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Zions Bancorp. (ZION) CEO Harris Simmons on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-21-19 Earnings Summary

Press Release SEC *10-Q* *Slides*

EPS of $1.17 beats by $0.09 | Revenue of $720M (1.98% Y/Y) beats by $7.93M

Earning Call Audio

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Zions Bancorp. (NASDAQ:ZION) Q3 2019 Earnings Conference Call October 21, 2019 11:30 AM ET

Company Participants

James Abbott - Director, Investor Relations

Harris Simmons - Chairman and Chief Executive Officer

Paul Burdiss - Chief Financial Officer

Scott McLean - President and Chief Operating Officer

Ed Schreiber - Chief Risk Officer

Michael Morris - Chief Credit Officer

Conference Call Participants

Ken Zerbe - Morgan Stanley

Ken Usdin - Jefferies

John Pancari - Evercore

Kevin Barker - Piper Jaffray

Steven Alexopoulos - JPMorgan

Jennifer Demba - SunTrust

Steve Moss - B. Riley

Erika Najarian - Bank of America

Gary Tenner - D.A. Davidson

David Long - Raymond James

Jon Arfstrom - RBC Capital Markets

Operator

Ladies and gentlemen, thank you for standing by and welcome to the Zions Bancorporation's Third Quarter 2019 Earnings Results Webcast. At this time, all participants are in a listen-only mode. After the speaker presentation, there will be a question-and-answer session. [Operator Instructions] I would now like to hand the conference over to your speaker, Director of Investor Relations, James Abbott. Sir, please go ahead.

James Abbott

Thank you and good evening. We welcome you to this conference call to discuss our 2019 third quarter earnings. For our agenda today, Harris Simmons, Chairman and Chief Executive Officer will provide a brief overview of key strategic and financial performance, after which Paul Burdiss, our Chief Financial Officer will provide additional detail on Zions' financial condition wrapping up with our financial outlook. Additional executives with us in the room today include Scott McLean, President and Chief Operating Officer and Ed Schreiber, Chief Risk Officer.

Referencing Slide 2, I would like to remind you that during this call we will be making forward-looking statements although actual results may differ materially. We encourage you to review the disclaimer in the press release or the slide deck dealing with this information which applies equally to statements made in this column. A copy of the full earnings release as well as a supplemental slide deck, are available at zionsbancorporation.com and we will be referring to these items during this call. The earnings release, related slide presentation and the earnings call contains several references to non-GAAP measures, including pre-provision net revenue and the efficiency ratio which are common industry terms used by investors and financial services analysts. The use of such non-GAAP measures are believed by management to be of substantial interest to the consumers of these financial disclosures and are used prominently throughout the disclosures. A full reconciliation of the difference between such measures and GAAP financials is provided within the published documents and participants are encouraged to carefully review this reconciliation. We intend to limit the length of this call to 1 hour. During the Q&A section of the call, we ask you to limit your questions to one primary and one related follow-up question to enable other participants to ask questions.

I will now turn time over to Harris Simmons.

Harris Simmons

Thank you very much, James, and we welcome all of you to our call today to discuss the third quarter results. Slide 3 is a summary of several key highlights. The results for the quarter were favorable in most areas compared to the year ago results. Loan growth was generally in line with our expectations for the quarter. Our outlook for our moderate loan growth remains unchanged even though loan growth has been somewhat stronger in recent quarters. Deposit growth in the third quarter on a linked quarter basis was broad-based and stronger than we anticipated. Topic that received the most attention as we met with many of you during the quarter was the net interest margin and the cost of deposits.

Although the cost of deposits for the full quarter did not decline when compared to the prior quarter, I am happy to report that recently deposit rates have been coming down and I would therefore expect the cost of deposits to decline moderately in the fourth quarter. Credit costs remained low. We don’t see any indicators of a broad-based recession on the horizon. Credit stress appears to be somewhat episodic within our loan portfolio with the only sub-sector demonstrating broad-based stress being agriculture, an industry to which we have limited exposure. We have not observed broad-based credit stress.

Regarding capital, we are pleased to have repurchased nearly 4% of our outstanding shares in the third quarter and 12% of our shares during the last year. During the past few months, we've been delivering an annualized common dividend yield of about 3%. Our common equity Tier 1 capital ratio remained strong at 10.4%.

On Slide 4, we show the earnings per share results for the last several quarters. In the third quarter of 2019, we reported $1.17 of earnings per share compared to $1.04 per share in the third quarter last year. Notably, our average diluted shares outstanding have declined by 23.9 million shares or nearly 12% over the past year, accounting for most of the earnings per share improvement. Still, we feel very good about the quality of this quarter's financial performance.

Turning to Slide 5 on the left side, as you will see adjusted pre-provision net revenue or PPNR which increased 6% over the same period a year ago, on the right side of the chart showing pre-provision net revenue less current period net charge-offs on a per share basis, which increased 19% over the prior year. We believe this view of bank performance will be perhaps more comparable across banks once the new CECL accounting standard goes into effect next year.

Slide 6 shows some of the key technology objectives we have been working on. We are enhancing digital experiences for our customers with the goal of being quite competitive for the best providers of financial service products, banks and non-banks alike, while remaining focused on continuous improvement and streamlining our processes thereby keeping non-interest expense under control.

I will conclude my remarks with Slide 7 which is a list of our key objectives and our commitment to shareholders. For our financial goals, we have long been committed to achieving stronger revenue growth and expense growth also referred to as positive operating leverage. In a period of falling interest rates, our ability to achieve positive operating leverage becomes more difficult. Over the long-term, we will remain focused on delivering positive operating leverage although we recognize that this challenge will increase as our operating efficiency improves.

As lower interest rates across the yield curve have materialized over the past several months, we have sharpened our focus on non-interest expenses. Today, we are announcing an acceleration of our drive toward improving operating efficiency, which will result in a near-term workforce reduction of about 5% along with other operating expense reductions. This acceleration will result in a temporary increase in non-interest expense in the fourth quarter as severance and other similar efficiency initiative-related charges are recognized. We believe this will enable us to achieve our previously stated outlook for non-interest expense for next year, which is to hold expenses to flat to down when compared to this year. Despite the efforts to reduce costs, we'll continue to invest in enabling technologies which will help to ensure our success in an increasingly competitive marketplace.

With that overview, I will turn the time over to Paul Burdiss to review our financials in additional detail. Paul?

Paul Burdiss

Thank you, Harris and good evening everyone. I will begin on Slide 8, which highlights two measures of profitability, return on assets and return on tangible common equity, both improved in the third quarter and our long-term goal is continued improvement in balance sheet profitability.

On Slide 9, for the third quarter of 2019, Zions' net interest income was essentially flat to the prior year period. Average earning assets increased just slightly more than 5% over that timeframe, and the yield on earning assets increased by 9 basis points. However, even though our average deposits increased to 3% over the past year, our cost of funds increased significantly due to the increase in short-term interest rates. This increase in our cost of funds more than offset the increase in the yield on earning assets.

Slide 10 breaks down net interest income by both rate and volume. You can see that our average loans grew 8% over the year ago period. Average loan growth in the third quarter was more modest up 4% annualized from the prior quarter. Over the prior-year period, the yield on loans increased 4 basis points. And relative to the prior quarter, the yield on loans declined 10 basis points. The reasons for this are the same as we provided in the last quarter: first, the recent decline in short-term rates and second, the turning of loans that is lower rates on new loans relative to maturing loans. That compression can be attributed to several factors, including competitive forces as well as a lower credit risk profile in the loan portfolio. I will discuss the benefits of a lower risk profile in just a moment when I review our capital position.

Shifting to funding, average total deposits increased 3% over the prior year period. We are reporting a relatively strong 7% annualized growth rate when compared to the prior quarter. Achieving such a strong rate of growth will likely be difficult to sustain, but we do not expect moderate deposit growth – sorry we do expect moderate deposit growth to accompany our loan growth. Our cost of total deposits increased just 1 basis point relative to the prior quarter and I expect the total cost of deposits to decline in the fourth quarter relative to the third quarter due to ongoing efforts to better align deposit cost with lower market rates.

Slide 11 depicts the key net interest margin components. Our net interest margin compressed 6 basis points relative to the second quarter as loans, securities and borrowing yields and costs reacted relatively quickly to lower interest rates. It is reasonable to expect that the net interest margin will compress further during the next few quarters, reflecting the forward curve and our best estimates of loan yields, deposit costs, balance sheet growth and other factors.

Turning to loan growth, Slide 12 depicts year-over-year period-end loan growth by portfolio type with the size of the circles on this chart representing the relative size of the portfolio. For nearly all categories, we are reporting solid and consistent growth. As a minor footnote, we reclassified about $250 million of construction and land development loans into the term commercial real estate portfolio. The credit risk of the total commercial real estate portfolio is unchanged by this reclassification. As mentioned previously, we are expecting moderate loan growth and the composition of the growth should be relatively similar to prior guidance with lower risk categories growing at a stronger rate than the higher risk categories.

Interest rate sensitivity is reported on Slide 13. Zions remains moderately asset sensitive, although we have continued to reduce the magnitude of that sensitivity. Earlier in the quarter, we utilized the mark-to-market gains and previously contracted out-of-the-money interest rate floors and converted those into interest rate swaps. Earlier in the year, we were inclined to keep some optionality for scenarios where interest rates may have continued to rise. However, as the year progressed and the likelihood of rates decline became more certain, there became a greater need to hedge the emerging near-term decline in net interest income.

The partial offset to declining net interest income due to falling rates is a strengthening of certain fee income items as discussed on Slide 14. Customer-related fees were up 11% from the year ago period. This increase is primarily attributable to strength in capital markets product sales, including interest rate swaps as commercial customers lock in low interest rates on their variable rate loans. We have also seen strength in other lending activities such as residential mortgage loan originations. Although the non-interest income lift associated with these products is often driven by market conditions and can be fleeting, we are optimistic that this increased activity can continue in the -term.

As shown on Slide 15, non-interest expense declined 1% to $415 million from $420 million in the year ago quarter. Relative to the prior year, the third quarter contained a reduction in incentive compensation reflecting the more challenging interest rate-driven environment for revenue growth and reductions in FDIC insurance premiums and credit costs offset by an increase in base salaries and software amortization. As Harris noted earlier, we are accelerating our efforts to streamline operations and improve overall efficiency. While this will create elevated non-interest expense in the near-term, driven by severance and other restructuring-related costs, we believe these changes will enable an ongoing expense level which is reflective of the current environment for revenue. In fact, we now expect that total adjusted non-interest expense for 2020 will be consistent with or slightly below full year 2019 which would mean that we will have kept non-interest expense level generally flat for more than five years.

Turning to Slide 16, the efficiency ratio was 57.3% compared to the year-ago period of 58.8%. One of our long-term financial goals is to achieve an efficiency ratio that is consistent with the pure median as a first step and eventually stronger than a pure median, while simultaneously investing in digital delivery strategies such as our core modern – our modern core system, top quality treasury management software and strong web and mobile banking platforms. Additionally, we are committed to maintaining a strong risk management infrastructure that will allow us to produce consistently good credit quality results throughout the cycle. We, therefore, plan to invest meaningfully in the business, while achieving improved efficiency.

As seen on Slide 17, credit quality continues to be remarkable as the trailing 12-month net charge-off ratio is only 1 basis point. We are reporting continued improvement in non-accrual loans and loans 90 days past due. Our non-performing assets plus loans 90 days past due expressed as a percentage of loans and other real estate-owned declined to below 50 basis points, a level not seen in quite some time. We had a slight uptick in classified loans, although we don’t see that as the beginning of a trend. The quality of the overall portfolio is very strong and we expect only modest provision for loan losses in the near-term, learning, of course, that the upcoming CECL based allowance for credit loss estimate, which I will discuss further in a few minutes, will fundamentally change the allowance for credit loss process and estimate. We continue to maintain disciplined underwriting standard and have even tightened standard somewhat in select areas as we continue to prepare to be a positive outlier during the next economic downturn.

Over the past few years, this improvement in portfolio quality and composition has adversely impacted our loan yields but has also translated into superior credit quality results relative to peers. This change has also lead to stronger performance in our stress test results which we continue to post on our website. The resulting improvement in our risk profile has supported our reduction in the amount of common equity needed to support the company, therefore enabling the repurchase of 12% of the company’s stock over the past year. Our improved risk management and credit performance have been key factors in an improvement of our debt ratings. Still, we believe we can make the case for further improvement in these external credit assessments. Slides comparing Zions’ financial performance to that of A and A- rated peer banks can be seen in the appendix.

During the third quarter, we ran a full parallel allowance for credit loss process, one for the incurred loss accounting standard and the other for the new current expected credit loss or CECL accounting standard.

Slide 19 reports the results of that parallel run. We have highlighted the various changes that may impact the allowance for each of the major loan portfolios with a total estimated impact on the allowance for credit losses at the bottom of the table. Our estimated day one impact and the allowance for credit losses associated with the adoption of the new CECL accounting standard currently ranges from a minus 15% to a positive 5%. We've given ranges to reflect the reality that the economic scenarios used to create the seasonal estimate are likely to change between now and adoption in January of 2020.

Slide 20 depicts our financial outlook for the next 12 months, relative to the third quarter of 2019. With regard to loan growth, we are leaving our outlook unchanged at moderately increasing. We do see some softening on that front as compared to what we reported earlier in the year. Not mentioned in the chart but incorporated in the outlook for net interest income is a modest further reduction in the size of the securities portfolio as we refine how much liquidity is needed to support the balance sheet. In September, we reduced our outlook for net interest income to slightly decreasing from stable to slightly decreasing as the outlook for interest rates have become more negative than it was in July. We continue to believe that this is the best estimate we can provide. We are incorporating into our outlook the current shape of the yield curve.

Regarding customer related fees, we had a very strong quarter and as I said earlier, it's likely that some of the factors that contributed to the strong third quarter will remain in the near term. It's a bit more difficult to expect such strength in this activity a year from now. Meanwhile however, we expect more steady growth in other fee income categories. The combination of these two trends seems likely to result in a relatively stable customer related fees a year from now when compared to the third quarter. Building on our prior comments related to non-interest expense, we expect the overall level of adjusted non-interest expense in 2020 to be consistent with or slightly below adjusted non-interest expense in 2019. However, total non-interest expense in the fourth quarter of 2019 is expected to be elevated by severance charges of about $25 million and other restructuring related items. Also as we have previously disclosed, we are in the process of eliminating our defined benefit pension plan, which is expected to result in a onetime charge likely towards the middle of 2020. Our outlook for adjusted non-interest expense excludes these items.

Finally, I will briefly discuss our outlook for capital management. Our CET 1 ratio has declined to 10.4% from more than 12% a year ago. This measure remains about 50 basis points above the median of our peers for the second quarter. We continue to feel that remaining stronger than the peer median is important and we believe this level of capital is also somewhat conservative relative to our risk profile. Maintaining a risk profile which compares favorably to peers, while also maintaining strong positions in capital and liquidity is prudent. Therefore, while the capital we return to shareholders in 2020 is likely to be less than it was in 2019 assuming the status quo in the economy, we expect to continue to return excess capital through dividends and share repurchases over the next several quarters.

This concludes our prepared remarks. Latif, would you please open the line for questions? Thank you.

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from the line of Ken Zerbe of Morgan Stanley. Your line is open.

Ken Zerbe

Great, thanks. Good evening, guys.

Paul Burdiss

Hi, Ken.

Harris Simmons

Hi, Ken.

Ken Zerbe

I guess Paul Burdiss first question for you, the $25 million of severance that you mentioned, is that the entire amount of the elevated expenses in the fourth quarter and also is there anything that carries over into the first quarter of 2020?

Paul Burdiss

The $25 million is an approximation of the severance charge that will occur in the fourth quarter. There are other charges related to for example branch closures that will occur in the fourth quarter, but those will likely carryover into at least the first quarter of 2020, but I have not specified the size of those items.

Ken Zerbe

Got it, okay. So first quarter could be elevated as well in addition to the seasonality of the normal comp increases?

Paul Burdiss

Right. And we will call those out as they occur.

Ken Zerbe

Okay, great. And then I guess my second question is the guidance for flat expenses in 2020, does that include the $25 million of expenses you are taking in 2019 or should we strip out the $25 million to get more of a core base number that you are going to be in line to below?

Paul Burdiss

Yes, our expense outlook is an adjusted expense outlook as you may recall. And we have a GAAP to non-GAAP reconcilement page that shows up at the back of our earnings release and at the back of our slides. And in that, you can see that items such as severance are excluded from that adjusted non-interest expense figure. So that’s a long way of saying that, yes, you should exclude that.

Ken Zerbe

Perfect, alright. Thank you very much for the questions.

Perfect, alright. Thank you very much for the questions.

Paul Burdiss

Thank you.

Operator

Thank you. Our next question comes from the line of Ken Usdin of Jefferies. Your line is open.

Ken Usdin

Thanks a lot. Hey, Paul. I know this is a tough question for you to answer and I appreciate the sliding scale point on Zions wanting to remain above the peers and you cited the 50 basis points gap, but you cited also that you continue to believe that you are going to return excess capital, which implies that you still think you can live at a lower absolute ratio. How do we just start to get a sense of where that bottoming spot is like where you are just not going to go below, because as you have said previously you wanted to stay above it in case we get to a different part of the cycle? Thanks.

Paul Burdiss

Right. Thank you for the question. And just to be clear, I am not sure that you referred to capital specifically in the question, but I believe you are talking about, in particular, the CET 1 ratio. What I was trying to say as it relates to excess capital is that – and what I am trying to say by the collective comments is that we are – as we have been telegraphing for the last six quarters or so, we're getting close to the level that we think make sense for us as an organization. And so, I would not expect it to go a lot lower from where we are at. So when I refer to excess capital, I'm referring to the capital that we generate through net income. We need to support the risk profile of the balance sheet, including loan growth we need to support dividends and then everything over and above that. I'm trying to say is, we will be available for distribution to shareholders through share buyback.

Ken Usdin

Understood. Thanks, Paul. And as a follow-up, just one question on the margin side, can you talk about just how impacted premium amortization was and whether it came from MBS and the SBA portfolio this quarter?

Paul Burdiss

Yes. On the securities portfolio yield, I have done the math on the margin it's only a couple of basis points. But on the securities portfolio yield, it's about 8 basis points quarter-over-quarter on premium amortization. A lot of that as it turns out is yes, some of it's MBS, but a lot of it is related to our SBA portfolio, which you may recall there is a couple of billion dollars and has about a 10% premium attached to it. For your information, that's not an asset class that we are continuing to add to.

Ken Usdin

Okay. Thank you, Paul.

Paul Burdiss

Yes, thanks.

Operator

Thank you. Our next question comes from John Pancari of Evercore. Your question please.

John Pancari

Good afternoon.

Harris Simmons

Hi, John.

Paul Burdiss

Hey, John.

John Pancari

On the expense side, regarding the 5% headcount reduction, could you just give us a little bit more detail in terms of the timing of that – of the reductions and the overall targeted savings as a result of the reductions? And I guess, the same question will go for the branch closures as well in terms of the targeted savings that you expect and maybe the number of branches?

Scott McLean

John, it's Scott. And on the targeted savings that come from the 5% reduction in workforce, it basically – it's occurring and we should see the benefit of it throughout 2020. So that's pretty much the outlook on that. And on the branch closures, again, it's a modest amount. We are absolutely committed to our branch footprint. We're relocating some branches, but we'll bring our total level of branches down by a very modest amount. We absolutely believe that our customer base, which as you know is largely small and medium-sized businesses. Most survey data reflects that they absolutely value convenience and locations and they value access to bankers. So, it's a modest trimming of the branch footprint.

Harris Simmons

I would just add – John, this is Harris, you can pretty much take that percentage and apply it to our salary and benefits number to give you a rough approximation. We were not going to give you a precise number, but that would get you to the ballpark. And it will – you will start to see that in the first quarter pretty much in full.

Scott McLean

And that's why the magnitude of that is why we're guiding to flat to slightly decreasing on non-interest expense.

John Pancari

Got it. Okay, alright. Thanks for that. And then separately, just on the margin, I know you indicated in your prepared remarks that the NIM should see some continued pressure over the next couple of quarters or several quarters I think you said. Could you give us a little bit – to help frame that out, maybe give us some color around the expected magnitude, and then maybe just remind us of what you're assuming in terms of the Fed? Thanks.

Paul Burdiss

Hey, John. This is Paul. We are kind of trying to follow the forward curve, and we are deliberately non-specific with respect to the number of basis points to expect. And the reason is, as you know, the rate outlook is a little uncertain. We don't know precisely what will happen there. But more importantly, I think you know that we are as – all banks are particularly leveraged to the cost of deposits. And so, we have been working really hard to manage that down. You saw the cost of total deposits, only – it was only up 1 basis point this quarter. And as I've said, we are expecting that to fall in the fourth quarter relative to the third. And the degree to which we are successful there will define in a large way our success in maintaining the net interest margin as we – as earning asset yields continue to fall.

John Pancari

Okay, great. Thanks, Paul.

Paul Burdiss

Thank you, John.

Operator

Thank you. Our next question comes from Kevin Barker of Piper Jaffray. Your line is open.

Kevin Barker

Thank you. The deposit growth was generally much better than what we expected. Are you still seeing some of that deposit growth into the fourth quarter? And is there any way you can manage that just given the NIM outlook for additional pressure?

Scott McLean

Yes, I would – this is Scott. I would just say that we don't really give sort of guidance during the quarter, but the deposit growth we're experiencing really – I know it maybe seem a little surprising to you, but if you look at the loan growth we've had over the last four quarters, it really is very deposit-friendly type of loan growth, it's C&I owner occupied, it's commercial loans, it's municipal and it's 1-to-4 family mortgages and our HELOC portfolio. So, those are very deposit-friendly types of loan growth. And as you know, we've had four really solid quarters now of loan growth and to see the deposits growing should happen with the portfolio like ours.

Harris Simmons

That said I wouldn't expect to see it continue as strong as we saw in the quarter. It was a little bit of a surprise.

Kevin Barker

Okay. And then just to follow-up on some of your comments about a lower risk profile and tightening of the underwriting. Are you – how much are you seeing a decline in new money yields versus your current book and also on the securities book as well like given some of the tightening, underwriting and also just decreasing the risk profile?

Harris Simmons

Yes. James may have a little precision I wouldn't describe the tightening as enormous. It's something that we've been dealing with quarter-by-quarter here for the last several years.

James Abbott

Yes. This is James. The amount is pretty similar to what we saw in the last three quarters, pretty much similar all year long actually, about 15 basis points or so per dollar volume during the year.

Kevin Barker

So, 15 basis points below where current new money yields are?

Paul Burdiss

That's correct, yes. The old loans are rolling off at a 15 basis point higher level than the new loans are coming on, and this is another way of saying it. Part of that's a mix shift, mortgage loans and municipal credit, how such a much lower risk profile that they have a much lower interest rate associated with them. And so it's not totally apples-to-apples. It's not same loan, same loan, but the new volume coming on is lower yield than the old loans rolling off.

Kevin Barker

Okay, thank you.

Operator

Thank you. Our next question comes from the line of Steven Alexopoulos of JPMorgan. Your question please.

Steven Alexopoulos

Hi, everybody.

Harris Simmons

Hi, Steven.

Steven Alexopoulos

To start, on the 5% workforce reduction, how does that roughly split between customer-facing roles, right, items such as closing branches, and then what I would consider as a back-office, right, outsourcing staff functions overseas, stuff like that?

Scott McLean

Thank you, Steven. This is Scott. It's about roughly 30%, what I would refer to as customer-facing and the remainder would be other enterprise activities and back-office activities.

Steven Alexopoulos

Okay, that's helpful. And then Harris, regarding the ability to deliver positive operating leverage long-term, I wasn't sure, were you signaling in your prepared comments maybe less of an ability beyond 2020?

Harris Simmons

Well, I guess, what I want to be saying is simply that in theory, you can't do it forever without fundamentally shrinking, I think. So, as the efficiency ratio gets lower, it becomes more challenging and so – at least the pace of it becomes tougher. And I think most notably in the short-term, because of the kind of the Fed's pivot on interest rates, what that's doing to margins in the industry, it's a particular headwind. But longer-term, it's something – I mean, we will absolutely continue to keep really focused on operating expenses. But at some point, you get convergence between growth rates in expenses and revenue.

Steven Alexopoulos

Got it. Okay.

Harris Simmons

Otherwise, we would all – the entire industry would be down at kind of 3% or something like that, I guess. I mean, what happens in part is that, as the industry becomes more productive, pricing changes too. So, it's up – that's really what we're trying to say.

Steven Alexopoulos

Okay, fair enough. Thanks for taking my questions.

Harris Simmons

Yes, thank you.

Operator

Thank you. Our next question comes from Jennifer Demba of SunTrust. Your line is open.

Jennifer Demba

Thank you. Good afternoon.

Harris Simmons

Yes.

Jennifer Demba

Question on credit quality remains really good, can you talk to us about any weakness you mentioned you saw in ag and can you also update us on credit quality in the energy portfolio?

Harris Simmons

Do you want to?

Michael Morris

This is Michael Morris speaking, Chief Credit Officer. I will defer the energy question to Scott McLean. We've seen a little stress in a couple of other portfolios like the restaurant sector and commercial subcontractors. Nothing to really get overly concerned about here, but I think it's been well represented in the industry that those are couple of segments that are experiencing some stress in this part of the cycle.

Harris Simmons

And I think ag is – I mean, we have a couple of credits. It was up in the state of Idaho, the potato crop that's had some challenges with early freezes. And so, I think nothing that we're expected to see any significant loss, but...

Scott McLean

No, we are – that's right, Harris. We are in about the fifth year of depressed commodity prices. Tariffs, trade war talk is adversely impacted mostly hay, beef and grain, potatoes a little bit, sugar bean a little bit. Most of our clients, especially our large borrowers, have fairly deep balance sheets but have experienced some working cap stress.

Harris Simmons

And the total ag portfolio is about...

Scott McLean

It's roughly $600 million.

Harris Simmons

$600 million, yes. And Jennifer, on the energy portfolio, basically classifieds non-performers that are flat for the most part, charge-offs are still pretty benign since the last couple of quarters, and natural gas prices have been soft. They generally trade either side of $3 and have for quite some time going back 5, 6, 7 years, but we are now down below $250, but that it tends to adjust. And as you know, our borrowing bases adjust also pretty naturally with it. So, we are watching it closely, but it's not something that's overly concerning to us at the moment. The declining rate count is something to watch, but interestingly as the rig count declines, so too will gas drilling, and that will allow for pricing to go up fairly quickly because most of these wells that are being driven – drilled are on three-year decline curves. So, in any event, we watch the energy portfolio very, very closely, but we think the fundamentals are in pretty good shape right now.

Paul Burdiss

I just add that gross charge-offs in the energy were $1.3 million during the quarter and we had recoveries of $1.5 million. So, when we say benign, it's pretty benign.

Harris Simmons

Which is not a word that I probably have used very much related to the energy portfolio so I probably should pick a different word.

Jennifer Demba

One follow-up if I could. What's the size of your restaurant portfolio and your commercial subcontractor bucket?

Paul Burdiss

The restaurant portfolio is roughly $750 million and the subcontractor and this would be just subcontractors, not general contractors closer to $300 million.

Jennifer Demba

Great. Thanks so much.

Harris Simmons

Thank you.

Operator

Thank you. Our next question comes from Steve Moss of B. Riley. Your question please.

Steve Moss

Good evening. Paul, on your comment, you said the securities portfolio would continue to decline here. Just wondering as a percentage of assets, where you see that heading over the next 12 months or so?

Paul Burdiss

Well, I would think of it really, usually I prefer things like percentages because they are kind of broader and more directional. But in the case of the securities portfolio, we signaled last quarter that we thought it was going to decline in the third quarter. And I'm just trying to signal that that may continue here into the fourth quarter. But it's in the range of kind of a couple of hundred million dollars, that's not a gigantic decline. And to your point, to the extent the balance sheet size changes, that will change that target too, because the investment portfolio really exists primarily for management of liquidity on the balance sheet.

Steve Moss

Okay. And then my second question, just on the loan pipeline, fourth quarter tends be a little stronger seasonally for you guys. Wondering how this compares with other fourth quarters.

Paul Burdiss

We don’t know because it’s two weeks into it.

Harris Simmons

And we are only 2 weeks into the quarter, so it’s really – it’s really hard to provide any sort of accurate prediction with precision on how the quarter turns out. But we are confident in our outlook for kind of moderate growth in the loan portfolio, and we’re sticking to that.

Steve Moss

Alright. Thank you very much.

Harris Simmons

Thank you.

Operator

Thank you. Our next question comes from the line of Erika Najarian of Bank of America. Your question please.

Erika Najarian

Hi, good afternoon.

Harris Simmons

Hi, Erika.

Erika Najarian

Hi, I thought the chart on Slide 13 was extraordinarily interesting when you showed us the data on deposits on the last 50 basis points of hikes versus cumulative. And I am wondering, given some of the feedback from your peers that competition, of course, remains strong, how you see the pacing continuing especially since yield curve expectations are extraordinarily volatile right now?

Paul Burdiss

That's all true. So I would fall back though on my comments regarding overall deposit pricing, and that is that as loan yields began to decline, we saw that deposit costs continue to increase in the second quarter. That flattened out in the third quarter and as we are actively managing this. And we think we continue to have some opportunity to do that. We are expecting the overall cost of deposits to begin to fall in the fourth quarter.

Erika Najarian

So, yes, so totally heard that loud and clear. I guess, I am just wondering as we think about the piece of it because some of your peers also have given us less consistent messaging, some have said an accelerated pace in the beginning and then a leveling off and some have indicated a more accelerated pace into 2020. And I'm wondering, as you think about it strategically, and again thinking about sort of volatile expectations for the short end of the curve, any thoughts on that pace – that kind of pacing?

Scott McLean

Well, overall, we have some of the best cost of deposits in the industry. And the reason for that, I would say is largely due to the fact that the composition of our portfolio is very granular. And where we look at sort of the most intense deposit pricing competition, it's typically on sort of a larger, I would say sort of lumpier deposits and because so many of our deposits are operating in nature, we have been able to benefit from a lower relative beta on the way up. And what that means though is that on the way down, my expectation is just as rates have been moving up rather slowly on the way up, it's going to take a lot of work to move them back on the way down. So, if you are asking about sort of an accelerating beta in the near-term I don't foresee that.

Erika Najarian

Got it. And if I could squeeze my second question, sorry – have to ask a two-part first question. But as I take a step back, I feel like Harris, every single quarter, you are asked about the capital ratios and the conservatism with which you manage your balance sheet exposure, capital and your liquidity. And I guess the message really here is that, clearly –

look a 10% CET 1 floor seems robust for your risk profile, but given the uncertainties, you would rather be using your balance sheet to win business in a downturn rather than draw it down right now. And so we should stop asking you that question, I am just trying to think about is the message from capital is really that this is the right for now?

Harris Simmons

What a good idea, I guess, I think somewhere around here is about where we are going to want to be given the fact that there is a fair amount of uncertainty in the world. And I think we have said we want to be sure that we don't want to have an enormous amount of excess capital just sitting here fallow. But I do want to be sure that we've got a strong balance sheet going into whatever the next down cycle looks like. And I think we are pretty well positioned for that and we are probably – we are just not going to see the kinds of levels of buybacks that we have had been able to accomplish over the last year. But particularly if we don't see reasonably strong loan growth, I think there is still going to be some room to continue down that path, but it just won't be at the same pace.

Erika Najarian

Got it. Thank you.

Harris Simmons

Yes. Thank you.

Operator

Thank you. Our next question comes from Gary Tenner of D.A. Davidson. Your question please.

Gary Tenner

Thanks everybody. My questions were actually asked and answered. Appreciate it.

Harris Simmons

Great, thank you.

Operator

Thank you. Our next question comes from David Long of Raymond James. Your line is open.

David Long

Thank you. Good afternoon, everyone.

Harris Simmons

Hey, David.

David Long

Question regarding mortgage banking, something that you guys have talked a little bit about lately in some investor meetings. And just want to get an idea as to what your appetite is to grow that part of the business to leverage your footprint, and also how big then can that become for the bank? Thank you.

Scott McLean

Thank you for the question. This is Scott McLean. Our mortgage business is really important to us. It will generate – will fund about $2.5 billion this year. That will be up from about $2.2 billion, $2.3 billion. We've been at these levels and higher. It is a perfect product for community bank model like us. And also a very high percentage of our mortgage clients are small business owners, which also fits really nicely in many cases their mortgage is larger than the business loans they ask us for. And so, it's a business too that we've just rolled out some really exciting customer-facing digital technologies. We'll take about 10,000 applications a year. And at this point last year, we were 100% paper. At this point as of right now, we are at 75% coming through our digital channel. That is a huge change in a short period of time going from paper to digital and it's allowing us to get more into their conforming mortgage business. Historically, we have principally been a jumbo lender average loan size about $600,000 and this new digital interface should allow us to start originating conforming mortgages much more actively than we have in the past. It's going to be a great product for our 430 branches. And that kind of mortgage lending also has fees associated with it, because we sell all those conforming mortgages, mortgages generally less than $430,000, $450,000. And so the fee income outlook associated with that volume is positive.

David Long

Got it. Thank you.

Operator

Thank you. [Operator Instructions] The next question comes from the line of Jon Arfstrom of RBC Capital Markets. Your line is open.

Jon Arfstrom

Good afternoon.

Harris Simmons

Hey, Jon.

Jon Arfstrom

Hey, question on the back-end loan growth. On your guidance slide, you talked about moderately increasing, and it may not be as strong as the prior 12 months, but then you also are talking about moderate to strong in C&I and owner-occupied and other areas. Just curious, bigger picture, are you any more or less optimistic on the growth outlook and any change in optimism from your typical SME borrower?

Paul Burdiss

Well, let me talk about the outlook specifically. Perhaps it wasn't clear the way we laid it out. What we were trying to say was that if you look back over the last 12 months, we had sort of a moderately increasing outlook, but what we achieved was actually better than that. And we are just trying to say, hey, that was a little better than moderately increasing and that's not what we are expecting. We are expecting moderately increasing, right. That was kind of the concept that we were trying to accomplish. But as it relates to overall sort of a composition of the growth and what we've seen and the mix of growth with the exception that I just laid out, I think we feel pretty good about that category growth over the next 12 months, which is what we are trying to convey.

Jon Arfstrom

Okay. And any change in the optimism of your clients?

James Abbott

Maybe ever so slightly, Jon. This is James.

Jon Arfstrom

Okay.

James Abbott

Very ever so slight among a very maybe handful of relationship managers would tell you that maybe some of their customers have experienced a little bit less optimism these days. But I don't think it's broad based.

Harris Simmons

And I would say it's kind of anecdotal and by definition really hard to measure.

Jon Arfstrom

Yes, okay. And then the other thing I just wanted to clarify on the fee income lines, you talk about stable from a very strong 3Q. Would you consider 3Q elevated? I realize it's clearly an offset to the margin and they seem to move in different directions, but would you consider that elevated, and if so, maybe sustainable in the near-term?

Scott McLean

Jon, it's Scott.

Jon Arfstrom

Hi, Scott.

Scott McLean

Yes, I think it was a little elevated. But with fee income, it seems like every quarter is a little muted or a little elevated. And so, we are still maintaining our guidance around mid single-digit fee income growth is what we sort of said year-over-year. And we saw really good strength in this quarter in a number of our capital markets businesses, and – but we're coming off a low base. And so, I'm optimistic about those products going forward and we have some other products that are going to be, I think positive for us next year also that could take the place of anything that we lose.

Harris Simmons

Yes, it's just – I think it's kind of – there is a silver lining to what we see in the yield curve, that's been in mortgage and then some capital markets activity – swaps in particular. And if we started to see some slope in the yield curve, it'd probably hurt those and help us in some other places, so.

Jon Arfstrom

Okay, thanks. Nice job, guys.

Harris Simmons

Thank you.

Operator

Thank you. At this time, I'd like to turn the call back over to James Abbott for any closing remarks. Sir?

James Abbott

Thank you, Latif and thank you everyone for joining the call this evening. We appreciate your time and interest in the company. We look forward to speaking with you throughout the quarter or at a conference. If you do have any follow-up questions, I will be around for a little while tonight and feel free to contact me directly and again thank you for your attendance this evening. Have a great night.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.