

Banking and Capital Markets
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Navigating through regulatory complexity

Perspectives on the
Canadian banking industry



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Canada's Big Six banks achieved combined profits of \$23.6 billion and have Tier 1 capital ratios ranging from 12% to 14.7%—above the OSFI minimum required levels

Overall, 2011 was another successful year for Canadian banks. With combined profits of \$23.6 billion, they have demonstrated once again their ability to achieve strong results and maintain solid capital levels in uncertain times. The banks' results were driven primarily by growth in deposits and retail lending while overcoming tightening margins due to competition and the long-term, low-interest rate outlook. All of the banks show strong balance sheets with Tier 1 capital ratios ranging from 12% to 14.7%, above the Office of the Superintendent of Financial Institutions (OSFI) minimum required levels (see Figure 1).

While the banks have long established their ability to manage events at home, winds of uncertainty are swirling in the global market that will likely be felt in Canada. The sovereign debt crisis in Europe has added to fears of a global recession and regulators are still grappling with the fallout of the credit crisis in 2008.

The Canadian banks have reported limited direct exposure to European debt, however, this does not mean they are immune to the events unfolding overseas. As a result of these events, the banks and the Bank of Canada have lowered their Canadian GDP growth estimates into 2012. This increases the risk for the banks where they hold debt of Canadian companies that have European operations. As well, long-term weakness in the global economy can hurt commodity prices as demand expectations are lowered. Lower commodity demand also reduces the need for capital expansion, which the banks help finance through debt, equity offerings or M&A activities.

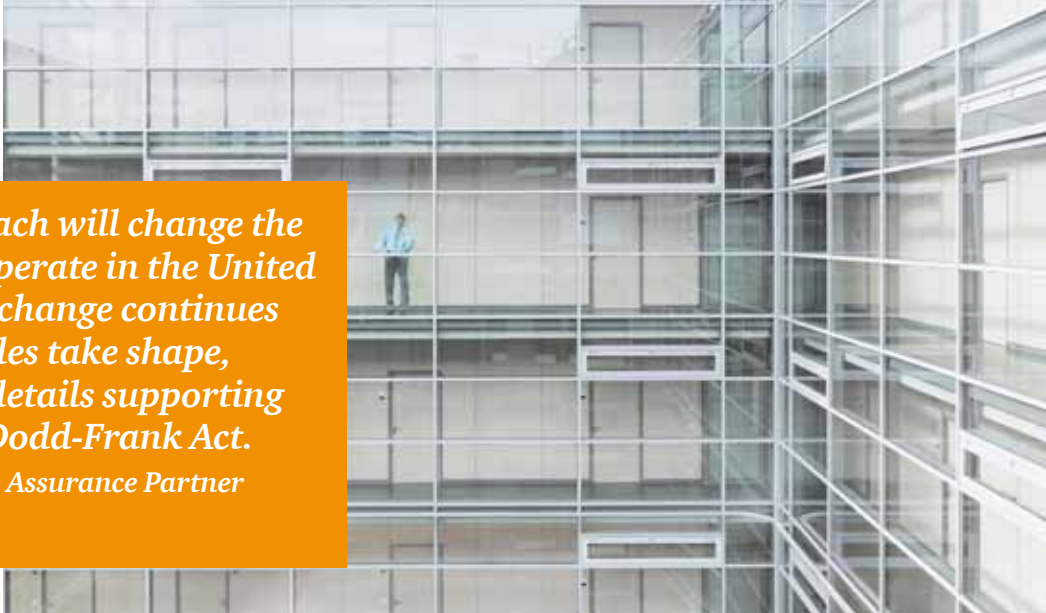
Canadian banks interact with numerous counterparties on a daily basis, including many European banks. The counterparty risk for Canadian banks climb as the risk of default by a sovereign or bank in Europe increases.

The sector is heading into a period of uncertainty with financial markets and global economic instability. This uncertainty, coupled with continued business pressures in a complex regulatory regime in many jurisdictions, will continue to consume significant management resources and boards' attention with no slow down in sight. The incremental costs associated (i.e., risk management, information reporting, etc.) with complying with new regulations will also be significant.

Figure 1: 2011 at a glance – Key metrics as at or the year ended October 31

Key metrics	BMO			BNS			CIBC			NBC			RBC			TD		
	2011	2010	2009	2011	2010	2009	2011	2010	2009	2011	2010	2009	2011	2010	2009	2011	2010	2009
Total market return ¹	2.4%	25.9%	22.9%	-0.2%	25.1%	17.5%	0.5%	31.8%	19.8%	10.1%	25.1%	30.2%	-6.8%	2.9%	21.3%	5.7%	23.4%	13.6%
Return on equity	15.3%	14.9%	9.9%	18.8%	18.3%	16.9%	21.3%	19.4%	9.1%	17.7%	17.7%	15.7%	12.9%	14.9%	11.9%	14.5%	12.1%	8.4%
Market capitalization (\$ billions)	37.6	34.0	27.6	57.2	57.0	46.4	30.1	30.7	23.8	11.4	10.9	9.1	69.9	77.5	77.7	67.8	64.5	53.0
Net income (\$ millions)	3,266	2,810	1,787	5,268	4,339	3,661	3,079	2,452	1,174	1,213	1,034	854	4,852	5,223	3,858	5,889	4,644	3,120
Efficiency ratio	62.7%	62.2%	66.7%	54.4%	51.8%	53.7%	60.0%	58.1%	67.1%	60.6%	60.5%	64.4%	52.7%	51.6%	50.8%	60.6%	62.2%	68.4%
Tier 1 capital ratio	12.0%	13.5%	12.2%	12.2%	11.8%	10.7%	14.7%	13.9%	12.1%	13.6%	14.0%	10.7%	13.3%	13.0%	13.0%	13.0%	12.2%	11.3%

¹ Calculated by change in share price plus dividends.



Dodd-Frank's broad reach will change the way Canadian banks operate in the United States. The full force of change continues to evolve as the final rules take shape, providing application details supporting the 2,300 pages of the Dodd-Frank Act.

—Ryan Leopold, PwC Audit & Assurance Partner

Dodd-Frank

Some of this regulatory complexity is driven by the the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which was released in July 2010.

As the regulatory details of the numerous segments of Dodd-Frank get finalized, its reach impacts not only every segment of the US financial services industry but also impacts financial institutions that deal with US banks in ways that may not have been fully anticipated.

Foreign Banking Operations

Dodd-Frank applies US national policies to Foreign Banking Operations (FBO) that do business in the United States through US branches, agencies, or bank subsidiaries. These FBOs are generally subject to the same rules as comparable US Bank Holding Companies (BHC). This could lead to situations where a FBO is considered to be systemically important to the US banking system. Systemically Important Financial Institutions (SIFIs) are defined as BHCs with US\$50 billion or more in consolidated assets. These SIFIs would be subject to more stringent standards compared to non-systemically important financial institutions. This may include capital and liquidity requirements, risk management, credit exposure reporting, and concentration

limits. It would also require these FBOs to produce resolution plans or “living wills” that would outline how the bank would unwind its operations in an orderly manner should it fail.

Even if Canadian banks' foreign operations are not considered to meet the SIFIs test, they will still be subject to other aspects of Dodd-Frank.

Volcker Rule

The Volcker Rule places prohibitions on banking entities from engaging in proprietary trading and certain relationships with hedge funds and private equity funds. Running throughout the Volcker Rule is the presumption that acting as “principal” is “speculating,” except where the rule says it is not. As a result, this could significantly change the economics of firms' capital markets and trading businesses. What complicates the prohibition is that trading as principal – the proposal's essential description of proprietary activity – occurs as part of other financial activities critical to the functioning of markets (market making) and to the management of risk (hedging), among other activities. It could also increase the risk of firms moving these businesses into non-regulated entities. The comment period for the proposed rule closes in January 2012, with an effective date of July 2012.

Over-the-counter (OTC) derivatives

Dodd-Frank aims to reform the derivatives markets through the implementation of new regulatory, business and operational oversight. This will include new clearing, margin and collateral requirements, recordkeeping and reporting duties, and new trade execution alternatives. The goal of the act is to increase transparency, reduce systemic risk, and ensure orderly markets. The key objective is to move a significant portion of the OTC derivative market to have clearing performed by central clearinghouses. New recordkeeping and reporting requirements aim to increase transparency for all participants and improve the ability of regulators to better monitor risks and potential market manipulation.

OTC derivative reform will fundamentally change the way banks and their customers interact in the derivatives market, the full ramifications of which are still being assessed, including the potential for unintended consequences.

—Jason Boggs, PwC Consulting & Deals Partner

The regulations will cover both entities that engage in derivative activities as well as derivative transactions themselves. While there are some proposed exemptions, the impact will remain significant. Regulated derivative participants will have to register as such, and be subject to specific regulations that drive how they function in this capacity.

With bank derivative dealers potentially facing enhanced capital and margin requirements, counterparties must consider the costs associated with potential widening bid-ask spreads, cost of capital associated with margin requirements, or other new costs.





Compliance with FATCA will not only involve significant costs for organizations, but also increase operational tax risks and can directly impact the customer experience.

—Mike Bondy, PwC Banking and Capital Markets Tax Leader

FATCA

Dodd-Frank is not the only piece of US legislation that will affect Canadian banks. The enactment of the Foreign Account Tax Compliance Act of 2009 (FATCA) is impacting global tax withholding and reporting, with the costs of implementation being borne by both US and non-US financial institutions. FATCA aims to reduce the risk of US tax evasion by “US persons” who use foreign financial institutions and US-owned foreign entities to shield their identity from the Internal Revenue Service (IRS). The US tax regime is unique in that it imposes worldwide taxation based on US citizenship regardless of where the citizen resides. FATCA creates a new 30% withholding tax on specific US source payments made to most foreign entities after December 31, 2013 unless the recipient complies with the FATCA rules. This includes US source interest, dividends, rent, salaries, wages, annuities and other fixed or determinable payments. Gross proceeds from the sale of US debt and equity will be subject to the 30% withholding tax effective January 1, 2015. In order to avoid withholding on such payments made to it, Foreign Financial Institutions (FFI) will be required to enter into an agreement with the IRS to identify, withhold and report on US persons and certain non-financial foreign entities. The compliance efforts are tremendous and include the use of electronically searchable databases to determine if there is any indication that an account holder may be a “US person” along with requests for follow-up verification being put into place. Verification of the status of existing accounts will be required and client onboarding systems will be affected.

MiFID II

Regulatory changes in the US aren't the only area that Canadian banks need to focus their attention. Sweeping changes are also planned to the European securities markets by the European Commission through its review of the Markets in Financial Instruments Directive: the MiFID review. Similar to Dodd-Frank, these rules will change the way securities markets operate in the European Union with the goal of enhancing system stability, market efficiency and competitiveness, and investor protection.

MiFID II is a focal point in a much wider overhaul of securities regulations, with specific links to the regulation on OTC derivatives, central counterparties and trade repositories (commonly referred to as the European Market Infrastructure Regulation or EMIR), the regulation on short selling and credit default swaps (short selling), as well as the review of the Market Abuse Directive (MAD), changes to the Transparency and Prospectus Directives, proposals for Central Securities Depositories (CSD), and amendments to the Securities Law Directive (SLD). It also links directly to key regulatory changes in the asset management industry, including the amendments to the Undertakings for Collective Investment in Transferable Securities Directive (UCITS), the Alternative Investment Fund Managers Directive (AIFMD), and the Packaged Retail Investment Products (PRIIPs) initiative.

Basel III

Basel III was developed by the Basel Committee on Banking Supervision in response to deficiencies revealed by the global financial crisis with the goal of promoting a more resilient banking sector. The Basel III reforms raise both the quality and quantity of the regulatory capital base and enhance the risk coverage of the Basel II capital framework to capture major on- and off-balance sheet risks. Basel III may represent one of the biggest regulatory changes that the banking industry has seen in decades.

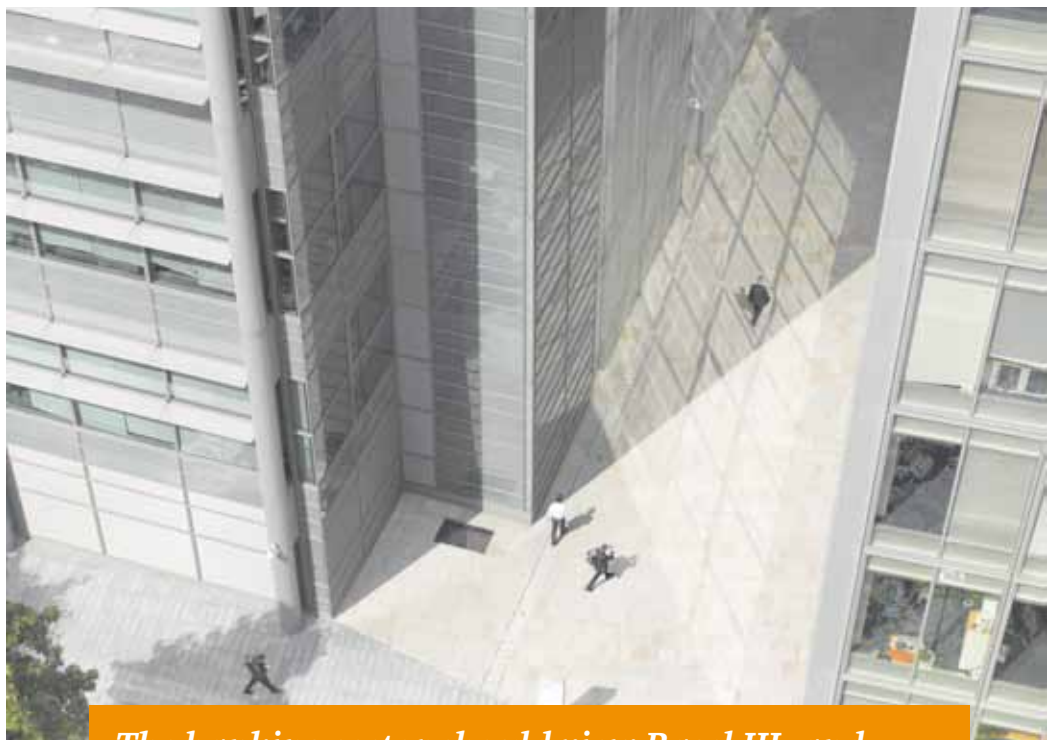
The new accord strengthens the quality, consistency and transparency of the capital base by defining and limiting the types of eligible capital instruments for both Tier 1 and Tier 2 capital, and introduces significant new regulatory requirements for bank liquidity, net stable funding, leverage, counterparty credit risk, and conservation and counter-cyclical buffers to “dampen” the pro-cyclical effects of Basel II minimum capital requirements. Basel III also addresses systemic risk and lack of transparency within the financial sector, including strong incentives for banks to move exposures to central clearing parties, higher risk weights on highly correlated exposures to financial institutions, and measures to mitigate reliance on external credit ratings and minimize cliff effects, and additional loss-absorbing capacity for systemically important banks.

Regulatory changes in Canada

The Canadian banks’ primary regulator, OSFI, continues its laser focus on the safety and soundness of the Canadian banking industry. The sector is working towards the adoption of Basel III starting in 2013, which will increase the level of required capital. In addition, the standard has a focus on quality of capital, phasing out the benefit of using certain innovative Tier 1 capital instruments.

The Department of Finance also recently introduced the Financial System

Review Act, updating various financial institution statutes by April 20, 2012. The proposed bill includes enhancements to a number of regulations including the requirement that the finance minister approve substantial foreign acquisitions. And Canadian regulators and market participants are working towards the implementation of Canada’s G20 commitments regarding OTC derivative reform. This will develop a framework of new clearing, margin and collateral requirements, recordkeeping and reporting duties for Canadian OTC derivative market participants.



The banking sector should view Basel III, and the associated jurisdiction-specific reforms, from an integrated strategic perspective. These reforms will have an impact on business models, profitability, and balance sheets, and will require significant process and system changes to support the information needed to make the right business decisions in the new environment.

— Elisabeth Burke, PwC Consulting & Deals Partner

In summary

This is a time of great change in the financial markets, both in terms of the economics and the global regulatory response. At the recent G20 Summit in Cannes, the G20 reiterated its commitment to complete its major reform of the financial sector and to align national arrangements to prevent risks of regulatory arbitrage. With the effects of the financial crisis being felt in all financial markets, this trend of enhancing regulations for all financial institutions shows no signs of slowing down. Canadian institutions need to stay on top of regulatory developments and then evaluate whether or not any new rules need to be followed.

In 2012, we will provide our perspective on opportunities and other issues facing the banks, along with a more detailed examination of the banks' results in our annual publication, *Canadian Banks 2012*. 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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