Conference Call

Second Quarter 2020

Financial Results

May 29, 2020

Caution Regarding Forward-Looking Statements

In this document and in other documents filed with Canadian regulatory authorities or in other communications, we may, from time to time, make written or oral forward-looking statements within the meaning of applicable securities legislation. Forward-looking statements may include, but are not limited to, statements regarding our business plan and financial objectives including statements contained in our 2019 Annual Report under the heading “Outlook”. The forward-looking statements contained in this document are used to assist readers in obtaining a better understanding of our financial position and the results of operations as at and for the periods ended on the dates presented and may not be appropriate for other purposes. Forward-looking statements typically are identified with words or phrases such as believe, estimate, forecast, project, expect, anticipate, plan, goal, target, may, should, could, would, will, intend or the negative of these terms, variations thereof or similar terminology.

By their very nature, forward-looking statements require us to make assumptions and are subject to inherent risks and uncertainties, both general and specific in nature. There is significant risk that the predictions, forecasts, projections or conclusions will prove to be inaccurate, that our assumptions may not be correct, and that actual results may differ materially from such predictions, forecasts, projections or conclusions.

We caution readers against placing undue reliance on forward-looking statements, as a number of factors, many of which are beyond our control and the effects of which can be difficult to predict, could cause our actual results to differ materially from the targets, plans, objectives, expectations, forecasts, estimates and intentions expressed in such forward-looking statements.

The future outcomes that relate to forward-looking statements may be influenced by many factors, including but not limited to: general economic and market conditions; changes in government monetary, fiscal or economic policies; changes in currency and interest rates; legislative and regulatory developments, including tax legislation and interpretation; critical accounting estimates and the effect of changes to accounting standards, rules and interpretations on these estimates; changes in competition; modifications to credit ratings; scarcity of human resources; developments with respect to labour relations; information technology and cyber security; developments in the technological environment; environmental risk including changes to global environmental policy and the effects of climate change; the possible effects of global conflicts and terrorism, natural disasters, public health emergencies, including the direct and indirect impacts of the novel coronavirus (COVID-19) pandemic, disruptions to public infrastructure and other catastrophic events; our ability to execute our strategic plans including the reorganization of our retail branches, the modernization of our core banking system and the implementation of the Advanced Internal Ratings-Based (AIRB) Approach to credit risk; as well as our ability to anticipate and effectively manage risks arising from the foregoing.

Since December 31, 2019, the outbreak of COVID-19 has resulted in governments worldwide enacting emergency measures to contain the spread of the virus. These measures, which include the implementation of travel bans, temporary business and school closures, self-imposed quarantine periods and physical distancing, have caused considerable financial and social disruption resulting in economic weakness and market volatility. Governments and central banks have reacted with monetary and fiscal interventions and proposed measures and subsidies designed to stabilize economic conditions. The magnitude, duration and outcome of the outbreak, including its impact on customers, team members and third-party providers; the efficacy of government and central bank interventions; and the related financial and social impacts are uncertain, and could have a material and adverse effect on our business. Such adverse effect could be rapid and unexpected. It is not possible to reliably estimate the length and severity of these developments and the impact on the financial results and condition of the Bank.

We further caution that the foregoing list of factors is not exhaustive. Other factors and risks could adversely affect our results. For more information on the risks, uncertainties and assumptions that would cause our actual results to differ from current expectations, please see the more detailed description of the risks associated with COVID-19 pandemic and related impacts in the Risk Management section below, the “Risk Appetite and Risk Management Framework” section of our 2019 Annual Report, as well as our other public filings available at www.sedar.com.

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

Operator

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

Susan Cohen, Director, Investor Relations

Good morning and thank you for joining us.

Today's review of the second quarter of 2020 results will be presented by François Desjardins, President and CEO, and François Laurin, Executive Vice President and CFO. All documents pertaining to the quarter, including Laurentian Bank Financial Group's Report to Shareholders, investor presentation and financial supplement can be found on our website in the Investor Center.

Following our formal comments, the senior management team will be available to answer questions and then Francois Desjardins will offer some closing remarks.

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

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

François Desjardins, President and Chief Executive Officer

Thank you, Susan, and good morning everyone.

These are challenging times and COVID-19 has had profound impacts on our economy, customers and communities.

Despite the many hardships that have resulted from this crisis, it has also demonstrated our ability to proactively manage through and adapt to the situation in order to provide service to our customers. I am particularly proud of our team members who were able to quickly take charge of the work required to ensure that our customers received the support and advice they need – now more than ever.

For as long as this environment persists, our actions will be aligned with the following priorities: to keep our team members and customers safe, to provide the financial help and support our customers' need, to position ourselves to withstand any uncertainties still to come, to take advantage of growth opportunities and last but not least, complete our strategic plan.

With approximately 80% of our team members working from home and most of our Financial Clinics, business centres, operations and call centres fully operational, day-to-day banking continues to be accessible. Team members have been able to help customers over the internet, phone and in person.

Our CET1 ratio stands at 8.8%, well in excess of the minimum regulatory requirement and our revised operating level that now stands at 8.1% to 8.5. We have a high level of liquidity and the provision for credit loss ratio continues to be lower than the banking industry. We have strong capital and liquidity positions and disciplined risk management – but, this is a time for prudence.

Although we still believe that current earnings are not reflective of the future earnings power of the organisation, we have reduced the quarterly dividend to $0.40 per share which improves operational flexibility until we reap the anticipated benefits of our strategic plan.

In terms of financial performance for the second quarter, Laurentian Bank Financial Group reported adjusted net earnings of $11.9 million, diluted earnings per share of 20 cents and an adjusted return on equity of 1.5%. COVID-19 has had a negative impact on operating income in the second quarter, and the underlying improvements in the quarter were overshadowed by the increase in provision for credit losses.

In the second quarter, loans to business customers grew by 3%, or 11% on an annualized basis, in line with our guidance for double-digit growth, and net interest income was 4% higher than a year ago, mainly due to a greater proportion of higher-yielding loans to business customers. This is demonstrating that our plan to improve the business mix is working.

I am encouraged by the business development results with respect to the mortgage and personal loan portfolios, where we have seen increased demand over the last few months and early signs of stabilisation.

Capital Markets had very strong results, generating good growth in revenues, largely from its Fixed Income business.

On the expense side, we reduced our workforce by about 200 people, of which about half was in early May. In the second quarter we reviewed our expenses and will continue to do so going forward, as we work towards improving efficiency.

Now, onto strategic initiatives.

In the current environment, we are reviewing the timetable of our investments, with an end goal that remains the same. We will complete what we started: setting a strong foundation, working on profitable growth and enhancing performance. More than ever, digital technology is part of our day-to-day life. Advancing technologies and eliminating all non-essential paper-based transactions are required in a modern financial institution.

Phase two of the core banking system replacement has already begun. This final phase includes the migration of all remaining products offered in the Financial Clinics and Business Services.

By mid-2021, all new personal customers will be onboarded digitally on the new core banking platform, and we will begin the migration of existing personal banking customers, which is targeted be completed by the end of calendar 2021. This will enable all our customers to enjoy a much-improved experience in managing their accounts and day-to-day transactions.

The migration of remaining business customers is now scheduled to start in November 2021 – a six-month delay from what was previously announced. Phase 2 should therefore be completed by early 2022, after which we will be able to progressively decommission our legacy systems, gradually eliminating the associated operating costs.

For Financial Clinics, the 100% Advice model is gaining momentum. We are expanding the advisor team which now stands at 400, having onboarded about 25 new advisors since the beginning of the year. As customers' behaviour continues to shift from in-person visits to virtual, we are further optimizing our footprint and expect to have 63 locations by year-end, down from 83.

Following the launch of LBC Digital, our coast to coast direct-to-customer channel, we are broadening and deepening our relationship with these customers and developing a complete high-value product suite.

At the end of the quarter, deposits from this channel stood slightly above $700 million, in line with our expectations. With this digital offering, we are well positioned to take advantage of the expected acceleration in the consumer adoption of digital banking.

Although we still firmly believe in the benefit of moving to the Advanced Internal Rating-Based Approach, in the current context, and given that we are prioritizing growth and efficiency initiatives, we are reviewing the

timeline for AIRB that was due to be completed by the end of 2022. For now, we expect a delay of at least a year.

When we started the year, I had a high degree of confidence that 2020 would be a year in which we would return to growth and the heavy lifting would come to an end. Recent events have certainly changed the timetable, but not our resolve.
While these times are challenging, they have also brought out the best in us. It is in these times that you define what your organization stands for. How we treat our customers today will be remembered for years to come.

I would like to thank our customers for their business, our team members for their dedication and our investors for their continued support. We are building a better and different financial institution, and our commitment to helping customers improve their financial health will not waiver - in good times and bad.

And now I will turn the call over to Francois Laurin to provide a more detailed review of our second quarter results.

Francois…

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

Thank you, François.

Good morning everyone.

I would like to begin by turning to slide 10. As François just mentioned, the financial impact of COVID-19 in the second quarter of 2020 reduced profitability, compared to last year and last quarter, essentially as a result of higher provision for credit losses.

As outlined on slide 11, adjusting items for the second quarter totalled $0.07 per share.

Slide 12 highlights total revenue in the second quarter of 2020 of $240.1 million which was relatively unchanged from last quarter and last year.

Net interest income increased by $6.2 million compared to last year and by $2 million compared to last quarter. These increases were mainly due to an improvement in business mix with a greater proportion of higher-yielding loans to business customers, as well as an improvement in funding costs through the greater use of secured funding.

This was partially offset by a decrease in loan volumes to personal customers and the unfavorable impact of the decrease in the Prime/BA spread.

As shown on Slide 13, NIM in the second quarter of 2020 was 1.88%, up 11 basis points compared to a year earlier and up 7 basis points sequentially, mainly due to the change in the loan portfolio mix and the improvement in funding costs and was partly offset by the decrease in the Prime/BA spread. The proportion of commercial loans in the portfolio stood at 40% versus 37% a year ago, as we are successfully executing our strategic plan to evolve the bank mix towards higher margin commercial loans.

Other income, as presented on Slide 14, totaled $69.4 million. The $5.9 million decline from last year was largely explained by a $1.9 million decrease in service charges as the retail banking environment and related customer behaviors evolve, a $1.7 million decrease in card service revenues as transaction volumes declined driven by a reduction in consumer spending since the beginning of the pandemic, and a $1.6 million decline in insurance income as customer claims increased. Sequentially, other income slightly declined as these same factors were partially offset by a $1.6 million increase in fees and securities brokerage commissions mainly due to strong results from fixed income operations.

Slide 15 highlights adjusted non-interest expenses of $179.6 million, which rose by $3.4 million year-over-year. Salaries and employee benefits increased by $3.5 million, mainly due to higher wages and special compensation paid to team members, who were required to work in our Financial Clinics or in our corporate offices during the pandemic of about half a million dollars. As well, performance-based compensation increased mainly due to brokerage operations and other sales driven compensation in Business Services. Premises and technology costs were relatively unchanged year-over-year and included costs of $500,000 associated with precautionary measures such as increased cleaning and reinforced security to enable about 80% of our team members to work remotely. Adjusted non-interest expenses improved by $3.1 million sequentially mainly due to lower share-based compensation and overall expense control measures, despite the COVID-19 related costs just mentioned of about $1 million.

The adjusted efficiency ratio of 74.8% in the second quarter of 2020 remains high. We are maintaining our focus on improving efficiency. As Francois had mentioned, continuing to optimize the network of Financial Clinics and reducing our workforce to better align with our operational needs are expected to contribute to this objective. These measures will generate an impairment charge related to lease contracts and severance costs of approximately $6 million in the third quarter of 2020.

Slide 16 highlights our well diversified sources of funds. In the second quarter of 2020 deposits stood at $25.3 billion, essentially unchanged from the prior period. Core direct personal deposits sourced through Financial Clinics increased for the second consecutive quarter and demand deposits through intermediaries also increased, while term deposits sourced through Advisors and Brokers declined. The digital direct to customer deposits reduced in line with expectations. Securitization activities increased by $400 million during the quarter as we continue to optimize our sources of funding.

In the context of the evolving global pandemic, we continue to prudently manage our level of liquid assets. In March, financial markets became extremely volatile, causing severe disruption to business and economic activity. To support our customers and provide the Bank with necessary buffers, we increased our liquidity level. Like all banks, we participated in various Bank of Canada programs to further diversify our funding sources at a lower cost and maintain higher liquid assets.

Slide 17 presents the CET1 ratio, under the Standardized Approach, of 8.8% at April 30, 2020 and highlights our healthy capital position. The impact of the OSFI transitional arrangements for provision for credit losses represents a positive adjustment to the CET1 ratio of about 10 basis point at the same date.

Our diversified loan portfolio is shown on Slide 19 and stands at $33.7 billion or 1% higher than at the end of the first quarter. Loans to business customers continue to be our growth engine and increased by 3% sequentially, fueled by inventory and equipment financing activities.

Slide 20 highlights our residential mortgage portfolio. At April 30, 2020, 50% of our mortgages were insured. Our Alt-A portfolio totalled $1.1 billion and represented 7% of the total mortgage book and 3% of the total loan portfolio.

Slide 21 highlights our well diversified commercial loan portfolio which is pan-Canadian with a U.S. presence. At $13.5 billion at the end of April, this portfolio grew 3% sequentially mainly due to growth in inventory and equipment financing.

In response to COVID-19, we continue to work with our customers who may need flexibility in managing their loans and are offering up to six months of payment deferral for residential mortgages and some personal loans. For commercial loans, customer requests and deferral programs are reviewed and approved on a case-by-case basis. These payment relief options allow customers to temporarily stop making their regular payments, while interest continues to accrue on the outstanding balance.

As shown on slide 22, at the end of the second quarter, we had authorized deferred payments on 19% of our mortgage portfolio for up to 3 months. Insured, conventional and Alt-A mortgages account for relatively similar proportions. The value of deferred payments for mortgages was $50 million for the deferral period.

With respect to personal loans, at the end of the second quarter we had authorized deferred payments on about 0.1% of that portfolio, with a deferred payment value of less than one million dollars for the deferral period.

As well, deferred payments were authorized for 11% of loans to business customers at the end of the second quarter, and the value of deferred payments was $58 million for the period.

Payment deferrals are not considered to automatically trigger a significant increase in credit risk or result in such loans being moved into Stage 2 or 3 when calculating Expected Credit Losses or ECL.

There has not been a material change in the level of authorized deferred payments during the month of May.

I would now like to discuss our disciplined approach to modeling expected credit losses. As a result of the deterioration in economic conditions caused by the spread of the COVID-19 pandemic and the related increase in economic uncertainty, three forward-looking economic scenarios – base, upside and downside - were updated and used for estimating ECL at April 30, 2020. The key assumptions are highlighted on Slide 23. High weights were assigned to the base and downside scenarios and a small residual weight was assigned to the upside scenario. Our ECL models were adapted to consider the recently announced monetary and fiscal measures to promote liquidity and ease financial stress on individuals and businesses. Expert judgement was also applied to account for this unprecedented situation.

Turning to slide 24, in the second quarter of 2020, the provision for credit losses was $54.9 million compared to $9.2 million a year ago and $14.9 million in the prior period. The increase was mainly a result of higher collective allowances.

Specifically, credit losses on personal loans in the second quarter of 2020 were $17.4 million compared to $4.0 million in the previous period. The increase mainly related to Stage 1 and 2 credit losses of $9.6 million compared to recoveries in the previous period and was essentially a result of the significant increase in credit risk due to COVID-19.

Credit losses on residential mortgage loans remained relatively unchanged at $1.4 million in the second quarter compared to last quarter and reflects strong underwriting criteria.

Credit losses on commercial loans totalled $36.1 million compared to $9.5 million in the previous quarter. Stage 1 and 2 provisions rose to $21.0 million from $927,000 last quarter as a result of the negative impact of COVID-19 on collective allowances and individual allowances on a limited number of loans. Stage 3 provisions were $15.0 million up from $8.5 million last quarter reflecting impairment charges from non-performing loans.

As shown on Slide 25, the provision for credit losses as a percentage of average loans was 67 basis points for the second quarter of 2020 compared to 18 basis points in the previous period. This ratio continues to compare favorably to the industry, reflecting our disciplined underwriting standards and the strength of the collateral.

The magnitude of the COVID-19 impact on the Canadian and U.S. economies remains highly uncertain. Therefore, it is difficult to predict whether the increase in expected credit losses will materialize into a significant level of write-offs or reversals and if the Bank will recognize additional increases in expected credit losses in subsequent periods.

Impaired loans are shown on Slide 26. Gross impaired loans totalled $235.2 million up $48.5 million sequentially, mainly due to an increase in the commercial loan portfolio. The allowances for loan losses against impaired loans increased by $13.8 million from the previous quarter, mainly driven by an adverse shift in forward-looking economic scenarios related to COVID-19.

Short-term, we, like most businesses, have little visibility on the course of the pandemic or the performance of the economy. But, as the pandemic wanes and we gain greater clarity, we will update our medium-term objectives.

To conclude, our response has been quick, and our actions have been prudent. We are well positioned to navigate through these challenging times and will be prepared for the future. In the interim, the operational flexibility that we are building, along with healthy capital and liquidity levels, allow us to support our clients, improve our business mix and grow profitably.

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

Susan Cohen, Director, Investor Relations

At this point, I would like to turn the call over to the conference operator for the question-and-answer session. Operator …

Operator

Thank you. If you'd like to ask a question, please signal by pressing star one on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star one to ask a question and we will pause for just a moment to allow everyone an opportunity to signal for questions. So, one moment please.

And we will take our first question from Sumit Malhotra of Scotiabank. Please go ahead.

Sumit Malhotra, Scotia Bank

Thanks guys. Good morning. First question, just thinking about the trend line in capital, you mentioned that you have lowered your expected target range for the CET1 ratio, and then frankly, I think that's understandable in this environment.

With respect to the reduction in the dividend, do you expect that that will keep you in this target range? I know you're above that right now and maybe more to the point, what type of risk-weighted asset inflation are you expecting as we go through this cycle? Obviously, your increase in RWA this quarter was pretty limited at 1%.

François Desjardins, President and Chief Executive Officer

Thank you, Sumit. We have strong capital and liquidity positions and disciplined risk management, but as you said, this is a time for prudence. Although we still believe that the current earnings are not reflective of the future earnings power of the organization, it is uncertain times with the COVID-19 pandemic upon us. And this decision improves operational flexibility, ensures that we can move forward, aim for growth, efficiencies, absorb credit losses should they arise, and complete the long-awaited strategic objectives.

We prefer to go forward with an abundance of caution, so a reduction in the quarterly dividend better aligned with our dividend policy in a pre-COVID world is best until we reach the anticipated benefits of the strategic work we're doing. We are keeping the payout ratio target at between 40% and 50% going forward.

William Mason, Executive Vice President and chief Risk Officer

Sumit, it's Liam, just in terms of RWA growth, as you noted, we had modest growth driven by the growth in business services. Really the growth depends on how the economy evolves. If we see things coming back, we will grow commensurate with the market. We have targeted plans as Francois has laid out, to grow our business. But how the RWAs evolve, really depends on how the situation changes.

Sumit Malhotra, Scotia Bank

And sorry, Liam, to be clear, I get the business piece and how that affects RWA. My question is more what is the bank assuming with respect to RWA inflation arising from credit migration as we go through the next several quarters? And presumably the underlying credit quality metrics begin to deteriorate and then you move you move through your models.

William Mason, Executive Vice President and chief Risk Officer

I can give some general comment. I'm not expecting a lot driven by the mortgage portfolio given the relatively low loan to value that we have. With the equities markets improving, some of the pressures that would have been on RWAs from our investment loans are coming off. But obviously that's one area of pressure.

And then with regard to migration, given the strength of our portfolios right now, I don't expect a lot of impact beyond that to our RWAs but we'll see how things evolve.

Sumit Malhotra, Scotia Bank

And some of this is obviously the benefit you're still getting from being under the standardized approach. Is that fair to say?

William Mason, Executive Vice President and chief Risk Officer

Some of the benefits is, yes, but I would remind you that in terms of our estimate, on an AIRB equivalent basis, we'd be approximately 200 basis points higher. So when Francois says target range of 8.1 to 8.5 on a standardized basis, that's an equivalent AIRB target range of 10.1 to 10.5 based on our view of the AIRB.

Sumit Malhotra, Scotia Bank

Thanks. I'll re-queue

François Desjardins, President and Chief Executive Officer

Thank you, Sumit.

Operator

And we will take our next question from Sohrab Movahedi of BMO Capital Markets. Please go ahead.

Sohrab Movahedi, BMO Capital Markets

Thank you. I mean, you've obviously talked to the economic uncertainty. It's a big degree of complexity on the strategic transformation program. I just wonder if you could just talk us through how you decided on the order of magnitude reduction of the dividends. I mean, I guess just trying to understand how the thinking went through it. Why we just said by 40%, not 80% or 20%. Is that something to talk to a little bit?

François Desjardins, President and Chief Executive Officer

Absolutely. Obviously when we went into the year after you know, a year and a half of labor woes, et cetera I started the year by thinking that we would earn our way out of it and that earnings would come back faster. I announced a year as being a year in which the heavy lifting would be coming to an end and we would focus on growth.

Obviously, COVID changes that slightly by introducing higher provisions for loan losses and delays, just in terms of priorities in terms of serving clients which is, you know, the ultimate priority in these times. So we just made the prudent choice to say, well you know, how do we better align the dividend payout with the policy in a pre-COVID world.

And instead of trying to earn our way out like we planned to do, make the cut right now, stay prudent, and as earnings grow back to what they should be in a post strategic plan world, then the dividend would grow along with it.

Sohrab Movahedi, BMO Capital Markets

Yes, François, I appreciate that and I think it is prudent, I'm not questioning the prudence, I just want to know how you arrived at the order of magnitude of reduction or what gives you comfort that at this new level, you will be able to operate within the target.

François Desjardins, President and Chief Executive Officer

Thank you. Well we took several factors into consideration and the first of which is the fact that in a pre-COVID environment, we were at 9% CET1, and we finished the quarter at 8.8 and that our revised target for operating at CET1 level is a range of 8.1 to 8.5.

So we have quite a bit of capital room here to be able to withstand any future losses, continue our growth plan, et cetera. And we didn't feel that it was required to go any further than what we did. And from trying to set the level, discussions around where were we in the last few quarters of last year, we were at a payout ratio that was higher than our policy. And, trying to set expectations in terms of where should be was at this level. These are the factors that influenced our decision making. But if your question is, what gives you comfort, I would think that the buffer that we have in terms of operations is a great comfort to me.

Sohrab Movahedi, BMO Capital Markets

Thank you very much for that color.

Operator

We'll now take our next question from Gabriel Dechaine of National Bank Financial. Please go ahead.

Gabriel Dechaine, National Bank Financial

Good morning. You know, the dividend cut is one strategy to preserve capital. I'm wondering if you're evaluating others. You've done the DRIP discount. Are you looking at any portfolio sales with potential to reduce the RWA? You've done that in the past, but maybe there's a harder look at that strategy today?

François Desjardins, President and Chief Executive Officer

Thank you for the question, Gabriel. No, we are not looking at portfolio sales at all. We are looking at growth in our portfolios, and no large-scale acquisitions like we've said in the past, but small portfolios, we'd be open to looking at that.

We want to put more assets on the balance sheet, and we've said so for the last year or so. And we've been working very hard and successfully on the business customer side. As we've said in our remarks, this has continued to be a growth engine for us and turning around the personal customer side has been our focus. I'm encouraged by the organic business development activities that we've been seeing. We've been slowly coming up the ranks in terms of market share on the mortgage broker business. And we've recently seen our efforts start to pay off on personal loan side as well. So, we're seeing some signs of stabilization. So really, as we're going through this crisis, now that everybody's home or 80% of our team members are home, we're open for business and we're looking for growth.

From a DRIP perspective obviously, we discuss that every quarter. And we'll discuss that again next quarter, but for the time being, given that these are unprecedented times we just left the DRIP as is for now and we'll see what we do with that at the next quarter. For the moment, it gives us extra flexibility on capital and of course more capital means more growth.

Gabriel Dechaine, National Bank Financial

Thank you. The comments about your economic scenarios and putting a heavier skew on the base case and the pessimistic case too. And that's what you use to determine your performing provision this quarter? If I understand correctly. The base cases, if I got it, is pretty much a V-shape recovery, so by Q4 or – sorry - early 2021 we are back to pre-COVID GDP growth levels. Is that how I should look at it?

François Desjardins, President and Chief Executive Officer

Liam, you want to answer that?

William Mason, Executive Vice President and chief Risk Officer

Thank you, Gabriel for the question. Good morning. We calibrated our scenarios based on the ranges of scenarios the Bank of Canada put out and all of the GDPs put out and provided economic scenarios. In our calibration, in terms of our base case the favorable case and the pessimistic case were based and aligned with what we saw the industry and the Bank of Canada provide.

Gabriel Dechaine, National Bank Financial

Right. But is my description, an accurate one at the –

William Mason, Executive Vice President and chief Risk Officer

The immediate theme would probably be too optimistic for our scenario. If you look at the Bank of Canada, it wasn't a V shape – it was more of a U-ish or an L.

Gabriel Dechaine, National Bank Financial

Okay. And, Liam, while I have you, the performing provision. We've got it by category. I was wondering what was the earmarked to or at least the allowance – can you tell me geographically, US versus Canada and how that was split?

William Mason, Executive Vice President and chief Risk Officer

We don't generally comment on breaking out the US. We're very comfortable with the results we're seeing in our NCF portfolio. In the US it's very diversified across geographies and products. And in Canadian terms, in terms of the sub segments, it's driven by commercial largely, overall.

Gabriel Dechaine, National Bank Financial

Would it be in line with the –

William Mason, Executive Vice President and chief Risk Officer

But there's nothing in Alberta – I think Gabriel, straight to your point, there's nothing Alberta specific. I mean, we don't have a lot of exposure to oil and gas almost none. And Alberta, a portfolio from a mortgage perspective is largely insured. So, there isn't a geographical bias per se.

Gabriel Dechaine, National Bank Financial

I'm not – I'm not really worried about your Alberta exposure. I'm wondering how much of the performing provision was assigned to Northpoint –

William Mason, Executive Vice President and chief Risk Officer

We don't generally speak to it, but we're very comfortable with the numbers. What I will say, Gabriel, is we calibrated those based on what we've seen in terms of losses in similar situations and factored in the government support. And we're very comfortable with provisions that we have there.

François Desjardins, President and Chief Executive Officer

Also, Gabriel, if I – if I may, FD here, ask us to jump in and talk about our NCF business if I might, because not all geographies are living the pandemic in the same way. Stephane, you want to jump in here for a sec?

Stéphane Therrien, Executive Vice President, Personal & Commercial Banking

Yeah. Thank you, François. Northpoint had another great start of the year, obviously pre-COVID, again, in the double-digit area. Latest results with Northpoint are showing a higher level of repayment than last year for April, meaning that we are getting reimbursed on units that are sold by the dealer faster than last year.

But there's less new advances, less new volume because the manufacturer closed for a couple of weeks and the goods we're financing through Northpoint as a corporation, this morning in the newspaper, there was a great article on BRP showing that the demand right now in the crisis for these types of goods are quite high. And this is what we're financing. A lot of what we're financing at Northpoint are the RVs and the boats. So right now the manufacturers are reopening. They're working at 80% to a 100% of their capacity with some challenges. They need to reschedule and reorganize their process, they need to rehire a staff in competition with the US government program, and they need to find solutions to supply chain issues for parts and materials. But the demand for a lot of what we're financing is close to being marked back to normal in the States. The RV industry specialists are saying that the less travel going forward could mean more RV sales. The same for both. People are re-directing their leisure budget to these types of goods. And this is what we're financing at Northpoint, the inventory of these types of goods, which we'll see and are already seeing a higher demand for, and which means future growth for us.

Gabriel Dechaine, National Bank Financial

That makes sense. Thanks.

Operator

Okay, we'll now take our next question from Darko Mihelic of RBC Capital Markets. Please go ahead.

Darko Mihelic, RBC Capital Markets

Hi. Good morning. Thank you. If you could provide a little more color on the commercial impairments this quarter and the stage three losses that you took against it. And as well just looking at the reserve for your commercial, stage three reserves versus the amount of loans in there. I wonder if you could provide some color on what happened in the quarter there and provide some ideas to why we should not expect further deterioration of this size.

William Mason, Executive Vice President and chief Risk Officer

Darko, thank you – thank you for your question. First of all, I'd just like to talk about how we develop our PCLs and just, when I looked at the analyst calls over the past little while, it seems to be a little question out there as to how the whole process works. And I want to make sure everybody's on the same page. The two key areas of change when you're looking at deriving your ACL as most of you know, it's as the asset migrates across the stages and as you change your economic scenarios, including the weighting on those scenarios. So both of those areas are impacted by COVID and the corresponding impact on the economy. Our approach is largely models based including the commercial.

For the commercial impairments, we have historical parameterization based on the previous financial crisis, we can adjust those for the government relief programs that went into our models. As we've said, that the PCL – other than this specific reserve was really driven on reserves on the performing loans.

Our commercial portfolio is not involved in many of the sectors that were challenged. We're not in oil and gas, we're not in hotels, we're not in restaurants. We did a deep dive on the portfolio line by line. And our commercial portfolio continues to perform relatively well and that's driven by our disciplined underwriting standards. You do have to factor in the Bank of Canada's government relief. But in terms of where we're at right now, we've calibrated to historical levels, a large part of it is really against performing assets and we're comfortable with where we are overall in terms of our provisions.

And if the scenarios evolve as expected, the reserves really will be driven by how those economic situations change in the next quarter and subsequent quarters and we see things get better, then you'll see the reserves get released, and if we don't, you'll see reserves increase, but we're very comfortable with where we are right now. Disciplined approach, not in a lot of the other areas and calibrated to what we saw historically adjusted for the government relief.

Darko Mihelic, RBC Capital Markets

Okay. And maybe just to be very specific, I mean, what I'm looking at is really on page 16 of your supplemental. Specifically, I'm looking at the commercial loans in stage three. 152.9 up from 109. That's a 40% quarter-over-quarter increase. We don't typically see that kind of an increase in impaired loans. I'm not talking about the modeling of stage one or stage two. I'm specifically zeroing in on the commercial impairments rising 40% quarter-over-quarter.

William Mason, Executive Vice President and chief Risk Officer

Yeah. We have seen a couple of files that have some challenges on it. We think these are isolated. We talked last quarter that there were a couple of files. This quarter, we've got a couple of files. I don't believe it to be a trend, but we have had a couple of files in one or two segments that have driven it. I don't think that this is a trend. I think it's more reflective of a combination of weaker files combined with the COVID impact that have pushed them over the edge in stage three.

Darko Mihelic, RBC Capital Markets

Okay, thank you.

Operator

And we will now take our next question from Doug Young of Desjardins Capital Markets. Please go ahead.

Doug Young, Desjardins Capital Markets

Good morning. Maybe following on that question. You know, the sequential increase in the commercial loans in stage one and two provisions and then the stage three provisions. Can you maybe talk about that– and then you can build in the impairments. Can you talk about it by segments? Was it more the inventory finance, equipment finance, commercial real estate or general commercial? Can you just give a little more perspective what drove the increase in impairments and the increase in the allowances on the commercial side?

William Mason, Executive Vice President and chief Risk Officer

Well, I guess I'll have my colleague Stéphane talk about how the business is evolving, but I don't think there's any one area that stood out in my mind. We saw relatively consistent impacts across the portfolio. I mean, the one thing I would say is the strength of our underwriting and collateral positions really do mitigate a lot of the impacts. Remember 97 plus percent of our portfolios is collateralized. So I wouldn't highlight any one segment as a big driver on the commercial side. If we're talking about the personal side, obviously, unsecured is, you know, cards is where you'd see bigger increases. Stéphane, do you want to add anything to that on the commercial?

Stéphane Therrien, Executive Vice President, Personal & Commercial Banking

Yeah. Thank you, Liam. Maybe just to add a point on the quality of the portfolio. As our competitors, we offered deferred payments both in commercial and in personal businesses. And just one point on the overall loan to business customers, only 10% of our portfolio is outstanding right now. So about 1.4 billion asked and were given a moratorium for three months. So 10% for us is – we feel it's a good place to be and it's low.

Doug Young, Desjardins Capital Markets

I mean, maybe just on the stage three. Like you said, there's a number of files. Was it all in one category? Was there a particular area or a particular business line that drove that sequential increase in impairments? Because you said there was a few files. Like what we often get from some of the banks just kind of this related to, you know, hospitality or transportation or whatnot. Like is there some more detail you can get?

William Mason, Executive Vice President and chief Risk Officer

Well, we don't have – Doug, we don't have a lot in hospitality or transportation. So that's why, you know, the big-affected sectors, we're not in those. So these are the more –

Doug Young, Desjardins Capital Markets

I was just using them as an example.

William Mason, Executive Vice President and chief Risk Officer

Yeah. No, no, I get that. These are more specific situations that we're facing some challenges and I think that the COVID situation pushed them over, you know, in terms of it. You know, there's been a spillover impact and if they were weak or were facing some challenges going into this, then the impact of the COVID has really highlighted and pushed them over the edge.

Doug Young, Desjardins Capital Markets

Okay. Just to François –

William Mason, Executive Vice President and chief Risk Officer

Like I said, like it's not – if there was a specific sector that I could highlight, I would, but it's not. It's a couple of individual sectors.

Doug Young, Desjardins Capital Markets

Then, François, the kind of dividends, you talked about targeting the 40 to 50% payout. I mean, are you suggesting that, you know, you simply do the math, the, you know, through this, these tough times, you know, 80 to 80 cents to a buck is roughly the range in which, you know, Laurentian Bank should be operating on a quarterly basis. Is that reasonable?

François Desjardins, President and Chief Executive Officer

I think that when we looked at lowering the dividend, it was really as a matter of prudence. As I've said in my previous answer, when we started the year, you know, the target of 40 to 50%, we thought we would earn our way to it. And if COVID wasn't there, it's likely that we would have maintained our course. This is by an abundance of caution. And as, you know, I've said at the end of the year, there's a lot of things that are behind us, but we've struggled with, you know, a difficult year in terms of personal customers. I'm seeing early signs of stabilization and we're working on growth. As growth comes and efficiency comes, then earnings will come. But I can't really predict, you know, the next six months. So doing this now, I think, is the prudent course. I wouldn't read too much into the level in terms of the future earnings. We will see. I don't know. François, do you want to add additional thoughts?

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

Thank you, François. I would just have to re-iterate what you said earlier. Pre-COVID, there was earning power, earnings that we have was also an indication – it was a touch point in our analysis, Doug.

Doug Young, Desjardins Capital Markets

Great, thank you.

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

Does that help?

Doug Young, Desjardins Capital Markets

Yeah, I think it seems too early. It seems like it's too early to tell that it's going to be within that range right now, but you – that's the range that you thought on a quarterly basis was reasonable, but maybe not over the next few quarters as you kind of look through this tough environment. Is that a fair characterization there?

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

We need to get through COVID as well. So it's very difficult to make any type of guidance on the outcome of COVID and the impact on the bank's results going forward.

François Desjardins, President and Chief Executive Officer

The one thing that I'd like to double back on is the work that we're doing on an efficiency side. And as you know we had talked about the latter half of the year as being better than the first half of the year on expenses. And of course, we've done some work, we've done some additional work, we've lowered our head count. This is work that's ongoing, so you know, expenses are a half of the recipe when we're talking about improving the efficiency ratio, the other half being revenues. So you know, I think that the work ongoing is still there and those positive impacts are going to be felt. But not knowing how the pandemic will play out gives us a little bit of reservation about commenting on forecasting.

Doug Young, Desjardins Capital Markets

Thank you.

Operator

And we will take our next question from Scott Chan, Canaccord Genuity. Please go ahead.

Scott Chan, Canaccord Genuity

The margin was really strong in the quarter on a sequential basis that held up your NII. Maybe can you just talk about the pieces in the quarter and maybe your outlook over the near term? Thanks.

François Desjardins, President and Chief Executive Officer

François Laurin, do you want to comment on that?

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

Thank you. Thank you, Scott. When compared to sequentially and last year, sequentially it's up there 11 bps. It's basically between the higher proportion of the higher yielding loans to business customers and the lower cost of funding. And that was partially offset by the decrease in the Prime / BA spread that everybody lived through in the last quarter. So to give you a sense, it was about half-half between the two elements. And the same thing for Q2 versus last year and Q2-over-Q1. It's the same explanation basically, Scott

Scott Chan, Canaccord Genuity

And did you maybe have an outlook?

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

So on the outlook, obviously it's dependent on the various factors as you know, including the volume mix in the second half of the year and all the factors that might influence funding costs going forward. However, we remain in a very low interest rate environment and that could put some modest pressure on NIM in the near future, which is kind of too early to tell, to provide very clear guidance at this point.

Scott Chan, Canaccord Genuity

Okay. And just maybe on the payment deferrals on the commercial loans, can you give us a sense if it's concentrated in any particular sector or region? And I assume these are flexible, I guess, like on a one-to-one basis?

François Desjardins, President and Chief Executive Officer

Liam, again?

William Mason, Executive Vice President and chief Risk Officer

Scott, as I previously mentioned, it's not concentrated in any region or sector. These are a few files, we're working through them, you know, in these circumstances when you have an account that is heading negative and then you have the compounding effect of COVID, it tends to push them over the edge. We're working through them, but we don't believe this is the trend and it's not a particular sector or segment, it's just a few files.

We're not in the segments that are more challenged.

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

Scott, François Laurin here, was part of your question on the deferred payments through commercial accounts?

Scott Chan, Canaccord Genuity

That's right. Yeah.

François Desjardins, President and Chief Executive Officer

So in terms of deferred payments, Stéphane, do you want to comment on that?

Scott Chan, Canaccord Genuity

Yhea

Stéphane Therrien, Executive Vice President, Personal & Commercial Banking

Yeah. Thanks, Scott. Obviously, I said that the 10% of our overall business services portfolio is under moratorium right now. It's a bit higher in commercial than in real estate for example. Commercial is roughly at the higher end at 15% and the real estate is very low at four, so a bit higher than commercial than real estate. That being said – in real estate, a lot of what we do – and because it's construction loans, all they pay is the interest. So obviously they have not asked for any moratorium, so it's a number, right, but it's not that revealing.

The inventory financing is at 19%, but even there, it's not exactly a payment deferral because these assets are still up for sale, so what we've done is we offered a program to all our dealers. Generally speaking, they pay for the interest on a monthly basis and after six months, if the unit is not sold, they start reimbursing part of the capital at roughly 2% per month – with the help of our manufacturer partner. We offered a new program whereby the dealer could defer some of these payments for up to four months and right now 19% of our portfolio is under that program. But that being said, again, these units are still up for sale and as soon as they sell them, they reimburse us. So it's not comparable dollar for dollar for a standard commercial loan.

Scott Chan, Canaccord Genuity

Thanks, that's helpful. And just lastly, maybe François, you kind of called out the special compensation that impacted mix, is this expected to continue throughout the pandemic?

François Desjardins, President and Chief Executive Officer

François Laurin?

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

Scott, we're re-evaluating constantly that position, so we don't make a commitment for a long-term, but we are re-evaluating this on a regular basis.

Scott Chan, Canaccord Genuity

Okay, fair enough. Thank you very much.

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

You're welcome.

Operator

And ladies and gentlemen, if you have any additional questions at this time, please press star one now. And we will take our next question from Sohrab Movahedi, BMO Capital Markets. Please go ahead.

Sohrab Movahedi, BMO Capital Markets

Yeah, thanks. Liam, I just wanted to get a bit of clarification there, the commercial stage three loans you were talking about. You said it was a – was it a couple of accounts or more than a couple of accounts?

William Mason, Executive Vice President and chief Risk Officer

No, a couple of accounts.

Sohrab Movahedi, BMO Capital Markets

So, I mean, 50-ish million increase, I mean, is it fair to say those accounts for an average 25 million bucks each?

William Mason, Executive Vice President and chief Risk Officer

I don't want to comment on the size of the accounts, but, you know, I can speak to our commercial limits which are about 40 million and it's a couple of accounts.

Sohrab Movahedi, BMO Capital Markets

Okay. And so can you comment how much you've provided against whatever notionals you have up on those two accounts?

William Mason, Executive Vice President and chief Risk Officer

I think we published our watch list numbers, I'd rather not get into the specifics. We can follow up with you online.

Sohrab Movahedi, BMO Capital Markets

Thank you.

Operator

And there are no further questions. I'd like to hand it back over to Mr François Desjardins for closing remarks.

François Desjardins, President and Chief Executive Officer

This week marks the beginning of our 175th year of operation. We are proud of our history and optimistic about our future. Over the past 174 years, we have seen the invention of cars, planes, computers and mobile devices. We've experienced times of war and peace, lived through market crashes and market booms – and now, a pandemic. But we've always stayed true to our mission of helping our customers improve their

financial health. We will be recognizing this achievement throughout the next year with the slogan – Laurentian Bank Financial Group, there when it counts since 1846.

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

Susan Cohen, Director, Investor Relations

Thank you for joining us today. Should you have any further questions, our contact information is included at the end of the presentation. Our third quarter 2020 conference call will be held on September 4 and we look forward to speaking with you then. Have a good day.

Operator

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