TD BANK GROUP
Q2 2022 EARNINGS CONFERENCE CALL
MAY 26, 2022

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Material economic assumptions underlying the forward-looking statements contained in this document are set out in the 2021 MD&A under the headings "Economic Summary and Outlook" and "The Bank's Response to COVID-19", under the headings "Key Priorities for 2022" and "Operating Environment and Outlook" for the Canadian Retail, U.S. Retail, and Wholesale Banking segments, and under the heading "Focus for 2022" for the Corporate segment, each as may be updated in subsequently filed quarterly reports to shareholders. Any forward-looking statements contained in this document represent the views of management only as of the date hereof and are presented for the purpose of assisting the Bank's shareholders and analysts in understanding the Bank's financial position, objectives and priorities and anticipated financial performance as at and for the periods ended on the dates presented, and may not be appropriate for other purposes. The Bank does not undertake to update any forward-looking statements, whether written or oral, that may be made from time to time by or on its behalf, except as required under applicable securities legislation.

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PRESENTATION

Brooke Hales – TD – Head of Investor Relations

Thank you, operator. Good afternoon, and welcome to TD Bank Group's second quarter 2022 investor presentation. We will begin today's presentation with remarks from Bharat Masrani, the bank's CEO. After which, Kelvin Tran, the bank's CFO, will present our second quarter operating results. Ajai Bambawale, Chief Risk Officer, will then offer comments on credit quality. After which, we will invite questions from prequalified analysts and investors on the phone.

Also present today to answer your questions are Michael Rhodes, Group Head, Canadian Personal Banking; Paul Douglas, Group Head, Canadian Business Banking; Raymond Chun, Group Head, Wealth Management and Insurance; Leo Salom, President and CEO, TD Bank, America's Most Convenient Bank; and Riaz Ahmed, Group Head, Wholesale Banking. Please turn to Slide 2.

At this time, I would like to caution our listeners that this presentation contains forward-looking statements, that there are risks that actual results could differ materially from what is discussed, and that certain material factors or assumptions were applied in making these forward-looking statements. I would also like to remind listeners that the Bank uses non-GAAP financial measures such as "adjusted" results to assess each of its businesses and to measure overall Bank performance. The Bank believes that adjusted results provide readers with a better understanding of how management views the Bank's performance. Bharat will be referring to adjusted results in his remarks. Additional information on items of note, the Bank's use of non-GAAP and other financial measures, the Bank's reported results and factors and assumptions related to forward-looking information are all available in our Q2 2022 Report to Shareholders. With that, let me turn the presentation over to Bharat.

Bharat Masrani – TD – Group President and CEO

Thank you, Brooke. And thank you, everyone, for joining us today. Q2 was a good quarter for TD. Earnings were $3.7 billion, and EPS was $2.02. We had strong revenue performance, up 8% year-over-year, reflecting increased customer activity and the benefits of our deposit rich franchise. We delivered approximately 200 basis points of operating leverage across the enterprise, as we continued to see strong returns from our investments.

The Bank's CET 1 ratio ended the quarter at 14.7 per cent, reflecting TD's consistent ability to generate capital organically. As Kelvin will discuss in his remarks, this quarter we are activating the DRIP discount as a prudent response to changes in the operating environment.

Our proven business model enables us to continue to deliver for our shareholders while building the better bank for our customers, colleagues, and communities in the digital age. Let me now turn to each of our businesses and review some highlights from Q2.

Our Canadian Retail segment earned $2.2 billion. Revenue increased 9% driven by volume and fee income growth, as customer activity continued to accelerate. The Personal Bank had a strong quarter. The power of our deposit franchise in this rising rate environment was amplified by significant growth this quarter, with deposits up 7% year-over-year. Moreover, we are seeing strength in critical segments. For example, New to Canada account acquisition is up more than 100% year-over-year. In our real estate secured lending business, we are benefitting from our journey-based approach and seeing progress in everything from advisor productivity to pipeline management to account retention. And in our branch network – we are seeing increased branch effectiveness in pull through and conversion rates. Our Cards business continued to perform very well. Card retail sales were up 22% year-over-year, with a notable rebound in travel-related spend. Focused on creating deeper engagement and loyalty, we launched My TD Rewards – a new loyalty and rewards hub where customers can easily access and redeem rewards and loyalty benefits online or on the go. Through this platform, customers will be able to take advantage of an integrated partnership with Starbucks Canada, helping them unlock even more value on everyday purchases. This partnership adds to our existing programs with Air Canada, Amazon, Expedia, and Canada Post – as TD continues to collaborate with the biggest consumer brands in the world. It was also a very strong quarter for the Business Bank, with double digit growth in loans. And TD Auto Finance ranked highest in dealer satisfaction among non-captive lenders with retail credit by JD Power, for the fifth year in a row. In our Wealth business, net asset growth and higher fee-based revenue helped offset a moderation in Direct Investing trading volumes from the all-time peak we saw last year. We have taken market share in both Direct Investing – as measured by new accounts, trades, and revenue – and Private Wealth Management, demonstrating the strength of our offerings across investor segments. And TD Asset Management led the banking industry in mutual fund sales for the second consecutive quarter. The competitive advantages of our Insurance business were also evident in the quarter as we strengthened our #1 position in both the Direct to Consumer and Affinity spaces. We also launched modernized, cloud-based Contact Centre capabilities – including leveraging AI for intent-based call routing. We believe that this investment – which we plan to roll out more broadly across the Bank over time – will enhance customer experience and accelerate response times.

Turning to the U.S., our U.S. Retail Bank earned US$769 million in Q2. Excluding PPP run-off, commercial loan volumes continued their momentum quarter-over-quarter, with strong originations and increasing utilization rates. Credit card sales and auto loan originations were up 15% and 36% year-over-year, respectively. And we saw good retail deposit volume growth, while benefiting from higher deposit margins in a rising rate environment. To support commercial customers, we launched a pilot program with a leading fintech to automate cash management by embedding TD banking products and services directly into their Enterprise Resource Planning and accounting software. We added a general purpose Mastercard to our offerings in Target's digital and store channels, further growing our strategic card partnership beyond the store-only RedCard. We continued to innovate in the payments space. This quarter, TD Auto Finance became the first indirect auto lender in the U.S. to offer real-time payments throughout the day to our dealer-clients nationwide, rather than sending batch payments overnight – a significant benefit for our clients. And, we launched TD Home Access Mortgage, a new product designed to increase home ownership opportunities in Black and Hispanic communities across several markets within our footprint. TD also received an Outstanding rating in its recently concluded Community Reinvestment Act examination. With the contribution from our investment in Schwab of US$177 million, segment earnings were US$946 million this quarter.

And we continue to make progress on our transaction with First Horizon. Since the agreement was announced in late February, our teams in the U.S. have been hard at work. We have held listening sessions and met with over a hundred community groups across TD and First Horizon's footprints. TD's commitment to local markets and our history of investment in the communities we serve were well-received, and I am pleased by the broad support we've heard for the transaction – including letters of support contributed by hundreds of community groups as part of the regulatory public comment period process.

In our Wholesale Banking business, we delivered solid performance this quarter in a challenging market and geopolitical environment – with earnings of $359 million, driven largely by higher trading revenues.

This quarter, TD Securities was named the Overall Canadian Fixed Income Service Quality Leader in the Coalition Greenwich Study for the fourth consecutive year. And the business continues to be recognized for the investments we've made to strengthen our global platform and enhance the capabilities we offer our clients. TD Securities was top 3 in the Overall Commodities Dealers category of the 2022 Energy Risk Commodity Rankings and was #1 and #2 in Base and Precious Metals, respectively.

Reflecting our leadership in sustainable finance, TD Securities was selected as Co-Structuring Adviser and a Joint Lead Manager on the Government of Canada's inaugural $5 billion green bond issuance, the largest Canadian green bond issued to date.

The Bank also set interim financed emissions targets this quarter. To help support our net-zero goals, we are focused on two high-emitting sectors — Energy and Power Generation — and TD Securities will work closely with clients to support and enable their transitions to a low-carbon future.

Overall, as I reflect on the quarter, I am pleased with the way we've navigated the rapidly evolving environment. Credit performance remained strong, and we saw growth in our businesses. However, we are also seeing elevated uncertainty, higher inflation, and increased risk of a potential economic slowdown. With our disciplined risk management approach and sustainable business model, TD is well-positioned to face the challenges – and seize the opportunities – that lie ahead.

To continue to exceed the rapidly changing expectations of our customers, we have launched an initiative we call the Next Evolution of Work (or "NEW" for short). Historically, the operating model of most banks, including TD, has been designed to support a smaller number of large-scale initiatives. It has served us well. However, it is not designed for the volume of change we are driving today – and for what we will need to drive in the future.

With NEW – we are building upon our strengths by modernizing our operating model and technology capabilities. This includes focusing on customer journeys to foster continuous improvement, adapting certain functions of the organization to maximize cross-functional effectiveness, enabling new tooling and platform capabilities including the use of the cloud, and adopting agile-at-scale processes. Key parts of the organization have shifted to the NEW model so far, and we are seeing positive results – including faster time to market and greater efficiencies in how we are building and deploying technology. This is enabling us to move at the speed of the market, and introduce new offers and services to our customers in a matter of weeks. It's still early days, but we are confident that we are on the right path.

TD also continues to lead the industry in AI innovation. For the second consecutive year, our Canadian banking app was honored by the Business Intelligence Group for AI-powered insights developed by Layer 6, our in-house AI team. TD was also recognized by Celent – a global research and advisory firm focused on technology for financial institutions – as the winner of the 2022 Model Bank Award for Customer Engagement, for our AI-powered digital experiences intended to improve financial outcomes for our customers.

We have world-leading AI capabilities at TD – and their applications extend far beyond banking. Last month, we were proud to announce our investment in Signal 1. Signal 1 will apply AI to help improve healthcare delivery for everyone – a clear need that has been amplified throughout the pandemic.

COVID-19 also heightened our focus on healthy facilities. This quarter, we were proud that TD achieved the WELL Health-Safety Rating certification across our entire North American retail and corporate real estate footprint – one of only a few organizations globally to have certified their entire portfolio.

And TD Bank, America's Most Convenient Bank was recognized by DiversityInc as a Top Company for Diversity for the tenth consecutive year and by Forbes as one of the Best Employers for Diversity for the fourth consecutive year. These awards only motivate us to work harder as we strive for a more diverse and inclusive future.

TD colleagues will contribute to that future, and we continue to invest in them as they are our most valuable asset. This quarter, I was pleased to announce a 3% pay raise or one-time cash award for the majority of our workforce below the Vice President level. After two years of effort through challenging circumstances, it is the right thing to do – to deliver for all of our stakeholders. It is a privilege to work alongside our over 90,000 TD bankers around the globe, and I thank them for all they do, every day.

With that, I'll turn things over to Kelvin.

Kelvin Tran – TD – Chief Financial Officer

Thank you, Bharat. Good afternoon everyone. Please turn to slide 11.

This quarter, the Bank reported earnings of $3.8 billion and EPS of $2.07, up 3% and 4%, respectively. Reported earnings include a litigation settlement recovery. Adjusted earnings were $3.7 billion, and adjusted EPS was $2.02, down 2% and 1%, respectively. Reported and adjusted revenue increased 10% and 8% year-over-year, respectively, reflecting volume and margin growth in our banking businesses, higher fee-based revenue in our banking and wealth businesses and prior year premium rebates for our insurance customers, partially offset by lower transaction revenue in our wealth business. Reported revenue also includes an insurance recovery related to litigation. Provision for credit losses was $27 million Expenses increased 5% year-over-year, reflecting higher spend supporting business growth and higher employee-related expenses, partially offset by prior year store optimization costs. Adjusted expenses also increased 5%. Absent the retailer partners' net share of the profits from the U.S. strategic card portfolio, adjusted expense growth was 6.5% year-over-year, or 6.6% ex-FX. Consistent with prior quarters, slide 25 shows how we calculate total bank PTPP and operating leverage removing the impact of the U.S. strategic card portfolio, along with the impact of foreign currency translation, and the insurance fair value charge. Reported total bank PTPP was up 16% year-over-year before these modifications, and adjusted PTPP was up 11% after these modifications, mainly reflecting higher revenues in our personal and commercial banking businesses. Please turn to slide 12.

Canadian Retail net income for the quarter was $2.2 billion, up 2% year-over-year. Revenue increased 9%, reflecting volume growth, prior year premium rebates for insurance customers and higher fee-based revenue in our banking and wealth businesses, partially offset by lower transaction revenue in our wealth business. Average loan volumes rose 9%, reflecting 8% growth in personal volumes and 16% growth in business volumes. Average deposits rose 8%, including 7% growth in personal volumes, 10% growth in business volumes, and 10% growth in wealth deposits. Wealth assets increased 4%. Net interest margin was 2.62%, up 9 bps compared to the prior quarter, primarily due to higher margin on deposits, reflecting the rising interest rate environment. Total PCL of $60 million increased $27 million sequentially. Total PCL as an annualized percentage of credit volume was 0.05%, up 2 basis points sequentially. Insurance claims increased 34% year over year, reflecting the normalization of claims, partially offset by the favourable impact of a higher discount rate which resulted in a similar decrease in fair value of investments supporting claims liabilities reported in non-interest income. Non-interest expenses increased 9% year over year, reflecting higher spend supporting business growth, including technology and marketing costs, higher employee-related expenses and variable compensation. Please turn to slide 13.

U.S. Retail segment reported net income for the quarter was US$1.1 billion, up 3% year-over-year. Adjusted net income was US$946 million, down 10% year-over-year. U.S. Retail Bank reported net income was US$902 million, up 6%, primarily reflecting higher revenue, partially offset by a lower recovery of PCL. U.S. Retail Bank adjusted net income was US$769 million, down 10%, primarily due to a lower recovery of PCL, partially offset by higher revenue. Reported and adjusted revenue increased 12% and 3% year-over-year, respectively, as the business overcame lower income from PPP loan forgiveness and lower gains on the sale of mortgage loans, with higher deposit volumes and margins and fee income growth from increased customer activity. Reported revenue includes an insurance recovery related to litigation of US$177 million. Average loan volumes decreased 4% year-over-year, reflecting a 4% increase in personal loans and an 11% decline in business loans, or 3% excluding PPP loans primarily due to continued paydowns of commercial loans. Average deposit volumes, excluding sweep deposits, were up 10% year-over-year. Personal deposits were up 12% and business deposits were up 7%. Sweep deposits declined 7%. Net interest margin was 2.21%, flat sequentially, as higher deposit margins reflecting the rising interest rate environment were offset by lower PPP loan forgiveness, lower loan margins and higher prepayment income in the prior quarter. On slide 29, we've continued our disclosure on the impact of the PPP program. This quarter, PPP revenue contributed approximately US$28 million to NII and 4 basis points to NIM. Most of the benefit of PPP revenue has now been realized. Total PCL was a recovery of US$15 million, a decline of $32 million sequentially. The U.S. Retail net PCL ratio, including only the Bank's share of PCL for the U.S. strategic cards portfolio, as an annualized percentage of credit volume was -0.04%, lower by 8 bps sequentially. Expenses increased 2% year-over-year, reflecting higher employee related expenses and business investments, partially offset by prior year store optimization costs, lower COVID-19 expenses and productivity savings in the current year. The contribution from TD's investment in Schwab was US$177 million, down 9% from a year ago. Please turn to slide 14.

Wholesale net income for the quarter was $359 million, a decrease of 6% year-over-year, reflecting higher non-interest expenses and a lower PCL recovery, partially offset by higher revenues. Revenue was $1.3 billion, up 8% year-over-year, primarily reflecting higher trading-related revenue, partially offset by lower underwriting fees. PCL for the quarter was a recovery of $9 million, compared with a recovery of $5 million in the prior quarter. Expenses increased 10% year-over-year, primarily reflecting the continued investments in Wholesale Banking's U.S. dollar strategy, including the hiring of banking, sales and trading, and technology professionals and the acquisition of TD Securities Automated Trading (previously Headlands Tech Global Markets, LLC). Please turn to slide 15

The Corporate segment reported a net loss of $151 million in the quarter, compared with reported net loss of $186 million in the second quarter last year. The year-over-year decrease reflects lower net corporate expenses and lower amortization of intangibles. Net corporate expenses decreased $25 million compared to the same quarter last year. Adjusted net loss for the quarter was $79 million, compared with an adjusted net loss of $106 million in the second quarter last year. Please turn to slide 16.

The Common Equity Tier 1 ratio ended the quarter at 14.7%, down 49 bps sequentially. We had strong organic capital generation this quarter, which added 45 basis points to CET 1 capital. This was more than offset by an increase in RWA, the impact of the repurchase of common shares prior to the First Horizon acquisition announcement and the impact from our US$494 million investment in First Horizon convertible preferred stock, which accounted for 8 basis points of CET 1 capital. We are activating the DRIP discount for our upcoming dividend as a prudent response to a number of developments and uncertainties in the operating environment. Inflationary pressures have led to greater volatility in interest rate markets, and there is increased possibility of an economic slowdown. Conversely, should interest rates continue to rise, we would expect expanding margins for TD's Canadian and US Retail segments and higher fair value accounting adjustments upon closing of the First Horizon transaction, which would result in a higher initial capital requirement and higher accretion of the fair value adjustments into earnings over time. We also expect the Canada Recovery Dividend to have an adverse impact on CET 1. Taking all of these developments and uncertainties into account, we believe it is appropriate to take steps to build our capital buffer to support continued business growth. RWA increased 4% quarter-over-quarter, mainly reflecting higher Credit Risk and Market Risk RWA. Credit Risk RWA increased $13.9 billion, or 4%, mainly reflecting higher volumes in Canadian Retail and Wholesale. Market Risk RWA increased $3.6 billion, or 18%, reflecting market volatility. The leverage ratio was 4.3 percent this quarter, and the LCR ratio was 119 percent, both well above regulatory minimums.

I will now turn the call over to Ajai.

Ajai Bambawale – TD – Group Head and Chief Risk Officer

Thank you, Kelvin and good afternoon everyone. Please turn to slide 17.

Gross impaired loan formations decreased 4 basis points quarter-over-quarter, to 12 basis points, reflecting higher prior quarter formations in U.S. Commercial, largely related to government guaranteed Paycheck Protection Program loans. Please turn to slide 18.

Gross impaired loans decreased 3 basis points quarter-over-quarter to a new cyclical low of 30 basis points, largely reflecting: Further resolution of Paycheck Protection Program loans in the U.S. Commercial portfolio. Please turn to slide 19.

Recall that our presentation reports PCL ratios both gross and net of the partners' share of the U.S. strategic card PCLs. We remind you that PCLs recorded in the Corporate segment are fully absorbed by our partners and do not impact the Bank's net income. The Bank recorded provisions of $27 million or 1 basis point this quarter, decreasing by $45 million quarter-over-quarter, reflecting: Lower impaired PCLs, and a larger performing allowance release. Please turn to slide 20.

The Bank's Impaired PCL was $314 million, decreasing by $15 million quarter-over-quarter, and remaining at cyclically low levels. Performing PCL was a recovery of $287 million, compared to a recovery of $257 million last quarter. The current quarter recovery reflects additional allowance releases across all segments. Please turn to slide 21.

The Allowance for Credit Losses decreased $231 million quarter-over-quarter to $6.9 billion or 87 basis points, reflecting improved credit conditions. However, the release was tempered due to increased economic uncertainty, largely related to geopolitical risks, and inflation. The Bank's allowance coverage remains elevated to account for this ongoing uncertainty that could affect the economic trajectory and credit performance. In summary, the Bank continued to exhibit strong credit performance this quarter, as evidenced by lower gross impaired loan formations, gross impaired loans, and PCLs. While these key credit metrics remain at or near cyclically low levels, economic uncertainty continues to be elevated.

TD, however, remains well positioned given we are adequately provisioned, we have a strong capital position, and we have a business that is broadly diversified across products and geographies.

With that, operator, we are now ready to begin the Q&A session.

QUESTION AND ANSWER

Operator

Thank you. We will now take questions from the telephone lines. [Operator Instructions] Your first question is from Ebrahim Poonawala from Bank of America. Please go ahead.

Ebrahim Poonawala – BofA Securities – Analyst

Good afternoon. I wanted to follow up on capital and better understand, maybe for Kelvin, give us a sense of what the hit to CET1 would be if rates stay where they are and if you would have closed the deal today. If you could help us quantify that. I'm just trying to understand the DRIP and whether the initiation of the DRIP is just out of abundance of caution or if there is a meaningful hit. So, would appreciate if you could quantify what the impact would be from the movement in interest rates, and then I will follow up tied to capital and how you're managing the results.

Bharat Masrani – TD – Group President and CEO

Just before Kelvin picks it up, Ebrahim, this is Bharat. Nice to hear you. Yes, I know there's been lots of questions on this. Kelvin told me on the earlier calls as well. And just to give you a sense, historically, in the bank on this particular issue, we don't go out and hedge, because if you look at the underlying offsets we have in the bank, the net interest sensitivity is what happens to our earnings when rates go up. In this case, even earnings at First Horizon, and what happens to them when rates are rising. And then finally, as Kelvin said in his comment, on this particular transaction, whatever this additional fair value adjustment will be, it will be offset with the accretion that we would earn after we close the transaction. So, just wanted to provide you with that sense as to how we think about this. And this has been our framework for many, many years in all the acquisitions we've done.

Maybe Kelvin can help you with some of the numbers you're asking on.

Kelvin Tran – TD – Chief Financial Officer

Yes. Thanks, Bharat. In other words, we do have a natural hedge when interest rates rise because we see margin expansion in both our Canadian and US businesses, including underlying earnings of First Horizon. But maybe I can just give you a more of a sensitivity measure because this number would move around. For every 50 basis point increase, it's about $350 million on an after-tax basis.

Ebrahim Poonawala – BofA Securities – Analyst

That's extremely helpful. And I totally get it, Bharat, in terms of that it's just a timing issue whether or not it's come through earnings over a period of time. And just one more question on First Horizon. I think the US regulatory process has become a little more prolonged over the last year. One of the concerns that I hear is TD uniquely is a GSIB relative to the other bank M&A that has been announced. Would love to hear your thoughts around the conviction level in terms of getting the deal through the regulatory sort of finish line and is TD different than the other five transactions that are out there because of being a G-SIB?

Bharat Masrani – TD – Group President and CEO

Well, I don't want to comment on what the other transactions out there might be. But we feel very comfortable, our process continues, and we did this transaction on the basis that it meets all the requirements of all the regulators. So, we continue to be comfortable and working hard to get it to closing. I don't think it'd be appropriate for me to comment on how this compares to other deals out there, as each one has its own unique feature.

Ebrahim Poonawala – BofA Securities – Analyst

That's fair. And just one last for Ajai on reserves. You still have loan loss allowance, which is about CAD $1.3 billion more than pre-COVID levels or CAD $1.4 billion. We've seen some of your peers take reserves down to pre-COVID or below. Is this entire excess reserve because of the uncertain macro backdrop and could this flow into earnings or is there something else going on with regards to mix or how you perceive the portfolio?

Ajai Bambawale – TD – Group Head and Chief Risk Officer

Thanks for the question and let me respond. What I would say is expect prudence from us. There is uncertainty out there, and the sources, as I said even on the last call, are changing. Our allowance really accounts for this uncertainty that's out there. Having said that, if the macro conditions improve and the uncertainty reduces, then, yes, we would be looking to release more reserves. But as you're aware, the situation is quite fluid right now. And what the future holds, who knows? But to the extent that we are in a recessionary scenario or even in a stagflation kind of scenario, it is possible we may have to build reserve. I think at this point because we are seeing all this uncertainty, we're just being very prudent, very careful, thoughtful, and deliberate in how we are releasing our reserves. So, hopefully that helps.

Scott Chan – Canaccord Genuity – Analyst

Hi. Good afternoon. So, just on First Horizon, talk about a lot of town halls with senior executives and Bharat, maybe at a high level, have you learned anything on these meetings after the announcement that you could possibly share, in terms of people or culture or anything like that?

Bharat Masrani – TD – Group President and CEO

I'll pass it on to Leo in a second. I attended some meetings with the various groups, and it was terrific to engage. And TD Bank, America's Most Convenient Bank and TD generally have always been well received in the communities. Our purpose is to enrich the lives, not only of our customers and our colleagues, but of our communities as well. And that has played well in all these meetings with that.

But maybe, Leo can give you a more color because Leo was in various meetings himself and his whole team was, as well, and can give you a bit of a color on the meetings we've had.

Leo Salom – TD – President and CEO, TD Bank America's Most Convenient Bank

Sure, Scott. Thank you very much for the question. We had the opportunity to essentially do 15 town halls across 13 cities over the course of the last four weeks. And it's been a terrific opportunity to get to know the entire organization. We met with over 6,000 employees. I'd say a couple of things that stood out. And I think more it falls in the category of reaffirming our beliefs going in. One, there's no question that First Horizon is a very strong commercial bank with very strong and deep ties in the local communities. And that came across with the talent in that space which we view is going to be very additive as we continue to build our commercial bank and as we continue to try to grow that in the marketplace.

I think the distribution that they've built across the Southeast is very compelling. They've got 412 branches. We got a chance to actually visit in many of those cities that are experiencing above average population growth and above average banking formation. And I think we're quite excited about how we can bring our retail model to bear, a model that served us very well on the East Coast, bring that to be able to grow the retail franchise. I think that was quite encouraging. Probably the thing that I would harp on the most is it's just the culture. I think it's an organization that's sort of humble at its core, but very ambitious in terms of what they want to achieve and very committed to serving their clients and their local communities. And I think that certainly resonates with us. It's how we built our franchise in the US and we look forward to bringing these two organizations together. The time that's been spent most recently is working very closely in our work streams to start to stitch together what the combined organization is going to look like. And I look forward to sharing some of our progress on that end on future calls.

Meny Grauman – Scotia Capital – Analyst

Hi. Good afternoon. Sticking to First Horizon, the community meeting is coming up for August and I'm wondering if any concessions are likely through that process.

Bharat Masrani – TD – Group President and CEO

Sorry, Meny, just to make sure we understand, what do you mean by concessions?

Meny Grauman – Scotia Capital – Analyst

Specifically, I'm wondering about overdraft. Could there be a scenario where you have to do something more on overdraft fees overall for US business? Is there a risk for that?

Bharat Masrani – TD – Group President and CEO

Well, I'll let Leo answer, but I think all these community arrangements are pretty consistent as far as how they work and that we would expect to follow a similar line.
But, Leo, do you have any further color on that?

Leo Salom – TD – President and CEO, TD Bank America's Most Convenient Bank

Meny, I can maybe just go back to what I shared last quarter. We are executing the overdraft strategy that we shared with you before. In fact, on April 8, we implemented the new minimum threshold for overdraft fees, increasing it to CAD $50. And that was a big part of the changes that we had proposed. We've got a series of other changes planned for the fourth quarter. The impact of those is tracking very much to what we shared in terms of the guidance that we provided last quarter. The only additional change that we've made in the interim, and it's unrelated to First Horizon, is the fact that we are going to go to zero on our NSF fees. So, that was the one incremental change from last quarter's overall impact. I can quantify that for you. It will be less than CAD $40 million a year. So, it's not material on its own. But those changes, we believe, that collectively, those that we've announced last quarter plus the NSF fee puts us in a very competitive space, and I think it provides our clients with choice and value. So, we're quite comfortable with the changes we've made from an overdraft standpoint. We are working, just to your point, on the community discussions. We have met with community leaders, over 100 community leaders in five listening tours that was organized by the NCRC. And those have been quite useful, and that input will be the groundwork for the actual community benefit agreement that we'll strike over time. That's unrelated to the public hearing itself.

Meny Grauman – Scotia Capital– Analyst

Got it. And then just as a follow up, in the US business, you highlight the lower fee income from overdraft and overdraft changes and then lower gains on the sale of mortgage loans. I'm wondering if you could break out the impact of both of those and how we should think about that going forward as well.

Leo Salom – TD – President and CEO, TD Bank America's Most Convenient Bank

Well, I would say from an overdraft standpoint, we implemented it April 8. So, it was a relatively small time series. The overall impact, which I shared with you last quarter, was that the aggregate impact of all the changes was CAD $250 million. And to that, you should add the CAD $40 million number and that'll give you a sense of what the impact is going to be related to overdraft. With regards to some of the other changes, prepayment, and some of the gain on sale of mortgages, it really depends on market conditions. So, I wouldn't necessarily read too much into it. To the extent that market conditions change, we would certainly look to seeing those numbers eb and flow over time. I do want to just comment that as we continue to grow our wealth franchise, we continue to lean into growing our core checking account base and continue to accelerate the growth in our cards business. We would expect us to be able to generate fee income from those activities to be able to help compensate some of the declines in the overdraft space.

Sohrab Movahedi – BMO Capital Markets – Analyst

Thank you. Just two quickies here. Leo, you obviously have spent a lot of time since announcing the First Horizon. Are you able to quantify some revenue synergies that may be coming?

Leo Salom – TD – President and CEO, TD Bank America's Most Convenient Bank

Sohrab, thanks again for the question. As I shared the last time we were together, we didn't put revenue synergies in the model. Now, that said, I do believe there's some really compelling opportunities as we bring our two organizations together, which will undoubtedly generate revenue synergies. I think top of that list is bringing our two commercial banks together, playing a much bigger role in the mid-market space when you combine some of their capabilities, our balance sheet, and the TD Securities product base. There's no question in my mind that that would be a platform for us to be able to grow and grow at an accelerated pace over time.

I mentioned on the previous – to the previous question the opportunity in the retail space. I'm excited about what we might be able to do. If you simply take the penetration rate that we enjoy today on some of our product sets and bring that to First Horizon, there'd be another source of significant synergy that we can build. So, we'll work through those and certainly we'll try to prioritize that as part of our overall integration efforts. Obviously, we provided a CAD $610 million expense guidance in terms of synergy, but we're equally going to be leaning in on these revenue synergies, because I think it's exciting. It will help us accelerate the growth of the franchise overall.

Sohrab Movahedi – BMO Capital Markets – Analyst

Okay. Exciting but not quantifiable yet, is that the right way to think about it?

Leo Salom – TD – President and CEO, TD Bank America's Most Convenient Bank

We're working through those, but suffice to say that we're very optimistic.

Sohrab Movahedi – BMO Capital Markets – Analyst

Okay. And Kelvin, just for clarification. The capital sensitivity you provided of about $350 million for every 50 basis points I think in rate hikes, was that in Canadian dollars or is that in US dollars?

Kelvin Tran – TD – Chief Financial Officer

That would be in US dollars.

Sohrab Movahedi – BMO Capital Markets – Analyst

So, US$350 million for every 50 basis points in fed rate hikes, is that the right way to think about it?

Kelvin Tran – TD – Chief Financial Officer

Yeah.[1]

Gabriel Dechaine – National Bank Financial – Analyst

All right. Just to clarify that one. The $350 million, that's an increase in goodwill or an increase in CET1 consumption?

Kelvin Tran – TD – Chief Financial Officer

It would be an increase in goodwill.

Gabriel Dechaine – National Bank Financial – Analyst

Okay. And when you talk about the timing, where you make that up with asset accretion over time, what kind of timeframe? Is that a three-year timeframe, five-year timeframe that you expect that? I'm trying to think maybe along the lines of asset duration.

Kelvin Tran – TD – Chief Financial Officer

Yeah. Along the line of asset duration, typically four to five years.

Gabriel Dechaine – National Bank Financial – Analyst

Got it. On expenses, you along with other banks have announced some wage hikes for most of your employees. Just wondering how that plays out in terms of your near-term outlook for positive operating leverage and efficiency ratio improvement. Is it likely that we could see you have zero operating leverage in the second half?

Kelvin Tran – TD – Chief Financial Officer

When we look at operating leverage, we don't manage expenses on a quarter to quarter, it's more on a medium-term basis. And so, we continue to work towards building positive operating leverage over that timeframe. And to help you quantify the expense impact of the 3%, it's about CAD $290 million on a run rate annualized basis.

Nigel D'Souza – Veritas Investment Research – Analyst

Thank you. Good afternoon. I just had a quick question for you first, just to clarify some of your information on slide 35 with your loan to value disclosure. The HELOC LTV is on that slide. Just wanted to clarify that is inclusive of the mortgage balances associated with those properties as well.

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[1] Refers to a 50 bps parallel shift in the curve.

Bharat Masrani – TD – Group President and CEO

It should be, yes.

Nigel D'Souza – Veritas Investment Research – Analyst

Okay. So, when I'm looking at those LTVs, the HELOC LTV is actually below the LTV in your mortgage book. I wonder if you could touch upon that because I would think borrowers with mortgages plus HELOC would have higher LTVs than borrowers with just mortgages.

Ajai Bambawale – TD – Group Head and Chief Risk Officer

We'll have to take that away. We'll have to look at the data and come back to you.

Nigel D'Souza – Veritas Investment Research – Analyst

Okay, sure. So, if I could switch gears to your allowances, I can understand how a deterioration in forward-looking indicators could lead to less reversals or more built-in provisions. But when I look at your Stage 2 loans, you have about 7% of your total loan portfolio sitting in Stage 2. Before the pandemic that was closer to 3%. So, you're running at about two to three times your pre-pandemic Stage 2 loan levels. Just wondering why those loans still haven't migrated to Stage 1? And what's preventing that migration?

Ajai Bambawale – TD – Group Head and Chief Risk Officer

We saw a lot of migration to Stage 2 through the pandemic. And I'd say over the last few quarters we've seen a lot of migration back. Not all the loans are migrated back because of the uncertainty out there and because of the macroeconomic scenarios we're using, which you've got to keep in mind that these Stage 2 loans don't just reflect delinquency numbers, but to the extent the macroeconomic scenarios drive different PDs, you're at a different stage of your loans. So, over time, as I said, as the macro conditions improve, we should see more migration and if the uncertainty reduces. However, things could go the other way as well as I've said – it's pretty fluid right now the whole situation.

Nigel D'Souza – Veritas Investment Research – Analyst

Okay. But fair to say that the Stage 2 loans have a higher PD than your Stage 1 loans?

Ajai Bambawale – TD – Group Head and Chief Risk Officer

That's right.

Nigel D'Souza – Veritas Investment Research – Analyst

Okay. And looking at your forward-looking indicator disclosure this quarter, when I look at the downside scenario, you now have a scenario where rates can move higher in the short term and real GDP could decline. So, is that representative of your stagflation scenario? And how does that impact your expected credit loss modeling this quarter?

Ajai Bambawale – TD – Group Head and Chief Risk Officer

Yes. Our downside case is a form of stagflation for sure, so high inflation, lower GDP. What's the second part of your question?

Nigel D'Souza – Veritas Investment Research – Analyst

How did it impact your expected credit loss modeling and provisions for performing loans this quarter by introducing that scenario?

Ajai Bambawale – TD – Group Head and Chief Risk Officer

We didn't change the weight on the downside. And if you look overall, the uncertain macro situation and the downside and the weight on the downside is a factor, led us to actually temper the release, which is we called out. So, overall macro between the base and the downside actually led to a tempering of our release.

Nigel D'Souza – Veritas Investment Research – Analyst

Got it. And last question for me. When I look at that downside scenario, the assumption you have for home prices is about the same as your base case scenario despite rates moving higher in the downside scenario. So, should we take that away with your expectation that home prices are going to remain where they are and not declining if rates move up?

Ajai Bambawale – TD – Group Head and Chief Risk Officer

That's a great question and thank you for calling it out. And let me talk about housing just for a minute. So, I think the starting point for housing is really two years ago and the big increase that we've seen in house prices over the last two years, I believe that number is 45%, is actually a material risk mitigant for our book. When we did our allowance scenarios, and this is partly because of timing, we did view that there would be some price growth both in the base and the downside case. And the reason for that is there are many supporting factors, including unemployment, income level, supply constraints, and of course, the population growth.

Our house view, however, is in recent data and the house view has adapted. And I think now we are expecting some correction in the housing market and some of that 45% gain that I talked about is going to recalibrate. So, we would see some unwinding of that in the coming quarters. And we did actually take that into consideration in our allowance process and put in an overlay. But what I drive comfort from is a few things. One is our customer base, and their risk profile is strong. Second, our underwriting standards haven't really changed, and they've been through the cycle. Third is we are using a qualifying rate, stress rate to approve these loans. And lastly, and this is an important point, the job market is still very strong. So, we'll re-look at it next quarter, but it's not like we completely ignored it. And those numbers that you call out, it was a point in time, yes and you're right in calling it out.

Lemar Persaud – Cormark Securities – Analyst

Yeah. Thanks for taking my question. Hopefully, just a quick modeling question to start off with here. I think I heard in the opening remarks there is either a 3% pay raise or a one-time cash award. Wonder how big the one-time cash award was in non-interest expenses since presumably it would be non-recurring in nature.

Kelvin Tran – TD – Chief Financial Officer

Hi, it's Kelvin. That's right. The one-time cash award is only CAD $10 million, and it is one-time.

Lemar Persaud – Cormark Securities – Analyst

Okay, inconsequential then. Okay, then to my real question here. I just want to come back to the discussion on capital, particularly as it relates to First Horizon. I understand that you get the benefit of additional accretion from higher rate or that natural hedge you're referring to when the deal closes. But does OSFI take that into consideration or would OSFI CET1 ratio even if temporarily kind of touch the 10.5%?

Bharat Masrani – TD – Group President and CEO

Hard to comment. This is Bharat, Lemar. Great question. Hard to comment on exactly how the regulators look at this. But this has been our traditional way of doing it. And we've been prudent capital managers. So, I feel comfortable that not only will we close the transaction the way we have intended, but we'll have capital levels that will meet all regulatory requirements.

Kelvin Tran – TD – Chief Financial Officer

Maybe I can just clarify. The accretion post day one would be an active capital post day one. And then what we're talking about is the natural hedge is not just post day one. Rate increases during this period, First Horizon would earn more revenue, and so does the bank in terms of the Canadian Retail and the US business, and so all of that acts as the natural hedge as well.

Paul Holden – CIBC – Analyst

Hi, good afternoon. Sorry to belabor this point, but I'm going to ask a follow-up question on this First Horizon fair value adjustment. So, there's a plausible scenario where rates increase significantly between now and then, and then a possibility that rates decrease thereafter. Would that therefore suggest you would take a goodwill impairment charge later on down the road and then thereby decrease your capital associated with the transaction? Is that how to think about the natural hedge in that type of scenario?

Kelvin Tran – TD – Chief Financial Officer

It's Kelvin here. No, the goodwill write-down is a significant event and it's not just based on rates alone. You have to look at the entire business and the value that it generates. So, I wouldn't draw the conclusion between those two.

Paul Holden – CIBC World Markets – Analyst

Okay. So how do we think about you earning that back and in that type of scenario, again, where rates move higher significantly in the next six, nine months. But then, if there is a recession, they're going to come back down.

Kelvin Tran – TD – Chief Financial Officer

Yeah. This is really the accounting of the business acquisition. So, I'm going to get a little bit technical here, so bear with me. So, on closing, what you do is you write-down the fair value of the – so let's say the loans is at par and you write it down to CAD $30 and over time that CAD $70 would accrete to par CAD $100. So, all of that would get back to you as you collect that cash and would come into earnings.

Paul Holden – CIBC World Markets – Analyst

I understand. Okay. Thank you for that. So, the other question I want to ask was just on your underwriting appetite today being very clear in terms of how you're managing your credit allowances and taking a conservative view. You also made some comments about expecting housing prices perhaps to decline here. Does that mean you decrease your underwriting appetite or I guess, tighten up your credit parameters today?

Ajai Bambawale – TD – Group Head and Chief Risk Officer

Yeah. It's Ajai. So, the simple answer is no. We're not going to change our credit parameters. I think you heard from us many times where through the cycle underwriters and we'd like to keep our underwriting standards consistent and that's the intent. So, we will not change our underwriting standards unless we thought there was going to be unexpected loss. So, consistent underwriting standards should be expected from us. The other comment I'd make is that we're actually seeing very good quality on our reserve book, whether it's HELOC or residential mortgages. If you look at delinquencies, charge-offs, formations, gross impaired loans, they're at historical lows. And you look at our origination metrics, you look at our customer quality, just the scores, they're in very good shape and the customers are in very good shape. I know things are changing and we need to monitor how things will change and how customer attributes may change. And to the extent they change, we'll certainly factor it into our allowance process. But as of now, like we feel pretty good about the quality of our book.

Joo Ho Kim – Credit Suisse Securities – Analyst

Hi. Good afternoon. Just a quick question on US Retail and wondering what you're seeing in terms of client demand and utilization for commercial loans, that the rate of decline seems to have slowed down and I think a part of that is the PPP impact diminishing. I'm just wondering when we could start seeing that commercial loan growth pickup ahead. Thank you.

Leo Salom – TD – President and CEO, TD Bank America's Most Convenient Bank

Yes, thank you very much for the question. You're right. We did see really an acceleration in terms of commercial lending in the quarter. Just to give you a sense, gross originations increased 47% year-on-year and probably more relevant is that we saw a slowdown in some of the paydown activity. And line utilization, which is the number we do provide, increased by 250 basis points. So, you put those three factors together and it resulted in the strong in-quarter spot growth of about 3%. So, we're pleased with that. Now, if I can give you a little bit more color as to where, because I think it's important, we're seeing that growth in the middle market space and in our specialty lending businesses, so healthcare, municipal, not for profit education, and some of the more established verticals that we have. But what we're still not seeing is quite as much loan demand in the small business and sort of lower end of our community banking space. And those, I think those businesses are still trying to find their way post-pandemic. And so, I think it's going to take a little longer to see some of the growth that we'd like from those sectors. But I'm really pleased with what we saw in the quarter certainly from our established mid-market and specialty businesses and I'm certainly encouraged. Now, to the point that Ajai raised, there's plenty of uncertainty in the marketplace right now. So, I'm encouraged by it, but we remain cautious with regard to the outlook

Joo Ho Kim – Credit Suisse Securities – Analyst

Thank you. And just a quick follow-up on capital. I know there was a lot of discussion on it, but just a quick one. Given the discount on DRIP and the constructive, I guess, growth outlook ahead. If you could speak to whether there's any change in where you see the CET1 ratio landing after the First Horizon acquisition closes if there's any change? Thank you.

Kelvin Tran – TD – Chief Financial Officer

Hi. It's Kelvin. No, we don't see any changes.

Darko Mihelic – RBC Capital Markets – Analyst

Thank you. Two questions. One is for Riaz and I guess the other one is maybe for Kelvin, maybe for Bharat. Just going back to this capital thing for a moment. When you announced the First Horizon deal, you mentioned you terminated the NCIB, which makes sense, but you didn't announce the DRIP then. So, what has changed from then until now to sort of make you guys think about employing the DRIP? I mean, I can think of one thing, which is maybe the federal budget, but I would have thought that the environment looked pretty gruesome back then and rate increases were already factored into your thought process. So, just want to make sure there isn't anything that I missed. It's like what has actually changed since February to now that says you have to use a DRIP?

Bharat Masrani – TD – Group President and CEO

I think you see a lot of uncertainty out, Darko. You see the volatility in the market. The volatility is quite intense. And I think you know us, we're being prudent here. We want to make sure that we're covering up all the bases. And we'd rather have this than to say, all right, we will just skate by. For us, this is the prudent approach and it's the right thing to do given the uncertain environment we live in. And since February things have changed. The war is a reality in Europe, you see energy prices all over the place. So, there is a lot of volatility here. And as is usual from TD to address volatility and uncertainty of this type, we want to be prudent.

Darko Mihelic – RBC Capital Markets – Analyst

Is it too late to hedge now, Bharat?

Bharat Masrani – TD – Group President and CEO

It's not been our approach. The natural way we look at it is it's served us well and I'm sure it'll serve us well here as well. So, we are quite comfortable with the approach we have taken. I think Kelvin has explained to you the accounting and I know before this deal ends each one of you are going to become experts in purchase accounting and know exactly what are the puts and takes on this. But we feel very comfortable. Look at TD's net interest rate sensitivity, if that is what you're worried about. Look at First Horizon's net interest sensitivity and then, of course, the accretion that comes after closing. So, I think overall we feel very comfortable, but we want to maintain a particular level of capitalization given the volatility that all of us are experiencing.

Darko Mihelic – RBC Capital Markets – Analyst

Okay. And a real quick question on TD Securities. I've seen now with all wholesale businesses that we saw a pretty big increase in average loans on the balance sheet. The one thing that I always found odd with TD Securities, though, is you've got a very low margin on that loan book once I take out the trading component to your NII, and it really fell quarter-over-quarter. Am I looking at that wrong or is there some sort of explanation as to why a little bit of loan growth causes such a big drop in the margin on those on assets at TD Securities?

Riaz Ahmed – TD – Group Head, Wholesale Banking

Thanks for that, Darko. I think, in our aggregate loan book of some CAD $4 billion had components of corporate lending, prime brokerage, securitizations, and other similar products. So, the margin that you would be looking at would be an aggregation of those and then as cost of funds increase, you can see that margin comes down a little bit, and in some areas we're able to adjust the margins fairly quickly, and then the corporate lending book as you know is maybe the last product that tends to adjust to margins. So, we're basically just continuing to make sure that we're managing that both prudently and pricing it to make sure that we are supporting the clients that we want to support and earning the returns that we need to earn.

Darko Mihelic – RBC Capital Markets – Analyst

Okay. Thank you for that. I may follow up with you afterwards. There may be a mechanism of my math behind why your margin is so much lower versus peers. So, I'd love to have a follow up, if we could. Thank you.

Bharat Masrani – TD – Group President and CEO

And Darko, your point on, I guess, it's a good way to say never say never. When I say, we are very comfortable with our position now, but I don't want to be guessing and be clairvoyant of what the markets might do. So, I'll never say never, but very comfortable with the approach we've taken historically and where we are in the cycle. Based on what we see, we continue to feel very comfortable.

Operator

Thank you. There are no further questions registered at this time. I would like to return the call over to Bharat Masrani for closing remarks.

Bharat Masrani – TD – Group President and CEO

Thank you, operator, and thank you all for joining us. I know it's been a busy day. Appreciate everybody taking the time. Like I said, before the end of this year, all of you are going to become experts on purchase accounting, which is great for everybody's benefit. But once again, we have very good numbers from TD. I'd like to take this opportunity to thank our 90,000 bankers around the world. They continue to deliver for all of our stakeholders, including our shareholders. So, really appreciate everything they do. And we'll see you folks in the next 90 days. Thank you very much.