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Capital One Financial (COF) Earnings Report: Q3 2015 Conference Call Transcript

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

Company Participants

- Jeff Norris; Capital One Financial; SVP of Global Finance
- Steve Crawford; Capital One Financial; CFO
- Rich Fairbank; Capital One Financial; Chairman & CEO

Other Participants

- Betsy Graseck; Morgan Stanley; Analyst
- Moshe Orenbuch; Credit Suisse; Analyst
- Sanjay Sakhrani; Keefe, Bruyette & Woods; Analyst
- Ryan Nash; Goldman Sachs; Analyst
- David Ho; Deutsche Bank; Analyst
- Don Fandetti; Citigroup; Analyst
- Chris Brendler; Stifel Nicolaus; Analyst
- Bill Carcache; Nomura Securities; Analyst
- Chris Spahr; CLSA; Analyst
- Rick Shane; JPMorgan; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

Welcome to the Capital One Third Quarter 2015 Earnings conference call. Today's call is being recorded.

(Operator Instructions)

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

Jeff Norris (SVP of Global Finance):

Thanks very much. Welcome, everybody, to Capital One's third-quarter 2015 earnings conference call.

As usual, we are webcasting live over the Internet. To access the call on the Internet, you can log on to Capital One's website at CapitalOne.com and follow the links from there. In addition to the press release and financials, we've included a presentation summarizing our third-quarter 2015 results.

With me this evening are Mr. Rich Fairbank, Capital One's Chairman and Chief Executive Officer, and Mr. Steve Crawford, Capital One's Chief Financial Officer. Rich and Steve are going to walk you through this presentation. To access a copy of the presentation and press release, please go to Capital One's website, click on Investors, and 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 and the

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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 materially from those described in forward-looking statements. And for more information on these factors, please see the section entitled Forward-Looking Information in the earnings release presentation and the Risk Factors section in our annual and quarterly reports accessible at the Capital One website and filed with the SEC.

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

Steve Crawford (CFO):

Thanks, Jeff. For the third quarter, Capital One earned $1.1 billion or $1.98 per share and had a return on average tangible common equity of 14.3%. On a continuing operations basis, we earned $1.99 per share. Net income was up $251 million versus the prior quarter, driven by higher linked-quarter pre-provision earnings and slightly lower provision expense.

Pre-provision earnings increased by $375 million versus the prior quarter, as we had higher revenue and lower non-interest expenses. As a reminder, we had $188 million of nonrecurring operating expenses in the second quarter. Excluding nonrecurring expenses, operating expenses were relatively flat versus the prior year.

Provision for credit losses decreased 3% on a linked-quarter basis, driven by a smaller allowance build. During the quarter, we added $69 million to our UK PPI reserve, with $49 million as a contra revenue and $20 million in operating expense. We have included an appendix slide in our earnings presentation, available on our website, illustrating the impacts from nonrecurring items to key line items and ratios in both the quarter and year to date.

The increase in our UK PPI reserve is driven by proposed new rules announced by the FCA in early October. As always, our 10-Q will provide further details on the factors we consider in estimating our reserve. Excluding the impact from the build in UK PPI reserve, earnings per share in the quarter were $2.10 per share.

Turning to net interest margin, as outlined on slide 4, reported NIM increased 17 basis points in the third quarter to 6.73%, primarily driven by higher loan yields in domestic card and an additional day to recognize revenue in the third quarter. We continue to be above the fully-phased-in LCR requirements as of September 30, 2015.

On slide 5, you can see our common equity Tier 1 capital ratio on a Basel III standardized basis was 12.1% as of September 30, 2015. On a fully-phased-in basis, we estimate the standardized ratio would be approximately 11.8%. This fully phased-in ratio is subject to change once we exit parallel run, and we expect it to be lower.

We reduced our net share count in the quarter by 7.6 million shares, primarily reflecting our share buyback actions. We entered parallel run for Basel III advanced approaches on January 1, 2015. And we continue to estimate that we are above our 8% target.

Let me now turn the call over to Rich.

Rich Fairbank (Chairman & CEO):

Thanks, Steve. I will begin on slide 7 with our Domestic Card business. Strong growth continued in the quarter. Year over year, ending loans and average loans were both up 12%; and purchase volume was up

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about 19%. We continue to see attractive and resilient growth opportunities in the Domestic Card business.

Revenue increased 10% year over year, slightly lagging average loan growth. Revenue margin declined year over year and remains healthy at 17%. Year-over-year non-interest expenses increased 7%, with higher marketing and growth-related operating expenses as well as continuing digital investments.

Credit continues to perform in line with our expectations in both our existing portfolio and our new originations. Two factors are driving our current credit trends and expectations.

First is growth math, which is the upward pressure on delinquencies and charge-offs as new loan balances season and become a larger proportion of our overall portfolio.

The second is seasonality. The third quarter has always been our seasonal low point. As a reminder, all else equal, seasonality results in increasing charge-off rate in the fourth quarter, rising to peak charge-off rate in the first quarter. This pattern has been particularly pronounced for the last couple of years, and we expect that to continue.

In the third quarter, the charge-off rate improved 34 basis points from the linked quarter to 3.08%, driven by seasonality. Year over year, the charge-off rate increased 25 basis points, primarily as the result of expected growth math impact. We still expect the quarterly charge-off rate to be in the mid to high 3% range in the fourth quarter. And in 2016, we expect the full-year charge-off rates to be around 4%, with quarterly seasonal variability.

Loan growth, coupled with our expectations for rising charge-off rates, drove an allowance build in the quarter. And we expect these same factors to drive allowance additions going forward.

Slide 8 summarizes third-quarter results for our Consumer Banking business. Ending loans were flat compared to the prior year. Growth in auto loans was offset by expected mortgage runoff. Auto loan growth is predominantly prime, as subprime auto originations have been essentially flat for several quarters. As a result, the mix of our auto loans is shifting toward prime.

Consumer banking revenue was up 1% year over year. Higher revenues from growth in auto loans was largely offset by the impacts of persistently low interest rates on the deposit business, declining mortgage balances, and margin compression in auto. Non-interest expense increased 5% year over year, driven by infrastructure and technology expenses in retail banking and growth in auto loans.

Provision for credit losses was relatively flat compared to the prior year at $188 million. Auto originations increased about 3% year over year and from the linked quarter.

We've discussed increased competition in pricing and underwriting for some time. In the third quarter, we continued to see aggressive underwriting practices by some competitors, particularly in subprime.

We continue to lose some contracts to competitors who are making more aggressive underwriting choices. We've also seen some softening in used-vehicle values, although they remain near historically high level. We will continue to pursue opportunities in auto lending that are consistent with our longstanding focus on resilience, including adding new relationships with well-qualified dealers and gaining greater share of prime originations with existing dealers.

Our Consumer Banking businesses face continuing headwinds. Persistently low interest rates will continue to pressure returns in our deposit businesses, even if rates begin to rise in 2016. Planned mortgage runoff continues and auto margins are compressing from exceptional levels due to the mix shift toward prime and continuing competitive pressure. We expect these trends will negatively affect revenues and efficiency ratio for the remainder of 2015 and in 2016.

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Moving to slide 9, I will discuss our Commercial Banking business. Ending loan balances increased 5% year over year and 2% from the linked quarter, with most of the growth in specialized industry verticals in CRE and C&I. Average loan balances were up 6% year over year.

As we have been signaling, our growth has slowed compared to prior years because of choices we're making in response to market conditions. While increasing competition is pressuring loan terms and pricing in plain vanilla CRE and C&I, we continue to see good growth opportunities in select specialty industry verticals.

Revenues for the quarter were essentially flat compared to the prior year and down 5% from the linked quarter. Continuing spread compression drove the quarterly revenue trends. Year to date, revenues are up 7% with 9% growth in average loans partially offset by the 22-basis-point decline in loan yields. Credit performance remains strong for the majority of our Commercial businesses, but credit pressures continue in the oil and gas and taxi medallion portfolios. Provision for credit losses increased $66 million from the prior year to $75 million, with higher charge-offs and allowance build.

The charge-off rate of 26 basis points was up from both the prior year and the linked quarter, driven by charge-offs of taxi medallion loans. We've built allowance over the last four quarters in anticipation of increasing risk in oil and gas and taxi medallion loans.

In the third quarter, nonperforming loans were up $292 million from the prior year to $453 million, and the NPL rate was up 55 basis points to 0.87%. These trends resulted from downgrades of oil and gas loans and, to a lesser extent, downgrades of taxi medallion loans. On a linked quarter basis, NPL rate improved three basis points.

We remain highly focused on managing credit risk and working with our oil and gas customers. Through Hibernia, we have been in this business for more than 50 years through multiple cycles. Of our approximately $3.2 billion portfolio of oil and gas loans, around half is in exploration and production. In this part of the business, loan structures provide some protection against the oil price cyclicality.

Around a third of our energy loans are in oil field services. We expect this part of the business will continue to present challenges, and we have been building reserves to reflect that concern.

Our taxi medallion loan portfolio is less than $1 billion in loans. In the face of growing competition from Uber and other entrants, taxi medallion values continue to be under pressure. And we continue to closely manage risk in this sector.

Finally, in the quarter we announced the acquisition of the GE healthcare finance business, which will add approximately $8.5 billion in loans to our existing healthcare specialty business. We are thrilled to welcome GE healthcare's outstanding leadership and talented associates to Capital One. The acquisition catapults us to a leading position in an industry with strong growth potential. We expect to complete the acquisition by the end of the fourth quarter.

Capital One posted solid results in the third quarter, highlighted once again by strong growth in our Domestic Card business. We are delivering attractive risk-adjusted returns today and investing to grow and sustain returns in the future.

We continue to expect full-year 2015 efficiency ratio will be around 55%, excluding nonrecurring items. Our expectation for full-year efficiency ratio implies a significant increase in fourth-quarter non-interest expense and fourth-quarter efficiency ratio. Both efficiency ratio and NIE are subject to potentially significant quarter-to-quarter variability. Both typically increase in the fourth quarter.

And growth-related operating and marketing costs will likely accentuate the fourth quarter increased this

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year. Given these three factors, we are still estimating full-year efficiency ratio will be around 55%, even though the third-quarter efficiency ratio is meaningfully lower.

In July, we said that we didn't expect much improvement in full-year 2016 efficiency ratio compared to full-year 2015. Since we gave that guidance just one quarter ago, the outlook for interest rates has reduced 2016 forecasted revenues. However, we remain optimistic about our progress and the trajectory of the underlying operating drivers of efficiency ratio.

We are managing costs tightly across our Business.

Our card growth will create positive operating leverage and, while not solely motivated by cost savings, our digital investments are already delivering tangible savings and productivity gains in servicing, core infrastructure and our legacy operations. We expect that these savings will grow and will help operating leverage over time. As we move three months closer to 2016, we expect modest improvement in full-year efficiency ratio in 2016, excluding nonrecurring items.

Pulling up, Capital One is well-positioned to deliver attractive shareholder returns over the long-term, with growth potential and sustained returns at the higher end of banks, as well as significant capital distribution subject to regulatory approval.

And now Steve and I will be happy to answer your questions.

Jeff?

Jeff Norris (SVP of Global Finance):

Thanks, Rich. We will now start the Q&A session. As a courtesy to the other investors and analysts who may wish to ask a question, I ask that you please limit yourself to one question plus a single follow-up. If you have any follow-up questions after the Q&A session, the Investor Relations team will be available after the call.

Lauren, please start the Q&A session.

QUESTIONS & ANSWERS

Operator:

(Operator Instructions) Our first question comes from Betsy Graseck with Morgan Stanley .

Betsy Graseck (Analyst - Morgan Stanley):

Hi, good afternoon.

Rich Fairbank (Chairman & CEO):

Good afternoon, Betsy.

Betsy Graseck (Analyst - Morgan Stanley):

Just two questions. One, a follow-up on what you just indicated, that you have sufficient expectation for having some operating leverage in 2016 and that's primarily coming from the savings that the digital investments are making? So is that coming from legacy ops, you being able to run them a little bit more efficiently or is that more from topline? If you could just talk to those two things.

Rich Fairbank (Chairman & CEO):

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I think it is a -- there is no one place to point. If we go back to last quarter, we said we did not expect much improvement in full-year 2016 efficiency ratio, excluding nonrecurring items, of course, compared to full-year 2015.

We noted, Betsy, of course, that we were predicting a volatile number 15 months in advance. We also said the investments that will pressure our efficiency ratio would, over time, contribute to positive operating leverage. And most notably, of course, those are our investments in card growth and our digital investment.

We are now three months closer, which helps reduce uncertainty somewhat and we have three more months of card revenue growth baking in the oven. We also continue to drive hard for cost savings. And we have seen some solid tangible evidence of cost savings arising from our digital investments and we know these savings will increase over time.

And we have identified more contingent cost levers to manage some of the revenue uncertainty. And while we are, of course, still one and a quarter years away from the end of 2016, we have enough confidence to say we expect modest improvement in full-year efficiency ratio in 2016, excluding nonrecurring items.

Betsy Graseck (Analyst - Morgan Stanley):

Okay. I got it. And then on your comments around the NCO outlook for card in 2016, is that a function of the 4% that you mentioned average for the full-year? Is that the function of what you are seeing in the portfolios today seasoning or is that a function of how you think new portfolios are going to traject, or is it a function of a potential slight slowdown in loan growth, where a reduction in new portfolios reduces the NCO ratios -- or increases the NCO ratio somewhat? Maybe you could just tease that out a little bit.

Rich Fairbank (Chairman & CEO):

You know, Betsy, it's really, I think, just how the growth math manifests itself in the context of having gone from a relatively low growth environment to an accelerating growth environment and how the losses play out.

Let's talk about that growth math for a bit. If you just looked at our back-book, you'd see exceptionally low and still improving credit losses. And that is because the back-book is made up mostly of customers who weathered the great recession. And it's also exceptionally seasoned as a result of low levels of originations over many years.

So from the starting point of that back-book, now almost any new business that we originate, of course, will have higher losses. And as a general rule of thumb, losses on new loans tend to ramp up over a couple of years and then peak and gradually come down. So when we accelerate growth, the majority of the loss effects are felt over the subsequent two years.

And this is the dynamic we have been calling growth math. And as we -- and things are continuing very much consistently with our own expectations with respect to how the credit is manifesting itself on the early vintages. And so what we have done as we get another quarter into this and another quarter closer, is to give you a bit of an extended window into basically the same growth math phenomenon that we have been talking about for several quarters.

Jeff Norris (SVP of Global Finance):

Next question, please.

Operator:

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

Moshe Orenbuch (Analyst - Credit Suisse):

Great. Rich, could you talk a little bit about the competitive environment in cards? As we have listened to some of the other players that have reported, one of the themes that has come up is that account acquisition hasn't been as much of a challenge as rewards. And can you talk about both of those factors?

Rich Fairbank (Chairman & CEO):

Yes. My overall comment I would say about the competitive environment is that it is fairly consistent. It is pretty intensely competitive. But overall relatively consistent, again relative to some of the things that we see in some of the other banking businesses that we're in. But taking the different components of what we are seeing here, starting with balances.

Industry balances, as you know, Moshe, of course, have been relatively flat for quite a while. But now industrywide, those are certainly moving up. So industry revolving debt held steady at about 1% for most of 2012 and 2013, but since July of 2014, it's been over 3% growth and over 4% growth in recent months. And bank card outstandings are up about 4% year-over-year.

So the first factor that we see is that there is a return to just ambient levels of balance growth in the industry. Pricing has been stable in the segments that we play in. Competition continues to be very intense, especially in rewards, but generally stable.

The one place that we would flag as where the competition has really increased substantially and to a point of concern is in the partnership side. The bidding has become very intense in this auction -based market, and there have been some very aggressive deals which we have -- we are not going to pay whatever it takes in that space.

But that, to me, is the most striking kind of thing that is in motion, specifically with respect to rewards competition. One thing I want to say is while it has some stability to it, it is intensely competitive and it has been that way for a lot of years. So I think the major players who are in it are very invested in it, and it takes years to build the brand and the market position to be able to succeed in that space.

I see the players in that space being generally intense -- investing intensely. Relatively consistent with what we have seen in the past, but certainly that's a very competitive --

Moshe Orenbuch (Analyst - Credit Suisse):

Just to follow up, given that you've got double-digit growth in net interest income and a decline actually, year over year, in interchange income, would you -- and with your comments just now about balance growth returning at the industry level, do you think this is a little bit of the return of the lend-centric model?

Rich Fairbank (Chairman & CEO):

I wondered the same things as I saw some of the industry model -- some of the industry data. I wouldn't necessarily declare that. I think that off of just such a stagnant growth environment, I think that there is some growth in the industry.

But certainly relative to the last time we saw the boom in the lending-centric environment -- of course, back then, Moshe, we saw some really crazy practices that got into some of the products in the industry, just intense teaser awards all over the place. Now, of course, for those who choose to play in that segment, that is certainly going on. And people stretching in terms of credit risk and so on.

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It is what we saw, again, in the mid 2000s, so I wouldn't say we see anything like that at this point, but I think it's good for you to make note that there has been a bit of a pickup on the -- in terms of balances and we will have to see where that goes.

Jeff Norris (SVP of Global Finance):

Next question, please.

Operator:

We'll go to Sanjay Sakhrani with KBW .

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

Great. I've got one question on the charge-off rate expectations.

Rich, you mentioned 4% for next year and how losses would peak, I guess, in the first quarter. Is that what the trajectory will be into next year and then we should expect it to moderate thereafter?

Rich Fairbank (Chairman & CEO):

Could you repeat the first -- just repeat your question one more time, Sanjay?

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

Sure. You mentioned how charge-offs would peak in the first quarter and you talked about the full-year charge-off rate being 4% for 2016. So should we expect a moderation in the loss rate after the first quarter?

Rich Fairbank (Chairman & CEO):

No, our point about -- there is a seasonal effect, there's two different effects going on. One is the seasonal effect, and if you allow yourself to just say if everything else were equal, here are the seasonal patterns. And I described those several minutes ago, and that has the characteristic of peeking, as you described.

Overlaid on top of that is another very important thing, which is the growth math of the acceleration that we have had in our business. And that actually picks up steam over time. For example, we had pointed to in the second half of 2015 that you will start seeing the net effects of growth. In fact, growth -- very early on when you start to accelerate growth, the losses actually, in a sense, have a movement in the other direction because you get to a build of a denominator before the numerator picks up steam.

But anyway, it's around this time, the third quarter of this year, that the growth math is starting to play an increasingly important role. That's why you are now starting to see year-over-year growth in our charge-off numbers. So the guidance for the full-year 2016, we are not giving quarterly guidance, but it will have seasonal effects and the increasing growth math effects. And they will combine in our view to generate a full-year average loss rate of around 4%.

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

Great. I guess my follow-up question may be for Steve or yourself, when I look at the card yield year-over-year, you obviously started growing loans at a faster clip, but the yield doesn't seem to be increasing all that much. Is that related to the mix of the types of accounts that you guys are originating or what exactly is driving that? I would've thought you would see that move up some.

Steve Crawford (CFO):

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I don't know why the yield would move up, Sanjay, because it's just average relative to the portfolio base. I'm not sure you'd see a change in yield. I'm sorry if I'm misunderstanding the question.

There's not a mixed change in the portfolio.

Jeff Norris (SVP of Global Finance):

Sanjay, I think we have lost you. If you want to follow-up with me after the call, feel free to do so. Let's go to the next question.

Oh, are you still on, Sanjay?

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

No, that's all right. It's cool. We will talk afterwards. Thanks.

Jeff Norris (SVP of Global Finance):

Next question then.

Operator:

We'll take our question from Ryan Nash with Goldman Sachs .

Ryan Nash (Analyst - Goldman Sachs):

Hey, good evening, guys. You know, Rich, I know a couple people have asked credit questions, so maybe I will try to ask it another way. It sounds like 3Q or 4Q is really the starting point of the pickup in growth math.

So assuming we don't see any further accelerations in loan growth, but does that imply that beyond 2016 we will continue to see a ramp in losses just because of the two-year period that you talked about before? And what does that mean for provisions as we think about 2016? And, lastly, does it continue to ramp once we get beyond that?

Rich Fairbank (Chairman & CEO):

There are too many factors that lie between now and the end of 2016 to make a forecast at this point on what is going on in 2017. You do make a very good point, though, that we all should remember that at the end of the day, of course, as we get into the latter parts of 2016, the allowance build will be driven very much by what is happening with losses and, very importantly, what is happening with growth at that period of time.

I think that the main point that I wanted to make is just the way growth math works, it is in the first two years after for any vintage of growth where the losses are climbing, and then they settle out and actually ultimately go down. Any one sort of vintage of growth.

All of this is the math of some things going and after they -- so, for example, as we get toward the latter part of 2016 and into 2017, some of the early growth vintages will be starting to settle out and you'll still have the effects, of course, of some of the more recent growth that we hope happens over the course of next year, for example.

But I think that keeping in mind this general effect of what happens over the two-year period following a surge in growth, and then understanding it is the blend of all the different vintages and the timing of that, I think that's pretty much how we would guide you at this point. Obviously collectively things eventually

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stabilize. And just the math of when accelerated growth happens for a period of time and settles out.

Ryan Nash (Analyst - Goldman Sachs):

Got it. Maybe just one quick follow-up for Steve. I think some of us might think modestly down to mean different things. Can you help us understand what you would consider to be modest improvement on efficiency range?

Steve Crawford (CFO):

I think those words were chosen carefully and we are probably not going to go a lot further than the guidance that was given. I appreciate you trying, and we would like to be more precise, but I don't think, particularly at this point, more precision is probably in your or in our interest.

Jeff Norris (SVP of Global Finance):

Next question, please.

Operator:

We'll go to David Ho with Deutsche Bank.

David Ho (Analyst - Deutsche Bank):

Good afternoon. In the US card business, it seems that the card fees rose nicely versus the overall volumes, closing the gap more so than previous quarters. Is that a function of maybe dialing back to the contra revenue rewards or the more function of better activation and engagement and can we expect this to continue?

Steve Crawford (CFO):

I'm not really sure where you're coming to that conclusion.

David Ho (Analyst - Deutsche Bank):

The domestic card, non-interest income was up 7% and higher than previous quarters versus your purchase volume growth was 19%.

Steve Crawford (CFO):

Yes, there's just a bunch of different factors. I think they can move in, move around on a quarterly basis. I don't think there is anything systemic or trend-wise that we point out. I think it's much better to probably look at these things on an annual basis.

David Ho (Analyst - Deutsche Bank):

Okay. And then on the auto regulatory environment, what's your outlook there? And has that been part of the reason why you pulled back in subprime? And in terms of what would get you back into that business, given how fragmented the industry is, what industry conditions would you need for you to increase the originations?

Rich Fairbank (Chairman & CEO):

Yes. So -- look, we still very much -- we very much like the business and we have spent 15 years building the capability to underwrite and manage risk in, for example, the subprime auto business. The flagging that we have done in recent quarters about some of the practices that we see, again is causing us to

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ultimately effectively slow down the origination growth that we had had. We are still generating good business and we love the business.

You mentioned the regulatory word and it is really not -- our slowdown, if you will, in origination growth is not driven by regulatory considerations. It is really driven by competitive situations. And in subprime, most importantly, some of the lending practices that we see that, you know, where I think more risk is being taken than we are comfortable to take to win a particular book -- piece of business. That's really what we're flagging there.

Jeff Norris (SVP of Global Finance):

Next question, please.

Operator:

We'll take our next question from Don Fandetti with Citi.

Don Fandetti (Analyst - Citigroup):

Yes, Rich, given your comments on partnership pricing, as you look out to 2016, what are your thoughts on portfolio acquisitions or other purchases? Are you seeing anything that's remotely of interest? You had a pretty interesting deal on the GE Healthcare portfolio. How do you think about 2016?

Rich Fairbank (Chairman & CEO):

We've often said about acquisitions that, look, we'll always -- the marketplace is always in flux and we said that we would continue to be interested, particularly in asset purchases and partnership businesses. Those would be the primary areas of focus. The partnerships, in many ways, we've not been the market-clearing price on some of the recent partnership bids. And I think our actions and discipline kind of speak for itself.

With respect to asset businesses, we're really excited about the unique opportunities. It's a very unusual thing to be able to, in an acquisition, at an attractive price, get someone that is like the leading and just absolute amazing performers that somebody like GE Healthcare business is. So a lot of planets aligned for us to get that. It is a byproduct of -- as I've said, we watch the marketplace and look for opportunities.

But as you can see over the last number of years, we have done more looking than we have buying anything. But I think the GE business represents a very special opportunity that arises, but it is a very unique thing. I don't think -- I think it is -- you could probably measure in decades the number of times a business comes along with such a good business and a market-leading position where that can be obtained at a reasonable price.

So we are happy about that. That's not an indication we are moving into big acquisition mode in the slice.

Don Fandetti (Analyst - Citigroup):

If I could just clarify one quick thing. You had mentioned softer used-car pricing for auto. Is that seasonal? I guess this would be the time you'd see that or are you sort of seeing something beyond seasonality that is noteworthy?

Rich Fairbank (Chairman & CEO):

First of all, we've been talking about auction prices for a long time. And the biggest reason we put so much focus on it. If you look back in a historical context, we are at record levels in terms of where auction

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prices are and they have sustained at record levels for a long period of time.

And there are arguments for that. Cars are lasting longer and a lot of things about that, but the thing that matters from an underwriting point of view is not how long a car lasts or its value on the other end. It's what its value is relative to what you underwrite -- wrote it expecting it.

So I just think, in general, there's asymmetrical risk in the auto finance industry when auction prices sustain as they have for a significant number of years at record levels. Although we underwrite to a decline in prices, at some point I think, there's just a risk that the industry gets a little too used to that. That's, in general, we have been flagging here.

If you look at the Manheim Index, you could go bowling on that flat index. Our own index that we see in the marketplace that's measured a little bit differently actually has shown recent declines relative to that. But the main thing is not so much what has happened -- and, no, it's really not a seasonal point. The main thing is just when we see small effects happening, we just talk a little bit louder to remind everyone that there's asymmetrical risk at the moment with respect to where auction prices are.

But I've been saying that several years. And they just keep on being high. That's what I wanted to flag on it.

Jeff Norris (SVP of Global Finance):

Next question, please.

Operator:

We'll take our next question from Chris Brendler with Stifel.

Chris Brendler (Analyst - Stifel Nicolaus):

Hi, thanks, good afternoon. Thanks for taking my question. I just wanted to ask another time on the US card business, non-interest income. The line I focused on last quarter, net interchange revenue growth of only 6% last quarter, again this quarter 6%, relatively flat.

Steve, I thought you indicated last quarter that that can bounced around and there's probably a natural growth rate of interchange when you're growing volume at 19% that would be a little higher than that? So are there any one-time items that are weighing on interchange growth? Or is this simply a function of all the high rewards costs products that you're having success with in the marketplace?

Rich Fairbank (Chairman & CEO):

I think that in any one quarter I wouldn't put any -- too much stake or stock in any one quarter with respect to this metric. But I do want to -- and probably the best way to look at that is looking at periods like year to date, for example, interchange revenue for Capital One has grown at 8%, for example.

I want to get a little bit behind why there is this disconnect. It has been going on for a few years now. It will continue, although at some point these numbers will converge. But the difference between the purchase volume -- the GPCC purchase volume versus the interchange growth rates.

And it isn't just -- I mean, yes, so we are out with attractive rewards proposition. You can see them advertised on television, for example. That is a factor. We are also upgrading rewards products for existing rewards customers. We're also extending rewards products to some existing customers who don't have rewards. And a higher mix of kind of all the originations that happened out there in the marketplace now have rewards than they had before.

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And really, this phenomenon -- every player, I think, is seeing this same phenomenon. There are differences in degrees depending on strategies and how they are -- especially the choices people make on do you want to go into your existing portfolio. How much are you going to take some cannibalization impact or not.

The main point is we are still having solid growth in interchange. it's well below purchase volume. That affect will continue over time. But in the longer run, these things will converge. In the meantime, we feel really good about the economics of reward products and the choices that we're making and the customers that we're originating.

Steve, did you want to add anything to that?

Steve Crawford (CFO):

No.

Rich Fairbank (Chairman & CEO):

Okay.

Chris Brendler (Analyst - Stifel Nicolaus):

Okay. Thank you. And maybe just an unrelated follow-up. In the UK business it looks like things slowed a little bit sequentially. Can you think about -- just an update on the UK business and how you're thinking about it and how changes in interchange rates in the UK could potentially impact your marketing and growth strategy there?

Rich Fairbank (Chairman & CEO):

Yes. The UK business is -- we really like our UK business. It's a tremendous synergy to have that business when we have such a big US business and we have a lot of cross-pollination going both ways and good ideas -- good business ideas going both ways. And some of our best ideas actually sometimes come from our UK folks.

That UK business isn't just a clone of our US business. And the most striking difference, if you look at the two, is sort of the absence in the UK of the big top of the market transacter, rewards-driven business. So while interchange dropped significantly, our business never was a really top-of-the-market spender, heavy business. The impact on us is relatively muted from the drop in interchange.

Jeff Norris (SVP of Global Finance):

Next question, please.

Operator:

Our next question comes from Bill Carcache with Nomura.

Bill Carcache (Analyst - Nomura Securities):

Hi, good evening, Rich and Steve. Can you tell us what proportion of your portfolio is comprised of your back-book versus your front-book and maybe help us understand what a normalized mix level between those books tends to be as you continue to grow?

Rich Fairbank (Chairman & CEO):

Bill, you didn't dislike the eloquence of this great story about how back-book performed and front-book

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performs. They're really not -- we don't have a thing at Capital One called just, you know, the back-book's over here and the front-book's over here because it's all a state of transition. Everybody starts in the front-book over time and then moves into the back-book.

It is a general descriptive method that we use to say that the metrics you are seeing on our portfolio are driven way disproportionately by the changes at the margin, especially in originations, but also in terms of things like line increases as well. The effects are so dramatic, particularly on a highly seasoned portfolio with just incredibly low losses like we have here. That's why we speak in terms of the front-book and the back-book, but they really -- it is more of a method of explaining how the business works.

Bill Carcache (Analyst - Nomura Securities):

Right. But I guess I was kind of --

Steve Crawford (CFO):

Bill, if I could just say also, a big part of not being able to do what you would like in terms of forecasting, as I think you've heard Rich talk forever about growth being windows of opportunity we see in the market. And we are not planning every year to get a certain amount of growth. When it is there and it makes sense we take it.

So that obviously pretty makes it pretty difficult to look into the future and see how the mix is going to change over time. And hopefully it goes without saying that these originations are performing as we expect. And we believe these are going to work out really well for our shareholders over time.

Bill Carcache (Analyst - Nomura Securities):

Right. I guess I was just trying to build off of the thought process that you guys described so well surrounding the growth math and the idea that you have peak losses somewhere around 18 to 30 months. So if we just draw a line in the sand at, let's say, 36 months. Then anything older than that is past peak losses and you have declining charge-off rates relating to anything that's older than 36 months and anything younger than that is experiencing, arguably, rising charge-offs.

And then so to the extent that you guys stopped growing post the great recession and more of your book was comprised of the back- book, that was a larger percentage of your book. But now as you have been growing and stepping on the gas, some of the newer vintages are representing a greater proportion of your overall book and, therefore, that is creating some of the growth math headwind.

And so I was looking for a little bit of color around that -- the interplay of those moving parts. But if you can't share that, I would love to either -- if you have some more color you could share on that that would be great, otherwise I would have a follow-up I would like to ask.

Rich Fairbank (Chairman & CEO):

Actually you did incredibly good job, probably better than I did of actually explaining the growth math general dynamics. And so if you have specific questions, we will try to answer them. But I think that, if you look at Capital One right now, we are in kind of a striking position if you look at our metrics relative to a number of players.

First of all, you may remember that in the period preceding this, Capital One was actually near the bottom of the league tables in terms of growth. And we talked all about running off high balance revolvers. We stopped talking all the time about that, but that's a phenomenon -- so we have had an exceptionally seasoned book.

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And then now as we are on the leading side of the industry with respect to our growth, then you are also going to see our metrics will move in ways that will diverge from competitors in striking ways. And that's why it's really important that we all communicate as clearly as we can about growth math.

And separating what is the difference between just natural maturation of businesses and customers behaving exactly as we expect versus changes in underlying credit performance or things like that. So at this time, where we are diverging from certainly some of the other players with respect to our credit performance, I again want to reiterate that things are coming in very consistent with our own expectations, both on the front-book and on the back-book.

Jeff Norris (SVP of Global Finance):

Next question, please.

Operator:

Our next question comes from Chris Spahr with CLSA.

Chris Spahr (Analyst - CLSA):

Hi, good afternoon. I noticed that most of the deposit growth has been in the other segment this quarter. Can you explain why that is and why you -- maybe if you had to raise your rates to get the business lines growing?

Steve Crawford (CFO):

Yes, so that's really -- all funding needs have been met more by wholesale funding sources, including securitization, brokerage CDs. We've been largely out of wholesale markets following the ING direct acquisition, and have been intentionally reestablishing our presence. That's just a market that you want to stay active in.

Remember, wholesale funding is also an important part of the LCR calculations. So there were a couple reasons why we, in addition to it being a pretty efficient market, but we believe we are very well-positioned to grow our deposits in our bank going forward.

Chris Spahr (Analyst - CLSA):

And can you give some guidance on the PPI charge outlook going forward?

Steve Crawford (CFO):

You know, I really can't. We had the rules issued by the FCA. And there is some specificity in how those actually work. So there is a two-year window for customers actually looking for relief. And what we did was we took, obviously, everything that was in that release and used it to come up with our best estimate of reserves.

But there are a lot of unknowns with respect to how the final nature of this is going to come in and how customer complaints will come in. And obviously we have done our best to estimate that in reserves and to the extent that things change, that will be something that we make you aware of.

Jeff Norris (SVP of Global Finance):

Next question, please.

Operator:

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And for our last question this evening, we'll go to Rick Shane with JPMorgan .

Rick Shane (Analyst - JPMorgan):

Thanks, guys, for taking my questions. Two.

In looking at some competitor data and some comments from your peers, it looks like there was a pickup in account growth.

Rich, you cited the fact that your loan growth has been substantially in excess of your peer group, which everybody has certainly been tracking pretty closely. Curious how much of this is a function of new accounts versus utilization and line limit increases?

Rich Fairbank, Capital One Financial Corporation; Chairman & CEO

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Rick, we also are enjoying a high level of account growth right now. I'm not sure I can speak for the other competitors, but if you look at when we went from very little growth a couple of years ago. When the growth began, we said that our originations have picked up, but also our line increases are going to be a little bit outsized here, because we are making up for a period of time when we were not able to do line increases as we were working on a solution to a new regulation that had come out.

And so early on in our growth surge, we were a little bit more than normally weighted toward line increases. That has now reached pretty much an equilibrium where the line increases -- the majority of our growth -- and, by the way, well, I would say just generally a majority of our growth is coming from on the origination side. An important minority of our growth is coming from line increases, but it is pretty much at sort of an equilibrium at this point.

Rick Shane (Analyst - JPMorgan):

Okay, great. Second question, it is a non sequitur, but during the quarter you issued some preferred that we potentially would have thought would've appeared in the preferred expense during the quarter. It doesn't seem to. What is the run rate headed into Q4 in terms of preferred expense?

Steve Crawford (CFO):

I think that's the semiannual payment, so it is December and June. That's why you don't see it this time around.

Rick Shane (Analyst - JPMorgan):

Okay, great, thank you.

Jeff Norris (SVP of Global Finance):

Thanks, everyone, for joining us on this conference call today. Thank you for your continuing interest in Capital One. Remember the Investor Relations team will be here this evening to answer any questions you may have remaining.

Have a great evening, and thanks.

Rich Fairbank (Chairman & CEO):

Thank you. Good evening.

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Operator:

That does conclude today's conference. We thank you for your participation.

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