

## Managing risk

At TD Bank Financial Group, our goal is to earn satisfactory returns from our various business activities within an acceptable level of risk. To do this, we need to understand the risks involved in our businesses and ensure that the risks we assume are within prudent limits.

Through our retail and wholesale businesses, we are exposed to four kinds of risk:

- credit risk
- market risk
- liquidity risk
- operational risk.

Managing risk means assessing the potential impact of each risk, and establishing policies and procedures to minimize them.

Our guiding principle is to involve qualified risk management professionals, who are independent of the business units, in setting our policy framework and in defining risk limits. Accountability and ownership of risk lies with the business units, whose structure for managing risk is defined based on business needs to meet governance standards. This is a disciplined process with appropriate reporting and escalation. Group Risk Management works with the business units to facilitate standards, reporting and common methodology.

The risk management review and oversight process that is now in place is illustrated as follows:

### Risk Committee of the Board of Directors

- Considers risk and trends in risk for TD
- Approves risk management policies
- Oversees the management of credit, market, liquidity and operational risk

### Executive Management Committees

#### Risk Oversight Committee

- Chaired by Vice Chair, Risk Management
- Responsible for the management and oversight of all risk management and legislative compliance activities of TD, exclusive of credit and market risk

#### Business Performance Review Committee

- Chaired by CEO
- Reviews overall strategies and operating performance

#### Credit and Market Risk Committee

- Chaired by CEO
- Reviews large individual credits, industry concentrations and major policy issues involving credit or market risk

This review and oversight process reflects changes made since October 31, 2002 to enhance the governance and oversight of risk at TD. In fiscal 2002, the Risk Committee of the Board of Directors was part of the Audit and Risk Management Committee of the Board of Directors which has been split into two separate committees. See Committees of the Board on page 89 of this annual report for more details. As a separate committee, the Risk Committee of the Board of Directors has a mandate to focus on the management of risk and risk trends, and oversee significant market, liquidity, credit and operational risks.

TD has a comprehensive ongoing risk management framework that incorporates the experience and specialized knowledge of our business units, Group Risk Management, Audit, Legal, Compliance, Finance, Human Resources and other corporate functions. Key strategic elements of our framework are governance and senior management oversight. This includes:

- an annual review of major risk policies by the Risk Committee of the Board of Directors.
- a regular review of operational risk, management policies and strategies, and key initiatives by an executive Risk Oversight Committee comprised of a team of our senior executives.
- comprehensive reviews by Internal Audit to provide senior management with assurance as to the quality of the internal control environment and compliance with established risk management policies and procedures.

The following pages describe the main risks we face and our strategies for managing them.

### Credit risk

Credit risk is the potential for financial loss if a borrower or counterparty in a transaction fails to meet its obligations.

We are exposed to credit risk through our traditional lending activities and transactions involving settlements between us and our counterparties, including other financial institutions. These include direct loans, commitments to extend credit, settlement exposures, derivative transactions and securities inventories.

### Who manages credit risk

We are increasing the resources applied to risk management and effectively creating an additional level of risk management. We have split the mandate for risk management between Group Risk Management and the business units and applied more resources to both groups. We have also made changes regarding who has the responsibility for a credit.

Group Risk Management's primary responsibility will now be focused on policy as well as authority and exposure limits. In addition, we are establishing a function responsible for researching and identifying industry and portfolio trends.

Each business unit will have a credit group that is primarily responsible for adjudication, and that will operate under strict authorization and exposure limits. Our strategy makes it clear that going forward we are lending on a business relationship basis and therefore each business unit has responsibility for loans.

Group Risk Management sets the policies and procedures for managing credit risk on a global basis and provides a second line of defense for TD. Its responsibilities include:

- setting guidelines that limit portfolio concentrations of credit exposure by country, industry and affiliated group.
- approving discretionary limits of officers throughout TD for extending lines of credit.
- setting standards for measuring credit exposure.
- approving the scoring techniques used in extending personal credit.
- approving all policies relating to all products and services that have credit risk.
- setting the criteria for rating risk on business accounts, based on a 21-category rating system.

The Risk Committee of the Board of Directors reviews and approves all major credit policies and procedures every year.

We have made changes to our provisioning, lending standards, procedures and practices, and have strengthened our organization so that we can manage all of our businesses in an extremely disciplined and conservative manner, with a strict focus on economic returns for all client relationships.

To strengthen the governance around corporate credit, we have established a Credit and Market Risk Committee to review and approve large individual credits, review industry concentrations and resolve any major policy issues involving market or credit risk.

### How we manage credit risk

#### *By country*

Country risk is the risk that economic or political change in a country could affect cross-border payments for goods and services, loans, trade-related finance and dividends, as well as the repatriation of TD's capital from the foreign country. We currently have exposure in 70 countries, with the largest portion in North America. We establish country exposure guidelines based on an internal risk rating system. Country limits cover all aspects of credit exposure across our various businesses.

#### *Business and government loans*

We also establish industry and group limits for credit exposure to businesses and governments. We use a systematic approach to set and communicate risk guidelines for each business industry in our loan portfolio. These guidelines are based on a risk assessment of the industry. We have identified 26 major business industry groups and divided them into 112 segments. We assign a risk rating to each industry segment on a scale of one to six.

Our analysis focuses on key risks inherent in a given industry, such as its cycles, exposure to technological change, political influence, regulatory change or barriers to entry. If we believe that several industry segments are affected by common risk factors, we assign a single exposure guideline to them. Group Risk Management conducts ongoing reviews of industry risk ratings and segmentation.

We assign each business or government borrower a risk rating using our 21-category rating system. We set limits on credit exposure to related business or government accounts based on these ratings. In addition, we use a Risk Adjusted Return on Capital model to assess the return on credit relationships in relation to the structure and maturity of the loans and internal ratings of the borrowers. We review the rating and return on capital for each borrower every year.

For accounts where exposures include derivatives that are traded over the counter, we use master netting agreements or collateral wherever possible to reduce our exposure.

TD Securities has been split into two distinct business groups. The division of our corporate lending book into "core" and "non-core" portfolios will result in a significantly smaller ongoing corporate loan book with less capital deployed, which can deliver earnings growth from an adjusted base with lower

volatility and improved rates of return. The non-core portfolio will consist of relationships we will exit over the next three years. The core portfolio represents the businesses we want to be in, both in corporate lending and investment banking, in Canada and abroad. This is our ongoing business and we will lend on a more limited and selective basis, focusing on those clients where we have a broader relationship.

In line with this strategy we have significantly reduced our group exposure guidelines.

#### *Financial institutions*

Our financial institutions portfolio is divided into 15 major groups. Individual companies in each group have similar attributes and common risk factors. We have developed specific exposure guidelines for 24 segments within these groups. Group Risk Management conducts ongoing reviews of the segment and exposure guidelines for each group.

We assign each group a risk rating using our 21-category rating system. These ratings are based on the strength of each firm's parent institution. We assign each group a credit rating based on each firm's net worth, the quality of its assets, the consistency and level of its profits, as well as the ratings of the major credit rating agencies. We may use additional criteria for certain types of financial institutions.

#### *Personal credit*

Credit requests are evaluated using automated credit scoring systems or are directed to regional credit centres operating within clear authority limits. Once retail credits are funded, they are continually monitored within quantitative account management programs to identify changes in risk and to provide opportunities that increase risk-adjusted performance. The centralized approach to reviewing retail credits has resulted in well-balanced portfolios with predictable performance characteristics. We plan to increase our investment in automated decision technology and credit scoring techniques that improve our ability to control retail credit losses within predictable ranges.

#### *Classified risk*

Classified risk refers to loans and other credit exposures that pose a higher credit risk than normal, based on our standards.

A loan is classified as impaired when, in management's opinion, we can no longer be reasonably assured that we will be able to collect the full amount of the principal and interest when it is due.

We establish specific allowances for impaired loans when a loss is likely or when the estimated value of the loan is less than its recorded value, based on discounting expected future cash flows.

Allowances for our personal credit portfolios are based on delinquency and type of security.

See Supplementary information [page 40, table 12](#)

See Notes to consolidated financial statements [page 48, note 1, \(g\) and \(h\)](#)

See Notes to consolidated financial statements [page 52, note 3](#)

*Specific allowances*

Specific allowances for credit losses are established to reduce the book values of loans to estimated realizable amounts in the ordinary course of business. Specific allowances are reviewed quarterly for each classified borrower or on an aggregated facility basis. Specific allowances for the corporate and commercial portfolios are established by the borrower. For the retail portfolio, provisions are calculated using a formula, which takes into account recent loss experience.

*General allowances*

General allowances for credit risk are established to recognize losses that management estimates to have occurred in the portfolio as at the balance sheet date relating to loans or credits not yet specifically identified as impaired. The level of general allowances reflects exposures across all portfolios and categories that give rise to credit risk and fluctuates in accordance with the nature and composition of our portfolio, shifts in the economic and credit cycles, our historic and expected loss experience, and other relevant factors. Changes in the level of general allowances may also result from a change in the level of specific allowances; however, this may not necessarily be on a dollar for dollar basis.

General allowances are computed on a periodic basis using credit risk models developed by TD. The level of allowances is based on the probability of a borrower defaulting on a loan obligation, the loss in the event of default and the expected exposure at the time of default. For the corporate and commercial portfolios, allowances are computed at the borrower level. The probability of default is assigned based on the risk ratings of the borrower. The loss given default is based upon the security of the facility. Exposure at default is a function of current usage, borrower risk rating and the committed amount. For the retail portfolio, the general allowance is computed on a portfolio-level and is based on a statistical estimate of loss using historical loss and recovery data models and forecast balances. Model parameters are validated against historic experience and are updated at least on an annual basis. The general allowance methodology is reviewed by the Board of Directors annually.

Our general allowance for loan losses was \$1,141 million at October 31, 2002, unchanged from the prior year. We also had a general credit reserve for certain derivative financial instruments of \$65 million such that general allowances totalled \$1,206 million at October 31, 2002. This represented 1% of risk-weighted assets of which \$1,056 million qualifies as Tier 2 capital, equal to .875% of risk-weighted assets under guidelines issued by the Office of the Superintendent of Financial Institutions Canada.

*Sectoral allowances*

We have established sectoral allowances for credit losses for industry sectors and geographic regions that have experienced specific adverse events or changes in economic conditions. In these cases it was necessary to establish an additional allowance for loan loss for groups of loans as a whole, even though the individual loans comprising each group are still performing.

Sectoral allowances are computed quarterly, on a portfolio basis, taking into account the expected loss of the portfolio of borrowers in the sector under review. The analysis includes a review of probabilities of default, loss given default and exposure at default. The results of the analysis are compared to the level of general allowances allocated to the portfolio using the general

allowance methodology with any excess requirement included in the sectoral allowances. The sectoral methodology and model inputs are reviewed on a quarterly basis.

When accounts, which were identified as part of a group of loans upon which a sectoral allowance has been established, become impaired, any sectoral allowances on these loans are transferred to specific allowances.

Our sectoral allowance for credit losses at October 31, 2002 was \$1,285 million, the majority of which can be attributed to loans in the communications and utilities sectors. These sectors have deteriorated as evidenced by a significant increase in the number of credit defaults as well as downgrades in publicly available debt ratings for companies in the sectors.

See Notes to consolidated financial statements [page 52, note 3](#)

*Provision for credit losses*

The provision for credit losses is the amount added to the allowance for credit losses to bring it to a level that management considers adequate to absorb all probable credit-related losses in the loan portfolio. The net provision for the year is reduced by any recoveries from loans previously written-off.

The deterioration in the North American economic environment in 2002 resulted in an increase in our provision for credit losses, from \$620 million in 2001, excluding the \$300 million special addition to the general allowance, to \$2,925 million in 2002. This level of provision for credit losses represents 2.24% of net average loans and customer's liability under acceptances compared with .48% in the prior year. The increase includes \$1,470 million in gross sectoral provisions for credit losses and was based on an assessment of business and economic conditions, historical and expected loss experience, loan portfolio composition and other relevant indicators.

See Notes to consolidated financial statements [page 52, note 3](#)

See Supplementary information [page 41, table 14](#)

*Net impaired loans*

TD monitors the level of net impaired loans in its portfolio, which it defines as the gross amount of impaired loans less the total of all specific, general and sectoral allowances for credit losses. This measure of net portfolio impairment is reported by the major Canadian banks, and thus provides a basis for comparison across the industry. For the year ended October 31, 2002, the total of all the above allowances exceeded gross impaired loans, resulting in excess allowances of \$975 million, compared to an excess of \$53 million a year ago.

See Supplementary information [page 40, table 12](#)

**Market risk**

Market risk is the potential for loss from changes in the value of financial instruments. The value of a financial instrument can be affected by changes in:

- interest rates
- foreign exchange rates
- equity and commodity prices
- credit spreads.

We are exposed to market risk when we enter into financial transactions through our four main trading activities:

- **Market-making.** We make markets for a large number of securities and other traded products. We keep an inventory of these securities to buy and sell with investors. We profit from the spread between bid and ask prices. Profitability is driven by trading volume.

- **Sales.** We provide a wide variety of financial products to meet the needs of our clients. We earn money on these products from price mark-ups or commissions. Profitability is driven by sales volume.
- **Arbitrage.** We take positions in certain markets or products and offset the risk in other markets or products. Our knowledge of various markets and products and how they relate to each other allows us to identify and benefit from pricing anomalies.
- **Positioning.** We aim to make profits by taking positions in certain financial markets in anticipation of changes in those markets. This is the riskiest of our trading activities and we use it selectively.

#### Who manages market risk

TD Securities has primary accountability for managing market risk while the Market Risk Group within Group Risk Management oversees market risk management. The Market Risk Group is not accountable for trading revenues. Its responsibilities include:

- designing and implementing methods for measuring and reporting market risk.
- approving new or additional trading limits.
- maintaining the Market Risk Policy Manual, which contains all policies relating to market risk in the trading businesses.
- monitoring exposure and approving any excesses compared with the approved limits.
- approving all new trading products from a market risk perspective.
- independent testing of all pricing models and trading systems.
- approving all market rates and prices used in valuing TD's trading positions and estimating market risk.
- stress testing the portfolio to determine the effect of large, unusual market movements.
- implementing and maintaining the models used to calculate regulatory capital required for market risk.

The Market Risk Group has established a Market Risk Committee that meets every two weeks for a peer review of the market risk profile of our trading businesses and to approve changes to risk policies. The committee is chaired by the Senior Vice President, Market Risk and includes members of senior management of TD Securities and Internal Audit. Significant market risk issues may be escalated to the Credit and Market Risk Committee, which is chaired by TD's CEO and includes senior management of TD Securities and the Vice Chair, Group Risk Management. The Risk Committee of the Board of Directors reviews market risk quarterly and approves all major market risk policies annually.

#### How we manage market risk

Managing market risk is a key part of our business planning process. We begin new trading operations and expand existing ones only if:

- the risk has been thoroughly assessed and is judged to be within our risk capacity and business expertise.
- we have the infrastructure in place to monitor, control and manage the risk.

We manage market risk primarily by enforcing trading limits and by "stress testing" our trading activities.

#### Trading limits

Value at Risk (VaR) measures the adverse impact that potential changes in market rates and prices could have on the value of a portfolio over a specified period of time.

We set trading limits that are consistent with the approved business plan for each business and our tolerance for the market risk of that business. When setting these limits, we consider market volatility, market liquidity, trader experience and business strategy.

Our primary measure for setting trading limits is VaR. We use VaR to monitor and control overall risk levels and to calculate the regulatory capital required.

We may also apply specialized limits, such as notional limits, credit spread limits, yield curve shift limits, loss exposure limits, stop loss limits and other limits, if it is appropriate to do so. These additional limits reduce the likelihood that trading losses will exceed VaR limits.

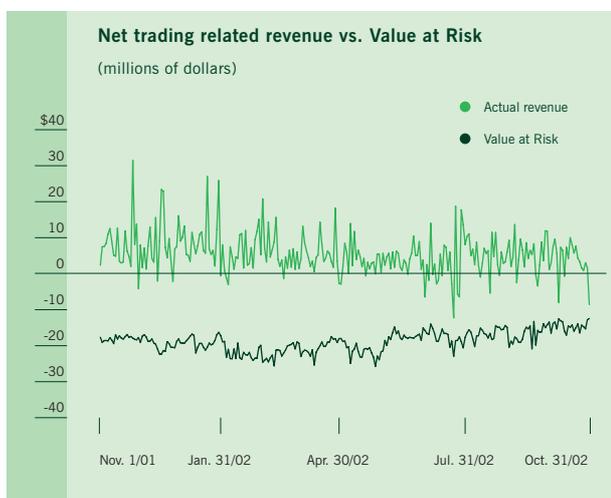
At the end of every day, Group Risk Management reviews daily trading exposure reports and compares the risks with their limits. If a trading limit has been exceeded, the trading desk must immediately bring the position within the limit, unless Group Risk Management or a designated business head approves an exception. An escalation process has been established for approving exceptions to established limits.

If, during the day, it appears that a trading limit will be exceeded, the trader must receive approval before carrying the position overnight.

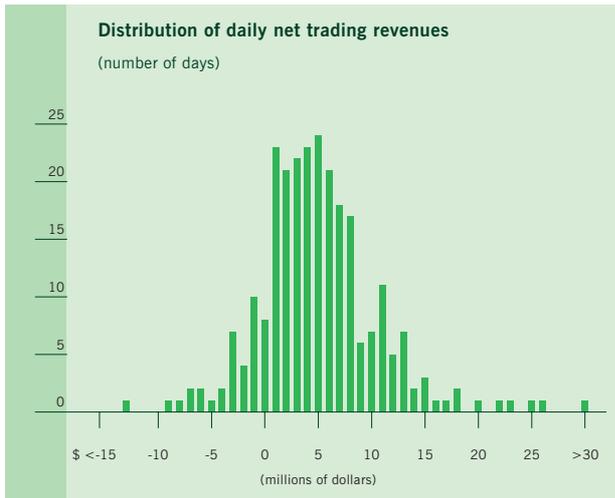
#### Calculating VaR

First we estimate VaR by creating a distribution of potential changes in the market value of the current portfolio. We value the current portfolio using the most recent 259 trading days of market price and rate changes. Then we calculate the VaR as the threshold level which potential portfolio losses are not expected to exceed more than one out of every 100 trading days.

The graph below compares net revenues in our trading businesses to daily VaR usage. Our VaR on October 31, 2002 was \$14.6 million, down \$7.9 million from October 31, 2001. The average VaR for fiscal year 2002 was \$17.7 million. Declines in the VaR during fiscal 2002 are due mainly to a better balance of risks in our credit derivative businesses, and to improvements to our VaR methodology and process. From May 1, 2002, net trading revenue excludes the impact of any individual transaction with deal origination revenue in excess of \$10 million.



The graph below shows the frequency distribution of our net trading revenue for fiscal 2002. Daily net trading revenues in 2002 were positive on 88% of the trading days in the year. Losses never exceeded our statistically predicted VaR for the total of our trading related businesses. Our worst daily loss was less than \$12 million. The distribution of trading revenues reflects the broad diversification of trading activities in TD Securities and shows that the probability of major losses exceeding our reported VaR is low.



**Stress testing**

We use stress testing to quantify the largest quarterly loss we are prepared to take in our trading activities and then limit market risk accordingly.

Our trading business is subject to an overall global stress test limit and each global business has a stress test limit. Stress tests are produced and reviewed each week with the head of Group Risk Management. They are reviewed with the Market Risk Committee every two weeks and four times a year with the Risk Committee of the Board of Directors. Stress scenarios are designed to model extreme economic events, replicate worst case historical experiences or introduce large but plausible moves in key market risk factors.

The following graph is a history of our weekly stress test results which shows the instantaneous impact of large market disturbances. We continued to reduce our credit spread risk in 2002 by buying credit protection in the form of synthetic collateralized debt obligations (CDOs) and credit default swaps. This improved management of credit risk has had a major positive impact on our risk profile.



**Asset liability management**

Asset liability management deals with managing the market risks of our traditional banking activities. Market risks primarily include interest rate risk and foreign exchange risk.

We are exposed to market risk when we enter into non-trading banking transactions with our customers. These transactions primarily include deposit taking and lending, which are also referred to as our “asset and liability” positions.

**Who is responsible for asset liability management**

The Treasury and Balance Sheet Management department within Group Finance measures and manages the market risks of our non-trading banking activities. The Risk Oversight Committee, which is chaired by the Vice Chair, Risk Management and includes senior executives, oversees and directs Treasury and Balance Sheet Management. The Risk Committee of the Board of Directors reviews and approves all market risk policies and procedures annually.

**How we manage our asset and liability positions**

We measure all product risks when products are issued, using a fully hedged option-adjusted transfer pricing framework. This framework allows Treasury and Balance Sheet Management to measure and manage risk within a target risk profile. It also ensures that TD’s business units engage in risk-taking activities only if they are productive.

**Managing interest rate risk**

Interest rate risk is the impact changes in interest rates could have on our margins, earnings and economic value. Rising interest rates could, for example, increase our funding costs, which would reduce the net interest income earned on certain loans.

The objective of interest rate risk management is to ensure stable and predictable earnings are realized over time. In this context, TD has adopted a "fully-hedged" approach to profitability management for its asset and liability positions. Key aspects of this approach are:

- negating the impact of interest rate risk on net interest income and economic value.
- measuring the contribution of each product on a risk-adjusted, fully-hedged basis, including the impact of financial options granted to customers.

We are exposed to interest rate risk when asset and liability principal and interest cash flows have different interest payment or maturity dates. These are called "mismatched positions". An interest-sensitive asset or liability is repriced when interest rates change or when there is cash flow from final maturity, normal amortization or when customers exercise prepayment, conversion or redemption options.

Our exposure depends on the size and direction of interest rate changes, and on the size and maturity of the mismatched positions. It is also affected by new business volumes, renewals of loans and deposits, and how actively customers exercise options like prepaying or redeeming a loan or deposit before its maturity date.

Interest rate risk is measured using interest rate shock scenarios to estimate the impact of changes in interest rates on both TD's annual Earnings at Risk (EaR) and Economic Value at Risk (EVaR). EaR is defined as the change in TD's annual net interest income for a 100 basis point unfavourable interest rate shock due to mismatched cash flows. EVaR is defined as the combined difference in the present value of TD's asset portfolio and the change in the present value of the TD's liability portfolio, including off-balance sheet instruments, for a 100 basis point unfavorable interest rate shock.

We perform valuations of all asset and liability positions as well as all off-balance sheet exposures every week, and value certain option positions daily. Our objective is to preserve or immunize the present value of the margin booked at the time of inception for fixed rate assets and liabilities and to reduce the volatility of earned net interest income over time. Our approach is to value the assets and liabilities by discounting future cash flows at a yield curve indicative of the blended cost or credit of funds for each asset or liability portfolio. The resulting net present value embeds the present value of margins booked. We then hedge the resulting financial position to a target risk profile. We use derivative financial instruments, wholesale instruments and other capital market alternatives and, less frequently, product pricing strategies to manage interest rate risk.

Within the financial position, we measure and manage interest rate risk exposure from instruments with closed (non-optioned) fixed rate cash flows separately from product options. Instruments in the closed book exhibit the traditional, almost linear or symmetrical payoff profile to parallel changes in interest rates (i.e. asset values increase as rates fall and decrease as rates rise). The portfolio management objective within the closed book is to eliminate cash flow mismatches thereby preserving the present value of product margins.

The graph below shows our interest rate risk exposure on October 31, 2002 on the closed (non-optioned) instruments within the financial position. If this portfolio had experienced an immediate and sustained 100 basis point decrease in rates on October 31, 2002, the economic value of shareholders' equity would have decreased by \$6 million after-tax (2001 – \$9 million). This same shock would reduce net income after tax by \$2 million over the next 12 months (2001 – \$6 million). Our EVaR in the closed book ranged from nil to \$17 million during the year ended October 31, 2002.



Product options, which expose TD to a non-linear or asymmetrical payoff profile, represent a significant financial risk, whether they are free-standing, such as mortgage rate commitments or embedded in loans and deposits. Product option exposures are managed by purchasing options or through a dynamic hedging process designed to replicate the payoff of a purchased option. Dynamic hedging involves rebalancing the hedging instruments we hold for small changes in interest rates.

The following graph shows our interest rate risk exposure on October 31, 2002 on all instruments within the financial position: the closed (non-optioned) instruments plus product options. The following graph assumes that the dynamic hedging portfolios held on October 31 are not rebalanced for the interest rate shock. An immediate and sustained 100 basis point decrease in rates would have decreased the economic value of shareholders' equity by \$46 million after-tax (2001 – \$40 million) or .4% of common equity. Our EVaR for the total portfolio ranged from \$28 million to \$73 million during the year ended October 31, 2002. TD's policy sets overall limits on asset liability mismatched positions that EVaR does not exceed 3% of TD's common equity (\$347 million) and EaR does not exceed 3% of TD's annualized net interest income (\$159 million).

<sup>1</sup> The interest rate risk exposure of non-maturity deposits and loans is measured based on assumed maturity profiles.



### Managing foreign exchange risk

Foreign exchange risk refers to losses that could result from changes in foreign currency exchange rates. Assets and liabilities that are denominated in foreign currencies have foreign exchange risk.

We are exposed to foreign exchange risk:

- when our foreign currency assets are greater or less than our liabilities in that currency. This creates a foreign currency open position.
- from our investments in foreign operations.

Our objective is to minimize the impact of an adverse foreign exchange rate change on reported net income and equity, and to minimize the impact of an adverse foreign exchange rate change on TD's capital ratios. Minimizing the impact of an adverse foreign exchange rate change on reported equity will cause some variability in the capital ratios due to the amount of risk-weighted assets that are denominated in a foreign currency. In the event that the Canadian dollar weakens, the Canadian dollar equivalent of TD's risk-weighted assets in a foreign currency increases thereby increasing TD's capital requirement. As a result, the foreign exchange risk arising from TD's net investment in foreign operations are hedged up to the point where the capital ratios change by no more than a tolerable amount for a given change in foreign exchange rates. The tolerable amount increases as TD's capital ratio increases.

TD's policy related to open currency exposure is to limit exposure to no more than \$200 million in aggregate. Our policy related to foreign exchange capital exposure is to minimize an adverse foreign exchange rate change on reported equity subject to the constraint that TD's capital ratios can change by no more than 10 basis points for a 5% change in foreign exchange rates. If target capital ratios are exceeded, TD's policy is to allow for a 25 basis point change in capital ratios for a 5% change in foreign exchange rates.

### Liquidity risk

Liquidity risk is the risk that we cannot meet a demand for cash or fund our obligations as they come due. Demand for cash can arise from withdrawals of deposits, debt maturities and commitments to provide credit. Liquidity risk also includes the risk of not being able to liquidate assets in a timely manner at a reasonable price.

During 2002, we implemented a revised global liquidity risk management framework to create a more integrated and effective liquidity management process that provides for enhanced reporting, a revised liquidity coverage structure, a more dynamic process and delegates management of liquidity risk by major business segment.

It is TD's policy to ensure that there is adequate liquidity coverage across all business units to sustain our ongoing operations in the event of a funding disruption with limited reliance on the forced sale of assets. We also ensure that there is sufficient liquidity available to fund asset growth and strategic opportunities.

### Who manages liquidity risk

The Risk Oversight Committee oversees the liquidity risk management program and ensures that there is an effective management structure in place to properly measure and manage liquidity risk. The Global Liquidity Forum, comprised of senior management from Group Finance, Group Risk Management and TD Securities, is responsible for identifying and monitoring our liquidity risks and recommending action as necessary to maintain our liquidity position within limits in both normal and stress conditions.

While TD operates under one global liquidity risk policy, measurement and management of our liquidity risks are separated into the major operating areas best positioned to manage the risks. The Treasury and Balance Sheet Management department within Group Finance is responsible for consolidating and reporting TD's global liquidity risk position and for managing the TD Canada Trust liquidity position. TD Securities is responsible for managing the liquidity risks inherent in the wholesale and corporate banking portfolios and TD Waterhouse is responsible for managing its liquidity position. Each area must adhere to the Global Liquidity Risk Management policy that is reviewed and approved by the Risk Committee of the Board of Directors on an annual basis.

### How we manage liquidity risk

TD's overall liquidity requirement is measured as the amount of liquidity required to fund expected cash outflows as well as a prudent liquidity reserve to fund potential cash outflows if there was a disruption in the capital markets or other event that could affect our access to liquidity. TD does not rely on short-term wholesale funding for purposes other than funding marketable securities or short-term assets. Liquidity requirements are measured under different stress scenarios with a base case scenario defining the minimum amount of liquidity that must be held at all times. This scenario provides coverage for 100% of our unsecured wholesale debt coming due as well as other potential deposit run-off and contingent liabilities for a minimum period of thirty days. Other scenarios may require greater coverage. We also use cash collateral reporting to monitor our ability to fund our operations on a fully collateralized basis, in the event that we are unable to replace our short-term unsecured debt beyond this timeframe for a period up to one year.

<sup>1</sup> The interest rate risk exposure of non-maturity deposits and loans is measured based on assumed maturity profiles.

Liquidity requirements are met by holding sufficient assets that can be readily converted into cash and managing our cash flows. Assets that qualify for liquidity purposes must be currently marketable, of sufficient credit quality and be accessible for sale. Liquid assets are represented in a cumulative liquidity gap framework based on settlement timing and current market depth. Assets that are encumbered or needed for collateral purposes are not included for liquidity purposes.

We manage liquidity on a global basis, ensuring the prudent management of liquidity risk in all of our operations. On October 31, 2002, our consolidated surplus liquid asset position at thirty days was \$5.5 billion in Canadian dollars, compared with a position of \$5 billion Canadian on October 31, 2001. The surplus liquid asset position is total liquid assets less TD's unsecured wholesale funding requirements, potential non-wholesale deposit run-off and contingent liabilities coming due in thirty days.

If there was a liquidity crisis, we have contingency plans to make sure we meet all of our obligations as they come due.

#### *Funding*

TD has a large base of stable retail and commercial deposits with personal deposits making up over 53% of the total. In addition, TD has an active wholesale funding program which incorporates the asset securitization infrastructure necessary to ensure we have access to widely diversified funding sources. TD's wholesale funding is also diversified geographically and by distribution networks. There are also depositor concentration limits in place to ensure that we do not overly rely on one or a small group of customers as a source of funding.

In fiscal 2002, TD securitized and sold \$3.5 billion of mortgages and issued \$1.5 billion of other medium and long term funding. All funding amounts are represented in Canadian dollars.

#### **Operational risk**

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external sources.

Operational risk is inherent in all business activities. Operational risk encompasses a broad range of risks, which includes transaction processing errors, fiduciary breaches, technology failures, business disruption, fraud and damage to physical assets originating from internal or outsourced business activities. Its impact can result in financial and reputational loss, regulatory penalties and censure.

While operational risk cannot be fully eliminated, proactive management of operational risk exposures to acceptable levels is a key objective of TD. Managing operational risk is essential to protecting, enhancing and creating shareholder value, operating efficiency and providing a safe working environment for staff and customers.

#### **Who manages operational risk**

Group Risk Management is responsible for establishing and coordinating the implementation of a global operational risk management framework, which consists of the policies and processes for the identification, assessment, mitigation and control of operational risk. Through the framework, corporate policies and standards are defined and reporting requirements are established. In addition, Group Risk Management coordinates strategic operational risk management activities throughout the organization.

Group Risk Management chairs the Operational Risk Management Committee and provides reporting to senior management, the Risk Oversight Committee and the Risk Committee of the Board of Directors on the level of operational risk within TD and the effectiveness of enterprise risk management practices.

Primary responsibility for the day-to-day management of operational risk lies with business unit management, with the support of specialist groups such as Information Technology, Finance and Human Resources. Business unit management is responsible for ensuring that the business complies with the operational risk management framework through the establishment and maintenance of appropriate policies, procedures, internal controls and business continuity plans. Each business unit operates a Risk Management Committee, comprised of the senior executives in the unit.

Internal Audit provides assurance to business unit management, senior management, and the Audit Committee of the Board of Directors on the extent to which business units adhere to the operational risk management framework, the quality and effectiveness of the system of internal controls and identifies any significant control weaknesses in the Bank.

#### **How we manage operational risk**

Group Risk Management works closely with the risk management functions in the business units to facilitate the implementation of the operational risk management framework and the implementation of leading industry practices. Group Risk Management is responsible for:

- continually identifying, measuring and reporting on the operational risk exposures of our businesses
- allocating economic capital based on assessments of operational risk
- overseeing the execution of key enterprise-wide risk management practices including an extensive system of internal controls, trained and competent people, segregating incompatible functions and clearly defined operating practices
- assessing, on a continuous basis, TD's insurable risk exposures, developing and implementing appropriate risk management solutions. These include managing a broad portfolio of insurance coverage combined with other risk transfer vehicles that protect TD from the adverse impact of internal and external events in the course of doing business
- managing a comprehensive Business Recovery Planning program, which includes standard policies and management oversight to minimize risk, duration and cost arising from unexpected disruptions affecting our operations.

Each of TD's business units has defined an independent risk management function that:

- oversees the implementation of enterprise-wide risk management practices within their business unit
- identifies, measures and reports on the operational risk exposures of their business
- works with business unit management to identify, develop and implement risk management practices specific to their business, including comprehensive business recovery plans.

Our focus in 2003 will be on the implementation of an enterprise-wide operational risk self-assessment process and tools, and the development of additional risk quantification methodologies.