

### MARKET-SENSITIVITY OF MAJOR CANADIAN BANKS

#### Market-Sensitive Businesses Represent 25% of Revenues Up 32% Over The Last Five Years

#### Bank Investors Should Take Fair Warning That A Significant Credit Tightening Could Negatively Impact Bank Earnings To A Higher Degree Than In Previous Cycles

#### **Conclusion: Market-Sensitivity Could Rival Loan Losses In A Credit Crunch**

The major Canadian banks have increased the proportion of revenue derived from market-sensitive businesses from 19% of total revenue in 2002 to 25% currently, a 32% increase over the last five years. This may come as no big surprise to investors but it will be a very key factor if a major market correction driven by a significant credit tightening were to occur as previously, the impact would have been largely geared to higher loan losses.

**Conclusion 1: Not so going forward.** With increased revenue dependency on market-sensitive businesses which includes (i) trading revenues, (ii) retail brokerage commissions, (iii) investment banking fees and (iv) merchant banking, venture capital and security gains, the major Canadian banks could see a revenue contraction in these market-sensitive businesses that could exasperate the negative impact on earnings of a down cycle. Individual bank market-sensitivities as we see it are:

- National Bank is the most sensitive by a substantial margin with a high 44% sensitivity. The highest in North America that we can determine.
- Scotiabank appears the least sensitive at 17%.
- RBC, BMO, TD and CIBC fall in a sensitivity range of 22% to 29%.

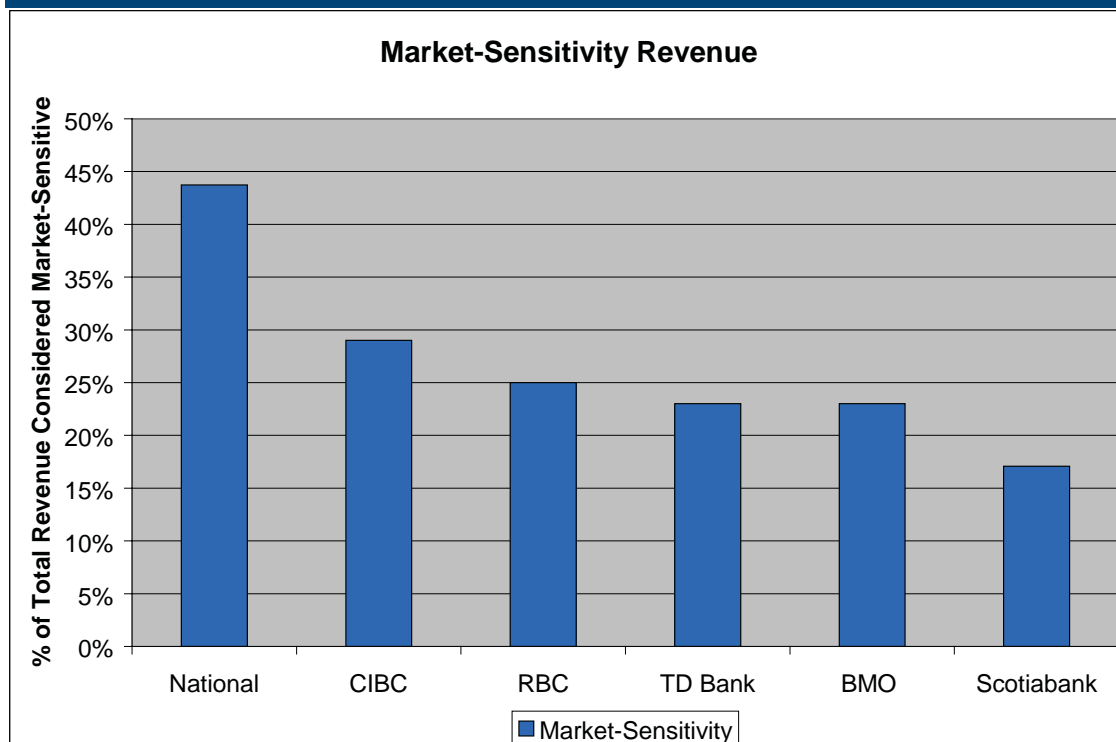
**Conclusion 2: Market-sensitivity impact on net operating income is even higher.** Although representing an average of 25% of total revenues, market-sensitive businesses are estimated to contribute over 30% of the total bank net operating income as profit margins on these businesses tend to be much higher than traditional banking margins.

**Conclusion 3: Market-sensitivity to rival the negative impact of higher loan losses.** Loan losses have declined from 13% of revenue in fiscal 2002 (the last bad year) to 3% in the fiscal YTD 2007 (one of the best periods in recent history). The impact on net operating income is over twice this figure. Consider then:

- A doubling of loan losses (not at all inconceivable given the historically low levels) could lower net operating income by 8% annually.
- A 25% drop in market-sensitive revenues could lower net operating income by a further 8%.

**Conclusion 4: In combination, a 16% reduction in bank net operating income.** The result of a significant credit tightening on the Canadian banks is material and would be expected to result in a freezing of dividend increases and a probable share price correction in the order of 20%.

Figure 1: Market-Sensitivity Revenue Chart



Source: eResearch

### What Are The Market Sensitive Businesses?

Market sensitive businesses include (i) trading revenues, (ii) retail brokerage commissions, (iii) investment banking fees and (iv) merchant banking, venture capital and security gains. As in previous cycles we have assumed that any downturn resulting from a credit tightening would result in a decline in retail commission volumes including discount brokerage commission revenue, a decrease in investment banking activity and diminished venture capital returns including the potential of security losses such as the recent BMO loss of \$680 million. Trading revenues are oftentimes more a function of market volatility and could therefore still result in good revenue production although the risks associated with these revenues could become considerably higher.

### Market-Sensitive Business Revenues Increased To 25% From 19% in 5 Years

Although it is difficult to determine the actual amount of revenue derived from each of these segments due to varying levels of financial disclosure among the banks, we have nonetheless estimated the relative levels of revenue derived from each sector. In certain cases revenues have been adjusted to eliminate extraordinary losses in order to provide as much as possible a normalized revenue contribution.

We have concluded that market-sensitive revenues have increased from 19% in 2002 to 25% of revenues in the first six months YTD of the banks fiscal 2007 as shown in the table. Furthermore, we have determined that the after-tax profits from market-sensitive businesses represent approximately 30% of net adjusted operating income (extraordinary losses and restructuring charges have been excluded) as the profit margins on these businesses tend on average to be higher than traditional banking margins.

**Table 1: Revenue Trends In Bank Market-Sensitive Businesses**

Years Ended Oct. 31	2002	2003	2004	2005	2006	YTD 2007
BMO Financial Grp	12%	15%	18%	20%	22%	23%
CIBC	21%	22%	23%	26%	26%	29%
National Bank	34%	39%	38%	44%	44%	44%
RBC Financial Grp	20%	22%	20%	20%	24%	25%
Scotiabank	12%	14%	17%	18%	17%	17%
TD Bank Financial	24%	21%	21%	23%	25%	23%
Average Cdn Banks	19%	20%	21%	23%	24%	25%

Source: eResearch

### Market-Sensitive Business Impact On Net Income Is Estimated At 30%+

We have assessed that the after-tax profits from market-sensitive businesses represent over 30% of net operating income versus the 25% of revenues as the profit margins on these businesses tend on average to be higher than traditional banking margins. Furthermore security gains may be replaced by losses as became the case recently with BMO which will exacerbate the impact on net operating income.

### Traditionally Credit Tightening Focused More On Loan Losses

In past business cycles involving a credit tightening, the focus of bank earnings sensitivity was on potential loan losses. To illustrate this, we show in the table below just how much loan losses can vary as a percentage of revenues in a cycle. In the last bad year which was 2002, loan losses were 13% of revenues. This particular year included a major provision by TD Bank and the write-off of Argentina by Scotiabank. [Note: If one were to go back in time to the mid-1980s with oil & gas loan problems, LDC loan write-offs in 1990 and real estate loan problems later in the 1990s, loan losses at times ran as high as 20% of revenues]. Subsequent to 2002, loan losses declined to approximately 3% of revenues which is one of the lowest levels in recent history and which has been aided by recoveries from the previous cycle. Generally the impact on net operating income is about 2.0 to 2.5 times this level, in other words, loan losses doubling from 3% of revenue to 6% would lower net operating income by 6% to 8%.

**Table 2: Revenue Sensitivity Of Bank Loan Losses**

Years Ended Oct. 31	2002	2003	2004	2005	2006	YTD 2007
BMO Financial Grp	9%	5%	1%	2%	2%	2%
CIBC	13%	10%	5%	6%	5%	5%
National Bank	11%	5%	4%	2%	2%	3%
RBC Financial Grp	6%	4%	3%	2%	2%	3%
Scotiabank	14%	9%	4%	2%	2%	2%
TD Bank Financial	28%	4%	3%	3%	4%	5%
Average Cdn Banks	13%	6%	3%	3%	3%	3%

Source: eResearch

### **How Do The Canadian Banks Compare To The U.S. Counterparts?**

The major U.S. banks which are capital markets oriented, including Citigroup, JPMorgan Chase and Wachovia, have similar percentage weightings of market-sensitive revenues to total revenues estimated in the 20% to 27% range with estimated market-sensitive net operating income to total net operating income ratios in the 25% to 35% range.

### **Recommendations**

Our recommendations for the major Canadian banks remain unchanged as follows:

- BNS, RY and TD have the highest potential 12-month returns based on current share prices. BNS has a relatively low market-sensitivity protected in part by unrealized security gains of over \$1 billion. Part of TD's market-sensitivity is contained in TD Ameritrade and therefore more indirect, but management recently announced an increased capital allocation to venture capital deals (such as Bell Canada's leveraged buyout). RY has had an impressive growth in capital markets net income in recent years. All three banks remain our top BUYS.
- NA also remains a BUY but could be the first bank to receive a downgrade due to the heavy dependence on market-sensitive businesses. Most of the banks earnings are restricted to Canada.
- BMO – Recently downgraded to HOLD. Market share losses and customer loyalty are still of concern. Trading losses caused some loss of credibility.
- CM – Recently downgraded to HOLD as it is still losing domestic market share in its lending operations, cost cutting benefits are essentially over and exposure to the U.S. subprime mortgage market is still not clear. Dividend increases and share repurchases have been reinstated.

Table 3: Bank Recommendations &amp; Expected 12-Month Returns

Canadian Banks	Recent Share Price	Target One Year Out	% Return on Share Price	Current Dividend	Yield	Total % One Year Return	Action	Current Market Cap.
BMO Financial	\$ 68.10	\$ 76.00	8.4%	\$ 2.72	3.9%	12.3%	HOLD	\$ 35,113
CIBC	\$ 94.25	\$ 110.00	13.3%	\$ 3.08	3.2%	16.5%	HOLD	\$ 33,741
Cdn Western Bank	\$ 28.15	\$ 30.00	4.5%	\$ 0.32	1.1%	5.6%	HOLD	\$ 870
Laurentian Bank	\$ 37.00	\$ 30.00	-22.4%	\$ 1.16	3.0%	-19.4%	SELL	\$ 908
National Bank	\$ 61.25	\$ 73.00	16.2%	\$ 2.40	3.8%	20.1%	BUY	\$ 10,515
RBC Financial	\$ 55.50	\$ 67.00	15.5%	\$ 1.84	3.2%	18.7%	BUY	\$ 74,588
Scotiabank	\$ 49.75	\$ 60.00	15.9%	\$ 1.80	3.5%	19.4%	BUY	\$ 51,491
TD Bank Financial	\$ 69.75	\$ 82.00	12.2%	\$ 2.12	2.9%	15.1%	BUY	\$ 52,632
<b>Avg. (Ex. LB,CWB)</b>			13.6%		3.4%	17.0%		\$ 259,858

Source: eResearch

Table 4: Bank Comparables

Canadian Banks (2)	Recent Share Price	Earnings Per Share			Recent Book Value	Price to Book	P/E Multiples			Dividends			
		Actual 2006	Est. 2007	Est. 2008			Actual 2006	Est. 2007	Est. 2008	Ind. Divid.	Divid. Yield	Payout 2007E	Payout 2008E
BMO Financial	\$ 68.10	\$ 5.10	\$ 4.90	\$ 5.75	\$ 28.95	2.35 x	13.35 x	13.90 x	11.84 x	\$ 2.72	4.0%	55.5%	47.3%
CIBC	\$ 94.25	\$ 6.95	\$ 8.00	\$ 8.75	\$ 32.67	2.88 x	13.56 x	11.78 x	10.77 x	\$ 3.08	3.3%	38.5%	35.2%
Cdn Western Bank	\$ 28.15	\$ 1.12	\$ 1.33	\$ 1.53	\$ 8.39	3.36 x	25.13 x	21.17 x	18.40 x	\$ 0.32	1.1%	24.1%	20.9%
Laurentian Bank	\$ 37.00	\$ 2.25	\$ 2.70	\$ 2.80	\$ 31.95	1.16 x	16.44 x	13.70 x	13.21 x	\$ 1.16	3.1%	43.0%	41.4%
National Bank	\$ 61.25	\$ 5.05	\$ 5.65	\$ 6.10	\$ 28.92	2.12 x	12.13 x	10.84 x	10.04 x	\$ 2.40	3.9%	42.5%	39.3%
RBC Financial	\$ 55.50	\$ 3.61	\$ 4.40	\$ 4.95	\$ 17.33	3.20 x	15.37 x	12.61 x	11.21 x	\$ 1.84	3.3%	41.8%	37.2%
Scotiabank	\$ 49.75	\$ 3.48	\$ 4.03	\$ 4.35	\$ 18.90	2.63 x	14.30 x	12.34 x	11.44 x	\$ 1.80	3.6%	44.7%	41.4%
TD Bank Financial	\$ 69.75	\$ 4.66	\$ 5.45	\$ 5.95	\$ 29.66	2.35 x	14.97 x	12.80 x	11.72 x	\$ 2.12	3.0%	38.9%	35.6%
<b>Avg. (ex. LB &amp; CWB)</b>						2.59 x	13.95 x	12.38 x	11.17 x		3.5%	43.6%	39.3%

U.S. Comparables (3)	Recent Share Price	Earnings Per Share			Recent Book Value	Price to Book	P/E Multiples			Dividends			
		Actual 2006	Est. 2007	Est. 2008			Actual 2006	Est. 2007	Est. 2008	Ind. Divid.	Divid. Yield	Payout 2007E	Payout 2008E
Citigroup	\$ 48.25	\$ 4.25	\$ 4.47	\$ 5.05	\$ 24.68	1.96 x	11.35 x	10.79 x	9.55 x	\$ 2.16	4.5%	48.3%	42.8%
Bank of America	\$ 48.35	\$ 4.70	\$ 4.88	\$ 5.28	\$ 30.38	1.59 x	10.29 x	9.91 x	9.16 x	\$ 2.24	4.6%	45.9%	42.4%
J.P. Morgan Chase	\$ 46.00	\$ 3.86	\$ 4.54	\$ 4.82	\$ 34.45	1.34 x	11.92 x	10.13 x	9.54 x	\$ 1.36	3.0%	30.0%	28.2%
Wachovia Corp.	\$ 48.75	\$ 4.68	\$ 4.94	\$ 5.40	\$ 36.47	1.34 x	10.42 x	9.87 x	9.03 x	\$ 2.24	4.6%	45.3%	41.5%
Wells Fargo & Co.	\$ 34.50	\$ 2.49	\$ 2.73	\$ 3.01	\$ 14.07	2.45 x	13.86 x	12.64 x	11.46 x	\$ 1.40	4.1%	51.3%	46.5%
US Bancorp	\$ 31.00	\$ 2.61	\$ 2.67	\$ 2.89	\$ 11.77	2.63 x	11.88 x	11.61 x	10.73 x	\$ 1.60	5.2%	59.9%	55.4%
<b>Average U.S. Banks</b>						1.88 x	11.62 x	10.83 x	9.91 x		4.3%	46.8%	42.8%

(1) Stated Book Value as at Mar. 31, 2007 for U.S. Comparables (2) Cash Basis

(3) \$US - Source Consensus Estimates: First Call / Thomson Financial / Thomson Investor Network

Source: eResearch

Robin Cornwell  
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 416-910-7985  
 rcornwell@catalystresearch.ca