

Building on strength

Perspectives on the Canadian banking industry





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We're at an unprecedented turning point in financial services. There's massive regulatory reform and uncertainty, we're rebounding from a series of recent scandals that have rocked the wider markets, and the industry must anticipate and respond to shifting consumer behaviours, demands and demographics. Before we look forward though, it's interesting to reflect upon where we've been in Canada and how the landscape has so dramatically changed to take us to where we are today.

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Snapshot of the Big Six* results

* Big Six in the context of this report refers to Canada's six major banks: National Bank of Canada (NBC), Royal Bank of Canada (RBC), The Bank of Montreal (BMO), Canadian Imperial Bank of Commerce (CIBC), The Bank of Nova Scotia (Scotiabank) and TD Canada Trust (TD).

Figure 1: 2012 at a glance – Key metrics as at or the year ended October 31

	BMO			BNS			CIBC			NBC			RBC			TD		
	2012	2011	2010	2012	2011	2010	2012	2011	2010	2012	2011	2010	2012	2011	2010	2012	2011	2010
Total Market Return¹	5.0%	2.4%	25.9%	7.4%	-0.2%	25.1%	9.5%	0.5%	31.8%	12.1%	10.1%	25.1%	21.8%	-6.8%	2.9%	11.8%	5.7%	23.4%
Return on Equity	15.9%	15.3%	14.9%	19.7%	18.8%	18.3%	22.0%	21.3%	19.4%	24.5%	17.7%	17.7%	19.5%	12.9%	14.9%	14.9%	14.5%	12.1%
Market Capitalization \$ billions	38.4	37.6	34.0	64.3	57.2	57.0	31.8	30.1	30.7	12.5	11.4	10.9	82.3	69.9	77.5	74.4	67.8	64.5
Net Income² \$ millions	4,115	3,266	2,810	6,243	5,268	4,339	3,331	3,079	2,452	1,561	1,213	1,034	7,442	4,852	5,223	6,171	5,889	4,644
Efficiency Ratio	63.5%	62.7%	62.2%	52.0%	54.4%	51.8%	57.5%	60.0%	58.1%	59.3%	60.6%	60.5%	51.5%	52.7%	51.6%	60.5%	60.6%	62.2%
Total Capital Ratio	14.9%	14.9%	15.9%	16.7%	13.9%	13.8%	17.3%	18.4%	17.8%	15.9%	16.9%	17.5%	15.1%	15.3%	14.4%	15.7%	16.0%	15.5%

1 Calculated by change in share price plus dividends.

2 Attributable to bank shareholders.

2012 has been another successful year for the Big Six banks, proving to be better than analysts' expectations. For the large part, results have been driven by trading and investment banking income rather than through the retail lending portfolios of the banks. Although retail lending has seen some growth this year, the market in Canada appears to be reaching a saturation point. Canadians are dealing with record personal debt levels and the housing market is starting to cool. Three of the Big Six banks actually saw their share prices drop because of the concerns around the outlook for the retail lending market upon release of their overall results.

With this economic backdrop, we expect it'll be a challenge for Canadian banks to maintain their results and it's likely that there will be a continued movement away from retail lending to other businesses. All of the banks indicated their intentions to seek growth outside of retail lending as the Canadian market approaches that saturation point. They're looking to other lines of business for growth opportunities. Some of those businesses are showing results this year, with the banks seeing their profits

driven by growth in wholesale banking and wealth businesses. For example, RBC announced that it was seeking a strategic wealth management acquisition and TD announced its acquisition of US-based asset management firm, Epoch.

The other option is to look at expansion abroad as a way to maintain returns. The banks so far have had mixed success in this area. Profits have generally not been as strong as for the domestic market and ROEs have been low. Sluggish international growth has generally been observed across the banks, as the global economy continues to recover very slowly with uncertainty still rife in the Eurozone. Scotiabank has had the strongest showing in this area, benefitting from a more diverse international operation compared to its Canadian counterparts, who have largely continued to concentrate on expansion in the US. Scotiabank's international banking segment saw an increase in net income of 18% year over year. Looking forward, this diversification in other international markets, particularly in fast growing emerging markets such as South America and Asia, provides them with a unique footprint to take advantage of higher growth markets.

Balancing capital and returns

Let's now focus on two of the most important key performance indicators: regulatory capital and return on shareholders' equity (ROE). There's a balance that needs to be struck between these two, sometimes conflicting, measures. Finding this balance to satisfy regulatory requirements and shareholder expectations is critical. In simplistic terms, the increase in regulatory capital will automatically decrease ROE if results remain stagnant. The question therefore becomes, how do the banks maintain or improve upon their returns in light of conflicting demands?



*“If I have seen further,
it is by standing on
shoulders of giants”*

Sir Isaac Newton



Regulatory capital

There's a clear pattern when looking at the average Tier 1 capital ratios (the ratios of banks' core equity capital to its total risk-weighted asset (RWA)) and total capital ratios for the Big Six. When the Basel Accord was first agreed upon in 1988, it primarily focused on credit risk and banks were required to hold capital equal to 8% of RWAs. Before that there were no standardized rules on capital requirements for banks. Formal reporting wasn't required in Canada until 1992, but some banks voluntarily disclosed

their Tier 1 and total capital ratios leading up to formal implementation. In the lead up, there was an interim capital target of 7.25% to allow the banks time to raise sufficient internal and external capital, which explains the slightly lower levels seen at that time.

There's a clear jump in regulatory capital ratios in the 2000s, coinciding with the shift in thinking with the introduction of Basel II. The aim of this framework, published in 2004, was to align better with the banks' own processes and support enhancements

in risk management and measurement. It was a more sensitive capital standard for credit and operational risk, requiring total capital ratio to be no lower than 8%, which led to the continuing increase in capital.

The Big Six are continuing to prepare for the introduction of the various phases of Basel III. The new accord calls for strengthening the consistency and transparency of the capital base by defining and limiting the types of eligible capital instruments and introducing significant new regulatory requirements. The impact of this will be raising the quality and quantity of the capital base. There are two main options available to achieve compliance with the new regulation – either through equity raises or divesting of higher RWA businesses, or a combination of the two. Both of these strategies present their own challenges linking back to the same issue – what impact will this increased regulatory capital ratio have on the return on shareholders' equity?

There may be margin implications if the industry is induced to withdraw from more RWA-intensive product areas if the banks don't have or can't justify the capital to support such activities, including uncollateralized long trades, shortening the time frame for trades and reducing certain securitization transactions.

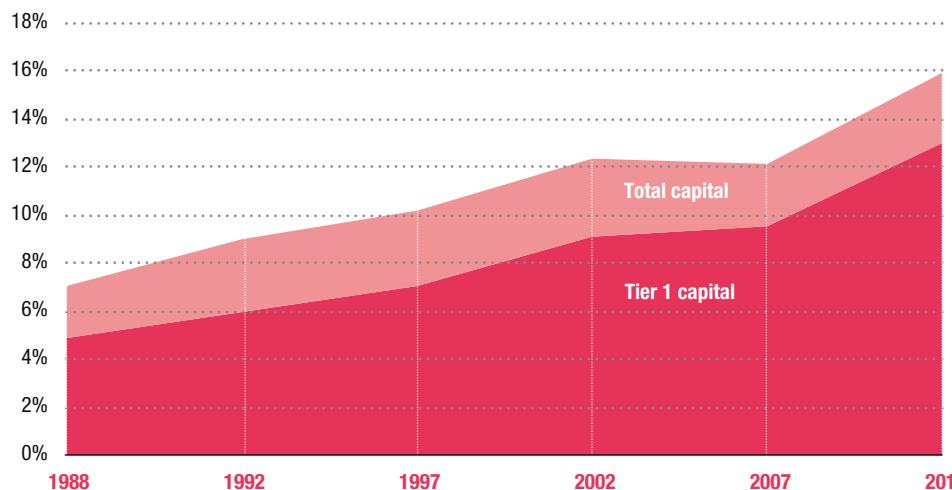
Due to the credit crisis over the past few years, Canadian banks have found themselves to be in a much stronger position in this regard than their international counterparts. The Office of the Superintendent of Financial Institutions Canada (OSFI) requires the banks to

hold higher levels of capital compared to international standards and they're also required to hold 75% of their Tier 1 capital in equity.

However, somewhat inevitably, though there have been criticisms aimed at the Big Six in the past regarding the holding of excess capital, there are important decisions that have to be made as to what to do with it. So what are those options?

- Invest organically in the business to help continue growth. Today, the question for banks shouldn't be "We have X capital; what's the best thing to do with it?" but should rather be a more strategic question such as "We see a profitable opportunity to service the needs of these certain customers in this way; what resources do we need for that?"
- Pay out dividends to investors or buy back shares, which will help the banks reduce any perceived excess capital, putting the decision of where returns should be sought in the hands of the investors. However, by doing this, banks could potentially infer that individual investors would be able to achieve higher returns with this excess capital by not investing in the bank.
- Make new acquisitions to aid expansion and growth in the US and other territories. This is one area where the Big Six have been using their competitive advantage in terms of excess capital. In particular, the banks have been looking for "tuck-in" acquisitions, which can allow for easier integration into an existing division of their operations.

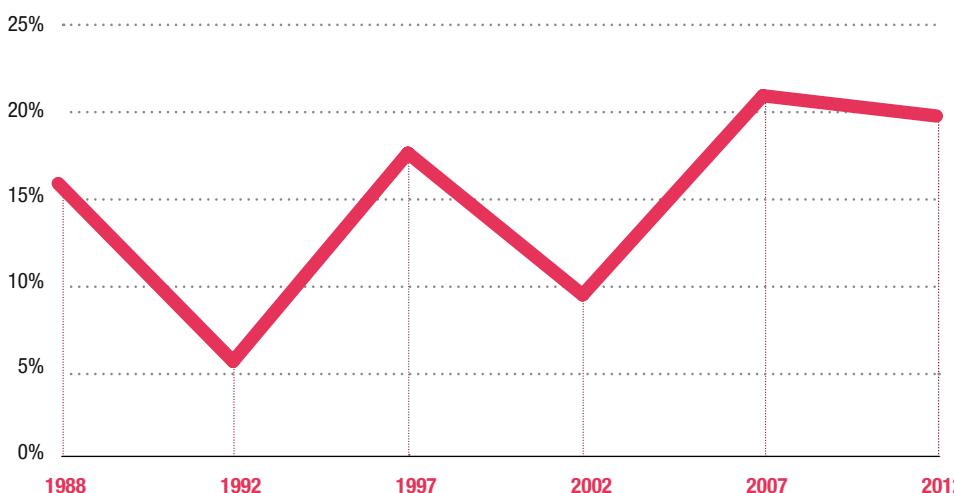
Figure 2: Regulatory capital



Return on shareholders' equity

Let's now turn our attention to ROE. From a long term lens, ROE has seen significant fluctuations over the past 25 years, with the norm now seemingly in the mid to high teens. A good question to ask is whether it's realistic for investors to expect the continued high level of returns seen since 2007 or should they adjust their expectations for a more realistic risk/return proposition in light of the regulatory capital changes?

Figure 3: Return on shareholders' equity



It will be a significant challenge to maintain or increase returns based on an increased capital base, since the increase in capital acts as a drag (as illustrated below). The figure shows how average return on equity for the Big Six has fared over the past 10 years. It's taken significant increases in net income of banks to produce small incremental percentage point increases in returns due to the offset of the increases in regulatory capital. The increase can be attributed to a change in the business mix and different business initiatives, including acquisitions and cost-cutting exercises.

ROE for the Big Six banks in 2012 averaged at around 19.7%. If the banks want to continue around the 18–20% range, there needs to be stasis in the relationship between net income and capital. This isn't easy to achieve as is evident from the income and cost measures we will discuss on the following pages. Banks have seen net interest margin gradually decrease over the past 25 years and have increasingly looked to activities other than domestic retail banking to generate revenue. This mix of product offerings will continue to be an area of focus as banks look to generate value despite new restrictions the regulatory capital requirements may bring.

Figures 4 and 5 show that as interest rates have dropped, the mix of interest to non-interest income has changed quite significantly from 1988. Banks now face the significant issue of operating in a long-term low interest rate environment. Bank of Canada stated in its semi-annual financial systems review paper issued on December 6, 2012, "The low interest rate environment in major advanced economies represents another risk to the financial system, both in Canada and globally". Canadians have been taking advantage of the low interest rates, leading to high levels of consumer debt.

These low interest rates have also been creating margin compression. As banks rely on interest rate spreads to generate returns, the level of returns available on a five-year 2.99% mortgage is not comparable to returns earned in higher rate environments.

There's also a correlation with the level of the banks' loan loss provision and their experience with ROEs. In their primary role as credit institutions, they're still at the mercy of the credit markets. Return on shareholders' equity took a deep dive in 1992 and 2002, coinciding with a spike in provision expense as a percentage of loan portfolios. In 1992, the banks were still feeling the effects of the recession of the early 1990s, as well as a weak real estate market. Poor economic conditions and intense competition among financial institutions resulted in higher levels of non-performing loans and increased loan loss provisions.

Figure 4: Average return on shareholders' equity for the Big Six banks, showing the drag effects of increases in regulatory capital

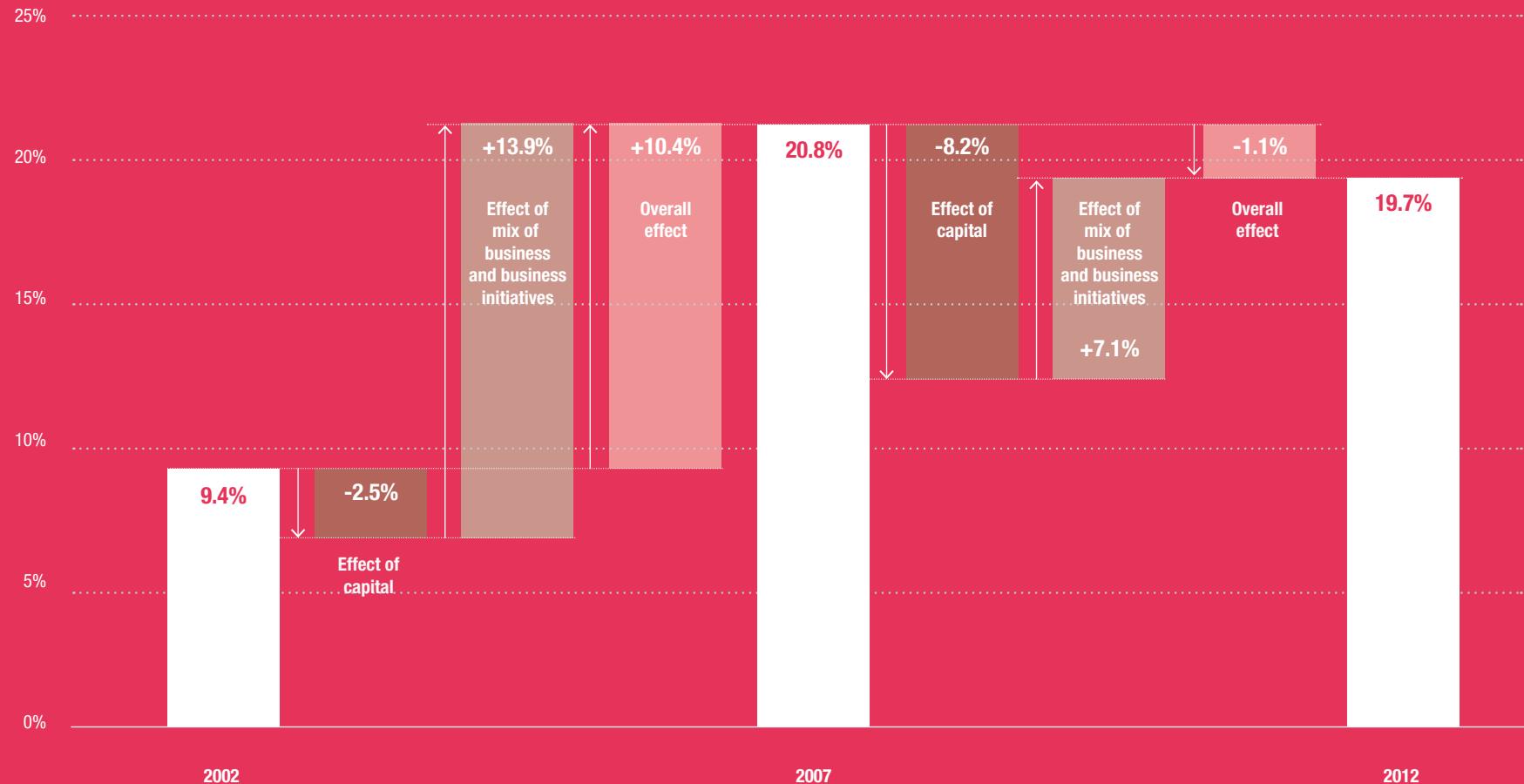
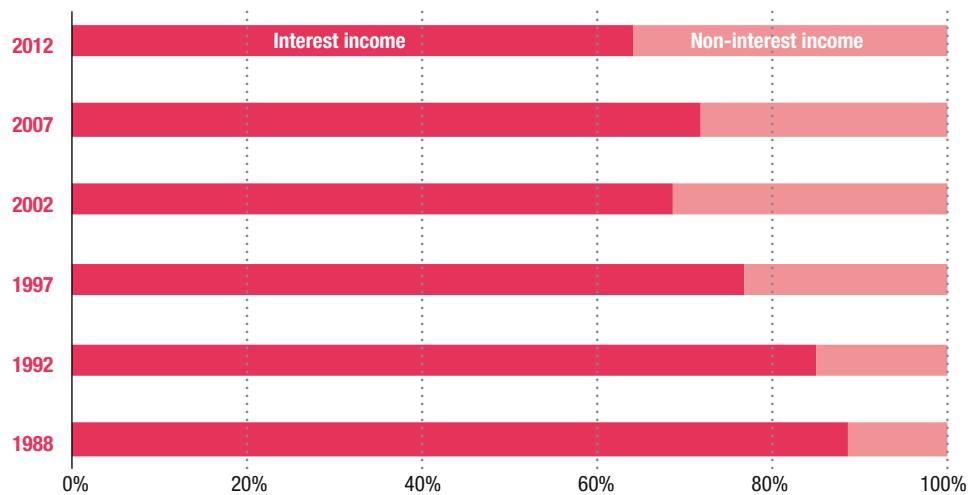




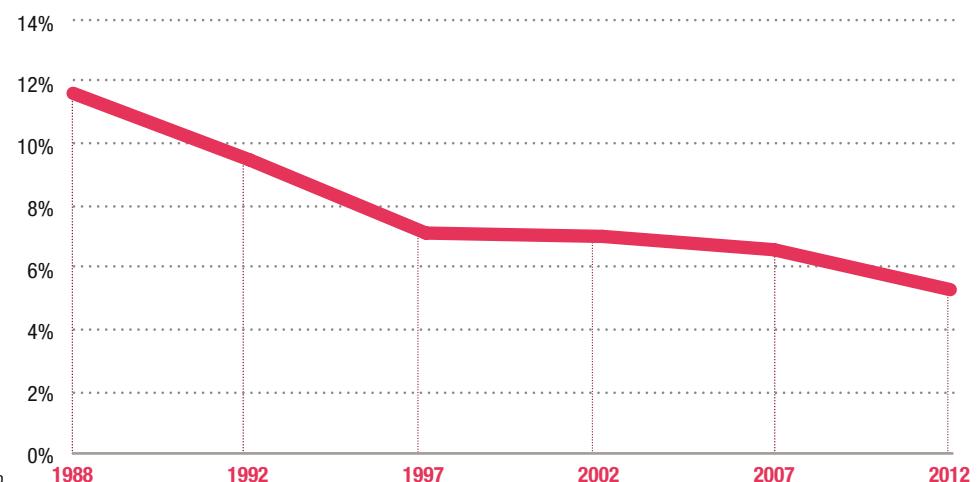
Figure 5: Interest vs. non-interest income



As stated earlier, it will be a challenge to continue to generate historic ROE levels through current product offerings, if the increases in regulatory capital induce banks to change their strategies in those areas with higher RWAs. There is inherent uncertainty with regards to how the market, regulatory environment and competitive landscape will change.

A good question to ask regarding the strategic use of capital pertains to the need to stay very focused in those businesses that drive value for target segments and relationships. Other businesses which tend to be more transactional in nature will come under increasing scrutiny, and particularly if they are major consumers of capital. From a retail perspective, the view is changing with the younger demographic becoming savvier about the choices available and very proficient with emerging technologies. Banks therefore have to ask themselves with any new products and services “Does the customer perceive value in the service being offered and do the charges and fees reflect that value?”

Figure 6: Five-year posted mortgage rates

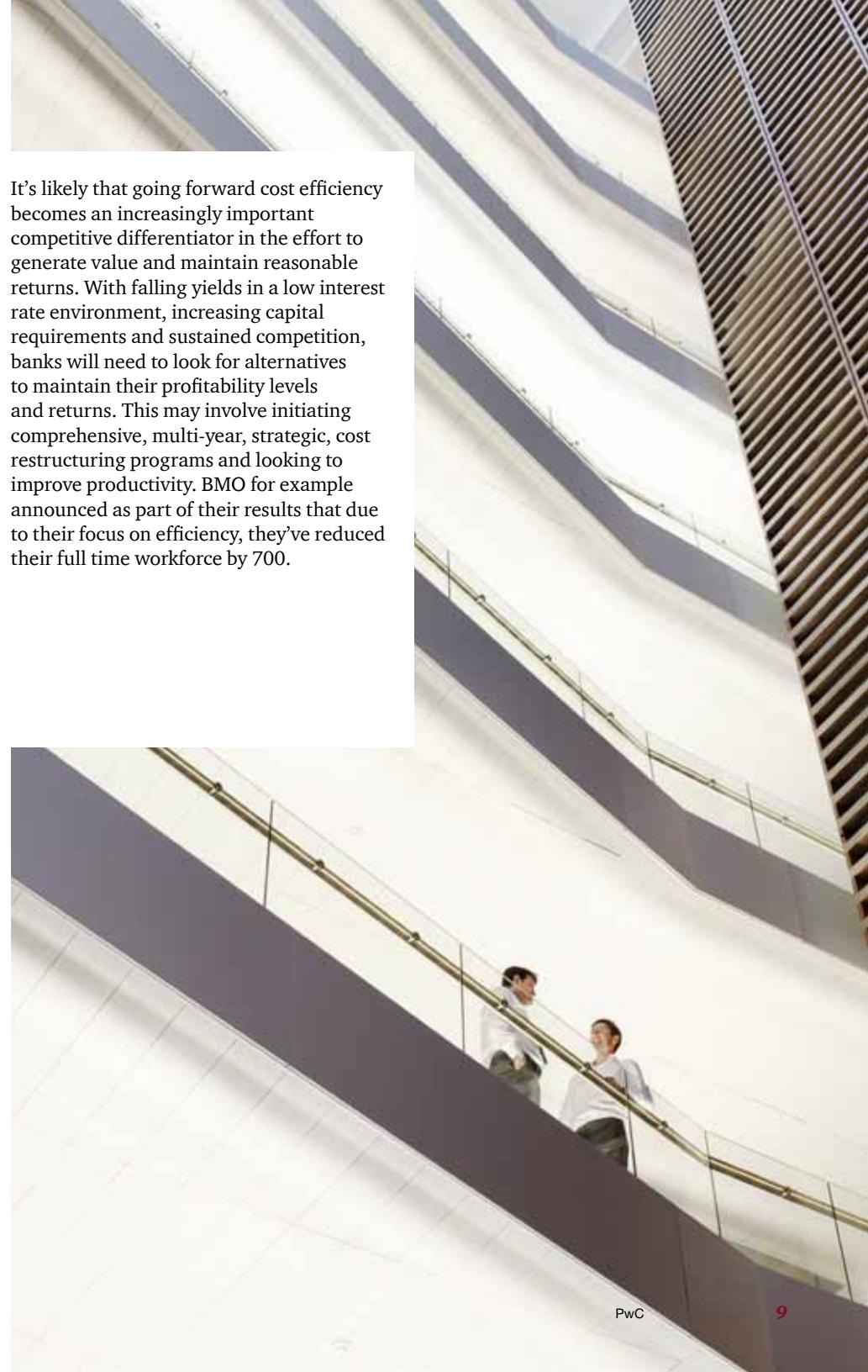


The other key consideration for the banks to help maintain ROEs is cost control and containment. The productivity ratio is calculated as total other expenses divided by the sum of net interest income (TEB) and other income. Productivity ratios, from an expense perspective, are improved by achievement of scale in operations, and the use of technology to drive automation of processes (i.e. mobile banking vs. branch banking).

Over the past several years with revenue growth being solid, it's easier to overlook some inefficiencies in the operations, and particularly those that may come at the expense of the customer experience.

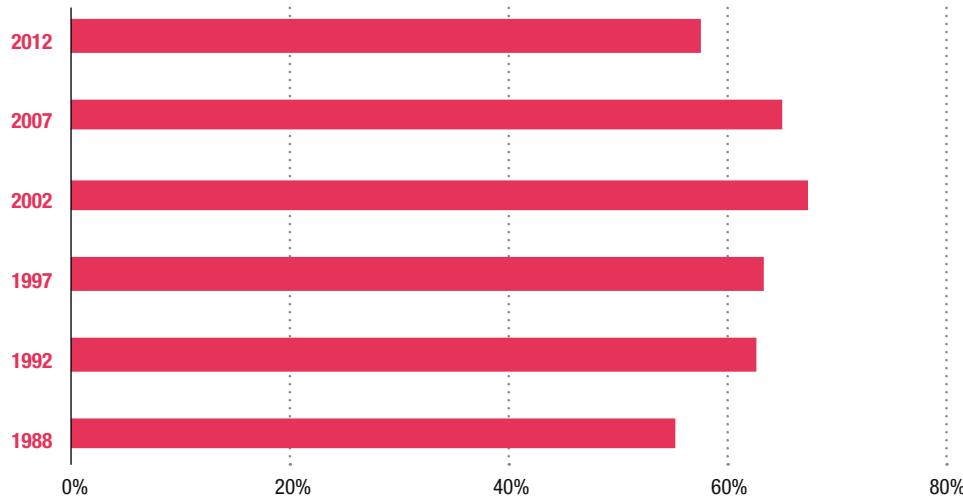
However, in this current environment of head-winds to revenue growth, great attention is being paid to cost structure and projects driving discretionary spend.

In our 2002 *Canadian Banks* publication, we noted that "...productivity at Canadian banks has typically been lower than comparable measures for US peers, attributed to the different business mixes. The more composite nature of Canadian banks as compared to the more segregated US industry means those securities businesses, which typically yield lower productivity, tend to drag the Canadian rates below those of their US counterparts."



It's likely that going forward cost efficiency becomes an increasingly important competitive differentiator in the effort to generate value and maintain reasonable returns. With falling yields in a low interest rate environment, increasing capital requirements and sustained competition, banks will need to look for alternatives to maintain their profitability levels and returns. This may involve initiating comprehensive, multi-year, strategic, cost restructuring programs and looking to improve productivity. BMO for example announced as part of their results that due to their focus on efficiency, they've reduced their full time workforce by 700.

Figure 7: Efficiency ratio





In summary

Canadian banks have undergone significant changes over the past 25 years, dealing with the challenges of recessions, fallout from extraordinary world events and ever-changing consumer behaviours. Despite these challenges, Canadian banks are considered some of the strongest banks in the world. There are both more challenges and opportunities to come and thinking strategically about the choices on the consumer front will be key as the banks look to grow returns.

In 2013, we'll explore the future changes facing the industry along with a more detailed examination of the banks' results in our annual publication, *Canadian Banks 2013*. This will also include an analysis of regulatory developments, changes in the product offerings including the introduction of new payment methods, and how banks can gain efficiencies on the cost side of their ledger. If you're interested in receiving this publication when it is released, please email us at: financial.services@ca.pwc.com.

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Thirty years of providing the information banks need to know

It has been 30 years since we launched our initial annual banking analysis publication, *Canadian Banks*. The publication started out small, consisting of only a few tables summarizing results of foreign banks in Canada. And just as the Canadian banking environment has evolved since 1982, so has our *Canadian Banks* publication. The publication has expanded to include a full analysis of the larger domestic banks and their results.

The 2013 edition of *Canadian Banks* will represent the 30th year that we have provided key information on metrics and measures of the banking industry in Canada. Pictured at left is the first edition of our report, *Foreign Banks in Canada*, produced by our legacy firm Price Waterhouse in 1982.

We look forward to keeping Canadian banks up to date and informed on the state of the industry for another thirty years. If you would like to find out more about our services for the Canadian banking and capital markets industry, visit www.pwc.com/ca/banking.