

Finding competitive advantage through adversity

Banking Review: A Canadian publication



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Accounting for change: Transparency in the midst of turmoil

The introduction of International Financial Reporting Standards (IFRS) in Europe in 2005 represented the greatest shake-up in financial reporting in modern times. PricewaterhouseCoopers' (PwC) 2006 survey "*Accounting for change: A survey of banks' 2005 IFRS annual reports*" summarized the extent to which the introduction of IFRS changed the way that European banks report their results. Since then, events in the financial markets have placed banks' reporting, not to mention the accounting framework itself, under significant scrutiny.

The media, shareholders and analysts in Europe have been asking detailed questions as to the transparency and consistency of application of accounting standards. Valuation methodologies, the use of unobservable parameters, exposure to structured finance activities, the level of disclosure and understanding in the market of a bank's financial risk management strategies have all come under intense focus.

The turmoil in the credit markets over the last year has raised many questions as to the effectiveness of the current accounting and disclosure frameworks. As such, we decided to investigate the extent to which the current model has delivered consistency and transparency in financial reporting in this difficult environment.

The August 2008 PwC survey, *Accounting for change. Transparency in the midst of turmoil*, reviewed the financial statements of 22 banks, providing a representative cross-section of global banks by size, diversity of operations and geographical spread. They also provide a mix of SEC and non-SEC registrants as well as certain US GAAP preparers. This survey focused on the following areas, which we believe are most directly affected by the market dislocation:

- Risk management disclosures.
- Fair value measurement and disclosures.

- Disclosures of structured finance activities.

In addition to assessing how well the current accounting and disclosure guidance stood up to the challenges of the recent market conditions, the survey also enabled us to make some suggestions as to how certain disclosures could be improved upon to increase the level of transparency and consistency in banks' financial reporting.

The survey presents our detailed observations on these items, however, our key observation is that new disclosures have found their way into reports and financial statements in a "layered on" approach. Disclosures were not rebuilt to properly incorporate the new IFRS 7 requirements in a clear and cohesive way. Overall, adopting IFRS provides Canadian financial institutions with the opportunity to present better organized and consistent financial statements to their users.

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Lessons for Canadian financial institutions

Along with comparing their own disclosures against those we highlighted in the survey, we believe there are other opportunities for Canadian financial institutions.

Having a clear articulation of the philosophy of disclosure can help the IFRS conversion team make important disclosure decisions. The following questions should be considered by the appropriate senior executives and governance personnel in the earlier stages of IFRS conversion projects:

- Where does the financial institution want to be on the spectrum that lies between simple compliance with disclosure requirements or using disclosure as a competitive advantage?
- What disclosures would provide readers with information about the financial institution, distinguishing it from competitors?
- Using financial statement presentation and disclosure, how could the financial institution help users to better understand their business, its

risks and the management/mitigation of risk (especially critical in these unprecedented times)?

Since our survey was released, the sub-prime difficulties that began in 2007 have escalated into a far more deep-seated crisis of funding, confidence and, for some institutions, even survival.

Balance sheets are coming under intense scrutiny. Trading, lending and business development strategies and the bases of valuation and compensation that underlie them are being re-examined. Recent market events have exasperated the questions about the approach to governance, risk management and disclosure within many banking and capital markets organizations. Accounting standard setters are accelerating their evaluation of accounting models in light of unprecedented market conditions.

The IASB has recently amended IAS 39 with respect to reclassification to align IFRS more closely to US GAAP.

From July 1, 2008, reclassifications of financial assets classified as held-for-trading (but not designated under the fair value option) are permitted in certain cases:

- If the financial asset would have met the definition of a loan or receivable and the entity now has the intent and ability to hold it for the foreseeable future or to maturity.
- For other financial assets (i.e. those that would not have met the definition of a loan or receivable), the financial asset may be reclassified only in rare circumstances. According to a press release issued by the IASB, the deterioration of the world's financial markets in the third quarter are a possible example of these "rare" circumstances.

From July 1, 2008, assets classified as AFS may be reclassified as loans and receivables provided: (a) they would have met the definition of a loan or receivable, and (b) the entity now has the intent and ability to hold the asset for the foreseeable future or to maturity.

IFRS 7 has also been amended to incorporate extensive disclosure requirements relating to any assets reclassified as a result of this amendment to IAS 39.



The Canadian Accounting Standards Board approved, subject to written ballot, amendments to Sections 3855, *Financial Instruments – Recognition and Measurement* and 3862, *Financial Instruments – Disclosures*. The amendments are based solely on those that the IASB recently made to corresponding provisions in IAS 39, *Financial Instruments: Recognition and Disclosures* and IFRS 7, *Financial Instruments: Disclosures*. The intention is to incorporate into Sections 3855 and 3862 the same amendments that the IASB made to IAS 39 outlined above, modified only to reflect pre-existing differences between Canadian standards and IFRS.

These amendments are effective for reclassifications made on or after July 1, 2008, but only for periods for which annual or interim financial statements have not been issued previously.

Recognizing the urgent need for these amendments to ensure consistency of Canadian GAAP with IFRS and US GAAP on this matter, the AcSB agreed to waive formal exposure.

While converting to IFRS, Canadian financial institutions need to keep a close watch on the many changes expected to accounting standards that affect these key areas of fair value, risk management and structured finance activities. As can be seen by the above amendments,

standard-setters are becoming quite nimble as market events unfold. This will require IFRS conversion plans at financial institutions to be equally nimble, including imbedding changes to Canadian GAAP that move in parallel.

Our view remains that care will need to be taken to ensure that the introduction of additional guidance, aimed at improving transparency, does not result in disclosure requirements that overwhelm the reader and ultimately mask the banks' true risk exposures.

Recent market events have exasperated the questions about the approach to governance, risk management and disclosure within many banking and capital markets organizations.

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Commercial banking: Boosting profitability through transformation

In the midst of the current unprecedented market volatility, banks face a multitude of critical challenges. Squeezed by slowing economic conditions and increasing customer expectations, one of the areas in which banks need to find ways to improve profitability and enhance customer experience is in their commercial banking business.

Banks are responding to this challenge in a variety of ways. Some are consolidating middle and back-office processes or are simplifying and standardizing credit processes. Others are leveraging sophisticated sales management tools or moving toward straight-through-processing by integrating front and back office functions. And several more are starting to define customer experience as part of their value proposition, structuring customer interactions to ensure a consistent experience across all channels and geographies.

While these approaches improve individual components of a bank's sales and service delivery model, they often fail to offer a holistic solution. To drive efficiency across the organization and increase the proportion of time spent by relationship managers on value-adding sales and relationship management activities, banks must exploit opportunities to leverage emerging best practices in customer segmentation and business operating model design.

Emerging best practices

Today, many banks do not differentiate the treatment of business banking customers according to profitability and the complexity of the customers' needs. In the past, banks have used client sales and loan size metrics as an input to aligning sales and service business operating models. This approach provides banks with little understanding of true customer profitability. It typically leads to over-servicing of low-value customers, customizing of credit products regardless of size, and applying the same credit and risk assessment processes to deals with similar risk profiles. In addition, relationship managers are involved in so many aspects of a deal that they spend less than 20 percent of their time on what should be their core function—sales and relationship management activities.

PricewaterhouseCoopers' (PwC) Canadian banking practice has developed a framework that allows commercial banks to better understand their customer base and significantly improve the economics of each customer segment. The approach starts with segmentation to identify a commercial bank's customer base across three dimensions: profitability, complexity of customer needs and customer preferences. By pinpointing the intersection of customer needs and profitability, banks can define a targeted value proposition and an appropriate

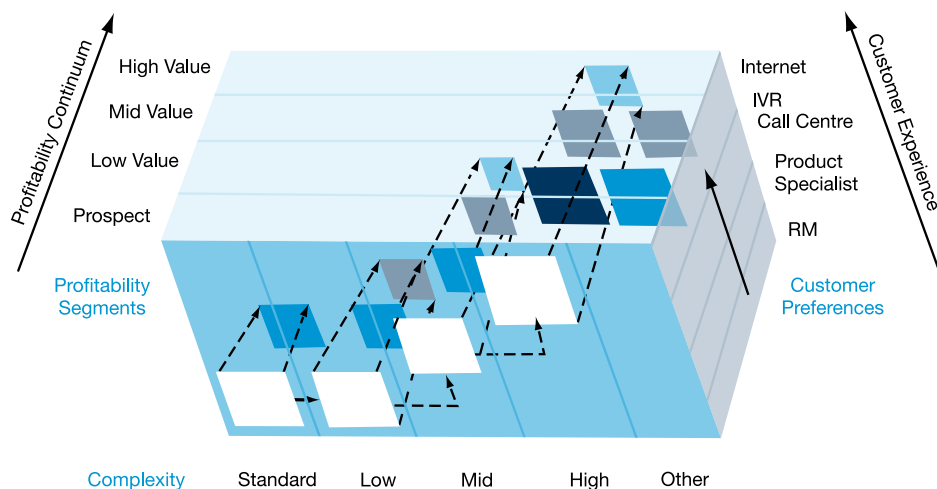
sales and service business model for each segment.

Operationalizing a client-centric business model requires that relationship coverage and origination processes be aligned to reflect a segment's preferences, profitability and complexity of needs. For example, Relationship Manager (RM) skills and specialization should increase from the low value/low complexity through the high value/high complexity segment. RM's aligned with the low value segment should be supported by a standard product set, standard terms and conditions and pre-defined pricing, all of which allow for more simplified and automated processes. The degree of product and process customization should increase as the complexity of the relationship grows. Consequently, RM portfolio loadings should decrease as the complexity and value of their clients increase.

Middle and back office functions are typically delivered across all Business Banking segments as a common business service to drive scale and efficiency. For example, many banks have established a common Portfolio Monitoring function which performs activities such as covenant compliance monitoring for all Business Banking customers.

Once a bank has defined a segment-aligned business model, it can leverage technology innovations to further drive

Commercial Banking Segmentation Framework



efficiencies. For example, some banks have leveraged enterprise content management capabilities, such as electronic forms, imaging, and workflow to compress origination cycle times. This allows for the automation of document preparation, electronic data submission from third parties and document tracking. Through these systems, a credit application can evolve into the final customer contract, thus rationalizing the number of credit documents produced and the number of times that data is keyed into systems.

The pay-off

From our experience, a business model that leverages segment-specific relationship coverage and processes and

middle and back office common business services, can translate into significant revenue and efficiency gains. Leading commercial banks have leveraged these innovations to increase the proportion of time relationship managers spend on valuable sales and relationship management activities from 20 percent to between 60 and 70 percent.

Banks that strive to be more competitive in the market should consider adopting leading segmentation and business delivery model practices. To be effective, the journey must begin by clearly defining the commercial banking end-state holistically across customer segments. Supporting processes and technology should be appropriately designed in the

context of commercial banking market practices and the bank's overall business strategies. It is also important to have a realistic understanding of current practices and capabilities that exist within the bank. This information should be the basis for a pragmatic and compelling roadmap and supporting business case to achieve the bank's desired objectives. The road map should be structured to ensure that the benefits of the new business delivery model will be realized early in the process and throughout the journey.

PwC has significant experience assisting commercial banks with the definition of business delivery models, both within Canada and across the globe. PwC offers advisory services to support banks in understanding emerging and current market practices, future state visioning, process and technology improvement, roadmap and cost/benefit analysis to build a pragmatic case for change.

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Enhancing the availability of capital to Canadian borrowers—The impact of domestic and treaty developments

Withholding taxes act as an impediment to liquidity. Given the current difficulty in accessing capital, it is useful to reflect on the effect that recent tax changes have on access to capital from non-resident lenders.

Many countries have in recent years eliminated their withholding taxes on cross-border payments of interest and royalties, and in so doing, have facilitated the transfer of capital and technology. Withholding taxes have been viewed as costly barriers to international trade with their cost often being borne by the taxpayers in the source country through higher prices or gross-up mechanisms. Canada's domestic rate of withholding is 25%, but is typically reduced in bilateral treaties. For example, the rate of withholding on interest paid to a non-resident in a treaty country is between 10% and 15%. Withholding taxes act as an impediment to liquidity. Given the current difficulty in accessing capital, it is useful to reflect on the effect that recent tax changes have on access to capital from non-resident lenders.

Effective January 1, 2008, Canada abolished its domestic withholding tax on most interest payments made

to arm's-length non-residents of any country. Certain arm's-length debts remain subject to withholding tax. The debts are referred to as 'participating debt' and include those where all or a part of the interest is contingent on the use of or production from Canadian property or is computed by reference to revenue, profit, cash flow, commodity prices or similar criterion, or by reference to dividends paid on shares. There are some further exceptions to these participating debt obligation rules, most notably in respect of security lending arrangements where the payments are deemed to be interest, and in some other cases, in respect of foreign real property. There are other exceptions and, since the payer of the interest is liable for failing to withhold and remit the required withholding tax, care is still warranted.

Traditionally, many Canadian corporate borrowers have structured the terms of the debt in such way to meet the

exemption for certain types of five year debt, thereby eliminating the need for withholding tax. With the change in the domestic withholding rules, liquidity is enhanced, since short term credit will be available to finance working capital and non-corporate borrowers will have access to non-resident lenders for both short and long term financing.

The Fifth Protocol (Protocol) to the Canada-US Treaty proposes to further extend the withholding exemptions. Under the Protocol, interest would be generally exempt from withholding tax. For related persons, the regular 10% withholding rate on interest will be exempted with a 3-year phase-in period. The first year, in which the Protocol is ratified, will have a 7% rate, the next calendar year a 4% rate, and

0% thereafter. The Protocol has received approval in both countries and is awaiting the exchange of notices to formalize its application. It is possible that the Protocol will become effective in 2008.

The exemption for payments to 'related persons' will require consideration of both the Canadian domestic definition of that term as well as the extended deeming rules in Article IX of the Treaty. The Treaty provides that a person is deemed to be related to another, if either person participates directly or indirectly in the management or control of the other, or if any third person or persons participate directly or indirectly in the management or control of either. Thus, it may be necessary to consider the management structure and board composition in certain situations.

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The exemption from withholding tax for interest paid to related persons marks a significant development in assisting Canadian businesses access capital.

Taxing issues for Islamic financing

The global market for the provision of financing, leasing and investment services in a manner compliant with Shariah Law is growing rapidly. In the United Kingdom, the Islamic mortgage market has grown to over half a billion pounds (one billion in Canadian dollars). In November 2007, the UK Treasury issued a consultative document seeking views on the potential for the UK Government to issue sterling Islamic financial instruments, enabling it to raise funds from Muslims at home and abroad. This step was part of a wider policy to make the UK a gateway to Islamic finance. Islam is the second largest faith in the UK. The UK is also the largest European trader with many Islamic countries.

In order to be compliant with the Shariah prohibitions of *riba* (interest), *gharar* (uncertainty) and *maisir* (gambling) however, the form of these transactions causes a range of tax problems. One transaction takes the form of transfers of property as opposed to principal and interest. Problems arising from this characterization include possible multiple applications of land transfer tax, and

migration of transactions from exempt to taxable treatment under the GST, with the potential for a GST cost to be borne by the provider or the customer. To address these problems, the UK has enacted a number of legislative reliefs. In 2003, the double stamp duty land tax charge on alternative financing was removed, fuelling a 50% increase in this market in one year. The 2007 Finance Act has specific provisions facilitating *sukuk*, broadly comparable to a bond in its economic effect. The latter move was made so that the UK could be a player in major international financing transactions where the principals favored an Islamic format. A recent example is the financing of the Dubai Ports project, facilitated by Barclays Capital (UK). To deal with the numerous Value Added Tax (VAT), or GST, problems, an administrative approach was adopted. Even though the UK has made efforts to facilitate Islamic finance transactions for years now, a number of VAT and other tax anomalies still remain, as legislative and administrative easements fail to keep pace with the increasing complexity of the transactions.

Given the growth of Islamic products in the UK and other markets, what is happening in Canada? You may be surprised to learn that a number of international conferences on Islamic Financing have taken place in Canada, and there is an Islamic Finance Advisory Board based in Ontario. If a range of Islamic finance alternatives to mortgages, commercial/consumer credit and insurance were launched, how far down the road is Canada with resolving the tax issues that are potential show stoppers? Not very far. Not even one step.

Islamic finance and investment is not merely a preference of a significant segment of the Canadian commercial and consumer markets. It is increasingly a precondition for access to a vast pool of international investment capital. Tax statutes that do not contemplate the formats of Islamic finance are effectively a barrier to that market. Canada cannot afford such barriers to capital investment. There is much work to do.

Tax statutes that do not contemplate the formats of Islamic finance are effectively a barrier to that market. Canada cannot afford such barriers to capital investment.

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