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EDITED TRANSCRIPT

EQB.TO - Q2 2017 Equitable Group Inc Earnings Call

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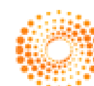

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CORPORATE PARTICIPANTS

Andrew R. G. Moor *Equitable Group Inc. - CEO, President and Director*

Timothy Wilson *Equitable Group Inc. - CFO, VP, CFO of Equitable Bank and VP of Equitable Bank*

CONFERENCE CALL PARTICIPANTS

Geoffrey Kwan *RBC Capital Markets, LLC, Research Division - Analyst*

Graham Ryding *TD Securities Equity Research - Research Analyst of Financial Services*

Marco Giurleo *CIBC World Markets Inc., Research Division - Associate*

Stephen Boland *GMP Securities L.P., Research Division - MD & Equity Research Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen, I'd like to welcome shareholders and analysts to Equitable's Second Quarter 2017 Conference Call. (Operator Instructions)

We remind you that certain forward-looking statements will be made on this call, including statements regarding possible future business and growth prospects. You are cautioned that forward-looking statements involve risks and uncertainties detailed in the company's periodic filings with Canadian regulatory authorities. Many factors could cause actual results or performance to be different from those expressed by such forward-looking statements. Equitable does not undertake to update any forward-looking statements made by itself or on its behalf, except in accordance with applicable securities laws.

This call is being recorded for replay purposes.

It's now my pleasure to turn the call over to Andrew Moor, President and CEO of Equitable Bank. Please go ahead, Mr. Moor.

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

Thank you, Karina. Good morning, everyone, and welcome to our call. I'm joined by Tim Wilson, Chief Financial Officer of the Bank.

In last quarter's call, we assured the Equitable stakeholder community that we were taking the appropriate steps to protect our Bank in the event of prolonged market volatility. Now that you've seen the Bank's results, I think it's accurate to conclude that Equitable made good on those commitments and still delivered a profitable quarter in challenging circumstances. Moreover, this episode proves the conservative way our Bank is governed allowed Equitable to keep the confidence of customers, business partners and the broader Canadian banking market.

Before jumping into the results of the quarter, I thank all stakeholders for recognizing the strength of our institution and the value of our rigorous approach to governance, internal controls, compliance and risk management. Your support is much appreciated.

I'm going to begin by highlighting the actions taken to reinforce the Bank's funding and liquidity positions and the outcome of both these moves, Tim will then fill in more details to give you a clear picture of the associated costs, and I'll conclude with thoughts on our operating environment, including updates to B20.

I'll begin with funding. As you know, funding markets were significantly disrupted in late April and into May. We crack activity. We began the second quarter with $9.9 billion of deposit principal. When the disruption began dominating the headlines, we experienced elevated levels of deposit

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attrition, as we spoke to you about last quarter. The Bank's sources of funds are well diversified, but we were still concerned and moved swiftly in response on a number of fronts.

As you know, and most importantly, we secured a $2 billion backstop facility from a syndicate of the big 6 Canadian banks. We did not use this funding in the quarter. And although it is cost-effective, we will not likely use it over the next 2 years now that funding markets appear to have stabilized. However, the facility provides very significant downside protection if we need it.

We also insured and securitized an $892 million portfolio of residential mortgages. While insuring the portfolio was expensive and will have a negative impact -- negative P&L impact over the next 3 quarters, this action will lower our funding costs over the following few years.

Looking at the outcomes of these steps, we succeeded increasing the Bank's liquid assets by over $400 million during the quarter. I'm also to report -- pleased to report that we ended Q2 with $10 billion of deposits, up $57 million for March 31. And those balances have continued to rise since the end of the quarter.

As we discussed on previous calls, the diversification of funding sources over the past few years is one of Equitable's most important strategic advancements and served us well during these moments of uncertainty.

Turning to quarterly results. Diluted EPS was 11% higher than a year ago, even though we incurred the cost of reinforcing our liquidity and despite the fact that shares outstanding were higher this year than last due to the OMERS private placement in December. Book value per share was also up 21% year-over-year at June 30. ROE, on the other hand, was 1.5 percentage points lower than a year ago at 15.6% and will likely range from 13% to 15% for the remainder of this year.

As you saw from today's earnings release, the quarterly dividend was increased by 4% to $0.24 per common share. That is 14% above the payment last October and marks the Bank's 12th dividend increase in 7 years.

Part of operating prudently in a risk-heightened environment is to control the cadence of asset growth so it does not put further pressure on funding or liquidity. As you recall, we made it very clear that we would not rush to fill the marketplace void left by the retrenchment of a competitor. In the face of surging demand, we stuck to our plan and controlled the flow of applications. As a result, while mortgages under management grew 18% year-over-year to a record $22 billion, originations were down, although not equally the same business line.

We chose to emphasize single family as it is fundamentally a franchise business and delivers the highest ROE. As a result, single-family originations of $939 million in that business line were just a shade lower than the record levels achieved in Q2 of last year, and were achieved through what appears to be significant market share gains.

Reflecting our ability to quickly control the flow of business, commercial lending originations were down 38% from a year ago. Again, this performance did not reflect a reduction in market demand but a rationing of our funding. This decision disrupted several quarters of momentum, but commercial principal was still up 16% since Q2 of last year due to strong activity in prior quarters.

Equitable remains committed to our commercial customers and partners and will continue to be an active lender on high-quality commercial deals. In fact, we expect commercial originations to grow into the third quarter compared to the second quarter, as we selectively address strong market demand. All things considered, we expect commercial principal to remain around the $2.8 billion level until the end of the year.

In Securitization Financing, the quarter played out pretty much as we anticipated. Our multifamily securitization business continued to provide a solid and reliable stream of activity with originations matched to our capacity to securitize loans through sales to the Canada Housing Trust.

Also as expected, activity in the insured single-family market declined and competition increased, resulting in our prime originations being 71% lower than last year. We believe this decline reflects the policy decisions made by the Department of Finance last fall to curb the growth of the insured market. Despite policy headwinds, our single-family team continues to make good progress in broadening our broker network for insured single-family loans and advancing toward our goal of being best-in-class in adjustable rate mortgages.

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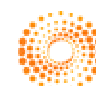

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Moving to credit performance. Net impaired mortgage assets were down $8.9 million from March 31 to $29.3 million or just 16 basis points of mortgage assets. This largely reflects a decrease in impaired loans in our single-family portfolio across multiple provinces, including a $2.3 million decrease in Alberta and Saskatchewan.

For the Bank as a whole, we expect our arrears rates and credit loss provisions to remain low for the final half of 2017, assuming that Canadian economic conditions stay within the broad -- range of broad market expectations.

I'd like to pause here to acknowledge our long-term track record of managing credit risk. For well over a decade, Equitable's net realized credit losses have been far lower as a percentage of total loans than any large Canadian Bank or other midsize competitors. This is not happenstance. It's the direct result of our culture, our robust internal control framework and our 3 lines of defense approach diligently applied every day in our mortgage underwriting process.

To point out the key features of our process, we take a balanced approach to credit adjudication, using every 1 of the 5 Cs of credit management to assess underlying collateral, credit history, character of the borrower, capital resources and capacity for repayment. And in so doing, always independently verify the income of that borrower in order to gain a true and complete picture the risks.

Our sales team has been separated from underwriting for years, and we maintain the separation of duty on our credit teams to reduce any possibility of collusion. And no member of our credit management staff has volume targets nor are they rewarded for the volumes they achieve. Effective, disciplined risk management is part of the DNA of our Bank and it's one of the key reasons for our long-term success and our performance this quarter.

Another telltale sign of prudent governance is the Bank's capital ratios. We have the highest capital ratios of any publicly traded Schedule I Bank and have had for some time. This includes a CET1 ratio of 14.8%, more than double the Basel III requirement. All told, Equitable is in a great position for whatever the market holds in store.

Now I'd like Tim to review our quarterly financial performance and explain the various costs incurred to reinforce our liquidity position. Tim?

Timothy Wilson - *Equitable Group Inc. - CFO, VP, CFO of Equitable Bank and VP of Equitable Bank*

Thanks, Andrew. And good morning, everyone. Second quarter performance, and most notably our NIM, was affected by costs related to bolstering our liquidity position. We've pegged those costs at about $8.5 million pretax or $0.38 per share in the quarter, comprised of upfront and standby fees associated with the $2 billion backstop facility, amortized premiums for insuring $892 million of residential mortgages and EQ Bank marketing campaign expenses that were pulled forward from later quarters.

Not included in these numbers are other key items which had an impact on our performance but where that impact wasn't black and white or may extend for an under-period -- undetermined time period, such as the increase in our deposit rates. I'll speak to some of those costs when reviewing noninterest expenses and NIM.

As a partial offset to the extra expenses incurred in the quarter, we are in $0.10 per share of gains associated with the Maple transaction. This level of earnings was higher than we had forecast as a result of gains we realized on certain investments that we acquired after the initial deal was closed. Our outlook is still for $0.06 to $0.08 of income in each of Q3 and Q4.

Moving to net interest income. It was 17% ahead of last year, mainly due to 15% asset growth. NIM was higher than last year by 2 basis points despite a 14-basis-point decrease in core lending NIM. The reason is that the core lending decline was more than offset by an 8-basis-point increase in securitization NIM, and more importantly, some positive portfolio mix effects.

Core NIM reflected the cost of the credit backstop facility and amortization of the portfolio insurance premium as well as slightly lower spreads within both single family and commercial, which were affected by the deposit rate increases that we implemented in May. These items were partially

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offset by higher prepayment income and a shift towards our lower-cost securitization funding options, which was made possible by securitizing the portfolio of insured mortgages.

Securitization Financing NIM grew largely because of mortgage prepayment income. In comparing Q2 to Q1, NIM was lower by 3 basis points, as the cost of managing through recent liquidity events was offset to some degree by higher prepayment income.

Looking to the balance of 2017. We expect year-over-year net interest income growth rates to be in the low-single digits, likely in the 2% to 5% range, reflecting our current asset growth assumptions and expectations for NIM, including the costs associated with the secured funding backstop. We expect core lending NIM to decrease by up to 20 basis points in Q3 and 10 basis points in Q4, all relative to Q2 levels, and primarily because full quarters of the liquidity event cost will now flow through our results.

I want to highlight here the impact of the mortgage insurance premiums we paid in Q2. Factoring in the cost of funds benefit and the capital release that this insurance provides, we expect the transaction to have a positive NPV. But it will be a drag on our near-term profitability, simply because we have to amortize the premiums more quickly than we realize the benefits. The premiums will be amortized over the current term of the mortgages and can't be extended into any estimated renewal period. In each of Q3 and Q4, we expect this mismatch to weigh on net interest income to the tune of about $2 million.

I will also note that in our outlook for NIM, and in particular, core lending NIM, we have not assumed any further increases to our average mortgage rates, which increased in late April by an effective rate of approximately 40 basis points. That previous pricing change started to flow through our book late in Q2 as the commitments we issued earlier were funded.

On Securitization Financing, we anticipate that NIM will decrease by 8 to 10 basis points from Q2, largely because we expect prepayment income to return to more normal levels. We also anticipate that prime margins will increase from unsustainably low levels, as mortgage rates move up slowly along with benchmark rates.

All in all, our outlook is for a decline in total NIM of up to 20 basis points in Q3 before recent pricing changes flow through more of our book and we regain some lost ground in Q4, again, relative to Q2. But to be clear, our Q4 expectation at this stage is that total NIM will still decline by up to 10 basis points compared with Q2.

Turning to costs. As a result of growth in the business, investments in support of our key business strategies, and most notably, an EQ Bank advertising campaign, noninterest expenses were 16% higher in Q1 and 22% above Q2 of last year. The EQ campaign inflated second quarter marketing expenses by $2.5 million quarter-over-quarter. In terms of investments in our business, we also increased our technology and systems cost by 14% year-over-year to support our core banking system and enhancements to our digital banking platform.

Looking forward, we expect total noninterest expenses to be slightly lower than in Q2 for the balance of the year, as our marketing spend will return to more normal levels.

That said, we will still invest in our key strategy and our capabilities, including our migration to AIRB.

Now back to Andrew.

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

Thanks, Tim. I will conclude with a few comments on proposed regulatory changes, our business outlook and enhancements we've recently made within our digital Bank.

As you know, OSFI has proposed updates to B20, the residential underwriting practices procedures that all residential lenders, including Canada's big banks and Equitable, must follow. Several aspects of the B20 proposals are of concern, most notably the requirement that borrowers qualify

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for an uninsured mortgage at a rate 200 basis points above their contract rate and the lenders not use co-lending arrangements in certain circumstances. These could shrink the size of our addressable market.

More broadly, we're concerned about how the proposed changes might run counter to broader public policy goals set out in the national housing strategy and its objective of building sustainable and inclusive communities. In particular, our assessment is that those who are self-employed or new to Canada will likely find it more difficult to access housing finance, and by implication, the benefits of homeownership.

The economic success of Canada is fueled to a large extent by the entrepreneurial energy of the self-employed and the vibrancy of those that choose to come from other countries and make Canada their home. We believe that OSFI is listening to these concerns. And we are hopeful that a policy balance can be found between improving the safety and soundness of banks and assuring there is appropriate access to sound financing solutions for our core customer base.

Overall estimated impact of these proposed changes are difficult at this stage. We've obviously done a lot of analysis on our current portfolio, but the overall outcome will depend on how consumers and other lenders react to the proposed changes and what the final version of B20 looks like.

We can wait for these dynamics to establish themselves before we factor them into our outlook. In any event, these dynamics are likely to have much more importance in 2018 than 2017, as B20 updates are still in the proposal stage.

Our outlook is subject to additional uncertainty, given other recent housing market developments. We are certainly concerned about some of the early data that we are seeing. But at the same time, some of it is conflicting. I think we need more months of data before we reach any conclusion.

That said, our underwriting and credit policies are built with a view that economic conditions do involve periods of contraction and expansion and house prices move down as well as up. Our Bank is built to be sound in all plausible economic scenarios.

On the funding side, you've heard me say that we believe market conditions have stabilized, and this creates an opportunity to grow all deposit channels, including additional platform.

For EQ Bank, one of the ways to grow is to ensure that account opening is quick and easy for our customers. To fulfill that commitment, we recently enhanced the sign-up experience and upgraded our supporting technology to enable a quick, digital-only, straight-through account sign-up process. This replaces more cumbersome procedure for customers and involved the use of checks to connect accounts. As a result of the changes we made in mid-July, an application can be verified without the submission of a check, and in a matter of minutes, which allows most customers to begin saving with EQ Bank right away.

This advancement positions EQ to convert more Savings Plus applications into accounts. And in the future, as we fulfill our vision of being Canada's challenger bank, we'll be launching more options to our customers to make their banking lives better. As Tim said, we will continue to invest in the growth of the business. And a good share of those investments will move EQ Bank forward on its well-defined technology and product road map.

In summary, we're not sure how proposed regulatory changes will play out in the near term, but we're certain of 2 things: One, we will deliver value for shareholders, as we continue to deliver excellent customer service to growing segments of Canadian society; two, our Bank remains a safe and secure store of value that our customers can depend on in all market conditions.

That concludes our prepared remarks. And I would like to invite your questions. Karina, can you please open the lines for analysts that have questions?

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question is from Marco Giurleo from CIBC.

Marco Giurleo - *CIBC World Markets Inc., Research Division - Associate*

My first question's on the proposed B20 changes. I was wondering what percentage of single-family originations would be impacted by the prohibition of co-lending. And similarly, with regards to the stress test on uninsured mortgages, I was hoping you could provide us with some guidance as to the potential impact on renewal rates and originations.

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

So with respect to the first question on co-lending, we do disclose in our supplementary disclosure documents how much -- how often we use the co-lending arrangements. It represents about 10% of our mortgages on the books. Having said that, we don't believe that the co-lending arrangements, as currently constructed, are really going to have a significant impact because it's still possible for those borrowers to go and get a second mortgage independently, even under the new rules. So we think that the impact on our business flows will actually be quite muted in the way we read it right now.

With respect to renewals, we'd actually expect renewal percentages to improve somewhat because it may be slightly more challenging on the margin for some of our borrowers to move to other lenders in a new B20 environment; i.e., they would be grandfathered in our books and not as easy able to move.

Marco Giurleo - *CIBC World Markets Inc., Research Division - Associate*

So what type of renewal rates are you seeing right now?

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

Well, we typically think about sort of renewal rates using our own metrics. It may not quite match with your models. But somewhere in the 60% to 70% range is what we look at for those mortgages that are up for renewal, closer to maturity. We'd have to have a bit of an off-line conversation about exactly what we're putting on the numerator and the denominator there. But it is in that range, and so that might sneak up a bit. Certainly, the stress test is the one issue on new originations that might have the most impact. And as I said, -- I mentioned during my remarks, it's pretty hard to really get a handle on what that number is because one can look at the current qualifications in our book and say that loan will no longer qualify. But there may well be many circumstances where, for example, we relied on just the husband's income in a couple and by the time you put the full family unit and then consider all their income, it would still qualify. But I don't certainly think it's -- above 10% of new mortgages being qualified would potentially be impacted by this. And our concern is, in particular, it's the self-employed and people who are new to Canada that will be most widely impacted. And I think one of the challenges is actually thinking about the stress tests as a higher level. The stress test essentially assumes that there's no income growth for our borrowers over the life of the loan. And clearly, the people that come to Canada and start to establish themselves and their career here are likely to see faster -- faster income growth than most Canadians. And some of the self-employed individuals and people starting up tech companies and so on are more likely to realize the returns later on in their careers than today, and frankly, will gain wealth over time. So thinking how to be a bit more nuanced about those populations in particular, I think is -- would be great. Public policy -- and we do think that the policymakers are listening to it.

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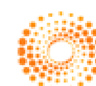

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Marco Giurleo - *CIBC World Markets Inc., Research Division - Associate*

All right. On to credit. I noticed that net write-offs rose to about $1 billion in the quarter, which is decently above the run rate seen over the last number of quarters. So was there anything in particular that drove the higher net write-offs this quarter? Or perhaps were any of them concentrated in a particular province?

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

I assume it's about $1 million, not $1 billion.

Marco Giurleo - *CIBC World Markets Inc., Research Division - Associate*

Yes. Sorry, sorry. $1 million.

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

No. I think it's a reflection of just cleaning up loans. And I think it's a good new story. So if you look at our impaireds, they're down. And part of the way that impaireds come down is to actually see the property being sold and losses being realized. And I think, actually, we've shown in this quarter, I believe, that our recoveries actually on the sale of some of those impaired properties are much better than the estimates we previously put away.

Tim, is that --

Timothy Wilson - *Equitable Group Inc. - CFO, VP, CFO of Equitable Bank and VP of Equitable Bank*

Yes, it's exactly right.

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

Yes. So -- no. I think it's actually a reflection on -- our workout team's doing a good job, actually, in releasing on some properties, reducing the amount of impaireds and getting those loans off our books.

Marco Giurleo - *CIBC World Markets Inc., Research Division - Associate*

All right. Great. And my last question was just on the high level of prepayment income seen in the quarter. Are there any theories as to what may have driven the higher level of prepayment income this quarter? By my math, it was in and around $3.6 million pretax or $0.16 per share.

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

I'll let Tim give some more detail on that. But certainly, one of the things is you do see a seasonal approach where single-family borrowers, clearly, are more inclined to move home in Q2, where school's out and that kind of thing. I mean, typically, the last week of June would be our biggest day for -- the biggest peak for funding. Certainly, part of it is that. But I think also some dynamics in the securitized book could also...

Timothy Wilson - *Equitable Group Inc. - CFO, VP, CFO of Equitable Bank and VP of Equitable Bank*

Yes. I mean, it's unfortunately a little tough for us to answer that question, Marco. Because when mortgage borrowers prepay, they don't typically give us a long list of reasons why. We just see the money flow in. You're right in how you quantified it. It's about $3.5 million of additional prepayment

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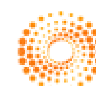

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income that we saw during the quarter. Part of that, as Andrew mentioned, is seasonal. Part of it, I think we're going to try to get a better understanding of, but there's no clear explanation for it at the moment. I -- the one thing I will say is that I don't believe it's related to any of the liquidity events that -- or the disruption in the marketplace during Q2.

Marco Giurleo - *CIBC World Markets Inc., Research Division - Associate*

Yes. That's sort of what I was getting at. And I was trying to figure out why that might have driven it, but I can't seem to figure that one out either. So all right. Any color would be appreciated.

Operator

Your next question is from just Geoff Kwan from RBC Capital Markets.

Geoffrey Kwan - *RBC Capital Markets, LLC, Research Division - Analyst*

Just wanted to follow-up on your response on the B20 impact on the stress as you mentioned, a little bit more than 10% figure. Is that on a net basis after factoring what you talked about in terms of maybe adding or including maybe other household members in the income line? Or was that before that?

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

That's -- and certainly, it's more than 10%, Geoff, just to be clear and a number that we're having a little bit of trouble being precise about. But that would be some estimate of the net number, assuming that consumer borrow [rate] doesn't change to some extent.

Geoffrey Kwan - *RBC Capital Markets, LLC, Research Division - Analyst*

Right. Sorry. That's after taking to account where someone -- if you had one household member, and now they've gone off-site. And -- but if you had a -- include someone else who's in the household and they bring it back on-site, like the 10% you talk about is where you've kind of taken a look and saying, well, this person could stay on-site. And so again, that would be a net number, the 10%?

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

That's exactly right. So it's already sort of -- the raw number. If you just took the numbers on their face, would be higher than that. And it's not a simple as just that. The case of one example I gave there. But it could be borrowing more money from a -- of a family member to make -- get a larger down payment or other changed consumer behaviors. So -- and to be clear, don't scale away. We're just thinking about 10% as being a number. We're really struggling to pin down how to figure out the modification in borrower behavior that might change this number. I think we'll have a much better color on it at the end of the coming quarter.

Geoffrey Kwan - *RBC Capital Markets, LLC, Research Division - Analyst*

Okay. And then you were talking about some of the discussions with OSFI, obviously. You're not going to say if you know what they may ultimately wind up going there. But do you get a sense, at least, that what has been proposed, that there's going to be some sort of modification to it? Or I don't know if you have any comments on that.

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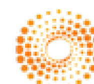

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Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

I think it's hard to know. I mean, certainly, OSFI is always a very open and engaged regulator to issues that are raised by the industry. And certainly, that was my experience in meeting with them recently. And some are the people in other forums They certainly are not saying we've got this perfectly down and this is what it could be. They are actively consulting with the industry. And I would expect them to make those central modifications, assuming they make the right case and right argument and can show that we're also trying to align with their public policy objectives and making sure the banking books are safe.

Geoffrey Kwan - *RBC Capital Markets, LLC, Research Division - Analyst*

Okay. Just the last question I had was, when you think about the NIM yield on your nonprime single-family residential before, call it, the turbulence in that part of the market. And in the meantime, we've seen funding cost go up but also mortgage rates have come up. What is your best guess as to, let's call it, when the dust settles? Do you think the NIM yields in the sector would be the same as where it was? Do you think it could be higher? Could it be lower?

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

Tim, do you want a crack at that one?

Timothy Wilson - *Equitable Group Inc. - CFO, VP, CFO of Equitable Bank and VP of Equitable Bank*

Yes. I mean -- I think, Geoff, our expectation is for -- to the -- those stabilized NIMs to ultimately revert to historical norms. I think the question is how long it takes to get there. We've seen a lot more stability in the funding markets. We've seen GIC pricing come off quite substantially to where it was just a few months ago, and relative to swap curves, to be in some cases near historic low levels. At the same time, mortgage pricing has moved up. So I think in the short term, we're going to see a NIM benefit. But over the long term, particularly if benchmark rates rise and GIC rates probably move up with those, I think we could see, again, NIMs revert to more normal levels, excluding the impact of any of the liquidity cost, like the backstop facility.

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

And I think, Geoff, as you'd be more aware than anyone, really, it does depend on the competitive landscape that we face and thinking through how that might evolve. I think you probably have as good a view as our management team. But clearly, we've gone from a position where we were the strong #2 player in the market and, typically, the pricing umbrella provided by the market leader. Now we're very much thinking about how we should set up -- set the stall up from a price perspective and make sure this is an appropriate pricing for our customers and to the returns for our shareholders. And so -- and how that will evolve over time is a bit of an open question.

Operator

Your next question is from Graham Ryding from TD Securities.

Graham Ryding - *TD Securities Equity Research - Research Analyst of Financial Services*

I'll start on that same theme. Just -- it looks like me like one of the key issues that's going to be weighing on your NIM for the remainder of 2017 is the higher liquidity balances that you're holding. Is that outside of the backstop facility? Is that sort of one of the key drivers behind your NIM outlook? And if so, then what is your expectation as you look into 2018? Has the game changed a little bit and going forward, you're going to hold higher levels of liquidity?

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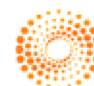

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Timothy Wilson - *Equitable Group Inc. - CFO, VP, CFO of Equitable Bank and VP of Equitable Bank*

I think, Graham, a couple points in response to that question. I think the most significant impact on our NIM, looking forward, is clearly the cost of the credit backstop facility; and for a couple of quarters, the cost of -- the amortization of the insurance premiums we paid. So I think those are by far and away, the most significant impacts. I think the increased level of liquidity balances that we're holding are going to have an impact as well, but it pales in comparison to those factors I mentioned earlier.

As to how that looks in 2018, I think it's something we're evaluating sort of month-by-month as we watch the funding markets and as we hopefully watch them continue to be stable relative to where they were. I think a prolonged period of stability might make us comfortable bringing those liquidity balances back down a little bit. But right now, it's still too early to tell when and to what degree that could happen.

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

I think, in particular, understanding that insurance costs is a pretty tricky thing Effectively what's happening is we paid a large amount of money upfront. We're amortizing it to the maturity of those -- the mortgages rate without insurance. But we expect to be able to renew a large chunk of them and be able to fund them with the much lower funding cost provided by mortgage-backed securities. So actually, this will have a positive impact on NIM. And certainly, as you get into the further out-years, 2019, 2020, as we can access at that funding.

Graham Ryding - *TD Securities Equity Research - Research Analyst of Financial Services*

So what is the renewal sort of outlook for that particular group of mortgages? Are they coming up largely in 2018 for renewal?

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

No. The average life is what, Tim?

Timothy Wilson - *Equitable Group Inc. - CFO, VP, CFO of Equitable Bank and VP of Equitable Bank*

It's -- the average life of the mortgage in that pool is about 18 months. So a significant portion come up in 2018. There's a good chunk in 2017 as well. And then the tail extends out into 2019.

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

And once we renew that mortgage, effectively the insurance premiums get amortized down to 0. We now benefit from the lower funding cost. And actually, that's where the enhanced NIM comes in.

Graham Ryding - *TD Securities Equity Research - Research Analyst of Financial Services*

Got it. The deposit balances, you gave some color around, I think, your GIC balances, in particular, are up almost 2% post quarter end. I'm wondering if you could give an update on your overall deposit balances, including everything (inaudible) on your EQ Bank. Where does that stand today relative to the quarter end?

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Timothy Wilson - *Equitable Group Inc. - CFO, VP, CFO of Equitable Bank and VP of Equitable Bank*

I think -- I believe, Graham, the number that we quoted in our press release was aggregate deposits, not just GICs. So that should give you an indication. At this point, we haven't provided any details as to how that looks across products. But I think what we can say is that we feel all the -- our funding position and the performance of each product has stabilized or did stabilize even quite a bit starting towards the end of May. And we're happy with the performance of all of our different deposit products since that point.

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

I think if we break it down to all 3 buckets, so it's the broker piece, the EQ Bank deposits and GICs. I believe we've seen growth in all 3 since quarter end.

Timothy Wilson - *Equitable Group Inc. - CFO, VP, CFO of Equitable Bank and VP of Equitable Bank*

In all 3.

Graham Ryding - *TD Securities Equity Research - Research Analyst of Financial Services*

Okay. And then just lastly, I guess the GTA housing market, we've seen some softness in Q2. Can you comment on sort of how you're feeling about that market and how you're feeling from an underwriting perspective, but also from a credit provisioning perspective? I guess, why did you not be a bit more conservative in provisioning, given the softness we've seen in that key market for you?

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

Appraising is going to become much more dynamic next year when we move to IFRS 9. So that will be a helpful evolution that would actually allow us to do that more dynamically, just to be clear. We -- clearly, as you can see in our supplementary information pack, so pretty low loan-to-values, because don't forget that we've come up. We've seen the underlying values inflate in Toronto. While we may see some softness that may be longer or shorter term in duration, we still feel we got plenty of coverage from a collateral value perspective. And many of the fundamentals of the GTA market that really lead to credit default losses remain very strong. So a lot of employment formation continues to be strong, family formation of the GTA. We don't particularly feel that we've got evident signs of risk. But as I indicated in my remarks, we're monitoring the market very closely, thinking about how we might want to change credit policies. And as we see things evolve, we will take that sort of fault into consideration. The data is a bit sort of -- today are coming out, the 70 points of the downside were on day sales outstanding, listings, and so on. But yet to really be able to put a comprehensive sort of analytics around that, that can inform us instead where we really think the market's going.

Operator

(Operator Instructions) Your next question is from Stephen Boland from GMP Securities.

Stephen Boland - *GMP Securities L.P., Research Division - MD & Equity Research Analyst*

Andrew, just if you could explain the difference on the co-lending arrangements. You said the rules are kind of pointing to one type of co-lending, but there may be a difference. Can you explain this? How the process works?

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

So the -- there's no industry definition of co-lending. But the way we think about co-lending is when a federally regulated financial institution combines a mortgage loan that it makes its own account, typically -- in -- always in our case, anyway, in first position; with money provided by a

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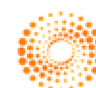

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non-prudentially regulated lender sitting in second position. And that's either provided as a single charge or 2 charges. But the (inaudible), the regulated entity is involved in organizing the second mortgage, even though their capital is not at risk with it. So that's what co-lending means. The sense is the B20's particular aim is dealing with loans that go -- that take the LTVs above 80%. So one could imagine that we're, like -- we, as a (inaudible) are allowed to lend at up to 80% under the Bank Act. If we then put unregulated money into it to pay up to 85%, that would not be permitted under the new B20. Interestingly, what would be still permitted, as we understand it, is that we could lend 80%. And assuming the debt service coverage ratio and so on worked, so we still wanted to make that loan 80%, a mortgage broker could organize a 5% second mortgage in a stand-alone position behind our loan. And that's where -- that's one of the reasons why we don't think this will have such a huge impact on the market. It may move capital flows a little bit in how mortgages are organized, but probably won't change loan volumes very much.

Stephen Boland - *GMP Securities L.P., Research Division - MD & Equity Research Analyst*

So it just sounds like it's shifting, that you can't organize it, but you could suggest to a borrower to go to a broker and then talk to them, and they could help the borrower organize it.

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

Like, I don't think we could even suggest it. But I'm sure the brokers themselves will organize themselves to meet that client need. That's how will they think about structuring.

Stephen Boland - *GMP Securities L.P., Research Division - MD & Equity Research Analyst*

Okay. And I'm not sure if you can answer this. But I guess when I look at the stress test, I mean, you're saying it could impact your volumes -- and for debt from other lenders. Who benefits from this? Like, which lenders, like, tend to benefit when -- I mean, do you see surplus? Like, I guess, maybe the main question is: Do the big banks gets hurt anywhere here with the stress test?

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

I think it aligns the uninsured less than 80% underwriting rules with those that already applied to the insured high-ratio market. So today, the big banks, as I understand, are testing 5-year fixed-rate prime mortgages at the contract rates. So that's 2.80% today on a 5-year. That's why they would be qualifying them rather than under the new rules, which would say 4.80%, right? So that it will limit the amount of mortgages that qualify at the large banks as well and generally slow down credit growth as a result. Because this has been expressed as a spread over the contract rate, though it does have a particular -- particularly more significance for alternative lenders since there's more -- charging a higher rate than a primary in the first place. The implicit assumption with a stress test is, once an alternative borrower, always an alternative borrower in the sense that you've got to be able to qualify that 200 basis points being presumed as a general increase in interest rates over the life of the loan.

It turns out that about 80% of our customers actually migrate to being prime borrowers within 5 years of the -- first originating the loan, and, therefore, would qualify for a prime loan. So it seems that it's overly punitive to those people that come into the old space, and then through benefits of homeownership, through thrift and paying down their mortgages and paying the mortgages and paying the mortgage on time, are able to then access homeownership. And particularly in -- as I noted in the self-employed and new-to-Canada groups. So that's especially where we're coming from. A lot of our old borrowers become prime borrowers over time.

Stephen Boland - *GMP Securities L.P., Research Division - MD & Equity Research Analyst*

I guess the last question, too. In your experience of, like, dealing with OSFI, how often, once they put out a consultation, do they make substantial changes? And going back to the original B20 and other rules that they put out over the years.

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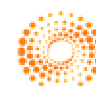

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Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

I think they're quite comfortable doing it. My sense is that they -- they are a professional civil service group that when they come out to consult, really do come out to consult and listen to the industry. We've had a very engaged dialogue with them recently. And everything from definitions, to make sure the industry and the regulator all on -- all the same page about what the intent is and what we're trying to achieve. And sometimes, there's difference in industry terms and colloquialisms that we use that don't make sense to both sides, or they don't see it quite the same way. So I don't think anybody's battened down yet. I think there is a reason why they have these consultations. They are real processes. And I would expect that OSFI is open to thinking about issues in an open and transparent way.

Stephen Boland - *GMP Securities L.P., Research Division - MD & Equity Research Analyst*

Okay. I'm sorry. Just last question. And I don't know if it's for you, Andrew, or -- you mentioned, when you move to IFRS next year, that your provisioning is going to be more dynamic. And I certainly get that. But when I hear dynamic, I tend to think higher. So if that's the case, is there no way under the current accounting rules that you could get ahead of that and put in a larger provision at this time?

Timothy Wilson - *Equitable Group Inc. - CFO, VP, CFO of Equitable Bank and VP of Equitable Bank*

Steven, it's Tim. I don't think you should net necessarily interpret dynamic as meaning higher. I think what IFRS 9 will lead to -- you'll hear this from any bank globally -- is more volatility in the mortgages, as we report deteriorations in credit qualities and categorize mortgages on basis and also to provisions. Just -- I'm happy to walk you through the details off-line. But just by the way, by virtue of the way the mechanics of IFRS 9 work, you will probably -- you will likely see a lot more volatility quarter-to-quarter. I think the global expectation is for higher provisions, higher allowance levels. I'm not sure that will be the case for Equitable, though we're still in the midst of assessing all of that. We have taken a very conservative approach to allowances over time. If you benchmark our allowance levels to the amounts that we have reserved on our balance sheet together against other institutions, you will see that. And as a result, we may not necessarily see the spike upwards in our allowance levels that other banks might.

Operator

There are no further questions at this time. I now turn the call back over to Mr. Moor for concluding remarks.

Andrew R. G. Moor - *Equitable Group Inc. - CEO, President and Director*

Thanks, Karina. And thanks to all of you for listening. We look forward to reporting our third quarter results in early November. Thanks for listening.

Operator

This concludes today's call. You may now disconnect.

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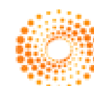

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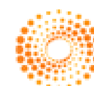

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