Capital One Financial (COF) Earnings Report: Q4 2014 Conference Call Transcript

The following Capital One Financial conference call took place on January 22, 2015, 05:00 PM ET. This is a transcript of that earnings call:

Company Participants

- Jeff Norris; Capital One Financial; SVP - Global Finance
- Steve Crawford; Capital One Financial; CFO
- Richard Fairbank; Capital One Financial; Chairman, CEO

Other Participants

- Moshe Orenbuch; Credit Suisse; Analyst
- Matt Burnell; Wells Fargo Securities; Analyst
- Don Fandetti; Citigroup; Analyst
- Sameer Gokhale; Janney Capital Markets; Analyst
- Ken Bruce; BofA Merrill Lynch; Analyst
- Sanjay Sakhrani; Keefe, Bruyette & Woods; Analyst
- Rick Shane; Jefferies; Analyst
- Eric Wasserstrom; Guggenheim Securities; Analyst
- Ryan Nash; Goldman Sachs; Analyst
- Chris Donat; Sandler O'Neill; Analyst
- Brian Foran; Nomura Securities; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

Welcome to the Capital One fourth quarter 2014 earnings conference call.

(Operator Instructions)

I would now like to turn the call over to Mr. Jeff Norris, Senior Vice President of Global Finance. Sir, you may begin.

Jeff Norris (SVP - Global Finance):

Thanks very much. Welcome, everyone, to Capital One's fourth quarter 2014 earnings conference call.

As usual we're webcasting live over the Internet. If you want to access the call on the Internet, please log on to Capital One's Web site at www.capitalone.com and follow the links from there. In addition to the press release and financials, we have included a presentation summarizing our fourth quarter 2014 results.

With me today are Mr. Richard Fairbank, Capital One's Chairman and Chief Executive Officer; Mr. Steve Crawford, Capital One's Chief Financial Officer. Rich and Steve will walk you through this presentation. To access a copy of the presentation and press release, please go to Capital One's Web site, click on investors, then click on quarterly earnings release.

Please note that this presentation may contain forward-looking statements. Information regarding Capital

One's financial performance and any forward-looking statements contained in today's discussion in the materials, speak only as of the particular date or dates indicated in the materials. Capital One does not undertake any obligation to update or revise any of this information, whether as a result of new information, future events or otherwise.

Numerous factors could cause our actual results to differ material from those described in forward-looking statements. For more information on these factors, please see the section titled forward-looking information in the earnings release presentation, and the risk factors section in our annual and quarterly reports, accessible at the Capital One Web site and filed with the SEC.

With that I'll turn the call over to Mr. Crawford. Steve?

Steve Crawford (CFO):

Thanks, Jeff.

I'll begin tonight with slide 3. 2014 full-year results reflect solid underlying performance across all of our businesses. Consistent with our expectations provided at the beginning of the year, 2014 pre-provision earnings were $10.1 billion.

Net income grew 7%, and earnings per share grew 10%. For the year, return on average tangible common equity was 15.8%. Our balance sheet remains strong with an ending common equity tier 1 capital ratio of 12.4%. And we reduced our common shares outstanding by 3%, reflecting our share buyback program that began in April.

For the fourth quarter, Capital One earned $999 million, or $1.73 per share. On a continuing operations basis, we earned $1.68 per share. Pre-provision earnings of $2.5 billion were down $125 million from the third quarter, as higher link quarter revenues were more than offset by higher marketing and operating expenses, largely driven by seasonal and growth related costs, and investments in our technology and regulatory agendas that we have highlighted for you over the past several quarters.

Provision for credit losses increased on a link quarter basis, as higher charge-offs more than offset a smaller allowance build over the previous quarter. As you can see on slide 4, reported NIM increased 12 basis points in the fourth quarter to 6.81%. Average interest earning assets were up quarter over quarter, driven by growth across our segments.

Turning to slide 5, our common equity Tier 1 capital ratio on a Basel III standardized basis was 12.4%, which reflects current phase-ins. On a standardized fully phased-in basis, we were at 11.4% in the fourth quarter.

We reduced our net share count by 5 million shares in the quarter, primarily reflecting our share buyback actions. We expect to complete our previously announced $2.5 billion buyback program in the first quarter of 2015.

We formally entered parallel run for Basel III advanced approaches as of January 1, 2015, and we continue to estimate that our common equity Tier 1 capital ratio is above our target of 8%. Regarding the LCR, as of year end we estimate that we are comfortably above the fully phased-in requirement for our consolidated company.

With that, let me turn it over to Rich.

Richard Fairbank (Chairman, CEO):

Thanks, Steve.

I'll begin on slide 7 with our Domestic Card business, which delivered another quarter of strong growth and results. Ending loans were up about 6% year over year. Growth from the linked quarter was also about 6%, stronger than typical seasonal growth. Continuing momentum and new account originations and credit line increase programs drove loan growth in the quarter.

Purchase volume, on general purpose credit cards, which excludes private label credit cards that don't produce interchange revenue, grew about 18% year-over-year. Revenue margin for the quarter decreased modestly to about 17.3%, consistent with normal seasonality. Revenue dollars grew 5% year over year, in line with average loan growth.

As expected, non-interest expenses increased significantly from the third quarter. Strong growth opportunities drove higher marketing, and operating expense increased to support loan and account growth, as well as our continuing investments to be a digital leader and meet rising industry regulatory requirements.

Credit trends in the fourth quarter were in line with our expectations. Last quarter we explained that the third quarter charge-off rate was unusually low. It was the seasonal low point for charge-off rate and also included the temporary benefit from better than expected delinquency rates in early 2014.

In the fourth quarter, charge-off rates increased 56 basis points to 3.39%. About half of the increase resulted from expected seasonality, and about half from normalization of the temporary delinquency favorability. The fourth quarter delinquency rate increased in line with normal seasonal patterns.

Our expectations for the charge-off rate have not changed. We continue to expect the quarterly Domestic Card charge-off rate throughout 2015 to be in the mid to high 3% range. We expect normal seasonal patterns throughout the year, including an increase in the charge-off rate in the first quarter.

In addition to seasonality, we continue to expect that loan growth will impact the charge-off rate, as new loan balances season, they put upward pressure on losses. While this impact on the charge-off rate will be modest at first, we expect that the impact will grow throughout 2015 and beyond.

In addition to rising charge-offs, we expect loan growth to drive allowance additions. For the full year 2014, the biggest story in our Domestic Card results was the return to growth. Ending loans grew 6%, and general purpose credit card purchase volume grew 16%. Revenues declined 5%, driven by our choice to sell the Best Buy portfolio.

Excluding the revenue impact of the portfolio sale, full-year 2014 revenues were flat, in line with average loans. Non-interest expense declined 6% with lower operating expense partially offset by higher marketing. Lower operating expense resulted from tight cost management across the business, lower acquisition related expenses, taking out costs associated with the Best Buy portfolio and the absence of a non-recurring legal reserve that impacted 2013 expenses.

Revision for credit losses improved modestly with lower charge-off rate offset by additions to the allowance. The rekindling of growth, along with our continuing focus on delivering strong and resilient returns, enabled the Domestic Card business to post strong net income while improving the quality of our franchise in 2014. Our card business remains well positioned.

Moving to slide 8, the Consumer Banking Business delivered another quarter of solid results. Ending loans were up about 1%, from both the linked quarter and the prior year. Growth in auto loans continues to be offset by expected mortgage runoff. Auto originations increased about 25% year over year, driven by strong auto sales and deepening relationships with our existing dealers.

Ending deposit balances were essentially flat compared to both the linked quarter and the prior year. We've had an abundance of deposits since the ING Direct acquisition, and we've been allowing the least attractive deposits from Capital One's legacy Direct Bank to run off. On a linked quarter basis, consumer banking revenue was up 2%. Non-interest expense increased $89 million, or 9% from the linked quarter, driven mostly by auto loan growth, infrastructure and digital investments, and higher marketing.

And provision for credit losses increased $24 million from the linked quarter, driven by expected seasonal trends in auto charge-offs. For the full year 2014, revenues were down 3%, driven by the impact of persistently low interest rates on the deposit business, declining mortgage balances, and margin compression in auto. Auto loan growth partially offset these negative revenue impacts.

Full year non-interest expense was up 3%, driven by auto loan growth and the change in the income statement geography of where we recognize auto repossession expenses. Full year provision for credit losses increased $47 million, or 7%, consistent with the gradual normalization of auto charge-offs, and allowance builds for auto loan growth.

Full year 2014 trends show that our consumer banking businesses are delivering solid performance in the face of continuing industry headwinds. While our auto business remains well positioned, we remain cautious and continue to closely monitor pricing, underwriting practices, used vehicle prices, and other competitor and market factors.

Returns on new origination vintages are lower than returns in the overall auto loan portfolio, but remain resilient and above hurdle. And in our retail deposit business, we expect that the inexorable impacts of the prolonged low rate environment will continue to pressure returns, even if rates rise in 2015.

As you can see on slide 9, our Commercial Banking Business delivered another quarter of profitable growth. Strong loan growth continued in the quarter, although the pace of growth is slowing. Loan balances increased about 2% in the quarter, and 13% year over year. Most of this growth is in specialized industry verticals, in C&I lending, and CRE.

Loan yields declined 6 basis points in the quarter, and 59 basis points compared to the prior year, driven mostly by increased competition, lower tax equivalent yield and our choice to originate more variable rate loans. The declining trend in loan yield stabilized somewhat in the quarter. Revenues increased 5% from the third quarter and about 2% from the prior year. Year over year, higher loan volumes have been largely offset by declining yields.

Non-interest expenses were up 4% from the prior year and 9% from the third quarter, as a result of growth in our portfolio and continuing infrastructure investment. Provision for credit losses increased $23 million from the linked quarter to $32 million. Charge-offs, non-performing loans and criticized loans remain strong in the fourth quarter. The current levels of commercial credit results are exceptionally low, and we continue to closely manage credit risk.

For the full year, ending loans grew 13% and average loans grew 17%. Revenues grew 6% as volume growth was partially offset by declining yields. Non-interest expense grew 13%, moderately lower than the growth in average loans. Provision for credit losses increased $117 million from a negative $24 million to positive $93 million, driven entirely by the swing from allowance releases in 2013 to allowance builds in 2014.

Our Commercial Banking Business is well positioned to navigate current market conditions. While falling oil prices are likely a positive for our consumer businesses, we're closely monitoring and managing the potential impact of low oil prices on our $3.7 billion energy portfolio. And competition remains intense in the commercial banking business, pressuring margins and returns. It's likely that the pace of our commercial loan growth will be slower in 2015. But we expect our Commercial Banking Business will continue to deliver solid results.

Pulling up, commercial banking is thriving at Capital One . The business has steadily and profitably grown to over $50 billion. We've built deep industry specialties and established great relationships with our commercial customers.

I'll conclude my remarks this evening on slide 10. 2014 was a strong year for Capital One . As Steve mentioned, we delivered 2014 pre-provision earnings of about $10.1 billion.

We posted strong earnings. We strengthened our balance sheet. We returned to growth in our card business and continued to prudently grow our auto and commercial businesses. We improved the quality of our franchise. And we returned significant capital to our shareholders.

We're poised to build on the momentum in 2015. Our expectations for 2015 include the impacts of the investments we've been discussing for several quarters. In our Domestic Card Business, we see attractive marketing opportunities to drive future growth. Marketing efficiency, costs to acquire new accounts, and the net present value of our marketing investments are strong.

We'll continue to invest to drive and support growth in loans, deposits, and account relationships across our businesses. We're making significant investments in our foundational infrastructure and capabilities to be a digital leader. Banking inherently is a digital product and digital will transform banking over time.

Capital One is well positioned to succeed in the digital world, with our heritage as an innovative information-based company. We are committed to deeply embedding digital in how we work, not merely bolting digital onto the side of our Company.

We're also spending to continue to meet rising industry regulatory requirements. We're enhancing our capabilities, infrastructure and talent to deliver on the broad set of expanding regulatory requirements and meet increasing expectations for risk management and regulatory reporting. And we're continuously improving processes for capital and liquidity management, including CCAR and the new LCR.

Capital One is delivering attractive risk adjusted returns today and we expect that that will continue. We have the financial strength to invest in our future without compromising current financial results. Pulling all this together, in 2015, we expect growth in full-year revenues driven by a growth in average loans. We expect that full-year marketing and operating expenses will both be higher in 2015 than they were in 2014.

Let me turn to our efficiency ratio, specifically our expectations for the full-year 2015 efficiency ratio. In July, we articulated an expected range of 53% to 54% excluding non-recurring items. We reaffirmed that range in October. Since then, we've experienced a sizable adverse change in interest rates. As a consequence, we now expect full-year 2015 efficiency ratio to be between 53.5% and 54.5%, excluding non-recurring items.

This change in range is driven entirely by the movement in rates. We don't take this change in expectations lightly, but we don't believe we should make long-term business decisions based on spot prices for interest rates. We continue to manage costs very tightly across our businesses, while making our planned expenditures to drive growth, be a digital leader and continue to meet rising industry regulatory requirements. These expenditures are essential to our ability to deliver strong shareholder returns on a sustainable basis.

We also expect that efficiency ratio will vary, perhaps significantly from quarter to quarter, based on factors such as day count, the timing of growth, and associated revenues, and the timing of investments throughout the year. Pulling up, our strategic priorities for 2015 have not changed, and we remain focused on the levers to create value and sustain strong performance.

We'll continue to pursue growth opportunities in card, auto, retail banking, and commercial banking. We'll maintain our longstanding discipline in underwriting across our businesses and our preemptive focus on resilience.

We'll manage costs tightly while we invest to grow, be a digital leader and to continue to meet rising industry regulatory requirements. And we'll actively work to return capital to shareholders, as capital distribution remains an important part of how we expect to deliver value to our investors.

And now Steve and I will be happy to take your questions. Jeff?

QUESTIONS & ANSWERS

Jeff Norris (SVP - Global Finance):

Thanks, Rich. We'll now start the Q&A session. As a courtesy to the other investors and analysts who may wish to ask a question, please limit yourself to one question plus a single follow-up. If you have any follow up questions after the Q&A session on the call, the investor relations team will be available after the call to answer them. Vickie, please start the Q&A session.

Operator:

(Operator Instructions)

We'll take our first question from Moshe Orenbuch with Credit Suisse.

Moshe Orenbuch (Analyst - Credit Suisse):

Rich, can you talk a little bit about the competitive environment, both in the branded card business and in the retail card business? I saw one of your competitors announced a portfolio acquisition today. Are there any things you could kind of discuss in that area?

Richard Fairbank (Chairman, CEO):

Yes, the -- Moshe, the competitive environment in the card business I would describe as, you know, intense but consistent and fairly rational. Industry balances remain flat -- have been flat for quite awhile. Now we're seeing a little bit of growth. Of course there have been some increases in marketing levels with respect to direct mail.

You can certainly feel in the rewards segment in particular, especially in cash-back products, a lot of competition, and it manifests itself in their version of teaser rates, which is early spend bonus offers. Long-term pricing in general has been stable in the segments that we compete in.

And overall, while again I think it is intense, I would describe this industry as pretty rational and more stable than the other markets that we compete in, most notably auto and commercial. That was a description of the branded card business.

The partnership business, which, as you know, Moshe, is sort of a deal flow business, and as one who has certainly been around the branded card business for more than a couple of decades, the most striking difference between these two businesses is the auction nature of the partnerships. And that has -- that is the biggest factor that leads this business to have, in my opinion, on an apples to apples kind of basis, lower inherent returns, and, you know, the wild card of the marketplace and the nature of sort of auction prices that exist at any point in time.

There are a number of partnerships that are sort of, quote-unquote, up for grabs in the marketplace. I would stress that one of the characteristics of this business is the significant majority of all partnerships actually sort of stay with the incumbent, but they certainly go -- nonetheless, most go through the RFP process.

So there's fair amount of activity in this space, and I am struck by how competitive that is, and certainly we've been to some auctions where people are stepping up and paying prices in excess of what we're comfortable with. But certainly I would describe that as pretty intensely competitive, and one that we're going to stay very disciplined.

Moshe Orenbuch (Analyst - Credit Suisse):

Just as a quick follow-up, Costco Canada launched a couple weeks ago for you guys. Anything you can tell us about it?

Richard Fairbank (Chairman, CEO):

Well, we were very happy to win the Costco partnership in Canada, and this of course, is a premier retailer with an amazing customer base. That partnership I think is off to a very good start, but that is very early days, and -- but it's a manifestation of the strategy that we have in the partnership business which is to try to focus more on the sort of, the premier players in the marketplace. That is where, of course, there's more intense competition to win these partnerships, but one that I think the players are more focused on really using these partnership card relationships as a way to really drive value for customers. And that lines up exactly with the value that we think we can add.

Jeff Norris (SVP - Global Finance):

Next question, please.

Operator:

We'll go next to Matt Burnell with Wells Fargo Securities.

Matt Burnell (Analyst - Wells Fargo Securities):

Good afternoon. I noticed there was an absence of PP&R guidance, although you did suggest that revenues would be higher in 2015, marketing and operating expenses would be higher in 2015. Would you be able to provide us some PP&R guidance, or does it sound like the revenue increase would offset the increase in expenses and therefore you would end up with about $10 billion again in pre-provision net revenue but with higher loan loss provisions?

Steve Crawford (CFO):

Matt, thanks for the question. We didn't give you PP for a specific reason, but what we did do is give you a lot of the building blocks. First of all, we've said that basically revenues are going to be driven by growth in average loans. We've obviously provided you an update on the efficiency ratio, and in addition, what we didn't do last year but have done this year is give you a sense for where charge-offs are going and our biggest business was in card.

So we really are trying to provide kind of the major building blocks. The primary unknown for us is the ultimate growth that we're going to experience in card. And that really contributes to almost every part of the income statement in an important way, and it's why we're reticent to be as specific on a particular number as we were in prior years.

Matt Burnell (Analyst - Wells Fargo Securities):

Fair enough. And then in terms of the US billed business, you had what appears to be stronger purchase volume in the fourth quarter on a year-over-year basis than many of the other domestic competitors, although the unit change was a little below our expectations. Is there some dynamic there that you can provide additional color on in terms of the growth in the spending but somewhat lower growth in the interchange?

Steve Crawford (CFO):

Yes, Matt. First of all, I want to say that the net interchange metric can have quarter-to-quarter variability, because it includes partnership contractual payments and international card, and we also periodically adjust our rewards liabilities based on customer trends and redemption rates and things like that.

But even beyond that, variability, and sort of if you look past quarterly noise, the phenomenon you're talking about is real and the net interchange growth has generally lagged general purpose credit card interchange growth for Capital One , and we would expect this trend to continue.

Our rewards programs have been, and they continue to be, very successful, with of course flagship products like Quicksilver card, the Venture card, the Spark card for small business. We're also building a long-term franchise by upgrading rewards products for our existing rewards customers, and in many ways consistent with the industry, extending rewards products to some existing customers what don't have rewards.

And there's some near-term cannibalization when we do this, but it's all part of building a stronger, deeper customer franchise. But the net effect of all of this, including leading with great flagship products, all of this contributes to that delta that we think will continue, although there will be a lot of volatility in that between purchase volume growth and interchange growth.

Jeff Norris (SVP - Global Finance):

Next question, please.

Operator:

We'll go next to Don Fandetti with Citigroup.

Don Fandetti (Analyst - Citigroup):

Yes, thanks. I wanted to follow up on the comments about the loan growth, and the potential variability. It seems like you'd have sort of a general sense of where things would be headed in terms of the market and your market shares. Is the variability maybe private label? Can you just talk a little bit about where could you go from here? Are you feeling like the 6% number could have upside?

Richard Fairbank (Chairman, CEO):

I think I learned quite long ago that when you have growth opportunities, trying to predict the growth rate at least from the way we do business at Capital One is just something that's not probably in anyone's interest. Because, just to reflect on how we make our decisions, we as you know, we're fanatical information-based company and across all the segments and sub-segments we're in, we are reading the data that is coming back and readjusting constantly our choices and so on.

What you have seen from our commentary for a number of quarters now, and this commentary even actually preceded when you started to see our growth numbers, is that we believe we're well positioned for -- to grow in ways that are right down the power alley of Capital One and the product of having invested for years, to have this competitive position and this opportunity. That said, I've been around the block enough to know that the market can change, and most importantly, competitive dynamics can change.

So what we do is try to share with you a general sense of -- and hopefully you can feel that reflected in the comments, a general sense of about the opportunity. And I say yet again now, and it's been several quarters that I've been saying it, I think we see a nice growth opportunity in front of Capital One .

I don't think we want to quantify this, but what we're going to do is, seize the opportunity as we have it, and, you know, when windows of opportunity, if they change, then we change accordingly. But this is why comments like marketing will be up and we think the growth opportunities for next year, that would be consistent. And in many ways, my message and the feel is pretty similar to the message I've been saying for a number of quarters now.

Don Fandetti (Analyst - Citigroup):

Thank you.

Jeff Norris (SVP - Global Finance):

Next question, please.

Operator:

We'll go next to Sameer Gokhale with Janney Capital Markets.

Sameer Gokhale (Analyst - Janney Capital Markets):

Hi, thank you for taking my questions. I was just curious in terms of the efficiency ratio guidance, if you could just clarify, have you assumed any sort of interest rate increase in the second half of 2015? I know some other banks have, so I was just curious about that, then I had another follow-on. Thank you.

Steve Crawford (CFO):

Yes, so our interest rate forecast that we use is based on forward, so there are some modest increases in the second half that we would have.

Sameer Gokhale (Analyst - Janney Capital Markets):

Thank you. I was trying to think of the interplay between, say, your consumer, and when I say consumer, just thinking catch-all, everything ex commercial loans, but the efficiency ratio dynamics between your commercial lending activities or commercial banking versus consumer banking. I know many other regional banks have actually had significant pressure in terms of managing their efficiency ratio primarily because of revenue pressures.

So I was curious from your standpoint, have you implemented any structural changes to try to bring the efficiency ratio down in the commercial bank, and how do you think of the interplay of commercial versus consumer? Are they moving in the same direction, or one is offsetting the other? That would be helpful. Thank you.

Steve Crawford (CFO):

So, Rich, I'm sure you may want to add to this. I think the biggest thing that the industry has talked about with respect to the efficiency ratio is the rate environment, and how that impacts pretty much all of the businesses. And I think you saw a lot of commentary from a number of players that it would be difficult to improve their efficiency ratio unless we had more of a normalization in the rate environment. And that plays out in the commercial and the consumer business probably more than it does in the card business.

Richard Fairbank (Chairman, CEO):

And the other things that affect efficiency ratio of course is what's happening on the cost side, the investment side, and if you think about the drivers of our commentary about efficiency ratio and costs at the margin, one is growth opportunities. We have been stepping up increasingly sort of in the card business to invest because we see particular opportunities there.

On the commercial side, if anything, our growth opportunity is decelerating because of the choices that we're making in response to market conditions. But those are factors that will play out over time.

The regulatory costs are pretty much all across the enterprise, and that's going in only one direction, and I'd be pretty surprised if over the next few years there's any forces that would move those cost pressures in the opposite direction. And finally the investment in digital.

And while digital is a big opportunity across consumer and commercial, certainly on a relative basis, I think the revolution is going to be greater on the consumer side, and it's literally going to transform all aspects of how banking is done. It's going to transform, not only as people often think through the lens of the customer experience, but really the whole way retail distribution works, the way operations, marketing, servicing and even something that's very, very core to how Capital One works, which is information-based strategies itself. So it's -- this is a big deal on the commercial side. It's pretty much a revolutionary deal on the consumer side.

Jeff Norris (SVP - Global Finance):

Next question, please.

Operator:

We'll go next to Ken Bruce with Bank of America Merrill Lynch.

Ken Bruce (Analyst - BofA Merrill Lynch):

Thank you. Good evening. I guess I would -- trying to maybe reconcile between some of the comments that you're making around auto and still what is a very strong origination business for Capital One . Can you just give us some understanding as to how you believe you're navigating what is increasingly a very intensely competitive part of the market, please?

Richard Fairbank (Chairman, CEO):

So, Ken, we've been saying the same things for quite awhile about the auto business. And it sort of started with our comments for some -- for many of the years right after the great recession started raging, which is we went into this kind of -- I don't think it's an exaggeration to call it sort of a once in a lifetime confluence of events that led the auto industry, both from a growth and from a kind of returns and credit point of view, to be absolutely exceptional. And most of what we have seen happening since then is sort of a regression more toward normal, if you will.

So what's happened I think for Capital One and certainly for other players, with each passing quarter the intensity of the commentary that people in the business make is increased. But if we pull way up, we don't see things that are -- would cause us to have great alarm about the business, but what we see is just on the pricing side, increased pressure, although that stabilized, when I look at prime and subprime that's stabilized more recently, but frankly in the prime space at a below kind of cycle norm. So things are very tight there. The subprime space has been steadily declining, a little bit stable of late.

On the underwriting side, the most noteworthy place that there has been any risk expansion has been in terms of terms, and there's been significant growth of the over 72-month loans. But still things like LTVs, which are probably the single most important variable, have remained, certainly on the prime side, stable and healthy. On the subprime side, moderately increasing but well below sort of pre-recession levels.

More of the way I would characterize this auto business is that we just have to stay very, very vigilant, and what I find is, you know, our choices, sort of one dealer and one deal at a time, end up with the growth moderating in subprime, for example. Subprime has been flat for -- at Capital One , I think for -- in originations for about, I'm guessing, since 2011 I think it's been pretty flat.

So that essentially all of the growth in originations has been on the near prime and especially the prime side, so I think that's a manifestation of our reaction to the marketplace and continuing to pursue opportunity where it is prudent and where we can build deeper dealer relationships.

But I would say that the important thing I want to leave with you is while even new originations, you can see have pound for pound kind of a bit higher credit risk than some of the exceptional stuff of the past, the business that we are originating, we still feel is well above hurdle and we like the opportunity.

Ken Bruce (Analyst - BofA Merrill Lynch):

This is a follow-up. In terms of your guidance on credit card charge-offs, it seems that really what you're saying is just the seasoning of some of the recent growth is going to have an upward bias on the loss rates. You're not really witnessing deterioration in terms of the underlying portfolio.

Richard Fairbank (Chairman, CEO):

Absolutely. Absolutely. In fact, let me just talk a little bit about the credit situation in the card business. First of all, it feels to us pretty much exactly the same as when we talked about this a quarter ago. But just to put this in perspective, card credit has been exceptionally strong over the past few years. And our portfolio has benefited from the improving economy and a generally more disciplined consumer.

Our back book, which is made up mostly of customers who weathered the great recession, that continues to show exceptionally low risk and is very resilient. We see great opportunities for resilient a new business, but from the starting point of our highly seasoned back book, most new business will have higher losses.

So the credit performance of our new originations and our credit line increases has been strong and in fact it's meeting -- it is meeting and in some cases, even exceeding our expectations in a good way. Since we've returned to growth I have been emphasizing that as these new loan balances season, they will start putting upward pressure on cards' overall charge-off rate, and this impact is going to be modest at first but we expect to the grow through 2015 and beyond. And we've been growing in the segments we've always been focused on.

We continue to avoid the segments that we think lack resilience, even if they have quite nice returns in today's environment. And that's -- that is really the essence of our credit story, and we wanted to make sure that people exactly understand what is the dynamic that is leading charge-offs to increase.

But back to the original question that you asked, this is not driven by a worsening of credit performance of the existing book or anything like this. It's really the by-product of our seizing a growth opportunity and sort of the vintage math of that.

Jeff Norris (SVP - Global Finance):

Next question, please.

Operator:

We'll go next to Sanjay Sakhrani with KBW.

Sanjay Sakhrani (Analyst - Keefe, Bruyette & Woods):

Thank you. I guess a question on the revenue margin assumptions for 2015. I guess implicit in your revenues are going to grow with average loans is flattish revenue margin. Is that a fair statement?

Steve Crawford (CFO):

Talking about card?

Sanjay Sakhrani (Analyst - Keefe, Bruyette & Woods):

Consolidated.

Steve Crawford (CFO):

Yes. Plus or minus, I think that's right. We've got card obviously is a big contributor. The runoff of home loans is a positive on the other side, we've talked for awhile about compression in auto and commercial, and the biggest kind of unknown is what happens to the rate environment overall. So you put those all in the mix master, our best guess right now is relatively stable.

Sanjay Sakhrani (Analyst - Keefe, Bruyette & Woods):

And then my second question following up, Rich, you mentioned the impact of lower fuel prices on consumer. How do you factor that into your guidance for next year's charge-off? Does that marginally benefit that ratio? And then, I'm sorry, one quick data point question. Steve, if you could help out on the tax rate for 2015.

Steve Crawford (CFO):

Let me do the easier one first. Our tax rate will be -- you look at the tax rate for the year, our best guess is it will be plus or minus to the tax rate that we experienced for the year in 2014.

Richard Fairbank (Chairman, CEO):

Sanjay, I can only speak intuitively about the gasoline price impact. Obviously it would be kind of hard to measure at this point. One reason it's hard to see is, of course, the sharpest drops in gas prices have been just over the past three months. And any credit benefit from falling gas prices is going to be really hard to disentangle from other economic effects, but it's just clear that falling gas prices translates into the equivalent of a wage increase for most households.

I do want to caution though that the flip side of sustained low gas prices may be economic stress in geographies that are heavily dependent on the energy sector, so we'll have to keep that in mind. But just intuitively, I think you have a pretty good net positive for consumers overall. We are not putting any of that into our own projections. But, it is clearly something we're going to start to see if we can measure it. Most likely I think it's going to be embedded in an overall economic performance.

Jeff Norris (SVP - Global Finance):

Next question, please.

Operator:

We'll go next to Rick Shane with JP Morgan.

Rick Shane (Analyst - Jefferies):

Hey, guys, thanks for taking my question. This is a little bit esoteric, but I'm curious if there was any change in policy related to funds transfer pricing at the consumer bank either in terms of rate that you apply or balances.

Steve Crawford (CFO):

The short answer is no. My guess is the reason for the question is you're looking at the other part of our income statement and the change year over year, and the biggest driver there was treasury. There are other things in there as well. We've got corporate items that run through that tend to be lumpy but the biggest year-over-year change was treasury.

There were several reasons for the improvement in treasury in 2014, including change in rates, hedging actions we took in 2014 to manage the rate risk in our balance sheet, and improved securities yield because of slower runoff. And there were a couple of one-time items in there, too. We had roughly $70 million of expenses for redeeming of preferred issuance in 2013 that we didn't in 2014.

The one thing we did do a little bit along the lines of what you're talking about is with LCR coming on, we continued to refine the way that we charge our businesses for the liquidity that they use. So we were passing out more liquidity costs to the business consistent with things like LCR.

Rick Shane (Analyst - Jefferies):

Got it. Great. Thank you very much.

Jeff Norris (SVP - Global Finance):

Next question, please.

Operator:

Our next question comes from Eric Wasserstrom with Guggenheim Securities.

Eric Wasserstrom (Analyst - Guggenheim Securities):

Rich, in the past you've highlighted some of the areas in which you are also seeking cost savings. Vendor relationships is one that has been mentioned and I think there are a few others. Wondering if you could update us on the progress on those initiatives and whether all of that benefit gets reinvested or whether some of it gets manifested into earnings.

Richard Fairbank (Chairman, CEO):

Eric, there are a number of areas that we -- first of all, across the board, we've been working incredibly hard on expenses for a long time. And this is, of course, in the context of headwinds that are pushing things so hard in the other direction, and you can see over the -- starting the second half of 2012 and through 2013 and 2014, the trajectory of operating expense and, of course, some of that comes from deal-related expenses that sort of automatically happen.

We've also worked hard to make sure that we get the synergies we talked about in the deals and drive out the integration costs and things like that. Also, though, other big areas of focus have been the area of procurement, and we -- we always sort of worked hard at that, but by building a big centralized and almost the whole science about it and making it have the feel almost like a line of business, has been something that's even exceeded our own expectations. We pretty rigorously measure, not just talking to ourselves about how things are better, but really a before and after kind of thing, and that has led to some tangible -- pretty sizable tangible benefits.

Another area that, of course, should generate increasing benefit, is in digitization. So a lot of the impacts of digital are really sort of hard to measure, and it really relates to the way we work. But things like going paperless, driving people away from some of the more expensive channels into the digital channels, and some of the transformation in terms of marketing to be more online and so on. These have effects that we measure, and they -- the numbers are starting to grow.

On digital, just take digital itself, that is a net trade that has costs a lot higher than benefits at the moment in terms of what you can purely measure. Because we're investing heavily in digital, and all of our -- there's almost nothing that we're investing in digital where the primary objective is to save money.

This digital transformation is such a comprehensive revolution, it really allows for things to be faster and way better for the customer, a better associate experience, much better controlled from a compliance point of view, more scalable, and yes, lower cost.

So right now, one of the important net negative trades is what's happening on just the pure cost side with respect to digital. But, by the way, the overall economic benefits of digital, I would argue that an important reason that we're on the growth trajectory we're on in the card business is, in fact, because of our digital success, not only in terms of the customer experience, but really in things like how we do marketing and things like that. So this will -- I believe the long term payoff of the digital investment is going to be very significant in the near term, from the cost line this is going to be a net negative trade.

And, of course, the investment in the regulatory thing is very substantial, and of course we know which direction those things are moving. And the other thing on the cost side, of course is the investment in growth itself. And there the biggest number is, of course, marketing, but there are also operating costs that go along with that as well.

And as you know, Eric, that's our highest priority for our own expenditures, is to make sure that we're investing in our own growth and those investments will continue. So, net-net, you know, one minus all of that needs to be just, there's kind of a fanatical multi-year quest to wring out every single penny that we can, and all of that is -- nets out in this number that I'm sure some people look at and say, wow, with all the growth and all the digital somehow shouldn't that be lower.

Jeff Norris (SVP - Global Finance):

Next question, please.

Operator:

We'll go next to Ryan Nash with Goldman Sachs.

Ryan Nash (Analyst - Goldman Sachs):

Hi, good evening, guys. Just first on the card reserve. This is the second quarter provisions did come in a bit higher than some of us were expecting. Just given your outlook for mid to high 3 US card charge-offs how should we think about the reserve on top of the charge-offs, Steve? Is there a target of 13 months forward? How do we think about the right level that you guys manage the reserve to?

Steve Crawford (CFO):

So I'd go back to what Rich was talking about on credit, because that's really the driver of our reserve, and it's not as simple nor would it ever be as simple as we take 13 months of anything. It's actually looking at loss content in our portfolio. There are two things that are really going on. One is the growth that we've talked about, and unless you assume growth has zero losses, adding growth will drive up a need for allowance.

The second piece of it is a little bit of the mix movement that Rich talked about, from an incredibly low and resilient back book, to a very much expected but higher loss front book. And as that becomes more of the equation, that is going to drive up the loss content which ultimately is reflected in allowance.

It's not a matter of not wanting to be helpful to actually give you a sense as to where our allowance would end up. We have to accurately forecast 24 months of losses and 12 months of balances, and that's better than, frankly, anybody has been able to do, and we think we're pretty good at looking at how credit evolves.

So we're not trying to be difficult. It's just out beyond particularly your delinquency roll rates, I think it's very hard to predict credit from a quarter to quarter basis. So in general one can think a little bit how the balances are growing, as being the first factor, and a trend rate in losses being a second factor, but even that's not enough, because our balanced growth quarter to quarter has a seasonal component, right.

So the fourth quarter uptick that you see isn't necessarily going last throughout the entire year. So we're actually trying to figure out which of those components are going to be more lasting. So there's whole bunch of things going in there, but I think you can see, since we expect growth going up, since we've talked about losses going up, there's going to be more need for allowance going forward.

Ryan Nash (Analyst - Goldman Sachs):

Got it. Steve, Rich talked about digitization. Can you size for us how big these costs are and over what time frame, and we've seen a lot of other banks try to self-fund a lot of these investments, and to what extent do you think you can self-fund these? Just related to the near term, can you at least commit to PP&R growth in 2015?

Steve Crawford (CFO):

I think we said we expect to grow revenue, and we expect our efficiency ratio basically to be flat to a little bit down on a GAAP basis. So I would draw a conclusion from that, that we expect PP&R to grow. We'll leave it more up to you as to by how much.

We're not going to go through and kind of evaluate how much of the spend is digital. I think we're trying to do a whole bunch of things here. Deliver very good returns in the near term, but also make sure we can do that for the next 20 years. And as we try and set our priorities, it's kind of cognizant of both factors. And so far we think we've done a pretty good job managing that and plan on continuing to going forward.

Richard Fairbank (Chairman, CEO):

Let me just add to that, that I want to go back to a comment I made before, and some other banks may feel differently about this, but I think it may also manifest what we're trying to achieve here. I think in the long run there is going to be very significant cost benefit from all these digital investments. But the biggest benefit and the reason we're doing it is, in almost all cases not for that reason.

And what I'm most excited about is actually the opportunities to generate growth and to generate better real-time decision making, to make better credit decisions, and in the end, build a deeper franchise through very significant improvements in the customer experience and things that really create more loyalty and more stickiness with customers.

And so over the years it will be very, very hard for us to measure that, because digital investments are turning -- are more and more turning us into a digital company as opposed to a company that just tries to digitize what they do, or the phrase I said earlier, to bolt digital on the side of a bank.

So it's more and more becoming over a longer period of time, who we are in terms of how we operate and how we make decisions and how information is used in the company. And if you notice my passion about this it's because I have not seen -- and probably this speaks for mankind as well, over our long history -- but certainly I haven't seen anything remotely like this in terms of the ability to transform how a business works. The only parallel is the thing that led me to go out and build Capital One in the first place, was looking at how information and technology were going to transform, starting with the card business and ultimately banking.

This is going to be a very, very big change, and I think its biggest impacts will not be the impacts that they have on cost. But what is also clear is that for anything as transformational as this, one has to, on a sustainable basis, invest to build the foundational capabilities upon which the sort of digital innovation that the world can see will occur. And this is going to be a longer journey, but I think it's ultimately as significant a transformation as what the information based opportunity we saw 20-some years ago turned out to be.

Steve Crawford (CFO):

Just one last thing. One other hesitation with separating out these expenses, is the overlap between our expenses. So things that one considers to be digital that also have enormous regulatory impact or enormous growth impact is pretty considerable. So the three things we've talked about that are growing, causing a growth in investment, kind of overlap in a lot of ways.

Richard Fairbank (Chairman, CEO):

The pretty much number one way to make sure that we're successful with respect to the breathtaking number of compliance requirements is, in fact, automation. Just trying hard and making sure we're well organized just doesn't cut it with the magnitude of what's going on. So it's just another aspect of the breadth and depth to which investment in digital can really put a company in a very good position.

Jeff Norris (SVP - Global Finance):

Next question, please.

Operator:

We'll go next to Chris Donat with Sandler O'Neill.

Chris Donat (Analyst - Sandler O'Neill):

Thanks for taking my question. Just wanted to follow up on the issue of the provision as we look forward, given there have been a lot of changes in consumer behavior and timeliness of payment, I'm just wondering if the assumption that new originations for card loans will have their peak charge-offs in 18 to 30 months.

Is that based on what we're seeing sort of post crisis, or is that really based on what we experienced over the history of the credit card business? I'm just wondering if anything is there that might be different this time around.

Richard Fairbank (Chairman, CEO):

Okay. Well, first of all, there's a few different phenomenon that are going on. When we talk about our charge-offs, especially in the second half of next year and into 2016, going up as a result of growth, that is the composite effect of all the different vintages of actions that are being taken, and I want to separate out a couple of different effects. One is originations, and one is credit line increases.

These themselves have quite different dynamics. They also have quite different flow in terms of many other metrics, including the timing of profitability and costs in the near term and so on. But with respect to credit, I would characterize credit line increases tend to -- right when they happen, they have a benefit with respect to losses, and then over time the charge-offs on a more delayed basis build over time.

Originations tend to -- they have a momentary kind of benefit from the speed boat effect that they have, but then they tend to peak earlier, and then actually improve over the longer term. And again, our credit guidance is just a sort of composite of all the different things that are going on. We have sizable credit line increase activity. We have very significant origination activity that's been going on over the past year, and we hope will continue.

And the most important thing we have wanted to do is just make sure that, as we started signaling some time ago, the charge-off math of this very good development for Capital One is pretty predictable, and we want to just make sure we got in front of that, and that's what we've done.

Chris Donat (Analyst - Sandler O'Neill):

Okay. So no real change in either -- from the originations or the credit line increases in consumer behavior kind of pre crisis versus post crisis, right?

Richard Fairbank (Chairman, CEO):

Well, so not in terms of the shapes of these curves. The consumer behavior pre crisis was, you know, tended to lead to what turned out to be higher losses in a lot of things back then. That was not nearly as cautious a consumer as now. So just about anything we do these days versus an equivalent action in 2006 or 2007, certainly we would expect would peak in a better place.

But the main thing is, we're also saying is that paradoxically, even as we are guiding to higher credit losses, and frankly guiding to more growth in credit losses than it appears that our competitors are, this is in the context of a very stable and good credit environment.

It's in the context of originations that are coming in very much as expected and consistent with what we've seen recently, and one that is really, therefore, entirely just the result of charge-off math associated with acceleration of growth and frankly going strikingly from a shrinking situation into one of pretty good growth.

Chris Donat (Analyst - Sandler O'Neill):

Got it. Thanks very much.

Richard Fairbank (Chairman, CEO):

Thank you.

Jeff Norris (SVP - Global Finance):

Next question, please.

Operator:

Our final question this evening comes from Brian Foran.

Brian Foran (Analyst - Nomura Securities):

The only thing I have left is on the rep and warranty reserve. I think you -- if you could give us any color on the $1.1 billion going to $700 million. Was there a settlement and should we expect the reasonable possible losses to come down in tandem?

Steve Crawford (CFO):

The reasonable possible losses we'll have to wait until the 10-K but, yes it was settlement activity that were the primary driver of the reduction in the reserve.

Brian Foran (Analyst - Nomura Securities):

Great. That was it for me. Thanks.

Steve Crawford (CFO):

Thanks, Brian.

Jeff Norris (SVP - Global Finance):

Okay. Well, with that, I'll just say thanks to everyone for joining us on the conference call today, and thank you for your continuing interest in Capital One . And remember the Investor Relations team will be here this evening to answer any further questions you may have. Have a good night.

Richard Fairbank (Chairman, CEO):

Thank you.

Operator:

That does conclude our conference, we thank you for your participation.