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PRESENTATION

Operator

Good morning, ladies and gentlemen, and thank you for standing by. Welcome to Genworth MI Canada, Inc. 2020 Second Quarter Earnings Conference Call. (Operator Instructions) I'd now like to remind you also that this conference is being recorded.

I'll now turn the conference over to your host, Mr. Aaron Williams, Vice President, Finance, Investor Relations. Mr. Williams, you may proceed.

Aaron Williams - *Genworth MI Canada Inc. - VP of Finance & IR*

Good morning, and thank you for joining Genworth Canada's Second Quarter 2020 Earnings Call. Leading today's call are Stuart Levings, our President and Chief Executive Officer; and Philip Mayers, our Chief Financial Officer.

We will start with our prepared remarks followed by an open question-and-answer session. Our news release, including our management's discussion and analysis of financial statements and financial supplement were released last night and are posted on our website at www.genworth.ca. A link to our live webcast and the slides for today's discussion are also posted on our website. A replay of this call will be available via the number noted in the press release and will also be available on our website following today's presentation. The call will be available online for approximately 45 days following today.

Our presentation and discussion today contain a disclaimer on forward-looking statements and non-IFRS statements. We note that our actual results may differ from statements that we make, which are forward-looking. We advise you to read the cautionary note regarding these forward-looking statements. As well, some of the financial metrics presented on this call today are non-IFRS measures, and as such, do not have a standardized meaning and are unlikely to be comparable to similar measures by other companies.

I would now like to turn the call over to Stuart to begin his remarks. Stuart?

Stuart Levings - *Genworth MI Canada Inc. - President, CEO & Director*

Thanks, Aaron. Good morning, and thanks for joining our call. Overall, we are pleased with our second quarter results, including positive top line momentum, a 27% loss ratio and 11% operating return on equity. While the environment continues to evolve in line with our base case expectations, there remains some economic uncertainty as governments and businesses navigate through the challenges of the COVID-19 pandemic and reopening of the economy. That said, we take comfort in the strength of our business model and capital position, along with our disciplined risk management and proven loss mitigation strategies to manage through this period of economic stress.

For the quarter, we delivered net operating income of $101 million, down 16% over the prior year period and 14% over the prior quarter, largely due to an increase in losses on claims. This resulted in fully diluted operating earnings per share of $1.17, down 15% over the prior year period and 13% over the prior quarter. Net premiums written totaled $227 million, up 17% over the prior year period. This increase was driven by significant demand for portfolio insurance, which totaled $13.4 billion for the quarter. The growth in portfolio insurance premiums more than offset the decline in transactional insurance premiums resulting from the COVID-19 environment and related economic shutdown.

The increase in demand for portfolio insurance was largely due to the introduction of a number of liquidity programs by the Governor of Canada, along with a temporary exception to allow for the insurance of refinance and extended amortization mortgages originated prior to March 20 this year. We were pleased with the opportunity to bid on a number of mortgage portfolios, and applied our disciplined risk management framework to select mortgages that aligned with our risk appetite, adjusted to account for the current pandemic environment and related economic uncertainty.

Our average portfolio insurance premium rate increased 12 basis points over the prior year as a result of shifts in portfolio mix as well as the inclusion of some refinance and extended amortization mortgages. While the transaction mortgage market slowed during April and May, as noted on our first quarter earnings call, we have seen a strong recovery in first-time homebuyer activity in June and July as buyers who remain confident about their employment status, took advantage of very low interest rates to compete for entry-level homes in a more rational marketplace.

In our view, this recovery reflects a degree of pent-up demand, essentially a delayed spring market, and therefore, activity may taper off somewhat in the second half of the year. That said, we are very encouraged by the strength and quality of the recovery to date. Provided this trend continues, we should see a positive impact on new insurance written in the second half of the year. In addition, there has been a shift in the competitive landscape that will influence the size of our addressable market going forward.

On June 4, CMHC announced that effective July 1, 2020, it would implement a number of product changes, effectively reducing the scope of mortgages on which it would be willing to provide default mortgage assurance. These changes include the elimination of any nontraditional sources of down payment, requiring mortgages to have a minimum credit score of 680 as compared to the PRMHIA minimum of 600 for LTVs greater than 80%, limiting the GDS ratio to 35% of annual income as compared to the PRMHIA limit of 39%, and limiting the TDS ratio to 42% of annual income as compared to the PRMHIA limit of 44%.

Both the GDS and TDS ratios are calculated using the Bank of Canada qualifying rate, which was 4.94% as of June 30, representing a buffer of approximately 200 to 250 basis points above the average contract rate for new insurance written in the second quarter of 2020.

As noted in our press release on June 8 this year, we confirmed that we would not be making these changes to our eligible mortgage loan requirements. In our analysis of our current exposure to the announced changes and the relative performance of these loans, we determined that our risk management framework, dynamic underwriting policies and current risk limits, together with ongoing monitoring of conditions and market developments, allow us to prudently adjudicate and manage our exposure to these loans.

Nontraditional sources of down payment and loans with a maximum credit score below 680 represent a very small proportion of our in-force portfolio and within our risk appetite limits. The higher debt service ratio business represented approximately 30% to 35% of our second quarter new insurance written, driven by the prevailing compliance rate and concentration of these loans in economically diverse but more expensive urban areas, including Toronto and Vancouver. As a result of not making similar product changes, we believe we will likely see an increase in our market share over the next few quarters. Given the recent timing of these changes, it is too early to determine the long-term impact on transactional new insurance written. That said, these changes may help to offset any tapering of market demand in the second half of this year. In the month of July, our transactional mortgage insurance commitments increased by approximately 75% and compared to the same month in 2019, reflecting both the strong housing recovery and the CMHC product changes. This has helped to close the gap resulting from the lower year-over-year volumes in April and May, driving our year-to-date commitment volumes slightly ahead of the prior year at the end of July. As a result, we have updated our outlook for total premiums written to be moderately higher than the prior year with growth in both portfolio and transactional insurance volumes.

While our loss ratio increased to 27% for the quarter, we are encouraged by the prudent and gradual reopening of provincial economies and the beginning of a job recovery. The loss ratio is largely influenced by our reserving approach, which includes an incurred but not reported amount to reflect losses embedded in the mortgage deferrals given these loans are not in a delinquent status.

The level of reported mortgage deferrals peaked in the high teens during the second quarter before declining to 13.7% by the end of June, in line with the level reported at the end of March. Provided the current economic trends continue, we expect the level of reported mortgage deferrals to decline over the second half of the year. Consistent with the first quarter, approximately 65% of these loans had an effective loan-to-value less than 80%, representing an equity buffer in the event they face ongoing income challenges. We continue to collaborate closely with our customers and other industry participants on the post-deferral loss mitigation strategy to implement a number of measures aimed at reducing the potential for mortgage delinquencies from this population.

We remain confident that the vast majority will resume mortgage payments at the end of the deferral period. Based on this, along with the current economic trends, we are lowering the top end of our full year estimated loss ratio range by 5 points to 25% to 35% for 2020. We ended the quarter with an estimated MICAT ratio of 169%, 4 points above the upper end of our targeted operating range.

As noted during our first quarter call, capital redeployment is on hold for the remainder of this year outside of ordinary dividends as we continue to assess the economic environment and our revised top line capital requirements. Our book value at $41.97 per share is up 6% over the prior quarter, driven by ongoing profitability.

With that, I'll turn it over to Phil for a deeper look at our financial results.

Philip Mayers - *Genworth MI Canada Inc. - Senior VP & CFO*

Thanks, Stuart, and good morning. We've seen the emergence of several important developments and trends in the second quarter as discussed by Stuart. Against this backdrop, we posted solid financial results, including year-over-year growth in premiums written of 17%, net operating income of $101 million, operating ROE of 11% and a strong capital position with a MICAT ratio of 169%.

Premiums earned were modestly higher by $1 million at $172 million. With our current outlook of moderately higher total premiums written for the full year, as Stuart noted, we now expect premiums earned to be flat to modestly higher in 2020. The loss ratio this quarter was 27% on losses on claims of $46 million. The resulting $22 million sequential increase primarily reflects the higher incurred but not reported reserve.

This IBNR reserve includes our estimate of the anticipated losses from defaults that would have otherwise occurred in the quarter had mortgage payment deferrals not been in place. In addition, we experienced modest adverse reserve development during the quarter.

While mortgage payment deferrals help borrowers bridge income interruptions, a subset of these deferrals will likely end up in default after the deferral period ends. Therefore, payment deferrals will delay the timing of delinquency for this subset. Given the company's internal loss forecast and model, the IBNR reserve has been calculated based on the probability weighted projected losses on claims under a base, downside and upside scenarios for regional unemployment rates and home prices. The most probable base case scenario assumes a U-shape recovery starting in the third quarter, while the downside scenario assumes a prolonged recovery following a second wave for COVID-19 cases in the second half of 2020.

This IBNR reserve is expected to build through the course of 2020, reflecting the typical time lag of 1 to 6 months between a borrower becoming unemployed and the mortgage going into arrears. As a result, our current outlook for the full year loss ratio is a range of 25% to 35% as compared to the reported loss ratio of 21% in the first half of this year. It is important to note that the loss ratio in the second half of 2020 is expected to be similar to or higher than the second quarter's loss ratio of 27%.

With respect to delinquency activity, the number of new delinquencies, net of cures, increased by 207 to 491, sequentially and the number of outstanding delinquencies also increased by 220 to 1,974. The delinquency rate was marginally higher at 22 basis points. Geographically, Ontario, Alberta and Québec accounted for most of the increases. With lenders and mortgage insurance temporarily suspended most collection activities after the onset of COVID-19, the number of cures declined by 117. As a result, portfolio insurance accounted for 100 of the total increase in net new delinquency, but it did not significantly contribute to losses in the quarter due to the lower effective loan to values.

At the same time, the average reserve per delinquency increased by approximately 8% to $85,000. Several factors contributed to this increase. First, our base scenario assumes softer housing market conditions in the second half of 2020; second, longer anticipated claim settlement periods due to process delays translated into higher expected interest, property management and property tax costs on existing delinquencies; and lastly, our total IBNR reserve increased modestly.

Expenses in the quarter totaled $32 million, and the resulting expense ratio of 19% was consistent with our targeted range of 18% to 20%. We expect to be around the high end of this range for the full year, including one-time transition costs related to our IT infrastructure and financial systems. We earned $48 million of operating investment income, which was lower sequentially by $6 million, primarily due to the impact of a lower interest rate environment. In total, we generated a fully diluted operating EPS of $1.17, and our diluted book value per share now stands at $41.97.

Turning to investments. The market value of our investment portfolio is $6.5 billion, an increase of approximately $350 million, including the meaningful recovery in the market value of our fixed income securities and preferred shares.

During the quarter, credit spreads narrowed significantly, the preferred shares index improved by approximately 13% and government rates remained low. As a result, the mark-to-market of the investment portfolio in derivatives has moved to an unrealized gain of $48 million from an unrealized loss of $229 million at the end of the first quarter.

Portfolio quality remains strong with 93% in investment-grade fixed income securities and cash, and 7% in highly rated preferred shares. We seen no defaults in the portfolio and our below-investment-grade holdings are only $6 million. While we continue to emphasize portfolio quality, we are also focused on optimizing the portfolio yield within our risk appetite. That being the case, the low rate environment will continue to pressure the current pretax equivalent book yield of 3%. Accordingly, we continue to expect operating investment income to be moderately lower for the full year as compared to 2019.

Overall, the company remains well capitalized with a MICAT ratio of 169%, holding company cash and investments of $108 million, a modest debt-to-total-capital ratio of 15% and a $300 million undrawn credit facility. A number of factors contributed to the MICAT ratio remaining comfortably above our targeted operating range of 160% to 165%. First, the improvement in the mark-to-market of the investment portfolio led to an increase in regulatory capital available; second, the strong portfolio insurance volumes contributed to increased regulatory capital requirements; and lastly, the capital runoff from the aging of the 2018 and prior books, especially as the larger 2015 and 2016 books, partially offset the increase in capital required.

In light of the ongoing economic uncertainty, regulatory considerations and the positive top line momentum, we expect to operate at or above the high end of our targeted MICAT operating range of 165% for the remainder of 2020.

In summary, the company is well positioned financially with high-quality investments, a strong capital position and growth opportunities going forward.

I'll now turn the call back to Stuart to wrap it up.

Stuart Levings - *Genworth MI Canada Inc. - President, CEO & Director*

Thanks, Phil. From an operational perspective, we continue to function well in a remote work environment, notwithstanding the significant increase in mortgage insurance applications. We have hired a number of additional people to ensure that we continue to maintain our underwriting service standards. We continue to make good progress on our strategic initiatives, including the transition of our IT infrastructure and financial reporting systems from the U.S. to Canada.

In addition, we are excited to launch our new brand during the fall of this year. We recognize that the COVID-19 pandemic and the economic environment continues to evolve and while the risk of a second wave and potential economic impact are real, we remain encouraged by the prudent reopening of businesses across the country as well as the ongoing support from the federal and provincial governments.

In closing, we are now more optimistic about our business prospects for this year, as demonstrated by our updated outlook. Thanks for listening.

That concludes our prepared remarks. I will now turn the call back to the operator to commence with Q&A.

QUESTIONS AND ANSWERS

Operator

As a reminder, the conference is being recorded for replay purposes. (Operator Instructions) Today's first question is coming from Mr. Tom MacKinnon, calling from BMO Capital.

Tom MacKinnon - *BMO Capital Markets Equity Research - MD & Analyst*

Just with respect to the -- your comment about more optimistic outlook. I can understand that with respect to the top line. But if I look on Slide 4, your base assumptions, I don't believe that dates have changed since you laid them out in the first quarter. If it has to, can you point really to which one it was that's changed? The housing market, doesn't look like your assumption on that has changed nor unemployment rate nor the GDP. So maybe you can tell us what, in terms of the economic environment, you're actually more optimistic about? And following on, did your combined -- did your loss ratio assumption change for 2020 simply because you had a better Q2 than what was anticipated?

Stuart Levings - *Genworth MI Canada Inc. - President, CEO & Director*

Tom, it's Stuart here. Thanks for the question. I think the nut of it is, we're more optimistic about the overall business prospects, given the change in top line, given the strength of what we're seeing in the housing market recovery overall. Yes, we haven't really updated our economic assumptions. I think they stand as they are, but our view is that they're manageable. And if you look at our loss ratio guidance, we do think that's a fairly strong outcome even if you consider where the economy is, where it's gone and what the pandemic has done. To get through this year with a 25% to 35% loss ratio, we feel is pretty good. The reason we did bring it down a bit from the top end is the fact that we are now here in early August, and we have seen continued recovery, ongoing job recovery and business reopening.

So we feel more confident about the trajectory for this year. We're still of the view that losses and loss ratios typically peak about a year or 2 after the economic shock. So we still think 2021 will have a higher loss ratio. At this point, we're not going to speculate on what that will be, but we'll give that guidance closer to the end of this year. But for sure, we feel more positive about the path of 2020 than we did back in the first quarter.

Tom MacKinnon - *BMO Capital Markets Equity Research - MD & Analyst*

And just as a follow-on. Some of the banks had pushed their deferral deadline up to September 30. And what happens if we had a further pushout in terms of the mortgage deferral deadline? Would that change your IBNR? How would that look -- how would that impact your loss ratio? And what are some of the concerns or implications of a pushout in the mortgage deferral deadline?

Stuart Levings - *Genworth MI Canada Inc. - President, CEO & Director*

I think the important piece to note here is that we're really not relying on the actual number of deferrals or length of deferrals to forecast or reserve for losses. We're really are relying on our loss forecasting models. And the assumptions that we have used, as you saw in the presentation there. So that the only thing that should really affect the level of our losses this year is the assumptions we make around the economy.

So to the extent we change those economic assumptions, that could influence the loss outcome. But in terms of where deferrals are headed or when they will come to an end, it's really more of an impact on the lag effect on the actual delinquencies that may now be pushed further out into 2021. But we are, in theory, reserving for those now by virtue of our loss forecasting model approach.

Operator

Now we'll go to Graham Ryding, calling in from TD Securities.

Graham Ryding - *TD Securities Equity Research - Research Analyst of Financial Services*

The new delinquencies, net of cures, the increase there, it seemed to be more about lower cures as opposed to higher new delinquencies. What drove the lower cures? Is it just the dynamic of COVID-19 operationally?

Philip Mayers - *Genworth MI Canada Inc. - Senior VP & CFO*

Yes, Graham, it's Phil. Yes, that's exactly it. During COVID-19, a number of the banks slowed down their collection activities. So as a result of it, a number of boards that would have cured through the interaction with the collection staff, those interactions were delayed. And therefore, the number of cures were lower. In particular, you saw that the new delinquencies, net of cures, for portfolio insurance increased by 100. And we know that they do not represent a significant loss exposure because of the embedded equity. But that's just a reflection of the impact of slower collection activities.

Graham Ryding - *TD Securities Equity Research - Research Analyst of Financial Services*

Okay. Got it. And then just the 27% loss ratio is driven by your IBNR reserving. And you said it was -- you're trying to reflect what would have been sort of the default situation if the deferrals were not in place. Should we assume -- we shouldn't assume that you're factoring in a default rate of 14%. I imagine you're assuming only a small portion of those deferrals will actually default. Is that accurate?

Philip Mayers - *Genworth MI Canada Inc. - Senior VP & CFO*

That's totally accurate. We do expect the vast majority of those deferrals will become performing mortgages as businesses reopen, people get back to work. One thing we would note is that we saw a higher level of deferral mid-quarter, and we've seen an improvement in the number of loans that are under the payment deferral as we move from mid-quarter to the end of the quarter. So we think that trend will continue.

Graham Ryding - *TD Securities Equity Research - Research Analyst of Financial Services*

And what do you think is realistic in terms of the delinquency rate building as we move into late 2020 and into 2021? Is 2 to 3x over the next 12 months, is that a reasonable expectation? And what are you thinking on delinquencies?

Philip Mayers - *Genworth MI Canada Inc. - Senior VP & CFO*

I think more likely around 2x. But that all depends on the timing of the end of the deferrals and what happens in the employment picture. But I think our base case would assume it going up to 2x, but we would be reflecting that in losses through the course of the next couple of quarters.

Operator

(Operator Instructions) We'll now go to Geoffrey Dunn, calling you from Dowling & Partners.

Geoffrey Dunn - *Dowling & Partners Securities, LLC - Partner*

Phil, I wanted to understand a little bit more about the reserve and mechanics. I guess, first off, given the mix you're seeing on the portfolio business coming in, is the severity factor on your incremental reserving still in the kind of the $80,000-plus area? Or is it a lower consideration on average?

Philip Mayers - *Genworth MI Canada Inc. - Senior VP & CFO*

It is still similar to around $80,000. And that's driven primarily because the delinquencies tend to be more focused from the transactional book than necessarily the portfolio insurance book.

Geoffrey Dunn - *Dowling & Partners Securities, LLC - Partner*

Okay. And the reason I asked that is, it looks -- I'm trying to get at the incidence assumption you're making on the payment deferral loans. And it seems like -- I wonder if you could confirm. It seems like maybe it's around 50 basis points.

Philip Mayers - *Genworth MI Canada Inc. - Senior VP & CFO*

We can probably follow-up on that, Geoff, the specific numbers. But I think the way we are looking at it is, generally speaking, what delinquencies would have otherwise occurred in the quarter as a result of the prevailing economic scenarios, both employment and home prices. So I think what you're describing is reasonable. Our approach is a lot more granular. And we sort of build it bottoms-up based on regional forecast for unemployment and home prices.

Stuart Levings - *Genworth MI Canada Inc. - President, CEO & Director*

Just to add to that, I think as we talked a bit about on the first quarter, we definitely have anecdotal evidence that many people who took the deferral did so more for safety and convenience than because they absolutely needed it. So we chose not to build our loss reserving approach off the deferral population just for that very reason. And rather would stick to what we've seen before from the loss forecasting model using the real drivers of losses, which is the base economic assumptions.

Operator

(Operator Instructions) Since there are no further questions, I turn the conference back over to Mr. Levings. Please go ahead, sir.

Stuart Levings - *Genworth MI Canada Inc. - President, CEO & Director*

Thank you very much. And I'd just like to thank everyone for joining us today. We appreciate your time, as always. And this concludes our Second Quarter 2020 Earnings Call. You may now disconnect.

Operator

Thank you very much, sir. Ladies and gentlemen, that will conclude today's conference. Thank you very much for your attendance. You may now disconnect. Have a good day.