Conference Call
Third Quarter 2019
Financial Results

August 29, 2019

LAURENTIAN BANK
FINANCIAL GROUP

Caution Regarding Forward-Looking Statements

In this document and in other documents filed with Canadian regulatory authorities or in other communications, we may from time to time make written or oral forward-looking statements within the meaning of applicable securities legislation. Forward-looking statements include, but are not limited to, statements regarding our business plan and financial objectives including statements contained in our 2018 Annual Report under the heading "Outlook". The forward-looking statements contained in this document are used to assist readers in obtaining a better understanding of our financial position and the results of operations as at and for the periods ended on the dates presented and may not be appropriate for other purposes. Forward-looking statements typically use the conditional, as well as words such as prospect, believe, estimate, forecast, project, expect, anticipate, plan, may, should, could and would, or the negative of these terms, variations thereof or similar terminology.

By their very nature, forward-looking statements are based on assumptions and involve inherent risks and uncertainties, both general and specific in nature. It is therefore possible that the forecasts, projections and other forward-looking statements will not be achieved or will prove to be inaccurate. Although we believe that the expectations reflected in these forward-looking statements are reasonable, we can give no assurances that these expectations will prove to be correct. Certain important assumptions by us in making forward-looking statements include, but are not limited to, our estimates and statements regarding our business plan and financial objectives including statements contained in our 2018 Annual Report under the heading "Outlook".

We caution readers against placing undue reliance on forward-looking statements when making decisions, as the actual results could differ considerably from the opinions, plans, objectives, expectations, forecasts, estimates and intentions expressed in such forward-looking statements due to various material factors. Among other things, these factors include: changes in capital market conditions, changes in government monetary, fiscal and economic policies, changes in interest rates, inflation levels and general economic conditions, legislative and regulatory developments, changes in competition, modifications to credit ratings, scarcity of human resources, developments with respect to labour relations, as well as developments in the technological environment. Furthermore, these factors include the ability to execute our plan and in particular the successful reorganization of our Retail Services operations, the modernization of our core banking system and the adoption of the Advanced Internal Ratings-Based approach to credit risk (the "AIRB approach").

We further caution that the foregoing list of factors is not exhaustive. For more information on the risks, uncertainties and assumptions that would cause our actual results to differ from current expectations, please also refer to the "Risk Appetite and Risk Management Framework" section of our 2018 Annual Report, as well as to other public filings available at www.sedar.com.

We do not undertake to update any forward-looking statements, whether oral or written, made by us or on our behalf, except to the extent required by the applicable securities laws.

NON-GAAP MEASURES

Management uses both generally accepted accounting principles (GAAP) and non-GAAP measures to assess the Bank's performance. Results prepared in accordance with GAAP are referred to as "reported" results. Non-GAAP measures presented throughout this document are referred to as "adjusted" measures and exclude the effect of certain amounts designated as adjusting items. Adjusting items relate to restructuring plans and to business combinations and have been designated as such as management does not believe they are indicative of underlying business performance. Non-GAAP measures are considered useful to readers in obtaining a better understanding of how management analyzes the Bank's results and in assessing underlying business performance and related trends. Non-GAAP measures do not have any standardized meaning prescribed by GAAP and are unlikely to be comparable to any similar measures presented by other issuers.

Operator

Welcome to the Laurentian Bank Financial Group conference call. Please note that this call is being recorded. I would now like to turn the meeting over to Ms. Susan Cohen. Please go ahead, Ms. Cohen.

Susan Cohen, Director, Investor Relations

Good morning and thank you for joining us.

Today's review of the third quarter of 2019 results will be presented by François Desjardins, President and CEO, and François Laurin, Executive Vice President and CFO. All documents pertaining to the quarter, including Laurentian Bank Financial Group's Report to Shareholders, investor presentation and financial supplement can be found on our website in the Investor Center.

Following our formal comments, the senior management team will be available to answer questions after which François Desjardins will offer some closing remarks.

Before we begin, let me remind you that during this conference call, forward-looking statements may be made, and it is possible that actual results may differ materially from those projected in such statements. For the complete cautionary note regarding forward-looking statements, please refer to our press release or to Slide 2 of the presentation.

It is now my pleasure to turn the call over to François Desjardins.

François Desjardins, President and Chief Executive Officer

Thank you, Susan, and good morning everyone.

Today, the Laurentian Bank Financial Group reported improving financial results. Adjusted net income, EPS and return on equity increased this quarter compared to the prior quarter. We reduced the level of liquidity which led to higher net interest income as well as higher margins and was partially offset by lower other income reflecting challenging capital market conditions, and we prudently managed expenses. As a result, the adjusted efficiency ratio improved, and operating leverage was positive.

Real estate financing along with equipment and inventory financing are niches where we have built expertise and strong relationships, translating into profitable growth. Moving toward higher margin commercial loans is one of our key strategic objectives. On that front, we increased loans to business customers and their proportion within the loan mix. We have yet to see a return to net growth of mortgages and personal loans.

The underlying credit quality of our portfolio remains good and our capital position remains strong, providing a solid financial foundation to grow our balance sheet.

The main focus of the last quarterly call was the new labour relations environment, which now has a redefined bargaining unit - limited to specific existing positions - and the signature of the collective agreement. From a strategic standpoint, there should be no doubt that this is a long awaited, hard-fought significant gain for this organisation as it fundamentally resets how talent is managed going forward and eliminates costly and unproductive processes. The percentage of employees represented by a union is now less than 25% compared to more than 50% at the end of 2015.

But more than anything, this great strategic achievement is allowing Retail Branch Operations to turn their complete attention to our customers' financial needs translating into more revenue generating activities, and the entire organisation to resume efforts on transformation-related strategic objectives.

Today, my remarks will highlight the progress we are making on 3 key initiatives that aim at fixing, and building, our retail distribution networks.

First, I am very pleased to say that we have completed the Quebec branch network transition from a traditional offer to 100% Advice. Yes – 100% Advice. From this point on, when customers visit our retail locations, they will benefit from a different experience where the conversation will be all about improving their financial health. Whether for a financial health assessment or a full financial plan, an RRSP contribution, a personal loan, a mortgage or mutual funds, customers have access, whenever and wherever it suits them, to the 450 advisors who now have the flexibility to meet their customers at home or in their office.

What it also means for customers is no longer having to pay for in-branch services they do not use, such as basic transactions that they can easily complete on their own by using our electronic services including ATM's.

No more walking around velvet ropes and waiting in line, no more different opening hours for services and no more passbooks. This is no longer an old sleepy bank anymore.

We are the first Canadian Bank to successfully transition our Retail branch network from a traditional offer to 100% Advice, a business model that we believe better fits the lifestyle and needs of modern customers. To reflect this change, going forward, our branches will be called Financial Clinics. The team is really excited about this transition. For them, 100% Advice means that they can now maximize value-added customer-advisor relationships, see more customers, get more referrals and help more people.

Second, we have begun to roll out our digital offering. B2B Bank is going to market with high-demand products, starting with digital bank accounts and deposit products. Indeed, from now on, B2B Bank's current and new customers will benefit from using the new platform for these products and will have access through mobile devices. Clients of the independent advisors and brokers across Canada are the first to benefit from our brand-new digital offering. Initial feedback from advisors is that the sign-up process is easy and intuitive, and they love the fact that this organisation continues to support independent advisors and brokers and helps them build their business.

Third, we are also planning to launch a digital offering under the Laurentian Bank brand to all Canadians before the end of the Fall. Even though Laurentian Bank has not been present outside Quebec in retail distribution since 2003, our brand recognition is high across Canada, and we expect to attract new customers - the young and young at heart - and develop new markets where clients are seeking hassle-free deposit products. Going forward, we are planning to use this mobile platform to strategically launch more digital products, and gradually gain new customers and deepen relationships.

Fixing our retail distribution is important to the success of our strategic plan. With these initiatives, and more to come, we are doing just that.

We are refocussing our team's efforts on revenue generating activities, which also means prioritizing growth and efficiency. It should be no surprise that from a growth perspective, all our retail teams - at Financial Clinics, at B2B Bank advisors and brokers and at LBC Digital - are now focused on growing mortgages, personal loans, credit cards, deposits and mutual funds.

On the efficiency front, we are eliminating non-core administrative activities and duplicate operations, as well as automating and outsourcing back office activities. We are looking forward to a more efficient cost structure - a simplified, less expensive operation. We are also reducing obsolete branch, back-office and administrative work. Indeed, moving to 100% Advice reduces the costs of managing traditional banking activities – specifically, expenses associated with handling cash and other obsolete processes.

So far, this has allowed us to regroup or outsource all our retail credit adjudication, collections and administrative responsibilities. We believe the savings from lower headcount and associated costs to be between $15 and $20 million annually, which we expect to gradually impact results through the first half of 2020.

Since the beginning of our plan, I have been keeping you informed of our progress on key elements. I understand the eagerness to see strategic wins and investments translate to financial results because I myself am eager to report improved performance. I have said before that to achieve our goal, this transformation needed to be and would be profound. What we have accomplished in the last 3 and a half years is tremendous work that had to be done to allow for a real change in the way we do business. We have improved many aspects of our organisation that are not yet visible to the naked eye: systems, processes, governance, leadership and culture. We are at a pivotal moment of our evolution, these are indeed exciting times.

Therefore, I want to thank our teams for their continued support and passion – and our shareholders for their confidence - it will be rewarded.

Lastly, I want to welcome our new Board members, Ms. Andrea Bolger and Mr. David Mowat. The Board of Directors, my Executive team and I are looking forward to working with them at this turning point in the history of our organization.

I will now ask Francois Laurin to provide a more in-depth review of our third quarter financial results.

François…

François Laurin, Executive Vice President, Finance, Treasury and Capital Markets and Chief Financial Officer

Thank you, François.

Good morning everyone.

I would like to begin by turning to slide 13 which highlights the Bank's financial performance. Adjusted net income of $51.9 million, EPS of $1.15 and ROE of 8.5% in the third quarter of 2019 improved sequentially and were lower year-over-year.

Reported earnings for the third quarter, as outlined on slide 14, were affected by adjusting items totalling $4.1 million after taxes or $0.10 per share and are related to restructuring charges and business combinations.

The drivers of our performance begin on slide 15. Total revenue in the third quarter of 2019 stood at $244.7 million, up 2% from the previous quarter and down 6% from a year earlier. Net interest income in the third quarter compared to last year was marginally lower as the impact of lower loan volumes was partly offset by an improving product mix. Compared to last quarter, net interest income improved by 7% due to the positive impact of 3 additional days, seasonally higher penalties on mortgage prepayments and a lower level of liquidity.

Net interest margin, shown on slide 16, was 1.85%. The main factors contributing to the 8 basis point year-over-year increase was the lower level of liquidity, the change in the loan portfolio mix and the favourable Prime/BA spread. As we mentioned last quarter, the new labour relations environment allowed us to reduce liquidity. The 8 basis point quarter-over-quarter increase was due to lower liquidity and seasonally higher prepayment penalties and the favourable Prime/BA spread. In the fourth quarter of 2019, we expect that margins may be relatively stable, excluding the impact of the seasonality of prepayment penalties. Over the medium-term, margins should modestly expand as volumes increase and the business mix continues to improve. Commercial loans now account for 38% of the portfolio compared to 35% a year ago and residential mortgages and personal loans account for 48% and 14% respectively.

Other income, as presented on Slide 17, totaled $68.6 million. Capital market sensitive revenues explained most of the year-over-year and quarter-over-quarter decline. Gains on inventory held for brokerage activities, gains on other trading activities and fees and commissions from brokerage activities were all lower than in the previous periods, mostly stemming from higher volatility and lower liquidity in capital markets.

Slide 18 highlights that adjusted non-interest expenses declined by 5% from last year and by 2% from last quarter as we prudently manage expenses. Compared to last year, lower salary expense from lower headcount, lower pension costs, as well as lower professional fees and labor relations costs explain most of the improvement. Compared to the last quarter, lower premises and equipment expense as well as lower other expenses accounted for the decline. The annual reduction in expenses of $15 to $20 million, related to streamlining operations, outsourcing and eliminating duplicate operations, is expected to gradually impact results through the first half of 2020, once we have completed the transition.

The adjusted efficiency ratio of 70.6% was 290 basis points lower than in the prior quarter. As discussed on previous conference calls, as we continue to invest in the Bank's transformation over the next few quarters, this ratio may fluctuate. However, we are making clear progress on our strategic initiatives which is expected to lead to sustainable improvement.

Slide 19 highlights our well diversified sources of funds. In the third quarter of 2019, deposits stood at $26.6 billion and fell by 2% sequentially. This is a result of the planned reduction in liquidity given the new labor relations environment and is in line with the loan portfolio. We continue to make use of efficient securitization conduits and in the third quarter, securitized $582 million of residential mortgages through the CMHC and a third-party purchaser, and $200 million of investment loans. These were partially offset by maturities and normal repayments. With the launch of our digital offering we expect to further diversify our deposit gathering channels. Our liquidity position continues to be strong and our liquidity portfolio consists mainly of highly rated government securities.

Slide 20 presents the CET1 ratio, under the Standardized Approach, of 9.0% at July 31, 2019. Our capital ratios are strong and support the Bank's strategic investments and growth.

Our diversified loan portfolio is highlighted on slide 22. Total loans stood at $33.9 billion at quarter-end. Commercial loans increased by 8% compared to a year ago and stood at $12.9 billion net of the sale of $433 million of non-core assets. Sequential growth of 1% was driven by an increase in real estate financing activity, offset by seasonality of the inventory financing portfolio as well as foreign exchange. There was a slight decline in the investment loan portfolio as consumers continue to deleverage, as well as in the residential mortgage portfolio with lower mortgage originations as we focus on higher-yielding loans. In 2020, we continue to expect double digit growth in loans to business customers and a gradual resumption of growth in residential mortgages.

Slide 23 provides a deep dive into our residential mortgage portfolio. We are maintaining our strategy to seek profitable niches, such as the high end of Alt-A business. At July 31, 2019, our Alt-A portfolio represents 7% of the total mortgage book and 3% of the total loan portfolio. This portfolio remains well diversified, with mortgage loans in the GTA representing about 21% of the portfolio and the GVA about 4%, and is high quality as evidenced by very low loss ratios.

Slide 24 highlights our commercial loan portfolio which is pan-Canadian with a US presence. It is well diversified, has a track record of strong credit quality and is positioned for sustainable profitable growth.

Turning to slide 25, credit quality remained good. The provision for credit losses was $12.1 million. This compared with $4.9 million a year ago and $9.2 million last quarter. A year ago, the provision had benefitted from favourable improvements to underlying assets. The provision in the third quarter of 2019 were impacted in part, by higher collective allowances resulting from changes to the probability of an economic downturn.

Looking at the individual portfolios, credit losses on personal loans decreased by $670 thousand sequentially, mainly as a result of lower loan volumes. Credit losses on residential mortgages increased by $1.6 million sequentially, mainly as a result of higher collective allowances on impaired loans. Credit losses on commercial loans increased by $2.0 million sequentially. The loss ratio of 14 basis points reflects the underlying good credit quality of our portfolios.

Turning to slide 26, the net impaired loan ratio of 45 basis points and the gross impaired loan ratio of 59 basis points are within historical fluctuations. We remain adequately provisioned.

We continue to expect that over the medium-term, the loss ratio could increase towards the high teens to reflect our changing business mix and macro economic conditions. However, with our current portfolio mix, conservative provisioning and a portfolio that is 97% collateralized, we expect that the loss ratio will remain below other Canadian banks.

To conclude, we are confident that the good progress we are making on our strategic initiatives will lead to sustainable growth and profitability.

Thank you for your attention and I will now turn the call back to Susan.

Susan Cohen, Director, Investor Relations

Thank you. At this point, I'd like to turn the call over to the conference call operator for the question and answer session. Operator?

Operator

Thank you. If you'd like to ask a question, please signal by pressing star one on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Once again, please press star one to ask a question. Our first question will come from Mr. Scott Chan of Canaccord Genuity. Please go ahead.

Scott Chan, Canaccord Genuity

Good morning. I just had a question on the tax rate. It looks like it was a bit low, similar to last quarter, and I think you did guide a lower tax rate, but it did come in much lower again. Perhaps you can maybe talk about that and perhaps an outlook into fiscal 2020?

François Desjardins, President and Chief Executive Officer

I'll ask François Laurin to comment.

François Laurin, Executive Vice President, Finance, Treasury and Capital Markets and Chief Financial Officer

Sure, Scott. The Q3 tax rate about an effective tax rate of 12.1% versus 19% basically last year, mainly resulted from the proportionally lower domestic income and it also includes a $1.5 million favorable adjustment related to the insurance business, which is about 290 basis points of the rate. So, if you put that back, it's mostly like 15%.

Note that this benefit would be in the next quarter again, but will not recur in 2020. So, as for a run rate going in 2020, would be high-teens, closer to 20% at that point.

Scott Chan, Canaccord Genuity

Okay. Thanks helpful. Thank you very much.

François Laurin, Executive Vice President, Finance, Treasury and Capital Markets and Chief Financial Officer

You're welcome.

Operator

Your next question will come from Mr. Meny Grauman of Cormark Securities. Please go ahead.

Meny Grauman, Cormark Securities

Hi. Good morning. Question about the retail transformation and just, as you track the success of your decision to move to advice-only branch model, I'm wondering what indicators are you tracking to basically gauge the success of this initiative? And over what timeframe do you need to wait before you can reasonably say mission accomplished here?

François Desjardins, President and Chief Executive Officer

I'll ask Stéphane Therrien to comment.

Stéphane Therrien, Executive Vice President, Personal & Commercial Banking

Thank you for the question. As you mentioned, during the first half of our transformation plan, a lot of our time was dedicated in simplifying our offering, preparing our customer to our new model and also in dealing with preparation activities in light of a potential work conflict. All of this is now behind us. And yes, we successfully transitioned our branches to 100% Advice. We are now in a growth mode. We are getting back to basics.

Our new Financial Clinics are now full of customers meeting their dedicated advisor to improve their financial health. We recently launched a Financial Health Assessment Tool, helping us to develop a full financial plan with our customer. Over 10,000 clients already use this tool with our advisors. We're confident that we can now win more going forward with our new model.

Similar to business services, we have a dedicated salesforce effectiveness team, helping our salesforce improve its performance by providing the right tools, improving the process and providing sales and technical training.

Finally, as mentioned previously by François, the new labor relations environment from a strategic standpoint resets our talent, can now be managed going forward helping us create a culture of performance. So, in terms of timing as soon as possible, the good news is that we're now back in the growth mode.

Meny Grauman, Cormark Securities

And in terms of specific indicators, are there specific numbers that you're tracking, for instance, if you look towards the end of next year, is deposit growth going to be an important indicator telling you whether your customers are really accepting this change? I'm just wondering if there's key measurable metrics that you can highlight.

François Desjardins, President and Chief Executive Officer

For sure. As we're now focusing on advice, deposit growth, mutual fund growth, mortgage growth, visa growth are the key indicators that we would be looking at going forward.

Meny Grauman, Cormark Securities

And, I mean, it sounds you're very confident in this. But there's always the chance that it doesn't stick with customers and this change doesn't work. The question is what's plan B? Is it relatively simple to go back and to adjust the model or is this change much harder to fix? Curious about your thoughts.

François Desjardins, President and Chief Executive Officer

Yeah, this has not been done overnight. We've been obviously discussing with our customers, preparing them for the change. But frankly, the customer behavior has already changed a few years ago. So, this model is in line with the new needs of our customer. So, we felt very good about the new model and feel even better right now.

Meny Grauman, Cormark Securities

Okay. Thank you.

Operator

Your next question comes from the line of Marco Giurleo of CIBC. Please go ahead.

Marco Giurleo, CIBC

Hi. Good morning.

François Desjardins, President and Chief Executive Officer

Good morning.

Marco Giurleo, CIBC

My first question is with respect to the loss ratio. We've seen basically $7 million of reserve releases in stage one and two, year-to-date, and impaired loans are trending higher. So I'm just wondering if you could speak to the reserve releases. Is that a function of the personal loan book shrinking?

And then on the impaired side, could you give some color on where you're seeing credit migration?

François Desjardins, President and Chief Executive Officer

I'll ask Liam Mason to comment.

William Mason, Executive Vice President and chief Risk Officer

Thank you. Good morning. Appreciate your question. So, first off with regards to the stage migration, we are seeing a degree of that. There are puts and takes within that. We have enough uptick. Some releases, as you've highlighted, in stage one and two and that's as a result of some shrinkage in the personal portfolio. But in stage three, small variations, slight uptick in personal and uptick in mortgages – that's due to slightly higher impaireds – and commercial generally from a stage three pretty flat. So, we're seeing some shifts in migration, but I would say it's normal variation.

And then in terms of your question on overall PCLs, PCLs remained very stable for us and consistent with our previous direction.

Marco Giurleo, CIBC

All right. And if the contraction in the personal book continues as is, would it be fair to continue to expect releases throughout the coming quarters?

William Mason, Executive Vice President and chief Risk Officer

Well, that's just a – that's a functional result. I mean, as you reduce the size of your book, your PCLs would go down proportionally. But our overall view is with the overall business strategies that are being laid out, we expect the personal book to grow.

François Desjardins, President and Chief Executive Officer

Francois?

François Laurin, Executive Vice President, Finance, Treasury and Capital Markets and Chief Financial Officer

The biggest portion was the liquidity, basically half of it. And the other half between the prepayments and the Prime-BA as well. So, a few bps.

Marco Giurleo, CIBC

All right, okay. And going forward, we've also seen a material fall-off in broker GIC rates year-to-date. Just curious if you anticipate this providing a tailwind for the margin?

François Laurin, Executive Vice President, Finance, Treasury and Capital Markets and Chief Financial Officer

In terms of margin Q4, we expect that it would relatively in the same range, considering the benefits of this seasonally higher prepayments – we need to consider the seasonality of the higher mortgage prepayment in Q3, offset by the continued improvement in the loan mix. So, we see this as to remain in the same neighborhood of the margin for Q4.

As for next year, we believe that we should be relatively stable. The only caveat would be whether lower rates coming in there might be a slight headwind.

Marco Giurleo, CIBC

Okay. Thank you very much.

François Laurin, Executive Vice President, Finance, Treasury and Capital Markets and Chief Financial Officer

You're welcome.

Operator

If you find that your question has been answered, you may remove yourself from the queue by pressing star two. And we'll now take our next question from Gabriel Dechaine from National Bank Financial. Please go ahead.

Gabriel Dechaine, National Bank Financial

Just a follow-up on the credit question. If I just look at the stage three provisions, commercial had an uptick versus what we saw in Q1 and Q2. Can you tell me where geographically those provisions occurred for those impairments?

François Desjardins, President and Chief Executive Officer

Liam?

William Mason, Executive Vice President and chief Risk Officer

Yeah. I couldn't comment, Gabriel, at this point on geographic. We don't tend to. But I think this is well within normal variation. I don't – but there is a slight –

Gabriel Dechaine, National Bank Financial

You can't tell me if it is Canada or the US?

William Mason, Executive Vice President and chief Risk Officer

It's Canada. It's absolutely Canada.

Gabriel Dechaine, National Bank Financial

Okay. How about the sector – industrial sector?

William Mason, Executive Vice President and chief Risk Officer

It's – I'll have to come back to you on the breakdown of that. I don't think there is any clear delineation across the key sectors.

Gabriel Dechaine, National Bank Financial

Okay. And just so I understand the messaging there, you've stated that you've added to collective provisions, i.e., stage one, stage two. You've taken a more conservative economic outlook.

William Mason, Executive Vice President and chief Risk Officer

That is correct. As part of our regular ECL and loan provisioning process, we look at our macroeconomic scenarios every quarter. And consistent I think with a number of other industry players, we've put an uptick on the downturn scenario this quarter. And that's kind of marginal impact of about $2 million.

Gabriel Dechaine, National Bank Financial

Okay. So that's – if not for that, the releases from stage one and stage two would have been $2 million higher?

William Mason, Executive Vice President and chief Risk Officer

If not for that, we would have had a run rate more around $10 million, yes.

Gabriel Dechaine, National Bank Financial

Got you. Then the branch – actually, let's talk about the strategy here, and I just want to make sure I understood that correctly. Part of the new structure of the bank and the manner in which you expect to gain efficiencies involve outsourcing; did I hear you correctly that you've outsourced some of your credit adjudication and collections functions?

François Desjardins, President and Chief Executive Officer

What you heard is that, either outsourced or combined or eliminated duplicate operations for collections, credit adjudication and administration. Of course, this has just occurred. So, obviously, on day one, you're not getting the benefits from headcount reductions or costs. But as these things are being combined over the next few quarters, what we're expecting is to see a gradual efficiency pull as we've folded all of our retail operations activities, back-office activities together.

Gabriel Dechaine, National Bank Financial

Great. I'm looking at it more from a strategic – yeah, efficiency is obviously important. But when you're moving in this direction, credit adjudication, i.e. underwriting and collections are the core parts of – core functions of what a bank does. And I just make sure we're not – I'm not hearing that you're outsourcing those functions entirely, are you?

François Desjardins, President and Chief Executive Officer

No. What you're hearing is that some functions were outsourced, which are non-strategic.

Gabriel Dechaine, National Bank Financial

Okay.

François Desjardins, President and Chief Executive Officer

But for credit adjudication per se, it's still within the Laurentian Bank Financial Group family.

Gabriel Dechaine, National Bank Financial

Okay, all right. Cool. Then lastly, on the mortgage book, and the – I guess, the bank service revenues. Mortgage book, you've indicated that you expect the growth to turn positive in the latter part of 2020, if I understand that correctly. Any indication of when we could see this poised-for-growth mantra start turning into positive revenue growth in the services line in the Other Income?

François Desjardins, President and Chief Executive Officer

Quite frankly, it can't happen soon enough, Gabriel. After a really hard year and a half of preparing and hoping for the best and preparing for the worst on the labor front, we had to make some really strategic moves there for the long-term betterment of the organization as a whole. And I think that that's really what the executives of this company have delivered.

Yeah, short-term we had to pull back from some of the growth activities. But we've proven in the past that we can successfully grow businesses. We did that in the first two years of my tenure at least. And that's what we're redoing now. So, what I'm happy about is that it's all hands on deck. We are seeing some initial upticks but it's not fast enough for me.

But it's not going to be done overnight either, right? It's going to take the efforts required to shake hands and go out and get brokers, clients in the door and happy to do business with us, as we have in the past.

Gabriel Dechaine, National Bank Financial

Thank you.

Operator

And we'll now take our next question from Richard Roth of TD Securities. Please go ahead.

François Desjardins, President and Chief Executive Officer

You're very welcome.

Richard Roth, TD Securities

Thanks. Just looking at Other Income for a second, is the decline in, I guess, your brokerage, Other Income lines a similar explanation to what you gave us in Q1, namely just weak market conditions, small cap stocks are down?

François Desjardins, President and Chief Executive Officer

Exactly, Richard. The volatility that we suffered, we all suffered as participants in the month of May, have hampered the results for Q3.

Richard Roth, TD Securities

And we've seen some volatility in – subsequent to the quarter end, so in August. How is that looking for you guys from a Q4 perspective?

François Laurin, Executive Vice President, Finance, Treasury and Capital Markets and Chief Financial Officer

August is still as you rightly pointed out, August is still a challenging month from a volatility perspective and liquidity on the market. So, we have a strong pipeline- in the DCM, ECM markets, but we need the capital market to stabilize and be more positive to see positive outcomes on that front.

Richard Roth, TD Securities

And what sectors are you guys generally focused on? Is it mining and like commodity guys?

François Laurin, Executive Vice President, Finance, Treasury and Capital Markets and Chief Financial Officer

We have a few verticals in terms of equity but our biggest sector is the debt capital market. Within equity, we have mining and a few industrial sectors, like a bit of transportation and specialized services, among others. But we cover a few verticals.

Richard Roth, TD Securities

Fine. You're fully advice now only in terms of branches. Should we expect to see lines like your commissions on mutual fund sales and other lines like that to start to move up, or are those still just going to be really tied to your small cap focus?

François Laurin, Executive Vice President, Finance, Treasury and Capital Markets and Chief Financial Officer

Now you're referring to the retail side of it – so clearly –

Richard Roth, TD Securities

Yeah.

François Laurin, Executive Vice President, Finance, Treasury and Capital Markets and Chief Financial Officer

On the retail side of it, so from the broker side, clearly that's part of the revenue stream that is generated. But most of it at this point is within the – potentially in the retail sector, the Financial Clinics part of it.

Richard Roth, TD Securities

Okay, thank you.

François Desjardins, President and Chief Executive Officer

From a mutual fund perspective.

Operator

Your next question will come from Darko Mihelic of RBC Capital Markets. Please go ahead.

Darko Mihelic, RBC Capital Markets

Hi. Thank you. Good morning. Just a question on the mortgage impaired losses. It seems like a lot. It's up 3x what you had in provisioned for credit loss in stage three of last quarter and last year. And just curious as to what's causing that?

And secondarily, as we think about the build of allowances and release, the competing factors, the release this quarter was bigger than the build. As I go forward, in the economic environment that we're in, and as we think about you growing balances, maybe you can give us an idea of where we would go from here? I'm envisioning a situation where you're building allowances for both portfolio growth, and possibly for weaker economic statistics because it's pretty hard to see that the economy can get better from here. So, just your thoughts on both those elements would be great.

François Desjardins, President and Chief Executive Officer

Liam?

William Mason, Executive Vice President and chief Risk Officer

Yeah. Darko, thanks for your question. We do see an uptick in the mortgage impaired losses. As I said, some earlier – some of that is affected due to shrinking in the portfolio. And I'd see some offset on that as we regrow. We have – just if you're looking though at our doubtful accounts overall on mortgages, as one of the indicators you've looked at in that vein, I would note though that in terms of total bank doubtfuls in the mortgage space, that we did have a methodology change over the past year that drove up the doubtful numbers in the mortgage space. So, that explains that uptick in doubtful.

In terms of the build and release, naturally, as we grow the book, I would expect absolutely a growth in PCLs commensurate with that. But our belief that this will be fully offset by higher NII as we build the business. And then back to the weaker economics, it's really a function of good credit management, adjusting your reserves commensurate with market conditions. And that would go up or down commensurate with those conditions. So, that's just normal course.

Darko Mihelic, RBC Capital Markets

Okay, thank you. And just the – so you're saying that there was a change in your methodology that resulted in a large stage three loss this quarter in mortgages?

William Mason, Executive Vice President and chief Risk Officer

No. I'm saying in terms of – I just want to make sure I tie the picture together. I'm talking in terms of doubtfuls.

Darko Mihelic, RBC Capital Markets

Okay.

William Mason, Executive Vice President and chief Risk Officer

In terms of doubtfuls and the absolute dollar amount of doubtfuls, we had a change in methodology where we shifted insurance greater than 90 days into the doubtfuls. So, if you bring the whole credit picture together, you have look at doubtfuls and you have to look at the shift in terms of the stages.

So that explains the doubtfuls. And as I said earlier, the shift in increase this quarter in stage three is due to slightly higher impaireds.

Darko Mihelic, RBC Capital Markets

Higher impaireds. But it's a big number, $2.2 million versus $700,000 last quarter. Was there maybe some fraud in the residential mortgages portfolio or something?

William Mason, Executive Vice President and chief Risk Officer

No. But on the year, Darko, it's flat. So, yeah, there is some ebbs and flows within the book.

Darko Mihelic, RBC Capital Markets

Okay. All right. Fair enough. Thanks.

Operator

And now our next question will come from Sumit Malhotra with Scotiabank. Please go ahead.

Sumit Malhotra, Scotia Bank

Maybe, Liam, just to stay with you for a minute. So, you've rolled to IFRS 9 provisioning to start this year. And I think that's come up a few times now that in every quarter we have seen your performing portfolio has had releases in provisions. And at least to some degree, there's assumptions, parameters for your view on the economic outlook, especially when it relates to your – let's call it your business lending portfolio. Can you give us some indication as to what parameter updates you've enacted that have resulted in – I know this quarter again we see a small but still a release there. That's the part of the book you're growing the fastest, and certainly that's what's been indicated to us. What are you changing in your model that's really – that's resulting in releases for commercial and the performing portfolio?

William Mason, Executive Vice President and chief Risk Officer

Thank you, Sumit, for your question overall on IFRS 9. So, we implemented IFRS 9 and we put in place a model framework. We've had basically a shakeout on that model framework over the past couple of months and some marginal enhancements on the methodology. And some of this – that enhancement comes as you do your annual renewals on the various parts of the book.

But overall, from an outlook right now we have adjusted the scenario to a higher expectation of downturn. So, that drives an uptick. But overall, we have marginal adjustments based on the annual credit renewal and in terms of enhancing our methodology on the margin. It's not big changes due to the methodology.

Sumit Malhotra, Scotia Bank

And if I stay with what I'll just call your commercial loan book for a minute. Obviously, there's been a significant shift in the interest rate backdrop in the last few months. I'm just curious as far as this portfolio is concerned. The bank has talked about margin improving as a result of mix shift, which I think essentially means commercial is going to be a larger portion going forward. How much of this book resets with market rates, like what percentage is based off BA rates, LIBOR that would see a more immediate re-pricing with the shift that we've seen? Can you give us any numbers around that?

François Desjardins, President and Chief Executive Officer

I'll ask Stéphane Therrien to answer that question.

Stéphane Therrien, Executive Vice President, Personal & Commercial Banking

I think we should come back to you on this one in terms of the percentage that would be affected by the Prime-BAs.

William Mason, Executive Vice President and chief Risk Officer

A portion of the book is prime-based and is affected and driven by the Prime-BA. It has an impact on our margin for Prime-BA spread. That is on the rise. We would expect some degree of shift in that, but a good part of the book is floating.

Sumit Malhotra, Scotia Bank

And just lastly, on the margin. You folks had indicated last quarter that with union negotiations complete, we would see liquidity put back to work, and that certainly seems to have benefited NIM this quarter. Is it fair to say – is that liquidity now where you want it to be? Is that no longer a catalyst for NIM in one direction or another as a result of the changes you've enacted post the negotiations completing?

François Desjardins, President and Chief Executive Officer

Yeah. In the third quarter, we reduced the excess liquidity which contributed to the improvement in net interest income and the NIM. The full impact of that is now behind us and realized in Q3. We also realized the cost related to labor relations, which contributed to lower non-interest expenses. That is also in our Q3 results. Through the first half of 2020, from now till then, we expect to see the rest, meaning the positive impact on outsourcing and eliminating duplicate operations. That had no impact on Q3 and is still in the future.

Sumit Malhotra, Scotia Bank

So that – and I'll stop there, obviously, expenses were one of the bright spots.

William Mason, Executive Vice President and chief Risk Officer

I just want to come back to your interest rate questions. There are two components just to try and answer it. We have a structural interest rate risk position that deals with the interest rate risk of the bank overall. We're close to our benchmark. We're not taking undue risk relative to our benchmark on that and that drives the aggregate structural interest rate component of your NIM.

The other component really is driven by basis shifts like Prime-BA, and we'll come back to you on that. But you need to always come back in terms of the aggregate bank to how we manage our structural rate position.

Sumit Malhotra, Scotia Bank

Got it. And you know what? I'll leave it there. We can pick some of those up afterwards. Thanks for your time.

William Mason, Executive Vice President and chief Risk Officer

Okay.

François Desjardins, President and Chief Executive Officer

Thank you.

Operator

Your next question comes from the line of Sohrab Movahedi of BMO Capital Markets. Please go ahead

Sohrab Movahedi, BMO Capital Markets

Hi, thanks. I was a little bit late getting on, so I apologize if some of these were covered off in your commentary in earlier questions. But just with respect to the balance sheet growth that you are expecting now to come, if I look at the slides, pages 23 and 24, you've got the geography listed out. And to start with commercial, 17% from the US, the rest in Canada. As you think ahead, I don't know 12, 18 months, how is that – how are those percentages going to shift?

François Desjardins, President and Chief Executive Officer

Thank you for the questions. I'll give a comment on growth overall and maybe just to set the stage here. I think the first part of your question, it really has to do with the percentage of loans to business customers in the total mix. We expect to have continued good growth in this portfolio. This portfolio has been growing in the last several years and we expect that that will continue to have double-digit growth as we continue. And that will continue to increase the loan mix.

But we haven't disclosed the target for the total percentage of loans to business customers within the whole portfolio. But needless to say that we have not reached the potential of this business and also, we're still far away from where we want to be.

On volume growth overall, though, and for the rest of the businesses, now that the new labor relations environment is – has stabilized, we're back in growth mode. So, of course, that has had impacts in the last quarter to reduce liquidity and you see that in the deposit growth retracting.

But what we're looking for really is growth in mortgages, personal loans, Visa cards, mutual funds as well. Last quarter, we said that we would stabilize and then grow the residential mortgages portfolio. You saw this quarter the decline was limited to 1%. We recently launched a new advertising campaign targeting mortgage brokers across Canada. We're introducing Alt-A mortgage is back into the mix, business-for-self products. We expect to generate volume growth from those products.

So, we're still continuing to expect a mid single-digit growth for 2020. We're just not there yet. It's taking us time to go and get that pipeline of business in the door. Personal loans were also part of the growth plan, specifically RSP lending, investment lending, which we want to put back on track and have initiatives to stabilize that portfolio as we exit 2020.

Sohrab Movahedi, BMO Capital Markets

But is the mix going to stay as it is right now geographically or – in other words, do you think the US is going to represent a bigger proportion overall, let's say, in the commercial loan portfolio?

François Desjardins, President and Chief Executive Officer

I'll ask Stéphane to answer.

Stéphane Therrien, Executive Vice President, Personal & Commercial Banking

The good news is that the Northpoint is performing according, if not better than planned, so we're really happy about the business. And since day one, when we acquired that business, we said that there could be synergies with equipment finance as well in the States. So, that percentage could slightly grow in the next few years.

Sohrab Movahedi, BMO Capital Markets

And so, Liam, when you talk about the credit considerations and the PCLs, you are taking into consideration that you may have higher growth in the US?

William Mason, Executive Vice President and chief Risk Officer

We take into account – obviously, you don't provision for future growth. But yes, in terms of our plans and our risk tolerance, we do take that into account.

Sohrab Movahedi, BMO Capital Markets

So, just one last question on that, Liam. How much room do you have in your current reserve levels to accommodate further growth in your, call it, performing stuff without having to add to the reserves?

William Mason, Executive Vice President and chief Risk Officer

Well, I talked about a couple of things, Sohrab. I talked about capital capacity. And we have – as described, we have a very strong capital position that gives us, per your question last quarter, an ability to grow RWAs. And from a provision perspective, our views are that if provisions were to grow, they'd be more than offset by net interest income.

Sohrab Movahedi, BMO Capital Markets

Okay. But my question was a little bit more specific as to within your stage one and two, how much more growth can you accommodate without having to add more to it?

William Mason, Executive Vice President and chief Risk Officer

I think the normal process, Sohrab, is as you add, you – they will factor into stage one or two, and come into there. I think it's a question really of capital capacity and what income are you seeing that offsets that increase.

Sohrab Movahedi, BMO Capital Markets

Okay. Thank you very much.

Operator

And we'll take our final question from Doug Young with Desjardins Securities. Please go ahead.

Doug Young, Desjardins Capital

Good morning. I think maybe just going back to what I think there's been a number of questions on is just the stage one and stage two PCLs. And I guess what we're struggling with is that there is a higher probability of an economic downturn built into your assumption, but we're seeing releases in stage one and two. And I'm still a little confused as to why that would necessarily be. So, I don't know if there's more you can flesh out on that, but I think that's where a lot of confusion lies right now.

William Mason, Executive Vice President and chief Risk Officer

So, let's talk about – obviously, an uptick as we said on the macro factors. But I mean, the book has not been growing and we're turning that around. So, as your book shrinks, depending on what stage the underlying assets are in, you're going to see a reduction in it. So, it's that dynamic.

Doug Young, Desjardins Capital

So, it's just simple – I mean, you're growing the commercial though and the impaired is up materially in commercial, yet you got releases on that side. So, that's – I guess, maybe there is a little confusion around that as well?

William Mason, Executive Vice President and chief Risk Officer

Well, I think you've also seen migration across the stages, as we see normal ebbs and flows with individual credits.

Doug Young, Desjardins Capital

Okay.

William Mason, Executive Vice President and chief Risk Officer

What we'll try going forward is to provide a little bit – and I think we provide in our disclosure of how things are moving, but I'll try to ensure we provide additional commentary on this going forward.

Doug Young, Desjardins Capital

It's very different than what we've seen from the other banks. But I know IFRS 9 is relatively new and we're all getting adjusted to this and whatnot. It's just a few opposing things that is confusing and tough to make sense of.

William Mason, Executive Vice President and chief Risk Officer

Yeah, I would note that for us, IFRS 9 is as recent as last October. So, it's a little bit – some of the other banks have had a shakeout and we've got some tweaks, to some of the earlier questions.

Doug Young, Desjardins Capital

And then just maybe I'll just finish off with the NIX ratio. And I think, François, you've mentioned you would expect in Q4 that to fluctuate. And I understand what your target is for fiscal 2021. By fluctuate I would assume you mean you would expect higher expenses, and so higher NIX ratio in Q4. And as you look out as you move towards your fiscal 2021 target, should we expect a gradual decline in that ratio through fiscal 2020?

François Laurin, Executive Vice President, Finance, Treasury and Capital Markets and Chief Financial Officer

Doug, obviously the target is to improve over time. We had said 2019 was year of investment, and we expect to see some benefits of outsourcing and elimination of duplicate operations, as François mentioned earlier, by the end of Q2 2020. But at this point, we're working to bringing those savings and obviously this should bring operational leverage, positive leverage going forward. But it's hard to commit a number at this point for 2020.

Doug Young, Desjardins Capital

Thank you very much.

François Laurin, Executive Vice President, Finance, Treasury and Capital Markets and Chief Financial Officer

Thank you.

Operator

And ladies and gentlemen, that's all the time we have for questions today. I'd like to turn the conference back over to Mr. François Desjardins for any additional or closing remarks.

François Desjardins, President and Chief Executive Officer

Thank you everyone for joining us today. At LBCFG, we're building a different and better financial institution. We talked about today transitioning our branch network to a traditional offer to 100% Advice. This is a business model that we believe better fits the lifestyle of modern customers. We're rolling out digital offering, receiving positive feedback from advisors and brokers that are eager to open accounts and we're eager to roll that out to all Canadians.

We're addressing the efficiency ratio by reorganizing outsourcing, simplifying teams, processes and product lines. This is something that's we're working towards a better efficiency ratio in the coming years.

We're moving towards higher margin commercial loans and have increased the proportion within the loan mix.

And finally, we're working towards improving the financial health of our current and future clients. Our teams have accomplished tremendous work and are now all hands-on deck, working on revenue-focused activities, efficiencies, and transformation-related strategic objectives. These are indeed exciting times. I will now turn it back to Susan.

Susan Cohen, Director, Investor Relations

Thank you, François. Should you have any further questions, our contact information is included at the end of the presentation. Our fourth quarter of 2019 conference call will be held on December 4 and we look forward to speaking with you then. Have a great day.

Operator

And this concludes today's call. We thank you for your participation. You may now disconnect your lines and have a wonderful day everyone.