U.S. Bancorp (USB) CEO Andy Cecere on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-16-19 Earnings Summary

Press Release *10-Q* *Slides*

EPS of $1.15 beats by $0.04 | Revenue of $5.89B (3.99% Y/Y) beats by $87.12M

Earning Call Audio

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U.S. Bancorp (NYSE:USB) Q3 2019 Earnings Conference Call September 16, 2019 9:30 AM ET

Company Participants

Jen Thompson - Director, Investor Relations

Andy Cecere - Chairman, President & Chief Executive Officer

Terry Dolan - Vice Chairman & Chief Financial Officer

Conference Call Participants

John McDonald - Autonomous Research

Betsy Graseck - Morgan Stanley

Ken Usdin - Jefferies

Mike Mayo - Wells Fargo Securities

Scott Siefers - Sandler O'Neill

Erika Najarian - Bank of America.

Vivek Juneja - JPMorgan

Matt O'Connor - Deutsche Bank

Saul Martinez - UBS

Gerard Cassidy - RBC

Operator

Welcome to U.S. Bancorp's Third Quarter 2019 Earnings Conference Call. Following a review of the results by Andy Cecere, Chairman, President and Chief Executive Officer, and Terry Dolan, U.S. Bancorp's Vice Chairman and Chief Financial Officer, there will be a formal question-and-answer session. [Operator Instructions]

This call will be recorded and available for replay beginning today at approximately 12:30 PM Eastern through Wednesday, October 23rd at 12 Midnight Eastern Standard Time.

I will now turn the conference over to Jen Thompson, Director of Investor Relations for U.S. Bancorp. You may begin.

Jen Thompson

Thank you, Polly and good morning to everyone who has joined our call. Andy Cecere and Terry Dolan are here with me today to review U.S. Bancorp's third quarter results and to answer your questions. Andy and Terry will be referencing a slide presentation during their prepared remarks. A copy of the slide presentation, as well as our earnings release and supplemental analyst schedules are available on our website at usbank.com.

I'd like to remind you that any forward-looking statements made during today's call are subject to risk and uncertainty. Factors that could materially change our current forward-looking assumptions are described on Page 2 of today's presentation, in our press release, and in our Form 10-K and subsequent reports on file with the SEC.

I'll now turn the call over to Andy.

Andy Cecere

Thanks Jen. Good morning everyone and thank you for joining our call. Following our prepared remarks, Terry and I will take your questions.

I'll begin on Slide 3. In the third quarter, we earned $1.15 per share. Despite a more challenging interest rate environment, we reported record levels of revenue and net income, driven by healthy loan and deposit growth and continued momentum across our key businesses. Credit quality remained stable.

Turning to capital management, our book value per share increased 10.6% from a year ago and during the quarter, we returned 80% of our earnings to shareholders through dividends and share buybacks.

Slide 4 provides key performance metrics. In the third quarter, we delivered a return on average common equity of 15.3% and a return on average assets of 1.57%. Our return on tangible common equity was 19.4%. Positive operating leverage drove improvement in our efficiency ratio on both a linked-quarter and a year-over-year basis.

Now, I'll turn the call over to Terry, who will provide more detail on the quarter as well as forward-looking guidance.

Terry Dolan

Thanks Andy. If you turn to Slide 5, I'll start with the balance sheet review followed by a discussion of third quarter earnings trends. As expected, average loans grew 1.1% on a linked-quarter basis and increased 4.7% year-over-year excluding the fourth quarter 2018 sale of FDIC-covered loans that had reached the end of the loss coverage period.

Strong residential mortgage and credit card loan growth supported both linked-quarter and year-over-year performance. Commercial and industrial loans grew 0.4% sequentially and 4.7% on a year-over-year basis. Paydown activity picked up in the third quarter, primarily reflecting the rate environment and robust capital market conditions. New business activity remains healthy, although paydown activity is likely to continue at elevated levels near term.

Commercial Real Estate loans decreased on a sequential and a year-over-year basis. This quarter, Commercial Real Estate contributed a 33-basis-point drag to linked-quarter average loan growth and an 89-basis-point drag to year-over-year average loan growth.

Turning to slide 6, deposits increased 1.4% on a linked-quarter basis and grew 6.0% year-over-year.

Compared with the prior period, we continued to see migration from non-interest-bearing to interest-bearing accounts. That migration along with deposit growth momentum in both our Wealth Management and Corporate and Commercial Banking divisions, helped drive average savings deposits up 8.4% year-over-year.

As you can see on slide 7, credit quality remained stable. On dollar basis, non-performing assets increased 2.7% versus the second quarter, but decreased by 2.5% compared with a year ago.

The ratio of non-performing assets to loans plus other real estate owned was stable at 33 basis points compared with the second quarter and modestly improved versus 36 basis points a year-ago.

Slide 8 highlights third quarter earnings results. We reported earnings per share of $1.15 compared with $1.06 a year ago.

Turning to slide 9, net interest income on a fully taxable equivalent basis declined by 0.5% compared with the second quarter and increased by 0.8% year-over-year, which is in line with our expectations.

Both linked quarter and year-over-year comparisons benefited from healthy loan growth, offset by the impact of declining rates and a flatter yield curve. Our net interest margin declined by 11 basis points versus the second quarter, in line with our expectations. About 4 basis points of the decline was due to higher cash balances, primarily reflecting changes in policies related to deposits by the European Central Bank.

Slide 10 highlights trends in non-interest income. Middle-single-digit year-over-year growth in each of the three payment fee lines, credit and debit card, corporate payments products, and merchant processing was driven by higher sales volumes.

As a reminder, processing day account will end up affecting year-over-year credit and debit card revenue growth comparisons in several quarters in 2019. In the third quarter, three additional processing days versus a year ago benefited revenue growth. In the fourth quarter, two fewer days will be a drag on year-over-year growth.

We continue to expect low-single-digit growth of credit and debit card fee revenue for the full year. Commercial product revenue increased 11.1% from a year ago, primarily due to higher corporate bond fees and trading revenue related to strong capital markets activity.

Mortgage banking revenue increased 56.3% year-over-year on strong origination and sales revenue growth. Compared with the third quarter of 2018, mortgage production volume increased by 40.3%, and mortgage application volume increased by 53.1%.

Refinancing activity represented about 40% of production in the third quarter of 2019 compared to about 30% in the linked-quarter. Refinancing represented 51% of applications in the third quarter. The year-over-year decline in deposit service charges reflected the impact of the sale of our third-party ATM servicing business in the fourth quarter of 2018.

The increase in other revenue was partly driven by the inclusion of the related transition services revenue, which will decrease over time, as well as higher equity investment income and a gain on sale of assets.

Turning to slide 11, the year-over-year increase in non-interest expense reflected higher personnel cost, partly due to higher variable compensation related to business production within mortgage banking and the capital markets business lines as well as increased medical costs.

Professional services expense increased primarily due to business investments and enhancement in risk management programs, while higher technology expense growth was primarily tied to business growth initiatives. A decrease in other expense primarily reflected lower costs related to tax-advantaged projects and lower FDIC assessment cost.

Slide 12 highlights our capital position. At September 30, our common equity Tier 1 capital ratio estimated using the Basel III standardized approach was 9.6%, and this compares to our target of 8.5%.

As previously discussed, our goal has been to manage the capital level closer to our target once we had clarity related to adopting CECL and the final capital rules were promulgated by the Federal Reserve.

With the recent release of the final rules, we plan to make a request to the Federal Reserve to increase our share repurchase program to enable us to begin reducing our common equity Tier 1 ratio from 9.0 -- 9.6% to approximately 9.0%.

I'll now provide some forward looking guidance. For the fourth quarter, we expect fully taxable equivalent net interest income to decline in the low-single digits on a year-over-year basis. We expect middle – mid-single-digit fee income growth on a core basis year-over-year. We expect to deliver positive operating leverage for the full year 2019 on a core basis in line with our previous guidance.

We continue to expect our taxable equivalent tax rate to be approximately 20% on a full year basis. Credit quality in the fourth quarter is expected to remain stable compared to the third quarter, loan loss provision expense growth will continue to be reflective of loan growth.

I'll hand it back to Andy for closing remarks.

Andy Cecere

Thanks Terry. The record results and industry-leading returns that we delivered in the third quarter, despite a more challenging interest rate environment is a testament to our well-balanced business model, our numerous competitive advantages and our risk management discipline. As we head in the final quarter of 2019, we feel good about our loan and deposit trends and our ability to continue to gain market share across our franchise.

As indicated on slide 13, we are seeing good digital update trends. As loans are increasingly sourced through our digital channels, we expect better customer experience, higher account and volume growth and improved operational efficiency.

Our core fee businesses are performing well. Investments made over the past few years in our payments and mortgage business lines are delivering anticipated results in the form of improving sales and volume growth.

Our scale and differentiated service model is helping us win new business and expand existing relationships in our trust and Investment Services business which is driving strong asset under management and fee growth. Importantly, we are deepening relationships across our entire franchise, as we bring the power of one U.S. Bank to each of our business customers and consumers.

Credit quality remains stable and we are not seeing any early indicators in our portfolio that causes concern. However, we are mindful that at some point industry will experience a credit downturn and we remain disciplined in terms of our origination quality and our long-term strategy of remaining within our defined credit box -- regardless of the competitive environment.

In closing, I'd like to reiterate the message I delivered at a recent Investor Day. We are in a position of strength and will continue to leverage the core competencies and competitive advantage that carry us to where we are today. However, the world is changing rapidly and we are adjusting -- investing for the future, so that we can continue to deliver the industry-leading growth and return to our shareholders that come to expect from us. I'd like to thank our employees for their hard work and commitment they bring to the job every day.

We will now open up the call for Q&A.

Question-and-Answer Session

Operator

[Operator Instructions] Your first question comes from Matt O'Connor with Deutsche Bank.

Andy Cecere

Good morning, Matt.

Jen Thompson

Polly, we're not hearing. We're not hearing, Matt.

Operator

Matt, your line is open.

Jen Thompson

We can go to the next caller and maybe Matt can dial in again.

Operator

Okay. And your next question comes from the line of John McDonald with Autonomous Research.

John McDonald

Hi. Good morning.

Terry Dolan

Good morning, John.

John McDonald

I was wondering -- Hi, Terry. I was wondering if you could just give a little more color on the request for the capital increase, just over what timeframe you might be looking to do the 9.6% down to 9%? Is that over the course of a year or a couple of months or? And, again, what gave you the -- what was the clarity you're looking for, was it CECL and tailoring, I think, you mentioned?

Terry Dolan

Yes. Well, with respect to the second part, I think, that we've now been through parallel run for a couple of different quarters, and the outlook from an economic standpoint is still relatively solid, and so I think we feel comfortable that we have a good range, and it's consistent with what we talked about at Investor Day. And then, obviously, the final rule coming out is helpful.

From a timing standpoint, it won't be accelerated. I think it will be bringing that 9.6% down to 9.0% really during the 2019 CCAR cycle, so by the end of the second quarter.

John McDonald

Okay. Got it. So, it is for this cycle to do it by the second quarter of next year.

Terry Dolan

Yes. Yes.

John McDonald

Okay. Got it. And then, I wanted to ask you guys just more broadly about your outlook, just in terms of kind of generating positive operating leverage in what's proving to be a difficult -- more difficult rate environment. As you turn the corner into 2020, is that a goal? And is that 100 basis points kind of a bogey still? And Terry you had mentioned at Investor Day that 2020 was a tougher year when you're talking about your three-year targets.

Terry Dolan

Yes.

John McDonald

And maybe also, Terry, you could just kind of clarify, I think, at Investor Day you said part of that outlook is --you thought your net interest income might grow faster than your fees and maybe if you could give a little follow-up color on that?

Terry Dolan

Yes. So a lot of different questions there. Certainly, in terms of positive operating leverage, it's a balancing act between certain long-term and we always kind of take that into consideration. 2020, as I said at Investor Day, I think, it is going to be a challenging year, because of where interest rates are today versus where they were a year ago. I mean, the long end of the curve, 10 years, is I think down 150 -- almost 150 basis points from where it was last year. So, the landscape certainly has changed relative to when that guidance came out.

When we -- right now, I think our outlook, with respect to positive operating leverage, is to achieve that in 2019 on a quarter basis, and as we kind of think about different initiatives, the certain things that we will take into consideration is the fact that our -- we continue to transform from a digital perspective. Derek talked about kind of a do-it-yourself sort of, a focus, so I think, you know, we're going to end up looking to add a lot of different things that we can do in order to try to manage expenses as prudently as we can. But you know, I think part of it is just what happens with interest rates, I mean, as it’s volatile right now, it's hard to really know and having an outlook that's much beyond a quarter is pretty tough.

Coming back to net interest income versus fees that guidance, right, those comments are really focused around what we think between now and three years out where that growth is going to come from, and I think part of that is an assumption that once we get beyond 2020, the interest rate environment starts to normalize and either stabilizes or starts to come up, and so I think that's part of the thought process between where that mix is going to come from.

Andy Cecere

And I’d just reiterate John that the theme that we talked about at Investor Day – talked about at Investor Day continues to hold which is delivering in the short-term while investing for the long-term. So we're going to manage short-term performance, understanding the rate environment on in the economic environment, but deliver on what we talked about in terms of positive operating leverage but at the same time investing for the long-term growth that we're seeking.

John McDonald

Got it. Thank you.

Andy Cecere

Sure, John.

Operator

And your next question comes from the line of Betsy Graseck with Morgan Stanley.

Andy Cecere

Good morning, Betsy.

Betsy Graseck

Hey, good morning. Hi. One follow-up there on the tailoring rule. There's also a benefit I think to the LCR and how your – reports calculate that and carry cash around that? And I'm wondering, does that have any impact on how you think about either the portfolio that you're holding or your ability to be more competitive for, you know, loans because you can value non-operating deposits or any other benefit from that that maybe we could get a loan under the hood on?

Andy Cecere

Yes, so with the rules related to the LCR coming out, you know, all it was essentially kind of reducing it to an 80% to 85% level. And as we've talked, it really helps free up our liquidity probably in the range of $11 billion to $15 billion kind of in that ballpark. And, you know, we're still formulating kind of what our game plan is, but – I think that we'll look at kind of remixing the investment portfolio in order to be able to both extend duration and possibly enhance the yield a little bit.

We may look at reducing our debt level in the wholesale markets, and I think that – a number of those different actions would be beneficial to the company, and it's going to be basis points, it's not going to be a major change I think in terms of net interest income just based upon kind of where the yield curve is, et cetera, but we're looking at all sorts of things.

Betsy Graseck

Right. And I get that. Every little bit helps so.

Andy Cecere

Yes. It does.

Betsy Graseck

And does it impact all the competitiveness with regard to commercial lending or not really?

Andy Cecere

I don't think so.

Betsy Graseck

Okay.

Andy Cecere

I mean we end up driving from a competitive standpoint based upon what the pricing is in the marketplace. And I just don't see it impacting that a lot.

Betsy Graseck

Okay.

Terry Dolan

And given our debt rating and our low cost of funds we're already in a pretty good position regarding our loan pricing.

Betsy Graseck

Got it. Okay. And then any just separately at Investor Day, really interesting kind of sidebar tech showcase that you had and I want to just understand how you're thinking about the offering that you've got for merchant acquiring Merchant Services? And understand where you think there's more that you can do there to expand your offering either to other verticals take what you've got and your restaurant hospitality, et cetera to other verticals? Or if there is more that you can do with adjacencies on some of the things that you've been adding to over the past year or so?

Terry Dolan

Yes, I think it's a three-pronged strategy. One is, continued focus on e-commerce and ISVs which we made good progress in over the last year, we'll continue to focus on it going forward. Secondly is the focus on certain verticals. You may have a couple of airlines, hotels, industry, and healthcare. And thirdly and importantly and probably the biggest opportunity is just combination of banking, products and services together with merchant products and services.

The fact is all of our merchants need a bank, many of our small business customers need a merchant provider, and our ability to weave and put those products together in a comprehensive set that helps the customers run their business and give them information I think is the key to our focus and one of the areas I think where we see the most potential.

Betsy Graseck

And is it primarily U.S. or is it also Europe? I know you have a more global footprint in this business.

Terry Dolan

Yes, so the first two would be global across the board, that combination of banking and merchant processing would be principally in the U.S.

Betsy Graseck

Okay. Thanks.

Terry Dolan

You bet.

Operator

And your next question comes from the line of Ken Usdin with Jefferies.

Terry Dolan

Good morning, Ken.

Andy Cecere

Hey Ken.

Ken Usdin

Hey good morning guys. How are you doing? Just a couple of fee follow-ups, obviously, mortgage banking was very strong and I'm sure built into your outlook for the fourth quarter growth, but can you just talk about how much more pipeline you expect to pull through on the mortgage side and what you're just seeing in terms of the gain on sale outlook and the loan officer side of the equation there?

Terry Dolan

Yes, so if you think about mortgage banking, I mean obviously, there was a very strong quarter from refinancing. When we end up thinking about the fourth quarter, it's very dependent upon where long-term rates are.

With the rates kind of acting or coming up a little bit most recently, it probably will not be as strong. But I think it will still be a good year-over-year story from a mortgage banking perspective. The application volume is a little strong in production. It was strong in the third quarter. We continue to see that momentum.

The other thing Ken is we talked about this; we've been over time making good investment in mortgage loan officers on the retail side of the equation, enhancing that. The digital platform that we talked about has a very high percentage of application capture and that just helps -- and it helps because those fee to market and our ability to be able to service those customers and get the loans booked.

We went through the last what I would say cycle of refinancing and our processing times were relatively short compared to competitors and certainly what we have experienced in the past and it's all because of those investments.

Ken Usdin

Got it. And a second question, I know this comes up from time-to-time, but inside the other, you always mentioned that the PE gains are there. We know that the ATM agreement is in there as well. Can you help us just understand the magnitude of the PE gains even on a comparison basis if not the number?

And then also just the ATM services -- how much is that in revenues and expenses today and how does that work going forward? Thanks Terry.

Terry Dolan

Yes. So, in terms of other revenue, it is a lumpy category. It ends up going up and down depending upon what's happening within the various categories. It includes a lot of different things and equity investment is just one piece of it. But if we end up looking at the overall increase on a year-over-year basis, I would break it down kind of like this about half of it is related to the transitional services revenue and about 25% of it's related to equity investment and then it's kind of combination of a lot of other things that are kind of driving that.

So, when we think about it, because I know this question is out there when we think about other revenue, we talked a little bit about this.

Over the course of last eight quarters, it has ranged anywhere on a quarterly basis from $160 million to as high as $300 million and when we end up looking at what is a core reasonable level that $200 million range is in that ballpark give or take. It'll be up a little bit some quarters and down a little bit in other quarters. And that's how we think about it.

Ken Usdin

And then could you just -- on the expense side of the ATM, is that a decent part of the growth on the expense side as well the services agreement?

Terry Dolan

Yeah, it is. That service agreement was really negotiated in order to be able to cover the cost and so the cost level associated with making that transition service agreements is fairly similar to the revenue that we're generating. And from a timing standpoint that will start to go away as conversions are taking place between now and the end of 2020.

Ken Usdin

Got it. Thank you.

Terry Dolan

Yeah.

Andy Cecere

Thanks, Ken.

Operator

And your next question comes from the line of Mike Mayo with Wells Fargo Securities.

Andy Cecere

Hey, Mike.

Mike Mayo

Hi. I know we just had your Investor Day, you are talking about positive operating leverage, driven by the digital transformation, so I guess I have a front office and a back-office question. The front office question, I guess you closed what like 150 branches in the last year, but it's still a decent deposit growth, so how much growth are you getting through digital channels, or some sort of metric that you can give us?

And then the harder question, the back-office, I mean, you're retooling the inside of the company. Can you give us any metrics when, like data centers, the peak where you are now where you expect them to go, or what percent of your applications you expect to migrate to the public cloud or anything else about the internal retooling too?

Andy Cecere

Mike I'll start and then Terry can add on. So from a sales perspective as we think about the digital initiatives, the revamping of our app and the focus on the digital capabilities it's focused on a couple of areas, one is insights and improving the ability to connect with the customers. But secondly, it's also the ability to improve sales activity and you see some of our loan stats in the deck that we provide as part of the earnings call.

Well, I tell you that both loan activity from a sales perspective as well as deposit activity is growing quite rapidly and we will see a continued movement of more sales activity, transactions is already high as you know digitally, but more sales activity to digital channels I think over time, which will allow for our continued opportunities on the expense side of the equation, and if you think about the backroom.

Terry Dolan

Yeah. So, I mean, was it in the back room or even was in the branches is a big part of the decision around closures related to branches and reinvestment in branches as well is really kind of the intersection of our employees, our people to digital and our customers, obviously, the customer behaviors are changing. The amount of transaction activity that's happening in the branch is significantly less than where it was and in fact 80% of it roughly – 70%, 80% of it goes through the digital channel today.

So, that gives us the opportunity to really reconfigure the branch network both in terms of size and numbers et cetera. And -- but also to changed the focus from a service oriented type of location to something that's much more either sales and/or advice focus. And so I think, those trends are going to continue, I don't necessarily have specific metrics.

On the deposit side, I would say that there are still room and opportunity for the percentage of sales from the deposit perspective to continue to grow. And I think, Derek at Investor Day had said, you know when you think about the opportunity from a digital perspective from sales and -- we would include deposits in this is that, you know that should get us closer to that 40%, 50% overtime. It'll take a while for us to get there because of the customer adoption that has to take place.

Q – Mike Mayo

Okay. And then, as far as the back-office, do you give any metrics on number of data centres? Or how many apps you expect to migrate to the public cloud or anything else just on the inside of the company?

Andy Cecere

We haven't disclosed a number of data centres. But I will tell you Mike, as we continue to migrate activity to the cloud and Jeff -- Jeff Von Gillern spoke a little bit about that at Investor Day, but most of our new activity in development will occur in the cloud which offers number of our advantages both in the capacity as well as cost development.

Q – Mike Mayo

All right. Thank you.

Andy Cecere

Thanks, Mike.

Operator

And your next question comes from Scott Siefers with Sandler O'Neill.

Andy Cecere

Good morning, Scott.

Q – Scott Seifers

Good morning, guys. Thanks for taking my questions. Just Terry, may be some updated thoughts on the margin, given that the noise from some of the transitory stuff in the third quarter, should presumably be settling in the fourth quarter?

I guess; one, when -- and apologies if you said this, when do you have any additional rate cuts baked into your own outlook there? And then, just as we go forward, we still thinking kind of $40 million to $45 million sort of all up will some impact from these rate cut?

A – Terry Dolan

Yeah. Well, let me kind of talk a little bit about kind of our guidance. And hopefully these will kind of get to some of your points. So our guidance with respect to low-single digits is really kind of looking at the implied market where rates in terms of where they're at in the first couple of weeks of October.

And kind of implied in that is an assumption that you know rates are going to decline and our assumption is that, it will be in 25 basis point cut in both October and in December. And I think there is still question as to December occurs.

The long end of the curve, we are assuming that it's roughly kind of where it is right now. So, that's kind of the assumptions that we're baking into kind of our perspective regarding margin or net interest income.

From a margin perspective, it's down about 11 basis points on a linked-quarter. There's about 4 basis points that's really related to those cash balances supporting the balances.

And so, when we think about the fourth quarter, we would expect our net interest margin to decline, but kind of in the range of that core level which is 7 to 8 basis points.

Q – Scott Seifers

Okay. So 7 to 8 basis points of margin decline in the fourth quarter?

A – Terry Dolan

In the fourth quarter. Yeah, I think, the other thing is that, it's just kind of interesting, if you think about third quarter, third quarter from an average perspective, short-term rates are actually up about 29 basis points, 30 basis points, although the long end was down about 100 -- a little over 100.

In the fourth quarter, that would be the first quarter on a year-over-year basis, when the short end is down, kind of in the range of that 40 to 50 basis points and the long end is down 150 basis points.

So in the industry, that's why people are looking at. And we would expect fourth quarter to become more challenging as it will go into the quarter end and into 2020.

Q – Scott Seifers

Okay. And then, so with that, just so I understand with that 7 to 8 basis points presumably that kind of moderates as we would look at additional rate cuts or is that, that sort of a new, new price that is I want to make sure, I'm sort of understanding that?

A – Terry Dolan

Yeah. I mean, I would say that given the fact that, that it's so volatile right now and we don't really know where rates are going take a look out beyond the fourth quarter.

Q – Scott Seifers

Okay. Fair enough. All right, thank you very much. I appreciate it.

A – Terry Dolan

Thanks, Scott.

Operator

And your next question comes from the line of Erika Najarian with Bank of America.

Q – Erika Najarian

Hi. Good morning.

Andy Cecere

Good morning, Erika.

Q – Erika Najarian

I wanted to follow-up on John's line of questioning, so even outside of mortgage the fee income trends are quite strong. Payments up 5% year-over-year, trust and investment management up 2% year-over-year, and I'm wondering, as we tie that back to your long-term revenue targets, is a 5% fee income clip over that three-year period, too optimistic or about in line with what you're thinking?

I guess, the reason I'm focusing on fees is because, like you said Terry, nobody has any idea on what the curve -- forward curve is going to look like, right? I mean, the probability of October changed over the past two hours. So I'm trying to think about the contribution of fees. And I have a follow-up on balance sheet growth.

Terry Dolan

Yes. Well, maybe, just kind of, again, this kind of ties a little bit to Investor Day and some of the guidance associated with that. The outlook for fee income, in part, will depend upon what happens with rates. I mean, the puts and takes with respect to mortgage banking and so all kind of a function in terms of what happens from a rate perspective.

But, I think, we're confident when we think about the investments that we've been making both in the payment space of business and our corporate trust and some of the digital capabilities, our capital markets business, all of those, we feel like we have a position of strength at this particular point in time and that momentum will continue to carry.

I mean, there will be puts and takes. It kind of depends upon what happens in the environment. Consumer spend continues to be strong. We don't see anything in the short-term, but where that ends up turning, I wouldn't get into 2020, is anybody's game.

Q – Erika Najarian

And on the balance sheet growth contribution to those long-term revenue targets, fully acknowledge the 2020 is going to be challenging. If the rate curve doesn't normalize as you think, but doesn't necessarily get worse than what's in the current expectation. Is there enough opportunity in terms of delivering all of the bank into your current customers, with regards to loan growth.

In other words, that implies to me that we would need mid single-digit loan growth over that three-year period in order to potentially mitigate some of the net interest margin volatility, or lack of help from the yield curve rather.

Terry Dolan

Yeah, maybe a couple of things. The target that we set are kind of based upon where we think the growth rates are going to be as we get into the second and third-year. I tried to be clear that that's not our expectation with respect to 2020 and it's not necessarily a compounded rate over the three years because of the challenges that will happen in 2020. But when you end up -- when we think about the balance sheet right now.

And again, this all kind of depend upon what happens in the economy and that's a little bit hard to predict, but consumers spend and consumer confidence continues to be strong, I think business activity continues to be strong, I think it's moderated somewhat because of tariff policy and that sort of thing or trade policy, but generally, I think the economy is solid.

And when we end up thinking about 2020 from a loan growth perspective, we think that some of the trends that we're seeing this year will continue. And as we talked, third quarter loan growth of about 4.7% on a core basis, we think that's achievable.

And I think from the U.S. bank's perspective, we have the lowest cost of funds in the industry and we have some competitive advantages from a pricing perspective that will enable us to be able to achieve those type of things. So I feel reasonably confident.

Andy Cecere

Yeah. And, Erika, if you think -- if you step back and look at the third quarter, our earning asset growth was just under 5%. Our deposit growth year-over-year was just about 6%. So thinking about the balance sheet growing in that mid-single-digit, I think it’s about right.

Terry Dolan

Yeah.

Erika Najarian

Got it. Great. Thank you.

Terry Dolan

Yeah.

Andy Cecere

Sure.

Operator

And your next question comes from Vivek Juneja with JP Morgan.

Andy Cecere

Good morning, Vivek.

Terry Dolan

Hey, Vivek.

Vivek Juneja

Good morning. Hi. Sorry, we've been jumping on multiple calls. I'm apologizing, if I'm making you repeat something. The other income, did you give any sort of way to think about what's the sort of run rate that seems reasonable?

Terry Dolan

Yeah. We did talk a little bit about that, and maybe just to reiterate, we end up looking at the back and when we think about it, we end up looking at that level on a quarterly basis, it's gone anywhere from $160 million to $300 million.

And as a function of the lumpiness that exists across a lot of different categories of income within that, including equity investments, et cetera. But if I were to – when we think about kind of that core level on a quarterly basis, $200 million, plus or minus is kind of the where we believe that is a reasonable kind of range.

And if you remember in the past I had said, somewhere between $175 million and $225 million, and that's kind of in that ballpark. So, when you end up looking at the year-over-year for the third quarter, but half of that growth is related to the transition servicing agreement that's tied to the ATM business, and so that goes away over time during 2020 tied to when those conversions occur.

Andy Cecere

Together with the expense.

Terry Dolan

Together with the expense. And the expense is pretty similar to the increase related to the transitions service agreement from a revenue point of view.

Vivek Juneja

And then, another one which is positive operating leverage. Your previous guidance you used to have the 100 to 150, which went to 100. Are you thinking full year 2019 given everything going on you've obviously got positives on mortgage banking, other income running higher, but then NII softer? Is it still closer to 100 basis points or do you think given where rates have gone it's – that's going to be harder to get to?

Andy Cecere

We're consistent with what we talked about Investor Day, Vivek, which is somewhat below 100 basis points, but still positive operating leverage.

Vivek Juneja

Okay, great. Thank you.

Andy Cecere

Thank you. Yes.

Operator

And your next question comes from the line of Matt O'Connor with Deutsche Bank.

Terry Dolan

Hey, Matt.

Andy Cecere

Welcome back, Matt.

Matt O'Connor

Hi. Thanks. Sorry about that before. Just stepping back kind of a bigger picture this whole operating leverage question. You've got the best revenue growth year-to-date I think of the big banks about 4%. It seems like the expense growth is also the highest. And I guess I am just conceptually wondering like is that the cost of doing business like to get that much revenue growth, that's the expense growth that you need or is there still some catching up in terms of infrastructure or something you are working on a few years ago?

Or is there something trying to get ahead of kind of to help drive revenue growth in the future. And obviously, I'm not looking for specific numbers, but just conceptually, some people would look at you and say, okay the revenue growth is really good but the expense growth was a bit higher, and it might just cost that much to generate that much revenue growth. So maybe you could just comment on something like that.

Andy Cecere

So I will start it Matt and Terry will add on. So first from a big picture standpoint, three big puts and takes. Number one is we're going to continue to optimize the number of initiatives from an operation standpoint, the way we’re delivering products and services. The way we are operating in the back room and all those things will allow for some saves because that's a positive.

Secondly, we are going to continue to invest with the long-term. In the digital initiatives we talked about Investor Day, so that's going to cost bit more, a lot of that’s already in the run rate.

If you look at the third quarter specifically though, there were a couple of areas of revenue growth, specifically mortgage and capital markets that have expenses related to missions associated with them and that was one of the reasons for a little higher expense growth.

Terry Dolan

Yes. I think I would just kind of maybe add to that because -- we see that in mortgage and we see that in capital markets specifically, but from an optimization standpoint, we talked about this Investor Day -- very focused on how the customer behaviors are changing making sure that we are staying lockstep with that and I think there is both opportunities in front office from a branch perspective and will continue to look at that and as I said, we may accelerate or increase you know some of the activity associated with that, but it's going to be tight what happens from a customer standpoint. And then you know as we continue to move to a digital platform I think there is back-office opportunities in terms of optimization.

And then the other thing in this kind of gets back to the digital activities that Andy was talking about, we're making important investments in all of our lines of businesses and we want to and will continue to do that because it's important for us to look both short-term as well long-term so.

Matt O'Connor

Okay, that’s helpful. I just -- I think sometimes we're also focused on the absolute level of operating leverage and the fact of matter is 80 bps of operating leverage with 4% revenue growth is a lot better than 1% plus operating leverage with 1% revenue growth just the way the math works so. Okay. That’s right. Thank you.

Terry Dolan

Yeah. No, that’s right. And -- that 0.8 positive operating leverage on 54 -- efficiency ratio 54 is a lot different than 1% on 62. So, -- it's all of those things, part of it as the starting point.

Andy Cecere

Thanks Matt.

Operator

And your next question comes from the line of Saul Martinez with UBS.

Saul Martinez

Hey, good morning, guys. So, you guys addressed -- a lot of my questions. I was going to ask you to speak to some of the loan growth trends which are pretty pronounced not only in terms of the absolute level balance sheet growth, but just a mix with commercial on an end-of-period basis commercial going 3% and consumer 7% even with home equity declining for the core even faster than that.

So, I guess a couple of parts though -- maybe you can adjust how much of that growth is related to exogenous factors? Or is dependent on a strong macro environment continuing how much of growth is a function of things you're doing at the company level to deepen relationships used analytics and whatnot?

And I guess the second part of my question though is around CCEL and whether -- do you guys even -- to you guys consider the impact of CCEL when addressing this growth because a lot of the growth is occurring in lending segments that are going to be disproportionally impacted by CCEL in longer term -- longer weighted average lives in higher loss content like cards.

And you I think yourself Terry mentioned at Investor Day that you will have higher ALLL -- to maintain that ALLL ratio, you have to provision more, but with this mix shift that ALLL ratio will continue to migrate upwards and is that something you guys think about or do you guys just say that hey that's accounting noise in the economics of this lending activity is the same, it doesn't really matter and over the life of the loan, the loss is the loss. So, just kind of whether -- the CCEL impact on your growth is something you guys think about and how we should think about in terms of modeling it?

Andy Cecere

Good question. And like -- we kind of talk a little bit about this in the past, when we think about loan growth and where it comes from and kind of our focus within the company. You already think about it more on an economic basis than we do on the accounting. But I do think there's a lot of accounting noise that occurs within CCEL for a lot of different reasons. One is that every company is going to have their own forecasts with respect to what happens in the economy and all the things that we talked about. So, we really think about it more from an economic standpoint.

In terms of loan growth, again just comes back in terms of what we're seeing today and what we see today is that consumer happen to be strong and consumer spend is strong and those things should tend for good growth from a consumer perspective. Even on the business side that while it may moderate, it's still a very solid business. So some of it is driven by macroeconomic, other especially as we kind of think out on a longer-term basis is driven by initiatives.

We started ABS lending sort of platform a year ago, but this focus and Andy talked about it, we have merchants and the merchant side of the equation and small businesses and there is a significant opportunity for us to build leverage both. So when you think about loan growth, we also begin to tighten some of our initiatives.

Saul Martinez

Okay. That’s helpful. Thank you very much.

Terry Dolan

Thanks.

Operator

And your final question comes from the line of Gerard Cassidy with RBC.

Terry Dolan

Good morning, Gerard.

Andy Cecere

Hey, Gerard.

Gerard Cassidy

Good morning guys. You guys have been very good at sharing with us the competition in Commercial Real Estate lending and what's going on in different loan markets. We hear from many of the smaller commercial banks that they're building out there treasury management products. Are you guys seeing any increased competition in that part of the commercial customer base that you deal with that gives us products?

Terry Dolan

Gerard, I would say it's not any different than we've seen historically. I would say probably the change is occurring to treasury management. You continue to see it going forward is the migration and the use case is really the real-time payments that have been developed and the new products and services as a result of that. So, I think that is going to continue to be a change and as you think about our capabilities in treasury management combined with our corporate payments, I think you're going to continue to see those things coming together and changing with this new rails that have been developed.

Gerard Cassidy

And do you think -- speaking on that Andy, do you think Zelle will play a role on that and a go forward basis as Zelle goes from a P2P to possibly a B2B?

Andy Cecere

Well, Zelle, we’ll start to use those new rails as a component of their mechanism, for sure that’s one. Number two, is I think Zelle has a lot of opportunity for growth in different aspects and there are also used cases, request for payment and other things there in the Zelle side. So you’re going to see changes on the business to business side related to the real-time rails. You’re going to see continued migration and changes and enhancement on the consumer side related to Zelle and at some point, some of those things particularly small business may come together a little bit.

Gerard Cassidy

Great.

Terry Dolan

Yeah, and the other thing Gerard, I would just say is that, I think the challenge or the competitive landscape is going to be one based upon who is able to make the investments in connecting the rail -- real-time rail or Zelle or where we made the case to the customer. And that's where our area of focus has really been around the used case is that creates a value proposition to the customer and that investment is very important, it's an area of focus for us.

Andy Cecere

That's absolutely right. Thank you.

Gerard Cassidy

Thank you. And then to pivot, you guys have been very conservative in your construction lending; the portfolio is about $10.7 billion down, just under 5% on a year-over-year basis, but there seems to be recently a resurgence in housing, today the National Association of Home Builders there market index rose bidding and consensus and there seems to be recently some pickup in activity here. Are you guys seeing that in any of your markers and are there opportunities for you to capture some of that growth?

A – Terry Dolan

Gerard, we have a housing capital group that does focus on home builders and we are seeing good growth there -- there West Coast and South principally is where our focus area is, and that -- that business is doing well on growing.

Some of the other aspects of Commercial Real Estate and some of the declines you're seeing are really a function of some of the credit components that we're seeing our competitors move to that we're not comfortable with. So yes, some positives, but we have some negatives and we're sticking with our core customers and within the credit box that we participate in.

Q – Gerard Cassidy

Great. Thank you so much. Appreciate it.

A – Terry Dolan

Thank you. All right.

Operator

And there are no further audio questions. Are there any closing remarks?

Jen Thompson

Yes. Thank you for listening to our earnings call and please call the Investor Relations Department if you have any follow-up questions. That concludes our call.

Operator

And thank you. Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.