Managing Capital

Regulatory capital structure and ratios at year end

(millions of dollars)	2003	2002	2001
Tier 1 capital			
Retained earnings	**$ 8,518**	$ 8,292	$ 9,203
Foreign currency translation adjustments	**(130)**	418	450
Common shares	**3,179**	2,846	2,259
Qualifying preferred shares	**1,535**	1,328	1,492
Contributed surplus	**9**	–	–
Non-controlling interest in subsidiaries	**1,250**	1,119	1,272
Less: goodwill and intangibles in excess of 5% limit	**(3,035)**	(4,213)	(4,041)
Total Tier 1 capital	**11,326**	9,790	10,635
Tier 2 capital			
Subordinated notes and debentures	**5,887**	4,343	4,892
Qualifying preferred shares and non-controlling interest in subsidiaries	**–**	157	–
General allowance for credit losses included in capital	**947**	1,056	1,112
Less: amortization of subordinated notes and debentures	**(241)**	(357)	(545)
Total Tier 2 capital	**6,593**	5,199	5,459
Investment in unconsolidated subsidiaries/substantial investments	**919**	870	697
First loss protection	**145**	159	288
Total regulatory capital	**$16,855**	$13,960	$15,109
Capital ratios			
To risk-weighted assets			
Tier 1 capital	**10.5%**	8.1%	8.4%
Total regulatory capital	**15.6**	11.6	11.9
Assets to capital multiple[1]	**15.2**	18.9	18.3

[1] Total assets plus off-balance sheet credit instruments such as letters of credit and guarantees less investments in associated corporations and goodwill and net intangibles divided by total regulatory capital.

Our goals
We want to provide enough capital to maintain the confidence of investors and depositors, while providing our common shareholders with a satisfactory return.

Our goals are to:
- Be an appropriately capitalized institution, as defined by regulatory authorities and compared with our peers.
- Maintain strong ratings.
- Make sure that we have enough capital and the right type of capital on hand or readily available at a reasonable cost.
- Achieve the lowest overall cost of capital consistent with preserving the appropriate mix of capital elements.
- Provide a satisfactory return to our common shareholders.

Where capital comes from
Most of our capital comes from common shareholders. Other sources of capital come from our preferred shareholders and holders of our subordinated debt.

Who manages our capital
Finance manages capital for the Bank. They're responsible for acquiring, maintaining and retiring capital. The Board of Directors oversees capital management.

Economic capital
The Bank uses in-house models to determine how much capital is required to cover unexpected loss from market, credit and operational risks. We refer to this measure as economic capital and note that it differs from current regulatory capital because it applies to deposit products as well as asset products, and it applies to operational as well as credit and market risk. Regulatory capital is set by regulations established by the Superintendent of Financial Institutions Canada (refer to next section).

Within the Bank's measurement framework, economic capital covers unexpected loss. Expected loss is considered a cost of doing business and is included in product pricing.

Economic capital is sufficient to absorb worst case loss at levels consistent with a AA ratings standard. Unlike rating agency and regulatory capital measures, economic capital refers solely to common equity capital. Since losses flow through the Consolidated Statement of Operations, the Bank ensures it has sufficient common equity to absorb worst case loss.

The Bank makes business decisions based on return on economic capital, while also ensuring that, in aggregate, regulatory and rating agency requirements and capital available are kept in balance.

Regulatory capital
Tier 1 capital
Retained earnings, when adjusted for foreign currency translation, declined by $322 million during the year. Foreign exchange adjustments unfavourably affected retained earnings by $548 million. However, our capital ratios were favourably affected by foreign currency translation adjustments to our assets. We raised $333 million of common stock including $286 million from the dividend reinvestment plan. In addition, we redeemed US$225 million and $150 million of our preferred shares and we issued $550 million of preferred shares during the year.

In fiscal 2003, goodwill and net intangibles (above 5% of gross Tier 1 capital), which are deducted from capital for regulatory purposes, decreased by $1,178 million as the result of the recognition of goodwill impairment of $624 million and the amortization of intangibles of $491 million, net of tax. The decrease was also favourably affected by foreign currency translation adjustments, but partially offset by the $126 million of new intangibles arising from the acquisition of Laurentian Bank branches.

Tier 2 capital

Actions taken to manage our capital during the year included maturing US$75 million and $100 million of debentures and issuing $1.9 billion of replacement subordinated medium term notes. The increases in Tier 2 capital, combined with higher Tier 1 capital and lower assets, have resulted in an improvement to the Bank's reported assets to capital multiple. See Notes 10 to 12 to the Bank's Consolidated Financial Statements for more details.

Dividends

The Bank's dividend policy is approved by the Board of Directors. During the year, the Bank increased its quarterly dividend to 32 cents per share, which is consistent with its target payout range of 35-45%. The Bank's ability to pay dividends is subject to the Bank Act and the regulations of the Superintendent of Financial Institutions Canada. Note 12 of the Bank's Consolidated Financial Statements provides further details.

Ratings

In December 2002, Standard & Poor's (S&P) announced that it had downgraded the senior debt rating of the Bank from AA- to A+. S&P cited concerns about weaker profitability and capital levels combined with deteriorating credit quality. In February 2003, Moody's Investors Service changed its rating outlook on the Bank's Aa3 rated senior debt from negative to stable. The confirmation of our rating by Moody's, combined with a lower risk profile in businesses which are ratings sensitive, have significantly mitigated the impact of the ratings change on earnings during the year.

Capital ratios

About capital ratios

Capital ratios are measures of financial strength and flexibility.

The Office of the Superintendent of Financial Institutions Canada (OSFI) defines two primary ratios to measure capital adequacy, the Tier 1 capital ratio and the total capital ratio. OSFI sets target levels for Canadian banks:

- The Tier 1 capital ratio is defined as Tier 1 capital divided by risk-weighted assets. OSFI has established a target Tier 1 capital requirement of 7%.
- The total capital ratio is defined as total regulatory capital divided by risk-weighted assets. OSFI has established a target total capital requirement of 10%.

Our Tier 1 and total capital ratios were 10.5% and 15.6%, respectively, on October 31, 2003 compared with 8.1% and 11.6% on October 31, 2002. The principal factors for the year-over-year increases were the stronger earnings in 2003 combined with successful management of growth in our risk-weighted assets primarily from reduction in our non-core loan portfolio. As a result we have exceeded our medium term target for Tier 1 of 9–9.5%.

OSFI measures the capital adequacy of Canadian banks according to its instructions for determining risk-adjusted capital, risk-weighted assets and off-balance sheet exposures. This approach is based on the Bank for International Settlements' (BIS) agreed framework for achieving a more consistent way to measure the capital adequacy and standards of banks engaged in international business.

Risk-weighted assets

Risk-weighted assets are determined by applying OSFI prescribed risk-weights to balance sheet assets and off-balance sheet financial instruments according to credit risk of the counterparty. Risk-weighted assets also include an amount for the market risk exposure associated with our trading portfolio.

Our total risk-weighted assets decreased by $12 billion or 10% in 2003. Total risk-weighted assets decreased as a result of our ongoing management of risk-weighted assets across all of our businesses, together with translation of our foreign currency assets based on the stronger Canadian currency.

We review balance sheet and off-balance sheet exposures when assessing risk.

See Managing risk **page 33** and Off-balance sheet arrangements **page 15**

Proposed accounting changes

Proposed Variable Interest Entity (VIE) accounting rules may require the Bank to consolidate additional assets onto its balance sheet. The rule change is currently scheduled for implementation in fiscal 2005. See Note 26 of the Bank's Consolidated Financial Statements for more details.

Accounting changes to the Canadian Institute of Chartered Accountants' Handbook Section 3860, *Financial Instruments – Disclosure and Presentation*, if implemented as currently drafted, may have the effect of classifying both the Bank's preferred shares and innovative Tier 1 capital as liabilities. Such an accounting recategorization could result in the disallowance of the Bank's preferred shares and innovative instruments for regulatory capital purposes. In the absence of grandfathering of the existing capital instruments by the Superintendent of Financial Institutions Canada, the Bank's capital ratios could be significantly affected.

Revised capital accord

The Basel Committee on Banking Supervision has published for consultation the New Basel Capital Accord to replace the accord originally introduced in 1988 and supplemented in 1996. The underlying principles of the new Accord are intended to be suitable for application to banks of varying levels of complexity and sophistication. The proposed Accord will allow qualifying banks to determine capital levels consistent with the manner in which they measure, manage and mitigate risk. The new framework provides a spectrum of methodologies, from simple to advanced, for the measurement of both credit and operational risk. More advanced measurement of risks should result in regulatory and economic capital being more closely aligned.

By providing a flexible approach to measurement methodology, each bank will be able, subject to review by regulators, to adopt approaches which best fit its level of sophistication and risk profile. The objective of the framework is to provide rewards for more rigorous and accurate risk management by reducing regulatory capital required under weaker or less sophisticated approaches. While the overall objective of the new Accord is to neither increase nor decrease the level of overall capital in the system, some financial institutions will see an increase in regulatory capital, while others will see a decrease. The impact will depend upon the approach used by a particular institution and its own risk profile.

The Bank has prepared project plans to collect, analyze and report the necessary data and is on track to meet the requirements of the new Accord. For Canadian banks, the expected proforma implementation will be for fiscal 2006, with formal implementation the following year.

Risk-weighted assets at year end

(millions of dollars)	**2003**		2002		2001	
	Balance	**Risk-weighted balance**	Balance	Risk-weighted balance	Balance	Risk-weighted balance
Balance sheet assets						
Cash resources	**$ 7,719**	**$ 1,344**	$ 6,538	$ 1,108	$ 5,945	$ 991
Securities purchased under resale agreements	**17,475**	**235**	13,060	282	20,205	324
Securities	**79,665**	**3,686**	82,197	6,247	97,194	6,946
Loans (net)	**118,058**	**59,273**	122,627	63,965	119,673	66,514
Customers' liability under acceptances	**6,645**	**6,400**	7,719	7,066	9,122	8,246
Other assets	**43,970**	**5,885**	45,899	6,288	35,699	6,342
Total balance sheet assets	**$273,532**	**$ 76,823**	$278,040	$ 84,956	$287,838	$ 89,363
Off-balance sheet assets						
Credit instruments		**10,937**		14,559		18,350
Derivative financial instruments		**5,987**		6,259		6,373
Total off-balance sheet assets		**16,924**		20,818		24,723
Total risk-weighted asset equivalent – credit risk		**93,747**		105,774		114,086
– market risk		**14,470**		14,859		13,032
Total risk-weighted assets		**$108,217**		$120,633		$127,118