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EDITED TRANSCRIPT

EQB.TO - Q3 2018 Equitable Group Inc Earnings Call

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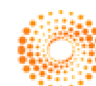

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CORPORATE PARTICIPANTS

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

Tim Wilson *Equitable Group Inc. - Senior VP & CFO*

CONFERENCE CALL PARTICIPANTS

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

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

Jaeme Gloyn *National Bank Financial, Inc., Research Division - Analyst*

Marco Giurleo *CIBC Capital Markets, Research Division - Associate*

Nikolaus Priebe *BMO Capital Markets Equity Research - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen, I'd like to welcome shareholders and analysts to Equitable's Third Quarter 2018 Conference Call and Webcast. (Operator Instructions) Before we begin on behalf of our speakers today, I will refer webcast viewers to slide 2 of the presentation and our callers to the following information, which contains the company's caution regarding forward-looking statements. We remind you that certain forward-looking statements will be made today, including statements regarding possible future business and growth prospects of the company. You are cautioned that forward-looking statements involve risks and uncertainties detailed in the company's periodic filings with Canadian regulatory authorities. Certain material factors or assumptions were applied in making these forward-looking statements, and many factors could cause actual results or performance to differ materially from those conclusions, forecasts or projections 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. Additional information on items of note, the company's reported results and factors and assumptions related to forward-looking statements are available in Equitable's Q3 2018 MD&A and earnings release.

This call is being recorded for replay purposes on November 9, 2018.

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

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

Thank you, Joanna. Good morning, everyone, and welcome. I'm joined by Tim Wilson, Senior Vice President and Chief Financial Officer of the Bank.

For all of our business lines Q3 was our most productive periods in our history and for the bank's earnings, our best quarter ever. On the strength on better-than-expected market conditions and great execution, mortgages under management are $1.4 billion higher than we thought they would be when the year started. This creates a substantial tailwind for future earnings. Meantime, EQ Bank surpassed $2 billion in savings deposits, further solidifying its position as the consumers' choice for all digital banking. Based on these results and on our update market and economic assessments, our outlook for growth has improved. Today, we'll be talking about at the underlying reasons, update you on progress against our priorities and provide insights and proposition as Canada's Challenger Bank.

Looking briefly to the quarter's key financial metrics. Diluted EPS was 27% higher than a year ago and 9% above the previous all-time records set in Q4 2016, which notably did not include any costs associated with managing through last year's liquidity events.

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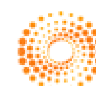

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As you know, liquidity event rated costs are now lower than a year ago, due to declining assurance premium amortization and the downsizing of our backstop last quarter. These lower costs along with strong underlying earnings performance supporting our ROE of 15.9% in Q3. Either way, our return to a high and demonstrate the advantage of Equitable's valuation approach. Of the shareholders this performance, we increased our dividend again yesterday to $0.28 per quarter or $1.12 annualized.

Turning now to report on our 5 key strategic priorities. The first is to grow existing businesses through superior service. In the third quarter, mortgages under management increased 14% year-over-year or $3.2 billion. In alternative single family, our book was up by 13% based on strong originations and excellent mortgage retention.

Let me update B-20 guideline that came effective in January was widely viewed as a headwind to originations. Several countervailing factors working our favor, including a concerted effort by our single-family team to give great service to brokers and borrowers, market share gains and higher retention rates on our existing book of business.

As you know, for more than a decade, Equitable centered its origination strategies on superior customer service to our mortgage broker customers. It's heartening to learn that in a recent national survey conducted by Canadian Mortgage Professional magazine, Equitable finished first amongst alternative lenders in 5 categories. Underwriter support, brokers support, turnaround times, satisfaction of credit policy and transparency of commission structure. These are coveted wins, and I thank our single-family team for the hard work and single-minded focus on customer service.

Our outlook for growth has improved again. We now expect an alternative single-family portfolio growth to be in a range of 11% to 13% for 2018 compared to our original forecast for the year of 2% to 4% expansion. That difference means that we'll end the year with approximately $840 million more in assets than we had expected setting the stage for a profitable 2019.

As we reported last quarter, growth in single-family also continued to be accompanied by higher average [Beacon scores with our uninsured residential portfolio. This uptick is a function of benign credit conditions in the economy and may also be a byproduct to B-20 changes. To certain current market conditions, the outlook for the broader economy and renewal dynamics, we expect revenue growth next year. We'll provide more color on our 2019 outlook next quarter after we worked through our normal budget cycle. Needless to stay, we are optimistic about the growth runway for our lending businesses.

In commercial, the bank set new high watermarks for mortgage principal and quarterly originations, up 27% and 48%, respectively. This best ever performance reflects our strategy of allocating more capital to commercial and the team's outstanding success in building the breadth and depth in our partner relationships through high-quality service.

Improvement in renewal rates, so far in 2018 have supported overall portfolio growth. Growth in our commercial assets are being spread across a wide variety of asset classes, including industrial, office, Multis and construction facilities.

We funded our first CHMC, a short construction loan in the quarter. This represents a new lending niche for the bank and another solution for our commercial customers. More generally, it reflects our ongoing desire to diversify and be recognized as Canada's Challenger Bank in all business lines.

We've also elevated our outlook for commercial. We now expect asset growth to range between 20% to 25% this year compared to our previous range, between 18% and 20%.

We continue to allocating -- we continue to allocate a healthy amount of capital to commercial and outlook is for ongoing growth in 2019.

Securitization and financing mortgages under management grew 11% versus last year, reflecting originations, renewals and multiunit residential mortgages and growth in our prime single-family book. Prime mortgages that we originated through our internal team grew 24% year-over-year, as a result of a steady increase in broker relationships built on service.

Those originations are supplemented by $400 million originations sourced through third-party partners.

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These prime mortgages aren't particularly profitable at the moment given price competition in the market. We expect them to be much more profitable on renewal.

Our second priority is to cement EQ Bank's position as Canada's leading digital banking platform. We gauge progress against this priority by cracking a number indicated, including customer feedback, savings deposit growth and new digital account openings. On each count, EQ Bank continues to make great progress. Last quarter, I said, EQ had reached 60,000 customers, that total now exceeds 66,000.

I also said that EQ was closing in on $2 billion into savings deposits, that number is now approaching $2.1 billion, 31% higher than a year ago.

Pervasive EQ Bank marketing early this year by our advertising, social media and partnerships has clearly lifted brand awareness, and led to more account openings, while market-leading digital capabilities and the recent launch of EQ GIC products are encouraging existing customers to save more with us for longer periods.

To pave the way for even more customer savings, we recently increased the deposit ceiling for the savings plus high interest account to $200,000. And allowed EQ customers to open up to 20 GICs each, which enables more effective laddering.

We're very excited about the roadmap we're on. Just this week, saw us launch a new EQ mobile bank app that enclosed the latest and biometric authentication capabilities, i.e. face recognition to open the app.

We also deeper into planning for 2019, developments, including enhanced customer contact center, and move to cloud infrastructure and several new product launches.

We're also delighted to receive approval from Bill Morneau, the Minister of Finance, to set up a new trust company, Equitable Trust, a subsidiary of the bank. Amongst other uses of the unique powers of the trust company, we expect to be able to offer more deposits insured by CDIC into the EQ Bank platform.

Priority 3 is to leverage our capabilities and balance sheet to diversify into attractive adjacent markets that can support asset growth over the long run. So far this year, the headline story is the launch of our reverse mortgage business, which from birth earlier this year is now finding its feet. We're getting great feedback from our mortgage broker partners. We recently made changes to enhanced competitiveness and more convinced than ever that reverse mortgages will become an important bank -- business for the bank over time.

More broadly, we're thinking about how Equitable can bring value to the people at the decumulation of assets stage of their lives, also known as retirement, and how bank -- the bank can bring valuable solutions to these people.

But in commercial, we also grew over specialized financing pipeline in the quarter, lending to other lenders who operate in attractive market segments, such as equipment financing. This business allows us to combine our balance sheet and strength to the secured lender for the distribution and credit management experience of other companies. And thereby diversify into new asset categories.

We expect to continue to see this business growing up coming years.

Priority 4 is to maintain a disciplined approach to capital management and a low-risk profile. Compared to last year, higher asset growth meant that our CET1 ratio edged lower in Q3, which means we have successfully and profitably deployed a significant portion of our excess capital that will benefit shareholders through stronger earnings in the future quarters.

Although we're still carrying some excess common equity, it is not as pronounced as last quarter.

As to maintain a low-risk profile, the evidence can be found in our credit metrics. Net impaired mortgage assets were just 16 basis points of total mortgage assets. While up from last year, due partly to the adoption of IFRS 9, 16 basis points is still an extraordinary low rate, even by our standards.

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Considering economic forecasts, our view is that risk in the Canadian residential real estate has decreased over the last couple of years, which is the more balanced supply and demand dynamics, the credit quality of the mortgages written.

As a result, we expect our arrears rate and credit loss provisions to be low for the remainder of 2018. That said, we're all prepared to act quickly to address any areas of elevated risk. And as a matter of policy, the bank remains well reserved with allowances for credit losses equal to 11 basis points of our assets, well above our long-term loss rates of 4 basis points.

Our 5th priority is to strengthen our key capabilities. We continue to do this by hiring great people investing our technology infrastructure and advancing our AIRB initiative. As you probably saw in a press release put out last week, we are committed to invest in the [Portage II] equity fund. This brings Equitable more centrally to a globally leading fintech ecosystem.

We already have a deep relationship with a team at Portage. We have been co-investors with Portage and Borrowell for number of years, which is really paying off for us. And we're providing deposits into the [well simple] platform a Portage investee company and the leading robo-adviser in Canada. I'm optimistic that we'll find additional opportunities for the bank to do business with other parts of the Portage ecosystem.

In other important news, our Board also strengthened its capabilities, with the appointment of Sue Ericksen. Sue has worked as a Chief Information or Technology Officer at several Fortune 500 companies such as; Coca-Cola, New York Life, Fiserv, Merrill Lynch and Citi.

Her experience in technology leadership positions will be invaluable to us, as we advance the IT infrastructure that has made us Canada's digital bank innovator. Now I'll turn the call over to Tim for his report.

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

Thanks, Andrew, and good morning, everyone. In Q3, our key profitability measures naming; net interest income, efficiency and EPS were well above last year and the expectations that we had communicated last quarter. We attribute our record performance to strong asset growth, the diminished cost of the now smaller backstop facility, low losses and improved margins.

We were truly firing on all cylinders in Q3.

Our results were also buoyed by $2.8 million of derivative gains related to our participation in the CMB program. Even normalizing for these gains, our performance would have been above expectations. EPS would have still been an all-time record of $2.68 and ROE would have been 15.2%.

Net interest income was up by 29% over last year due to 13% growth in average assets and improved margins.

Total NIM expanded by 22 basis points compared to last year to stand at 1.69% in Q3, the best showing in 7 quarters.

NIM in core lending was 22 basis points above last year due to lower liquidity event cost. Higher margins in our commercial book and various shifts in asset mix, all of which are itemized in our MD&A.

NIM was higher despite reduced levels of prepayment income in single-family. As expected, quarterly interest expenses associated with what is now an $850 million backstop facility declined to $2.3 million in Q3 compared to $5.4 million a year ago and last quarter.

In addition, last year, we recorded $4 million of amortization expense associated with mortgage insurance that we obtained during the liquidity event. This year that number was essentially 0. In other words, quarterly liquidity event costs are down to $2.4 million after hitting a high of $9.4 million last year in Q3. And it should stabilize at that level, at least until next June when our facility matures.

Our NIM performance far exceeded what we had expected, particularly in core lending. We had expected core NIM to be between 2.3% and 2.35%, but we exceeded the top end of that range by 12 basis points, for 4 main reasons: First, the level of price competition in the single-family market abated slightly compared to our last outlook. Between May and October, we were able to put through a few rounds of price increases to some of

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the products on which we're seeing the tightest spreads and those increases seem to have stuck; second, GIC rates dipped by approximately 20 basis points for a period in both July and late August, which also helped third quarter margins; thirdly, the spreads on new commercial deals continued to move up in the quarter, partly due to ongoing increases in the prime rate. And finally, our loan margin liquidity portfolio decreased in relative size, which caused a positive mix shift in our assets. This decrease was a function of normal seasonality in our business. We need less cash on hand as we head towards Q4 and Q1, which are typically periods of lower mortgage fundings. The spreads in our liquid assets were also helped by the prime rate changes.

Looking ahead, we believe, that Q4 NII will increase at year-over-year rates in the high teens. This is higher than we expected last quarter due to both, asset growth and margin stability. While GIC rates have moved up over the past month, recent prime rate and mortgage rate increases should offset the majority of that rise in our cost of funds.

I also want to highlight that while we expect NIM to be relatively consistent from Q3 to Q4 within each business unit, you will likely see a decline in our overall weighted average NIM. And this is partly due to asset mix. We expect our lower yielding securitization financing portfolio to grow more quickly than core lending, which will cause the weighted average NIM to decline.

Despite investing more in strategic initiatives, our efficiency ratio improved to 36.3% in the quarter, 1.1 percentage points lower than last year and 6.6 percentage points lower than last quarter. Expenses themselves grew at 19% year-over-year, just above the growth rates of our assets as we had expected. Drivers of the year-over-year expense growth, some of it in advance of the benefits realized included 12% higher FTE and a 23% increase in spending on technology and systems, consistent with our objective of building our IT capabilities to support our growth.

Marketing and corporate expenses were up 39%, but down sequentially, as we completed a very successful marketing campaign for EQ Bank in Q2.

For the remainder of 2018, we will continue investing in our strategic priorities. Consequently, we anticipate the Q4 noninterest expenses will increase year-over-year rates slightly higher than the growth rate of the bank's asset and that our efficiency ratio will be in the high 30% range. In dollar terms, we expect expenses to increase by up to $2 million from Q3, as a result of continued hiring and investments in some important technology initiatives such as the move to cloud infrastructure that Andrew mentioned earlier. With that, back to Andrew.

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

Thanks, Tim. Equitable is really hitting a stride as Canada's Challenger Bank. A challenger is partly a position of strategy and partly an attitude to taking an innovative more authentic position of change in the market. To reflect our challenger spirit, we have chosen to reimagination -- reimagine our banks brand and identification, including our logo, which you'll now see on all public investor facing communications. We believe, our new branding is bright, clear, powerful and indicative of all the commitment through rethinking all elements of banking as a service focused innovator.

All of the great work involved in this redesign was done internally by our marketing team at Equitable, and I sincerely thank them for their creativity and passion. I must admit, I'm pretty damn impressed by the intellectual insight that underpins what you see in this branding change.

In closing, the record earnings we reported and the strong growth we delivered across all of our business lines is very encouraging. Out TAMs for 2019 are taking shape. Our outlook for earnings growth is positive. Our opportunities to build new businesses are many. And we look forward to Canada's Challenger Bank delivering more value to its customers and shareholders in the years ahead.

That concludes our prepared remarks, now I would like to invite your questions. Joanna, can you please open the lines to our analysts that have questions.

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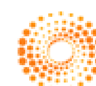

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QUESTIONS AND ANSWERS

Operator

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

Marco Giurleo - *CIBC Capital Markets, Research Division - Associate*

My first question today is on the prime single-family growth. You saw very strong growth of 11% sequentially this quarter. I'm just wondering if you can give us some color on: One, what's driving the growth? And two, Andrew, I think you mentioned these loans are less profitable, but I think you were referring to mainly the lower NIM. Can you talk about maybe the ROE on this -- on these loans? And how you expect the growth of this business to impact your overall ROE?

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

Sure, thanks, Marco. It's something that we can think about it, that we actually recently it turns out. In terms of growth, it's really been a matter of the prime team and I may sound like a broken record on this. But it -- we come in every day trying to out-service our customers. And our team has just done a fabulous job in this area over the last little while. It's almost as simple as that. Combined though with a really state-of-the-art switch program. So we're seeing more opportunity for when mortgages reach the end of the term being able to switch them into the bank. So one could imagine the mortgage with another lender. And historically, it's been quite difficult for brokers to bring that mortgage on renewal to another bank. We however, regard a state-of-the-art switch program, and that's helping to drive earnings. In terms of ROE, there's very little capital in this business, it's almost 0 capital, and these are insured either by Genworth or CMHC, if they are insured by a private insurer or for that matter Canada Guaranty. If they are insured by a private insurer, there is small amount of capital associated with the loans. So this thing at any kind of margin, the ROE is effectively infinite, although it does use some of your leverage ratio. And we actually end up with a slightly different accounting results when we buy loans from third parties. We'll pay a single up front fee and amortize it over the life of the loan. And those do have a positive impact on ROE right from the day we buy them. When we originate them internally, the internal cost structure expense right up front. So the accounting impact is actually to be probably to even make a loss in the first year, which is recovered in later years. So this doesn't really have much been impact on earnings in the year of origination and any impact over the last plus 3 to 4 years. Once you get to renew this mortgage further, the cost associated with reunderwriting are much lower, and the -- any fees to brokers that are typically more modest. So there's a higher margin at that point. So the spreads are very tight right now.

Marco Giurleo - *CIBC Capital Markets, Research Division - Associate*

All right. And so what proportion of the growth would you say is acquisition versus EQB originated?

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

There were roughly $300 million of acquired mortgages added to that portfolio in the quarter, Marco.

Marco Giurleo - *CIBC Capital Markets, Research Division - Associate*

Okay.

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

That's the number that we expect roughly to repeat in Q4. Beyond that, we're still in negotiations in terms of these sourcing partnerships. So don't have visibility into the origin of -- into the origination potential beyond Q4 at the moment.

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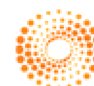

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Andrew R. G. Moor - *Equitable Group Inc. - President, CEO & Director*

Tim, we report what we originate on our own account as well separately in the MD&A.

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

Not separately. No.

Marco Giurleo - *CIBC Capital Markets, Research Division - Associate*

And so the terms on these mortgages, is that similar to your traditional business or your non-prime business?

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

These will be mostly 5-year loans.

Marco Giurleo - *CIBC Capital Markets, Research Division - Associate*

5-year loans, okay. So -- and then on renewal you get better terms.

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

That's right.

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

That's right.

Marco Giurleo - *CIBC Capital Markets, Research Division - Associate*

And my last question is just on the tighter rules around HELOCs introduced by some of the big 6 banks this week. I just wondering, if we could get your take on the tightening of the rules and if you think it will be a tailwind for your mortgage business?

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

It's too early to say. I mean, I've been asked recently about what we think the next regulatory change might be, if there are any. It does seem that HELOCs are a bit of a -- haven't really fully embraced into the B-20 world. One of the obvious gaps is that if you qualify for HELOC, it appears that the qualification level is never revisited, i.e. you could be in your mid 50s earning at a peak earnings power, and you still have that drawable amount, as the approved credit 20 years later without it being revisited under the most bank, which clearly doesn't make much sense when you think about the 5 Cs of credit in the capacity to repay. So generally speaking, we would think this is something of a tailwind for our reverse mortgage business, if HELOC rules start to come back to a little more rational around how we think about these things. I'm not saying, by the way, there's any need for change, but there's clearly a much more rigorous approach to new regular mortgage advances than there is to HELOCs, and so it's a area that wouldn't surprise to see regulatory pressure.

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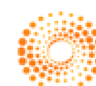

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Operator

Your next question is from Jaeme Gloyn of National Bank Financial.

Jaeme Gloyn - *National Bank Financial, Inc., Research Division - Analyst*

My first question is related to some commentary in your outlook and it's regarding some specialty lending programs and financing some of these specialty lending programs, 3 of them, in particular, and you highlight equipment leasing, as part of the -- 1 of the strategic initiatives. Can you give us some color around what -- what kind of specialty lending programs these are? What center line assets, size, expected revenues, things of that nature?

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

Yes, sort of modest revenue. I think facilities, roughly speaking, 3 facilities, $25 million a piece, secured by hard assets typically, things like trailers or construction equipment where we're in the senior lenders position, so the owner of the specialty lender has subordinated position behind us, and effectively, sort of, we're cross-collateralized across all of the asset pool. So we feel pretty good about the structures we're putting in place there. And this is clearly a part of a broader push to understand equipment financing markets. In general, with a view that over time that might be something that the bank as a whole is more encouraged in participating more directly. It seems like a pretty interesting area of lending to us. It turns out that we've got a couple of senior people in our risk area that really understand this market, I mean, coming from one of the leaders in this business, a few years ago. So it's a bit of a, kind of, evolution in development.

Jaeme Gloyn - *National Bank Financial, Inc., Research Division - Analyst*

And so you're -- the programs are set up to finance the lenders' activities. Are there -- are any of these lenders are publically traded? Or is it -- I'm just trying to get a sense as to who you're financing? Who's is doing the, I guess, adjudication of some of these loans as well?

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

None of them publically created. These are smaller, specially financed shops, typically backed by private equity banks.

Jaeme Gloyn - *National Bank Financial, Inc., Research Division - Analyst*

Okay. One of the comments, Page 15 of the MD&A, around your noninterest income is, lower gains on sale of foreclosed homes as a driver of year-over-year decline in noninterest income as well as amortization and characterization of certain fees. Can you talk about, I guess, why that lower gains on sale foreclosed homes didn't show up in the sequential decline as well? And then also about what kind of changes happened to your noninterest income to adjust amortization periods in categorizations?

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

Yes, I can take that one, Jaeme. On that first point about the foreclosed homes, the gains and losses that we realized are really individual property dependent. So I have to go back and reference the exact properties we (inaudible).

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

It wasn't a home. I think it was 1 commercial property, a mole that we had foreclosed on a few years ago that we so sold for a gain last summer. A small mole for the things that actually homes.

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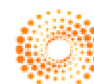

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Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

And then, the other point about the fee income that one is easier to explain. There are certain fees, we charge on renewal of mortgages, and we actually changed the categorization of the reporting of those fees during the quarter. And we move them from other income into NII, which is more consistent with the way we treat every other fee. So while it was the change with significant that it created a blip in other income, it's not significant enough that you actually noted the difference in NII. And going forward, we will be reporting it is part of the net interest income.

Jaeme Gloyn - *National Bank Financial, Inc., Research Division - Analyst*

Okay. So safe to say, the Q3 number is a fairly clean number at this point.

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

It's a clean number. And I'd use that as your run-rate.

Jaeme Gloyn - *National Bank Financial, Inc., Research Division - Analyst*

Right. Next question is related to some changes in the stage 2 mortgages -- mortgage commitment risk and stage 2 mortgages receivable in the -- both in the standard risk homes or rows I guess, seen an uptick there from Q2 and Q1. Can you just explain or maybe just give us a little more color as to what's driving the increase in those stage 2 mortgages -- commitments and mortgage receivables?

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

I wouldn't say there's anything in particular I'd note there. I mean the stage 2 can be affected by the performance of individual loans, but also by macroeconomic factors. So to the extent that the macroeconomic forecast that we obtain from a third priority agency deteriorate a little bit in the quarter, that can move more loans into stage 2, which is the exactly the dynamic we saw. There wasn't a significant change in that credit performance of our mortgages.

Jaeme Gloyn - *National Bank Financial, Inc., Research Division - Analyst*

Okay, and would there be any particular geographic focus in that change or underlying asset type that drove the increase?

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

No. Not that I'm aware of. A very small change, but across the board.

Jaeme Gloyn - *National Bank Financial, Inc., Research Division - Analyst*

Okay, so more broad as opposed to, let's say, [BC getting their] troubles.

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

But I'll take that away and move back with you, if that wasn't right.

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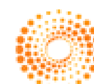

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Jaeme Gloyn - *National Bank Financial, Inc., Research Division - Analyst*

Okay, last one from me is around Basel III and potential lost fee changes on commercial mortgages. How are you guys are thinking through the potential increase in risk weights on those products and any potential impacts there or thoughts?

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

Well, I think, sort of, since [OSFI] itself hasn't, kind of, come out with any guidance. In general, the change is standardized, we think we'll get pressure provide risk weight relief. So I wouldn't think of it in aggregate. So we'll wait and see. And see what OSFI has to say on that. We have had dialogue with the regulators about how this might evolve, but it's clear that thinking about it constructively and sensibly and no decisions have been made yet. And really the only, sort of word on standardized so for is about floors as it faced the [DS -- DSiB sense] and the fact that standardized approach used for the DSiB floor calculation will be different than the made in Canada solution for standardized banks. It so far includes Equitable, but would have -- will have a slightly difficult -- have some different calculation methodology to reflect the regulator's view of risk as to various asset classes.

Operator

(Operator Instructions) The next question is from Steven [Bullent] from [Enfor].

Unidentified Analyst

Just following up on Jaeme's question on the equipment leasing. I guess, I just want to clarify, these are not like securitization facilities. You like, there is recourse to you it's not like a credit enhancement type facility? You're actually the -- like you said the senior lender on this equipment?

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

That's right. I mean, users -- we wouldn't think of it as a securitization, but uses securitization technology, if you like. There's certain -- if arrears' rates rise to a certain higher levels than we would get, sort of, turbo collection of all the cash flows out of these portfolios and so on. But it is a corporate loan.

Unidentified Analyst

Okay. And just in your commentary in the beginning, you talked about the backstop facility, it almost seems that you're in a position where you feel you don't need that backstop facility when the maturity comes around next year since your funding mix has changed so much over the past couple of years?

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

That's where I'm at Steve, personally. But this is still a conversation what we're having with our board, with other stakeholders. We want this. This is obviously an important decision to make and get it right. So we're thinking it through. My own belief is that our liquidity position, our avenues attached to liquidity as structural funding position of our balance sheet is such that we shouldn't need this, but this is a decision the board makes and other members of the senior executive team have views with, and people in the community broadly. So certainly welcome to listen to the views from shareholders, creditors and so on, about how they think about this, but my sense is, come next June that we'll be in a position to eliminate the backstop.

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Unidentified Analyst

Okay, and just last question getting another trust license. I mean, I remember when you converted from a trust to a bank, part of it was the lack of recognition about a trust and certainly, that you are paying more on deposits, more for -- you had to give out more on GICs. Is this really just to allow people to diversify, if they want to, sort of, get the insurance as opposed to going out to the market with a trust GIC that might be a 10 or 20 basis point more than -- that you're offering with the bank?

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

Certainly, we want to be able to offer high limits to our customers from CDIC coverage perspective. So you can imagine, that as we build the tax stack within EQ Bank, first $100,000 will be sitting as an EQ Bank insured CDIC loan deposit, second $200,000 would actually move automatically down to the trust company where it will also have the benefit of trust. Obviously, CDIC coverage because it is a separate legal entity with separate CDIC coverage. More than that, as mentioned earlier, we are thinking about as part of our challenge bank agenda, the decumulation of assets, and the stage in the people's life when that's relevant to them and having trust powers that allow -- may allow us to develop other businesses, using this trust license. So it's yes, it's about CDIC, but it's about delivering other value to Canadian consumer.

Operator

Your next question comes from Geoff Kwan from RBC.

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

You mentioned, I think, it's Page 7 of the MD&A, referencing market conditions, causing non-prime origination shift to higher credit quality. Your comments on the call seemed to suggest that you don't see market conditions turning the wrong way. Is it then just a matter of seeing maybe a higher proportion of borrowers with weaker credits? Or is there something else that's behind those comments?

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

I'm not quite sure that I understood that quite right Geoff, could you...

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

In Page 7 of your MD&A, you just -- there's a reference talking about market conditions and the way that they are, is causing the non-prime originations to shift to higher credit quality borrowers.

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

Yes.

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

I'm just trying to get a sense as to what driving that?

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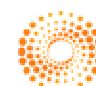

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Andrew R. G. Moor - *Equitable Group Inc. - President, CEO & Director*

Right. I think it's primarily because -- with the B-20 stress test, you could add 2% and so on to make the GDS TDS work on debt service coverage. Some of the lower Beacon borrowers are getting knocked out by that disproportionate number of the lower Beacon borrowers as they're getting knocked out as lending opportunities, so is causing a migration with in credit quality.

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

Okay. So it's purely --it's a B-20 as to what it is. It is nothing else that you've been seeing in terms of the applicants or the market conditions?

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

No, I think that's, right. It is B-20.

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

Okay, just the other question I had was that, the gross impaireds in the quarter on the single-family side went from $23 million to $29 million quarter-over-quarter. But the specific provisions was unchanged, just wanted any color on that, is what the just the LTVs on the new gross impaireds was really low or is there is some other factors there?

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

Yes, I think, that's exactly right. I mean, it was a collection. I think the number is 14 single family loan came nearly impaired during the quarter. Broad-based, no particular reason of the country and we don't expect really any losses or material losses on any of those loans.

Operator

Your next question comes from Graham Ryding from TD.

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

Could I start with capital, there was just the drop on your CET1 ratio, was that-- maybe I missed it on in your comments. Is that of reflection of strong growth your commercial book this quarter?

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

That was certainly one of the bigger drivers in risk weights. And of course as earnings go up, we will also put more risk weight against operational risk. It is a curious thing that better you do the more capital you have to put away. But those would be 2 of the drivers, for sure.

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

And then, so given your outlook, I guess, for both commercial and residential growth. Going into next year, how you're thinking about managing your capital? Do you see commercial growth slowing or if not, do you need to raise capital to keep that common equity to one ratio at that level?

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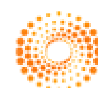

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Andrew R. G. Moor - *Equitable Group Inc. - President, CEO & Director*

The best view we have today is that we wouldn't need to -- we don't need to raise capital and the -- to that kind of organic growth. As we continue to face the market in a constructive fashion, we'll just about match the retained growth from earnings. So it feels like a pretty good level flight where CET1 should be relatively stable around these levels of next little while. We do see seasonality thinking that CET1 might grow slow in the winter months. But we need to, kind of, restore it a little bit to have to head to more seasonal peaks in next summer.

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

And I think implied in that Graham, the growth rate of our commercial portfolio will come down. I think roughly mid 20 rates we've seen this year aren't sustainable over the longer term. We wouldn't want to be growing that portfolio at those rates indefinitely, so it will drop, as we start to move into 2019.

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

And what sort of -- what is a more sustainable growth rate for that commercial book?

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

I think generally, you should think about growth rates of our risk weighted assets and those growing just below the rate will return on equity. So our organic growth in capital. How commercial grows relative to single family is going to be partly a function of opportunities out of particular point in time. So to the extent 1 market offers more attractive returns than the other, we'll deploy our capital to that market. So can't comment conclusively other than that, that's a portfolio level.

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

So I think we would expect -- we would continue to first choice to put capital in the single-family market, but if you currently say, similar cadence to this year, then that result is you end up in the commercial book growing by 15% to 20% next year.

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

Okay. And then just sticking with capital, is there any discussion at the board level, I guess, we're looking at the rising rate environment to fairly soft residential market. Is there any discussion on holding a bit more capital going forward, relative to perhaps your last 5-year average? Or how are you sort of thinking about capital given your outlook?

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

I think, with the certainly discussion the board always about capital levels and capital holding. I think when we think about sort of sweet spot though, so sort of 13.5%, CET1 is, kind of -- 13.5%, plus or minus half is really how we think about our optimal capital position. And we don't think anything is so evident in front of us -- the need to change that. But it's a very active conversation every quarter as part of our ICAP process, to consider what that appropriate capital level is -- yes, it is reviewed quite regularly. That might change, but all of the conversation we have had to-date, have been just sitting in the same position.

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

Okay, got it. And when you talk about your commercial growth you made a comment about increased absent breath of your partner relationships, much of that was this quarter, last quarter but are you referring to syndications with other lenders or these relationships with actual commercial investors that are becoming deeper and broader?

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

I think as you know, we have long history with [National], Timber Creek, pretty much all of the commercial specialist mortgage banks. Many cases we are putting A-loans ahead with our putting significant chunks in mezzanine loans or equity behind us. So it's really those partners that I am speaking of. So high quality commercial originated that have a lot of skin in the game behind us.

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

Okay, and then just my last question, if I could. Equipment leasing, how much are you originating right now? And what is the size of this portfolio?

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

I think there are 3 facilities of $25 million a piece in place. And I think we grown less than $20 million, I believe we've got that's what the scale.

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

Yes.

Operator

The next person comes from Nik Priebe with BMO.

Nikolaus Priebe - *BMO Capital Markets Equity Research - Analyst*

Just wanted to start by asking a few question on some of the factors that might have impacted reported net interest margins in the quarter. I thought I would start with liquidity, it looks like liquidity levels were a bit lower sequentially. I am just wondering if you could talk about whether there is a bit of a seasonal influence on liquidity there. And how should we expect that to evolve over the next few quarters?

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

Yes, Nik, it's Tim. There's definitely a seasonal influence in the liquidity numbers as you see, in fact it's almost entirely driven by seasonal factors. So with the way we think about liquidity is, we look ahead at our cash flow needs, which would involve mortgage funding and GIC maturities over the coming months and then we hold liquidity partially based on those factors. So as we enter a period of lower mortgage funding, which would be Q4 and Q1, our need for a larger liquidity portfolio drops. So it's a normal pattern you see and then, we expect liquidity to move up again as we move into late Q1 and Q2 of next year.

Nikolaus Priebe - *BMO Capital Markets Equity Research - Analyst*

Got it, okay. And then, maybe just 1 clarifying question as well, kind of, staying along the same vein on the seasonal factor, but on prepayment income and the single-family portfolio, I understand that they are both secular and cyclical forces affecting the level of prepayment income that

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you guys realize in any given quarter. Just wondering if you can talk about seasonality there as well. Like, should we expect higher levels of prepayment as well in the more seasonally active quarters, kind of, associated with above-average discharges and then, again lower in Q4 and Q1 similar to liquidity, I just want to make sure I'm thinking about that correctly?

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

You thinking about it is absolutely right. Prepayment income does peak in Q2. And typically drops off an either side of that. So Q2 being highest, Q3, second, Q4 and Q1 are both typically quite low.

Nikolaus Priebe - *BMO Capital Markets Equity Research - Analyst*

Got it. Okay, perfect. And maybe one last one here. And Andrew, you alluded to this in your prepared remarks, but I just wondering if you expand a little bit on the advantages that you, kind of, expecting to obtain from the investment in the Portage fund. I recognize the connection with one of your new partners, but are there any sort of opportunities you see arising there?

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

It's lots. In fact, it's been 3 days, months, couple of weeks ago, talking to many of the CEOs of that startup their investee companies and so many learnings that bringing in from all around the world. You may not think that a mortgage broker in -- sorry, insurance broker in Germany was a very interesting model, has much to sort of do with how a challenger bank in Canada may be operating, but there's a lot of things to learn from all of these different approaches, I think you -- we highlight 2 relationships within the Portage ecosystem but I'm extremely confident there are going to be many over the ways ahead. Some of them may just be a sort of a point solution and part of our value chain, some clever widget whatever to help us with the mortgage application. Portage has an investment in one of the leading AI firms in financial services base very interesting financial help out of California. It just opens your eyes to the possibility what a Challenger Bank can be -- could be in the middle of that ecosystem, is actually is incredibly exciting for us and I think we're very realistic about. We know what we're trying to do and build our own brand, but to see and think about what others are doing and how they're building markets and customer bases. It is really interesting and I sort of sat next to one of the leading guys from a Chinese ventures in financial services. So it's kind of learning that Equitable never had before so I think our opportunity to really expand on our vision of one of Canada's Challenger Bank through this relationship is really enhanced.

Operator

Your next question comes from Jaeme Gloyn of National Bank Financial.

Jaeme Gloyn - *National Bank Financial, Inc., Research Division - Analyst*

Just a follow up here on the gross impaired loan question. It increased $7 million in the quarter. And I think you said, it was related to 14 loans, so let's say $500 million loan. That seems a little bit larger than your average loan we sort of discussed maybe a couple of years ago at the Investor Day, I think it was closer to sort of $300 million. Can you talk about maybe like what those loans? Are they within the last 12 months? Or are they a different loan than your typical loan that you would be lending into? Maybe just a little more color around that.

Tim Wilson - *Equitable Group Inc. - Senior VP & CFO*

Yes, I mean, obviously, I'm happy to answer that, Jaeme, I am not sure I'd have all the details at fingertips on this call. But if I don't answer your question, we can regroup later. I mean obviously, since a couple of years ago, our average loan size would have increased given general inflation in the trends in the housing market. I wouldn't see any of these loans were typically outsized. Again they are broadly geographically diversified. And then, there were 14 single family loans, there are also other movements within their portfolio, right, I mean, various commercial properties

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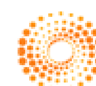

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and so forth. I wouldn't say that there was anything again, particularly outstanding about these loans. They were roughly in line with the average of the portfolio.

Operator

Thank you. There are no further questions. I'll now turn the call back over to Andrew Moor.

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

Thanks, Joanna. To conclude, we look forward to delivering our next quarterly report, which will be in 2019. So everybody, have a great holiday season, and we'll talk to you then. Thank you for listening.

Operator

Ladies and gentlemen, this concludes today's conference call. We thank you for participating and we ask that you please disconnect your lines.

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