

Keeping pace with accelerating change

Banking Review: A Canadian perspective

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Keeping pace with accelerating change

Key banking and capital markets findings from the 14th Annual Global CEO Survey

The global economy is still recovering from the worst economic crisis in 75 years, with many countries grappling with the aftermath of the recession. So we set out to uncover how CEOs are approaching growth during a time when sustainable economic growth is far from certain. We surveyed 1,201 business leaders in 70 countries around the globe, in the last quarter of 2010, and conducted further in-depth interviews with 31 CEOs.


The PricewaterhouseCoopers 14th Annual Global CEO Survey documents a surprising level of confidence in this environment; chief executives were nearly as confident of growth this coming year as in the boom years before the crisis. The survey also revealed where CEOs saw growth coming in 2011, and how they were going to achieve it. In *Growth reimagined: Prospects in emerging markets*, we show how CEO confidence is being driven by targeted investments in particular emerging markets – often far from home.

This is a summary of the findings in the banking and capital markets sector, which is based on a survey of 69 industry leaders. To explore the full results from the 14th Annual Global CEO Survey, please visit www.pwc.com/ceosurvey

Accelerating pace of change

The changes in customer behaviour, shift in global economic power and increasing government influence over banking and capital markets business are not temporary blips; they herald the beginning of more far-reaching changes.

Many banking and capital markets CEOs are facing challenges they won't have seen in their careers. One of the most striking features of the post-crisis environment is the unprecedented savings levels. Many people assume that savings will begin to fall back again and that appetite for consumer credit will increase, once unemployment and other economic concerns recede. However, Richard K. Davis, President and CEO of Bancorp, who was interviewed as part of the CEO survey, sees high savings and cautious borrowing as an enduring long-term trend. "In the same way, for the younger people who went through this recession, it will forever have an impact on the way they behave, the way they incur debt, the way they spend, the way they save. It will be a permanent change," he said.



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Richard K. Davis, President and CEO of U.S. Bancorp

Our own analysis points to a similar conclusion. In the US, for example, we estimate that increased life expectancy, together with the decline in defined benefit pensions and resulting uncertainty over retirement funding, could raise the savings rate to as high as 10% of disposable income, a level not seen since the 1970s. (In the years leading up to the financial crisis it was running at below 3%.¹) Pension concerns may also slow down any reduction in China's high savings rates and impede attempts to boost consumption there, both factors which could play an important role in stimulating global growth.

Opportunities for growth

The demographic shift and its impact on the banking and wider financial services industry is one of the 'mega trends' explored in Project Blue: From ubiquity to precision, our latest analysis of the prospects for banking industry. The rise of the emerging markets is another of the global developments that are set to shape the direction and fortunes of the sector.

Our economic forecasts suggest that the GDP of the E7 emerging economies could be bigger than that of the G7 economies by 2020, and that China may overtake the US before the end of the decade.² Many Western banks are looking to offset the slow growth in their home markets by strengthening their presence in South America, Africa, Asia and the Middle East (SAAAME). Most

of the banking and capital markets leaders participating in our survey are clearly in this camp. 61% think that emerging markets will be more important than developed markets to their organization's future.

However, success will be hard won. Global groups face tough challenges in securing sufficient talent to meet their growth aspirations across the SAAAME markets. 57% of banking and capital markets CEOs see the availability of key talent as a significant threat to their growth prospects.

Western banks are also set to face stronger competition from E7 banks, both within the emerging markets and, increasingly, on their own turf. The market capitalization of some of the E7 banks is now bigger than that of their G7 competitors and they will want to take advantage of their growing scale.

¹ PwC, The New Rule of 10%: The coming pension crisis, higher savings rates and fundamental changes in the US financial services industry (May 2010).

² PwC, The World in 2050: The accelerating shift of global economic power: challenges and opportunities (January 2011).



“In the future, we hope to further expand our overseas networks through a range of strategic options that include establishing additional branches and considering select merger and acquisition opportunities. Regardless of the approach, though, our objective is to improve the efficiency and profitability of our overseas operations.”

Li Lihui, President of the Bank of China

Li Lihui, President of the Bank of China, summed up such ambitions, when he said: “In the future, we hope to further expand our overseas networks through a range of strategic options that include establishing additional branches and considering select merger and acquisition opportunities. Regardless of the approach, though, our objective is to improve the efficiency and profitability of our overseas operations.”

One of the keys to sustaining a competitive position in this new environment will be the ability to tap into the rapidly increasing emerging-to-emerging market trade flows. With much of the SAAAME commerce now bypassing the West, developed market banks face the challenge of making inroads into business they may rarely see.

Hands tied

A further challenge to Western banks’ current business models and future growth aspirations is set to come from the rise of state-directed capitalism, another of the mega trends highlighted in our analysis. The vast majority of banking and capital markets CEOs (80%) see over-regulation as the biggest threat to their growth prospects (see Figure 1). Their room for manoeuvre could be restricted still further in the coming years.

As Western banks go back to basics in the wake of the financial crisis, their fortunes are very much tied to the real economy. Many governments now play a much more active role in directing the economy, following the crisis, and want banks to play a more active role in supporting local business. Nicholas Moore, CEO of the Macquarie Group Limited, believes that this public/private partnership is likely to be extended in the future. “We expect that governments will not only be looking to the private sector for the provision of capital, but increasingly for the delivery of a whole range of social services. For example, in the UK the government is

looking at different ways to procure services from the private sector in terms of meeting the government’s objectives,” he said.

The majority of the banking and capital markets CEOs taking part in our survey seem to hold similar views. More than two-thirds (68%) think that business will need to actively support new government policies that promote good growth and are financially, socially and environmentally sustainable. Nearly three-quarters (74%) are also strengthening their focus on rebuilding public trust.

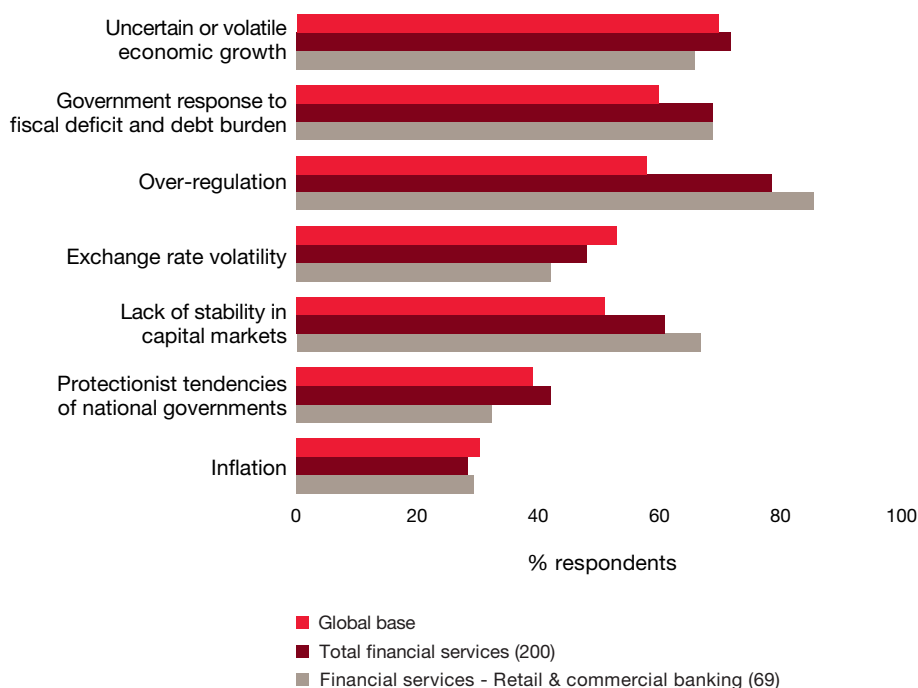
However, it could be difficult for Western banks to sustain profitability and growth in this environment. If banks are required to primarily focus on their home markets, the pool of available customers is set to shrink. This may be especially challenging for international banks based in countries with relatively small populations. It may also be harder to release the necessary investment for overseas growth. There may be heightened risks if banks are required to buy government debt or support local businesses, as, in the event of a crisis, they would face both direct losses and the fallout from any resulting downturn.

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Nicholas Moore, CEO of the Macquarie Group Limited

Figure 1: Policy and economic threats

Respondents who stated ‘extremely’ or ‘somewhat concerned’



Q: How concerned are you about the following potential economic and policy threats to your business growth prospects?

Base: All respondents (1,201)

Source: PricewaterhouseCoopers 14th Annual Global CEO Survey 2011



Unstable world

The pressure on natural resources is driving up the price of food, commodities and other goods, and creating the potential for social unrest and international conflict. A number of presentations at the latest PwC sponsored 'Risk Minds' conference highlighted the destabilizing impact of food and commodity price inflation. Recent examples include food riots in various African and Asian states. Threats to food and water security, and the resulting potential for geopolitical instability, also feature prominently in the World Economic Forum's Global Risks 2011 Report, which was launched at Davos in January.³

Banks face the challenge of adjusting to a world where assets that are now taken for granted, such as land and water, may become increasingly scarce. They will almost certainly come under growing pressure to invest in sustainable technologies. Yet, although many banking and capital markets CEOs (51%) saw political instability as the most significant global risk, they did not generally rate a number of the underlying causes as important. For example, only 17% see scarcity of natural resources as a significant risk, and only 30% are worried about the impact of inflation.

Yet, although many banking and capital markets CEOs (51%) saw political instability as the most significant global risk, they did not generally rate a number of the underlying causes as important.

For example, only 17% see scarcity of natural resources as a significant risk, and only 30% are worried about the impact of inflation.

3 World Economic Forum, Global Risks 2011 (January 2011).

It's notable that 87% of banking and capital markets CEOs believe that innovations will lead to operational efficiencies and provide them with a competitive advantage. 64% also believe that their IT investments will help them to tap into new marketing and transactional opportunities such as mobile devices and social media.

Facing the future

In short, our 14th Annual CEO Survey shows that banking and capital markets CEOs recognize that the world is changing and that their organizations will have to change with it. However, some of them may have underestimated the potential threat to the viability of their business models and the urgency of the pressure to change.

While the CEO survey looks to the near- and medium-term, the effects of many of the longer term mega trends identified in our analysis of the prospects for banking, Project Blue: From ubiquity to precision, are already being felt. As a result, some traditional revenue streams may no longer be sustainable, and some growth plans may need to be rethought or shelved altogether. But there will also be opportunities for smart organizations to take advantage of this new environment and pull ahead of their competitors.

Technology and innovation will be critical in enabling banks to cut their costs, respond to changing customer expectations and create the agility needed to capitalise on opportunities. It's notable that 87% of banking and capital markets CEOs believe that innovations will lead to operational efficiencies and provide them with a competitive advantage. 64% also believe that their IT investments will help them to tap into new marketing and transactional opportunities such as mobile devices and social media.

Ultimately, however, the most successful organizations are likely to be those that can identify and make the most of their principal competitive strengths. This will probably accelerate the move from ubiquity to precision as banks become ever more ruthless in the defense and optimization of their core franchise.

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The way forward

Capital management in banking

The future of banking is becoming clearer. It is a future of more capital, more liquidity and less risk. And, inevitably, it is a future with lower returns on capital, higher costs of doing business and slower growth with ultimate effects to be felt by shareholders and end consumers. Greater scrutiny by investors, regulators and other stakeholders regarding balance sheet usage is also expected.

Basel III is set to redraw the global banking landscape. It will have a profound impact on profitability and force many banks to transform their business models. It will also require firms to undertake significant process and system changes.

The good news is that most banks are expecting to meet the more stringent requirements without raising additional capital, as reported in recent bank earning releases. In addition, the Basel III framework does not begin to come into operation

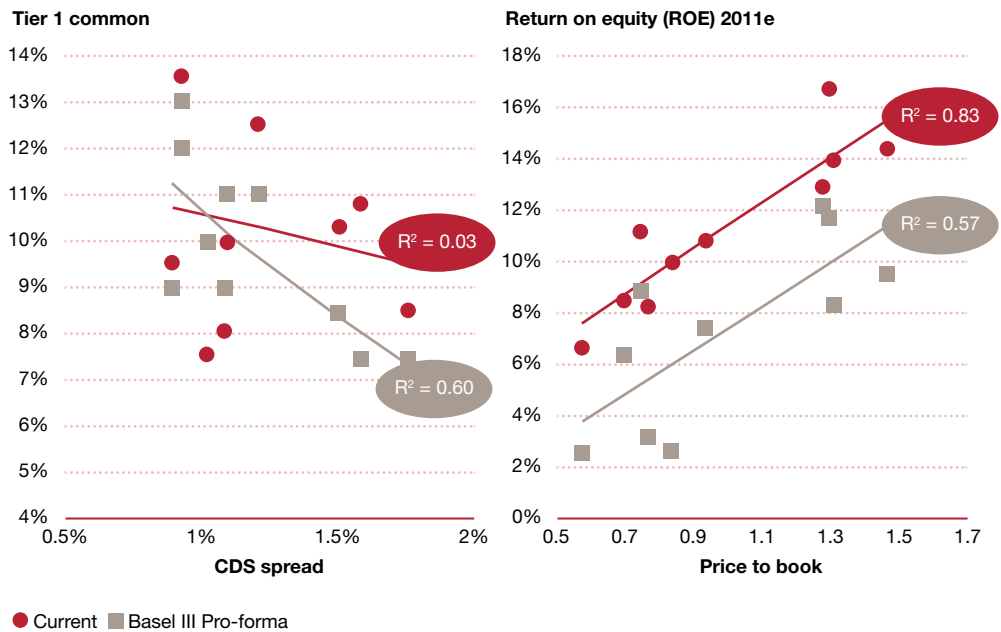
until January 2013 and its full effects will not be felt before January 2019, when the new regime's transitional period ends. Nonetheless, it is critical that firms start to reset their business models now to adapt to the new capital and liquidity standards. By doing so, they can not only start to tackle Basel III's many challenges but also keep abreast of the competition.

The markets have already started to price Basel III impact. As shown in Figure 1, the credit default swap (CDS) market already

pays more attention to banks' pro-forma capital adequacy levels under Basel III rather than to the current standards. As the equity markets better understand the return on equity (ROE) impact of new standards and bank strategies become more clearly articulated, investors will be in a better position to analyse and compare risk-adjusted performance and thus to drive stock valuation differences in due course. Recent US Federal Reserve guidance requiring Basel III pro-forma analysis to restore dividend and buyback programs is another sign that Basel III is here.¹

¹ Revised Temporary Addendum to SR letter 09-4: Dividend Increases and Other Capital Distributions for the 19 Supervisory Capital Assessment Program Bank Holding Companies – 11.10.

Figure 1: Basel III market impact analysis



Source: PwC analysis based on global 3Q10 bank Tier 1 common disclosures, CDS information from Markit Partners and ROE and P/B from Bloomberg as of November 2010.

R^2 represents the statistical explanatory power of the relationship, the higher R^2 the higher the correlation.

Figure 2: Basel III market impact analysis

The new framework:

- Raises the quality, consistency and transparency of the capital base through stricter rules on eligibility of instruments to be included in (core) Tier 1 capital.
- Enhances risk coverage by strengthening counterparty credit risk capital requirements arising from derivatives, repurchase transactions and securities financing.
- Supplements risk-based capital requirements with the addition of a non-risk-based leverage ratio as a backstop measure.
- Reduces procyclicality and promotes countercyclical capital buffers through a combination of forward-looking provisioning and capital buffers.
- Introduces new global liquidity standards that include a stressed liquidity coverage ratio and a longer-term structural liquidity ratio.
- Addresses systemic risk and interconnectedness, with more specific proposals yet to be developed.

The key changes

Basel III establishes tougher capital standards through more restrictive capital definitions, higher risk-weighted assets (RWA), additional capital buffers and higher requirements for minimum capital ratios. (For further details, see Figure 2). Primary sources for RWA inflation include trading market risk, securitization exposures and over the counter risk (OTC) derivatives counterparty exposure. As well as rethinking their business models, many banks will need to achieve upgrades in the areas of stress testing, counterparty risk and capital management infrastructure.

The reforms will impact most heavily on banks with large capital markets businesses. Higher capital requirements will primarily come from trading books, securitizations, securities lending and OTC derivatives.

Basel III also establishes new liquidity standards that will drive changes in banks' balance sheet composition to limit illiquid assets, restrict wholesale or unstable sources of funding and manage higher funding costs. These new standards will have a broad impact across most banks, particularly those that focus on commercial and wholesale banking activities.

Business model implications of Basel III

Basel III's increased capital and liquidity requirements will have significant systemic and idiosyncratic effects across the banking industry and capital markets. Higher capital and funding costs should incentivize banks to move toward different business models. Some examples of anticipated changes and opportunities include:

- Shrinkage of securitization market and structured credit businesses, putting pressure on originate-and-sell lending businesses.
- Reduced volumes in OTC derivatives and migration to clearing houses.
- Emphasis on customer facilitation activities with reduction of trading inventories, particularly of less liquid assets such as low credit quality, commodity and emerging market instruments—thus reducing the liquidity of those market segments and resulting in block trading opportunities.
- Expansion of businesses dedicated to trade clearing, trade processing and servicing.
- Transfer of proprietary trading to hedge funds.
- Increased competition from less regulated firms and potential loss of human capital to new entrants.
- New structuring opportunities for banks considering contingent capital instruments.
- Pricing strategies will be altered in those businesses that over the medium term are not able to deliver acceptable returns.
- Cost efficiency will more than ever be a key differentiator.

With regard to liquidity, banks are bound to face greater competition—and increased costs—in respect of retail deposits.

Emphasis on deposit gathering will result in increased competition, product innovations and enhanced customer services. Repo financing and lending of securities positions will become more costly. Wholesale loan products, including committed credit and back-up liquidity lines, will be rationalized, pushing more borrowers to the securities markets. It is, at the current time, difficult to predict the future structure of the wholesale funding markets.

The cost of funding is likely to increase for all institutions, with materiality depending on balance sheet management and funding strategies. Finally, firms will be obliged to invest in substantial upgrades in IT infrastructure, reporting systems and data management. The upgrade of capital management practices should help banks bridge risk and strategy to address business model challenges and opportunities.

Capital management strategies

Banks should assess the impact of the new rules on their capital adequacy through a comprehensive capital planning and optimization/mitigation process. Global banks with large sales and trading businesses have estimated a total RWA average increase of 60% from current levels under Basel III². This substantial increase will be compensated by mitigation efforts estimated at 25% of total RWA on average.

The size of the capital increase impact, the need to deliver promised RWA savings and the limited room for volatility surrounding compliance with minimum Basel III capital targets all reinforce the need for RWA optimisation programs. These programs (see Figure 3 for illustration) should do the following:

- Estimate RWA impact by business line and product including sources of increase.
- Evaluate alternative RWA mitigation/de-risking and capital re-allocation strategies.
- Assess impact on business model and marginal risk-adjusted returns of proposed actions.
- Optimize mix of RWA initiatives and plan savings in capital requirements over a three-year horizon.
- Evaluate overall capital strategy including organic generation in combination with their dividend and share repurchase programmes and various proposed RWA mitigation scenarios.
- Calibrate capital structure, emphasize high-quality equity, manage impact of new Basel III deductions, phase out hybrid capital instruments and evaluate contingent capital instruments.

Figure 3: RWA optimization and mitigation program overview

Line of business		RWA mitigation and optimisation impact					Potential RWA mitigation strategies	RWA projected savings				Business model impact
		VaR/IRC	CCR	50/50	Model	Data		'10	'11	'12	'13	
Sales and trading	Equities						<ul style="list-style-type: none">Position/Securitization run-offReduction of trading and investment positionsIncreased use of hedging and collateralReduced market/credit risk limitsDerivatives business from OTC to exchangePricing/data/model adjustments					
	Fixed income						<ul style="list-style-type: none">Position/Securitization run-offReduction of trading and investment positionsIncreased use of hedging and collateralReduced market/credit risk limitsDerivatives business from OTC to exchangePricing/data/model adjustments					
	Commodities						<ul style="list-style-type: none">Position/Securitization run-offReduction of trading and investment positionsIncreased use of hedging and collateralReduced market/credit risk limitsDerivatives business from OTC to exchangePricing/data/model adjustments					
Treasury/cash management services							<ul style="list-style-type: none">Position/Securitization run-offReduction of trading and investment positionsIncreased use of hedging and collateralReduced market/credit risk limitsDerivatives business from OTC to exchangePricing/data/model adjustments					
Retail banking							<ul style="list-style-type: none">Position/Securitization run-offReduction of trading and investment positionsIncreased use of hedging and collateralReduced market/credit risk limitsDerivatives business from OTC to exchangePricing/data/model adjustments					

n.b. These circles are an indication of the impact (the fuller the circle the higher the potential impact).

Liquidity and funding strategies

For many institutions, Basel III's liquidity challenge is likely to be greater than its capital challenge. Supply constraints—such as the availability of deposits, reliance on wholesale funding sources and high-quality liquid assets—are likely to be a key issue. The impact of the liquidity proposals is less known and banks have not yet disclosed pro-forma impact as liquidity standards will only start to be phased in by 2015. In anticipation of the impact of Basel III on liquidity, firms should seek to reduce the number of their businesses with an unfavourable liquidity treatment; raise the liquidity of their investments; raise their retail deposits; increase their additional long-term debt and capital; reduce their committed credit and liquidity facilities; reduce their wholesale credit; and adjust their pricing to compensate for the higher cost of funding.

A planned response to Basel III

Large banks will, in all probability, seek to manage their businesses to Basel III's requirements prior to the proposed deadline of January 2019 for full implementation. Firms should, therefore, look to tackle the balance sheet consequences of the new regime sooner rather than later. Before setting out on this challenging journey, however, they should equip themselves with a roadmap that sets out both short and long-term goals for upgrading their capital management strategies and practices.

One of the immediate next steps management should consider is the development of a capital plan under the new Basel III regime which considers potential impact on capital level, liquidity position and overall key financial metrics. The plan should also contemplate capital and liquidity management strategies to be employed,

2 As reported in Q3 2010 earning releases of Bank of America, Citi, JPMorgan Chase, Goldman Sachs, Morgan Stanley, Barclays, Deutsche Bank, Credit Suisse and UBS.

so as to ensure compliance with the new requirements, including changes in capital models and related infrastructure.

Management should also seek to anticipate changes in their firm's business model, product offering and client pricing strategies. They should assign a finance/risk/business line team to plan key implementation steps and continue providing comments to regulators on consultative documents. Management should also communicate with investors to ensure transparency in relation to Basel III's impact and the bank's mitigation strategies.

Looking further ahead, if banks are to achieve an effective upgrade of their capital management governance and processes, a successful integration of Pillar 2/ICAAP programmes and the new rules will be critical. Firms need to continue to assess how much capital is required to cover all of their material risks and to generate forecasts that utilise forward-looking stress scenarios. Given the new regime's inclusion of conservation, countercyclical and systemic buffers, banks should reconcile their current management buffers with the projected buffers under Basel III. Firms should also benchmark their ICAAP governance and processes, including IT infrastructure and reporting components, to supervisory expectations.

Banks beware

While banks should begin to prepare for the new framework without delay, they also need to be mindful of areas that require further clarity. Although the leverage ratio is broadly defined and the implementation timetable has been proposed, there is still a lot of important detail to be filled.

More information is also expected in relation to the countercyclical capital buffer that banks will need to meet. There are as yet no guidelines as to how such buffers may be applied and how and when they may be released. An approach for systemic banks by local regulators has yet to be agreed, with the eventual solution perhaps including an additional capital surcharge such as that proposed by Swiss regulators.

Liquidity standards need to be completed and calibrated. Given its large potential consequences in business models, the constraints related to the net stable funding ratio will demand particular attention. Banks should also keep in mind the need to integrate their response to Basel III with other initiatives, such as impact of the overall regulatory reform (e.g. Dodd-Frank Act), migration of derivatives to clearing houses, improving trade settlement arrangements, achieving more effective netting of interbank exposures; developing recovery and resolution plans; and establishing greater clarity over the management of the various separate legal entities within a banking group.

An uncertain future

At the date of publication, Basel III's proposals had been already endorsed by the G20. A number of other initiatives—including consultations on capital buffers and 'gone concern capital'; calibration of the lowest current rate (LCR), net stable funding ratio (NSFR), and the capital charge for credit value adjustment (CVA); and various national and regional changes (such as the new EU white paper on bank governance)—are scheduled to conclude at the end of 2010. Meanwhile, accounting standard changes (relating, for example, to forward-looking provisions) are targeted for 2011.

Thus, while the picture is becoming clearer, the future of banking is still shrouded in uncertainty. Though firms may be tempted to play a waiting game, they should in fact already be taking steps to ready themselves for the demands of Basel III.

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Canadian Banks 2011 Perspectives on the Canadian banking industry

Coming out of one of the most profound financial crisis in history, in 2010, Canada's six largest banks posted solid earnings, and once again demonstrated why they are considered among the most stable in the world.

Looking ahead, what does the future bring for Canadian banks? Fully armed with capital, how will they take advantage of opportunities, both domestically and abroad, to drive earnings growth and differentiate themselves from the competition?

Visit www.pwc.com/ca/canadianbanks to download this year's analysis and view our Canadian Banks 2011 video for a synopsis of our findings.



After the recession

What's next for consumer lending in Canada?



We've all seen the headlines: "Mortgage debt tops \$1 trillion"¹; "Curb your enthusiasm for debt – Mark Carney"²; "Excessive personal debt a concern."³ PwC's consumer lending survey findings show that the financial crisis has left consumers more risk averse, cost constrained and conscious of their debt loads. In this new landscape, how can Canadian banks continue to grow their consumer lending business? What's next for consumer lending in Canada?

1 CBC.com, November 8, 2010, retrieved November 24, 2010

2 The Globe and Mail, September 30, 2010, retrieved November 24, 2010

3 The Globe and Mail, October 20, 2010, retrieved November 24, 2010



PwC's survey of over 600 Canadians, homeowners with incomes over \$100,000, conducted by Leger Marketing, reveals that the majority of survey respondents plan on acting on their current debt levels in the next 12 months. 64% are planning to reduce their debt in the next year. They are less willing to take on additional credit despite confidence their banks can provide them with more. In order to reduce debt, they intend to cut back on discretionary spending. And they are looking for more advice when it comes to credit management. Consumer lending drives a significant portion of retail banking profitability. In order to continue to sustain top-line growth, banks will need to increase the proportion of a customer's borrowing, keep their existing customers longer and, wherever possible, try to acquire new customers.

76% of customers "always shop around" for credit, although a similar proportion of customers start with their primary financial institution. From this, it seems that customers shop around to ensure that they are receiving an appropriate rate from their primary bank.

Lastly, many lending products have a fixed term, requiring new loans or refinancing at the end of each term—practically forcing your customers to shop around for the best offer. Evergreen lending products, based on a home equity line of credit, but with additional flexibility, can help to reduce credit risk while increasing duration of the loans.

Banks are introducing new products to help consumers, while reducing their own risks and increasing volumes. Integrated lending products are one of the most popular new concepts; but while many banks have tried to gain traction in the marketplace, few have really succeeded. According to the survey respondents, the majority find consolidated lending products appealing, and most are looking for education about how this product can best work to fit their unique needs. To successfully market

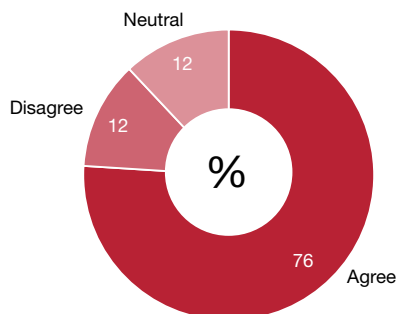
consolidated lending products, bankers need to understand their clients' needs and tune the many detailed product features to each customer's unique circumstances. Listening to and understanding customer needs is critical.

Introducing these new products will likely require transformational change programs at the banks to create new products, and new sales and servicing capabilities. In this document, we summarize the survey results, share insights into successful tactics and behaviors we've seen in the industry, and offer ideas which could help banks achieve their financial objectives and differentiate themselves in the marketplace.

Drowning in debt: How do Canadians feel about their current levels of debt?

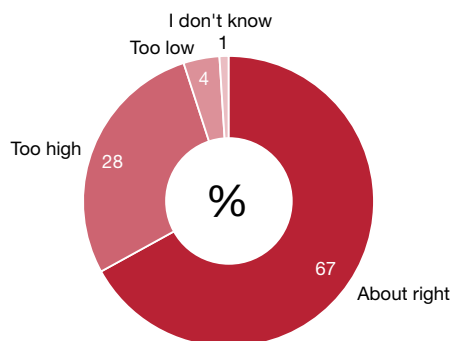
According to the survey, debt isn't a particularly scary word to the majority of Canadians. Nearly 80% agree that borrowing money is necessary to maintain their household.

Figure 1: To what extent do you agree with the following statement: "I believe borrowing money is necessary."



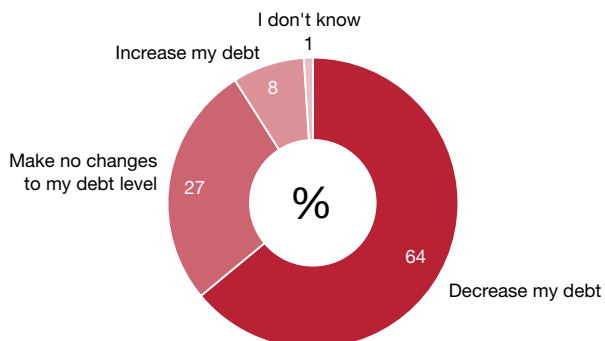
Additionally, 67% are comfortable with their borrowing.

Figure 2: Do you feel your current level of debt is...?



Regardless, most (64%) intend to decrease their borrowing over the next 12 months.

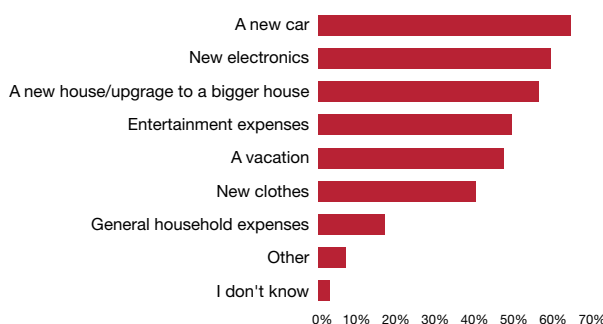
Figure 3: In the next 12 months, I have plans to:



While the consumers polled in this survey may be generally comfortable with their debt, Bank of Canada Governor Mark Carney warned Canadians in December 2010 to curb their enthusiasm for debt. Using particularly strong language, Mr. Carney said that the ratio of household debt to disposable income hit 148% in the third quarter of the year, a new record and a level that surpasses that of the US for the first time in 12 years. "This cannot continue," he warned, adding that while the net worth of Canadians is about six times the level of average disposable income, asset prices rise and fall but "debt endures." And despite the buoyancy of the real estate market, the debt-to-asset ratio among Canadian households is at its highest in more than two decades.

So, what is the primary motivator for Canadians to reduce their debt? The fear of not being able to pay off their debt if it gets too high, followed by the economy and job security. Widespread media coverage of potentially rising interest rates, personal bankruptcies, job losses and big government deficits could be the reasons behind this motivation.

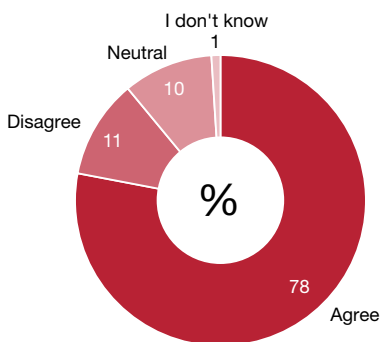
Figure 4: In order to reduce debt, what purchases would you be most willing to delay?



To reduce debt, consumers are willing to defer spending on big ticket items such as: car, electronics, a new house or home improvement, entertainment expenses, followed by vacations. Those that feel stretched now realize that with rising interest rates they will inevitably feel more stretched as rates continue to rise.

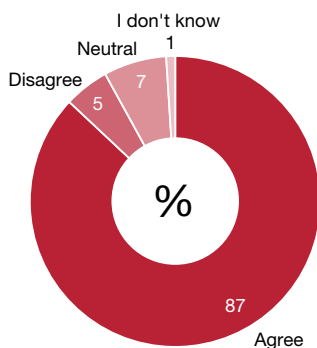
Surprisingly, 78% of respondents still believe they have the capacity to borrow more.

Figure 5: To what extent do you agree with the following statement: “I believe I have the capacity to responsibly borrow more.”



Almost 9 in 10 agree their bank is willing to offer them additional credit.

Figure 6: To what extent do you agree with the following statement: “I think my bank is willing to offer me the credit I need.”



So, if the majority of consumers plan to reduce their debt, what do banks need to do to continue to increase profitability in their consumer lending portfolios?

1. Grow “share of wallet” for their existing customers, and
2. Acquire new customers.

Banks create opportunities for customers to leave

Many lending products have a defined term after which customers need to renegotiate

Earlier, we discussed the need to grow share of wallet for high value customers. Strangely, some lending products do the exact opposite—they create opportunities for customers to leave. For example, mortgages require that a customer renegotiate major contract terms at maturity. While various terms are available, most consumers are steered toward a five year mortgage, and changes to the mortgage mid-stream can trigger costly penalty payments.

Similarly, consumers often have one or more consumer loans outstanding alongside their mortgage, perhaps for a car, a second property or a consumer item. With each purchase, the customer seeks credit, to finance the acquisition. The cost of onboarding a customer, performing the requisite verifications and validations is expensive. To optimize the return on this investment, and to improve the customer experience and grow the size of the relationship with each customer, the bank should create a new product, similar to a home-equity line of credit, but with more flexibility and options, and offer **lifetime borrowing solutions** for their best customers.

Consumer Lending Transformation

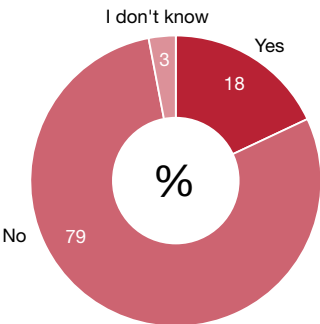
The conclusions from the first three sections are:

1. Grow the “share of wallet” for existing customers
2. Develop truly differentiated **products** and superior **service** levels
3. Offer lifetime borrowing solutions

Integrated Lending Products are designed to combine all of a customer’s borrowing into a single multi-use account secured by their home, at a lower interest rate, and with the ability to re-pay and re-borrow as their situation changes. Integrated lending products reduce risk to the bank, as they are secured through home equity, while “locking-in” the customer through an evergreen credit facility—it never expires, and can be used again and again with minimal cost to re-advance. Some of the more advanced examples allow customers to set up and manage separate facilities within the overall agreement. For example, the product can be configured to allow customers to set a portion of their mortgage to a fixed rate, for say five years, a second portion at a with a fixed rate for two years, with a variable rate line of credit for the balance of the loan. Similarly, the customer can set up a portion of the loan reflecting a shorter repayment time-horizon, for example, a three year facility to finance an automobile, a 10 year facility for a home renovation, and a one year facility for a vacation. The idea is to have a single aggregate secured credit product, with the ability to divide it into smaller facilities to suit the borrower’s needs.

According to the survey, 6 in 10 of the respondents have a mortgage, 7 in 10 have a line of credit, but 8 in 10 do not have a product like the integrated lending product.

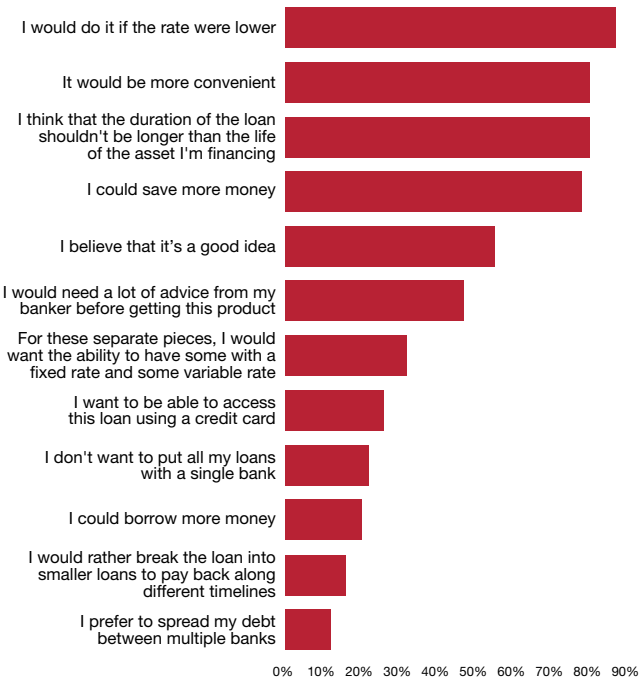
Figure 7: Do you already have a product that consolidates all your debt into a single, easy to modify loan?



How do consumers react to these products?

Overwhelmingly, 87% of respondents would consolidate their debt into a single, easy to modify loan if the rate were lower. When considering a customer's portfolio of debt, it would be simple to demonstrate the lower rate with the integrated lending product.

Figure 8: If you had the option of consolidating all your debt into a single, easy-to-modify loan, to what extent would you agree with the following?



Clearly, the opportunity, in this appealing demographic, is quite large.

How does it need to be sold?

As integrated lending products enter the market, bank staff will need to gain the right skills and attitudes to conduct needs-oriented conversations with clients.

Another statistic from Figure 8 is that approximately half (47%) of respondents would require advice from their banker before considering moving to this type of product. The good news is that since the majority of customers value their personal bankers' advice, this as an excellent opportunity for banks to build awareness and educate their clients on the potential benefits of such an integrated lending product in responsibly managing debt. This is a relatively complex product, and as such, it is necessary for personal bankers to have a conversation to understand their clients' needs, so that they can best position the most relevant product features.

To effectively promote the value of the features in integrated lending products and to match the relevant features to their customers' needs, bank staff need to spend time listening to their customers about their attitude towards debt. Additionally, this means that staff need to understand the target market for this type of product and concentrate their efforts appropriately. In our experience, the ideal customer has gone through one or more mortgage renewals, has material debt that will be carried into the future, and has sufficient financial experience to have generated insight into how the markets are moving or an opinion on where rates are going. This audience should have a borrowing time horizon long enough to justify the sales and origination effort of this more complex product and the sophistication to value the product features.

There are numerous ways to structure integrated lending products, and it turns out that consumers are looking to use the product in different ways, depending on various demographic characteristics. When looking at the product features, younger borrowers are more likely to want to split the loans into smaller tranches with specific repayment periods for each, offering them the ability to pay back loans along different timelines. More sophisticated borrowers, on the other hand, are more likely to have a view on interest rates, and want the flexibility to allocate portions of their debt between rates.

We acknowledge that most of the big banks' platforms can't easily support a product of this sophistication today. To enable these sorts of capabilities, banks need to focus on both their front-office and their core operations through the following five elements:

- **Sales and service delivery models:** We've described the required sales conversations and the basics of the target audience for the integrated lending product. Current performance measures focus on short term sales and speed of action; these need to be adjusted to help front line staff to focus on longer term product sales and more in-depth customer conversations.

- **Effective role design:** As these new sales conversations will take more time, it is important to create sufficient capacity in those roles for them to invest this required time. Identify non-customer facing activities that can be moved to a shared services function, and create specialized support functions in line with this direction.
 - **Effective process design:** Today's loan origination process typically involves capturing the required data according to the screen flow in the legacy lending application. For the integrated lending product, the sales dialogue should take the form of an interview, with responses recorded online (unobtrusively) such that further questions can be triggered, and, behind the scenes, debt service ratios and loan-to-value calculated. At the end of the conversation, the customer can leave with a printout, or a web-link, to their specific scenario(s).
 - **Flexible technology platform:** Most Canadian banks are looking to improve their consumer lending technology, and these projects tend to be massive and complex, and determining what to fix first can be a challenge. Elements for focus include a sales interview/scripting capability, and robust product servicing capabilities—the integrated lending product requires significant integration between servicing platforms so that balances can be shifted, and interest payments recalculated based on the new facilities without manual intervention.
 - **Project implementation:** Complex transformations like the introduction of integrated lending capabilities often slip due to a lack of consensus or changing priorities. Advanced skills in project management, stakeholder management, and governance are critical to implementation. Through the execution of clear program management principles, banks can better achieve their transformation agenda.
- Through the application of some or all of these project elements, banks will have a better understanding of their front- and back-end processes and in-branch activity to put in place proper project implementation plans and roadmaps. Based on our experience, going through these activities can benefit banks substantially:
- **Improved sales and higher, longer lasting credit balances:** focusing sales time on the most likely targets and longer duration lending products.
 - **Decreased costs:** more effective resource allocation to sales activities and centralization of non-customer facing processes.
 - **Improved employee satisfaction:** clarity of vision improves satisfaction as staff are clear in what they need to do.
 - **Improved customer satisfaction:** efficient bank/branch processes and needs driven conversations better meet clients' specific situations.

The road ahead

The results of PwC's consumer credit survey reveal that the financial crisis continues to leave its mark on Canadians. While the majority believe their banks would provide them with more credit if needed, they plan to reduce their level of debt.

So, where does this leave banks as they aim to increase their consumer lending profits? Many banks are looking to promote integrated lending products as a means to help customers better manage their debt. But in order to successfully develop, implement and market these products, banks will need to undergo transformational change to align their front- and back-end operations. This includes changing customer conversations, both in branch and through online channels, to enable selling of more sophisticated products.

Overall, the survey results are clear: Canadians are willing to stay with their banks as they manage their debt loads. Integrated lending products and a distinctive sales and service culture will improve share of wallet, and increase the average duration of the loans, while decreasing risk to the bank.

To download the full report *After the recession: What's next for consumer lending in Canada*, please visit www.pwc.com/ca/banking.

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U.S. Regulatory Reform The Dodd-Frank Wall Street Reform and Consumer Protection Act

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Banking Banana Skins 2010

The Banking Banana Skins Survey is conducted by the Centre for the Study of Financial Innovation (CSFI) and sponsored by PricewaterhouseCoopers. This survey of leading members of the finance industry seeks to find out their concerns about the soundness of the financial markets and puts together a league table identifying risks to banks and ranks them by severity.



Global CEO survey 2011: Growth reimagined – Prospects in emerging markets drive CEO confidence

The 2011 Global CEO Survey documents a surprising level of confidence. Despite the uncertain environment, chief executives were nearly as confident of growth this year as they were in the boom years before the crisis. The survey reveals where CEOs foresaw growth in 2011, and how they expected to achieve it.



The world in 2050

The global financial crisis has accelerated the shift in economic power to emerging economies. In the latest in a series of PwC's *World in 2050* reports, analysis reveals that the E7 emerging economies (China, India, Brazil, Russia, Mexico, Indonesia and Turkey) are set to overtake the G7 economies (U.S., Japan, Germany, UK, France, Italy and Canada) before 2020.

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This series of audio podcasts explores key issues affecting businesses in Canada and shares strategies companies can use to address them. Visit www.pwc.com/ca/strategytalks to listen.



Unleashing enterprise mobility

In this issue of the *Technology Forecast*, we examine how the current generation of smart handhelds implies more opportunities for enterprises than might be obvious at first glance.

Our services

Our team of professionals offer value-creating ideas, innovative application of leading-edge technology and deep industry experience to our clients, helping them focus on what they do best. The following provides an overview of our key services and value we bring to our clients:

Your business needs					
Solid financial management and controls		Effective strategy, operations and technology	Sound management of risks and regulations	Well executed transactions	Strong tax planning and compliance
Our solutions	Assurance <ul style="list-style-type: none"> Annual audit 5970/SAS70 Outsourcing contract review 	Operations and strategy <ul style="list-style-type: none"> Growth and channel strategies Front and back office transformation Joint ventures and M&A Financial management information Business and retail credit product processing 	Risk management <ul style="list-style-type: none"> Market, credit, trading operations and actuarial Model validation Enterprise risk management 	Acquisitions <ul style="list-style-type: none"> Capital sourcing Due diligence Valuations, fairness opinions, PPA 	Income and capital <ul style="list-style-type: none"> Planning/recovery Compliance Structuring Risk management
	IFRS <ul style="list-style-type: none"> IFRS policy, diagnostics, conversion and embedding 	Customer <ul style="list-style-type: none"> Customer strategy and experience Customer information and profitability 	Regulatory <ul style="list-style-type: none"> Regulatory compliance and investigations 	Divestiture <ul style="list-style-type: none"> Lead advisor Vendor due diligence Valuations 	Indirect <ul style="list-style-type: none"> Planning/recovery Recovery methods Filings Audit support
	Accounting support <ul style="list-style-type: none"> Technical accounting Financial instruments Structuring advice 	Technology and data <ul style="list-style-type: none"> IT effectiveness and architecture Information security Data integrity Business applications Application development, integration and testing Program/project management 	Forensics <ul style="list-style-type: none"> Forensic technology Forensic investigation Dispute analysis 	Merger Integration <ul style="list-style-type: none"> Planning and reporting Identify and resolve risks Identify, quantify, track value drivers 	Transfer pricing <ul style="list-style-type: none"> Planning Compliance/ documentation Transactions Audit defence
	Financial management <ul style="list-style-type: none"> Strategic cost management Management information Finance transformation 	Business resilience <ul style="list-style-type: none"> Physical security Business continuity Disaster recovery Crisis management 	Internal audit <ul style="list-style-type: none"> Quality assurance Co-sourcing and outsourcing 	Distressed strategy <ul style="list-style-type: none"> Distressed M&A Restructuring, CCAA Working capital strategies 	International <ul style="list-style-type: none"> Expatriate planning/ compliance Policy analysis Reorganization Financing
	Controls <ul style="list-style-type: none"> Process and controls assessments SOX compliance IT controls 	Outsourcing <ul style="list-style-type: none"> Shared services Business process outsourcing advisory IT outsourcing advisory Service level agreements 	Sustainability <ul style="list-style-type: none"> Social responsibility Climate change Assurance 	Litigation and disputes <ul style="list-style-type: none"> Loss quantification Litigation support Expert witness Mediation/arbitration 	SR&D <ul style="list-style-type: none"> Project identification Data collection Confirmation and filing/ audit support

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