CIT Group

First Quarter 2020 Earnings Conference Call

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CORPORATE PARTICIPANTS

Ellen Alemany - Chairwoman, CEO
John Fawcett – CFO
Marisa Harney - Chief Credit Officer
Barbara Callahan - Head of Investor Relations
PRESENTATION

Operator
Good morning and welcome to CIT’s first quarter 2020 earnings conference call. My name is Alyssa and I will be your operator today. All participants will be in a listen-only mode.

After today’s presentation, there will be an opportunity to ask questions. To ask a question, you may press star then one on your touchtone phone. To withdraw your question, please press star then two. If at any time during the call you require assistance, please press the star key followed by zero and an operator will be happy to assist you.

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

Barbara Callahan
Thank you, Alyssa. Good morning, and welcome to CIT’s first quarter 2020 earnings conference call. Our call today will be hosted by Ellen Alemany, Chairwoman and CEO; and John Fawcett, our CFO. Also joining us for the Q&A discussion is our Chief Credit Officer, Marisa Harney.

During this call, we will be referencing the earnings presentation as well as a supplemental presentation that describes our preparedness in response to COVID-19. Both are available in the Investor Relations section of our website at cit.com.

Our forward-looking statements disclosure and non-GAAP reconciliations are included in today’s earnings materials and within our SEC filings. These cover our presentation materials, prepared comments, and the question and answer segment of today’s call.

I’ll now turn the call over to Ellen Alemany.

Ellen Alemany
Thank you, Barbara. Good morning and thanks for joining the call. Wherever you are tuning in from, I hope you are safe and well. The first quarter has clearly presented a new paradigm for all of us and the personal and economic challenges related to the COVID-19 pandemic have been unprecedented. Often times, periods of great challenge provide an opportunity to also test a company’s strength, agility, and values, and these past few months have tested us and demonstrated that we have the fortitude to navigate the issues before us.

CIT today is the result of a multi-year enterprise transformation that has led to an organization with ample liquidity, sufficient capital, substantially less risk in the portfolio, nimble operational capacity, leading franchises with deep expertise supporting them, four diversified and stable core deposit channels, and a seasoned management team that knows how to navigate in a dynamic environment.

We entered 2020 with a much stronger foundation, which has enabled us to actively respond to the challenges presented by this pandemic, as well as advance some of our key strategic initiatives in the quarter. Let me touch on our COVID response first and then I’ll share other highlights from the quarter.
In a matter of weeks, we have effectively transformed the way we operate, while also prioritizing the health, safety and financial needs of our employees, customers and communities. First and foremost, we worked to ensure our employees were safe, and we took a number of steps early in the process to enact the best available guidance on healthy workplace protocols and social distancing. We were one of the first banks to fully shift to a remote-working model in key urban centers like New York City and Chicago as the outbreak started to progress in mid-March. Currently, 93% of our employees are effectively working remotely as a result of our investments in technology and the digital transformation we put in place over recent years. This is a best-in-class standard in our industry and a vital part of our business continuity.

We also continue to evolve our workplace protocols as more information is available on reducing the spread of this virus and understanding the best ways to ultimately emerge from the current isolation measures. We are offering enhanced health benefits for COVID testing and care, as well as ongoing wellness programming to help employees through the stress and isolation of these new lifestyle requirements. We implemented an enhanced pay plan for employees that are not able to work remotely and are providing vital services in support of our business. And, I’m proud to say all of our branches remain open and able to serve customers.

We’ve modified hours and enhanced safety protocols, but we remain open for business. We’re also focused on working with our customers who have been affected by the pandemic and providing relief when we can. We are working with more than 8,600 small businesses primarily in our Business Capital division to provide them deferrals on their existing leases and loans. We quickly stood up an entirely new operational process in order to participate in the government’s Paycheck Protection Program.

We are providing mortgage forbearance to borrowers. We are waiving fees so customers could access deposits without penalty. And, we continue to have ongoing dialogue with our commercial clients and offer them our banking and structuring expertise and assistance in navigating during this period. We know it is a challenging time for many and we are committed to working with our customers. Commitment to our communities remains very important as well, and CIT has committed $1 million to support nonprofit partners with COVID-19 relief efforts in our key markets. While this is still an evolving landscape, I’m proud of the way we’ve been able to adapt to the situation and demonstrate our resilience and commitment to do what’s right for our team, our customers, our communities and ultimately our shareholders.

Turning to the quarter, our results were primarily affected by the impact of the pandemic on the macroeconomic environment, which led to increased credit reserves and a goodwill impairment. The adoption of CECL, which dramatically changed the credit reserve model amid a volatile period. And, the completion of the Mutual of Omaha Bank acquisition, which added about $8 billion of assets and $7 billion of deposits and impacted the comparability of our results versus prior periods. We posted a net loss of $628 million, or $6.40 per diluted common share, due to the increased credit reserves and goodwill impairment. John will go into more detail on the underlying drivers of performance, but first I want to touch on a few key highlights.

We completed the acquisition on Jan. 1 and immediately kicked off our integration efforts, which remain on track and are expected to be completed by year-end. We improved our deposit costs by 34 basis points in the quarter, through the addition and growth of the homeowner association deposit channel, and also through our efforts to further optimize funding in the consumer channels.
The community association banking business, which is the division that drives the HOA deposits, has been off to a strong start and had one of their best growth quarters ever. Between the existing portfolio and the growth in the quarter, that business added another $5 billion of lower-cost deposits to CIT’s funding profile and further bolstered our deposit base. We have already made investments in this business and launched a new reserve deposit product suite, as well as expanded our sales team, and we expect to remain on track in doubling the size of this business in five years.

Our balance sheet remained strong, ending the quarter with more than $42 billion in deposits and $9.5 billion in liquid assets. Our core average loans and leases were up 1% from the prior quarter, excluding the acquisition. Our loans and leases-to-deposit ratio at the bank increased slightly to 95%. And, we remained on target with our expense initiatives.

Managing our risks remains critically important, as it has been for some time. We have maintained prudent underwriting standards and are thoughtfully originating business in areas where we believe there are opportunities. We continue to proactively manage our portfolio and over recent years we have sold or significantly reduced our high-risk portfolios and shifted more toward collateral-based lending. We know there are still some portfolios that will feel the stress of the economic disruption more than others and we have shared more disclosure in the COVID response deck that was posted today.

I’ll touch on the two key areas, which are Energy and Retail. As you know, we are a leader in the Power & Renewables space and have continued to grow that part of our Power & Energy business. We do still have loan exposure to Oil & Gas, though, and it is comprised of about $1 billion in funded exposure, most of which is secured, and represents about 3% of our total loans.

Our exposure to the Retail sector is primarily in our factoring business and half of that factoring exposure is made up of our top 10 customers, which are investment grade or near investment grade companies. Our client base is fairly diversified across consumer segments, and we continue to have frequent dialogue with our clients and work closely with them through this period. Some clients have also shifted their business to produce or procure masks, gowns and other much-needed items in the fight against the coronavirus, and we are pleased to help support them in those efforts. We are closely monitoring these and other portfolios that may be further impacted as a result of the current economic environment.

As mentioned, this quarter we adopted CECL, and we leveraged the capital stress testing capabilities we built when we were a CCAR bank. We conducted a robust process as we set our reserves that reflected what our best view of the economic environment was at that point in time and its potential impact on the portfolio going forward. John will walk you through the details of that process shortly, and as we mentioned, we also have our Chief Credit Officer Marisa Harney available for Q&A later in the call.

To summarize we have ample liquidity and a robust stress testing process to ensure we can meet our funding needs, even in a stressed environment. We continue to run severely adverse stress scenarios, even though we are no longer subject to the CCAR process, which informs our capital levels. Our reserves are strong covering 2.9% of loans and we have an additional $120 million of allowance for off-balance sheet credit exposures. We are confident in our ability to respond to the challenges before us and weather this economic downturn. The work we have done in recent years, has best positioned us for this period and we are actively managing every facet of the company and the continuity of our business.
With that, I’ll turn it to John.

John Fawcett
Thank you, Ellen, and good morning everyone. Our results this quarter reflect three key events during the quarter. First, the acquisition of Mutual of Omaha Bank on January 1st which impacts the comparability of our financial results to prior quarters. Second, we adopted CECL on January 1st. Given that the CECL standard introduces economic forecasting into the allowance for credit loss process, the impact of the COVID-19 pandemic significantly increased our first quarter provision for credit losses. And third, the deterioration of the macroeconomic environment triggered an interim goodwill assessment at quarter-end that resulted in a goodwill impairment.

As Ellen indicated, well ahead of this crisis, we completed a significant transformation of our business that strengthened our risk profile and focused our priorities. We strengthened our balance sheet, as deposits now constitute 84% of our total funding and we eliminated less stable sources of wholesale funding. And we strengthened our risk management practices, sold higher-risk portfolios, shifted our portfolio to more collateral-based loans and significantly decreased our criticized assets, which are down 10% from a year ago.

As a result of our transformation, we entered this challenging environment with a stronger balance sheet to support our customers, clients, communities and employees, as we navigate through this period together.

We have provided a supplemental presentation on our website that describes our preparedness in response to COVID-19, including descriptions of our transformation, corporate and operational response and our liquidity, funding and capital position.

Before I get into the results for the quarter, I want to point out that our funding and liquidity levels remain strong, and we believe, sufficient to endure the current cycle. Our liquidity position is based on a robust stress testing process to ensure we are able to meet expected and contingent funding needs under combined idiosyncratic and market stresses, and we are well positioned to endure this stressed environment.

At the end of the quarter, we maintained $9.5 billion of liquid assets, comprised of available cash and unencumbered HQLA securities, making up approximately 16% of total assets. We also had $3.5 billion of availability under our contingent liquidity sources through secured facilities and our corporate revolver. In addition, our funding mix is substantially deposit based and diversified across multiple channels, including our new stable, lower-cost HOA deposit channel added from the Mutual of Omaha Bank acquisition, which had a record quarter of deposit growth. As Ellen indicated, we are off to a good start and remain committed to doubling this deposit channel over the next five years. Our loan and lease to deposit ratio stands at 95% at the Bank and at 109% on a consolidated basis.

We also have access to unsecured debt markets at both the Bank and the Bank Holding Company. Over the years we have flattened and staggered our debt maturity schedule, and as a result, our next unsecured debt maturity is only $500 million and not due until March of 2021.
Our capital position is sufficient to withstand a severely adverse stress scenario that includes both market and idiosyncratic stresses. While we are no longer a CCAR bank, we continue to run our own models using the severely adverse stress scenario provided by the Federal Reserve. We ended the quarter with a CET1 ratio of 9.7%, reflecting the Mutual of Omaha Bank acquisition on January 1, which reduced the CET1 ratio to approximately 10%, and the adoption of CECL, which as a result of the current macroeconomic forecast, added $405 million to our credit provision.

Throughout the month of March, we continued to assess changes in macroeconomic scenarios as the impact of the pandemic accelerated globally. We analyzed and modeled various scenarios from a third party that is widely used in the industry, to quantify the sensitivity of the Allowance for Credit Loss, or ACL, to changes in the underlying macroeconomic forecast. We ultimately utilized an updated baseline scenario, which reflected expectations for economic impacts from COVID 19 as of March 20th and added an additional downside adjustment that took into consideration developments heading into quarter-end.

The baseline scenario assumed a return to economic growth in late 2020 while the downside adjustment incorporated more stressful scenarios. These additional scenarios assumed a more severe V-shaped recession with a reduction in annualized real GDP growth of close to 20% in 2Q of this year, as well as a less volatile but more prolonged U-shaped recession that assumed an elevated unemployment rate through early 2022.

We also took into consideration scenario probabilities, the potential impact of government support, prior capital stress testing results and the limitation of models when a high degree of volatility is introduced to the macro forecast. We estimate that the impact of the additional reserve reduced capital by about 60 basis points after adjusting for the new 5-year transition per the Inter-agency Interim Final Rule. We provided a CET1 walk in the appendix of the earnings presentation that highlights the impact of the transition rule.

We maintain our commitment to our regulators to raise our CET1 ratio to our target level of 10.5%, although our timing to achieve that goal may now be longer than initially expected. Based on our current capital and RWA levels, we have a capital buffer of $1.2 billion when compared to the Federal Reserve Minimums, including the Capital Conservation Buffer levels.

To provide some additional context around the sufficiency of our capital levels with respect to on-going uncertainty in the economic environment and CECL reserves for loan losses, we conducted a sensitivity analysis leveraging our nine quarter cumulative loss rate from our 2019 severely adverse stress scenario to our current level of loans.

This scenario reflected a deep and prolonged recession with declines in GDP for seven consecutive quarters and an unemployment rate in excess of 8% for all periods except the first three quarters, peaking at 10%. Based on this sensitivity analysis, our current reserve level of $1.1 billion would be about 60% of the implied stressed losses over a nine quarter period, implying an increase in the CECL reserve of approximately $800 million compared to the March 31 reported amount. We will update our capital stress test later this year as markets normalize and intend to also run the Federal Reserve’s 2020 severely adverse stress scenario applied by the CCAR banks.

Before we get into the details, I want to let you know that given the uncertainties created by the COVID-19 pandemic on the current macroenvironment, we are withdrawing our outlook for full year 2020 and our medium term ROTCE target.
Turning to the Financial Results on slide 3 of the presentation, I will refer to the First Quarter 2020 Earnings slide deck.

We reported a GAAP net loss of $628 million or $6.40 per diluted share, driven by a goodwill impairment and a higher credit provision, both a result of the market environment driven by the COVID-19 pandemic. Noteworthy items are listed on slide 5 and included an after-tax goodwill impairment charge of $339 million.

The deterioration of the macroeconomic environment, the low rate environment, and in particular, the decrease in CIT’s and peer bank stock prices, triggered an interim goodwill impairment assessment that resulted in an impairment charge. The charge did not include the goodwill recognized with the acquisition of Mutual of Omaha Bank, and is a non-cash charge and did not have any impact on regulatory capital.

Other noteworthy items resulted from the Mutual of Omaha Bank acquisition and included the $37 million after-tax CECL reserve on acquired non-PCD loans that flowed through the P&L as a credit provision on the day of acquisition. The charge represents a double-counting of credit risk in both the purchase price and the allowance build. In addition, we recognized $14 million in after-tax merger and integration costs.

Excluding noteworthy items, we reported a net loss of $238 million or $2.43 per share, reflecting the credit provision of which $405 million, or $332 million after tax, is driven by the forecasted macroeconomic environment.

Slides 6 & 7 highlight our net finance revenue and margin. Net finance revenue grew from the prior quarter, reflecting higher assets from the Mutual of Omaha Bank acquisition on January 1st and growth in our core loans and leases. However, Net Finance Margin declined to 2.73% as the swift 150 basis point cut in the Fed Funds rate this quarter and lower Libor levels resulted in a significant reduction in the yields on our floating rate loans and securities.

The reduction in asset yields also reflects the addition of the Mutual of Omaha Bank loans and securities that are lower yielding. We also recognized $9 million of accelerated premium amortization in our MBS portfolio, reducing margin by 6 basis points. And, loan prepayment levels fell significantly as a result of the current environment, resulting in lower prepayment related benefits.

In our rail business, net operating lease revenues declined further than expected, as utilization declined to about 91% from 94% last quarter. Renewal rates repriced down 18% on average, and maintenance costs were higher, including increased storage costs from off-lease cars. Lower borrowing costs offset some of the impact on asset yields, as the addition of lower cost HOA deposits from Mutual of Omaha Bank, lower market rates and pricing actions across all our deposit channels resulted in a reduction in deposit rates.

Other non-interest income improved to $131 million and is illustrated on slide 8. The increase reflects higher net gains on sales of assets. Improvements in fee income from last quarter included activity from our Community Association Business acquired from Mutual of Omaha Bank. Capital markets fees increased modestly as we continued to build momentum earlier in the quarter before the challenges of the COVID-19 pandemic. We had a minimal long position at the end of the quarter, and took a $4 million mark, which we believe is appropriate to clear these positions in the coming months.
Given the historic level of interest rate volatility, our customer derivatives business had a record quarter. However, the increase was more than offset by a negative mark of $8 million on credit valuation adjustments given widening credit spreads.

Factoring commissions were down reflecting lower factoring volume from seasonality and the slowdown later in the quarter resulting from the current macroeconomic environment.

We generated about $14 million of gains on sale of securities, as we took advantage of opportunities in the fixed income market and sold some of our investment securities, including non HQLA securities, acquired from Mutual of Omaha Bank. As part of our ongoing portfolio risk management activities, we opportunistically sold PCD loans from the legacy consumer mortgage portfolio. While higher yielding, we generated approximately $13 million in gains, further reduced our risk profile and released reserves.

Looking into the second quarter, we see the following trends. A significant reduction in factoring volume reflecting a full quarter impact from COVID-19 and the U.S. retail shutdown, which will impact commissions significantly. As part of our portfolio management activity of our rail fleet, gain on sale of rail cars have been running between $15-$25 million per quarter. We expect lower gains next quarter as we will likely delay some of that activity to later in the year given the dislocation in the market.

We will continue to look for opportunities to selectively prune the LCM portfolio although the current environment may make this challenging in the near term. In terms of capital markets activity, we continue to see opportunities to lead transactions in our core industries less impacted by the current environment, although we are pursuing more arrangements in this environment.

These deals are likely to have stronger structural protections and wider spreads. Our capital markets pipeline is reasonably strong in those industries, although predicting when deals will come together is still uncertain.

Turning to slide 9, we continue to be disciplined on the management of our expenses and remain focused on achieving the additional $50 million in net cost reductions in 2021 along with the additional $30 million in cost synergies we committed to from the Mutual of Omaha Bank acquisition.

The increase in operating expenses this quarter primarily reflects the addition of Mutual of Omaha Bank and seasonality, and to a lesser extent from first quarter benefit restarts. For 2020, we still expect to achieve the $16 million in cost synergies related to the Mutual of Omaha Bank acquisition.

Slide 11 provides more detail on average loans and leases by division. Excluding the $6.3 billion in loans acquired from Mutual of Omaha Bank, our average core loans and leases increased by 1%. In Commercial Banking, our pipelines were strong heading into the quarter and while market sentiment shifted dramatically in March following the acceleration of the COVID-19 pandemic, we continue to close deals for our clients.

Origination volumes were up 30% from the year-ago quarter and essentially flat compared to the 4th quarter. In March, prepayments slowed considerably in Commercial Finance and Real Estate Finance, contributing to asset growth.
Revolver utilization increased in the second and third week of March as clients drew on their lines given increased business uncertainty, although defensive draws started to moderate toward the end of March and have been modest since the beginning of April.

Given our middle market focus, we generally don’t participate in larger revolving loans, and therefore, we don’t expect to see the same level of revolver draws as some of our regional bank peers. Through last week, we have funded $620 million of defensive draws for our clients across commercial banking. A little over a third of those draws were in commercial services, our factoring business, with a little more than half across the rest of Commercial Finance and the rest in Real Estate Finance. Our increased focus in Treasury and Payment Services helped us to retain a significant portion of these draws as commercial deposits.

As Ellen indicated we are also working with our small sized customers to provide payment deferrals for up to three-months for qualifying customers impacted by the economic events brought upon by COVID 19. We expect these loan modifications to meet the requirements to suspend the TDR classification, and any related impairment for accounting purposes.

The macroenvironment has also added pressure to the North American Rail Industry. Rail car loadings have generally declined as the impact of COVID-19 has put more pressure on most industrial sectors and the low oil prices have reduced car demand in that sector. We are seeing more resiliency in demand in our cars carrying grain, and plastics.

Given the macroenvironment, we expect further deterioration and now think our lease rates will reprice down 20% in 2020 and utilization could decline to the mid to high 80% area over the next 12 months, depending on the duration of lower oil prices and the COVID-19 pandemic. We are staying in close communication with our rail customers and stand ready to support them through this crisis.

We have a diverse fleet with broad market coverage servicing a wide range of industries. Our strategy is to remain vigilant on asset readiness and ensure we have the cars that meet our customer demand requirements. The average age of our fleet is 14 years, the youngest in the North American market. We have more higher load capacity cars, which maximizes shipping optimization for our customers. And our strong market position and management team, as well as our customer service, positions us well to navigate the current environment.

Moving onto deposits on page 13, we are off to a good start in our new lower cost, HOA channel, as we focus on doubling these deposits over the next 5 years. First quarter growth tends to be seasonally high, and this year the team had their highest growth rate ever. We ended the quarter with just over $5 billion in deposits and expect continued growth in line with expectations as we move further into the year.

Average overall deposit costs declined 34 basis points to 150 basis points reflecting the mix of lower cost deposits from the acquisition as well as continued downward repricing in all other channels.

In the Direct Bank we will continue to monitor the market and remain competitive in products that align with our strategy, as we optimize costs and funding needs. Our Direct Bank deposits have grown a little over $1 billion since the start of the quarter and we lowered our non-maturity deposit rates by 5 basis points on April 5th and another 15 basis points on April 20th.
Direct Banks, including ourselves, have reduced their rates for CDs and Savings products, but we have not seen a significant reduction in alignment with the sharp reduction in Fed Funds rates. That said, we expect over time we will see larger rate reductions in non-maturity deposits from the online banks, ourselves included.

Slide 14 highlights our credit trends. Net charge-offs increased this quarter and were primarily driven by oil and gas loans, most of which were acquired in the Mutual of Omaha Bank acquisition, and an increase in the Business Capital division, mostly related to transportation. For non-accrual loans, the increase in Consumer Banking relates to the accounting presentation for PCD loans, which upon the adoption of CECL are now subject to the same presentation and disclosure as non-PCD loans.

The adoption of CECL and the Mutual of Omaha Bank acquisition, increased our ACL, on January 1st, by $280 million, representing a coverage ratio of about 2%. Note that $141 million of this increase relates to PCD loans and therefore did not impact capital.

In the first quarter, we significantly increased those reserves to $1.1 billion, due to the impact of the COVID-19 environment, bringing our coverage ratio to 2.9% of total loans. We also added $65 million to our allowance for off balance sheet credit exposures, bringing total reserves for on and off-balance sheet exposures to over $1.2 billion. We have included a page in the appendix of the presentation that provides some more detail on the components of the reserve. Note that our ACL reserve is a point in time measure that will continue to be informed by ever changing macroeconomic conditions and impacted variables.

Before I turn it back to Ellen, I wanted to highlight that we also provided in the COVID-19 supplemental information additional information on portions of our portfolio expected to be more impacted by the current environment, including:

Retail exposure within our factoring business, which consists principally of unsecured, short-term discretionary lines and where our top ten customers, who constitute about 50% of our exposure are investment grade or near investment grade. Oil and gas loans, which are geographically diversified across major producing basins, and where only about half of our loan exposure is to reserve-based loans. Borrowers with exposures to commodity prices are predominantly hedged in 2020 and into 2021.

Retail and hotel exposure within our Real Estate Finance division, which are backed by strong sponsors with whom we have long-term relationships. Senior Living exposure which is geographically diversified gaming exposure, which is more to regional borrowers, as opposed to tourist destinations. And Restaurants/Franchise Finance where the majority of the exposure is to strong, national brands in the quick-serve industry.

We also added a number of pages in the appendix of the presentation to provide additional information on some of our portfolios including Collateral-backed portfolios, cashflow loan portfolio and our rail fleet.

Our collateral-backed loan portfolio includes loans made to financial sponsors that are secured by strong collateral with LTVs as of the end of the year in the 50-60% area. These include Commercial Airlines exposure, which is primarily to financial sponsors and backed by commercial aircraft leased to strong quality airlines. And our Maritime exposure, which is to well-diversified, mainstream, ocean-going assets and primarily with long-term contracts. We have no exposure to cruise lines.
We also added a page to describe our Cashflow loans, which we reduced to about 10% of our total loan and lease exposure in the transformation. And finally, we included some additional disclosure on our rail fleet to highlight the diversification of our fleet by both car count and net investment.

We are watching all these sectors closely and applying sector specific stresses on cashflows, analyzing collateral and staying in close communication with our clients as we monitor the vulnerabilities within the portfolio.

With that, I will turn the call back over to Ellen.

Ellen Alemany
Thanks, John. As mentioned, these are unprecedented times, and I am confident that we have the resources, expertise and rigor to continue to navigate this environment with diligence and care. The CIT of today is completely different than the company that went through the last economic disruption.

We are a national bank with diverse and stable sources of funding. We have strong liquidity levels and robust risk management practices. We will continue to focus on ensuring we have ample capital and liquidity to weather this environment and believe the strength of our balance sheet gives us a stabilizing force through this volatile period. We are also focused on pursuing opportunities where we see them in the HOA banking channel and other areas of the commercial segment that could align to our strengths. We remain steadfast in doing the right thing for our employees, customers, communities and shareholders.

And, with that, we’re happy to take your questions.

QUESTION AND ANSWER

Operator
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 are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press Star, then 2.

The first question today comes from Moshe Orenbuch of Credit Suisse. Please go ahead.

Moshe Orenbuch
Great, thanks. I guess I saw the disclosure there in the discussion about the performance and the reserve needs in the severely adverse scenario. I’m wondering if you can talk about whether there are portfolios that you think would perform potentially less bad than in the severely adverse and ones that could perform worse than that, given what you know today about current effects and trends.

Ellen Alemany
You know what, Moshe, we have Marisa Harney, our Credit Officer, on the line. I’m going to turn that one over to Marisa.

Moshe Orenbuch
Great, thanks.
**Marisa Harney**
So, thanks, Ellen. Good morning. Less bad and more bad are relative terms, obviously in the current environment. I think that less bad is going to be more dictated by duration than necessarily a specific industry.

We have a pretty broad-based middle market business. We also have technology businesses and renewable energy that I think I would put on the greener side of being more positive in the current environment. And, as Ellen identified, and John identified, I think that obviously with oil falling into negative territory, I think oil and gas—which we have about $550 million of E&P exposure, and that’s disclosed in the additional material—is clearly something we need to watch closely. And, then there’s a very unpredictable environment going on in retail, which will be dictated by, again, the duration of the government—the U.S. government keeping us closed.

I think that as Ellen also indicated, 50 percent of our portfolio and our factoring retail is in investment grade companies and I expect those to be not as impacted.

**Moshe Orenbuch**
Okay, thanks. Maybe as a follow up, John, you talked a bit about the rail portfolio and talked about the potential for higher costs as you kind of do some repositioning and potentially maybe—is there a way to kind of think about the impact of that on net finance revenue as we go forward?

**John Fawcett**
Yeah, well, look, as a starting point, I think obviously we withdrew guidance, as I think most banks did. I think there’s just not a lot of visibility. I think, Moshe, when I sat with you on stage back in the end of February at the Credit Suisse conference, we talked about utilization maybe going down to 92 percent and then starting to bounce back a little bit around the rest of the year.

You’ve got 24 percent North American fleet is still parked in storage and that seems to be increasing. If you just look at—and don’t usually do this, but weekly rail loadings are reflecting the economy. Auto is down 67 percent week on week and obviously we’re light—well, not obviously, but we’re light in auto tracks. Chemicals and petroleum and down 7 percent week on week. That’s likely to continue with the glide of oil.

And, the bright spots are in agriculture and paper products. And, so it’s tough. I think our guidance is, is that we expect that rail utilization could go into the mid-80s and mid to high 80s from where we’re at right now. And, then beyond that, you’ve got the incremental cost as utilization declines of the storage—of more cars going into storage.

So, it’s just going to be challenging. I think like everything else, it’s going to be tied largely to the pace of the recovery and what kind of recovery we start to see in terms of whether it’s U-shaped or V-shaped. If it’s a V-shape recovery, you might expect these trends to reverse fairly quickly. If it’s other than that, it could be retracted much longer. But, it’s clearly going to have an adverse impact on net finance margin going forward.

**Ellen Alemany**
Yeah, but I also want to add that there’s a lot of things that we’re doing about this. One is just rigorous portfolio management. We have received some request for lease restructuring and rental relief and we are addressing these on a case by case basis.
We are looking for opportunities to repurpose sand cars. We’re also working on continuing to drive down our maintenance costs and we have a lot of initiatives going there, including managing our repair process, increasing the use of mobile repair units, and so this has allowed us to offset the pricing trend a little bit.

And, then as John mentioned in his script before that other strategies about selling older cars as a gain, we’ll probably expect lower gains over the next quarter. But, I do want to leave everybody with the thought that we should remember that rail cars are long lived assets and their performance should be reviewed over cycle, not just a point in time.

Moshe Orenbuech
Got it. Ellen, John, and Marisa, thanks and good luck.

John Fawcett
Thank you.

Operator
The next question today comes from Eric Wasserstrom of UBS. Please go ahead.

Eric Wasserstrom
Great, thank you. Can you hear me all right?

Ellen Alemany
Yes, we can.

Eric Wasserstrom
All right, great, thanks. John, just to start, could you help us from what economic outlook is your base case scenario for whatever your horizon is at this point?

John Fawcett
Yeah. So, I think the easiest way to describe the way I think about it is it’s kind of a scenario cocktail. And, we use three scenarios. We added an updated baseline pandemic scenario for Moody’s on March 20th, which was our baseline. and that’s when we kind of snapped the line in terms of preparation for quarter end.

We had the more volatile V-shape scenario, which had a deeper cut into the second quarter and a more spontaneous recovery into the third quarter. And, then we leveraged another scenario, which we labeled as S3, which was a severely adverse scenario.

And, so just to kind of give you some context in terms of the different scenarios, in terms of GDP, if you looked on our baseline, it had GDP down 5 percent and then moderating in the third quarter, down just .3 percent. If you looked at the more volatile V-shape scenario, you had GDP in the second quarter down almost 20 percent, but recovering 11 percent in the third quarter. And, then in the severely adverse scenario that we also kind of applied as an overlay against the base case, you had GDP down 5 percent in the second quarter and then down another almost 3 percent in the third quarter.

And, so it’s a little bit of alchemy in terms of pulling all the numbers together. And, I think if you look at a new baseline that I guess Moody’s has provided on April 10th, it pretends that again, it’s another V-shape recovery, but in the second quarter, you’d have GDP declined by 30 percent, but in the third quarter, it would bounce back to 17 percent.
So, I mean, that kind of—the thoughts around the way we kind of manage through the process. I think obviously, we’re going to continue to monitor the scenarios, our own portfolios in terms of real experience, the capacity of the government programs to provide some level of recovery going into the economy. And, I think we’ll have a better sense of this and more refinement as we get into the second quarter, but it’s obviously very fluid.

**Eric Wasserstrom**
Great, thank you for that. And, sorry, that was really the preference to what is my real question, which is if we think about the vulnerabilities as being in three categories around revenue, around operating expense, and around provision, if you were to move let’s say from that central scenario to the S3 scenario, where would the vulnerability be most acute, relative to your financial position today? More on the revenue side or potentially more on the provision side?

**John Fawcett**
Well, I think it’s clearly more on the provision side and the revenue side. I mean, we’re at 0 rates. I mean, so we’re already kind of feeling that challenge and it started to feed through in March. I mean, if you looked at the first quarter, January and February were actually quite good months for us and even halfway into March, we were fine.

Part of this is—and part of the way we’re thinking about forecasting—and it’s very difficult because it remains very fluid—is that you can almost run rate March into the second quarter and absent—we wouldn’t expect that we’re going to take another $400 million charge and obviously goodwill is behind us now. But, run rating March and then having potentially some incremental element of provision I think is really the larger challenge in terms of what we’re going to face on a go-forward basis is provision.

**Ellen Alemany**
Yeah, I would just add that on the expense side, we’re on target for all of our cost reductions. We had the $50 million in that cost reductions for 2021 over and above the $16 million in the cost saves from Mutual of Omaha. So, we feel we’re on track and we actually believe there’s some more opportunity there on the expense side of the business.

And, I think we do see some potential opportunities on the revenue side of the business. Going into the pandemic, we had a really good quarter in capital markets with organic growth. Fees were up, like, 25 percent. We’re having very good momentum on the deposit side of the business. In fact, when you look at the defensive drawdowns from the commercial business, we were able to keep a third of those deposits now for company-like CIT, which really, I think that’s been a really big accomplishment for CIT to do that. It really shows our strategy of trying to expand customer relationship and focus on deposits.

And, I think that our strengths in ABL and our industry expertise is going to position us well for a lot of the restructures going on in the market and restructuring activity. In business capital, one of the bright spots has been technology leasing because of the trend of schooling at home and working at home. We’ve had really good volumes in technology and I think one of the first places we’re going to recover here is in construction, which will also bear well for the business.

So, we do see some bright spots here coming out of it.

**Eric Wasserstrom**
Thanks very much for taking my questions.
John Fawcett
Sure.

Operator
The next question today comes from Chris Kotowski of Oppenheimer and Company. Please go ahead.

Chris Kotowski
Yeah, good morning. I guess my key question is the durability, overall the durability of your pre-provisioned net revenues. And, I guess looking at the rail and leasing business there, you mentioned the utilization rates coming down and increased maintenance costs and all that. But, when we see--if you look at it linked quarter, the net lease revenues went from, like, $98 million to $78 million. I mean, how much of the impact have we seen? Because I mean, it just seems like we would have only had, like, a couple of weeks of the impact in 1Q. So, should we expect another meaningful drop in that net lease revenue or can you size that for us in any way?

John Fawcett
Yeah, hey Chris, it's John. I mean, it can't probably be sized just because it's a function of, I guess, the recovery period. I guess what I would say also, it really depends. So, in any given quarter, you'll have between 4/5/6,000 cars that are renewing and it fundamentally depends on what kind of cars are renewing.

Since the impact, obviously the renewal rate is going forward. And, so it's all tied back to the recovery or the pace of the kind of recovery we still--look, I clearly--we weren't anticipating utilization going down to 91 percent or 90.7 percent in this quarter. If we see a V-shape recovery, that could bounce back pretty quickly, especially if the economy starts to come online, people start going back to work as social distancing protocols all start to abate, and the economy gets back online.

But, absent an economy, it's not clear what you're actually shipping. And, so it's all interrelated and I'm sorry I can't give you a better answer. But, there is no clear answer.

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

Operator
Again, if you have a question, please press Star, then 1. The next question today comes from Arren Cyganovich of Citi. Please go ahead.

Arren Cyganovich
Thanks. Looking at the COVID deck that you put out, slide 15 I found pretty useful. The--I'd say that the only area that I think I'd be a little bit concerned about is when you look at the size of the various areas that you highlight here.

You're looking at, like, three and a half billion excluding the factoring as kind of problem areas, where you have $1.2 billion of capital above your buffer. How do you give us a little bit more comfort that you're not going to have 50 percent severity in your oil and gas and hotel and gaming? There's all these different kind of subsectors where there's seemingly a large level of potential loss capability from those books.
Ellen Alemany
Marisa, you want to take that one?

Marisa Harney
Sure. I think that these are not equal in severity. As we mentioned, in the factoring receivables, a considerable portion of that is investment grade. So, we’re not anticipating that that’s going to result in any material issues for us.

When you look at the oil and gas number—I know you were running your finger down that left-hand column—only about half of that is actually exposed in the E&P sector and we believe that our customers are hedged 75 percent this year and 50 percent into next year at considerably higher levels of oil prices. I guess anything is considerably higher than negative, but they’re in many cases over $50 a barrel.

The real estate is collateralized with good properties and with strong sponsors, and we—so, we’re negotiating those individually. We really focus on strong partners on the construction side and on the management side. And, again, for things like hotels and lodging, duration is going to be key.

Our senior living exposure is pretty diversified and obviously collateralized as well. And, the gaming—again, duration on the gaming side, in the last downturn, regional gaming actually was much more resilient than tourist-based gaming, although every cycle is different. And, so this is really about making sure that these companies have sufficient liquidity to weather through to an opening.

And, then in our franchise finance business—which is relatively small—the quick serve industry, the fast food industry, is actually a little bit more resilient than casual—certainly more than casual dining because they have—it’s a lot easier for them to do takeout and drive thru. So, again, the severity levels are very different, and they’re taken on a case by case basis. And, I think as I said before, duration is key.

Arren Cyganovich
Okay, I appreciate that. That’s helpful. Maybe we could just dig a little bit more onto the factoring side, because I think this is an area where people don’t have a deep understanding of the risks associated with those and those are obviously have large numbers when you just look at the total receivables that you have in that business and understanding that you have strong counterparties on half of the book. Maybe just talk about the other part of the book, the smaller customers you have there, what the credit risk of this book is. Is it more of a credit issue or is it more of a fact of that you may actually just lose a significant amount of volume here from retailers that may be struggling?

Marisa Harney
Well, I’ll take the credit question. The remainder of the book is spread out over about 25,000 individual retail customers, and these are customers of our clients. And, we’ve been monitoring this portfolio very aggressively, since—well, for a long time, but in particular, since 2016 when it was clear that there was a secular issue in bricks and mortar retail.

And, so we’ve been taking considerable actions where we could and where it was available to us to mitigate the risk that we had, either through cash collateral, letters of credit, and also other techniques that we have in terms of how we manage those receivables in the context of our client exposures.
And, so we’ve done a considerable amount of work to reduce lines, lines under which we purchase factored receivables, and as I said, engage in other risk mitigating techniques. Our exposures are short term. They’re trade receivables. Typically, unless someone is in liquidation, we would expect that they would want to protect their trade credit and so--and we’ve been monitoring retailers in terms of the ones that we thought had the survivability way before this.

So, we entered this crisis in good shape, but as I said, it’s extremely unpredictable. It’s going to be driven by duration. But, seven out of ten of our top ten clients issued in the capital markets in the last several months. So, the markets are open to the industry.

Ellen Alemany
Right. Yeah, and I just want to add that we’re in daily contact with our factoring clients, providing them a lot of expertise and advice during this period. And, one is that China factories are back open. They’re running, like, at 80 percent.

We have observed that certain of our customers are gathering liquidity in anticipation of re-opening, which really could pretend their intention to meet vender obligations. We also have exposure to certain retailers who remain open, such as the discount and online stores. But, it’s an evolving situation and we’re continuing to work closely with them, navigating with them during this time.

John Fawcett
And, the other thing in would add is just to be really clear as we do expect factoring commissions to be down in the second quarter. I mean, this is a supply challenge, as well as a demand challenge.

Retailers have to start opening and shipments start--have to start coming in from not just China, but around the world. So, a lot has to happen for us to get back in standing.

Ellen Aleman
Yeah.

Arren Cyganovich
Thank you.

Operator
This concludes our question and answer session. I would like to turn the conference back over to management for any closing remarks.

CONCLUSION

Barbara Callahan
Great, thank you, Alyssa, and thank you, everyone, for joining this morning. If you have any follow up questions, please feel free to contact the Investor Relations team. Our contact information is on the website. Thank you again for your time. Stay safe and healthy, and have a great day.

Operator
The conference has now concluded. Thank you for attending today’s presentation. You may now disconnect.