SCOTIABANK

Q1 2019 EARNINGS CONFERENCE CALL

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PRESENTATION

Philip Smith - The Bank of Nova Scotia - SVP of Investor Relations

Good morning, and welcome to Scotiabank's 2019 First Quarter Results Presentation. My name is Philip Smith, Senior Vice President of Investor Relations. Presenting to you this morning is Brian Porter, Scotiabank's President and Chief Executive Officer; Raj Viswanathan, our Chief Financial Officer; and Daniel Moore, our Chief Risk Officer. Following our comments, we'll be glad to take your questions. Also present to take questions are Scotiabank's business line group heads: James O'Sullivan from Canadian Banking; Nacho Deschamps from International Banking; and Jake Lawrence and James Neate 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, Phil, and good morning, everyone. I will be starting on Slide 4.

During the first quarter, we demonstrated continued progress in the execution of our strategy by achieving several important objectives, which position us for further growth, simplify our footprint and operations and derisk the bank. This morning, we advance the strategy even further by announcing that the bank has signed a non-binding Memorandum of Understanding to combine Thanachart Bank with Thai Military Bank. This transaction, if completed, would allow us to monetize most of our investments in Thanachart Bank and increase our common equity Tier 1 ratio while retaining a smaller equity interest in a larger, stronger combined bank.

In terms of our financial performance in the quarter, the bank delivered adjusted earnings of $2.3 billion and diluted earnings per share of $1.75. Our return on equity was 13.7%. Based on these results, we are increasing our quarterly dividend to shareholders by $0.02 to $0.87 per share. This represents a 6% increase over the prior year.

While market volatility negatively impacted some of our businesses in the quarter, we still experienced strong growth in revenue, up 7%, assets up 12% and deposits up 9% on a year-over-year basis while continuing to invest in our businesses. International Banking delivered double-digit earnings growth and positive operating leverage. Our capital ratios continue to be strong, and our integration efforts are tracking very well. This growth allowed the bank to reach $1 trillion in assets for the first time. I would like to thank our customers for their trust and loyalty and our employees for their dedication and hard work in achieving this important milestone.

Higher expenses reflected the impact of acquisitions and continued investment in our businesses. We also demonstrated good progress integrating previously announced acquisitions. BBVA Chile and MD Financial are experiencing excellent retention of both clients and assets, and synergies are being realized as we have previously outlined. These efforts remain key bank priorities for the balance of the year. Raj will have more to say on our integration progress in a moment.

To recap, over the last 5 years, we have invested strategically to increase our scale and market share across our key markets in Canada and the Pacific Alliance while improving earnings growth and asset quality. We have simplified the bank by selling our operations in 18 countries that were either rated non-investment grade or unrated while redeploying capital in higher-rated, investment-grade jurisdictions such as Canada and Chile. In addition to divestitures, we announced last fall we were selling our pension and insurance business in the Dominican Republic and our banking operations in El Salvador.

Finally, we have consistently invested in technology and strengthened the core functions of the bank. These include investments in the digitization of the bank, investments in AML and cybersecurity to protect the bank and our customers. As we continue to execute our strategy, the bank will be better positioned for consistent long-term growth and improve shareholder returns.

Turning to our business lines, I'd like to make a few brief comments.

The Canadian Bank had strong loan and deposit growth and good credit quality. We saw some signs of moderation in mortgage growth, in line with the low end of our guidance range given the pull forward of demand in the same period last year due to the B20 guidelines. The competitive environment remained strong and mortgage spreads were very tight during the quarter.

Wealth Management also demonstrated solid growth with net income up 7% year-over-year and stable asset levels in the quarter despite volatile markets, with good contribution from our acquisitions.

Our private banking segment was a highlight, demonstrating very strong growth compared to last year. Importantly, the quality of our overall Wealth Management business was recognized by a record number of industry performance awards in the first quarter.

International Banking's strong performance continued in the first quarter with earnings increasing 18% and delivering positive operating leverage. Our acquisitions are continuing – are contributing to the growth, in line with our expectations. We are seeing positive fundamentals in the Pacific Alliance countries.

Capital markets volatility was challenging for the industry in both Canada and the U.S., and this directly impacted our origination and secondary trading businesses within our Global Banking and Markets business. Despite these conditions, we delivered strong corporate loan growth in the quarter, and the better results overall in January support our outlook for stronger results over the remainder of the year.

Our digital strategy continues to progress well with steady progress in digital retail sales and digital adoption. We recently announced the establishment of a FinTech accelerator in Mexico City, which will develop solutions in a variety of areas, including data analytics, electronic payments and cybersecurity. This represents yet another example of our leadership in digital banking and our commitment to technology.

The bank remains well capitalized with a common equity Tier 1 ratio of 11.1% or 11.2% on a pro forma basis. The monetization of our interest in Thanachart Bank would further increase our capital position by approximately 25 basis points and provide even greater flexibility for capital deployment.

While economic growth in Canada has moderated slightly, unemployment levels remain below 6%, and we see continued wage growth, job creation and immigration, which is positive for the Canadian economy. We remain constructive on our economic outlook for the balance of the year.

Across the Pacific Alliance, we continue to see a positive economic outlook with GDP growth averaging 3% across the region for the balance of the year.

In summary, the quarter's performance reflects continued progress in the execution of our strategy.

I'll now turn the call over to Raj to update you on our recent acquisitions.

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

Thanks, Brian. I'll begin on Slide 6, which provides a brief progress update on integration and synergies associated with our recent material acquisitions of BBVA Chile and MD Financial.

Client retention rates at MD Financial are ahead of plan with 98% of both assets and clients so far, which speaks to the continued high levels of client trust with MD Financial. Employee satisfaction also remains high, and we've experienced minimal advisor attrition. We had over 1,600 cross-referrals between Scotiabank and MD Financial since September 2018.

With regards to BBVA Chile, we have captured approximately 45% of our total target synergies to date and remain on track to achieve total pre-tax synergies of $150 million to $180 million per year by 2020. Our existing operations in Chile with BBVA Chile has resulted in increased loan market share of approximately 16 basis points year-over-year. Client attrition is tracking well below our expectations, which were 5% in retail and 10% in commercial.

Overall, we remain on track to achieve our targeted accretion of $0.15 to adjusted diluted EPS in 2020 for acquisitions that we announced in 2018.

Turning now to the Q1/19 key financial performance on Slide 7. All of my comments will be on an adjusted basis, which excludes acquisition-related costs.

We're pleased with the bank's solid start to 2019, particularly in light of the market volatility that negatively impacted our Global Banking and Markets businesses. The bank delivered $2.3 billion in earnings and diluted EPS of $1.75 for the quarter, down 6% compared to last year. Excluding the impact of the remeasurement benefit of $150 million or $0.12 per share in Q1 2018, adjusted diluted EPS was in line year-over-year.

Revenues increased 7% from last year, driven by solid growth in both net interest and non-interest income, including the benefit from acquisitions. As noted earlier, challenging industry market conditions negatively impacted our capital markets revenue-related revenues, which reduced all bank revenue growth by approximately 2%.

Net interest income was up 9%, about 2/3rd from acquisitions and the rest from volume growth. In addition to continued residential mortgage volume growth in Canadian Banking, business lending grew double-digits and credit cards grew high-single-digits.

In the Pacific Alliance, we saw double-digit growth in both commercial and retail loans as well as strong corporate loan growth in Global Banking and Markets.

The core banking margin was down 1 basis point versus last year due to the change in business mix from the impact of International Banking acquisitions and higher margins in Canadian Banking. This was offset by lower margin in Global Banking and Markets and asset/liability management activities.

Non-interest income grew 6% compared to last year. This growth was driven by strong contribution from acquisitions, income from associated corporations, insurance revenues as well as the impact of the gain on a foreclosed asset in International Banking and the alignment of the reporting period of Peru with the bank this quarter. Partly offsetting were lower trading revenues, advisory fees and impact of the new revenue accounting standard, which requires card-related expenses to be offset against card-related revenues applied prospectively.

Expenses were up 18% year-over-year. Acquisitions and the prior year benefit remeasurement, and the impact of the new revenue accounting standard contributed approximately 2/3rd of this expense growth. The remaining growth related to increased investments in technology and regulatory initiatives, higher share-based payments costs, business growth-related expenses and the negative impact of foreign currency translation.

The bank's productivity ratio increased to 54.1%. Adjusting for the acquisition-related costs and the impact of the prior year benefits remeasurement credit, the productivity ratio was up 220 basis points.

The credit quality of our portfolios remained solid with a PCL ratio on impaired loans of 47 basis points, up 4 basis points from last year. There were net provisions on performing loans of $9 million and, when combined with provisions on impaired loans, resulted in a total PCL ratio of 47 basis points.

Our tax rate was in line with last quarter due to higher tax benefits in a number of jurisdictions. The effective tax rate is expected to be in the lower end of our outlook through the remainder of 2019.

On Slide 8, we provide an evolution of our CET1 capital ratio over the last quarter.

The bank's strong internal capital generation of 28 basis points was deployed in organic growth and the growth in risk-weighted assets. This quarter, the bank's capital ratio was impacted 9 basis points by the remeasurement of employee pension and post-retirement benefits largely due to the decline in the discount rate by 40 basis points.

Risk-weighted assets increased by approximately $8 billion or 2% primarily due to strong organic asset growth across our businesses and the impact of foreign currency translation.

During the quarter, we repurchased 3.25 million shares at $71.93 per share. Since June 2018, under the current NCIB, we have purchased 9.23 million shares.

Including the pro forma impact of all announced acquisitions and select non-core dispositions yet to close, the CET1 ratio is expected to be 11.2%. We are pleased with the pace of capital results, driven by strong internal capital generation and the divestitures that will improve the bank's CET1 ratio to exceed 11.5% by the end of fiscal 2019. As Brian mentioned earlier, the monetization of our significant investment in Thanachart Bank would further increase our pro forma CET1 ratio by approximately 25 basis points.

Turning now to the business line results beginning on Slide 9.

Canadian Banking reported net income of $1.1 billion, down 3% year-over-year or down 2% adjusting for the impact of acquisition-related costs. Revenues were up 3% from last year, including strong contributions from acquisitions. Net interest income grew 5% due to improved spreads and volume growth. Residential mortgages grew 3%, business loans a strong 10% and personal loans at 3%. Deposits grew by 9% with personal deposits growing at 7% and nonpersonal deposit at a strong 12%. For the second straight quarter, deposit growth outpaced asset growth.

The net interest margin was up 3 basis points year-over-year primarily due to the impact of prior Bank of Canada rate increases and business mix. Sequentially, margins were down 1 basis point, reflecting competitive pricing pressures and slightly higher funding costs.

Non-interest income was up 1% due to higher fee income, driven by the wealth acquisitions and higher credit fees. These were mostly offset by lower net card revenues due to the adoption of the new revenue accounting standard, which reduced both non-interest income and expenses by approximately $55 million; lower gains on sale of real estate; and the prior year Interac reorganization gains.

Wealth Management adjusted earnings increased by 6% year-over-year, driven by strong contributions from the MD Financial and JF acquisitions.

Global Asset Management has leveraged strong foundational growth and momentum to strengthen the collective businesses in Q1 2019. In Global Asset Management, ScotiaFunds is ranked #1 amongst the banks for 1-year and 3-year performance. And combined with Dynamic Funds, 94% of Scotia and Dynamic Funds assets were in the top 2 quartile in 1-year returns. ScotiaMcLeod was ranked #1 in revenue and #1 in assets per advisor, and Scotiatrust was ranked #1 in Trust & Foundation assets and Total Estate revenue for the full year by Investor Economics.

Provision for credit losses were up $23 million. Higher provision on impaired loans was primarily due to higher provisions on one commercial account. Provisions on performing loans increased in line with asset growth.

On an adjusted basis, expenses increased 7% year-over-year with half of the growth driven by acquisitions and the adoption of the new revenue accounting standard. The balance growth was driven by higher investment in regulatory initiatives, digital and technology, partly offset by the benefits from cost reduction initiatives. The division's adjusted productivity ratio was 50%.

Turning to the next slide on International Banking.

On a reported basis, earnings of $782 million in Q1/19 were up 16% year-over-year, while adjusted earnings of $805 million were up 19% year-over-year. 6% of the adjusted earnings growth related to the alignment of the reporting period of Peru with the bank this quarter.

My comments which follow are on an adjusted and constant currency basis.

Q1 results reflected strong asset and deposit growth in the Pacific Alliance, including the benefit of recent acquisitions, positive operating leverage and good credit quality. The Pacific Alliance had very strong net income growth of 23%, driven by strong loan and deposit growth. The results benefited from a strong performance in Chile, Mexico and Colombia.

Revenues grew a strong 22%, of which approximately half was driven by recently closed acquisitions. The Pacific Alliance saw an increase of 31% in revenue year-over-year.

Loans grew by 29% compared to a year ago. Loan growth in the Pacific Alliance region increased 44% year-over-year, including acquisitions in both retail and commercial in Chile and Colombia. Mexico and Peru had strong, double-digit loan growth.

Net interest margin of 4.52% was down 14 basis points year-over-year primarily due to the business mix impact of the BBVA acquisition, as we previously indicated. Quarter-over-quarter, the margin was stable.

The provision for credit loss ratio on impaired loans decreased 2 basis points year-over-year, while provision on performing loans increased by $21 million, in line with asset growth and due to lower commercial provision last year.

Expenses were up 18% with approximately 2/3rds driven by acquisitions. The remaining increase was driven by business volume growth and inflation.

Operating leverage was a strong positive 4.2% for the quarter, leading to an improvement in the productivity ratio of approximately 180 basis points. Excluding the alignment of the reporting period of Peru with the bank this quarter, operating leverage was positive 2.1%, and the improvement in the productivity ratio was approximately 90 basis points.

Moving to Slide 11, Global Banking and Markets.

Net income of $335 million was down 26% year-over-year, significantly impacted by lower market-sensitive revenues given the industry conditions. Lower trading revenues, primarily in interest and credit trading, and higher non-interest expenses were partly offset by the favorable impact of foreign currency translation, reversal of provision for credit losses and slightly lower taxes.

Revenues were down 10% year-over-year, mainly reflecting lower non-interest income.

Non-interest income was down 12% year-over-year primarily due to lower client-driven, trading-related revenues that were down approximately $90 million. This was partly offset by higher fee income.

Net interest income was down 5% versus last year due to lower lending margins primarily due to lower loan origination fees. Margins, however, were up a strong 8 basis points compared to last quarter.

Corporate loan growth was strong, up 8% quarter-over-quarter and 15% year-over-year. The strong growth in lending in our corporate book was primarily due to M&A activity in the U.S. Approximately 90% of the growth in lending volumes this quarter was to investment-grade corporates.

The PCL ratio improved 3 basis points year-over-year. The improvement was primarily driven by reversals on performing loans due to improving credit quality in the energy portfolio.

Expenses were up 13% year-over-year, driven by higher regulatory and technology investments, share-based compensation and the favorable impact of foreign currency translation.

I'll now turn to the Other segment on Slide 12, which incorporates the results of Group Treasury, smaller operating units and certain corporate adjustments. The results also include the net impact of asset and liability management activities.

The Other segment reported a net loss of $54 million this quarter. The net loss in this segment versus net income last year was due to higher non-interest expenses as Q1/18 benefited from the benefits remeasurement credit, lower gains on the sale of investment securities and lower contributions from asset/liability management activities, which were driven by margin compression on high-quality, liquid assets. This was partly offset by higher tax benefits this quarter.

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, Raj. And I'll turn to Slide 14.

In summary, we continue to be comfortable with the risk fundamentals of our portfolio. That's because underlying credit quality trends are stable across our retail and commercial portfolios in Canada and, indeed, across our Pacific Alliance countries. For instance, in Canada, we continue to see improving delinquency rates in all geographies and products. We believe this performance is attributable to our focus on high-quality A- and B-grade customers. The bank continues to make tangible investments across our selection capabilities and in our data analytics capabilities to better segment our customers for preapprovals and credit limit increases as well as credit limit reductions where necessary. As well, we continue to perform ongoing stress testing, which considers factors such as concentrated declines, higher interest rates, unemployment as well as the impact of higher trade tensions across global economies. These capabilities, along with our diversified geographic and product footprint, position us well for a variety of macroeconomic outcomes.

Turning now to the quarter.

Our PCL ratio on impaired loans, or what is referred to as Stage 3, came in at 47 basis points, up 5 basis points compared to last quarter and 4 basis points relative to last year. This growth was in line with portfolio growth and changes in business mix as international, which has a higher PCL ratio than Global Banking and Markets and Premium Banking, now comprises a larger portion of our total portfolio due to recent acquisitions. The total PCL ratio was up 8 basis points versus last quarter, reflecting higher performing and impaired PCL. The increase in performing loan PCL this quarter was primarily due to higher provisions in International Banking, which benefited last quarter from the reversal of hurricane-related provisions. The increase in impaired provisions, on the other hand, was due to lower recoveries in Canadian retail and one specific Canadian commercial account.

Overall, we see continued strength in our Canadian personal and commercial Banking businesses relative to last quarter, which benefited from higher recoveries. Higher domestic commercial impaired provisions this quarter were driven mainly by the one client fraud-related specific syndicated commercial account I just mentioned.

Moving onto International Banking.

We continue to see good credit quality trends and the benefits of our diversification. Lower commercial impaired losses were due to the Barbados debt restructuring charge last quarter while retail impaired losses remained relatively flat.

In Global Banking and Markets, recoveries in the performing portfolio were driven by continued improvement in the U.S. energy book. And given our focused operations in Europe, we do not see any material impact to the bank related to Brexit.

Looking now at other credit metrics.

Gross impaired loans increased modestly to $5.3 billion from $5.1 billion last quarter, but the gross impaired loans ratio remains generally flat versus last quarter and down compared to a year ago. Our net formations of $941 million were above the 2-year average. The increased formations were partially driven by Global Banking and Markets in Europe and the U.S. as well as in our P&C business and were partly offset by lower commercial formations.

Turning now to Slide 15. You can see here the recent trend in loss ratios for each of our businesses.

Our overall trend is stable, which we expect to continue over the balance of the year. We believe our credit portfolios continue to reflect the benefits of broad diversification, and underlying performance remained strong.

I would highlight the quarter-over-quarter increase in Canadian Banking was driven in part by the provision on that one specific client fraud-related commercial account. And similarly, the quarter-over-quarter increase in International Banking was also due to commercial PCLs but, in this case, driven by the reversal of previously recorded hurricane-related provisions in the Caribbean that are no longer needed. GBM continues to see reversals from corporate energy-related disposals.

Turning now to Slide 16. You can see the recent trends in net write-off ratios for each of our businesses.

Looking over the last 5 quarters, our net write-off ratio has been relatively stable with a small impact in International Banking from the previously recorded 1-month reporting lag in Peru and acquisitions. And we would expect that stable trend to continue.

In summary, we continue to see the benefits of our diversified business model and our investments in digital and analytics, as evidenced by our stable PCL ratios, by our stable delinquency rates and by our stable net write-offs. We remain confident in the credit quality of our portfolio.

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

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

Thank you, Daniel. Before we open the call for questions, I'd like to make a few comments on the bank's strategic progress to date and where we are headed.

Regarding the announcement today on the Thanachart Bank, it marks a major step in the repositioning of the bank's geographic footprint that began 5 years ago. During this period, we have announced or completed the sale of our operations in 18 countries and sold 5 non-core businesses while simultaneously gaining scale in our key markets and businesses, improving the quality of our earnings, building capital and greatly improving our technology and controls. The collective management actions results in a better, lower-risk bank with focused operations. We are better positioned to provide excellent products and services to our customers and a stronger return to our shareholders.

As I discussed previously in 2019, we will be focused on the integration of our recent acquisitions. If completed, the sale of Thanachart Bank would provide the bank with greater optionality, which includes growing our key operations in the Americas.

With that, I'll now turn the call back to Raj.

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

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

QUESTIONS AND ANSWERS

Operator

Yes, sir. We'll first go to Robert Sedran with CIBC Capital Markets.

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

I wanted to ask about expenses and, I guess, both in Canada and in the Global Banking and Markets segment, and maybe start with James. Just the operating leverage guidance for the year was better, I guess, than what we saw in Q1. Can you give us a bit of an update on what you're thinking? And then on the global banking side, a pretty big surge in expenses, and the explanation is the same on both slides, the technology and regulatory spending. Just curious if there's something abnormal in that Global Banking and Markets number this quarter?

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

All right, well, I'll start then with domestic banking, Rob. So expense growth in domestic banking was 2% year-over-year. There is an IFRS 15 impact there, so adjusted for IFRS 15, expense growth was at 6%. We do expect it to moderate from here. We had what I would describe as a bit of a tough comp from this time last year. So our perspective on expenses is that expense growth will take their cue from revenue growth, and that's how we're thinking about the balance of the year. In terms of operating leverage, we did have negative operating leverage for the quarter. But I think with the productivity ratio of 46% for the quarter in our domestic banking business, I think we pretty clearly have our medium-term target of 45% or better in sight, and that's what we're gunning for.

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

I'll start on GBM, Rob. It's Raj. Year-over-year, yes, expense growth was off – it's supposed to be 13%. But as you can see, it's off a very small base. And GBM has got a lot of regulatory and technology investment ongoing simply because of the markets that we operate in, the fact that we need to predict the parameter of the bank, and a lot of those relating to either regulatory changes or AML related. And Jake, I don't know if you want to add some more on that.

Jake Lawrence - The Bank of Nova Scotia - Co-Group Head of Global Banking & Markets

Yes, Rob, quarter-over-quarter, we also had some seasonality in performance-related compensation, but we're more confident in the revenue outlook from here, which will drive a better operating leverage picture as we go over the course in 2019.

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

And I think specifically on the expense, Rob, for GBM, we expect it to moderate towards the second half of the year. It's a lot of investments in the early part of the year, frankly, starting from the second half of last year, but we expect it to moderate in the second half of this year.

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

Because when I look at the slide pack, Raj, I see it almost $100 million higher than in Q3 and Q4 of last year. That's – I understand it's off of a smaller base, but $100 million is still a fair bit of a move. So I appreciate the comments around seasonality, but I was just curious if there's something that I'm missing on that front. But I guess we'll move on.

Operator

We'll next go to Meny Grauman with Cormark Securities.

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

Just wanted to dig a little bit deeper into revenue growth in Canadian Banking, especially when we look excluding Wealth Management flat year-over-year and down sequentially. So just wondering if there's anything unusual there that you'd highlight. And then if you look forward, what is the improvement for the rest of the year? Or do you expect this picture to improve for the rest of the year?

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

Yes, sure. Thanks, Meny. So again, if you adjust for the impact of IFRS 15 and the impact of reduced one-timers, because we did have an Interac gain this time last year and meaningful real estate gains as well, if you adjust for those 2, revenue growth is about 4%. And I'd say the balance, the difference between that and what we might have expected for Q1 I would describe as business conditions, including volumes and spreads. Volumes were lower than planned, and margins were tighter than planned. But we have a positive outlook, Meny. November and December, I think, were months of peak volatility in markets. Clearly, markets have recovered. We think normalcy is returning to the business environment as well, and that really forms the basis of our outlook. We think job creation is going to continue, and that's going to drive consumer borrowing. So for revenue growth, we expect it to improve from here, particularly, I would say, in the second half of the year. And again, I think it's improving macro and the reduced impact of one-timers are going to drive that revenue growth.

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

And just on a related question, I know that there's a report that the federal budget is going to include some easing of mortgage rules. Where do you stand on that issue? And do you factor that into your outlook in terms of maybe seeing even an acceleration in mortgage business related to that?

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

Yes, so residential mortgage growth came in at 3% on a year-over-year basis, as it did last quarter. I think there are some really important information for all of us just around the corner, and that information is going to come to us in the spring housing market, which should start in the coming weeks. And we're positioning ourselves, Meny, for that market. We want to be a strong participant in it. So as we sit here today, our goal would continue to be 4% or so mortgage growth for the full year. And as we've said before, we feel much better about Canada's housing markets today than we did 24 months ago. We continue to believe that we're getting the soft landing that many of us have encouraged. And I think if you look at the latest data from the Canadian Real Estate Association, or the MLS data, I think it's consistent with that view. Home sales are down 4% year-over-year, but the Home Price Index is up 1%. So we look at the market, and we see strong housing demand fundamentals. So that's low unemployment, tight labor markets pretty much across the country, aging millennials and strong immigration. So we think fundamentals can and will drive the market forward, and we were particularly impressed with the January employment data. So look, just around the corner is the spring housing market. We think that's a very important data point for everyone associated with this industry.

Operator

Next we'll go to Doug Young with Desjardins Capital Markets.

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

I guess maybe just a 2-part question on the International Banking side, but it should be fairly quick. Just, one, if I do the back of the envelope, it looks like Peru earnings actually declined year-over-year. Correct me if I'm wrong. And if that's the case, just wanted little bit more detail. And then in the past, you've given what BBVA Chile contributed earnings-wise. Just wanted to know if you would be willing to give that number for Q1.

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

Sure, this is Nacho. Let me tell you first about Peru. Peru had a softer quarter this Q1. And let's remember Peru growth was 50% of earnings last year, and we continue to – Peru's outlook to be positive. They had a very positive loan growth. Retail loans grew 4%. And we expect the economy to grow in Peru 4% in 2019. So overall, we see stronger revenue growth, stronger loan growth and activity going forward. I would say the reason for the year-over-year comparison, we had a significant capital market gains last year and treasury results. In terms of Chile, we are very pleased with the integration of Chile. And I would say the most important data point there is that the combined entity, which is 14%, grew 16 – or 15 bps market share by the end of last year. We have captured $30 million in pre-tax synergies, which is $70 million run rate. I mentioned that during the first year, we had expected to pick up NIAT between $50 million and $70 million. I can tell you that I'm confident now we will be above $70 million of NIAT during the first year. And the integration from a technology perspective is on track and on budget. We expect to conclude it by the end of this year.

Operator

Next question comes from Gabriel Dechaine with National Bank.

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

A couple of quick ones here. Corporate loan book, you had the big growth number. I'm just wondering what the visibility or timing of ancillary fee revenue generation from that balance sheet growth. Then on the card fees, the card expenses, I guess they moved up higher. We also saw balances move higher. Is there a relationship there? And when do you expect the expenses to maybe moderate as maybe some promotions fade?

Jake Lawrence - The Bank of Nova Scotia - Co-Group Head of Global Banking & Markets

Hey, Gabe, it's Jake. I'll talk to the first piece. Yes, we did have strong corporate loan growth. As Raj noted in his comments, 90% of the growth was investment grade, so we're not compromising credit quality. Some of the transactions that led to the growth was existing customers and some was M&A related. I mean, we expect the ancillary and capital markets related to show up likely in the second half of this year is the expectation.

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

On credit cards, average balances are up about 7% year-over-year. I think purchase volumes are up about 9%. Our Tangerines card balances, by the way, are up a very strong 39% year-over-year. In terms of movements in revenue and expenses, we would have to adjust for the impact of IFRS 15. That's where the bulk of the IFRS 15 impact resides.

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

I know, but on the expense line there, it's up quite a bit year-over-year, the card expenses. But I don't think that's an IFRS 15 item, what you incurred on promotional and loyalty costs, is it not?

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

Yes, card expenses have been slightly elevated, but it also includes our international bank card offerings, I think, Gabe, the number you were referring to which is not (inaudible). And I wouldn't say anything unusual over there. It's primarily volume driven over there and specific promotions which we've had in multiple parts of our operations. But I wouldn't call out anything specific.

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

Maybe a timing promotion phase sort of thing? Anyway, well...

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

Yes, we expect it to moderate for sure.

Operator

We'll next go to Ebrahim Poonawala with Bank of America Merrill Lynch.

Ebrahim Huseini Poonawala - BofA Merrill Lynch, Research Division - Director

I was wondering if you can give talk to just in terms of your margin outlook both in Canada and International Banking. And tied to that, just in terms of what are the pluses and minuses when you think about balance sheet growth, the rate environment across these markets that we should be thinking through when we think about your margin guidance.

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

Ebrahim, it's James. I'll start with a Canadian perspective. So the margin this quarter at 2.39% was down 1 basis point sequentially and up 4 basis points year-over-year. I would describe it as one of those kind of unusual quarters where what you gain on a swing if you lose on the roundabouts. Because if you peel it back, we picked up 6 basis points in deposit margins sequentially. We lost 7 basis points in asset margin, and the bulk of that would have been in the mortgage book. Q1 was a highly unusual quarter in the mortgage market. There were bunch of things going on associated with both the months of December – November and December that we described as months of peak volatility. You had the 5-year government of Canada rate declining 70, 80 basis points from kind of 2.50% to 1.80%. You had a what I would describe as a persistently high kind of cost of funds in the face of that. And you had a very competitive market given that the comp for last year included a lot of B20 pull forward. So it was an unusual quarter when you look underneath, but it netted out to down 1 basis point sequentially. So going forward, I think when you look in particularly at our strong deposit growth, which we expect to continue, and our rate outlook, which now would include, say, one hike in the back half of the year, so it moderated that view, you're going to get a basis point, maybe 2, but let's call it a basis point or so of improvement from here for the balance of the year.

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

In the case of International Banking for the past 16 quarters, we have had stable NIM with a variation of plus/minus 10 bps. Q-over-Q, you see our NIM is flat at 4.50%. The year-over-year comparison difference is due to the acquisition of Chile. We have incorporated around $20 billion in assets with lower margin, lower risk, too. But our NIM is flat Q-over-Q, and we expect it to remain at that level of around 4.50% with some variation, plus/minus 10, going forward.

Ebrahim Huseini Poonawala - BofA Merrill Lynch, Research Division - Director

Right. And if I can just follow up very quickly on both those. One, just to clarify, James, the basis point improvement from 1Q level, is that for the rest of the year? Or is it a basis point expansion you expect for every quarter going forward? And to Nacho, what...

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

Well – yes, no, finish your question.

Ebrahim Huseini Poonawala - BofA Merrill Lynch, Research Division - Director

Yes, and just one for Nacho just quickly in terms of the 10 basis points, plus or minus. My understanding is, as we are looking to grow our unsecured consumer book in these markets, where we should see higher yields, so why should margins not actually move higher? Like what's mitigating that?

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

So for Canada, it would be a basis point or so per quarter for the balance of the year.

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

And in international, more of the secured, which is a longer-term impact. The variation of these plus/minus 10 bps is really due to the relative growth of wholesale and retail business.

Operator

We'll go to Mario Mendonca with TD Securities.

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

First then, how would you and this is probably best directed at capital markets. How would you characterize the changes expected in capital markets going forward? Is this like a complete overhaul of the capital markets business? Or are you just sort of retooling things at the edges? And then so following on that, like, what do you really expect this to cost, this retooling or rejigging of capital markets? And when do you think it will be complete? There's a lot there, but I'm trying to understand that business better.

Jake Lawrence - The Bank of Nova Scotia - Co-Group Head of Global Banking & Markets

Okay. Thanks for the question. The repositioning of the business is completed. That had been done over the past few years, whether it was around the metals business, some of our portfolios overseas. We're now focused on growth as we look forward. We've got a lot of strength in the business. It shows up in corporate lending this quarter. What we need to do is broaden out our capabilities in some areas so we can tap into those corporate relationships and better drive fee income as we move forward. We'll see some of that showing up in Q2 and on through the balance of the year. In terms of the costs, we don't expect there to be a material increase. This is a people-based business, and we're going to make investments in our existing people, into new people, and that will drive the better result.

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

Now the increase in the expenses that Rob Sedran referred to, is that essentially just adding a bunch of new people? Or is that, like, comp associated with adding, or like broadening out your capabilities, as you said?

Jake Lawrence - The Bank of Nova Scotia - Co-Group Head of Global Banking & Markets

No, it's not, Mario. A lot of it is project and regulatory related to AML. And as Raj alluded to, we expect that to be winding down over the second half of this year. There is obviously also some seasonality we noted quarter-over-quarter, which won't occur again in Q2. So we're not expecting a big investment required from here. We've got a lot of great pieces in place in our business. We need to get them further aligned, working better together. And we expect that's going to start to deliver improved results beginning in Q2.

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

Okay. And then just finally a quick question for Brian Porter. The pace of change at this bank over the last few years, whether it's 2, 3, 4 years, has been greater than I've seen at any bank, whether it's personnel, acquisitions, divestitures, digital transformation. How do you see it over the next 3 or 4 years? Will the pace of change slow materially going forward?

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

Yes, thank you for the question, Mario. The pace of change will slow. As I said in my comments, that we dealt with our geographic footprint. We were able to dispose of the businesses that we felt were non-core. We're comfortable with the work we've done in terms of aligning our footprint. The acquisitions we did last year were critically important to get scale in Chile, which is a key market. We basically reworked our whole Wealth Management business in Canada, and we're very pleased with the end result. So anything you see from here on in will be what I would classify as tinkering. The major transactions are done and announced. The Thanachart Bank transaction, we're pleased with this. This has been on and off for the better part of 4 years, and it's taken – it's been heavily negotiated. The transaction will probably close late in calendar '19, so Q1 of 2020, if you will. And so we're pleased to have that behind us, and we're focusing on the optionality we have within our footprint and continuing to grow our business.

Operator

Next question comes from Sohrab Movahedi with BMO Capital markets.

Sohrab Movahedi - BMO Capital Markets Equity Research - Analyst

Quickly, Jake or James. Since, I don't know, Q1/14, let's say, quarterly – 20 quarters, there's only been 6 or 7 quarters where the earnings out of capital markets has had a 3 handle on it. You've had lower quarters, but this is amongst the lowest ones. So why would you think; how do you rejig? What do you see the earnings potential, call it, on a quarterly basis out of that segment?

Jake Lawrence - The Bank of Nova Scotia - Co-Group Head of Global Banking & Markets

Thanks, Sohrab, for the question. And yes, the business had largely been focused on not being a volatile contributor to the overall bank earnings. It is driven around our corporate customers and built around those customers. So as we look forward, I'm not going to give you specific quarterly guidance, but we do see a material uptick from here in Q2, and we want to see strengthening over the course of the year. So as I noted in my earlier answer, the repositioning is done. The focus is now on growth, investing to drive a better result. We're about 15% of earnings this quarter. That's not where we want to be as a division. We want to be generating better returns on the capital that our shareholders are providing us, and we view this as the bottom point.

Sohrab Movahedi - BMO Capital Markets Equity Research - Analyst

Okay. And Brian, on the Thanachart, I mean, obviously, there are some earnings that will be disposed of, I assume, if the transaction transpires. Where do you see that earnings kind of being backfilled? And then can you maybe give a bit of a color as to how you see the mix of earnings then 3 years down the road, 2 years down the road between Canada, international and, I guess, GBM and wealth as well?

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

Good question. Thanachart contributes about $250 million of earnings today. The acquisitions we announced last year, so Chile and MD largely along with Jarislowsky-Fraser and the purchase in Colombia, contributed about $300 million of earnings. So there's a nice match there. And this provides us optionality to further invest in our business throughout our footprint in the Americas, whether it's Canada, one of the Pacific Alliance countries or our wealth business. And we like the optionality of the bank. We also have the option of repurchasing shares, which – we like to have that in our toolbox. So there isn't going to be anything that's off strategy here. We're going to be – continue to focus on our operations. The other point I'd make is, and I know that there's concern about technology spend out there, I would go back to the BB&T-SunTrust announcement. And the major impetus for that transaction, as spoken by the 2 CEOs involved, was the investment – the importance of the investment in technology. And that's what we're doing here at this bank. We're focused on the long-term positioning of this franchise. And if you're not investing in technology, if you're not digitizing your bank, if you're not investing in cyber and AML, you're going to be left behind. So that's our primary focus. We're unrelenting on that. We're going to stay very focused, and that's a key point.

Sohrab Movahedi - BMO Capital Markets Equity Research - Analyst

So in international and just, Brian, not to belabour the point, but how do you see the mix of business here? I mean, is the mix of business going to continue to be as is? Or do you see Canada becoming a smaller portion of the overall bank?

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

No, you're not going to see Canada go below 50% of earnings for the bank. We like balance. We like diversification. If something happens in one country, then we've got that balance. And one thing that I think is misunderstood about the bank is that over the last 5 years, we had the least volatility in our quarterly earnings of our peer group. So diversification matters. So we take balance into account. That's why we felt the Wealth Management acquisitions here in Canada were critically important diversification away from RWA, consistent predictability in terms of fee income. That type of thing is very important for us. So that doesn't mean we're not going to invest outside the country, but it's all of about balance.

Operator

We'll next go to Darko Mihelic with RBC Capital Markets.

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

I was looking at Slide 6 where you provided a bit of an integration update, and I wanted to maybe better understand the MD Financial statistics that are on this page. Maybe it's just me and I really have a fundamental misunderstanding of how things work. I would have thought that there would been a great, big welcome package sent out to all the MD Financial physicians and so on. So when I look at these numbers, I see 1,600 cross-referrals and 775 new banking customers. That's on a base of 110,000 clients. So it doesn't look like a big number to me, and I'm wondering, does this is sort of accelerate as you go forward? Is this in fact a slow start or – and I guess the 98% client retention, that means 2% left. That's actually 2,200 clients. It's actually more than what you brought on. So I'm just – maybe you can better conceptualize this for me. And does it sort of speed up over time? And will that have a meaningful impact on the Canadian results for the back half of the year?

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

Sure. Well, Darko, it's James. Let me be very clear here, we couldn't be more pleased with how MD is going so far. We could not be more pleased. The retention is 98.4% based on assets. And to your opening comment, everyone got a welcome package, a great, big welcome package. And there's more to come to be sure. But let me give you a bit of color on what MD accomplished over the quarter. AUM were up in Q1 notwithstanding fairly volatile markets. MD added 7 new strategic partnerships with national medical associations over the course of the quarter. So examples of that would be The Canadian Association of General Surgeons. But let me just take a moment to really kind of re-emphasize our core strategy and why we're confident in this business. MD has been in business now for 50 years. That's an unparalleled 50 years serving the unique needs of the physician community across this country. And the physician community has unique needs. They navigate substantial student debt. They have to transition into practice. They have to run their own businesses. They have to decide whether to incorporate. They have to wind down businesses at the end of their career. This is not the kind of business that is built by anyone overnight. We're going to leverage 50 years of unique experience, plus capital, plus talent. And we're going to take this business to even greater heights, and it's off to an amazing start.

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

I guess the question – and so, does it accelerate it from here? And what is it that you do to accelerate the referrals and the new customers?

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

Absolutely, it accelerates from here. And so where you're going to see the greatest opportunity or where we're going to see the greatest opportunity is in private banking, it'll be in insurance consulting and it'll be in our estate and wills business, which we have already sort of combined with theirs. So this was primarily a wealth management shop. It was doing a great job of managing the investments of physicians. Now we have an opportunity to approach this way more holistically and bring just much, much more to the physician community, and that's well under way.

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

So we apologize that we have run out of time and we won't be able to take any more additional questions given the next bank call is almost at time to start. For the analyst questions we did not get to, we will follow up and give you individual calls to ensure that we answer your questions. Thanks, everybody, for participating in today's call, and see you next quarter. Thanks again.