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PRESENTATION

Operator

Please be advised that this conference call is being recorded. Good morning, and welcome to the Manulife Financial Second Quarter 2023 Financial Results Conference Call. Your host for today will be Mr. Hung Ko. Please go ahead, Mr. Ko.

Hung Ko - Manulife Financial Corporation - VP, Group Investor Relations

Thank you. Welcome to Manulife’s earnings conference call to discuss our second quarter and year-to-date 2023 financial and operating results. Our earnings materials, including the webcast slides for today’s call are available on the Investor Relations section of our website at manulife.com.

Turning to Slide 4. We will begin today’s presentation with an overview of our second quarter results and strategic update by Roy Gori, our President and Chief Executive Officer. Following Roy’s remarks, Colin Simpson, our Chief Financial Officer, will discuss the company’s financial and operating results. After the prepared remarks, we’ll move to the live Q&A portion of the call. (Operator Instructions)

Before we start, please refer to Slide 2 for a caution on forward-looking statements. Note that certain material factors or assumptions are applied in making forward-looking statements, and actual results may differ materially from what is stated. I would also refer you to Slide 38 for a note on the non-GAAP and other financial measures used in this presentation, which includes an explanation of our use of transitional results for 2022 comparison.
With that, I'd like to turn the call over to Roy Gori, our President and Chief Executive Officer. Roy?

Roy Gori - Manulife Financial Corporation - President & Chief Executive Officer

Thanks, Hung, and thank you, everyone, for joining us today. Yesterday, we announced our second quarter 2023 financial results. In our second quarterly reporting under IFRS 17, we delivered strong operating results, including core earnings of $1.6 billion, net income of $1 billion, strong growth in EPS and core EPS, and core ROE of 15.5%. I'm encouraged by the strong top line momentum that we're building across our new business metrics, with double-digit growth in APE sales, NBV and new business CSM compared with 2022.

We also generated Global WAM net inflows of $2.2 billion. APE sales increased by 12% from the prior year quarter, led by Asia, where APE sales increased 26% year-on-year as we capitalized on the post-pandemic recovery in the region. The strong sales supported a 10% increase in NBV and a 15% increase in our new business CSM. The increase in new business CSM was in line with our medium-term target.

The strong growth in new business CSM, particularly in Asia, gives us confidence in the future growth of our insurance service results.

Turning to Slide 7. Our strong core earnings of $1.6 billion were up 4% from the prior year quarter, as growth across our insurance and corporate segments was partially offset by a decline in Global WAM. Our continued capital deployment through share buybacks contributed to our core EPS growing 6% from the prior year quarter. Net income of $1 billion was impacted by lower-than-expected returns on our ALDA portfolio. While some of the ALDA classes are facing headwinds, we continued to generate overall positive return from the portfolio.

We also delivered strong core ROE of 15.5%, which is in line with our medium-term target of 15% plus.

Turning to Slide 8. We continue to maintain a strong capital position supported by a LICAT ratio of 136% and a leverage ratio of 25.8%. We also reported adjusted book value per share of $29.42, a 5% increase from the prior year quarter, over a period that had sizable interest rate movements and during which we returned significant capital to shareholders. While this amount was modestly down from the first quarter, the majority of the decline was attributed to the currency translation of foreign operations, which does not reflect the fundamental performance of our business. This graph is a great illustration of the strength and stability of our adjusted book value under IFRS 17.

Turning to Slide 9. Overall, we have a very attractive business mix, including exposure to the emerging middle class in Asia and the developed North American economies, as well as a scaled global asset manager. And the three megatrends that underpin our business remain unchanged, a growing middle class in Asia, an aging population and digitization of the consumer. We are strongly positioned to capitalize on these opportunities and the momentum we generated in the quarter is an illustration of our growth potential.

In Asia, the team is capturing the opportunity as the region continues to recover from the pandemic. I'm really excited that Phil Witherington, formerly our CFO, returned to Asia in July to lead the business. Phil has a deep appreciation of our Asia franchise, having previously served as Manulife Asia’s Interim CEO as well as its CFO. In the short time that he’s been there, we are seeing strong momentum building in our Asia businesses in the third quarter. Our top line metrics bode well for the future earnings growth of the segment. I'm confident that Phil will lead our team and double down on our growth ambitions in the region, and he’s here on the call with us today. I would also like to thank Damien Green, who has transitioned to the position of Chair of Manulife Financial Asia for his leadership.

In Global WAM, we delivered strong net inflows of $6.6 billion in the first half of 2023, supported by our unique business profile, which is diversified by geography and business line. We’ve maintained strong sales rankings in many of our key markets, including the #1 spot in Canada and Hong Kong retirement, and #2 in the U.S. mid-case retirement market.

Core earnings were down from the prior year period, due in part to higher investments as we strive to continue building new business. However, I’m encouraged to see us building momentum, with our core earnings improving 12% and core EBITDA margin improving by 2.2 percentage points from the first quarter. As part of delivering value to shareholders, we’re committed to helping our customers live longer, healthier, better lives. And we’re executing against our ESG strategy and commitments.
In Hong Kong, we launched enhanced healthcare coverage to better address the growing demand for health and protection services. In Canada, we further expanded our behavioural insurance program, making Manulife Vitality available on new Manulife Par individual insurance policies. And currently, our owned timberland and agriculture properties already remove more carbon from the atmosphere than our operations emit. We strengthened our commitment to reducing emissions by disclosing science-based targets, including an increased ambition to reduce absolute scope 1 and 2 emissions 40% by 2035. This is all part of our commitment to helping make decisions easier and lives better, which will drive value for shareholders.

And finally, since we resumed our share buyback program in 2022, our strong capital position has enabled us to return over $6.6 billion of capital to shareholders through dividends and share buybacks, including more than $440 million of share buybacks during the second quarter. As of the end of June, we still had capacity to purchase approximately 30 million common shares under our current NCIB program. Overall, it was a very encouraging quarter with strong top line momentum and our strong sales performance leaves me optimistic for the future.

With that, I'm happy to turn it over to Colin Simpson, who has succeeded Phil as our Group Chief Financial Officer. Colin brings a wealth of experience within the insurance industry. You'll get to know Colin very well as we intensify our focus to generate value for our shareholders and customers. With that, I'll hand it over to Colin.

Colin Simpson - Manulife Financial Corporation - Chief Financial Officer

Thanks, Roy. I wanted to start by saying I'm really excited to take on this role. I truly believe Manulife has an enviable portfolio of businesses and incredible potential. And as I get my feet under the desk, I look forward to connecting with the investment community.

I'll start on Slide 11, which shows a snapshot of our financial KPIs for the second quarter of 2023. We delivered strong results. Core EPS increased 6%, and we generated strong momentum in our top line metrics with APE sales, new business value and new business CSM each up by double digits. We also delivered positive Global WAM net flows of $2.2 billion.

Our balance sheet remains strong with 5% growth in adjusted book value per share, and our LICAT ratio of 136% provides ample financial flexibility.

Moving to our top line and turning to Slide 12. We generated APE sales of $1.6 billion and new business value of $585 million, new business CSM of $592 million increased 15% from the prior year, which is a step-up from the first quarter 2023 growth rate and in line with our medium-term target. Asia-led APE sales growth fueled by Hong Kong, where APE sales doubled primarily due to a return of demand from Mainland Chinese visitors. I will say the emergence from the pandemic has been uneven across our operating regions in Asia, but momentum is encouraging with 26% growth in new business CSM.

In Canada, APE sales declined 11%, driven by lower group insurance sales as the prior year included very strong large case sales and segregated fund products, which was broadly consistent with the industry. Despite the decline in sales in Canada, new business CSM increased 21%. In the U.S., APE sales declined 15%. We continued to see higher short-term interest rates attract customers away from longer duration accumulation products, particularly for our higher net worth customers, which is a target market for John Hancock. But we have maintained pricing discipline in a competitive environment, and we saw quarter-on-quarter growth in both new business value and new business CSM.

Slide 13 illustrates the changes in Contractual Service Margin balance, which is an important store of future profits under IFRS 17. During the first half of 2023, the contribution from new insurance business and expected CSM roll-forward exceeded the CSM recognized for service provided, which sets the foundation for organic CSM growth. This was partially offset by insurance experience reported through the CSM of $127 million. Unfavorable lapse experience in the U.S. and persistency in Asia Emerging Markets outweighed favorable Long-Term Care experience. As a reminder, under IFRS 17, it's important to consider insurance experience through both core earnings and the CSM; a holistic view is available in the appendix of this presentation.

I would add, because I know it is a focal point for some, that LTC experience was a modest net gain this quarter across core earnings and CSM combined. Putting this all together, organic growth in CSM was 3% during the first half of 2023 or 5% on an annualized basis. Inorganic CSM movement, which is influenced by market impacts, declined by $342 million over the same time period, largely driven by foreign exchange rate.
movements, which are not reflective of the fundamental business performance. Overall, the total CSM balance increased 4% in the first half of 2023 on a constant exchange rate basis, and we remain focused on achieving our medium-term CSM growth target of 8% to 10%.

Turning to Slide 14. Our Global WAM business recorded net inflows of $2.2 billion, up from $1.7 billion in the prior year. We experienced lower mutual fund redemption rates, which improved retail fund flows. The prior year also benefited from a $1.9 billion institutional equity mandate. Overall, Global WAM's average assets under management and administration increased by 1%, driven by the acquisition of full ownership interest in Manulife Fund Management in Mainland China, which in itself is an exciting opportunity for us.

Net fee income yield of 44 basis points increased modestly, reflecting higher fee spread and a change in business mix. We've been investing in our Global WAM business, resulting in higher expenses, and you can see that the core EBITDA margin decreased 350 basis points to 24.6%. This was also slightly impacted by lower earnings from seed capital as we repatriated funds.

Moving to Slide 15, which shows our Drivers of Earnings analysis, which we are showing relative to the prior year and prior quarter, to give you a sense of our progress. The first area I'd like to focus on is how higher interest rates are flowing through core earnings.

You will notice higher expected investment earnings driven by higher investment rates in fixed income securities as well as business growth. In addition, we earned more interest on surplus in the higher-yield environment. These two factors are partially offset by higher debt costs, which you can see in Other core earnings and slower CSM amortization on certain VFA, or variable fee approach, contracts, impacting the overall insurance service result.

The second point to draw out from this slide is on insurance experience, which shows a modest experience loss of $22 million. The prior year quarter had a significant benefit in U.S. Life during a period of volatile mortality related to COVID. Finally, you will notice that our expected credit loss is neutral this quarter, which is a significant improvement on the charge in the first quarter.

Slide 16 shows our earnings reconciliation to net income attributed to shareholders for the second quarter. Despite the improvement from the prior year quarter transitional net income, there was a $570 million market experience net charge. This included a $478 million charge from lower-than-expected returns on ALDA, largely driven by real estate and energy-related private equity investments. The $141 million adverse other investment result mostly reflects a change in the Japanese Yen currency rate, which saw a sizable movement during the quarter.

Note that while we reported a net ALDA charge reflecting challenges faced by certain asset classes, the portfolio generated a positive return in the quarter, albeit below our long-term expectation. The commercial real estate market continues to be difficult. And in recent quarters, we’ve seen capitalization rates rise as interest rates have increased, adversely impacting valuations. It is worth reiterating that the vast majority of our real estate portfolio is independently appraised on a quarterly basis. So while difficult conditions persist in the office commercial real estate market, we believe our valuations are current.

For example, our most recent valuations on our U.S. office portfolio reflect an approximately 30% reduction from peak. I would also note that over the past decade, our North American office exposure has decreased from over 40% of ALDA in 2013 to close to 10% today.

Turning to Slide 17 and our ALDA portfolio. Returns have been lower in recent quarters, but we invest in asset classes that are well suited for insurance liabilities and generate attractive returns, with lower volatility relative to both equity and credit indices over a medium to long time period. In 2020, for example, our ALDA portfolio generated a $1.4 billion loss relative to expectations, though we more than recovered that loss in 2021. And in the 5 years preceding 2023, the portfolio outperformed our assumed returns on a net basis during a volatile period that included the pandemic.

Over the years, Manulife has built up strong asset origination and management capabilities, which I view as a competitive advantage. The historic return profile, which we show on this slide gives us confidence in achieving our expected long-term returns. We have also added a slide in the appendix to show ALDA performance over the past 5 years.
Moving to Slide 18. We delivered core ROE of 15.5%, in line with our medium-term target of 15% plus. And when you consider our current valuation, I believe a mid-teens ROE, coupled with improved stability of earnings and book value, offers investors significant value. This is a key factor in our decision to remain active in our share buyback program. And during the quarter, we purchased for cancellation nearly 1% of our outstanding common shares for over $440 million. And you can see we’ve steadily returned capital to shareholders over the past five quarters. This has contributed to the expansion of our core ROE.

On to Slide 19. We continue to maintain a strong balance sheet and capital position. This underpins our commitment we make to our customers with every policy sold and gives us financial flexibility. At the end of the quarter, we had $21 billion of capital above our supervisory target ratio, and our LICAT ratio of 136% remains robust. The 2 percentage point decrease in our LICAT ratio in the second quarter was primarily driven by the redemption of subordinated debt and share buybacks, which also drove a net 0.2 percentage point reduction in our financial leverage ratio.

And finally, moving to Slide 21, which shows how we’re tracking against our medium-term targets. Our core EPS growth has been solid in the first half of the year, though slightly below our target. Core ROE of 15.2% year-to-date is in line with our medium-term target. And although our CSM metrics have performed below target in the first half, we built strong momentum in the second quarter, including new business CSM growth of 15%. All in, we’ve delivered strong results in the first half of 2023 and are well positioned to deliver for our customers, shareholders and colleagues.

This concludes our prepared remarks. Before we move to the Q&A session, Operator, we’ll now open the call to questions.

**QUESTIONS AND ANSWERS**

**Operator**

(Operator Instructions) Our first question is from Meny Grauman from Scotiabank.

**Meny Grauman** - Scotiabank Global Banking and Markets, Research Division - MD of Financial Services Equity Research & Analyst

First question, I wanted to ask about expected investment earnings. We’re seeing a big improvement sequentially and then very, very strong growth year-over-year. Just trying to understand the sustainability and the potential variability in that number going forward. I guess the first question is what we’re seeing from a year-over-year basis, really just a function of the higher rate environment? Or is there some other key factors that we should keep in mind? And as we look forward, if we assume that the rate environment maybe has peaked to some extent, what does that mean about the trajectory of this line item going forward?

**Colin Simpson** - Manulife Financial Corporation - Chief Financial Officer

Meny, it's Colin here. I'll kick off and others can join in. I mean what you're seeing is, absolutely as you intimated, high yields. We're looking at and through core earnings, to the extent that yields stay where they are, we would expect this to persist. So absolutely sustainable, if yields go up even further than we would expect to earn more through that line item.

**Scott Hartz** - Manulife Financial Corporation - Chief Investment Officer

Sorry, this is Scott, to add a bit to that. What's driving it is the higher rate environment. And as Colin said, if rates stay where they are, we would expect it to be sustainable and, in fact, even grow a bit. As the portfolio turns over, we will be turning it over at higher yields.
Meny Grauman - Scotiabank Global Banking and Markets, Research Division - MD of Financial Services Equity Research & Analyst

And how does the inversion of the yield curve, is that playing a factor here in terms of how this line item behaves? And so how should we think about sort of the shape of the yield curve in terms of what the impact is on this line item?

Scott Hartz - Manulife Financial Corporation - Chief Investment Officer

I think while the yield curve is inverted, all yields are higher than that exist on the current portfolio, so that’s all positive.

Operator

Our following question is from Paul Holden of CIBC.

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

So strong results out of Hong Kong sales, as you highlighted. And then, Roy, you also mentioned continued positive momentum in Q3. I guess what I want to understand there better is just everything we read here talks about sort of the stall of the consumer recovery in China. So wondering how we square those two factors. And then I also want to understand, was Q2 like an abnormally strong quarter because it’s a little bit of a catch-up based on pent-up demand? Or do you think there is momentum based of sort of that run rate?

Phil Witherington - Manulife Financial Corporation - President & CEO, Manulife Asia

Paul, it’s Phil. Thank you for the question. And can I just start by saying how fantastic it’s been to be back on the ground in Hong Kong and in this role representing our Asia segment. And Paul, that leads me into your question. There is a lot of media talking down the conditions in Hong Kong and China. But the reality is being on the ground, there’s a tremendous amount of activity and it feels to me very much like it did pre-pandemic. And I think you’re seeing that in our performance in the second quarter. That 26% growth in APE across Asia, translating to a 26% growth in new business CSM, I think that’s very encouraging. And of course, as we’ve said before, that CSM growth will translate to future core earnings growth as well.

So I remain very optimistic about the prospects for Hong Kong, China and Asia. And I will point out that actually, in China, we hear about the potential stalls to the recovery in China, but our second quarter was the strongest second quarter on record in China. I think that does demonstrate the robust emergence from the pandemic. You referenced in the second component of your question, whether Q2 should be seen as abnormal. I don’t see it as abnormal at all. I see what we’ve experienced in the second quarter is a continuation of the momentum across Asia from the first quarter. And as Colin mentioned, there is an uneven recovery from the pandemic across markets, but that’s the benefit that we have of a diversified portfolio.

And of course, an important driver of our growth in the second quarter is the Mainland Chinese Visitor customer segment to Hong Kong. That has been very notable. It’s consistent with our strategy to capture a greater share of the MCV flows, but I don’t want that to overshadow a strong domestic business, a strong domestic performance in Hong Kong and across Asia. And the same statistic is true, if we strip out the benefit that we’ve seen from Mainland Chinese visitors, which I believe is sustainable. But if we strip that out, we’re still seeing high single-digit growth rates in APE in the second quarter.

So a strong domestic business in Hong Kong, supplemented by incremental growth in Mainland Chinese visitors that, I believe, is sustainable, I don’t think we’ll see the same levels of growth that we’ve seen in the first and second quarters, but I think this is something that will continue to be in the run rate, reflecting the fact that the underlying customer needs remain in place. And Hong Kong is right at the center of the Greater Bay Area, and that’s been formalized and really confirmed through government policies put in place during the pandemic.
Roy Gori - Manulife Financial Corporation - President & Chief Executive Officer

Paul, Roy here. Just a couple of adds. Two of the core strengths of our Asia franchise are, (a), that we are at scale. In fact, we're the third largest Pan-Asian player. That makes a big difference in terms of the ability to defray costs and actually continue to deliver momentum. And then the second big advantage of our franchise is that we're incredibly diverse, both from a geographic perspective, but also from a channel perspective, with good contribution from agency, banca as well as direct now. So that really does fill us with confidence, as Phil highlighted.

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

And my second question is on commercial real estate. Obviously, higher cap rates, as you highlighted, have been a drag on returns. I guess what to understand better is if cap rates stop increasing and just kind of level out from here, would you be able to meet your long-term return assumption? Do you think at this point on real estate or are we going to be in for sort of a longer period of below normal returns?

Scott Hartz - Manulife Financial Corporation - Chief Investment Officer

Yes. Paul, it's Scott. Thank you for the question. And to your point, there's been a couple of factors driving the underperformance in real estate versus assumptions. One has been, obviously, the stress in the office market with a lot of the work from home reducing demand, which it's hard to say where that's going to go. Although we do see positive signs with companies like Zoom coming back to the office. But the other one, which is probably more in recent quarters, what's been driving has been the rise in cap rates. And there may be a little bit of continued pressure on that in the short run, but I'll remind you that rising cap rates are -- mean that we're discounting at higher interest rates, the future cash flow of those properties. So higher cap rates actually imply higher future returns. So I'm very confident over the long term, we'll be able to achieve those assumptions. In the short term, it's obviously hard to predict in the short term, but there may be a bit more pressure in the coming quarters.

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

Just a question with respect to the Asia sales. If I look at year-over-year, the 25% increase in the Asia APE translates into a 25% increase into the new business CSM. This is all from Page 22 of your SIP. But you're only getting a 3% year-over-year increase in your Asia new business value. So help me understand the differences here. Is this -- CSM obviously be a function of the sales here, but is the new -- what's difference in the calculation of the new business value? Is there capital taken to account here? Just help me understand that. And why is that so much lower than the growth in the CSM?

Phil Witherington - Manulife Financial Corporation - President & CEO, Manulife Asia

Tom, this is Phil. And you're right to point out the growth in APE and new business CSM, both growing 26% across the region. 3% new business value growth. And I'll hand over to Steve to comment further, but one thing that I will highlight is that new business CSM and NBV are both good metrics to look at as indications of the value that we generate from the growth that we deliver. But there may be variations quarter-to-quarter. And one thing to highlight with respect to 2023 versus 2022 is product mix.

And you may recall that a year ago, the voluntary health insurance scheme in Hong Kong was introduced, that drove quite a lot of interest in health products in Hong Kong. That's an annually re-priceable short-term product that for IFRS 17, therefore, doesn't impact the CSM because it goes through the premium allocation approach model. But it is -- it was something that was reflected in new business value. So that's one thing that reflects the divergence in growth rate in 2023 between the two metrics. But Steve, you may wish to comment further on the methodology.
Steve Finch - Manulife Financial Corporation - Chief Actuary

Yes. And Tom, I call your attention to the fact that total company level, we saw a broad alignment between new business CSM growth at 15%, APE growth at 12% and NBV growth at 10%. So just as under IFRS 4, you'll recall, we would see some variability between the new business gains and the NBV. And similarly, under IFRS 17, we'll see some variability between new business CSM and NBV. But over time, they will be directionally consistent, and that's what you should expect to see in all of our businesses. Just want to add to Phil's was -- we also from higher interest rates, we increased risk discount rates in Asia, which was a slight headwind to NBV.

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

And then just as a follow-up, the NBV margins in Hong Kong were running like 80%, and now they're 50%. Is there a business mix issue there? And they haven't really moved quarter-over-quarter despite the big jump in the sales.

Phil Witherington - Manulife Financial Corporation - President & CEO, Manulife Asia

Well, thanks for the question, Tom. You're right to point that one out. Hong Kong total NBV margin approximately 50%, just over 50%. What's happening here is that we have seen the shift in business mix. With the volume having doubled in Q2 2023 relative to the second quarter of 2022, a big driver of that being the MCV customer segment. Important to note upfront that MCV business is high-quality business, it's profitable, but it has been lower margin than the rest of our business in Hong Kong. And consistent with the rest of the industry in Hong Kong, we are seeing customer demand from MCV customers being skewed towards lower-margin, savings-oriented products.

That is a notable difference from the pre-pandemic period, where we saw greater demand for protection, critical illness, health products from the MCV customer segment. And we do see an opportunity here to improve product mix, help our customers fulfill a wider range of their needs, and that is something that could be a potential tailwind to our margins in the future. Really important to note as well that our domestic business in Hong Kong remains very important. It's been growing in a stable manner during the pandemic. In fact, we've taken share domestically in this high-margin business that we have in Hong Kong. Relative to the first quarter of 2019, our business has actually grown. Domestic business has grown by 11%. Whereas the market as a whole, the domestic market, has contracted by just over 20%. So I think that speaks to the quality of the underlying business, which is our highest margin business across the region. I think I'll leave it there, Tom, but happy to take any further follow-ups.

Roy Gori - Manulife Financial Corporation - President & Chief Executive Officer

Tom, I might just add as well that 50% NBV margin is incredibly high. That's really solid and strong. We're really very happy with our margins out of Hong Kong, quite frankly, out of Asia. And the 80% margin that you referred to is slightly elevated versus our more average medium-term NBV margin coming out of Hong Kong. So there is a bit of a comparison year-on-year that makes that look more dramatic than it actually is. And as Phil highlights, our focus is on growing NBV. Absolutely -- obviously, we want to do that at high margins, and we think there's more opportunity to continue to grow our margin, as we have over the years.

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

Is the distribution of the MCV business, is that more broker related or more of career agent related?

Phil Witherington - Manulife Financial Corporation - President & CEO, Manulife Asia

Yes. Thanks for the follow-up, Tom. Brokers are really important part of it, but also agency is an important part as well. We have made some specific investments over the course of the pandemic in order to take a greater share of the MCV customer segment. And we feel that's appropriate given
that really the legitimization of the segment through government policies that have been put in place over the course of the pandemic and the important role that Hong Kong has to play in the development of the Greater Bay Area.

So some of the things that we've been doing, we've opened customer service centers in places that are convenient for Mainland Chinese customers, as well as that we've been developing our hospital network in Mainland China. In fact, we're a leader in that regard. We've been enhancing the customer materials that we have into multilingual materials. So not just traditional Chinese for the Hong Kong domestic market, but also simplified Chinese as used in Mainland China.

So lots of things that we've been doing and in particular, in agency, which is a really important channel for us in Hong Kong, we've been really looking at hiring a greater proportion of Mandarin-speaking agents that will be able to interact more comfortably with Mainland Chinese Visitor customers.

Operator

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


I've got a strategy question and a numbers question. I'll start with the numbers one. Your Slide 25 is pretty helpful. Very helpful, actually, to show the balance between experience items that go through P&L and then through the CSM. If we can drill down a little bit on some of the moving pieces. There were some -- can you quantify the bigger pieces? I mean I'd like to know how the negative LTC experience that went through P&L, positive through CSM. And then I guess some individual life experience was a bigger drag on the CSM as well. So maybe we can just kind of break down some of the bigger chunks flowing through that graph?

Steve Finch - Manulife Financial Corporation - Chief Actuary

Sure. Yes. Thanks, Gabriel. I'll take that one, it's Steve. Start with LTC. As you know, overall -- and I remind you that I look at total experience. It does show up in both P&L and CSM, and I'll touch on that. But total LTC experience was a modest gain in the quarter. the negative that went through P&L, that's the cash payments that we're making in the quarter. So higher cash benefit reimbursements than expectations, but that was more than offset by favorable incidence experience, favorable lapse experience, slightly offset by lower levels of mortality.

If we look more broadly at some of the drivers overall of the -- between the 2 sections, $110 million in total pretax impact. The -- what's going through the P&L - so I mentioned the LTC; overall, we had positive claims experience across a number of areas, including continued favorable experience in Canadian group benefits. That was offset by expense results. And then moving to the CSM, the two material drivers there of the experience: one is adverse persistency primarily from Vietnam, and the other is continued low lapse rates in the U.S.. Both of those trends are not what we expect over the long-term. So I'll stop with that, but happy to drill into more detail.


Well, I mean, what I was hoping for was some numbers. But you got the numbers for me?

Steve Finch - Manulife Financial Corporation - Chief Actuary

I think I mentioned the biggest drivers there.
Okay. Now the strategy question, your -- one of your peers in Hong Kong, Canadian domiciled one, with operations in Hong Kong. Similar to you in the sense that you want to increase your Mainland Chinese sales or sales to Mainland Chinese customers in Hong Kong compared to what you did in prior years. I'm wondering what the motivation is there, just to get a better sense of why that strategy makes sense now, whereas it didn’t pre-COVID.

Let me start, Gabriel, and I'll hand over to Phil. The first thing I'd say is that MCV sales has always been part of our strategy. We've been focused on the Chinese consumer that's been moving to Hong Kong or tapping into Hong Kong for their insurance and health needs. And again, a core competency of our franchise is that we are diverse. But we also have a strong presence both in Hong Kong and in China, which lends itself to capturing that segment. And I would highlight that for us, the key differentiators on why we think we can win and why we quite frankly have won in the MCV space is a strong brand.

And having a strong brand in Asia makes a massive difference. Obviously, being there for more than 127 years and having established credibility with consumers and all other stakeholders really matters because people can trust us. We also aspire to have the best products in market, and we have the best people. So I think those combinations are why we will continue to outperform in Asia and, quite frankly, in the MCV space. So it's always been a part of our focus. And now with the reopening, given that, that market had gone away for some time. we're just doubling down on it, is the way I would position it. But Phil, you might want to supplement that.

Sure. Happy to. And Gabe, thanks for the question. A couple of supplements to what Roy has said. The first thing, and I referenced this a few minutes ago, is really over the course of the pandemic, the formalization of the Greater Bay Area framework, puts Hong Kong right at the center of the GBA. And I think that is something for us that provides us with confidence this is a good market for us to capture strategically.

I think the second thing is that looking on at the underlying customer needs that exist within our Chinese Mainland customer segment, those needs are there greater than ever before: the need for long-term savings for retirement, the need for health care, the need for critical illness. And it absolutely makes sense that that’s an appropriate market for us to capture. And then the final point that I'll make is that given our scale position in Hong Kong, we have the capabilities, we have the products. It just makes strategic sense for us to scale that with the flows that are coming into Hong Kong through MCV visitors.

What I will say is that we've seen a big surge in the first and second quarter. I do expect that to be maintained, but I don't expect those rates of growth to continue. I think that rate of growth reflects a bounce back. But as we've seen pre-pandemic there can be variation quarter-to-quarter in MCV volumes, but it's there over a long period of time, I expect the customer segment demand to continue.

Following question is from Mario Mendonca from TD Securities.

First, going back to Asia for a moment. The addition to the CSM from new business was obviously very strong this quarter. And when I try to connect that to something like insurance sales, we're just -- it would appear that the contribution this quarter was far greater than the increase in insurance sales. So my question is am I missing something? Should I also be considering the annuity sales? Or is it appropriate to just compare that CSM increase to the insurance sales?
Phil Witherington - Manulife Financial Corporation - President & CEO, Manulife Asia

Mario, it’s Phil. Thanks for the question. I would encourage you to look at APE sales in total, taking into account both insurance and annuity sales. The annuity sales, as presented in the SIP, are absolute dollar amounts, not APE and therefore, it can be skewed by single premium, regular premium mix. So we look at APE sales as the key metric, and that’s been -- in aggregate, as Steve mentioned earlier, closely correlated between new business CSM and APE.

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

But would you agree Phil, that this quarter the increase in new business, the CSM, was outsized relative to the increase in APE? It just appears that way. I can see APE this quarter, $879 million, very similar to last quarter, yet the increase in the CSM from new business is far greater.

Phil Witherington - Manulife Financial Corporation - President & CEO, Manulife Asia

Yes. I'll answer with respect to Asia and then hand over to Steve to answer.

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

This is directly -- I'm asking about Asia specifically. So it's appropriate for you, I guess.

Phil Witherington - Manulife Financial Corporation - President & CEO, Manulife Asia

Yes. No problem, Mario. I know Steve may still wish to supplement. There is a higher new business CSM this quarter. We have made some refinements to our methodology, which have had a benefit. But specifically for Asia, the -- if we strip out the impacts of those refinements, we'd still be seeing growth of approximately 20% in new business CSM, which is a strong demonstration of the value that we're driving. So I agree with you, Mario, it's a little elevated this quarter, but I do expect to see strong new business CSM growth in the quarters to come. Steve...

Steve Finch - Manulife Financial Corporation - Chief Actuary

No, nothing to add.

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

Steve, just so we're clear, does that mean there was like a onetime catch-up this quarter? Or is this the new sort of sustainable level of CSM, if APE were to be the same?

Steve Finch - Manulife Financial Corporation - Chief Actuary

There was a modest catch-up, year-to-date catch-up in the quarter on some par methodology. But -- so as Phil said, it was still a very strong quarter of growth. So the year-over-year growth instead of 26% still would have been approximately or north of 20%. So fairly (inaudible).

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

That's helpful. Okay. So then the other question I have, and this is something we're seeing for all of the insurance companies. This growing disparity between reported and core earnings. It's definitely not unique to Manulife, we're seeing it across the board. And one of the big differences in these
expected returns on your assets are just so different from what’s actually materializing. So what I want to do is think about the ALDA portfolio for a moment.

We're looking at about a $53 billion portfolio. If the company were to reduce the expected return on the ALDA, then presumably, these differences would moderate somewhat. But the trade-off then of course, is that if you reduce the expected return on the ALDA, then your net investment income would go down. So what I'm trying to understand is, first of all, have I characterized that right? Like if you reduce the ALDA return, there's no P&L impact immediately, it's just the ongoing lower net investment. Is that correct?

Scott Hartz - Manulife Financial Corporation - Chief Investment Officer

Yes, Mario, it's Scott. Thanks for the question. That's correct. But that -- we've tried to put in a rate of return that we think we can achieve or exceed on a through-the-cycle basis. And we have shown that we've accomplished that in the long-term, and we put the additional slide in the appendix this time to show that not only in the long term but over the last 3 and 5 years. And there is going to be variability. I mean this portfolio is marked to market every quarter. And again, from that slide, you can see that variability quarter-to-quarter. And we think the right way to think about the ongoing earnings power of the company over time is to look at that return.

If we reduce that return, we would show a lower underperformance in the quarters where we're underperforming, but a higher overperformance in the quarters where we're outperforming. And so net, we would end up showing over time a higher net income relative to core, which we don't think is appropriate. We're trying to call it right down the middle and end up with core and net income be the same over time.

Roy Gori - Manulife Financial Corporation - President & Chief Executive Officer

Mario, I'd just add that, again, if you look at the last 3 years, which have been incredibly volatile years, and look at our net income versus core, our net income has actually been higher than core for those 3 years. And for us, the assumption should be what do we feel confident, we can deliver over a longer period of time. And as you've seen from our deck, over 18.5 years, we've delivered against the assumption.

And then we looked at more recent time periods, which again have been very volatile, 3 and 5 years, which you see in the appendix, we've also delivered against that assumption. So for us, it's about making sure that we've got the assumption that makes sense. And again, in some quarters, we're going to be over. In others, we'll be under. And that's why we have a core metric because we don't think that's the fundamental performance of the franchise.

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

Yes, that's helpful. But I mean the only people that matter are the investors. And if the investors have lost faith -- and again, this is not unique to Manulife. This is true for everybody. If investors are losing faith in this expected versus actual -- I mean, it leads guys like me to have to just say, okay, forget saying, just come up with a number on our own for what investors are focusing on. I guess the bottom line here is what is your outlook for the second half of the year? Do these differences between core and reported, do they start to attenuate somewhat? Is this sort of the name of the game for the next little while?

Scott Hartz - Manulife Financial Corporation - Chief Investment Officer

Yes. Mario, it's Scott. And these questions always come up when ALDA has underperformed assumptions. We've seen this before. And then if you look at that graph, we had sort of eight straight quarters where we outperformed and these questions kind of go away. And so while there is variability, there's value to being in an ALDA portfolio, which Colin articulated in his opening remarks. And I think you asked a good question last quarter when you said, well, is that variability worth it.
And so that was, again, a bit of a motivation for that chart we put in the appendix to show you exactly what that variability is and what the gross earnings are. And those gross earnings are probably double the earnings, on average, we would have for fully fixed income. So yes, it’s up to investors to decide. But I think that given the extra earnings we get versus fixed income is quite high, I think it’s worth it for that variability. And it’s, again, why we would have you focus on core in any given quarter. Over the long term, it’s certainly fair to compare net income to core, but in any given quarter, that’s why we have the core metric.

Operator

Following question is from Lemar Persaud from Cormark Securities.

Lemar Persaud - Cormark Securities Inc., Research Division - Research Analyst

I want to stick on that line of questioning on the ALDA portfolio. I understand the point you’re trying to make on that ALDA slide in the appendix suggesting that the returns are solid over the past 3 and 5 years, so over the longer term. But it has been below the expectation for a full year now. So I guess, is there like a line in the sand that we can draw suggesting that if expected actual returns are below the expected for, say, let’s say, 2 years, then you guys have to revisit the return assumptions? Or could that persist for 2 to 3 years before you guys have to revisit those assumptions? I'll leave it there and then I have a follow-up.

Scott Hartz - Manulife Financial Corporation - Chief Investment Officer

Sure, Lemar. Scott again, thanks for the question. We revisit those assumptions every year. So every year, my team works with Steve’s team to look at historical returns, to look at what the market is expecting on these things going forward. And it is a very long-term assumption. So looking at any quarter or any given year, is not really the right way to look at it. And I would tell you, I have more confidence in achieving those returns now after having underperformed over the last year.

A lot of that underperformance is driven by higher discount rates on these assets, which does weigh on valuations now. But higher discount rates imply higher returns in the future. So frankly, in periods of underperformance, I have more confidence going forward. It’s almost the reverse. If we outperform for a while, because discount rates are down, that’s when we start to ask ourselves should we be bringing down the long-term returns. But in this environment, I’m very confident in achieving those long-term returns.

Steve Finch - Manulife Financial Corporation - Chief Actuary

And Lemar, it’s Steve. I'll chime in. In the past, a lot of these questions came to me because if there was a change in assumptions that went through reserves. But I wanted to add as well that these assumptions are important for our product pricing, etc. And just reinforcing Scott’s point, it’s a very thorough process that we go through each year to validate long-term return assumptions. And I won't repeat what Scott said, but I also have conviction in these assumptions that they’re appropriate over the long term.

Lemar Persaud - Cormark Securities Inc., Research Division - Research Analyst

Okay. And then looking at your Slide 17, your average ALDA return over the last 18.5 years was 9.1. But on the same slide, you show that the S&P 500 was actually 9.4. Is the right way to think about the value of ALDA being the lower standard deviation of these returns? Because I would expect there’d be an illiquidity premium to being invested in these ALDA. Like how do I answer that question from investors? Like why not just look at the S&P 500 and say the ALDA portfolio is underperforming now? Like where is the value in your opinion?
Scott Hartz - Manulife Financial Corporation - Chief Investment Officer

Yes, thanks. Great question. And the S&P has performed very well over this time period. You look at the TSX and it hasn’t performed as well and other foreign markets. And we’re invested in public equities in different markets depending upon where we do business. So I would say versus more global markets, and our ALDA portfolio is a global portfolio, and it has outperformed public markets. But to your point, the real value is in the lower volatility. It’s a tenet in investing that what you really want to look at is the amount of return you’re getting per unit of risk.

And over the long-term, I think our -- the volatility has been, as you can see on this chart, less - about 1/3 of the volatility of the public equity markets. And in fact, if we redid that chart over the last 5 years, and had we been invested in the S&P 500, the S&P 500 actually would have outperformed on average, but the volatility was intense. There would have been quarters where we would have lost like $6 billion because of the extreme volatility we’ve seen in that market over the last 5 years.

So it is the lower volatility that’s really the powerful part of the portfolio, and that’s a function of a very diversified portfolio in six different categories that are not all correlated and are staying at the low end of the risk return spectrum.

Lemar Persaud - Cormark Securities Inc., Research Division - Research Analyst

And then my next question, it wasn’t long ago where we were looking at wealth management momentum in the core EBITDA margins, and they were approaching kind of the 30% range. But it looks like over the past few quarters, there’s been a change. We have to be thinking of more in the kind of below 25% range. I just want to revisit that assumption. Is there a pass back to the high 20s to low 30s EBITDA margins? Or is that off the table until we see more of a recovery in industry trends and wealth management?

Paul Lorentz - Manulife Financial Corporation - President & CEO, Global Wealth and Asset Management

Yes. Thanks for the question. It’s Paul here. We’re still committed to the 30% margin, and it probably would make sense to give you some context for what we saw year-over-year and then what you’re seeing from prior quarter. If we just take a step back to last year, there was a couple of items impacting the year-over-year. The first is we did have some repatriation of some seed assets and some alternative assets that were moved into a fund raise. That and the other impact was the step-up acquisition of Manulife Fund Management in China. While that’s accretive to earnings, there’s a little bit of a drag on the overall margin in the short-term, but we do expect that to be a tailwind over time.

The combination of those two would have been about 100 basis points of the decline from last year. The remainder amount was really a combination of muted market growth as we continue to invest in the business. And that brings you to Q1 versus what you’re seeing in Q2. In Q2, you’re starting to see a lot of that come back for a number of reasons, but the primary reason is just the strong fundamentals of the business. There is one more day in Q2 versus Q1, that’s worth about 30 basis points. But the remainder, close to 200 basis points, that’s really just from the strong fundamentals of the business.

You’re seeing very strong flows again in a very difficult market. We’ve got a resilient net fee income yield. You’ve seen some good expense management come through Q2 versus Q1. You’ve seen the margin come forward and improve because of that. The other thing worth noting is when you look at the year-on-year comparison, we also did see a relatively significant increase in expenses as markets opened up, travel opened up, and we would not expect that to continue. And you’re starting to see that moderate where we’ve been able to really pull that back in from Q2 versus Q1.

So we would expect, looking forward, we can’t control markets, but our track record of positive flows, the strong market share, the consistency of our net fee income yield, positions us well to continue to drive this margin going forward. And as I mentioned at the start, we’re still committed to that 30% margin, assuming we get back to regular market growth.
Following question is from Joo Ho Kim from Credit Suisse.

Joo Ho Kim - Crédit Suisse AG, Research Division - Research Analyst

Just a couple of quick ones here. For the expected credit loss line, the benefit that we saw from parameters and model updates was $50 million in Stage 1. Could you talk about the moving pieces in that line? I'm just trying to get a sense of what drove that this quarter, whether it was improved macroeconomic outlook or something else?

Scott Hartz - Manulife Financial Corporation - Chief Investment Officer

Sure, Joo, it's Scott. And thank you for the question. And you have that right. The way the ECL works is we try to model out future credit losses, and that's a function of both the credit quality of the portfolio and how it's changed, but also the current macroeconomic environment. What goes into that model are things like the volatility of equity markets, equity markets in general, unemployment. And all those parameters or most of those parameters on balance got a little bit better, so that led to a little bit of a reduction in the ECL.

Joo Ho Kim - Crédit Suisse AG, Research Division - Research Analyst

Got it. And just last one from me. Similar line of questioning, just on expenses. At the top of the house, when I look at your expense efficiency ratio target below 50%, it was around, I think, 46% so far this year. And then when I look at it even in the prior, it's been under your target for a number of quarters. So I'm just trying to get a sense, what drove the good performance so far this year? And if you would consider lowering that medium-term efficiency ratio target?

Colin Simpson - Manulife Financial Corporation - Chief Financial Officer

Yes. Thanks, Joo. You're right to point out expenses. There's quarter-on-quarter improvement. 200 basis points, actually down to 45.1% for the quarter. So we're pleased with that trajectory, but never satisfied. Certainly not going to announce a new target today. But really, the drive for efficiency is really important for me personally and for the organization.

And we've got a great track record. When you look at the expense CAGR between 2019 and 2022, it's only 1%. And Phil did allude to it a few quarters ago, a bit of a step-up in absolute expenses. But the reality is, as Paul also spoke to, is we're starting to see a moderation of post-pandemic expense activity, and expense efficiency is just a real priority going forward.

Roy Gori - Manulife Financial Corporation - President & Chief Executive Officer

Roy here. I'll just add to Colin's comments. I think he hit the nail on the head. But it has been a massive focus for our franchise, and we're proud of the progress that we've made, and we're not stopping, if that's the implication in your question. We still feel that there's much more for us to do. We've invested more than $1 billion to digitize our business, and we've seen that come through in our straight-through processing metrics, where they've improved quite significantly.

In fact, in 2018, only 68% of the transactions that we processed were digital straight through without any human intervention. At the end of '22, that got up to 83%. And actually, year-to-date this year, we're up a further 2%. So those efforts to digitize our business are really translating into that improvement, and we still think that there's much more opportunity for a scaled operation like ours to continue to digitize, which not only gives us the cost benefits that you highlight, but also translates into better customer experiences, which ultimately leads to satisfied customers and more product sales. So this is a journey that we're continuing and committed to.
Operator
The following question is from Doug Young from Desjardin Capital Markets.

Doug Young - Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst
Just to kind of maybe follow-up questions to earlier questions. But first is, Steve, on the unfavorable lapse experience in the U.S. that went through the CSM, can you kind of dig a little bit more into that? Can you quantify it? And where I'm going with this is, obviously, secondary guarantee UL has been a hot topic, been an area of some pressure for some of your peers in the U.S. Is that where we're seeing the pressure? And why shouldn't that be a concern for us and investors?

Steve Finch - Manulife Financial Corporation - Chief Actuary
Sure, Doug. I can dive into that one a little bit more. And I'll take you back to just before the pandemic. We have been -- as you know, we update assumptions frequently as experience emerges. And before the pandemic, we were up to date on U.S. lapse assumptions, we had strengthened the reserves there over the years, which you probably recall. And then during the pandemic, what we saw almost right away in 2000, was disconnects in lapse rates on some of our products. So protection products in the U.S. dropped about 20%. We saw a similar phenomenon in Canada with some similar product design showing drops in lapse rates, drop in lapse rates on variable annuities.

And what we've seen since that time is in Canada and in particular in the past couple of quarters, we have seen a trend back to pre-pandemic lapse rates in those product lines, Level COI, UL and seg funds. And also informing my views, which I'll get to, is during the global financial crisis, while it was a different shock to the system, we saw similar types of discontinuities and lapse rates on different products. And over time, those lapse rates trended back to pre-shock levels. So that continues to be my expectation in the U.S., is that we will see a trending back to U.S. lapse rates over time -- to pre-pandemic lapse rates over time.

Doug Young - Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst
And so just to confirm, this was related to the no-lapse guarantee UL block. Is that -- am I correct in that?

Steve Finch - Manulife Financial Corporation - Chief Actuary
It would include the no-lapse guarantee block as well, but we also have other protection products where we've seen some similar trends. So -- and that was included.

Doug Young - Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst
And can you quantify, like, is it just an immaterial amount? Like...

Steve Finch - Manulife Financial Corporation - Chief Actuary
It is -- this is the key driver in terms of the CSM experience in the quarter for the U.S. that you can see in the results. And I guess the other thing I'd add, I'll remind you here that on these protection products, lapse rates are very low. So we're not talking about a change from 5% annual lapse rates to 3%. These are variable -- like on the NLG lapse rates, those expected rates are below 1%. And these are small changes in lapse rates. But capitalized over a long period of time, they can have an impact. But we'll wrap that with my conviction that I do expect those rates to trend back over time.
Okay. And then just maybe, Phil, Hong Kong, I think we talked a bit about this. I mean sales were up 100% core earnings down 13%. You talked a bit about the mix shift, the margins down. I guess lower amortization for the VFA. Is there anything else that’s really putting pressure on Hong Kong outside of those items? And then with the VFA, like, if we see rates start to stabilize and maybe go the other way, is that something that could be a bit of a tailwind? Can you quantify -- maybe the other way to think of it, how can you quantify how big the slower amortization of VFA has actually had on Hong Kong or on the Asia business?

Phil Witherington - Manulife Financial Corporation - President & CEO, Manulife Asia

Sure. This is Phil. Thanks for the question. The core earnings in Hong Kong, you do highlight the 13% decline relative to second quarter of ’22. I will point out the stability, sequential stability with Q1, which is important in the context of the point we made in the first quarter that you just highlighted, there is a headwind coming from slower amortization of CSM in response to higher interest rates. And I’ll let Steve comment on how we expect that to trend prospectively in a few moments.

But in terms of other things going on, under IFRS 17, we typically expect stable but growing earnings to emerge as new business is put on the books and CSM builds. What we’ve seen over the course of the pandemic is slower -- lower levels of new business than we would typically expect, as well as the effect of the macro environment on the CSM balance, the inorganic movements in the CSM balance. And that is translating to a headwind in terms of core earnings growth in Hong Kong and across other markets as well.

However, from here, our focus is very much on the underlying commercial drivers of value. And you see that coming through in the second quarter with the new business CSM growth. But also the organic CSM growth, 11% annualized in the second quarter, and this will translate to future core earnings growth for the Asia segment. So I remain optimistic that we’ll see core earnings expansion in future quarters. But at this point, I’ll hand over to Steve to comment on the amortization methodology.

Steve Finch - Manulife Financial Corporation - Chief Actuary

Sure. Thanks, Phil. And yes, the slower CSM amortization on the VFA contracts that is impacting the -- each of the insurance segments to different degrees. As noted earlier, the benefits of higher interest rates, so significant benefit in total for the company of about $110 million pretax relative to prior year Q2. Embedded in that is a headwind of approximately $60 million pretax from this slower amortization.

However, going forward, we were looking at our methodology on amortization. We implemented a refinement to our methodology so that going forward, we would expect materially less variability in CSM amortization due to interest rate changes. So Q2 of this year is a good run rate going forward that we will grow off of as we continue to write profitable new business.

Okay. That’s good color. And if I can sneak one more in just, I think they’re talking about or have implemented fee caps in China, I forget, but you can kind of correct me if I’m wrong. You’ve obviously expanded the wealth management in China. What implication does that have for the GWAM business?

Paul Lorentz - Manulife Financial Corporation - President & CEO, Global Wealth and Asset Management

Yes. Thanks for the question. It’s Paul here. Yes. So the regulator did impose some caps on equity funds, and the intent of that is to encourage more investors to come into the market, which over the medium to long-term will be good for the industry and for us. From our perspective, it’s not material to the GWAM business in terms of what they’re doing there. And it doesn’t change kind of our outlook and product pipeline. And if you
look at our focus globally as an organization, one of our big strengths is global fixed income and particularly Asia fixed income, and we think we're well-positioned to capitalize on that in the market.

So the team there is taking that in and then looking at whether it would have any material impact on their product plans, and the answer to that is no. So we don't see a material impact to us there. We're still very optimistic about the acquisition of our partner there and the plans we have going forward. And the product pipeline we have for the second half of the year is mostly focused more on the fixed income side. So we feel good about the progress going forward.

Operator
The following question is from Nigel D'Souza from Veritas Investment Research.

Nigel D'Souza - Veritas Investment Research Corporation - Senior Investment Analyst
I have some follow-up questions for you first on the commercial real estate portfolio. I think last quarter, you mentioned specific markets that drove the fair value losses there. I think Chicago is one of the markets you singled out. But were there any specific markets that drove the impact this quarter? Or was it broad-based across the portfolio? And from what I recollect, I think you mentioned that you didn't expect to take another fair value, I guess, write-down here, unless market conditions deteriorated. So my understanding was cap rates were mostly fully reflected or higher cap rates were mostly fully reflected in Q1. So just some additional color there would be helpful.

Scott Hartz - Manulife Financial Corporation - Chief Investment Officer
Sure, Nigel. Yes, thanks for the question. It's Scott. So in commercial real estate, we're seeing broad-based weaker valuations as cap rates rise across the board. I'll remind you that, as Colin mentioned, over 95% of the portfolio is externally appraised each quarter. So we are up to date on our valuations, but the appraisers are still trying to figure out where this market should settle. They've continued to raise cap rates. So we -- office is a little bit worse for sure. But we are seeing pressure across industrial, across multifamily in all the different North American geographies.

I would say our Asian portfolio, which is 28% of our real estate portfolio, has actually held up fairly well. And really, the question going forward everyone is trying to figure out is are we done? And we do feel like the majority of that raising cap rates is done, but it may not be fully done. And it will be a function of where long-term rates go. So there may be a little bit of weakness going forward, but we wouldn't expect a similar amount of weakness that we saw in the first half of the year.

Nigel D'Souza - Veritas Investment Research Corporation - Senior Investment Analyst
Okay. And then the second question I have was circling back to expected investment earnings. Any sizing of the portion of the portfolio that's already rolled over to higher reinvestment yields? Just trying to get a sense of the remaining runway here. And comparing that to earnings on surplus, just want to clarify that the reason we aren't seeing a similar earnings surplus quarter-over-quarter is due to high interest cost? Just some color there, that's helpful.

Scott Hartz - Manulife Financial Corporation - Chief Investment Officer
Yes. It's Scott. I'll take the turnover question. I think what you've seen is, first of all, we hold, as you'd expect, prudently a decent amount of cash, and that has -- earnings raise on that has gone up tremendously over the past year and maybe even a little bit more recently. And so that's always turning over at current short-term rates. For the long-term portfolio, we have a very long portfolio to prudently match our long liabilities. So the vast majority of the portfolio has not turned over, but it's not going to turn over a tremendous amount in a given quarter or a given year. I think the average duration of our portfolio interest rate duration is something like 12 years. So that's about how long it takes to turn the whole thing over.
Colin Simpson - Manulife Financial Corporation - Chief Financial Officer

Nigel, just on your higher interest on surplus, it's $94 million higher year-on-year, but that has been offset by higher cost of variable debt, which is $32 million. So you do actually see the number in the core earnings. It's just partially offset by higher cost of debt.

Nigel D'Souza - Veritas Investment Research Corporation - Senior Investment Analyst

Okay. And just a quick clarification there. From the comments on the portfolio turnover, is it -- am I understanding correctly that it's actually the short end of the curve that's benefited that line item over the recent quarters and there's a greater, I guess, payback to the short end of the curve? Or am I misunderstanding the dynamic there?

Scott Hartz - Manulife Financial Corporation - Chief Investment Officer

Yes. I think the short end going up a lot has certainly helped the cash earnings for sure. That's been a tremendous increase, but rates are up everywhere. So while we do long investing and we -- as those assets turn over, if we kept them shorter, we could probably earn more in the short run, but that would not be a prudent match against our liabilities. So we do reinvest them long-term. And long-term rates are a lot higher now than they were before, even though the yield curve's inverted.

Operator

Following question is from Darko Mihelic from RBC Capital Markets.

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

I promise I do have a long-term view on stuff, but I'm going to focus a little bit on the short term today. And I thought I heard somewhere in prepared remarks that -- my first question is around commercial real estate values dropping by about 30% in the U.S., I think I heard that correctly. Trouble is I'm not an expert, so I'm looking for a little bit of color around that. In other words, you also just mentioned it was 95% externally appraised. So is 30% kind of in line with what we're seeing at most other places? Is there any benchmarks you could provide? Even internally, how does that compare to your Canada, Asia portfolio of commercial real estate? And maybe lastly, a little bit of color around that would be, would that mark also include own use commercial real estate? So just looking for some color that tells me you are conservative on the CRE portfolio, would be helpful.

Scott Hartz - Manulife Financial Corporation - Chief Investment Officer

Sure. Thanks, Darko. So yes, you heard correctly. Colin's opening remarks that our U.S. real estate portfolio -- U.S. office real estate portfolio, which is only 5% of the overall ALDA portfolio, it was a much higher percent if you went back post the GFC, we sold over $3.5 billion worth of North American office in the last 5 years. So we really have dramatically reduced it. But still, when it drops 30%, that's going to hit your income a bit. And yes, we do have over 95% of the portfolio appraised externally each quarter. So we think the valuations are absolutely up to date, but that doesn't mean there could be additional pressure going forward.

And as I said earlier, I do think the pressure we're seeing at this point is more broad-based in terms of rising cap rates as opposed to an asset class where people are concerned about higher vacancies going forward, which was certainly the case for U.S. office. Now we do have a diversified portfolio. We -- 28% of the portfolio is in Asia, the balance is in the U.S. and Canada. In Asia, there aren't the same pressures on office. There, people continue to go into the office. And so we haven't seen much, if any, valuation drops in Asia, and would not really expect to going forward. In fact, we've seen in certain markets like Singapore, actually increased appraisals given the dynamics there.
And yes, this office and that 5% of the U.S. would include the stuff that we occupy. And so it’s probably down a little bit less, given that the -- you wouldn’t expect big vacancies there going forward. But rental levels are down because vacancies are up. And our businesses will benefit from that. We will charge them lower rents as rents come down and that gets capitalized into the value of the real estate. So it does include the home office real estate.

And I guess, finally, we are using external appraisals. We think that’s largely what people would say, they would expect U.S. office broadly to be down about 30%. I think if you look at some competitors out there, it’s maybe down a little bit less than 30%. But I don’t know if they’ve all used external appraisers and are completely up to date. We feel like we’re very up to date on that. It doesn’t mean there couldn’t be further weakness, but we feel we’re up to date.

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

Okay. That’s really helpful. And a follow-up question is with respect to the lending that you do against portfolios of commercial real estate, and specifically office. Not small in your portfolio. And the reason why I’m asking this question is I cover banks and we are all under IFRS 9 accounting. And if I really wanted to, every quarter, I can look up the stage 2 reserve, so to speak. Or it would be more broadly based, but I can look at it. And banks offer up LTVs on that portfolio. They offer up delinquency movements in stage 2.

And so I’m surprised when I see the expected credit loss basically being nothing overall this quarter for the company, considering that there’s some stress in that portfolio. Or at least as an outside observer, I think there’s some stress. So can you speak to maybe the stage 2 reserve you have against that portfolio, delinquencies there, LTV, anything else that you could offer on the direct mortgage portfolio that has office exposure, and how well reserved you are, and what that portfolio kind of looks like right now?

Scott Hartz - Manulife Financial Corporation - Chief Investment Officer

Yes. It’s a really good question. Obviously, real estate, and office in particular, is under pressure. Now our commercial mortgage portfolio is 7% of our overall portfolio, and office loans are only 2% of the overall portfolio. So it’s not a very large exposure. And I would say, when you compare insurance companies to banks, we tend to be, as an industry, pretty conservative lenders. So I would expect -- and you saw this in the GFC, you would expect insurance companies to do better than the CMBS market, which is a more aggressive lending market in the banks.

If you look at our portfolio, it’s currently -- and we’ve revalued all the properties, we’re doing that now on a quarterly basis, it’s at a 59% loan to value. So on average, it’s in good shape. Now there can be pockets of weakness in different markets, certainly office. If you look at our office alone, it’s a 64% on average, still a very comfortable number. But there are pockets of stress. At the end of June reporting period, we didn’t actually have any delinquencies in the portfolio, but I do expect those to rise. And so we have put up some impairments, some stage 3 impairments and some Stage 2, which is more -- stage 2 is more a downgrade. Stage 3 is where you’re putting up a specific provision.

We did in the first quarter put up some. We put up some in the second quarter as well. That was then the modeling, which we talked about earlier, and the model inputs reduce that back to about a net nil. So we -- I think we’ve been prudent in trying to get ahead of what’s coming at us by putting up some impairments in that portfolio, even though we did not have any delinquencies. And it will continue to be under pressure. But I guess my final message as in industry, the insurance industry, and us specifically, we are conservative lenders in a market that is having all the concerns.

Operator

We have no further questions at this time. I would now like to the meeting over to Mr. Hung Ko.
Hung Ko - Manulife Financial Corporation - VP, Group Investor Relations

Thank you, operator. We'll be available after the call if there are any follow-up questions. Have a good day, everyone.

Operator

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

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