SCOTIABANK

Q2 2018 EARNINGS CONFERENCE CALL

MAY 29, 2018

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PRESENTATION

Adam Borgatti - The Bank of Nova Scotia - VP of Investor Relations

Good morning, and welcome to Scotiabank's 2018 Second Quarter Results Presentation. My name is Adam Borgatti, Vice President of Investor Relations. Presenting to you this morning is Brian Porter, Scotiabank's President and Chief Executive Officer; Sean McGuckin, our Chief Financial Officer; and Daniel Moore, our Chief Risk Officer.

Following our comments, we will be glad to take your questions. Also in the room with us to take questions are Scotiabank's business line group heads: James O'Sullivan from Canadian Banking; Nacho Deschamps from International Banking; and Dieter Jentsch from Global Banking and Markets.

Before we start and on behalf of those speaking today, I will refer you to Slide 2 of our presentation, which contains Scotiabank's caution regarding forward-looking statements.

With that, I will now turn the call over to Brian Porter.

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

Thank you, Adam, and good morning, everyone. I'll start on Slide 4. We're pleased to report our second quarter results to our shareholders. In Q2, Scotiabank delivered $2.2 billion of earnings, up 6% compared to last year. Diluted earnings per share of $1.70 was up 5% while return on equity was strong at 14.9%.

Turning to the business lines. For the fourth straight quarter, Canadian Banking delivered earnings in excess of $1 billion. The division performed well, and results were driven by solid asset growth led by commercial and small business, auto and mortgages, margin expansion and improving credit quality. Higher year-over-year levels of investment in regulatory and technology will support stronger controls, enhance digital capabilities and an improved omni-channel experience for our customers.

International Banking delivered another strong quarter, driven by double-digit loan growth in the Pacific Alliance, positive operating leverage and solid credit quality. Overall, our personal and commercial banking businesses, which generate roughly 80% of Scotiabank's earnings, continued to deliver strong earnings growth and improving return on equity.

Global Banking and Markets performance was marked by increases in net interest income and improving credit quality. This was against a very strong comparable quarter last year that was driven by unusually high levels of client equity trading activity.

At the enterprise level, I'm pleased to report that our structural cost-reduction initiatives are 1 year ahead of schedule. For the first half of the year, the bank generated positive operating leverage of 3.3%, adjusted for the benefits of the remeasurement credit in the first quarter.

The bank remains very well capitalized with a common equity Tier 1 ratio of 12%. Our strong financial position provides us with optionality to invest in our businesses organically, grow through acquisitions and return capital to our shareholders. This quarter's strong performance reflects the ongoing execution of our strategy to build a superior experience for our customers, harness the bank's untapped potential across our footprint and strengthen the core of the bank by enhancing our capabilities and controls.

I'll now the turn the call over to Sean to discuss our financial performance.

Sean D. McGuckin - The Bank of Nova Scotia - Group Head & CFO

Thanks, Brian, and good morning. I will begin on Slide 6, which shows our key financial performance metrics for Q2 2018.

The bank reported diluted earnings per share of $1.70, up 5% year-over-year. Our core personal and commercial banking businesses reported very strong earnings growth. Lower real estate gains this year was offset by 1 additional month of earnings from Chile and the Canadian insurance business in order to align the reporting periods with the bank.

Revenue growth was up 7% from last year, driven by solid net interest income and non-interest income growth. Net interest income was up 6% from strong personal and commercial lending growth in Canada and international as well as higher levels of treasury assets. The core banking margin was down 7 basis points compared to last year, driven by lower International Banking margins and higher volumes of low-margin treasury assets, partially offset by higher margins in Canadian Banking. However, the recent trend of an improving margin over the last few quarters continued, with the margin up 1 basis point versus last quarter.

Non-interest income grew 9% compared to last year from higher trading revenues in the equities business on a non-TEB basis and income from investments and associated corporations. These were partly offset by the impact of the sale of HollisWealth last year. Lower real estate and investment securities gains were offset by the benefit from the alignment of reporting periods.

Expenses were up 3% due to higher salaries and related employee benefit costs and a continued investment in technology and regulatory initiatives. These were partially offset by the impact of the sale of HollisWealth last year, positive impact of FX and cost-reduction initiatives.

The bank delivered strong positive operating leverage again this quarter, further improving the bank's productivity ratio. The credit quality of our portfolios remain solid with a loan loss ratio on impaired loans of 46 basis points, down from 49 basis points last year. There was a net reversal of provisions on performing loans of $61 million. And when combined with provisions on impaired loans, this resulted in a total loan loss ratio of 42 basis points. A large portion of the net reversal on performing loans related to previously established reserves set up for 2017 hurricane losses, with most of that reversal from performing loans now being applied to specific loan accounts in the Caribbean in the second quarter.

On Slide 7, we provide an evolution of our common equity Tier 1 capital ratio over the last quarter. The bank continues to maintain a strong capital position with a common equity Tier 1 ratio of 12%. Strong internal capital generation contributed roughly 30 basis points to our common equity Tier 1 ratio, and the impact of moving to the Basel II floor added another 50 basis points.

Risk-weighted assets declined 2% quarter-over-quarter or $6 billion primarily due to the implementation of the Basel II capital floor as well as improvements in portfolio credit quality. These were partially offset by foreign exchange, organic growth and counterparty credit risk-weighted asset growth. The impact of the previously announced acquisitions will result in a pro forma common equity Tier 1 ratio of approximately 11% when they close, likely by the end of Q4 of this fiscal year.

Turning now to business line results, beginning on Slide 8. Canadian Banking had net income of $1 billion, up 5% year-over-year or 7% adjusting for the impact of the lower real estate gains and the benefit of the additional earnings from the alignment of the reporting period of the Canadian insurance business with the bank. The results reflect strong asset growth, margin expansion and improved credit performance.

Revenues were up 3% from last year, driven by net interest income growth of 8% partly offset by a 3% decline in non-interest income due to the Hollis sale and lower real estate gains. The higher net interest margin was primarily due to the impact of recent Bank of Canada rate increases and changes in business mix.

Loans and acceptances increased 7% from last year. Residential mortgages grew 6%, and business loans were up a strong 14%. Residential mortgage growth year-over-year remained good despite the B20 regulation and higher mortgage rates, though the sequential pace of growth moderated somewhat.

Provision for credit losses on impaired loans improved 6 basis points year-over-year and was down 2 basis points quarter-over-quarter.

Expenses increased 3% year-over-year. There were higher investments in technology, digital and regulatory initiatives, which also support a stronger control environment to grow our digital businesses and the use of omni-channel banking by our customers. These were partially offset by continued progress on our cost-reduction initiatives and the impact of the sale of HollisWealth last year.

Turning to the next slide on International Banking. Net income of $675 million in Q2 was up 14% year-over-year on a reported basis. My comments to follow are on a constant-currency basis. Q2 results reflected strong asset and deposit growth, positive operating leverage and good portfolio quality.

Net income was up 15% year-over-year or 11% adjusting for the net income benefit of aligning Chile's reporting period with the bank. Revenues grew 7%, including an 11% increase in the Pacific Alliance countries. Loans grew by 11% compared to a year ago, led by the Pacific Alliance region, which grew by 16%. The net interest margin of 4.74% was down 26 basis points year-over-year, partly driven by the higher net inflation impact benefits in Chile last year. However, the margin was up 8 basis points versus the previous quarter.

The provision for credit loss ratio on impaired loans was up 5 basis points year-over-year, mainly related to one commercial account that was further impacted by the hurricane-related events in Puerto Rico. However, taking into account the reversal of previously established reserves set up for these 2017 expected hurricane losses and other reversals of provisions on performing loans, the total loan loss ratio improved by 11 basis points.

Expenses were up 5% as higher business volume growth, inflation costs and increased technology and digital investments were partly offset by the benefits of cost-reduction initiatives. Operating leverage was strong at positive 2.8% year-to-date, leading to an improvement in the productivity ratio of approximately 140 basis points on a year-to-date basis.

Moving to Slide 10, Global Banking and Markets. Net income of $447 million was down 14% compared to last year. Lower net income was driven by lower income from equities, fixed income and investment banking and higher regulatory costs. These were partially offset by higher foreign exchange business earnings, corporate banking results and lower loan losses. Recall that last year, net income was bolstered by unusually high levels of client activity in equities. On a quarter-over-quarter basis, net income declined 2% as strong growth in equity business was offset by lower corporate banking and foreign exchange business earnings.

Trading revenues on a taxable equivalent basis were down 16% year-over-year. Revenues were down 4% year-over-year, mainly reflecting lower non-interest income primarily in our global equities business, reflecting the elevated levels of client trading activity last year. Net interest income was up 12%, mainly from higher deposit volumes and higher lending margins in Canada and Europe. And the loan loss ratio improved 6 basis points year-over-year.

Expenses were up 13% year-over-year, driven by higher regulatory and technology costs, partly offset by lower performance-related compensation and the positive impact of foreign currency translation. The year-over-year pace of growth on regulatory and technology cost is expected to moderate somewhat as the year progresses.

I'll now turn to the Other segment on Slide 11, which incorporates the results of group treasury, smaller operating units and certain corporate adjustments. The results include the net impact of asset and liability management activities. The Other segment reported a net loss of $32 million this quarter. The net loss in this segment decreased year-over-year due to the positive impact of foreign exchange translation and related hedges and lower expenses. These were partially offset by lower gains on investment securities.

This completes my review of our financial results. I'll now turn it over to Daniel, who will discuss risk management.

Daniel Moore - The Bank of Nova Scotia - Executive VP & CRO

Thank you, Sean. I'll turn to Slide 13. We remain comfortable with the fundamentals of the bank's risk portfolio. Our PCL ratio on impaired loans, otherwise referred to as Stage 3, was 46 basis points, an increase of 3 basis points from last quarter, a decline by 3 basis points from the same quarter of last year. However, considering the total loan book, our all-bank PCL ratio remained at 42 basis points, consistent with last quarter and reflected a $61 million net reversal on performing loans primarily in International Banking.

Overall, we are seeing stable credit conditions in our Canadian personal and commercial banking businesses and continued improvements in our International Banking segment. Specifically, in our Canadian Banking business, lower retail credit losses were driven mainly by lower auto portfolio provisions due to portfolio performance improvements and continued benign commercial losses.

Moving on to International Banking. We continue to see good credit quality trends and the benefits of our diversification. We continue to monitor the impacts of our customer assistance programs in areas impacted by natural events and growth in unsecured lending across our international footprint. However, our portfolio is stable and within our risk appetite.

As Sean mentioned earlier, a portion of the provision related to hurricanes in the Caribbean that was previously recorded for performing loans was offset by the increase in impaired loan provisions primarily related to one previously impaired account in Puerto Rico impacted by hurricane-related events. In Global Banking and Markets, reversals were driven mainly by lower provisions on performing loans due to improvements in credit quality and improving economic conditions in the quarter.

Now looking at the other credit metrics. Gross impaired loans were generally stable at roughly $5 billion. And the gross impaired loans ratio remains flat versus last quarter while net formations of $695 million remained below the 2-year average.

Turning now to Slide 14. Our residential mortgage portfolio is of high quality and lower risk. 47% is insured, and the uninsured portfolio has an average loan to value of 54%, providing a substantial home equity buffer. New uninsured originations this quarter continue to reflect an average loan to value of 63%, consistent with prior levels. Origination levels did decline relative to last quarter. However, last quarter's origination volumes were aided by some pull forward related to the new B20 mortgage rule, which became effective on January 1. Overall, we would say that the pipeline looks good, and we reiterate our mid-single-digit mortgage volume growth outlook for the full year.

Turning to Slide 15. You can see the recent trend in loss rates for each of our businesses. Canadian Banking's impaired credit loss ratio declined 2 basis points versus last quarter. International Banking's impaired PCL ratio increased 13 basis points over last quarter from 125 to 138 basis points due, as we said, primarily to one account which was impacted by the hurricanes in Puerto Rico.

As mentioned in the fourth quarter of 2017, we had established provisions for the impact of the hurricanes, and as a result, the total PCL ratio declined by 4 basis points. Overall, our credit portfolio continued to reflect the benefits of broad diversification, and we believe that our underlying performance remains strong.

Turning to Slide 16. You can see the recent trend in net write-off rates for each of our businesses. Looking over the last 5 quarters, our net write-off ratio has been relatively stable, and we would expect that trend to continue. In Canadian Banking specifically, we have seen the ratio decline 8 basis points year-over-year, primarily due to improvements in our retail portfolio. Specifically, our continued focus on up-tiering customers in our unsecured lending portfolio, coupled with enhanced collection strategies, are driving lower delinquencies in our automotive and credit card portfolios.

I'll now turn the call back over to Brian.

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

Thank you, Daniel. I'd like to take a moment to highlight some of the key themes from our presentation and comment on the outlook for Scotiabank. As mentioned, we delivered strong results in the first half of 2018 and expect this momentum to continue as we move into the second half of the year.

In Canada, we continue to focus on growing our primary customer base, investing in digital capabilities and improving our productivity. With the benefits of a rising interest rate environment and a good economic backdrop, we remain positive on the outlook for our Canadian Banking division. We also reiterate our mortgage volume outlook at mid-single-digit growth despite the current headwinds.

I wanted to take this opportunity to welcome our partners at Jarislowsky-Fraser to the Scotiabank team. The acquisition which was completed on May 1 aligns with our strategic commitment to diversify and grow our Global Wealth Management businesses, including enhancing our institutional and our high-net-worth capabilities.

Internationally, we see great potential across the Pacific Alliance region. We will continue to strengthen our presence in key markets and leverage our partnerships and footprint to improve connectivity. Earlier this month, we reached an agreement to acquire a 51% controlling interest in Banco Cencosud, which will position Scotiabank as the second-largest credit card issuer in Peru and allow the bank to build new customer relationships and drive further organic growth.

The acquisition also extends and deepens our relationship with Cencosud, where we have similar arrangements in Chile and Colombia. Along with the BBVA Chile and Citibank Colombia transactions, these acquisitions will help to drive our Pacific Alliance strategy and create long-term value for our shareholders. Our efforts to complete these acquisitions in the second half of this year are on track.

Shifting focus to Mexico for a moment. Our Mexican businesses continues to deliver very strong results. As the NAFTA negotiations continue and with the election scheduled in Mexico for July 1, I wanted to reiterate our confidence in the resilience of the Mexican market as well as the established regulatory framework that exists for the banking system. We are confident that Mexico's robust and diversified economy will continue to grow and adapt accordingly to NAFTA and any political outcome.

In Global Banking and Markets, we continue to expand our investment banking capabilities here in Canada and throughout our Pacific Alliance footprint. We continue to sharpen our strategic lending efforts, which are leading to improved results. The bank continues to earn through these important investments, in part through structural cost-reduction initiatives, as evidenced by our improving productivity ratio.

At the enterprise level, the bank is tracking well against the targets we shared at our all-bank Investor Day earlier this year. We are seeing good progress on primary customer growth, improved productivity and overall solid earnings growth performance.

Our digital transformation is also progressing very well. We continue to make significant investments in the people, processes and technology necessary to enhance the customer experience and strengthen the core of the bank. Through these collective efforts, we are sustainably growing earnings and dividends for our shareholders while harnessing the power of our scale and footprint to build a better integrated and connected bank.

With that, I'll turn it back to Sean for the Q&A.

Sean D. McGuckin - The Bank of Nova Scotia - Group Head & CFO

Thanks, Brian. That concludes our prepared remarks. We'll now be pleased to take your questions. Operator, can we have the first question on the phone, please.

QUESTIONS AND ANSWERS

Operator

We'll now take our first question from Robert Sedran from CIBC Capital Management.

Robert Sedran - CIBC Capital Markets, Research Division - MD & Head of Research

I think Sean touched on this a little bit, but I'm wondering if, James, maybe you can add some color. If I look at Canadian Banking excluding wealth, expense run rate or expense growth rate, on a year-over-year basis was in the double-digits this quarter. So some thoughts on, a) where that spending is going; and b) what the outlook for operating leverage might be into the second half and beyond.

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

Sure, Rob. Let me start with the division and then I'll move into the core P&C business, as you requested. So for the division overall, we had strong positive operating leverage of 270 basis points year-to-date, and reported expense growth was 3%. And we had, I think, quite healthy improvement in the productivity ratio. That improved 130 basis points year-to-date. So if we look at Canadian Banking excluding wealth, expenses were, to your point, they were elevated in Q2 at about 11%, and they're running at 7% year-to-date. I would describe them, Rob, as rather low in Q1 at 4% and running a bit high in Q2. So if we'd been investing meaningfully and thoughtfully in the business as we've described in previous calls, some of it's regulatory, much of it is technology and projects and people to support a better customer experience and a better employee experience. And if I look at the business, Rob, on an underlying basis, I'd say the core P&C businesses, expenses are up probably a bit more than 6% year-to-date. So we're committed to reducing that somewhat and, perhaps more importantly, decreasing the variance sort of Q-over-Q. But I do want to point out we're earning through this. So core P&C reported earnings are up 6% year-over-year and 10% year-to-date. And if we only adjust for the items that we've called out in the MD&A, earnings are up a very healthy 9% year-over-year and 14% year-to-date. And I'll just finish by saying the outlook is positive. We have good balance sheet growth. We have rising margins, and we have stable-to-declining PCLs. And I think all of that bodes well for the business as we move through the back half of the year.

Robert Sedran - CIBC Capital Markets, Research Division - MD & Head of Research

I'm sure you have some fairly ambitious targets for client acquisition over the next few years. I'm assuming that's part of the higher run rate of expenses. And so as some of this investment is in pursuit of that goal, I would imagine, so we should expect a bit of a hotter run rate on expense growth going forward than there used to be? Is that a fair comment?

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

Look, I think we're more focused on the variance or the volatility of expenses from quarter-to-quarter. And my goal would be to reduce the variance and to continue to deliver strong, positive operating leverage and annual improvements in the productivity ratio, all in line with the commitments we made at our Investor Day in February, where we laid out new goals for productivity ratio for the division on a consolidated basis as well as the core P&C business and the wealth business separately.

Operator

We'll now take our next question from Gabriel Dechaine.

Gabriel Dechaine - National Bank Financial, Inc., Research Division - Analyst

Just a question on the new mortgage origination disclosure. And I'd like to thank you just for confirming the uninsured portion there. Why did you add that? I'm just curious. It's helpful, it just wasn't there before.

Daniel Moore - The Bank of Nova Scotia - Executive VP & CRO

We really wanted to provide – so it's Daniel Moore here, provide some insight into the strength of our portfolio, which we're very proud of, the origination practices that we have. And given that the total Canadian consumer indebtedness continues to be an area of focus across the banking industry in Canada, bringing a level of disclosure that's comparable to some of our peers and gives you greater insight into our strong outlook going forward.

Gabriel Dechaine - National Bank Financial, Inc., Research Division - Analyst

So speaking of the mid-single-digit decline, and you did mention the concerns, I guess, around Canadian indebtedness. I noticed your personal loan category, which includes your auto book and, I think, HELOCs in there as well, has been flat for 3 quarters, up only 4%. What's going on in the auto book? Are there any areas you're kind of restricting growth at all?

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

Yes. It's James. Let me address that. So we'll start with mortgages. Mortgages are up 6% year-over-year and 6% year-to-date. So steady as she goes on the mortgages side. We're quite pleased with the performance of that business. The auto business is up 8% year-over-year and 8% year-to-date, so we're very pleased with auto as well. Commercial's come in at about 13% loan growth year-over-year; small business, 12%. So the balance sheet is growing nicely, reflecting, I think, favorable macroeconomic trends.

Daniel Moore - The Bank of Nova Scotia - Executive VP & CRO

If I might add, backed up by that, we've seen improving credit quality both in terms of the ratings of our clients as well as the delinquency rates in each one of those portfolios across the Q-over-Q and year-over-year basis.

Gabriel Dechaine - National Bank Financial, Inc., Research Division - Analyst

Fair enough. I'm just wondering what's in that $71.4 billion that's not growing at 8%.

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

So credit cards would be growing at kind of 4% excluding the MasterCard portfolio, which has a bit of run-off left in it. And ULOCs or unsecured lines of credit would have a similar sort of, call it, low single-digit growth rate year-over-year.

Operator

We'll now take our next question from Meny Grauman of Cormark Securities.

Meny Grauman - Cormark Securities Inc., Research Division - MD & Head of Institutional Equity Research

Just another question on mortgages. Wondering if you could comment on what you're seeing in terms of pull forward in Q2. How much of the growth was just activity that was pulled forward still from last year? And also curious to hear what you're seeing in terms of retention rates, whether that's climbing, and what your expectation for that is.

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

Yes. So with the new disclosure, you can see that bookings or originations were down sequentially, so that would reflect some of the pull forward that we saw in Q1, Meny. But as I indicated, the business has been growing quite steadily here, 6% year-over-year and 6% year-to-date. We continue to view ourselves as quite fortunate in that we're participating in 3 channels, and we're particularly pleased with the broker channel. There, we can modulate volumes, if you will, consistent with our view of risk and reward. So given the growth year-to-date of 6%, our outlook for growth of nominal GDP-plus or mid-single-digit, I think looks quite reasonable. And just to give you sort of a mathematical example of that. We're planning for growth in Q3 sequentially, to be sure. But if there were no growth sequentially from Q2 to Q3 in average balances, we still show year-over-year growth in Q3 of 4.5%. So you're going to have 6%, 6%, at least 4.5%. So I think the year is going to fall somewhere right in line with what we indicated 1 and 2 quarters ago. In terms of retention, it's high. It trended up modestly. I would describe it as strong. We're pleased with retention.

Meny Grauman - Cormark Securities Inc., Research Division - MD & Head of Institutional Equity Research

And just a follow-up on the comment on the broker channel. What you're saying, you're seeing an increase, or you're emphasizing that more than in the past. I'm wondering, as you look forward, do you expect to rely more on the broker channel over the remaining part of the year?

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

Well, look, as with every channel, competitive dynamics shift. And as others have left that channel, I think that has become a relatively attractive channel to us. We have very strong leadership in the mortgage business, led by John Webster, who has 30 years of experience in that channel. So it's an important channel, to be sure. But I want to be clear. Our direct sales force channel and our branch channel are very important to us, as is what I would describe as an emerging digital channel that we're investing dollars in as we speak. So look, we like the optionality that multiple channels give us. We're committed to all of these channels. But certainly, we're finding in this market many Canadians are attracted to the mortgage broker channel, and we're pleased to participate in it.

Operator

Our next question comes from Sohrab Movahedi.

Sohrab Movahedi - BMO Capital Markets Equity Research - Analyst

Just a quickie for James. James, can you just remind us, 100 basis points lower mortgage growth translates into how much earnings for the total bank?

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

I think it's $15 million pre-tax – or after-tax. So it's a modest number.

Sohrab Movahedi - BMO Capital Markets Equity Research - Analyst

Okay. And the commercial loan growth, can you provide a little bit more color as to which industries or geographies that's coming in from and how the pricing compares to the back book?

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

Sure. It was a strong quarter, and I think we're enjoying a strong year. I would say, Sohrab, we see clear evidence of momentum in that business. So we're seeing good growth in focus areas such as British Columbia if I think geographically and agriculture if I think sectorally. But to be honest, as I go through it, it is quite widespread. And I'd say the business if you think about it and you think about the growth rate, remember what's driving the business. It's growth in customers' working capital needs. It's investments in plant and equipment. It's commercial real estate development. It's business succession, including mid-market, private equity. And we also own Roynat, which is a very successful mid-market lender focused on MBOs and business succession. So 13% growth in assets year-over-year, 10% growth in deposits. It has been and will continue to be a focus priority. I don't have exact numbers to give you on front book versus back book in terms of pricing. You won't be surprised to hear it's a pretty competitive space as we speak, although I don't think the pricing or for instance that you might see in corporate has fully migrated into commercial. I think we're still able to generate attractive returns for our shareholders there.

Operator

Our next question comes from Darko Mihelic from RBC Capital.

Darko Mihelic - RBC Capital Markets, LLC, Research Division - Financials Analyst

My question is for James as well. James, seeing excellent growth in revenues versus peers and net income, but one area where your growth is weaker is personal deposits. And your NIM also is not growing as fast as some of your bigger peers. In particular, Royal and TD have, off of a higher personal deposit base, higher growth rates and better improvement in NIM. So how should I think about that going forward? If we have a rising rate environment and your peers have better deposit growth, should I be concerned that, as we get into 2019, your NIM will fall back relative to peers even further and potentially have less revenue growth? Or is there something that you're doing intentionally on the deposit side that's having deposits come in at a weaker growth rate?

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

Sure. So let me address that then. So look, to your point and clearly, there's just a relationship or a correlation between deposit and margin just given how it's calculated. It's net interest income divided by average earning assets. But average deposits were up 3% year-over-year, and I would say, Darko, there's some areas of strength and there's some areas of opportunity. So non-personal deposits were up 5% year-over-year, and that would have been led by our commercial banking business, where deposits were up a strong 10%. But personal deposits, to be sure, were softer at 1%. If we peel that back a bit, checking balances were up a strong 8%. HISA balances, though, were 4%. So core deposit growth was 5% year-over-year. I do want to point out we've had an noticeable decline in what I'll call our broker deposit book, and we have mixed feelings about that book, to be honest with you. It has become an expensive source of deposit given new entrants over the past several years and sort of various competitive dynamics. So to this point, we've not been prepared to pay up in that market, and it's down 10% year-over-year to around kind of $17 billion. And I would say that simply there's been better funding sources available to the bank. But look, overall, the focus on deposit gathering is going to continue. It needs to, to support our asset growth. And I think our Investor Day initiative of 1 million new primary banking customers will be a big driver of that. And if I think about growth in primary banking, one of the businesses that's contributing mightily to that as we speak is Tangerine. So let me just finish by saying very directly I'm very focused on deposits because I understand the mathematics of margin and what's going to drive the business in a rising rate environment.

Darko Mihelic - RBC Capital Markets, LLC, Research Division - Financials Analyst

And just a quick follow-up, if I may. So when I look at your margin versus, say, TD, last year, TD's margin was 67 basis points higher than yours. Today, it's 80. Royal's was 28 basis points last year; today, it's 36. I think you used to speak about closing that gap. And in your mind, is closing the gap going to be personal deposits? Or is it something else on the balances side that will help you close that gap?

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

Yes. So I think we made good progress in narrowing the gap. Our goal was never to close it, but was to narrow it. And so over, certainly, the first 2 years, call it, I don't know, '15 and '16, we made good progress in narrowing the gap. And look, I think going forward, progress there is going to be driven by growing deposits. And the asset side of the balance sheet is going to be pretty relevant as well. And so when I think about what drove the progress over the past couple of years, our very successful initiative in credit cards was clearly one of the drivers of that.

Operator

Our next question comes from Steve Theriault from Eight Capital.

Stephen Theriault - Eight Capital, Research Division - Principal & Co-Head of Research

A question on credit for Daniel. Daniel, the Stage 3 PCLs were significantly higher quarter-on-quarter. Just wondering, can you remind us, or get into a little bit, is there much in the way of seasonality here? Last year, Q3 and Q4 PCL were lower than Q2. Maybe that reflected some seasonality. We're 2 quarters into IFRS 9, so we're struggling a little bit with the all-in PCL outlook. So maybe you can give us a bit of a hand, what are you thinking for the second half of the year?

Daniel Moore - The Bank of Nova Scotia - Executive VP & CRO

Sure. Thanks, Steve. And I think we'll be talking about IFRS 9 for a while as we collectively understand the dynamics of this new PCL model. As we indicated in our remarks earlier, the big driver in the Stage 3 change quarter-over-quarter, which was the $14 million increase that we looked at, was the increase primarily due to one account that was affected by the hurricanes. That came from a release of an allowance that we talked about in Q4 that we set aside for such issues. So the net release in Stage 1 and 2 on the performing loan book was $61 million. That was driven by a mixture of retail credit quality in IB, which is about $14 million release Q-over-Q; and $35 million due to the hurricane release, were the primary drivers of that. Again, that was offset by the one account we spoke about before. So it's a bit of swings and roundabouts, Steve, as we move from what was a specifically noted and set-up allowance for this outcome and then the realization of that outcome.

Stephen Theriault - Eight Capital, Research Division - Principal & Co-Head of Research

And when you think about the second half – go ahead.

Daniel Moore - The Bank of Nova Scotia - Executive VP & CRO

Yes, sure. So going forward, I think that's where you were headed, we're looking at the impact of the hurricanes in particular. We think we've got the appropriate reserves now for the position that we have there, so we wouldn't anticipate any particular volatility driven by that impact going forward. Of course, we do still have [inaudible] and will be, as I indicated, probably having discussions about 1, 2 and 3 going forward. But we will focus our discussion, Steve, on the Stage 3, the impact on the impaired book where there's much less model discretion and impact to things like forward indicators in growth.

Operator

Our next question comes from Mario Mendonca.

Mario Mendonca - TD Securities Equity Research - MD and Research Analyst

If I could just, first, get an understanding of what is the broad message you're giving us on expenses. And the reason why I'm asking the question this way is, depending on how you look at the quarter, you could arrive at the conclusion that operating leverage was fairly weak, if you do take into account the unusually high equity trading numbers in Q2/17. So how do you view operating leverage as being good this quarter even though another look at it would send a different message. So rather than focusing too much on the quarter, what is the broad message you're sending us on expenses for the remainder of the year?

Sean D. McGuckin - The Bank of Nova Scotia - Group Head & CFO

It's Sean. I'd say you're right, Mario. Looking quarter-to-quarter can be a trap you can fall into. For the first half of the year, our productivity ratio was 52.5%, and that excludes the large postretirement benefit credit in Q1, which is well on our way of our goal of hitting 52% by the end of next year. So we're tracking very well against that goal. I think what you've been hearing so far is that expenses were elevated this quarter, and we would expect them to come off from that higher level as the year progresses. And again, our goal is to continue to march towards that 52% or better productivity ratio by the end of next year, and we're on target to perhaps meet that by the end of this year as opposed to next year.

Mario Mendonca - TD Securities Equity Research - MD and Research Analyst

Yes. That's where I was going to go with that because you're exactly right, you can get awfully close in 2018. Does that mean you'd revise the outlook for 2019?

Sean D. McGuckin - The Bank of Nova Scotia - Group Head & CFO

We will continue to grow. You may recall at the Digital Banking Investor Day, which is now 18 months ago, we have said that even beyond 2019, as we continue to make investments in digital, we would expect our productivity ratio to continue to improve beyond '19 by, I think, another 1 percentage – 100 basis points per year. So our goal isn't just to stop when we get to 52%, Mario. We will continue to drive a more productive bank, which will drive a better ROE and better returns for our shareholders.

Mario Mendonca - TD Securities Equity Research - MD and Research Analyst

Okay. And then finally, and maybe this is for Brian or Dieter, I've learned over time not to rely too much on political polls, but the ones in Mexico don't look that favorable, considering on who you're rooting for. What is your outlook on that election? And in the past, because you've been through this before when elections haven't gone maybe the way you'd hoped, how do things play out in the near term and then a longer-term look?

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

Mario, I'm going to let Nacho start with that, and I might have something to finish it off.

Ignacio Deschamps - The Bank of Nova Scotia - Group Head of International Banking & Digital Transformation

Mario, well, Scotiabank has been in Mexico for the past 20 years, as you say. And in these 20 years, we have seen different political parties take government. And the country has continued to improve. The economy has grown significantly. I would especially highlight institutional strengthening in the country. Very important, is the role of the independent central bank in this process. So our expectation is that, regardless of the candidate, we continue to see a bright future for Mexico in the medium-term. And very importantly, there were very important there were some very significant structural reforms in the first year of this government. We don't see any of the candidates getting enough votes in Congress to reverse these reforms, which will be important for economic growth. Brian?

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

Yes. Mario, I think that we're being cautious here. We're running higher levels of liquidity in Mexico, which we think is prudent, just because you always get volatility running into these things and afterwards. But the Mexican economy has come a long way, as Nacho said. This is a very diversified manufacturing economy. It's not just autos, it's electronics, it's medical devices, it's sophisticated manufacturing across the board. So I think that if AMLO is going to win, which it looks certainly like they will, it doesn't look like they'll win Congress. So there, you've got a bit of a hung situation there. And I think that the leader of AMLO has been a strong student of politics. He has made statements about not overturning some of the structural reforms. We could see some interesting things in the energy sector. But in terms of engagement with the business community, he's more focused on the importance of a growing economy to support any social programs that he has in mind. So that's how we read the Mexican election. Obviously, there's an important election in Colombia. You saw the results on Sunday. The center-right candidate is the frontrunner. And the other big election in LatAm later this summer is in Brazil, and we're obviously watching that with interest.

Operator

Our next question comes from Doug Young of Desjardins Capital Markets.

Doug Young - Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst

Just sticking with the international side. I know Colombia in the past has struggled a little bit around the energy side, and this quarter, earnings were essentially flat year-over-year. So I'm just wondering to get, and I think last quarter, you indicated that maybe you would start to see some improvement. So hoping to get maybe, Nacho, a little bit more of a glimpse into what's going on in Colombia from a PCL, from an expense, from just a general growth perspective. And then just within Mexico, obviously was a key growth driver when we look at the earnings contribution. And Sean, was there a tax benefit that came through? There was mention of that in the MD&A. I just wanted to get some color on that.

Ignacio Deschamps - The Bank of Nova Scotia - Group Head of International Banking & Digital Transformation

Thank you very much. Well, I would say we are very pleased with the improvement of Colombia. Underlying NIAT is growing 20%, and this is driven by a better economic outlook. GDP is expected to grow 2.5% this year relative to 1.8%, definitely much stronger. This is reflected in our loan growth, which is at 10%, and revenue growth is also growing high single-digit. And we have 200 positive operating leverage in Colombia. So we will expect Colombia to continue to improve in future quarters. And relative to Mexico, the only thing to add is that Mexico had a fantastic quarter. If we look at Mexico in the past 3 years, Mexico has organically grown 200 basis points of market share. So we're very pleased with the evolution of Mexico. When you think of Mexico, it's very important also to understand that it's part of the North American economy. And the U.S. economy is growing quite strongly, and that's positive for Mexico.

Sean D. McGuckin - The Bank of Nova Scotia - Group Head & CFO

And regarding tax...

Doug Young - Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst

And Nacho – I'm sorry, go ahead.

Sean D. McGuckin - The Bank of Nova Scotia - Group Head & CFO

No. You finish with Nacho.

Doug Young - Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst

No, I was just going to say just Nacho, it sounds like some of the underlying themes were really strong. But when I look at the year-over-year earnings growth from Colombia, it wasn't flowing through. So I'm wondering if there's anything noise-wise in there.

Sean D. McGuckin - The Bank of Nova Scotia - Group Head & CFO

I'm not – Doug, I'll answer. I'm not sure what you're looking at. But Colombia is up 14% year-over-year and up 31% versus last quarter. So it's...

Doug Young - Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst

Yes. I can take offline. I'm just looking at your MD&A and geographic, again, we can take it offline. But just on Mexico, on the tax side, Sean.

Sean D. McGuckin - The Bank of Nova Scotia - Group Head & CFO

Yes. Small tax, yes, there's a small tax benefit this quarter. You'll see the tax rate compared to last quarter was only off about 1% in that division, so it was not that significant.

Operator

Our next question comes from John Aiken of Barclays.

John Aiken - Barclays Bank PLC, Research Division - Director & Senior Analyst

Sean, just a little bit of clarification on your pro forma guidance on the CET1 ratio. When you said 11% roughly in Q4, does that include the impact of internally generated capital on the ratio?

Sean D. McGuckin - The Bank of Nova Scotia - Group Head & CFO

Yes. So when we say in and around 11%, it could be 11.1%, 11.2%, thereabouts. So we're just guiding to around 11%. This quarter, we generated about 20 basis points of internally generated capital when you look at the capital less the organic RWA. And these acquisitions that we've announced, the Chile, Colombia, the Peru, not much with Jarislowsky-Fraser because we issued mostly equity, they amount to about 110 basis points, so we will be in and around that 11% mark.

John Aiken - Barclays Bank PLC, Research Division - Director & Senior Analyst

That's great. And can we assume that you're not necessarily going to be terribly aggressive with the renewal of the buyback until we actually see the dust settle on these acquisitions?

Sean D. McGuckin - The Bank of Nova Scotia - Group Head & CFO

It's linked ultimately to our capital accretion. If we are accreting more capital than what we're suggesting at that in and around 11%, then that gives us a bit more opportunity to go do that buyback. You've heard us mention in the past the Jarislowsky-Fraser transaction. Because we issued equity there, we will look for opportunities, over the next 18 months or so, to buy back in some of those shares we issued to reduce the dilution effect. So again, as you've heard us talk in the past, it's a tool in our toolkit to deploy capital, and we'll deploy it as we see opportunities arise.

All right. I think that's the last question. Thank you for all listening in on our second quarter, and we look forward to talking to you again in Q3. Have a great day.