CIT Group, Inc.

Q2 2018 CIT Group, Inc. Earnings Conference Call

Tuesday, July 24, 2018, 8:00 AM Eastern

CORPORATE PARTICIPANTS

Barbara Callahan - *Head of Investor Relations*

Ellen Alemany - *Chairwoman, Chief Executive Officer*

John Fawcett - *Chief Financial Officer*

PRESENTATION

Operator
Good morning and welcome to CIT's Second Quarter 2018 Earnings Conference Call. My name is Keith and I will be your operator today. At this time, all participants are in listen-only mode.

There will be a question and answer session after today's call. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press Star, then 1 on your telephone keypad. To withdraw your question, please press Star, then 2. If, at any time during the call, you would require operator assistance, please signal Star and 0, and an operator will be happy to assist you.

As a reminder, this conference call is being recorded. And, now I'd like to turn the call over to Barbara Callahan, Head of Investor Relations. Please proceed, ma'am.

Barbara Callahan
Thank you, Keith. Good morning and welcome to CIT's Second Quarter 2018 Earnings Conference Call. Our call today will be hosted by Ellen Alemany, Chairwoman and CEO, and John Fawcett, our CFO. After Ellen and John's prepared remarks, we will have a question and answer session.

As a courtesy to others on the call, we ask that you limit yourself to one question and a follow up, and then return to the call queue if you have additional questions. We will do our best to answer as many questions as possible in the time we have this morning.

Elements of this call are forward-looking in nature and may involve risks, uncertainties, and contingencies that may cause actual results to differ materially from those anticipated. Any forward-looking statements relate only to the time and date of this call. We disclaim any duty to update these statements based on new information, future events, or otherwise.

For information about risk factors relating to the business, please refer to our 2017 Form 10-K. Any references to non-GAAP financial measures are meant to provide meaningful insights and are reconciled with GAAP in your press release.

Also, as part of the call this morning, we will be referencing a presentation that is available on the Investor Relations section of our website, at www.CIT.com. Now, I'll turn the call over to Ellen Alemany.

Ellen Alemany
Thank you, Barbara. Good morning and thank you for joining the call.

I'll start with an overview of results and then provide some updates on our strategic plan. We posted net income available to common shareholders at $117 million in the second quarter, or 94 cents per diluted share, an income from continuing operations, excluding noteworthy items of $125 million, or a dollar per diluted share. Results reflect continued progress on the strategic plan, including lower operating expenses, advances in optimizing the capital structure, and growth in our core businesses, despite some highly competitive markets.

Additionally, we completed the sale of the reverse mortgage business and related loan portfolio, as well as outsource the forward mortgage servicing operations. These actions further simplify and strengthen CIT by exiting non-core operations and driving greater efficiency in our go-forward mortgage business.

John will walk you through a more detailed account of financial results shortly, but first I want to touch on a few key elements of our plan, which are on Slide 2.

Origination volume was strong across the board, up about 30%t year over year, which demonstrates the progress we are making in the marketplace by adding expertise to key business verticals and delivering value for our customers. This volume was someone offset by an elevated level of prepayments in the commercial, finance, and real estate finance divisions, and that affected core asset growth, which was up about 1%.

Business capital had another very strong quarter, with core loans and leases up 8 percent year over year and 2% quarter over quarter. Small business competence is strong and we are well positioned to help our customers grow their business.

Our technology industry expertise and knowledge of residual values gives us a strong position in the equipment finance market. Most recently, we announced that our leading FlexAbility digital platform is now integrated with a key software product in the Office Imaging space, which will enable dealers and their customers to have a completely automated experience when leasing equipment.

Factoring volume is also up year over year, driven by increases in the technology sector. Origination volume was up 24% versus the prior year in the Commercial Finance division, largely from the Aviation, Healthcare, and energy verticals. The CIT Northbridge JV has also started to gain traction.

Our pipeline of transactions and commercial finance continues to be strong. At the same time, we remain disciplined in our approach to this market, which has seen aggressive leverage levels and structures. Likewise, our Real Estate Finance business continues to be competitive, but also experienced a higher level of prepayments. The industry overall is seeing some softening and we are being prudent in picking our spots.

In rail, we have seen an uptick in railcar loadings, fueled by some improvement in the industrial sector. There is still a surplus of equipment, but our team has been successful in increasing the utilization of our North America rail fleet over the past several quarters, to 98%, which is up 350 basis points from last year, and 100 basis points from last quarter.

The NACCO transaction continues to progress and is expected to close by the second half of this year. We continue to advance our strategic business initiatives and build on our core strengths and small business in the middle market.

Operating expenses decreased 9%in the second quarter, compared to a year ago, and we remain committed to achieving our expense target for the year. We posted total average deposit growth in the quarter of $900 million, compared to the prior quarter, as we strategically decreased broker deposits and grew customer deposits at the direct bank.

The cornerstone of our deposit growth is the direct bank, which had another strong quarter and added $1.5 billion of average deposits and 20,000 new customers. The new Money Market account has been a key contributor to deposit growth, as we offer consumers additional savings options with a competitive value proposition.

We continue to make strides in optimizing the capital structure and creating value for shareholders. We purchased $680 million of common shares in the quarter and plan to return up to $750 million of additional capital as we advance our plan. We also have recently announced a 56% per share increase in our common stock dividend to $0.25.

As we previously disclosed, with the passage of the Regulatory Relief legislation, CIT is no longer subject to the DFAST or CCAR processes. Our capital planning and risk management practices will continue to be reviewed through the regular supervisory process and we are committed to maintaining strong capital planning and risk practices, while also working to reach our target capital levels.

And, lastly, our credit reserves remain strong. With that, let me turn it to our CFO, John.

John Fawcett
Thank you, Ellen, and good morning everyone.

Turning to our results on page 3 of the presentation…

We posted GAAP net income for the quarter of $117 million or $0.94 per common share.
Page 4 highlights income from continuing operations excluding noteworthy items which was $125 million or $1.00 per common share this quarter, up from $97 million or $0.74 per common share last quarter and down modestly from $126 million or $0.68 per common share in the year-ago quarter. Earnings per common share increases also reflect the decline in the average number of diluted common shares outstanding to 125 million from 132 million last quarter and 184 million in the year-ago quarter.

The increase in net income from the prior quarter reflects lower operating expenses and a lower, more normal, credit provision. The current quarter also included a $9.4 million preferred stock dividend. The year-ago quarter benefited from an unusually low credit provision and no preferred dividend, which was offset by higher operating expenses and a higher tax rate.

We posted strong new business activity in the second quarter in almost all our businesses and our average core portfolio grew 1% from the prior quarter despite high prepayments in Commercial Finance and Real Estate Finance. Total average loans and leases were modestly lower reflecting the sale of the reverse mortgage portfolio and continued run off of the legacy consumer mortgage book.

As shown on page 5 of the presentation, we had a number of noteworthy items resulting from our strategic initiatives that offset one another but impacted continuing and discontinued operations a bit differently. The sale of the Financial Freedom servicing business included an after-tax loss of $14 million in discontinued operations from additional reserves and transaction costs, while continuing operations included a $22 million after-tax benefit from the sale of reverse mortgages related to the Financial Freedom transaction. We also incurred debt extinguishment costs of $14 million, after-tax, from our liability management actions and a $6 million after-tax benefit from suspended depreciation related to the pending NACCO disposition, which we expect to close later this year.

I will now go into further detail on our financial results for the quarter. Please note that in this discussion, I will refer to our results from continuing operations excluding noteworthy items, unless otherwise noted.

Turning to page 6 of the presentation, net finance revenue was relatively flat from the prior quarter, while net finance margin declined by 8 basis points. Compared to the year-ago quarter, net finance revenue was down $23 million and the margin declined 15 basis points. The flat net finance revenue compared to the prior quarter reflects higher income on our loans, leases and investments which was offset by higher interest expense. Net purchase accounting accretion was unchanged from last quarter as a $2 million decline in accretion in our Real Estate Finance division was offset by a decrease in negative interest income on the indemnification assets in Consumer Banking. We continue to see a reduction in PAA as the portfolios run off. We now have approximately $665 million in total PAA remaining of which almost $590 million relates to the Legacy Consumer Mortgage portfolio, which runs off about 10-15% annually. The remaining $75 million relates to Commercial Finance and Real Estate Finance and we are forecasting 40-50% of it to accrete over the next four quarters.

Turning to page 7, although net finance revenue was flat, Net Finance Margin declined by 8 basis points compared to the prior quarter to 3.29%, which was partially driven by a change in the mix of average earning assets. Deposit rates increased this quarter reducing margin by 10 basis points reflecting upward market trends and strong growth in our Direct Bank's money market savings product as we get ahead of some of our projected funding needs in the second half of the year. Higher borrowing costs reduced margin by 8 basis points, about half the increase was due to an increase in FHLB costs, most of which was rate driven, and the rest was mostly due to a full quarter impact of the Tier 2 qualifying subordinated debt issued in March. The yield on our loans and investments benefited from higher interest rates which contributed about 13 basis points to the overall margin. However, this was offset by about 5 basis points from a higher level of average interest bearing cash during the quarter resulting from the timing of our liability management and capital actions as well as the sale of the reverse mortgage portfolio. This quarter, rail yields benefited from a customer prepayment. In addition to the trends I just described, the decline in net finance margin from the year-ago quarter also reflected lower net purchase accounting accretion, other prepayment benefits and rail yields.

Turning to page 8, other non-interest income was relatively flat when compared to the prior quarter. Compared to last year, other non-interest income was up significantly reflecting income from BOLI which has been relatively consistent at $7 million over the past two quarters and gains on derivative activity, which is more episodic. As I noted in the last couple of quarters, other Non-interest income included elevated activity related to the reverse mortgage portfolio that was sold on May 31st. This quarter included $5 million in other revenues while we recognized $7 million last quarter.

Other non-interest income in the current quarter also included a $6 million benefit from a release of reserves related to the OneWest acquisition. Fee income was relatively flat to the prior quarter and down from the year-ago quarter resulting from lower capital markets fees which can be uneven throughout the year. Factoring commissions were down in the second quarter reflecting seasonally lower volumes. Compared to a year-ago, factoring commissions were relatively flat, reflecting increasing volumes, primarily from the technology sector, offset by lower pricing from a continued shift in the mix of services provided. Gain on sale of leasing equipment, predominantly from our portfolio management activities in Rail, has remained relatively flat when compared to the prior and year-ago quarters.

Turning to page 9, operating expenses decreased from the prior quarter reflecting lower compensation costs and professional fees. In addition, the current quarter benefited from a $5 million reversal of an international tax related reserve. Compared to a year-ago, operating expenses declined primarily reflecting lower professional fees and insurance costs as well as the reversal of the international tax related reserve that was originally recorded in the year-ago quarter. We remain on track to achieve our 2018 annual operating expense target of one billion, fifty million dollars ($1,050). As a reminder, this excludes intangibles and restructuring costs. We expect operating expenses to continue to decline in the second half of the year, with much of the reduction resulting from lower compensation and benefit costs

Page 10 describes our consolidated average balance sheet. This page demonstrates the progress that we have made over the past year repositioning our cash to build out the investment portfolio, reducing wholesale funded debt and returning significant capital to our shareholders. Compared to the prior quarter, average earning assets were up almost $1 Billion, reflecting higher interest bearing cash related to the timing of our liability management and capital actions over the past two quarters, as well as the sale of the reverse mortgage portfolio on May 31st, which also reduced average loans.

The increase in liabilities reflects deposit growth and a full quarter impact from the liability management actions. These actions included the issuance of $400 million of Tier 2 qualifying subordinated debt and $1 billion of senior unsecured debt in March, and the redemption of nearly $900 million of senior unsecured debt in April, which allowed us to extend our overall debt maturities at a modest incremental cost and improve the efficiency of our capital structure. The decline in equity reflects our stock repurchases of approximately $680 million and a $22 million reduction from unrealized losses in our investment securities book that runs through OCI.

Page 11 provides more detail on average loans and leases by division. As I mentioned earlier, we saw strong origination volumes this quarter in most of our businesses, which resulted in 1% average growth in our core portfolios despite high prepayments in Commercial Finance and Real Estate Finance. Commercial Banking’s average loans and leases were flat compared to the prior quarter, reflecting strong growth in Business Capital offset by a reduction in Real Estate Finance and Commercial Finance. Compared to the year-ago quarter, Commercial Banking grew 3% driven by Business Capital, Commercial Finance and Rail partially offset by a reduction in Real Estate Finance.

The middle market continues to be challenging, and we remain disciplined in a highly competitive environment, while finding opportunities where we can grow. In Commercial Finance, average loans and leases were down 1% this quarter. Compared to the year-ago quarter, average loans and leases were up 2%. Origination volumes were up significantly from the prior and year-ago quarters but spreads remain pressured and prepayments increased as borrowers are taking advantage of tighter spreads by refinancing. We continue to find opportunities with strong origination volumes in the healthcare and energy verticals. In addition, asset-based originations remain over 50% of total new business volume driven by our re-entry into aviation finance and our repositioning efforts. Real Estate Finance was down 2% this quarter, excluding the legacy non SFR portfolio run-off, reflecting lower volumes and higher prepayments.

As I mentioned last quarter, the market has become more competitive as CMBS and debt funds are more active. As a result we are seeing spreads compressing and more aggressive debt structures, increasing the incentive for borrowers to refinance. We are remaining disciplined in our new business originations and continue to pick our spots amid the market conditions. North American Rail assets were up modestly, as new deliveries were offset by depreciation. We are seeing some momentum in the industrial sector and rail loadings are up. The general surplus of equipment across North America has improved from last year but remains high at 17%. The rail team has been successful in increasing utilization in the current environment, which grew to 98% this quarter. Overall lease rates repriced down 17% this quarter reflecting the persistent surplus of equipment and the mix of cars renewing. We are seeing improvement in renewal rates on certain freight cars such as boxcars, cement and sand cars, mill gondolas and plastics. In addition, tank car markets have overall stabilized with opportunities developing in Canada from pipeline capacity constraints, in Mexico for refined products and for retrofitted tank cars servicing multiple markets. That said, we continue to expect leases to reprice down on average 20-30% through 2019, driven by continued pressure from tank car lease rates, which are renewing at a faster pace and at rates that are down from peak levels.

Business Capital grew 2% compared to the prior quarter with growth across all our equipment lending businesses. Origination volume was strong, up 17% from last quarter and small business optimism remains high. We continue to gain momentum across all our platforms from the investments we made in our sales force as well as the technology that differentiates us in this space. Pricing has remained relatively constant as the leases and loans are predominantly fixed rate and it is more difficult to pass along rate increases in this industry. As a result, the increase in funding costs has put pressure on the margins, but we have recently increased lending rates in select markets.

In Consumer Banking, growth in our Other Consumer Banking businesses was more than offset by the run off of the Legacy Consumer Mortgage portfolio and the sale of the reverse mortgages. Average loans in the core mortgage lending business increased by over $300 million or 13% this quarter from the continued strong originations in the retail and correspondent lending channels, and we continue to experience an increase in loans from our SBA lending platform. In all our businesses, we continue to be selective and disciplined in the face of current competitive market conditions, emphasizing opportunities that build upon our expertise and to seek to grow in areas that are not overheated.

Page 12 highlights our average funding mix, compared to the prior quarter, total borrowed funds and deposits increased while the overall mix remained stable. Funding costs as a percent of average earning assets increased this quarter by 18 basis points. As I mentioned, higher deposit costs contributed 10 basis points while our debt actions in March and higher FHLB costs added 8 basis points to our borrowing costs.

Page 13 – Illustrates the deposit mix by type and channel. Quarter over quarter, our average deposits increased approximately $900 million to $31 billion, reflecting growth in our Online channel of $1.5 Billion or 12%, primarily offset by a reduction in brokered and commercial deposits. We have been growing our Non-maturity deposits in conjunction with our strategy to optimize deposit costs while working within our risk management discipline. The cost of our deposits increased 14 basis points this quarter.

The beta on total deposits in the current quarter was approximately 40% resulting in a cumulative beta over the past year of approximately 30% and 15% since the first rate hike of the current tightening cycle in December 2015. Actual betas in this tightening cycle have been generally lower than modeled due to a lack of market pressure, disciplined pricing in our Retail Savings and run-off of our higher-cost Brokered deposits and high cost CDs. Growth in our money market savings product contributed to the higher beta this quarter, and we expect the trailing twelve month betas to continue to ramp up to around 40-50% by the end of the year.

Page 14 highlights our credit trends. Credit metrics remain stable and our results reflected a more normal provision. The credit provision this quarter was $33 million, compared to $69 million last quarter and only $4 million in the year-ago quarter. The current quarter's provision was in line with our near term outlook of $30 to $40 million while the prior quarter included a $22 million charge-off of a single commercial exposure, that was episodic in nature and a higher level of reserves primarily within the Commercial Finance division. The year-ago quarter's credit provision was unusually low and well below our normal run rate.

This quarter's provision reflected 21 basis points on net charge-offs, below our near term outlook guidance and remains within cycle lows in most of our businesses. The provision also included an increase in reserves resulting from a higher level of non-accrual loans within Commercial Finance where changes in non-accruals have some variability and have been running at historically low levels. I would also point out that we are not seeing an overall deterioration in the credit environment and new business origination continues to come in at better risk ratings than the overall risk rating of the performing portfolio.

Turning to capital on page 15, our capital levels remain strong and we ended the quarter with a CET1 ratio of 13.2%, down 120 basis points from the end of last year. We are committed to returning capital to shareholders and reducing our CET1 ratio to our target level of 10-11% in the medium term. As Ellen mentioned, with the recent passage of the Regulatory Relief legislation, we are no longer a SIFI bank. And, even though we are no longer subject to DFAST and CCAR, our target capital levels and capital planning process will continue to reflect our desire to maintain a sound risk management framework, which will be reviewed through the regulatory supervision process.

We ended the quarter with 116 million common shares outstanding. In the second quarter we returned $680 million of common equity through the tender and open market repurchases, bringing our total share repurchases in the first half of the year to $875 million, representing 16.2 million shares at an average repurchase price of 54.14 per share. We increased our dividend last week by 56% per share to 25 cents. If you recall, we raised our dividend in the 3rd quarter of last year as well, resulting in a 67% cumulative per share dividend increase over the past year.

In addition to the dividend increase, our Board has authorized a capital return of up to $750 million and we intend to return sufficient capital by the end of this year to achieve our guidance of a CET1 ratio of 11.5% to 12%. So far in the third quarter through Friday, July 20th, we've repurchased $105 million in common shares at an average price of $51.82 per share. We remain committed to achieving the upper end of our target CET1 ratio of 10-11% in 2019 and will continue to review options to return the capital as efficiently and prudently as possible while working within the confines of the supervisory review process.

Page 16 highlights our key performance metrics both on a reported basis as well as excluding noteworthy items. Our effective tax rate excluding discrete items was 27% consistent with our updated guidance of 26-28%. Our ROTCE, excluding noteworthy items, was 8.6% and if you normalize for the preferred dividend being semi-annual, our ROTCE would have been 8.9%.

Before I turn it back to Ellen, I wanted to give you some thoughts on the third quarter outlook which is on page 17. We expect total average earning assets to be relatively flat with low single digit quarterly growth in our core portfolios, mostly offset by the run off of the legacy consumer mortgage portfolio and the full quarter impact from the sale of the reverse mortgage portfolio. We expect net finance margin to be relatively flat and remain in the middle of the 2018 target range driven by a reduction from the sale of the reverse mortgages, which included two months

of activity in the current quarter, and rail repricing offset by the net impact of higher interest rates. We expect operating expenses to trend down as we achieve our $1,050 target for the year. We continue to expect net charge offs to be within the annual target range of 35-45 bps, and we expect the effective tax rate before the impact of discrete items to be 26-28% and we continue to work through the impacts of state tax changes.
With that I will turn it over to Ellen

Ellen Alemany
Thanks, John. I want to reiterate our commitment to our return on intangible common equity goals. As previously mentioned, we are targeting 9.5-10% return on tangible common equity at the end of this year, and 11 to 12% over the medium term.

In closing, we are delivering steady progress on our plan to maximize the potential of our core businesses, enhance our operational efficiency, optimize our funding costs, optimize our capital structure, and maintain strong risk management. With that, we're happy to take your questions.

QUESTION AND ANSWER

Operator
Thank you. We will now begin the question and answer session. To ask a question, you may press Star, then 1 on your touchtone phone. If you're using a speaker phone, please pick up your handset before pressing the keys. To withdraw your question, please press Star, then 2.

At this time, we will pause momentarily to assemble the roster.

And, this morning's first question comes from Moshe Orenbuch from Credit Suisse.

Moshe Orenbuch
Great, thanks. I guess, looking at the margin walk that you talked about, and you've kind of alluded to some of the pieces of this, but I'm hoping you can kind of pull it together for us because essentially, I mean, this is a company that we've kind of been told was asset sensitive and yet you've got an 18 basis point hit to margin as a result of higher interest rates in the quarter. I mean, it seems like--it seems high and you talked about, like I said, some of the pieces, but can you kind of flesh out what will it take to get to the point of actually demonstrating that asset sensitivity, or is it the fact that pressure on yields has just offset that?

John Fawcett
Yeah, so Moshe, this is John. So, I'll take a crack at this. I think a lot of it, is competition in the space and change in mix of business. I think as you all know also, there's a lot of puts and takes that work their way through the net finance revenue line in terms of the indemnification asset, the drag-back rates, the runoff of the purchase accounting accretion, which is half of what it was last year.

I think the other thing that's kind of out there a little bit is in terms of lease maintenance. And, so as you start to see some of the cars come out of storage and you see our utilization go up, that drives a little bit of lease maintenance. And, so as we take cars out, there's a higher volume of remarketing from pulling cars from storage and sending the cars into service. So, that's also a part of it.

The other element of it that's probably unique a little bit to this quarter is the elevated level of cash, which I think we were probably overly circumspective in the capital actions and probably impacted net interest margin in a disproportionate way. And, then as I mentioned, the other two big drivers of this were the subordinated debt. So, we had the full quarter of a 6 and 1/8 coupon work their way through on $400 million, and then, of course, we've had great success with the build out of the money market in our online bank and that was an offer rate of 1.85% that probably launched in late February, but ran through part of the first quarter and all of the second quarter.

So, hopefully that gives you a little bit more color in terms of what's going on.

Moshe Orenbuch
Right, okay. And, you talked about the lease rates being down kind of still 20 to 30 percent on renewal. Can you talk about the percentage of the book that's renewing in '18 and how that changes in '19? And, when do you think that number could be closer to where that will be more of a wash?

John Fawcett
Yeah, so this is a question of the pig and the python, and so I think as--and you have to break the book into almost two pieces. So, you've got kind of--the way I look at it is you have the freight and the infrastructure book and you have the tank cars, and so kind of in broad strokes, 35 percent of what's repricing in '18 is tank related cars and then that starts to trend down. '19 is probably sub 30, '20 is sub 25, and '21 is sub 20.

So, it continues to work its way through. I think on the tank side, to the extent that oil stabilizes at 70 or continues to move higher, that bodes well in terms of the rates that we can reprice that. Similarly, it also depends on the vintage of the cars that are coming off lease. And, so you're starting to see a convergence of high lease cars in the tank space coming off at the same time that lease rates on tanks are starting to modestly move.

I think the other thing, too, is in terms of utilization in the rail business, I think you'd have to go back to probably '15 before you'd ever see a 1 percent increase quarter on quarter in terms of utilization and in terms of other kind of bright lights on the horizon. Something as probably out of favor is coal cars in the last year has gone from mid-80s utilization to mid-90s utilization. So, it feels like there are a lot of things that are going on in the rail space that are potentially good. But, again, we're still going to have to work through the challenges we face in the tank space.

Moshe Orenbuch
Right, but just about how long do you think that takes until?

John Fawcett
I think certainly through '19 and in '20 it starts to see a turn. But, again, a lot of this has to do with the mix of cars. A lot of it has to do with infrastructure and look, if Trump were able to do the same thing for infrastructure as he's been talking about, as what he did with tax reform, I think that would potentially be a fairly decent lift. So, we just have to see how it plays out.

Moshe Orenbuch
Great, thanks.

John Fawcett
You're welcome.

Operator

Thank you. And, the next question comes from Eric Wasserstrom with UBS.

Eric Wasserstrom
Thanks very much. I'm afraid my question is also on that interest margin. I'm looking at page 7 of the slide deck, which has the margin walk from the first to second quarter. And, I'm just sort of contemplating these same categories from second to third in line with the guidance, and I guess where I'm struggling is if we look at the left side, for example, the cash and investment income, and assume that the balance sheet is largely flat, then maybe there's a couple of basis points of benefit there.

But, the continued increase in deposit costs along the lines of the beta that you suggested would suggest that there's still going to be this pressure. And, so I'm just wondering how all of that reconciles to a flat quarter over quarter net finance margin?

John Fawcett
Yeah, so on the left hand side, in my call script, I alluded to the fact that we've started to introduce some pricing. We'll have to see how that goes in the Business Capital space. It largely becomes also a question of the pace of prepayments. I mean, very high levels of prepayments in the second quarter. So, if that abates a little bit, there's probably some good news there. Spot cash is already down and we expect it will become a little bit more efficient on the balance sheet, given that we're not going to have a tender to work through.

On the right hand side, in terms of borrowing costs, you'd expect some moderation, at least in the debt space. But, on the deposit costs, depending upon the timing of subsequent Fed actions, that should be modestly flat-ish. So, I think we're pretty comfortable with our range of 320 to 340 in terms of net finance margin, in the middle part of that range.

Eric Wasserstrom
And, then maybe if I could just ask one follow up on the cost. I know that you mentioned that it's competition and benefits that is the primary driver from recalling from the scripts, but can you give us a sense of, within the organization, where that cost leverage is emanating from? Because I also see these very strong hiring announcements and I'm just trying to put the two and two together.

John Fawcett
Yeah--oh, I'm sorry.

Ellen Alemany
Yeah, so I'll just take this, John. So, we are still committed to the $1,050 at year end, and a lot of the cost declines are coming from really compensation costs, lower professional fees. We also have a lot of digitization efforts going across the business, which is resulting in a lot more operational efficiency. And, I would add that with the passage of the regulatory relief legislation, there is some potential for further expense reduction.

And, what we're doing is we're rebalancing, using some of these cost saves to make investments in the business and then otherwise just getting the cost saves back. So, it's a little bit of rebalancing here.

Eric Wasserstrom
Thanks very much.

Operator
Thank you. And, the next question comes from Donald Fandetti with Wells Fargo.

Donald Fandetti
Hi, John. Can you talk a little bit more about credit, the non-accruals, as you mentioned, were up and if you think about last quarter, you had the episodic event in commercial. I guess two part question. One, is there any particular industry that drove the non-accruals? And, then how are you thinking about credit, generally speaking, going forward? It seems like maybe it's softening a little bit in the commercial side.

John Fawcett
Yeah, so the increase in non-accruals was not due to any specific industry or common theme. So, again, kind of episodic. The increases in reserves were primarily related to Commercial Finance, where non-accruals have some variability. And, again, non-accruals and charge offs aren't demonstrating any particular pockets of challenge.

I mean, if you look at the top of the house, across most of the metrics, net charge offs as a percentage of average loans, 21 basis points, and if you look across the last five quarters, that's a low point for us, in terms of low being good.

Provision against average loans, second quarter of 2017 was ridiculously low and the first quarter had that challenge of the episodic one credit going bad. But, at 45 basis points, it's very consistent with third and fourth quarter. If you look at non-performing loans to end of period loans, again, kind of still below 1 percent and you don't see any trends breaking out there.

And, then, we feel pretty good about our allowance. So, across the book of business, there's nothing out there that causes any particular challenges. And, then as I said in the call script, the new business origination in the industry is coming in at better risk ratings than the overall risk rating of the performing portfolio.

So, at this point, we feel pretty good about where we are in the credit cycle.

Donald Fandetti
Thanks.

John Fawcett
You're welcome.

Operator
Thank you. And, the next question comes from Chris Kotowski with Oppenheimer and Company.

Chris Kotowski
Yeah, good morning. I'm wondering in terms of the capital returns, if you can say--you indicated you were in the market, that you did 106 million I believe you said so far. Should we expect you to complete your authorization in the open market or through additional tenders?

John Fawcett
So, everything's on the table. I mean, the reality is if you do the arithmetic between when we started at 105 million, it feels like we could do the whole thing in an open market and get through the return. But, we look at everything all the time, and so all these regular options are

there in terms of an ASR, open market repurchase, and a tender. I wouldn't expect that you're going to see any kind of a special cash dividend, but we're going to continue to march to deliver the target, 11.5-12%, by the end of the year. And, I think if you do the arithmetic, we started the year at, call it 14.5%. We're at half year at 13.2%, so that's 120, 130 basis points, and we're targeting 11.5-12%, which is another 120 to 170 basis points.

So, it feels like, across the course of the year, we're going to have delivered between 250 and 300 basis points of reduced common equity tier one. And, if you do the arithmetic, you can kind of discern that the bulk of this 750 that was authorized by the Board is very much front loaded to get to those targets at year end.

Chris Kotowski
All right, okay. And, then just going back to the non-accruals, I mean, they increased a little over $50 million. Was it multiple loans, or was it a couple of big relationships?

John Fawcett
It's multiple loans. It's not a single credit at all and it's different industries. There's literally no correlation between any of the loans that have moved into non-accrual.

Chris Kotowski
Okay, that's it for me. Thank you.

John Fawcett
You're welcome.

Operator
Thank you. And, the next question comes from Scott Valentin with Compass Point.

Scott Valentin
Good morning and thanks for taking my question. Just, John, I think you said earlier in prepared remarks about this core deposit growth, there were some initiatives in the second half and maybe you guys were kind of pre-funding if I heard you correctly. Is there anything specific you have planned for the second half in terms of assets?

John Fawcett
No. No, it's steady as she goes.

Scott Valentin
Okay.

John Fawcett
And, by the way, welcome, Scott.

Scott Valentin
Oh, thank you. And, then just on the capital return, now that you guys are no longer SIFI, just wondering in terms, SIFI was a pretty structured process in terms of the admissions and timings, things like that. I assume there's a lot more flexibility now going forward with regard to capital return requests. In other words, if you guys can finish the current capital return, you can just go back and request additional, if you so see fit, to return capital. There's no specific timeframes or any kind of, I guess, structured calendar in terms of requesting capital?

John Fawcett
Yeah, I--

Ellen Alemany
Yeah, I mean, I think that's right, Scott. But, that being said, I think the regulators have also made it clear that, to make sure that our capital planning and risk management practices, they'll be continued to be reviewed through the regular supervisory process and we've got to be prudent in our requests, etc.

John Fawcett
And, the only thing I would add is look, the laws are out there. They have to be converted into regulation and they have to be applied for supervision. I think a lot of people are under the impression that there's open season on capital, but the reality is that CCAR may be gone, but capital planning, as Ellen said, remains alive and well. It's still subject to supervisory oversight and there are specific rules in terms of SRO-904 and there are others in place still governing payment of dividends.

And, so we expect to continue to work very closely with the Federal Reserve in terms of what our ability is to return capital and the pacing and timing of which that would happen.

Scott Valentin
Okay, that's helpful. Thanks very much.

John Fawcett
You're welcome.

Operator
Thank you. And, the next question comes from Vincent Caintic with Stephens.

Vincent Caintic
Hey, thanks. Good morning, guys. A couple of questions, or two questions on the rail car business. So, first, you alluded to the yields this quarter being supported by a prepayment. I'm just wondering what the yields--the yield would have been without the prepayment. And, then secondly, so the 98 percent utilization rate, so a great number after having dipped into the low 90s, I'm just kind of wondering how sustainable that is. And, particularly, when you think about pricing versus utilization, where do you think that can go? Thanks.

John Fawcett
Yeah, Barb will probably get back to you on the impact of the prepayment. It was kind of a modest number in the overall scheme of things. On the infrastructure side and the freight cars, it feels like we're in a pretty good place in terms of renewals against car lease rates, and so maybe there's potentially a little bit of upside there. Again, it depends on what happens in the broader market.

And, on tanks, it's just going to run its course. So, I don't know that there's much more visibility that I can give you in terms of what I said before. I think it all still kind of holds true. It's wait and see. I think there are glimmers of hope on the horizon, but one quarter doesn't necessarily make the trend. I think oil prices have to sustain themselves, infrastructure has to keep going. There's got to be a void in the economy to kind of support some of the flow.

But, there are a lot of good signs in terms of loadings being up, and I think loadings are up--you'd have to go back to '14 or '15 to see the pace of loadings that we're seeing right now.

Vincent Caintic
Okay, got it.

Vincent Caintic
Great. And, then separate but maybe a little bit related question, if you could discuss the prepayment activity a little bit more. I'm just wondering, so the prepayment activity was high, just generally, in the second quarter. Is that something that you--I don't know whether this is competition in commercial, or in the real estate business, or other things. But, do you expect the prepayment activity to be elevated going forward? And, is it something where, say, rising rates is a driver for that and we should kind of tie the two? Thanks.

Ellen Alemany
This is Ellen. It's really hard to predict the prepayment rate. We had a lot of prepayment rates in the last quarter of last year. It was a little lighter this past quarter. But, it's really just a combination of the debt funds out there, that's been a challenge for us and for many other institutions. And, it's also, it's been an erosion of the deal structures in the marketplace and we're really staying firm on the credit side of the business.

So, I would say that we'll just see how it goes. But, otherwise, the business volume is as strong as I've ever seen it in terms of the new volumes that we're writing, but it's really hard to predict the prepayment activity.

Vincent Caintic
Okay, got it. Thanks very much.

Operator
Thank you. And, the next question comes from Arren Cyganovich with Citi.

Arren Cyganovich
Thanks. So, the return on tangible equity continues to improve but even your targets are somewhat below tiers, largely I think because of the higher cost of deposit funding compared to other banks. What're your thoughts on maybe improving that or do you need to actually sell to somebody else or to now somehow acquire cheaper deposits to make returns more comparable with other banks? Your thoughts on M&A there?

Ellen Alemany
I mean, I think it's just--it's continued execution against the plan, so it's a whole combination of factors that we're going at it, which is the revenue momentum we have in the business, continuous improvement on the operating expense line, etc. And, it's basically just quarter over quarter progress. So, we're having a lot of success running off the brokered CDs and growing the direct bank deposits. But, it's going to be a combination of all these factors that is going to drive the improvement on the return on tangible common equity and maybe some--we're aggressively looking for some portfolio purchases in the market, etc. that may help. But, it's just going at it every quarter.

John Fawcett
Yeah, and I would just add that look, we remain committed to the return on the tangible common equity walk that's kind of out there. So, fourth quarter, '19, 9.5-10%, and then targeting 11-12%

percent return on tangible common equity in the medium term. And, so there are a lot of levers here at work and I would say we're working them all, and we remain committed to deliver against the commitments we've made.

Arren Cyganovich
Okay, thank you.

John Fawcett
You're welcome.

Operator
Thank you. And, once again, please press Star and then 1 if you would like to ask a question. And, the next question comes from Derrick Hewitt with Bank of America Merrill Lynch.

Derrick Hewitt
Good morning, Ellen, and John. Could you discuss opportunities to further improve operating expense? I don't think the $1,050 guidance in 2018 contemplated the change in SIFI status?

Ellen Alemany
No, it didn't. This is Ellen. It didn't, but what we are doing is really balancing future investment with the expense saves. So, over the past 18 months, we've been investing in a lot of new front office origination capabilities, whether it's material handling, logistics expertise, air, etc. and also investing in technology in the company. But, on the other hand, on the expense side, where I would say lower professional fees, lower compensation costs. We're doing all the spans and layers exercise and looking at locations. So, there're still a lot of expense initiatives in the works.

We will, with the passage of the regulatory relief, have potential to take out some more expenses. For example, we won't have to do resolution planning anymore. We won't have to do certain reports that are required for DFAST or CCAR. We won't be subject to some of the Federal Reserve Bank supervisory assessments. But, as I said, we're looking at how we rebalance and put some investment in the business and then do some cost take-outs.

But, we'll probably come out with some guidance later on this year, after we reach our $1,050 target, of kind of the future expense number after that.

Derrick Hewitt
Okay, great. And, then what percentage of the North American rail portfolio is currently housed in CIT Bank? And, are there additional opportunities to move the portfolio that's financed outside of the bank into the bank at this point?

Ellen Alemany
Well, roughly, I think half the rail portfolio is in the bank today. The other half is up at the holding company. And, then after the sale of NACCO, we'll reduce the rail in half up at the holding company level. And, then as we continue to grow the bank, we'll be able to put more rail assets into the bank.

Derrick Hewitt
Okay, great, thank you.

Operator
Thank you. And, as there are no more questions at the present time, I would like to return the call to management for any closing comments.

CONCLUSION

Barbara Callahan
So, thank you everyone for joining this morning, and if you have any follow up questions, please feel free to contact me or any member of the Investor Relations team. You can find our contact information along with other information on the Investor Relations section of our website, at CIT.com. Thanks again for your time and have a great day.

Operator
That concludes today’s call. Thank you for participating.