

Testimony of W Edmund Clark
Senate Committee on Homeland Security and Governmental Affairs,
Where Were the Watchdogs? Financial Regulatory Lessons from Abroad

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Mr. Chairman and Other Members of the Senate Committee:

I am Ed Clark, President and CEO of TD Bank Financial Group. Thank you for this opportunity to testify before this Senate Committee.

I have been asked to provide comments on the Canadian Banking experience. I should state up front though that I do not think it is my role to opine on how the U.S. banking system should be set up moving forward. What I can do is tell you how Canadian Banks have operated. Let me start, however, with a few words about TD.

TD is a North American bank that offers a full range of financial products and services to our 17 million customers worldwide of which 6.5 million banking customers are in the U.S. We have four key businesses: Canadian Personal & Commercial Banking, Wealth Management, U.S. Personal & Commercial Banking and Wholesale Banking. Currently we have 1,009 bank branches in the U.S. and 1,107 branches in Canada. We also own 45% of TD Ameritrade which has over 6 million customers and is the world's largest online broker as measured by trades per day.

At the end of our first quarter of 2009 we had \$477 billion (USD) in assets and \$328B (USD) in deposits. We employ more than 65,000 full time employees including more than 23,000 in the U.S. We have a strong capital base with our Tier 1 ratio above 10% of

which more than 75% is tangible common equity. We are one of only three banks listed on the NYSE that are rated Aaa by Moody's. Our market capitalization is \$35.9B USD which makes us the 5th largest bank in North America.

Our retail model in both Canada and the U.S. is built upon our unique service and convenience proposition to our customers. In both the US and Canada, our branches are open on average 50% longer than our competitors. In both markets, J.D. Power and Associates has repeatedly recognized TD's outstanding customer service. In fact, just this week TD Bank, America's Most Convenient Bank, ranked highest in customer satisfaction in the Mid-Atlantic region according to the J.D. Power and Associates 2009 Retail Banking Customer Satisfaction StudySM. We have earned this recognition for the fourth year in a row.

We largely avoided the major issues that damaged banks around the world in the financial crisis. With respect to our wholesale business we made the strategic decision to exit the structured products area in 2005 as we were not comfortable with the associated risks. In the U.S. we avoided lending in the way that got many U.S. banks in trouble. Specifically, we did not do subprime lending nor did we lend significantly out of our footprint. We also lent using our own people and distribution system, not third party commissioned sales people.

The fact that we were able to stay profitable through this crisis has meant that we have been able to grow – adding almost 50 branches on a North American basis last year and we continue to lend. Our U.S. lending is up QoQ, 17% on an annualized basis.

Let me now turn to what has made Canada different throughout this global crisis. The Canadian banking system has weathered the financial crisis better than most. Our banks are profitable. They have been able to manage through this crisis without any kind of bailout from the Canadian taxpayer. No single answer explains this performance; rather it is a combination of factors. Sound management has a lot to do with any banks' success. But Canadian banks' strength is also the result of good public and monetary policy, a strong regulatory environment, and a large Canadian investor base that was willing to back the banks throughout this period. From the very beginning the Bank of Canada, OSFI (Office of the Superintendent of Financial Institutions) and Canadian bank CEOs have worked closely together – pro-actively trying to get in front of upcoming challenges. A core difference in Canada compared to other countries was the reliance on the private sector to provide equity to reinforce our banking system. The willingness of the Canadian banks to price that equity attractively, to raise the desired capital, and the confidence of the Canadian investment community in the soundness of our institutions was a critical factor.

There were other, longer term structural advantages in our system.

- The structure of the Canadian banks is such that the large dealers are owned by the major banks. Therefore we did not have a Bear Stearns or Lehman equivalent.

This does not mean that we have avoided dealer losses; the Canadian banks have written down about \$18 billion (CAD) since the crisis began (although TD has had almost no write-downs). What the Canadian structure does mean, however, is that the retail earnings power of the Canadian banks has allowed them to shoulder the dealer losses incurred.

- In Canada the mortgage market is fundamentally different than the one in the U.S. First, in Canada we cannot write a mortgage loan for more than 80% loan to value unless it is insured. Second, our mortgages are underwritten to hold which means Canadian banks have “skin in the game”. Third, the mortgage market was heavily concentrated in the banks and they opposed sub-prime mortgages because they would bear the risks though a small market did develop outside of the banks. As a result, the development of more exotic type mortgage instruments such as no-document loans or Option Arms were either very limited or never created in Canada. In addition, mortgage interest is not tax deductible in Canada so our customers are less inclined to leverage up.
- The Canadian mortgage system also enabled us to solve the liquidity problems that surfaced world-wide during the crisis. Given that many of our mortgages were government guaranteed we were able to sell them back to the Canadian government without the government taking any additional risk. Indeed the government made substantial profits on the sales while providing the banks with needed liquidity and avoiding any government guarantee of our debt issuance.

- From a regulatory perspective we are governed by capital tests that look at both the total assets and risk weighted assets. In general, the risk weighted test is the binding restraint. Because of this we are not incented to sell low risk assets. There is a legitimate concern that an absence of tough total asset leverage ratios has allowed wholesale banks to become excessively leveraged. In developing these tests it is worthwhile recognizing that a total leverage test, applied as the binding restraint, to a typical personal and commercial bank may result in such a bank being precluded from running a lower risk retail model like ours.
- Speaking specifically about Canadian regulators, we have a single regulator for all the major banks – OSFI – Office of the Superintendent of Financial Institutions. It has focused:
 - o First, on capital and in particular the quality of capital. Before the crisis, to be considered well capitalized required a Tier 1 ratio of 7% of which 70% had to be common equity. In response to the crisis, particularly the need to ensure Canadian banks could easily raise the capital needed to keep lending, and to ensure that Canadian banks had more comparable leverage ratios to the more leveraged capital structures of non-Canadian banks, OSFI moved from a 70% to 60% common equity requirement. This provided the additional flexibility required to level the playing field. And while OSFI had set a target of a 7% Tier 1 ratio, they also encouraged

the Canadian banks to have robust internal capital adequacy processes, which in turn played a role in banks having Tier 1 ratios much higher than 7% - closer to 9% or 10% in fact.

- o Second, the regulator has taken a less detailed and more principle based approach to risk. Specifically, they want to know that we understand the risks we are taking and fully appreciate that ultimately, we own the risks associated with our decisions. They want to understand our risk management processes and they focus on the role of our Board – and its knowledge of the risk choices we have made. Regulators can obviously lean against banks and their actions but it is the people at the top that must be accountable for the system to function successfully in the long term.
- There has been a lot of talk about compensation and the role of compensation management practices in the crisis. Canadian Banks moved to adopt some time ago, in response to investor suggestions, changes consistent with what are now considered best practises. At TD our compensation programs are designed to align with shareholder outcomes. In fact, executives experience more downside than shareholders in tougher economic times. This alignment is achieved by providing a significant portion of compensation for our most senior executives in long term equity; having the highest share ownership requirements relative to our peer group; requiring share ownership to extend post termination or retirement; reducing the use of stock options over time and limiting the leverage in our compensation plans. This approach to compensation is utilized for all executives

at TD, including the most senior executives of our wholesale and personal and commercial businesses. In addition, the pay for all executives at TD is impacted by the financial performance of the bank overall and not just their individual businesses and most importantly by the results of our ongoing measure of customer experience.

- The Canadian banks corporate governance is such that they all have separate CEOs and Chairs. These distinct roles, held by two qualified leaders, ensure that the interests of the shareholders, customers and employees are balanced. The Directors of the Board regularly meet at Board and Committee meetings without the CEO or management present.

Conclusion

I said at the start of my remarks on the Canadian banking system that the simple fact is that there is no magic bullet – no single answer – but rather it is a combination of factors as to why the Canadian banks have come out of this crisis better positioned than most of their global peers. I also think we have to be very careful about exaggerating the “unique” success of Canada. As it happens we did very well through this crisis but I would not want to assume that will always be the case nor do I think we can rest on our laurels.

I believe that at the heart of well run financial institutions and ultimately financial systems are leaders that run their institution in a way that it can withstand significant shocks. I think I speak for all the Canadian bank CEOs when I say we understand that we must take care of our shareholders and the institution for the long haul. We feel an obligation, the same as many U.S. bank CEOs do, to leave the institution in better shape than when we started so that it survives for generations to come. We all appreciate that our institutions are vital to the economies where we operate – in our case predominantly Canada and the U.S. And as a result we manage them in a way that doesn't put them at risk for potentially lucrative short term plays. This thinking is reinforced by our regulator and as I said earlier our compensation aligns to this way of thinking. And the stability of our earnings and nature of our capital regime allows us to withstand the shocks I talked about earlier.

In conclusion, I think it is also important to appreciate that it is unlikely that a regulatory system on its own can solve all the problems. A mix of sound regulation and sound business practices from the financial institutions is required. But having only the former without the latter would lead inevitably to a regulatory structure that would be detrimental to the marketplace. For Canada, it has been a combination of the commitment of Canadian bank CEOs, the relationship between the regulator, government and Canadian banks and the support of the equity market that has enabled the Canadian banks to weather this storm successfully.

Thank you again for this opportunity to testify before this Senate Committee. Please feel free to ask any questions you might have.