SCOTIABANK

Q2 2023 EARNINGS CONFERENCE CALL

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Additional information relating to the Bank can be located on the SEDAR website at www.sedar.com and on the EDGAR section of the SEC's website at www.sec.gov.

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John McCartney – The Bank of Nova Scotia – SVP of IR

Good morning, and welcome to Scotiabank's 2023's Second Quarter Results Presentation. My name is John McCartney and I'm Head of Investor Relations here at Scotiabank.

Presenting to you this morning are Scott Thomson, Scotiabank's President and Chief Executive Officer; Raj Viswanathan, our Chief Financial Officer; and Phil Thomas, our Chief Risk Officer.

Following our comments, we'll be glad to take your questions. Also present to take questions are the following Scotiabank executives: Dan Rees from Canadian Banking; Glen Gowland from Global Wealth Management; Francisco Aristeguieta from International Banking; and Jake Lawrence 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 Scott.

Scott Thomson - The Bank of Nova Scotia – President & CEO

Thank you, John, and good morning, everyone. We appreciate you joining us today. Before I begin, I want to take a moment to acknowledge the ongoing impact of the wildfires in Western Canada. The bank has made a donation to the Canadian Red Cross to support the relief efforts, and we have initiatives and branches across Canada to raise additional funds.

I would like to thank our teams for supporting our customers and the communities that have been impacted. As the situation evolves, our top priority is the safety of our employees and ensuring we continue to support customers as they recover from these fires.

Despite the challenging market conditions this quarter, the bank delivered resilient operating performance, reflecting the stability of our business model, while absorbing the impact of elevated funding costs and higher operating expenses.

Our common equity Tier 1 capital ratio strengthened in the quarter to 12.3%. The capital build this quarter brings us above our 12% target sooner than expected, and we will aim to remain at 12% or above until we have more conviction on the macroeconomic outlook and regulatory expectations.

This morning, we also announced a 3% increase to our quarterly dividend, bringing it to $1.06 per share. The bank also made progress in strengthening its liquidity position with deposits outpacing loan growth quarter-over-quarter. Our liquidity coverage ratio was a healthy 131% at quarter end, up from 122% in the prior quarter.

The events in March in the U.S. regional banking sector and in Europe highlighted the stability and security of the Canadian banking system. Throughout our Americas footprint, customer confidence in Scotiabank was reflected through deposit balance stability during this time of dislocation.

Our diversified global business model is a competitive advantage for our business. I was particularly pleased to see the improvement in deposit growth across our platform. Year-over-year deposits increased by 11% or approximately $68 billion, and on a sequential basis, deposits increased by 2%.

Importantly, our overall loan-to-deposit ratio improved modestly quarter-over-quarter driven by improved results in Canadian and International Banking. Deposit growth in Canada accelerated to 11% year-over-year and 3% quarter-over-quarter, outpacing loan growth for the second consecutive quarter. Throughout our international banking footprint, we experienced solid deposit growth above our loan growth on both a year-over-year and quarter-over-quarter basis.

The loan-to-deposit ratio improved by approximately 250 basis points quarter-over-quarter. The credit quality of our loan book continues to be high. Our retail loan portfolio is primarily secured and the corporate lending book is mostly investment grade. However, in light of a more uncertain macroeconomic outlook and given the significant growth in our loan book over the last year, we're taking a more conservative view and increase in our performing loan allowances and thereby building our overall ACL coverage.

Specific to our commercial real estate exposure, we provided additional disclosures related to the composition of the portfolio. Our exposure and recent growth are heavily weighted to the Residential and Industrial segments, which together comprise 75% of the portfolio. The Office segment represents less than 10% of our overall commercial real estate exposure with U.S. exposure at only $300 million.

Looking ahead, although I continue to remain cautious on the outlook for the remainder of the year, there are some encouraging signs that lead us to believe our revenue and pre-tax, pre-provision profit should improve modestly in the coming quarters.

First, the bank's net interest margin modestly improved in Q2, driven by loan repricing in Canada and International Banking, which should continue. Net interest margin in Canadian Banking was up 4 basis points and in International, up 12 basis points with a strong Caribbean contribution, where we are competitively advantaged from a deposit perspective as the lead relationship bank in many of our markets.

Second, with the exception of Canadian mortgages, we expect to see modest quarter-over-quarter loan growth across the bank for the balance of the year.

Finally, on the expense line, we expect quarter-over-quarter growth to be modest. We will continue to be vigilant on expense growth for the remainder of the year. Overall, we believe Q2 will be a low point for our profitability in 2023 with modest improvement going forward.

Lastly, given the increased profitability for rates to remain higher for longer, we have modified our interest rate positioning. Even with this repositioning, we stand to meaningfully benefit from declining rates because of the structure of our balance sheet.

Going forward, our 3 priority areas are focusing on primary customer growth to drive long-term multiproduct profitable relationships, purposely allocating capital to improve our business mix and support profitability, and operate in an efficient and agile fashion to drive both revenues and reduce costs.

I would like to make a few observations on our business performance in the context of these objectives.

First, focusing on customer orientation. This quarter, we completed the national rollout of our Scene+ program in Empire stores with the Quebec rollout in March. Later this summer, we will continue to add to this market-leading loyalty program with the addition of Home Hardware, building off the success of adding Expedia and Rakuten last year.

The deposit growth in the rollout of Scene+ are key components of our strategy to grow primary relationships with our customers in Canada. And so far, the Scene+ program is exceeding our expectations. Scene+ has in excess of 13 million members and climbing with Quebec driving an oversized share of that growth.

Since the national launch began, we've added over 600,000 new Scotia debit and credit card accounts into the Scene+ program. Our data confirms that customers who are Scene+ members are 4x more likely to have 3 or more products with the bank.

Tangerine is now the 6th largest personal deposit bank in Canada with $47 billion in deposits and assets under management of $6.1 billion. Our success to date can be attributed to a strong brand, a market-leading digital customer experience and an unrelenting focus on growing deposits. Given Tangerine's limited overlap with Scotiabank's customer base, this franchise presents a great opportunity for us to win market share and grow our presence in the Canadian market with a digital-first approach.

In International Banking, we continue to focus on priority customer segments strengthening digital and improving customer experience to drive customer primacy and long-term deposit growth. Digital remains instrumental in driving our customer engagement with digital sales reaching almost 70% in the quarter. We have seen improvements in customer experience metrics across all of our international markets.

GBM continues to build capabilities in order to provide a growing product suite to clients. To further capitalize on the growing private capital space, we recently announced the hiring of a U.S.-based private credit structuring, syndication and sales team.

In addition, our domestic Canadian ECM and DCM businesses have moved to leading market share positions in recent quarters. Our U.S. DCM business continues to gain share. And in the Pacific Alliance countries, we ranked 2nd year-to-date in the DCM league tables.

Our global wealth business continues to execute on the total wealth strategy, bringing fully integrated solutions to our high net worth clients. The business was recognized by Global Finance as the Best Private Bank for net worth between $1 million and $25 million and by Euromoney as the Best Domestic Private Bank in Canada.

Encouragingly, the International wealth business continues to grow at double-digit rates with 19% growth year-over-year. In short, Q2 was a period of progress on client franchise initiatives already underway.

The second objective, purposely allocating capital to improve our business mix and support profitability. We continue to build more discipline in our approach to capital allocation, and we are viewing this through an enterprise-wide lens. We will prioritize relationships where we can provide value beyond just the balance sheet. I was encouraged to see the improvement in multiproduct relationships in Canada during the quarter and pleased to see the discipline around client prioritization in our GBM business.

And finally, operational excellence. As part of my objective to drive operational excellence throughout the bank, I remain committed to disciplined cost management. Strong expense management has long been an important hallmark of the bank's culture. It is notable this quarter that our expenses grew much faster than our revenues. I was encouraged to see the deceleration of expense growth on a sequential basis in our Canadian and GBM franchises. But as a management team, we recognize the need to deliver positive operating leverage over time.

By focusing on these strategic priorities, we'll be a more efficient and more profitable bank. Before concluding, I wanted to make a comment on our recent leadership announcement. I am thrilled to welcome Francisco Aristeguieta as our Head of International Banking. Francisco joins us with a career of experience in highly successful leadership roles in global banks and brings significant operating experience throughout our international footprint. Francisco officially joined the bank earlier this month and is with us here today on the call. Welcome, Francisco.

I will now turn the call over to Raj for a more detailed presentation on the financial results.

Rajagopal Viswanathan - The Bank of Nova Scotia - Group Head & CFO

Thank you, Scott, and good morning, everyone. All my comments that follow will be on an adjusted basis for the usual acquisition-related costs.

I'll begin with a review of the performance of the quarter on Slide 5.

The bank reported quarterly adjusted earnings of $2.2 billion and diluted earnings per share of $1.70. The return on equity was 12.4%. All banks pre-tax pre-provision profit decreased 11% year-over-year, driven mainly by higher expenses relating to personnel costs and relating to business development initiatives.

Net interest income was in line as growth in mortgages and business banking balances as well as the benefit from foreign exchange was offset by margin compression due to a significant increase in cost of funds year-over-year. Net interest margin declined 10 basis points year-over-year, mostly from higher funding costs.

Quarter-over-quarter, net interest margin improved by 2 basis points from higher margins in both International Banking and Canadian Banking that expanded 12 basis points and 4 basis points, respectively.

Non-interest income was $3.5 billion in Q2, in line with last year as higher banking revenues and other fee and commission were offset by lower wealth management revenues, which were down 4%.

The PCL ratio was 37 basis points for the quarter. The performing PCL ratio was 4 basis points as the bank continues to prudently build allowances reflecting the uncertain macroeconomic environment.

Expenses increased by 10% year-over-year or 7% excluding the unfavorable impact of foreign currency translation, reflecting the continued investment for business growth and inflationary impact across most expense categories.

Quarter-over-quarter expenses were up 2.5% or a modest 1.3% excluding the impact of unfavorable foreign exchange. The productivity ratio was 57.5% this quarter, resulting in a year-to-date negative operating leverage of 8.5%.

The effective tax rate for the bank was 18.4% this quarter compared to 22.9% a year ago, driven by higher income from lower tax rate jurisdictions and higher tax exempt income in the quarter.

Slide 6 provides an evolution of the common equity Tier 1 ratio over the quarter as well as the quarter's changes in risk-weighted assets. The bank reported a common equity Tier 1 ratio of 12.3%, an increase of approximately 80 basis points quarter-over-quarter. The ratio benefited from the adoption of revised Basel III requirements by 56 basis points.

Net internal capital generation was strong at 14 basis points, while the recently introduced dividend reinvestment plan contributed 9 basis points. Risk-weighted assets declined $20 billion during the quarter. The adoption of revised Basel III requirements reduced the pre-floor risk-weighted assets by approximately $31.7 billion. That was partly offset by the floor add-on of $5.1 billion, resulting in a net reduction of $26.6 billion, mostly related to non-retail credit risk due to the elimination of the scalar and adoption of the foundational approach.

During the quarter, risk-weighted assets grew $1.4 billion, excluding FX, mostly in market risk. In addition, the bank's liquidity coverage ratio improved 9% to 131% this quarter.

Turning now to the business line results, beginning on Slide 7. Canadian Banking reported earnings of $1.1 billion, a decrease of 10% year-over-year due to higher provision for credit losses and higher non-interest expenses. Pre-tax, pre-provision profit grew 6% year-over-year, driven by strong revenue growth of 8%.

Net interest income increased 9% year-over-year as loans grew 6%, while deposits grew a strong 11%, supporting year-over-year margin expansion of 8 basis points. Loan margin expansion resulted in the margin expanding by 4 basis points quarter-over-quarter. Loan growth was 6% year-over-year as mortgages grew a modest 3%. Business loans grew 18%; automotive, 8%; credit card, 16%; and personal, loans 6%, all higher-yielding portfolios.

Quarter-over-quarter, average loans were in line with Q1 as the decline in mortgage balances offset growth in other higher-yielding loan categories. Average deposits grew a strong 11% year-over-year, driven by a 15% increase in personal deposits and a 5% increase in non-personal deposits, reflecting the strategic focus of the business.

The loan-to-deposit ratio improved to 132%. Non-interest income increased by 5% year-over-year, driven by higher private equity gains and higher insurance revenue. Expenses increased 10% year-over-year, driven by higher personnel and advertising and business development costs as the business continues to invest in growth areas.

Expenses were up a modest 1% quarter-over-quarter, largely due to higher personnel costs. The PCL ratio was 20 basis points, a slight increase of 1 basis point quarter-over-quarter.

Turning now to Global Wealth Management on Slide 8. Earnings of $359 million declined 13% year-over-year, primarily due to the Canadian Wealth being down 17%, while International Wealth earnings grew a strong 19%. Revenue declined 4% year-over-year due primarily to lower mutual fund and brokerage revenues, partially offset by strong private banking loan growth and higher deposit margins across our Canadian and International businesses.

Expenses were up a modest 2% year-over-year and quarter-over-quarter, relating to sales force expansion and technology investments offset by strong expense controls despite the inflationary environment. Assets under management increased 1% year-over-year to $330 billion, driven by market appreciation, while assets under administration increased 5% to $624 billion as a result of higher net sales and market appreciation.

The bank maintained its #2 ranking in investment funds in Canada. Strong international wealth results were driven by higher net interest income and business volume growth across the Pacific Alliance and the Caribbean.

Turning to Slide 9, Global Banking and Markets. Global Banking and Markets generated earnings of $401 million, down 18% compared to the prior year. While revenues grew 7%, earnings were impacted by higher operating expenses and increased performing provision for

credit losses. Solid business banking performance was supported by loan growth of 29% and primarily in Canada and the United States, while average deposits grew 11%. Capital Markets revenue was in line with last year.

Net interest income grew 7% year-over-year as a result of the strong loan and deposit growth and the positive impact of foreign currency translation. Non-interest income also grew 7% year-over-year, primarily due to higher fee income owned and fixed income and prime services businesses while trading income was lower.

Expenses were down 3% quarter-over-quarter, mainly from lower performance-based compensation and the shorter quarter. On a year-over-year basis, expenses were up 15% due mainly to higher personnel costs and technology investments, both related to the business growth and the negative impact of foreign currency translation. The provision for credit losses was $53 million, almost all relating to performing loans.

GBM Latin America, which is reported as part of International Banking, had another strong quarter, reporting earnings of $276 million, up 49%year-over-year driven by good performance in Mexico, Chile and Brazil

Moving to Slide 10 for the review of International Banking results. My comments that follow are on an adjusted and constant dollar basis. The segment reported net income of $650 million, in line with last year. Pre-tax, pre-provision profit grew 6% with the Caribbean and Central America are up a strong 27%. Revenue was up 8% year-over-year, driven by good loan growth, higher net interest margin and strong capital markets revenues. Year-over-year, loans grew 9% with mortgages up 12% and business banking up 8%, while personal loans and credit cards grew 8% as well.

Deposits grew a strong 10% year-over-year and 2% quarter-over-quarter that reduced the loan-to-debt ratio by approximately 250 basis points. Compared to the last quarter, net interest margin was up a strong 12 basis points with net interest margin expanding in the Caribbean and Central America and Pacific Alliance countries by 32 basis points and 14 basis points, respectively.

We expect the margin to remain at or slightly above these levels for the rest of the year. The provision for credit losses was $436 million, up from $422 million last quarter. On a quarter-over-quarter basis, expenses were down 1% due to lower business taxes, partly offset by higher personnel costs.

On a year-over-year basis, non-interest expenses were up 9%, driven mainly by the inflationary impacts on compensation, offset by the benefits of efficiency initiatives. The tax rate of 20.7% for the quarter increased from 19.6% in the prior quarter due to lower inflationary adjustments in Mexico and Chile. We expect the tax rate to continue to increase in line with reduction in inflation.

Turning to Slide 11. The Other segment reported an adjusted net loss attributable to equity holders of $323 million in line with the previous quarter. Quarter-over-quarter, net interest income was impacted by higher funding costs due to the full quarter impact of previous rate increases, partly offset by better returns on high-quality liquid assets. Non-interest income benefited from higher investment gains and income from associated corporations.

I'll now turn the call over to Phil to discuss risk.

Philip M. Thomas - The Bank of Nova Scotia - Chief Risk Officer

Thanks, Raj, and good morning, everyone. The bank's balance sheet continues to be well diversified across business lines, customer segments and geographies. As we adapt to the evolving landscape, we remain proactive in building our allowances. As such, our PCL this quarter was $709 million or 37 basis points, including performing PCL of $88 million or 4 basis points.

The higher provisions quarter-over-quarter is due to a more unfavorable macroeconomic outlook and provisioning scenarios that reflect more pessimistic GDP forecasts in our key markets compared to the prior quarter. This is driven by our assumptions around the following potential headwinds, increased risk of a recession and a potentially more challenging credit cycle, sustained, elevated inflation causing a higher for longer rate environment, which may impact retail consumers and commercial operating budgets.

While the quality of our book and our risk appetite remains stable, the recent market turmoil in the U.S. has added an element of financial uncertainty.

Starting with our Canadian retail portfolio. Customer delinquency of 20 basis points in the quarter remained stable, within expectations and well below pre-pandemic delinquency of approximately 30 basis points.

Our Canadian mortgage book remains solid with stable performance despite 36% of balances being from our variable rate portfolio. As you would recall, our variable rate mortgages repriced with monthly payment increases tied to policy rate changes. This gives us confidence in understanding our customers' ability to stay current with mortgage payments while maintaining the contractual amortization period. Our variable rate portfolio continues to be of high credit quality with customers' FICO scores of approximately 800.

We continuously monitor deposit balances of these customers, which, on average, remain higher than our fixed rate portfolio. Our customers are managing through this period of heightened interest rates by making trade-offs. For example, discretionary spending such as retail spending entertainment is down 10% year-over-year for our variable rate customers. The strong performance of our Canadian mortgage portfolio is reflective of our customers' prudent financial management as they navigate higher rate environments.

Moving to International retail. The total international retail banking 90-plus day delinquency rate of 2.56% has increased modestly by 4 basis points quarter-over-quarter. However, it is still below pre-pandemic levels of 3.22%.

International Banking maintained its focus on driving secured growth with balances remaining at 73% of the portfolio, up from 65% pre-pandemic. We continue to leverage our data analytics and collections practices to proactively manage through the credit cycle. Specifically in Chile and Colombia, we are working with our customers as unsecured delinquencies continue their upward trend, as budgets -- as customer budgets are strained due to sustained inflation.

Turning to business banking. The underlying portfolio continues to perform well. Our direct exposure to U.S. regional banks is immaterial. And our well-diversified business lines, customer segments and geographies, give us confidence in our balance sheet and liquidity positions.

With respect to commercial real estate, our exposure was $67 billion as of Q2. And of this, Office represents approximately 10% and 2/3 of the portfolio is Investment grade. The bank's real estate portfolio is strong with 75% of our exposure being Residential and Industrial. These exposures are primarily with top-tier developers where we have long-standing relationships. We remain comfortable with our business banking portfolio, but remain prudent based on forward-looking macroeconomic indicators.

Moving to Slide 13. We saw modest increases in gross impaired loans in Canadian Banking and International Banking with slight improvements in GBM. Overall, loans were marginally higher at 67 basis points this quarter. In Canada, the new formations were mainly in prime auto and commercial.

Overall, the Canadian Banking's 30-day and 90-day delinquency rates continue to trend up modestly. In International, gross impaired loans were up $139 million quarter-over-quarter as a result of foreign exchange and higher retail formations primarily in the Pacific Alliance region.

Moving to Slide 14. PCLs in Q2 were $709 million or 37 basis points. In Canadian Banking, total PCLs were stable this quarter at $280 million, translating to a PCL ratio of 20 basis points. In International Banking, PCLs increased moderately to $436 million, primarily a result of higher delinquencies and a challenging market conditions in Chile and in Colombia.

International commercial remained stable quarter-over-quarter. This translated into an international banking PCL ratio of 103 basis points. While credit quality in GBM is solid, given the potential headwinds and sizable asset growth the business has achieved over the past year, we attributed approximately 2 basis points of the build to this quarter to GBM, all in Stage 1 ACL. This adjustment will offer greater stability in the medium term.

From a balance sheet perspective, the bank's Q2 ACL ratio was 75 basis points or $5.9 billion, up 3 basis points quarter-over-quarter. Similar to Q1, we continue to build performing allowances this quarter, and we expect this trend to continue for the remainder of the year.

In closing, given the current economic outlook, we expect PCLs to remain elevated for the remainder of the year. We believe in the strength of our balance sheet, which will offer stability in the medium term. We continue to be cognizant of the current operating environment, but are comfortable with how we have positioned our book to perform through economic cycles.

With that, I will pass it back to John.

John McCartney – The Bank of Nova Scotia – SVP of IR

Thank you, Phil. We'll now be pleased to take your questions. Operator, and we have the first question on the phone, please.

QUESTIONS AND ANSWERS

Operator

Our first question is from Ebrahim Poonawala from Bank of America.

Ebrahim Poonawala - BofA Securities, Research Division - MD of United States Equity Research & Head of North American Banks Research

Good morning. So I guess, maybe just for the 1 question on capital. So Raj, maybe for you, maybe Scott wants to add anything. But one, the impact from Basel III adoption was greater than you expected last quarter. What drove that?

And then talk to us the feedback from a phase-in over the next few years, how you think about the 56 basis points reverses itself over time? And second, you still have, I believe, the [grip] all. Do you end that now? And then just talk to us in terms of the appetite to buy back stock in the near term. I know Scott mentioned once, only be about 12% CET1. You're at 12.3%. I'm just wondering does this CET1 ratio drift higher? Or what your expectations are as we move into the back half of the year?

Rajagopal Viswanathan - The Bank of Nova Scotia - Group Head & CFO

Sure, Ebrahim. Thanks for your question. I'll start on the Basel implementation benefit and how we think it will progress, and then I'll pass it over to Scott to talk about drift and buybacks and those kind of things.

The 56 basis points benefit was slightly higher than what we thought. We had indicated 20 basis points to 30 basis points on the previous call. Part of it was there's lots of data changes that is going through as part of the implementation of Basel III. And some of it I thought would not be implemented in time for this quarter, we obviously got it done earlier. So that benefit is higher basically because of that, which would have anyway flowed through likely in Q3 or Q4. So it's pure timing more than anything else.

On the specifics of the 56 basis points benefit, Ebrahim, I probably categorize it in 3 particular markets when we -- and you can see all of it in our regulatory capital disclosure. So one is Basel III previously had a 6% scale out on all ARB exposures through Basel III, the reforms implementation. They've eliminated the scalar. That's about $14 billion of RWA benefit. So that's going to stay, right? So that's not going to reverse at all.

The second thing I would say is there is a requirement to adopt what we call the foundational IRB approach for certain exposures, specifically in the non-retail book, and that results in a couple of benefits for us. It requires us to put up lower LGDs, and it also requires us to have lower credit conversion factors. So that's going to stay, too. That's not the worst thing.

The third one is operational risk-weighted assets. We had a $2 billion RWA benefit. You can see it on Page 18, the sub-pack, all these disclosures. And that is obviously dependent on operational risk and how it's calculated in the future, smaller benefit that can move one way or the other, it could get better. It could get worse depending on the operational loss experience of the bank.

Looking forward, and if you notice it on Page 17 in the sub-pack, you will see that the banks was actually impacted by the floor, as it is this quarter, roughly $8 billion benefit -- sorry, impact, which I referred to in my prepared remarks as well. Now that floor is going to increase 2.5% every year, we know. It's going to -- first one will come through November '23, likewise November '24 and so on, in line with [Basel III] implementation plans.

So that floor will bring down our capital as of November 1, 2023, depending on where we land in October '23. The second thing which will happen in November '23 is the fundamental review of the trading book implementation, which will impact our market risk and counter-party credit risk capital, the trading businesses. I don't have an estimate for you, but I know directionally that it will take down the capital ratio on November 1, depending on what it would be.

We'll probably talk about it more closely in the Q4 call. So that's where I think this will go. And what I will tell you is, considering all this, including the internal capital generation, which you have seen this quarter, which I think will continue to contribute positively, the capital ratio will grow for the remainder of this year from $12.3 million. And we believe even in 2024, we will remain about 12%, which is what Scott had talked about as our intention at this point in time.

Scott, do you want to talk about that?

Scott Thomson - The Bank of Nova Scotia – President & CEO

Yes, a couple of things. So Ebrahim, I mean, I was pleased with the capital generation this quarter, and I think it puts us in good stead as we go through the end of the year in 2024. I do think there's a lot of uncertainty out there from a macro perspective and then also from what OCC is going to do. And so that would keep us inclined to stay around these levels of 12%, as Raj has highlighted. It doesn't feel good to have the drip on in raising equity at these levels. So that's not something that we would continue to do over time once we get some certainty. And from a share buyback perspective, that's not in the cards. So hopefully, that answers your questions.

Ebrahim Poonawala - BofA Securities, Research Division - MD of United States Equity Research & Head of North American Banks Research

And just on that, Scott, in terms of what the OCC is going to do, is implied within there that you think that there might be a chance that they increase the ESC buffer again later this year?

Scott Thomson - The Bank of Nova Scotia – President & CEO

I don't know, Ebrahim, honestly. I think there -- we'll wait to see in June. And that's another reason to run at a little bit higher capital levels right now until we get some certainty on that front.

Operator

The following question is from Gabriel Dechaine from National Bank Financial.

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

A couple of questions here. One, the NII drag in corporate keeps getting bigger, and it sounds like you took some actions this quarter to maybe mollify that a little bit in the coming quarters? And if you can maybe walk me through that. And then on expenses, we've had back-to-back quarters of big expense growth, pretty atypical from Scotia. I'm just wondering, as the bank -- I don't know what you're calling it, but

you're engaging in some sort of transformation plan or strategic direction. Should we expect these expenses -- this type of expense growth to continue as you may need to invest in how you want the bank to look and perform in the future?

Rajagopal Viswanathan - The Bank of Nova Scotia - Group Head & CFO

I'll start, Gabe, and Scott might have a thought on expenses as we look forward. As far as the interest rate NII, what you're seeing in the other segment is simply the increase in the term funding cost. There was administrated rate increases last quarter. You've seen the full quarter impact of it.

So a few moving parts, NII. Term funding cost was definitely a headwind quarter-over-quarter. The returns from what we call high-quality liquid assets, where the liquidity purpose was actually a tailwind because we're learning more on those liquid assets. And then the hedges are frankly neutral.

What we did during the quarter, yes, we reduced the sensitivity to approximately $50 million. You can see in the 100 basis points increase in the sensitivity that we disclosed because we now believe that rates are likely to remain higher for longer. So with inflation being elevated, and all we did was adjusted the risk profile of the bank accordingly. So it sets us up more towards being neutral to the rate curve movements and avoiding any negative NII impact due to short-term rate increases. So that's what we are positioned from an interest rate risk perspective. And typically, this shows up in the other segment like you pointed out.

As far as expenses goes, great, I think what you're seeing is the inflation impact year-over-year. I think I talked about excluding FX, it's a little over 7%. It is high for this bank, as you point out. A lot of it comes back to all the increases, the base salary increases that we have had across the footprint. Along with other banks, we did interim increases last year, and then there is the annual increase. The full quarter impact what you see in Q2 because these things go into effect in January. And that's the general impact of inflation on all expense lines. So that's what you're seeing year-over-year.

Quarter-over-quarter, what we should expect to see going forward is a modest growth in the expense line in absolute terms. Low single digits is probably a good number to start with from our perspective, and that's what we are targeting. We try to manage expenses as prudently as possible. We prioritize, and we try to manage it in line with the income or revenue growth. This will be one of those years where inflation has an outside impact, not just in Canada. You got to remember, in the International Banking, we operate in a highly inflationary environment.

And there, having 9% growth year-over-year I think is very credible considering the level of inflation. And quarter-over-quarter, the expense in IB is actually lower by 1%. So a lot of good things, but definitely challenges from an expense perspective. Not to say that we don't try to manage it as best as we can, but some inflation-related impacts are tough to manage.

Scott Thomson - The Bank of Nova Scotia – President & CEO

Yes, just a couple of comments to add on. I mean, I think the expense growth is -- we would all recognize it's too high relative to the revenue growth. I think the encouraging things, as Raj said, the deceleration quarter-over-quarter, which is encouraging. We'll try to keep a control of expenses going forward. As you think about the strategic refresh I wouldn't necessarily assume that results in higher expense levels. I think there will be areas that we'll want to invest in, but there will also be areas that we won't invest in as much.

And so I think this management team recognizes over the medium term, we need to get the positive operating leverage, and that will continue to be a hallmark of the bank and what we try to do going forward.

Operator

The next question is from Paul Holden from CIBC.

Paul David Holden - CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research

So with respect to the change in your macro views for the higher rates for longer and more persistent inflation. You've addressed the implications for NIM on that. I mean, talk a little bit about your PCL expectations. But maybe you can just tie it all together, like what does that change in macro view mean more probably for some things like loan growth, again, for your view on non-credit or some other items maybe we haven't talked about. Just wondering what's changing in terms of your plan, I guess, overall would that change macro view?

Rajagopal Viswanathan - The Bank of Nova Scotia - Group Head & CFO

Sure, Paul. It's Raj. I'll start. I think as far as loan growth is concerned, Canadian Bank, International Bank, we know that sequentially quarter-over-quarter, there will be modest loan growth.

Now with the exception like perhaps on the Canadian mortgage book, which we think will be around the levels you have seen now, it all depends on how the housing market evolves, rate situation, those kind of things as much as we can forecast over here. So that should be a reasonable loan growth quarter-over-quarter across both these businesses.

GBM will likely be in line with what you've seen in the loan balances this quarter. Where I think the uplift will come in the NII line is, as you saw this quarter, you're going to see margin expansion modestly, but certainly margin expanding as assets reprice and our funding costs remain fairly stable, as I talked about a little earlier in my prepared remarks. So that's how we see the macro impacting our NII line and benefiting through the expansion in NIM with loan growth being reasonably modest.

From a PCL perspective, I think Phil indicated talking about slightly elevated PCL ratio on the 37 basis points what you saw this quarter compared to an earlier out where we told you it must be mid 30s, and that relates mostly to how we want to build our performing loans allowances across the various books that we have. Phil, you might want to comment about it?

But the expense question I addressed. Hopefully, that helps you with how we think about the macro and the impact on our expense line for the bank. Phil?

Philip M. Thomas - The Bank of Nova Scotia - Chief Risk Officer

Thanks, Raj. We -- as we look at our PCLs, we are expecting to be elevated for the remainder of the year, as I said in my prepared remarks, and we're going to be focused on building, particularly on performing allowances.

If I look at the underlying portfolios, though, we've got no indications of falling angels in GBM. I'm very confident on the business that Dan is running in Canadian banking. In fact -- and if you look at that business, we actually are seeing pay down rates on credit cards continuing to be higher than pre-pandemic levels. FICO scores continue to be higher than pre-pandemic levels, and our customers are weathering the increased interest rates quite well.

So I look at International Banking, I'm very confident in terms of the lending we've been doing in Mexico, Peru and the Caribbean. The strategy that we put in place there is working. But I'm very mindful of the sort of pockets of weakness, particularly in Colombia and in Chile. We have those 2 markets that are in recession, and we're building allowances accordingly and we're bringing the full weight of the bank's collection activities and data and analytics work to those markets today. So that would be sort of my summary from a credit perspective.

Operator

Our following question is from Darko Mihelic from RBC Capital Markets.

Darko Mihelic - RBC Capital Markets, Research Division - MD & Equity Analyst

Phil, I appreciate the details on some of the credit, all the metrics you mentioned. I wanted to just talk a little bit or just dig into a little bit more the variable rate mortgage portfolio. And I'm not interested in averages. I'm actually more interested in a cohort or a vintage where they may have originally underwritten the mortgage with, say, a 2% rate or lower.

And I want to understand how that group of customers is performing with presumably much higher rate and much higher payment. So I wonder if you can dig into that vintage or that cohort, how are they coping and how you think they will cope if rates stay higher for longer? And are you currently deferring payments or giving them some holidays to help them cope?

Philip M. Thomas - The Bank of Nova Scotia - Chief Risk Officer

It's a good question and I appreciate it. Thanks, Darko. So if we look at that cohort and those customers have had a payment increase given interest rates of about 46%. And so we have to be mindful about how those customers are sort of weathering these increases. And I think one of the great things about our portfolio is we see it upfront, and we haven't -- we have probably the lowest amortization, not probably, we do have the lowest amortization rates on the Street.

So right now, what we've been seeing through the cycle is our customers had a very large payment buffer coming out of the pandemic. They have been drawing down on that payment buffer. They still have more deposits in their account than they did pre-pandemic, but we're starting to see those deposits run off as payment levels increase.

One of the things that's interesting as we dig into the data behind how these customers are performing. I touched on it in my prepared remarks. But we are seeing them make trade-offs. So the spend patterns, particularly for variable rate customers, have changed, and they're making decisions on not spending money on discretionary spending or discretionary retail spending like entertainment, as an example.

And so we're seeing customers. The interesting paradigm, we're seeing customers making choices as they're moving through the cycle. As a risk manager, the area that I focus most on is our tail risk. And at this point, we haven't seen major increases in tail risk in these portfolios.

And if I look at Taylor, just to give you a sense, we have about 950,000 mortgage customers in the bank. And I'm looking at maybe around probably a little bit less than 2,000 customers, just to give you some perspective over our entire mortgage book. And with these customers, we're looking at treatments like pre-delinquency activities through our collection center and our branches. We're looking at how we can leverage machine learning to identify consumer behaviors, to identify customers before they go delinquent. And all of these things are being -- working hand-in-hand with Dan Rees and his team as well as the -- as our collections and operations team.

So there's a really good monitoring in progress on these customers, and we're just trying to be as proactive as possible. But again, if you look, we're still -- our delinquency rates in these books are still below pre-pandemic. But we are going to work with customers. If we see further stress in the portfolio, we'll be proactive in helping us to manage that.

Darko Mihelic - RBC Capital Markets, Research Division - MD & Equity Analyst

Okay. So there are deferrals happening? And do you have any statistics on that?

Philip M. Thomas - The Bank of Nova Scotia - Chief Risk Officer

No, we're not doing deferrals. No, no.

Operator

Our following question is from John Aiken from Barclays.

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

Scott, I think that the market is anxiously waiting the update on your strategic outlook and even if it's not the market, I know that I am. I know that you're not likely to give us any state secrets on this call. But do you -- are you able to give us a timeline as to when you may have been able to wrap up your strategic overview and give us some idea in terms of what your thoughts are moving forward?

Scott Thomson - The Bank of Nova Scotia – President & CEO

Sure. Yes. Thanks, John, and we'll come back to the market by the end of the calendar year with some more insights. But I think even this quarter, you're starting to see some of the things that I said in January start to play out, right? I mean, strengthening the foundation here on capital and liquidity to give us some optionality, improved profitability from a NIM perspective, repositioning the balance sheet in terms of interest rate positioning.

I mean, I think these are all consistent with what I talked about in January. Even through my comments today, you heard me talk about capital-light businesses in wealth. And you see the International Wealth business up 19%. You heard me talk about Tangerine. Here's an asset that is a fantastic asset that we need to accelerate. Talking here in my comments around Scene, right, in terms of areas in Canada where we're underpenetrated, but making progress.

And then in some of the segments like Jake's business and advisory. I think the improvements in our DCM and ECM positioning over the last 3, 6, 9 months has been really impressive. So you'll hear more. But I think through my comments and through our performance, you're starting to see some of the actions that you can expect going forward.

Operator

The following question is from Mario Mendonca from TD Securities.

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

I took notice of that meaningful increase in the liquidity coverage ratio. It's clear the bank is, as you said, Scott, is building up liquidity and maybe changing the funding profile a little bit. What I want to get at now is, is this a lasting change, this increase in liquidity coverage ratio? Or is it mostly just a reaction to what happened in -- with U.S. regional banks and you can sort of drift back down to something lower in the near term?

And a related question is, do you expect any changes from regulators around the world as it relates to liquidity requirements and funding requirements?

Rajagopal Viswanathan - The Bank of Nova Scotia - Group Head & CFO

Great. Thanks, Mario. Listen, I think the U.S. dislocation was meaningful for all of us. I think the Canadian banks did really well through that period. I think the fact that we had deposit stability and actually deposit inflow should give us all comfort about our diversified business model.

I think it also highlights, though, the importance of running capital kind of at similar levels to where we are and a little bit more heightened liquidity, and that's why we took the liquidity from $121 million to $130 million. I think those liquidity levels are actually pretty relevant for us. I think that's the kind of liquidity levels that we should be running at going forward. So I don't think you'd see us going back to the 120 level and 130 is appropriate. And we can adjust over time once we get more clarity on the macro and the regulatory environment.

So I actually think there was some -- obviously, we're on a journey. The results weren't exactly as we'd like them from a P&L perspective, revenues and expenses. But I think there was a lot of progress in this quarter when you look at capital, when you look at liquidity, when you look at interest rate positioning, and when you look at profitability. So I actually was pleased with the progress this quarter, recognizing more work to do.

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

Do you think the regulators are going to have a say in this in the next little while?

Rajagopal Viswanathan - The Bank of Nova Scotia - Group Head & CFO

So, I think in the U.S. right now, there's a lot of discussions. I'm not sure it's exactly clear, but increased regulation, particularly in that regional banking sector, is probably part of the equation. And I suspect higher capital levels and liquidity will be front and center for people.

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

Okay. And then sorry, a different question. You talked about -- I think it was Phil, you talked about wanting to be a little more proactive in building outperforming loan reserves. I'm trying to understand what that means.

In any given quarter, 4 or 5 basis points to me is just your normal level. It's consistent with the overall balance sheet growth. So when you say you want to start building performing loan reserves, are you talking about something north of that basic 4 to 5 basis points?

Philip M. Thomas - The Bank of Nova Scotia - Chief Risk Officer

No, no. That -- we usually run at around 1 to 2 basis points increasing. And so what we're talking about is getting that more to the sort of 4 to 4-ish every quarter. But again, I mean, listen, we want to be guided by what the macro is telling us. And so I don't want to commit to a certain percentage build every quarter. We'll watch to see how the how the economy performs. We've already made some changes to our macroeconomic scenarios to reflect some more pessimism. But that's -- nothing is more substantial than what we're already putting forward this quarter.

Operator

The following question is from Doug Young from Desjardin Capital Markets.

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

On International Banking NIM, 4.2%. I think, Raj, you talked a bit about more upside from here. Just wanted to get a little bit more color of what drives that? And then maybe attached to this in International Banking, Colombia continues to struggle when we look at the underlying results. I mean what are the issues there? What are you doing to address these? And any discussions with the other entity that owns a good chunk of that around the put option on the Colombia business?

Rajagopal Viswanathan - The Bank of Nova Scotia - Group Head & CFO

Sure. I think I'll talk on the NIM, and I'll probably pass it on to Francisco to talk about Colombia and at least it's early thoughts on what we're doing from there.

The net interest margin of International Banking, as I said before, has got too many moving parts out, right? A lot of it changes because of inflation. We have so many countries. Each one has a different rate situation depending on how we are positioned as well, for example,

some we benefit by declining rates. Balance sheet positioning. Well, in the Caribbean, we benefit from increasing rates. So lots of puts and takes over there.

What I think, I would say, with a reasonable confidence is the 412 basis points is a really good number for us across that footprint. And we think there will be some modest expansion. I don't think it's going to be 12 basis points quarter-over-quarter. That much I can say with certainty looking forward. But it's something that will be around these levels for the remainder of this year, and then we'll see how the rate situation evolves. On Colombia, Francisco?

Francisco Alberto Aristeguieta Silva - The Bank of Nova Scotia - Group Head of International Banking

Let me, first and foremost, welcome everybody to the call. Thank you for joining, and I look forward to meeting you in person soon.

It's been just a few weeks since I joined the organization. But during that time, I've traveled extensively to all the important markets where we have a presence, including Colombia. Colombia is a market I know well. I operate there personally over 3 years. So I know the country well and have Colombia as a matter of fact. I don't know if that counts for anything, but that's fact.

And I was there recently. The view that I have on who we are in Colombia is, first and foremost, we have scale. We have an MVL brand and an MVO client base, and we're recognized in the market as a strong player. So we have a strong foundation to build upon. I was able to review the plan that we have in place is a recently built plan to turn around the operation. And it's a sound plan and a plan that I will continue to review and adjust as I see and track performance.

I also had the opportunity to meet with our partners in Colombia, who I know well from my time there. And they have the full support of the plan and the management team, and we've made recent changes to the management team in Colombia. So we have to see that plan through. I'm confident that we're going to execute it well. And over time, we'll keep updating this group in terms of our performance.

Scott Thomson - The Bank of Nova Scotia – President & CEO

And just one, this is Scott. Just one thing on the put. The put window that we've gone through that. So there's no ability of our partner to exercise that put for another 2 years. So we'll work closely arm-in-arm with our partner to improve the performance of Colombia, recognizing the current performance is not acceptable.

Operator

Our last question is from Sohrab Movahedi from BMO Capital Markets.

Sohrab Movahedi - BMO Capital Markets Equity Research - Banks Analyst

Okay. Maybe just for clarification, Raj, I think you covered quite a bit of it. But so when you put it all together in the corporate segment with some of the repositioning, do you expect the drag to lessen in the coming quarters and into next year? Or are we still in this $250 million to $300 million per quarter range?

Rajagopal Viswanathan - The Bank of Nova Scotia - Group Head & CFO

Yes. I think directionally, you saw some improvement this quarter, Sohrab, as we had indicated, we thought it would be likely in line with last quarter or maybe even higher I thought the loss might be. It came in better simply because of all the actions. Some of the investment gains we took as well, which you know is not predictable really.

I would say, for the rest of this year, I won't get into 2024 because the rate situation has such a big impact on the other segment results. I think somewhere around these levels, maybe a little better than this as we see the interest rate situation evolve today, I think will likely be the way it is going to be. I don't think it will get down meaningfully for the remainder of this year, but that might be a different story in 2024, which we can talk about at the end of the year.

Sohrab Movahedi - BMO Capital Markets Equity Research - Banks Analyst

Okay. And very quickly, just when I look at the capital situation, obviously, lots of good news on the numerator in particular. But when you look at the RWA growth, obviously, that was also a tailwind. That's a very kind of very minimal overall RWA growth. Where do you think that RWA growth is going to be, Raj, given all the excellent business plans that the business has put in front of you over the next, I don't know, 4 quarters?

Rajagopal Viswanathan - The Bank of Nova Scotia - Group Head & CFO

I'll answer over the next 2 quarters, which is probably a little more certain as we think about the macroeconomic environment. I think you talked about loan growth being modest quarter-over-quarter improvements with the exception of perhaps the Canadian mortgage book. And that's a modest growth compared to some of the growth we saw, for example, in 2022, Sohrab. So there's going to be strong internal capital generation.

This quarter, we saw 4 basis points on. Frankly, a lower EPS than what we would expect to generate going forward. So that should be a tailwind to growing the capital and absorbing any additional RWA growth. But I do think RWA growth will be fairly muted, similar to what you saw this quarter for the rest of this year, and that should help for capital accretion. And that's just simply a factor of how loan growth is expected to evolve considering the macros we see today across the footprint. 2024 might be a different story. Like I said, we can talk about it towards the end of the year.

Sohrab Movahedi - BMO Capital Markets Equity Research - Banks Analyst

Okay. But just for crystal clarity, Raj, the more moderate loan growth is not you pulling back on risk taking, it's just a function of the environment you're operating in?

Rajagopal Viswanathan - The Bank of Nova Scotia - Group Head & CFO

It's mostly a function of the environment. There's no changes in risk appetite of any significance that we'll talk about. But from time-to-time, right, I mean, we're trying to focus more on the customer. You've heard Scott talk about it.

So some of those do drive certain outcomes, but it's generally the macro. The demand is a little lower, particularly if we get to the International Banking segment, and we're going to react appropriately. So I wouldn't say one is greater than the other, but it's mostly relating to the macro if you want a big one.

Operator

That's all the time we have for questions. I would now like to turn the meeting over to Raj.

Rajagopal Viswanathan - The Bank of Nova Scotia - Group Head & CFO

Thank you. On behalf of the entire management team, I want to thank everyone for participating in our call today, and we look forward to speaking with you again at our Q3 call in August. This concludes our second quarter results call. Have a great day.

Operator

Thank you. The conference has now ended. Please disconnect your lines at this time, and we thank you for your participation.