Okay, all right, thanks for taking my question.

Operator

Thank you. Our next question comes from Gerard Cassidy, RBC. Please go ahead.

Gerard Cassidy

Good morning, Bill. Good morning, Rob.

William Demchak

Hey, Gerard.

Gerard Cassidy

Bill, can you expand upon obviously you've had success in growing outside the traditional PNC footprint with your treasury management products on the commercial side. In the wins that you've had, can you share with us what's driving the wins, is it the quality of the product or do you price it so attractively that the person wants it or the company wants it and then you can cross-sell other products into it to better build that relationship. What's really leading that success?

William Demchak

Well, it is not pricing. We don't differentiate in pricing new markets or old markets or established markets. Look we hire really good people, and we're very patient. So what you're seeing is today as a result of seeds that we planted three and four and even five years ago, if you go back to some of the stuff we've done in the Southeast, we hired good bankers, we call, we have good ideas, we eventually get a shot.

And then our TM product is such that once you get in the door, we have the ability to continue to show new ideas, we're always working with them and the ability to kind of up-sell the initial offering given all the products we have in TM is pretty strong.

Through time, we moved from being a participant in somebody else's credit deal to being rightly the left lead and we just – this just played out for us. You start with good people, you are consistent, you show good ideas, you have good products and services.

You pick the right clients to begin with, so that when we enter a market, we know the top 50 clients we want to bank. We don't get the 50 that will have us. So we will be very patient to get the right 50, and we've been at this for a while. So it's starting to play out.

Robert Reilly

And I would add to that and we've covered this on previous calls that so called top 50 that we've targeted that Bill pointed out, the receptivity of those companies to our calling effort is very high. So, once you are accepted and that receptivity is encouraged then we're just running our players like we do everywhere else. We know how to compete. The key is the ability to have that dialogue.

Gerard Cassidy

Go ahead, Bill.

William Demchak

As you said, Peter, how many markets did we open since Mike started this? We've grown from 12 to 30 and we are 20 – so we've opened 10. So we basically have been you think about the investment we put into it, right? We invested dollars, negative carry on 10 new markets and people and community support and everything else and we're finally starting to getting the return on that investment.

Robert Reilly

Yes. That's right.

Gerard Cassidy

That's very good. And when you target those markets, you mentioned these 50 companies that you target. What's the sales size of the typical success story? Is it somebody with $250 million in revenue or quite a bit higher or lower?

William Demchak

It's all over the place. I mean we do less on the commercial side, the smaller commercial more on the mid market to large corporate. But I'd tell you one of us, one of our largest wins this year was a Fortune 100 company in a new market. So it just depends. We happen to have a solution that that particular…

Robert Reilly

I think it is entirely similar like you said, as those new markets would be there, and then the legacy just the lower end isn't there. So it's middle market and above.

Gerard Cassidy

Very good. And then coming back to profitability you addressed the issues on capital and potentially giving back more capital next year with the tailoring rules, which obviously would boost your ROE. When you look at PNC going back many, many years, and I know the world has changed from the '90s when PNC was able to earn ROAs in the high 1% range.

And I'm not suggesting you can get there today, because of the new regulations you all have to deal with, but what do you think peak profitability for your a company like yours today from an – not so much in ROE standpoint but more from an ROA standpoint, is it where you are now, or is there actually room for improvement to bring it up to north of 150 on ROA?

William Demchak

I mean, I don't know. You can come up with so many iterations. Look, our margin, I was looking at this the other day. Our margin coming out of the crisis was 408 including our accretion accounting. So give me low provisions and the right interest rate environment now…

Robert Reilly

Yes.

William Demchak

Yes. We'll show you a return on assets that's high. I think through time, right drivers, take the interest rate curve out for a second. I think through time our growth in fees continues. And that if anything becomes a larger percentage of what we do, which in turn will drive up our ROA all else equal across the interest rate environment and the basic notion that we aren't changing our credit mix. But whether you can go from where we are today to 150 is dependent, I think more on the yield curve than what we can do in fees.

Robert Reilly

And that's a math drill.

Gerard Cassidy

Got it. All right. I appreciate it. Thank you.

William Demchak

Sure.

Operator

Thank you. Our next question comes from Saul Martinez of UBS. Please go ahead.

Saul Martinez

Hey, good morning guys. I wanted to go back to capital and your capital strategy. Your CET1 is 9.6, even if you opt out of the OCI. The tailoring takes you to 10.1. CECL is not really a material hit to your capital base, the day one impact, at least. And I believe you guys have said your optimal capital – optimal CET1 is around 8.5 and I think you mentioned you could even bring that down further.

I mean, once you get some of the questions that you kind of laid out answered on stress losses, how quickly can you bring your CET1 down to optimal levels assuming risk, no real acceleration in risk weighted asset growth? Is this over a CCAR cycle over a few CCAR cycles, how do we think about the glide path down to what an optimal capital level is?

William Demchak

We hit all the variables. The numbers are basically right.

Robert Reilly

The numbers are good.

William Demchak

Yes, and it is the right question. But I think we owe you further guidance on that and I'm just not going to give it until we get into the fourth quarter and start working on next year's CCAR. I mean obviously we could buy it down quickly, I don't know if that is the best thing to do for shareholder value long-term.

I think notwithstanding the near-term ROE impact, the practical implications of carrying excess capital that's what we – if that's what we choose to do, is it material long-term as long as we don't waste that capital, right?

We're good stewards of the capital. So whether we buy it down in a hurry or we do it through the course of the year, we'll get to the right place, and we'll do it intelligently and we'll give you more background on that as we start to work on CCAR 2020.

Robert Reilly

And having that additional flexibility is a good thing.

Saul Martinez

Got it. But what are some of the variables you think about in terms of answering that question for yourself in terms of what – how quickly…

William Demchak

Well the biggest one right now is the opportunity that might be presented by some of the chaos in the market. If in fact and I don't, we don't believe this to be the case. But if in fact there is a slowdown, we'll use that slowdown to accelerate. I think there'll be a lot of opportunities for us to do that.

So I'd hate to be in a place where for the sake of driving up ROE near-term, a few cents per share, that's, that we get from buyback, I'd hate to be in a place that we can't take strategic advantage of a slowdown to grow assets and clients and so forth. But that's the biggest one.

Robert Reilly

And the intelligence required rather than just…

Saul Martinez

All right, great, that's helpful. I'd like to change gears a little bit. How do you think about – how the lower rate environment impacts your national digital strategy, if at all, you have been using higher cost CDs as sort of a client acquisition tool in these markets and with lower rates arguably that becomes more, becomes less attractive, those CDs. Does a lower rate environment you think hinder your ability to grow in expansion markets?

William Demchak

First to clarify, we haven't been using CDs. It's kind of been posted money market rates and how and we're in the course of our sort of experimentation across markets. We've probably grown 20% to 25% of our total clients in straight traditional DDA account, our Virtual Wallet product.

So that's less impacted by rates, obviously the yield seekers will be less active in a lower rate environment and we take that into account as we think about this going forward. It's one of the reasons why we continue to think our branches matter. It's one of the reasons brand matters. It's one of the reasons feet on the ground matters. So all of that stuff we're thinking about as we plan for the future.

Robert Reilly

And it's not simply – that strategy is not simply reliant on high rates.

William Demchak

Yes.

Saul Martinez

Right. Okay, all right. Thanks a lot. I appreciate it.

Operator

Thank you. We have no further questions.

William Demchak

All right. Well thank you, everybody. And we'll see in the fourth quarter. Thank you.

Robert Reilly

Yes.

Operator

This concludes today's conference call. You may now disconnect.