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EDITED TRANSCRIPT

EQB.TO - Q1 2016 Equitable Group Inc Earnings Call

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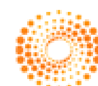

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Equitable Group 2016 first-quarter conference call.

Before we begin, we would like to remind you that certain forward-looking statements may be made on this call including statements regarding possible future business and growth prospects. You are cautioned that such 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 on May 13, 2016, at 10 am Eastern for replay purposes.

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

Andrew Moor - *Equitable Group Inc. - President & CEO*

Thank you, Nick, and good morning, everyone.

Joining me is Tim Wilson, Chief Financial Officer of the Bank and Equitable Group. As a reminder, a slide deck accompanies our remarks and is available at www.egbank.ca.

The first quarter was transformational for Equitable and it marked the very successful launch of EQ Bank, our state of the art digital platform. Beyond giving us another source of funding, its held an important objective. EQ Bank serves as a new channel for us to reach Canadians and give them purpose built and completely mobile banking experience that is differentiated and, more importantly, many of our customers think very valuable.

EQ and the Savings Plus Account, the first product on our new platform, changed the way Canadians can grow their savings and, in a functionality sense, tear down the artificial barrier between checking and savings through easy to use features such as free electronic bill payments and e-transfers from the interest bearing account. Based on some numbers I'll share with you in a few minutes, many Canadians take a notice of EQ and have made its debut far and away more successful than we thought possible. We had some challenges with service levels at the time of launch and we're disappointed with our miss on delivering exceptional service in the early going, but we made the necessary adjustments and I'm pleased with where we are today.

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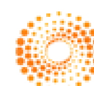

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Of course it took a sizeable investment to make this happen and that investment did weigh on our first quarter performance. Looking at our results of CAD28 million, or an EPS of CAD1.71 per diluted share, first quarter earnings were solid. The EPS results reflected the impact of CAD2.6 million, or about CAD0.12 per share of costs incurred to advertise the lunch of the digital bank.

We also incurred other EQ Bank costs that were not present a year ago of CAD2.4 million, or CAD0.11 per share. This is a price worth paying given the transformational nature of the EQ platform on a status of the branchless bank and the advantages it creates for our savings business.

Also effecting Q1 was a CAD1.2 million hedge loss related to securitization, which reduced first quarter earnings by CAD0.06. It's important to note that this an accounting not an economic loss. Our hedging programs work well and so there is an offsetting gain that will flow through our income statement over time by way of reduced funding costs. Or put another way, through higher spreads.

Another factor that affected our performance versus expectations was our decision not to execute any IO strip sales transactions to generate gain on sale income. Recall that we've been suggesting for several quarters that we expected these volumes to increase and to largely offset the cost of our strategic initiatives such as digital banking. We changed our approach after considering the implications on our leverage ratio. There is definitely an element of longer term thinking about creating value for shareholders with this decision at the expense of short-term earnings.

The bottom line, reported EPS was CAD0.10 below the first quart last year, but adjusted just for the advertising spend and hedge loss, EPS would have been CAD1.89, or CAD0.08 higher than last year on substantial growth in assets. As a result of slightly lower earnings, the bank produced a first quarter ROE of 14.7%. This is below our five year average of 17.7%. We pride ourselves on delivering consistently higher returns, so while this ROE performance is understandable in the context of first quarter spending, we very much aim to get back on track in future periods.

Book value increased 13%, or CAD5.68 per share year-over-year, which underscores the enduring advantage of our branchless bank business model and value creation strategies. On still strong earnings and a positive outlook, our board declared a quarterly common share dividend of CAD0.21 for holders of record on June 15, payable on July 7. This is an 11% increase over the dividend declared at this time last year. And yet again, even with a higher dividend payment, our earnings retention rate was high and our CT rev 1 ratio was strong. We believe retaining earnings continues to make economic sense as we are finding very productive ways to deploy shareholders capital for high returns.

Looking at the lending side of the bank, our fundamentals remain very strong. Mortgage under management grew 22% year-over-year to a record $17.7 billion at March 31. Once again, alternative single family was a significant driver. Mortgage principal increased 19% to a record $6.8 billion at March 31 and was ahead 5% during the quarter itself.

This increase is attributable to our good and continually improving reputation for outstanding customer service. First quarter alternative single family originations were very strong, amounting to $674 million, also 19% higher than in the opening quarter of 2015. This growth was achieved despite a 17% decrease in originations in Alberta and Saskatchewan.

From what we can see today in our markets, we would expect alternative single family lending assets to continue to grow at mid to high teen rates throughout the rest of 2016. At $2.3 billion, commercial mortgage principal was 4% higher than at year-end and pretty much unchanged from a year ago.

Commercial originations were $202 million in the quarter, slightly lower than a year ago. This performance was in line with our expectations and reflected the pricing and risk management discipline we've employed in the last couple of years to sustain the high returns our bank generates in our commercial businesses.

We've made changes that we hope will sharpen our focus on the market. Our commercial team is working to broaden and deepen our partnerships and broker relationships as a means of increasing our access to high quality lending opportunities. We'll take time to realize significant results from our actions, but we are already seeing early wins and believe that commercial originations will increase from Q1 levels as we move through 2016.

In the very near term, we expect the bank's commercial lend portfolio to remain flat as high originations are offset by the run-off of maturing construction loans funded in prior years and by the impact of reduced activity in Alberta. The other significant driver of asset growth was securitization

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funding financing where mortgages under management were up 34% year-over-year and 7% since the end of 2015, driven by the ongoing development of our prime mortgage business.

We originate prime loans internally and through third party agents and then securitize those mortgages through the CMHC MBS program. During quarter we funded $444 million of prime loans, more than double the amount funded last year at this time. As a result, prime single family mortgages under management stood at $2.5 billion at quarter end, almost three times higher than a year ago.

In context, we're in the early stages of building broker relationships on the prime side and expanding geographic coverage. I'm happy with our progress so far and I'm seeing signs of more momentum every month. Prime mortgages are a competitive market, and gaining meaningful share with our internally generated business will take time. We've got a great team with a lot of energy, great ideas and a passion to succeed and I'm confident they will deliver the results.

There's no change in the banks credit performance during the first quarter, which is to say it remains best-in-class amongst Canada's Schedule I banks. Our provision for credit losses was 1 basis point of mortgage principal outstanding in the quarter, down from three basis points last quarter and last year. This performance attests to the quality of our books.

I said on our last call that we would review our loan loss provisioning in light of the fact that Equitable uses a much more conservative approach than most of Canada's other banks and a steadily built collective allowance that we considered to be sufficient. We undertook that review, leveraging the sophisticated data models that we have built for our AIRB exploration and our long term loss experience and determined that further additions to our collective allowance were unnecessary this quarter.

Given current economic forecasts, we expect our single family res rates and credit provisions to remain low throughout 2016. Although given deteriorating conditions in Alberta and Saskatchewan, the exceptionally low loss and the res rates for the past few years make it way to more normal levels. As expected, we are starting to see a res increase out West with impaired loan balances in Alberta and Saskatchewan went up by $2 million during the quarter and earlier res up by $9 million. In the interest strip transparency, we have begun to disclose the specific figures in our MD&A and we are monitoring the situation closely.

Looking at our lending portfolios in these two energy-driven provinces for a moment, as of March 31, 18% of our total mortgage principal was in Alberta and Saskatchewan. More than half of those assets are insured. Of the uninsured portion, 84% was in Calgary and Edmonton, which have more diversified economies and employment sources. And the another 8% was in Regina and Saskatoon, both urban centers with relatively more economic stability. Average LTV on our uninsured book in those provinces were 69%.

These portfolio stats, along with the proactive measures we've taken in these provinces since late 2014 to adjust our lending criteria and the stress testing we perform, make us comfortable with our current position. We believe any losses, even under a severely stressed scenario, will be manageable.

Turning to our savings businesses, the first quarter was a period of ongoing strategic advancement, not only as a result of EQ Bank but with our brokered deposits. We're very pleased to report the balances on our brokered HSA at quarter end surpassed $1.1 billion, proving this is a product professional advisors are highly recommending.

In terms of the EQ Bank platform, the EQ Bank Savings Plus account, the response to this product has been overwhelming. In less than three months, Canadians deposit $794 million in over 17,000 Savings Plus accounts. We thought our offering would capture interest, given the combination of great payment features, helpful savings tool and an intuitive app from an account with a great interest rate that is even more popular than we anticipated.

In order to manage future account growth and sustain our high levels of service, we reduced the interest rate at mid-April to a still very competitive 2.25%. We continue to sign up new customers and add balances to this interest rate and the feedback from our customers on our service is good. As Tim will tell you, we've reduced our EQ Bank advertising budget this year because of the success we've had with our go-to-market strategy. Those marketing savings will be to redeployed into our service initiatives and to help offset the higher interest expense on this account.

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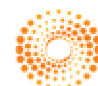

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With that, Tim will now provide his report.

Tim Wilson - *Equitable Group Inc. - CFO*

Thanks, Andrew.

First quarter net interest income grew 13% year-over-year. This growth reflected an increase in our average asset balances in both core lending and securitization financing, which in aggregate were up 21% year-over-year. As I noted last quarter, we expected NIM to decline throughout 2016. NIM dropped a little more than expected in the first quarter, being down 10 basis points year-over-year.

Looking at that year-over-year change, the very successful growth of the EQ Bank Savings Plus account was a significant weight on core lending NIM. Growth in EQ Bank deposits caused us to hold excess liquidity through parts of the quarter with liquid assets having a negative margin and thereby pressuring NIM. Comparing Q1 to Q4, overall NIM was down 7 basis points and core NIM down 13 with EQ Bank growth being a factor again. A substantial decline in core lending prepayment income also reduced our core lending margins.

Looking to the remainder of 2016, our outlook for net interest income is relatively unchanged from the view we expressed in our last quarterly call. That is, we expect that it will increase at low to mid teen rates as the bank continues to grow its assets by meeting the needs of Canadian borrowers across a wide range of mortgage products.

Factoring in both core lending and securitization financing expectations on NIM, which are discussed in detail in our MD&A, we believe that overall NIM will trend a bit lower over the course of 2016 -- possibly up to five basis points lower. This reflects mainly the high growth of our lower margin securitization financing business and the resulting mix shift towards it and also the continued growth of EQ Bank balances.

Moving on, Andrew mentioned the impact of strategic investments on first quarter EPS. As you will note in table 6 of our MD&A, we separate investments in our future from non-interest costs related to normal course growth. In terms of normal course cost, non-interest expenses amounted to CAD23.6 million, about CAD5 million or 27% higher than last year.

This reflects the costs associated with growing our assets under management by 23% year-over-year. Higher FTE was the main driver of the increase being up 25% year-over-year and 5% sequentially. We also incurred costs to an office expansion to accommodate our growing staff in complement. But rest assured, we still remain proudly branchless.

Total investments in our future amounted to CAD5.7 million, more than five times higher than a year ago. The main item, as Andrew pointed out, was a CAD2.6 million advertising expense to support the launch of EQ Bank. Beyond advertising and relative to Q1 of last year, we invested an incremental CAD700,000 to add to our digital banking team and CAD600,000 more to support our digital banking system.

For the first time we also began to amortize the cost of previously capitalized digital banking investments this quarter. This resulted in CAD600,000 of amortization expense. We are generally amortizing those costs over a 10-year period and they will be a regular expense item going forward.

The overall increase in strategic investments accounted for almost half of the year-over-year expense growth in the quarter. Without this investment, our adjusted efficiency ratio in Q1 2016 would have been 35% instead of 43.2% as reported. The initial success with our marketing campaign has allowed us to reduce planned spending in support of EQ Bank for the remainder of the year.

Our current plan is to spend approximately CAD1 million in Q2 through Q4 versus our original plan to spend $5 million. This expense reduction will be partly reinvested in service and will also help to offset the interest expenses resulting from high balance growth.

Our other strategic investments will continue too. We plan to continue building our prime single family team and exploring a migration to AIRB. Over time, the cost of all these strategic initiatives should be partially offset by the incremental gain on sale revenue generated from securitized mortgages.

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And I use the word partially very deliberately. That expectation varies from what we said last quarter, at which point we had expected almost a full offset. We recently updated our plans regarding our derecognition activity for the reasons Andrew stated earlier.

Beyond these initiative investments, we anticipate that over the next five quarters all other non-interest expenses will increase at rates in line with the growth of the overall business. We expect that our efficiency ratio will decrease beginning in Q2, although we remain in the mid to high 30% range through the balance of 2016. Even at these levels, Equitable would remain Canada's most efficient publicly traded Schedule I bank. Our capital ratios at quarter end all continued to surpass minimum regulatory standards and most industry comparables. And we expect to continue operating above these benchmarks as we grow.

Now back to Andrew.

Andrew Moor - *Equitable Group Inc. - President & CEO*

Thanks, Tim.

We've definitely invested more in the business than ever and I can assure you that we expect results from all of our activities. Overall, we're pleased with the consumer receptivity to our latest products and service offerings. Of course, not all come out of the gate as strong as EQ Bank or our brokered HSA but, then again, the objective with all our offerings isn't short-term in nature. It's to delight our customers, build a market position, create a brand that will sustain long term growth and generate high ROEs for the business.

A great example of that is the work done over the past 10 years in our alternative single family lending business. Through constant effort, we really hit stride and our bank now has a unique position in the market with mortgage brokers who value our service quality and products.

That's not to suggest our work is done. We have more to give and more opportunity for growth in all of the new regional markets we've entered and the products we've launched over the past five years. We're building those positions cautiously in a way that is entirely consistent with our conservative underwriting standards and risk management disciplines. But the point is we're building them and they offer good prospects for the long run.

One of the key elements of success when launching a new product or service is the willingness to patiently fine tune it so that it finds its niche. This is what we've been doing with our Equitable Bank home equity line of credit.

We launched our HELOC in 2014. Since then, by listening to the market and adjusting the product while still adhering to our risk management practices, we've been able to double HELOC balances over the past year to about CAD22 million at the end of Q1. Again, there is substantial runway for growth and we think we have got a product that works.

Our outlook is what explains our first quarter MD&A, so I'd invite you to review it in more detail. For a comprehensive review of value creation model, please see the shareholders letter in our annual report.

To summarize, the bank's fundamentals are strong and solid asset growth continues. Our digital platform is already proven to be incredibly popular with Canadian savers who are making Equitable their digital bank of choice. And as our cost decline in relative terms following this period of heavy investment, we will show good earnings increases.

That concludes our prepared remarks. Now I'd like to invite for questions. Nick, could you please open the lines to our callers?

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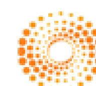

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

We will take our first question from the line of Jeff Fenwick at Cormark Securities.

Jeff Fenwick - *Cormark Securities - Analyst*

Good morning.

I just wanted to start my questioning off with the EQ Bank deposit growth. And you'd mentioned you'd lowered the rate there. Obviously, the early response was a lot higher than you would have expected, which I guess you could certainly view that as a success. But it did weigh on the NIM. And I guess the go forward outlook from here -- do you think with that lower rate you're better able to pace the growth of deposits, and we're not going to see this NIM pressure perhaps get worse over the course of the year?

Andrew Moor - *Equitable Group Inc. - President & CEO*

I'll let Tim give the financials -- thanks, Jeff, on that question. I'll let Tim deal with the math on what that means to NIM.

Just to give you some sense of what happened when we changed the rates. We did see some early run-off of the accounts. So some people had been looking for that higher rate did leave us in the initial going. At the time we had a large number of customers on a wait list -- waiting to be onboarded because we want to make sure as they became onboarded they had a great customer experience. And so we've been opening up that queue. I think we had about 10,000 people in the queue at one point. We're slowly working through that back book log and over the next couple of weeks expect to be through that backlog. And we are slowly adding balances; so running at about $1 million a day as we speak. So we saw the early run-off, and now we're clearly adding to the deposit base and adding more customers at a good steady clip.

Tim Wilson - *Equitable Group Inc. - CFO*

And, Jeff, just add to comment on the impact on NIM. I think it will continue to have an impact, but not as noticeable as we saw in the first quarter. Even at 2.25%, that rate is higher than what we pay on our other alternative sources of funding. So obviously there is a bit of a negative impact. But again, it won't be as substantial going forward.

Jeff Fenwick - *Cormark Securities - Analyst*

And I guess it's fair to say at this point, given that you're so early on, it's a little bit difficult to gauge the sensitivity around those interest rate levels that you're offering as well. Is that fair? (multiple speakers)

Andrew Moor - *Equitable Group Inc. - President & CEO*

I think it's fair to say that every day we're learning more about running this business. We obviously knew -- when we launched, we knew we want in the business. Now we do and also seeing how competitors might respond to our rate changes. I think we're not just a silent actor that can move our rates and not see other people respond to it, given the level of response we've had. So I think we're slowly seeing how that all shakes out.

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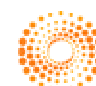

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Jeff Fenwick - *Cormark Securities - Analyst*

And with respect to the securitization guidance you've given us in terms of retaining a bit more on the balance sheet versus moving them off -- is Q1 then roughly indicative of what you'd think the level it would be flowing through in terms of gains would be? And the level of sales through the rest of the year here then?

Tim Wilson - *Equitable Group Inc. - CFO*

Jeff, it's Tim.

I would expect as we move forward -- and when I say forward, I mean over the course of the next year or two -- that those gains will start to increase. Our trade -- the way we think about derecognition is really based on our capital ratios. And we're not at a point where their leverage ratio -- where we needed to sell -- strips in any sort of volume in the first quarter. I think with continued growth of our assets, we will get there a couple quarters down the road. But for now we weren't.

The only gains that we recognized in Q1 were related to securitization of non-prepayable multi-unit residential pools. Those are automatically derecognized without us executing any transactions that caused the derecognition. But again, that picture is going to change going forward. And I expect those gains will -- we start selling IO strips and those gains will increase.

Andrew Moor - *Equitable Group Inc. - President & CEO*

I hope we made it clear, Jeff, that the way we think about this is trying to maximize the net present value of cash flows to the shareholders. So the discount rates that we give up on the derecognition of strip sale are reasonably significant. Now it's still going to make sense for us if it keeps us under the right leverage ratio. But we're better, if you like releasing that into earnings later down the road when we have a little more pressure on the leverage ratio.

Jeff Fenwick - *Cormark Securities - Analyst*

I appreciate that color.

Maybe just one last one here on -- thanks for that detail on the Alberta and Saskatchewan markets, there. So interesting you are seeing some of the impairments begin to move higher. But overall for Equitable, the loss provision in the quarter was actually quite small. So when you think about your allowance that you've got there on the balance sheet today, it's in the context of feeling like you're very comfortable with any movement you're getting out of Alberta, and you don't necessarily need to add a lot here in the near term to accommodate that?

Andrew Moor - *Equitable Group Inc. - President & CEO*

That's certainly our feeling. Obviously, if we felt we should be adding some we would have done. I did actually sit down with the -- we've got a very good man who does -- runs the collections in our Alberta office. And Ron Tratch and I walk through -- Ron Tratch being the Chief Risk Officer -- walk through every account that he's looking at that early stage delinquency. So that's over 30 days. And it is clear that some of our customers are having a harder time. So some of them might be subcontractors to larger entities where they are owed money and those entities are paying a little bit later. So that's causing some delinquency. So I think that's why we want to give a little bit of the color there. People are struggling a bit in the patch, for sure. We're trying to be helpful where we can. Most of our customers are working hard with us and we are working hard in response to that. They are a very resilient group and we would really want to help where we can. But it's definitely tougher times.

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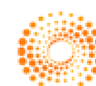

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Jeff Fenwick - *Cormark Securities - Analyst*

That's all I had. Thank you. I'll requeue.

Andrew Moor - *Equitable Group Inc. - President & CEO*

Thanks, Jeff.

Operator

Our next question comes from the line of Graham Ryding at TD Securities.

Graham Ryding - *TD Securities - Analyst*

Good morning, gentlemen.

Jumping back just the derecognition, it sounds like your decision not to derecognize this quarter and possibly next is really about your leverage ratio. And it's not anything to do with the economics that are currently out there, or just the demand for interest only strips not being what you would like. Is that accurate?

Andrew Moor - *Equitable Group Inc. - President & CEO*

That's absolutely right. I think we know that the most cost-effective transaction we could move more than $2 billion off trend -- we could get $2 billion recognized in very short order through the non-IO strip sale approach. And we have a whole bunch of IO strips that could be sold. And we believe there's demand for those, too.

Graham Ryding - *TD Securities - Analyst*

And any context for what sort of demand you see out there for the IO strips if you wanted to release some leverage -- relieve some pressure on your leverage ratio?

Tim Wilson - *Equitable Group Inc. - CFO*

I think at the extreme, Graham, that we could derecognize every securitized asset that we have on our balance sheet. So there's that much demand and more. So I don't think demand enters into this equation at all. This was really about long-term shareholder value. So if our capital is such that we don't need to derecognize any assets to keep on growing, it is a much better decision for us to retain those assets on balance sheet than sell the IO strips. Sure, the IO strips would generate current period income. It would help offset some of the lumpy expenses we have. But it wasn't the right decision for the long term. Hence we held off.

Andrew Moor - *Equitable Group Inc. - President & CEO*

And the capital that Tim talks of is simply the leverage ratio, which is -- it's the total assets on Tier One. So that's -- it's not a fundamental set one ratio that's impacted here.

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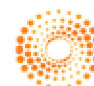

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Graham Ryding - *TD Securities - Analyst*

Yes. I appreciate that.

I appreciate your stress testing you provided around the residential book in Alberta, Saskatchewan. Have you done any stress testing on your commercial book? I think it's $300 million. Is there any color you can provide on what sort of losses you potentially could see there under a stressed environment?

Andrew Moor - *Equitable Group Inc. - President & CEO*

Yes, rather than at a $300 million individual asset type approach, we haven't done the kind of aggregate stress test. We've simply looked at them loan by loan and walked through the loan book on that basis, and don't see any reasonable sort of prospects for significant losses there. As we always talk about in commercial, strange things can happen. A single loan could create a single largish loss. But we have been through that book in detail and don't see much possibility of that at this point.

Graham Ryding - *TD Securities - Analyst*

What's the average loan to value on that commercial book, uninsured?

Andrew Moor - *Equitable Group Inc. - President & CEO*

I'm sure we can get back to you with that data point. I don't have it, though, and wouldn't want to guess it.

Graham Ryding - *TD Securities - Analyst*

Okay. No problem.

And lastly if I could, you've obviously attracted a lot of customers to your EQ Bank. At what point do you start looking at these customers and potentially looking beyond the high-interest savings account and potentially launching some other products that you could maybe cross-sell to this target audience?

Andrew Moor - *Equitable Group Inc. - President & CEO*

I think that's a year or two out. We already believe that we've got some industry-leading customer experience. And I do encourage you all to try and sign up for an account. And what we really want to be focused on is extending that lead of customer experience with some more functionality. So rather than adding more products, which would be the conventional mind set, we really want to make this a great solution for our customer base. And so we're pushing on that and want to invest in that area so that we can be unapologetic about having the leading digital banking experience in Canada.

I think we might already be there. I could do all of my banking pretty much out of my EQ Bank account. But I think we have a lot to do to convince people that's a general solution for everybody. And what I mean by that, we don't offer joint accounts yet. We don't have a TFSA. So there's some simple products that people need as part of that solution. And there's more we can do in making our payment solution slicker, and making it slicker to add additional bank accounts to third parties. So I think you will expect to see that over the next year or two as being the major thrust for us.

Graham Ryding - *TD Securities - Analyst*

Thank you.

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Operator

Our next question comes from the line of Jamie Goin at National Bank.

Jamie Goin - *National Bank Financial - Analyst*

Good morning.

Andrew Moor - *Equitable Group Inc. - President & CEO*

Good morning, Jamie.

Jamie Goin - *National Bank Financial - Analyst*

Just a question on the delinquency rates jumping up 30-plus days -- or, sorry, the 30 to 59 days portion jumping up from about 34 basis points to 65 basis points. Can you just give us a little bit more color on what was driving that?

Andrew Moor - *Equitable Group Inc. - President & CEO*

That is related to the Alberta exposure. That's where we go with that. And I think, as I mentioned, we did walk through all of the loans -- the senior executive team walked through all the loans to find out what's going on there. And we have one large commercial loan in Quebec that is actually a great asset. I've walked the asset. It's right in the middle of downtown Montreal. And it was actually delinquent at the end -- it was in arrears at the end of the period. It's now current and we're very comfortable with it. It's a great location but it had a vacant retail frontage on the front of the building and had borrowed a little bit of glue without the cash flow. But it's an eminently leasable space and that's worked itself out. So that's one thing that solves most of the problem; and then the rest is related to the Alberta.

Jamie Goin - *National Bank Financial - Analyst*

So the breakdown -- would it be half and half between Alberta and the commercial? Or more towards Alberta? Just to get --

Andrew Moor - *Equitable Group Inc. - President & CEO*

About half and half. I think half and half is accurate enough.

Jamie Goin - *National Bank Financial - Analyst*

Okay, great.

And then just moving to net interest margins. The guidances were flat in NIM in the core lending portfolio for the rest of the year. From the comments and the guidance, it sounds like the EQ Bank high interest rate savings account is going to continue to have an impact and so is the shift towards single family homes -- or single family mortgages. What gives you confidence that it's going to be flat through 2016 from Q1 levels?

Tim Wilson - *Equitable Group Inc. - CFO*

Jamie, it's Tim.

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I think our best view at the moment is that it's going to stay flat. There's always a bunch of puts and takes in there. As you notice in our disclosures, prepayment income, which is inherently a volatile line item, tends to cause a lot of fluctuations in NIM. And if you look Q4 to Q1, it's a 9 basis-point impact -- quite substantial. When we look at the different puts and takes of the factors you mentioned, along with prepayment income and some other factors, right now, given the visibility we have and our estimates around the way EQ Bank accounts are going to grow, flat is the conclusion that we arrive at.

Andrew Moor - *Equitable Group Inc. - President & CEO*

I think one of the points we may want to mention is that in our HISA in the [fund serve] channel -- so the EQB 200 channel -- we did actually drop rates in the middle of the first quarter. So that will reflect lower interest expense in subsequent quarters.

Jamie Goin - *National Bank Financial - Analyst*

Okay, great. And just again on the -- no, sorry. That was actually already covered. Thanks. That was it for me.

Andrew Moor - *Equitable Group Inc. - President & CEO*

Thanks, Jamie.

Operator

(Operator Instructions)

Our next question comes from the line of Brian Horey at Aurelian Management.

Brian Horey - *Aurelian Management - Analyst*

Thanks for taking my question.

I had a couple questions on Alberta to start. Are you at the point where you're starting to make modifications in the loans with your borrowers that are stressed out there?

Andrew Moor - *Equitable Group Inc. - President & CEO*

We make relatively few modifications. We do make what we would call an arrangement. So the [up time] -- the guy will say, the payment's due on Friday. And he'll say, well, I'm due to get a check or whatever next week, or I'm doing something else to get the cash flow. So people can work with us on that basis. We'll make those kinds of deals. But generally speaking, there's very little in the way of loaning. It's not whether we would consider it to be traditional loan modification when you think about it in the US, where it turns something that really is in arrears into a current loan. There's little to none of that going on.

Brian Horey - *Aurelian Management - Analyst*

Okay. And in your stress testing that you highlighted in the MD&A, what kind of severity are you all assuming in that scenario?

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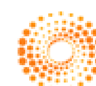

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Tim Wilson - *Equitable Group Inc. - CFO*

I think we provided the assumptions in the outlook. So it's really unemployment escalating to about 10.5% and house prices dropping 30% -- so quite significant stress in the Alberta market.

Brian Horey - *Aurelian Management - Analyst*

Right. But what kind of severity in terms of loss on the loans are you assuming in that?

Andrew Moor - *Equitable Group Inc. - President & CEO*

Well, the severity calculation depends on -- so we go through the entire book, and then we will figure out the severity based on that assumption on house price change. So we mark down the underlying value of the asset, take the assumed cost of collections, and so we're based on that history to figure out what the LGDs are going to be.

Tim Wilson - *Equitable Group Inc. - CFO*

The severity is really loan-dependent, depending on the LTV and other factors.

Brian Horey - *Aurelian Management - Analyst*

Okay. And then I had a third question.

Just thinking about the major growth factors in the business at this point -- which is the single family securitization on the asset side and the bank deposit growth on the liability side -- what kind of incremental NIM or incremental margin do you all see on that combination of asset growth and funding increase?

Andrew Moor - *Equitable Group Inc. - President & CEO*

Are we talking NII, as in net interest income rather than NIM -- rather than the spread? Are you looking for a nominal dollar type increase?

Brian Horey - *Aurelian Management - Analyst*

Well I was looking more for the spread on that business, given a cost of funds and the yield on those kinds of assets.

Andrew Moor - *Equitable Group Inc. - President & CEO*

Certainly in the securitization business we don't fund those with deposits. Right? So that would be funded through MBS. And that, as we've always talked about, can be slightly volatile. Spreads are okay right now, but it's a spread between prime mortgages and the MBS yields in the marketplace. So it's all in the CMHC program. But it doesn't really relate to the deposits coming in from the digital bank, which you use to fund conventional mortgages we keep on our balance sheet.

Brian Horey - *Aurelian Management - Analyst*

What are the trends -- go ahead.

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Tim Wilson - *Equitable Group Inc. - CFO*

I think we've laid out our expectations around both the dollar net interest income growth and our margin trends quite clearly, if you reference page 8 of our MD&A, the outlook section. So we've lifted all of the different puts and takes and our expectations for NIM there.

Brian Horey - *Aurelian Management - Analyst*

Okay. And are you seeing much in the way of change in the profitability of the business you're doing with CMHC at this point?

Andrew Moor - *Equitable Group Inc. - President & CEO*

No. That's the bottom line. It's broadly stable but that can change quite quickly. Let's not forget that we're a small bank, and there are five big banks that provide the pricing -- effectively drive the pricing; and we have to manage that pricing. So they're funding off a slightly different base than us.

The way we think about this is that a good chunk of those mortgages are actually going to be funded through the deposit note market of the big five banks. So we spend a lot of time looking at their cost of funds and the spreads that they are getting. Where the spread that we are more concerned about is the mortgage spread against the MBS spread so we can look at five-year newly issued MBS and HAMBS and look at that spread. So in the beginning part of the [agency], deposit note spreads increased, which certainly created a favorable backdrop for us. Those spreads have come back in again compared to MBS. So the big banks might be slightly more competitive over the next little while. As we sit today, we've got good -- I would say they're sort of at the average. They're where we would expect them to be.

Brian Horey - *Aurelian Management - Analyst*

So since the end of the quarter, they've gotten better or worse, would you say?

Andrew Moor - *Equitable Group Inc. - President & CEO*

Since the end of the quarter they've gotten slightly worse, I think -- slightly worse over the last -- sorry --

Tim Wilson - *Equitable Group Inc. - CFO*

And then they've rebounded in the last week or two. So there's been the expected volatility in those margins. But overall, I'd say relative to a longer-term average, they've been relatively stable.

Brian Horey - *Aurelian Management - Analyst*

Okay. Thank you.

Operator

(Operator Instructions)

Our next question comes from the line of [Sam Shade] at [Shade Advisors].

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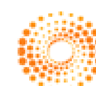

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Sam Shade - *Shade Advisors - Analyst*

Thanks for taking my question. I have two questions.

I'm trying to wrap my head around the impairments going from 45 to, call it 78, December to March. And I'm trying to reconcile that with the 1 basis-point reserve you're taking. Can you help me with that a little bit?

Tim Wilson - *Equitable Group Inc. - CFO*

The 1 basis-point reserve, Sam -- how we arrive at that number is, we actually do a review of every individual loan that's in the impaired category. We update the valuation. We estimate potential foreclosure-related cost. And then we arrive at an estimated loss from there. That estimated loss then drives the amount that we book through the P&L and in our provision for (inaudible). So it's a really in-depth loan-by-loan analysis and we're confident that the allowance that we have on our balance sheet is adequate, given all of those factors.

Sam Shade - *Shade Advisors - Analyst*

If delinquencies are going from 45 to 78 over 90 days, I'm just stumped on 1 basis point is nothing, given a 70% increase. I mean, are you saying these impaireds -- they are 99.9% money good?

Tim Wilson - *Equitable Group Inc. - CFO*

Sam, which numbers are you referencing?

Sam Shade - *Shade Advisors - Analyst*

I'm looking on your discussions. It says: impaired past due but not classified as impaired are as follows. December 31, 2015 the total is 45.3. March 31, 2016, 78.0.

Andrew Moor - *Equitable Group Inc. - President & CEO*

Okay. So I think most of that relates to the -- sorry I think we are sitting on the P&L and have the MD&A in front of us here. But the -- most of that relates to that conversation we were just having about the one mortgage in Montreal for about $10 million or $11 million. That's cleaned up post-quarter end and was frankly -- it was actually cleaned up as we opened the financial statements together, so we obviously knew that was in good shape.

Sam Shade - *Shade Advisors - Analyst*

Okay. So then we're 50% higher. I mean I just don't want to get hit with a pie in the face on a 50% increase. I mean a 1 basis-point reserve -- why even bother?

Tim Wilson - *Equitable Group Inc. - CFO*

I guess, Sam, a couple things.

So the reserve we typically take -- so the analysis that I talked about represents a reserve against mortgages that are impaired. So those are typically the loans that are more than 90 days in arrears. The figure that you're representing are very early arrears where we might still be in discussion with the mortgagers, with the borrowers that they missed a payment or two. We're working on payment plans, collection, so forth. So while that may

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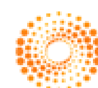

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be an indicator of future arrears and future losses, as we actually talked about specifically in our MD&A, we're not at the point with those accounts where we're booking losses against them.

That said, we've got about $30 million of collective allowance on our balance sheet, which represents an amount set aside for potential future losses that haven't yet been identified on accounts that aren't yet impaired. So I think when you look at that $30 million against the $63 million, we've got pretty good coverage already and didn't see the need for any more reserves.

Andrew Moor - *Equitable Group Inc. - President & CEO*

And actually -- sorry, I do have the numbers in front of me now. So the $63 million that you're looking at -- actually $6.5 million of that is insured by mortgage impairment insurance. So there's almost no possibility of loss on that, or there's no possibility of loss, really. So you've got $57 million that could become problematic, of which, as we mentioned this, I think $11 million cleaned up in Montreal. And we have got some early stage delinquency in Alberta that we more fully disclosed elsewhere in the MD&A and that's the conversation we're having about that.

Sam Shade - *Shade Advisors - Analyst*

Okay. And my last question is -- you're paying right now 2.2% to savers. Is that the number -- 2.2%?

Andrew Moor - *Equitable Group Inc. - President & CEO*

2.25%, actually.

Sam Shade - *Shade Advisors - Analyst*

And the conventional mortgage rate is what, right now, that you're putting the money out at?

Andrew Moor - *Equitable Group Inc. - President & CEO*

Well on a -- most of our mortgages have been written at about around about 4%, plus or minus.

Sam Shade - *Shade Advisors - Analyst*

Okay.

Tim Wilson - *Equitable Group Inc. - CFO*

It's still quite a healthy margin in there, even at 2.25%.

Sam Shade - *Shade Advisors - Analyst*

And the conventional mortgages are done at what rate?

Andrew Moor - *Equitable Group Inc. - President & CEO*

Around about 4%.

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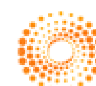

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Sam Shade - *Shade Advisors - Analyst*

Okay, perfect. Thank you.

Andrew Moor - *Equitable Group Inc. - President & CEO*

Thank you for your interest.

Operator

Mr. Moor, there are no further questions at this time. Back to you.

Andrew Moor - *Equitable Group Inc. - President & CEO*

Thanks, Nick.

Before concluding, I'd like to invite you to join us for our annual meeting of shareholders next Tuesday, May 17, at Toronto's TMX Broadcast Centre to 10 AM Eastern. Thanks for listening and goodbye for now.

Operator

This concludes today's call. Thank you for your participation. You may now disconnect.

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