

INSIGHTS

INTO CANADIAN BANKING

Financial Services / Spring 2011 Edition

Positioned to lead

Achieving regulatory balance

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- Knowledge, not data, drives customer profitability
- Pressure for change: Balancing the pace of core banking system conversion
- Better tax governance

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Positioned to Lead

Canadian banks stand tall on the global stage



Mary Filippelli
National Banking Leader

In 2008, during the darker days of the financial crisis, Canadians flocked to the safety of cash and GIC deposits with our national banks. This was not only a successful test of the deposit insurance system, it also clearly demonstrated the confidence of consumers in our banking system overall. I believe this confidence was well placed and that Canada will continue to be a beacon of light, bringing much needed equilibrium to the global banking system.

Already, banking and financial services leaders around the world are looking at the success story the Canadian banking system wrote during the financial crisis. We did not see a run on our banks and our system, sometimes criticized pre-crisis as overly conservative, emerged relatively unscathed. The fact is, Canadian banks are uniquely positioned with the capital and liquidity necessary to actively pursue growth while their global counterparts focus on divestiture and restructuring.

To capitalize on this growth agenda, banks must continue to build the trust and confidence of global markets. For example, by strategically embracing the



new regulatory environment—carefully balancing the implementation of new compliance mandates with existing stability and future growth potential—Canadian banks can continue to take a lead role on the global financial stage. Our rising financial profile can already be seen with the announcement that a global risk management institute will be established in Toronto to track international financial issues and better deal with future potential crises.

Certainly, many challenges remain for Canadian banks and, as a firm that relies on the trust we've built through our experience, knowledge and integrity, we ultimately understand those challenges. Global markets remain unstable and consumers—despite a basic confidence in the stability of the Canadian banking system—are justifiably unnerved by the

aura of uncertainty and volatility that surrounds global financial structures. While banks feel some pressure to “de-risk” their activity profiles in response to this generally leaner, more wary financial environment, such strategies, if not carefully implemented, can pose a real threat to financial performance and profitability.

Change is clearly necessary, though it should be adaptive or incremental rather than radical. If not approached judiciously, change can erode performance, impact pricing models and threaten gains in consumer trust. Canadian banks have earned this trust by strategizing carefully and working diligently to meet the vast array of post-crisis challenges—challenges our top financial advisers examine in the following series of articles.

Achieving regulatory balance in the changing landscape



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Canadian banks weathered the financial crisis that put many countries on the economic brink and, with early analysis, strategic evaluation and robust planning, we are confident that they can continue to lead. Certainly, global regulatory implementation presents enormous challenges of scale and complexity, but Canadian banks that can balance the spirit of regulatory change with an acute focus on new sources of revenue and customer profitability will likely be a step ahead when it comes to managing growth in the new regulatory environment.

Regulatory reform is here to stay and the focus of attention is now shifting to implementation—progressing action on the business implications and planning for compliance. Banks must also remain flexible to adapt to subsequent changes and developments, with a number of other parallel policy initiatives being put in place, notably recovery and resolution



planning, attention to corporate governance, enhanced college of supervisor arrangements and continuing uncertainty over tax. Changes in any of these will impact a regulatory response plan.

Certainly, there will be adaptation and implementation challenges as banks work to understand new standards, predict impacts, implement complex new compliance procedures and design appropriate regulatory controls. While the outlay of resources can strain operations and slow growth, current changes in the banking regulatory landscape are the necessary products of a long series of hard lessons. On the plus side, the new regulatory environment should ultimately lead to renewed customer confidence, profit stability, and growth opportunities for banks, especially for those, such as in Canada, whose sound practices allowed them to preserve capital and liquidity and weather the recent downturn. With the spirit of good governance, risk management and compliance already built into our financial structures, Canadian banks are particularly well positioned to move seamlessly into the new regulatory environment.

The emerging framework to strengthen banking regulation

Although still debated, most financial analysts agree that better regulation could have at least stemmed the tide of the recent global financial crisis. With those lessons still fresh, individual countries all over the world are striving to create regulatory frameworks that address certain deficiencies. According to the Chairman of the Basel Committee of Banking Supervision, this would include poor liquidity risk management and insufficient liquidity buffers; excessive leverage combined with weak underwriting; inadequate amounts and insufficient quality of bank capital; and shortcomings in corporate governance, risk management and market transparency.

The development, implementation and ultimate oversight of such a framework (or frameworks) is a monumental task that will take years, and it will not be uniformly smooth. Already, major

players are taking different paths and implementing diverging policies, and timelines will be radically different for countries facing different economic realities. But the basic intent of the new regulations is to add layers of comfort and safety to the banking system for customers using it and within the system itself. These regulations attempt to address systemic risks that had not been widely anticipated. They also attempt to ensure that banks operate in ways that limit those risks and that they are better prepared to respond to serious future financial events.

The following is a brief summary of some of the regulatory changes banks are currently facing. The key will be balancing compliance yet understanding the converged impact to our Canadian banks' business models.

Basel III

The features of Basel III that address identified deficiencies include an increase in the quantity and quality of capital, a leverage ratio, capital buffers (conservation and counter-cyclical) and global liquidity standards. Within Basel III, there are other efforts to strengthen risk management and supervisory practices beyond capital and liquidity. These areas of change—such as governance, supervision, deposit insurance, methods to identify systemically important financial institutions (SIFIs) at the global and domestic level and reliance on external ratings—have a separate consultation, debate and implementation phase, adding considerably to implementation challenges.

Dodd-Frank

The *Dodd-Frank Act* is a major, comprehensive regulatory legislation intended to assure stability in US financial markets, the impact of which will likely exceed that of Sarbanes Oxley. The *Dodd-Frank Act* has broad implications on the financial services industry in eight key areas:

- Systemic Risk (limiting concentration)
- Financial Stability and Capital Requirements
- Volcker Rule (limiting proprietary trading)
- OTC Derivatives (managing counterparty credit risk)

- Consumer Protection and Mortgage Reform
- Federal Bank Supervision
- Registration of Investment Advisers
- Other Areas (Compensation, Asset-Back Securities, Whistleblower Programs, and more).

Though it is US legislation, it will have global effects on both the financial services industry and corporate accountability in general, affecting banking, securities, derivatives, executive compensation, consumer protection and corporate governance.

Foreign Account Tax Compliance Act (FATCA)

Under this legislation, the US government intends to combat tax evasion intensely by imposing a 30 percent withholding tax on US source income, unless a receiving financial institution enters into an agreement with the IRS and reports its US customers. Financial institutions that are impacted include any bank invested in the US market for its customers' accounts or for its own account, as well as any bank that is part of a group that invests in the US market for its customers' accounts or for its own account. The FATCA provisions are additional and not substitutive to the current QI regime already in place. The tax is applied on any payment (interest, dividend or sales proceeds) on US securities made to a foreign financial institution (FFI), unless it agrees to identify US accounts, comply with verification and due diligence procedures, perform annual reporting, deduct and withhold 30 percent from any pass-through payment made to a recalcitrant account holder or another institution without an FFI agreement, and comply with requests for additional information.

Recovery and resolution planning or living Wills

Arising from all of the regulations above and supported by the G20, a living Will is a regulator-approved plan, or "Will," for SIFIs that lays out an orderly wind down in case of a "life"-threatening event. It would provide a much wider range of options than straight government bail out.

Impacts and challenges – Key questions surrounding growth

The successful implementation of changes to business operations in order to comply with these regulations will radically alter the Canadian and global banking environments, and despite the expected return of customer and investor confidence in global markets, banks will face some specific challenges. Canadian banks have been growing, which is obviously a trend that the financial industry and the Canadian economy at large would like to see continue, but in the initial stages of regulatory adjustment, it may be reasonable to expect a slow-down of this trend. The mechanics and cost of compliance will initially increase costs for virtually all financial entities. The question is, once business returns to "normal" under the new regulatory umbrella, how much will growth be affected by the new regulatory environment? Assuming customer confidence grows and profitability grows, will the organization be able to leverage that success into global growth?

One major question is how consistently regulatory reform will be implemented globally. If it is inconsistent, regulatory arbitrage may continue to fragment overall financial system stability, as it has despite earlier reforms such as Basel I and Basel II. It is, of course, impossible to predict exactly how this regulatory landscape will develop, but Canadian banks should consider possible scenarios and apply some critical questions to their long-term strategies.

Canada is in a good position relative to many other countries. The banking industry in general has strong liquidity and capital, and, comparatively speaking, should emerge as a global leader in accessing available opportunities. But how much and what kind of risks—always necessary to success and growth—will be removed or lessened as a strategic option? Will significant growth be achievable via the same strategies as

before? Canadian financial institutions need and want to be part of the global imperative to eliminate events like the financial crisis, but they are well aware of the fine line between controlling risk and reducing risk to the point where commercial viability is affected. If profit is too constrained, customer banking costs may be affected, running the risk of undoing any gains revitalized customer confidence might provide.

Balance – Build toward a new risk/profit equation

As in all businesses, there is a trade-off between risk and profitability. The greatest challenge for Canadian banks is to understand how this equation gets reconstituted in the new regulatory environment. The goal of regulatory reform is not to destroy the ability of banks to grow and earn, but the formulae will certainly be different. How do banks leverage their core strengths moving forward? Where can they take on risk to provide extra return? How can this all happen while safeguarding the customer relationship the industry is working so hard to recapture? Are there opportunities to become more efficient and offset the adverse effect on profitability that greater regulation can entail?

The answers will differ for individual banks. The positive aspect is that Canada will likely be as well off as any country in the new milieu—set to transition effectively to new regulatory mandates, ready to enhance customer confidence and better positioned than most to develop effective growth strategies. The key is to formulate governance and risk management infrastructures that balance the goals and requirements of compliance and the strengthening of the financial system with commercial realities.

Insights into Canadian Banking

Pressure for change

Balancing the pace of core banking system conversion is key to long-term sustainable advantage



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The idea that banks should invest in a large scale replacement of legacy systems has had some traction.

Current core banking systems, replacement proponents suggest, are decades old and simply can't serve banks effectively anymore on a host of levels. Certainly, a perfect systems turnover could yield operational improvements and eventual cost reductions, but is it a realistic prospect? Is it even realistic for the majority of banks to implement wholesale retooling projects on systems that, in many cases, remain highly stable and reliable?

While the replacement case has been strongly made, there is growing resistance to the idea that it's an imminent industry necessity. Banks are asking whether the advantages, at this point, outweigh the risks. Even if legacy systems have obvious limitations, it may

be better to manage current needs with modular sub-systems; develop a strategic long-term plan for the changeover eventuality; and allow conversion technologies, expertise, processes and success rates to continue improving.

To make a decision that balances current system requirements and cost management with the eventual necessity of change, banks should consider the pressures driving change, key reasons to carefully evaluate the process and steps to take to prepare for the future.

The drivers of change

The push to replace legacy systems is based on several arguments, including:

- **Aging workforce** – Core technologies date back to the 80s, even the 70s. There are numerous inefficiencies and, as the current IT workforce retires, companies may be challenged to find staff that understands these systems enough to maintain and run them.
- **Technology/scalability** – Legacy systems have difficulty handling the sheer volume and complexity of today's data streams, applications and network demands. It is also difficult to incorporate new industry standard technologies and customer-centric applications into these often customized systems.
- **Regulatory issues** – As regulatory changes demand access to more and different kinds of information, legacy systems may not be designed



to analyze the data as requested, requiring expensive workarounds and potentially risking non-compliance.

It's also possible that catastrophic events relating to system failure, such as fraud or personal data breaches, could affect ongoing operations, damage share price or cause loss of consumer confidence.

A total overhaul is not totally realistic

The push for immediate change has waned, though, as a host of reasons to proceed warily have come to the fore:

- Legacy systems are simply too pervasive and cross too many different lines of business and geographies to be changed all at once
- They are actually quite stable and reliable, supporting the major transactional operations for most banks
- In the current climate, the enormous cost of replacement would expose banks to risks that they cannot afford and that their stakeholders will not accept.

For these reasons and more, many financial institutions are discovering the wisdom of applying a multi-phased approach to systems replacement, taking careful steps to plan each small transition.

Consider the real world example of a large Canadian bank trying to merge customer activity to provide customer service representatives with an at-a-glance view of each customer's deposit, investment and loan activity. To achieve this objective, the bank needed to consolidate information from various legacy source systems, driving it to replace one of its core lending systems to ensure all new loans would contain the information required for proper consolidation. However, given the massive amounts of customer loan data being managed and manipulated, this changeover presented the potential of serious loss of profit, reputation and customer confidence. To mitigate these risks, the bank chose to simultaneously run its legacy and replacement systems during a transition period, allowing existing lending products to run out before decommissioning the legacy systems.

What should banks be doing now?

What are the practical steps banks should take to prepare strategically for a system conversion process that will eventually become inevitable?

- Carefully assess the full range of complexities and challenges involved in moving to new technologies. For instance:

- If you cannot switch over to the new system in a single procedure, the organization may have to support legacy as well as new applications for a multi-year period
- Traditional retail product lines are usually supported by legacy systems that have been modified over time to fit ongoing business needs. Numerous custom code changes, patches and “bolt-on” modules are now very difficult to separate—and equally as difficult to replace
- Instead of wholesale replacement, consider replacing as required on an application-by-application basis.
- Analyze the impact of conversion on costing and budget processes
- Develop and implement more effective workforce strategies, such as:
 - Training new staff to understand, operate and maintain legacy systems
 - Encouraging a culture of acceptance around new systems technology for senior staff.

In general, rather than planning a massive overhaul, banks should undertake an ongoing risk assessment program, regularly discussing conversion timelines at staff and strategy meetings.

With many core systems interlinked across the industry, banks need to mutually engage in change initiatives. The payment system, for instance, cannot be changed by one bank. It requires industry-wide cooperation and coordination.

Build consumer confidence

If your underlying platforms are stable and reliable, it may be wiser to spend current resources in other places, such as building consumer confidence. That process begins with security. Certainly, many of the Canadian banks have to some extent ventured beyond the Canadian borders exploring growth opportunities. If your ultimate conversion plans will coincide with a global growth initiative, it's absolutely critical to demonstrate to customers that global systems will be reliable and secure. Otherwise, they will turn to more regional and local banking relationships where they feel their money and information are safe from cross-border compromise. The same holds true for the increasing popularity of mobile banking. Customer loyalty will follow security.

It's a decision, not an imperative

The decision will be different for every bank. You must self-assess, but accurately, taking a range of factors into account. For most banks, immediate wholesale change is unrealistic. For many, particularly smaller businesses, moving too quickly may raise unwarranted risks and exposures. Some banks are ready and have a comprehensive plan, but hesitancy is a legitimate response.

There is a clear case to be made for legacy system replacement, but it's far from a closed case. With customer confidence still strained by recent economic events, banks need to carefully balance the pressures and risks of fast change with the advantages of an evolving process, then take the steps that are right for their situation.

Insights into Canadian Banking

Post-crisis bank losses prompt calls for better tax governance



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According to the Organisation for Economic Co-operation and Development (OECD), the world's banks suffered write-downs and losses of US\$1.3 trillion up to January 2010 due to the 2008 financial crisis. The OECD Forum of Tax Administrators (FTA) fears that the scale of these losses and the potential regulatory capital, profit and cash-flow benefits for banks able to convert them into cash create potential tax compliance risks from aggressive tax planning involving losses.

To address fears of inappropriate tax planning, the Canada Revenue Agency (CRA) and its FTA colleagues are reaching out to banks and other large corporations to create new relationships based on mutual transparency and trust. By positioning tax risk management as a corporate governance issue, the world's tax authorities are seeking to expand their dealings beyond tax departments to engage company directors and C-level executives and promote better tax compliance.

While Canadian banks fared better than most during the recent crisis,

stakeholder confidence in all financial institutions has been eroded. Today's financial institutions need to respond to the new focus on tax governance while complying with ever more complex tax laws and managing the impact of tax on their bottom lines. To strike the right balance and gain the CRA's confidence and trust, financial institutions can benefit from putting in place a solid framework for governing their tax risk.

Tax risk focus zeros in on banks

Over the past several years, the FTA has raised concerns about the risk to tax systems posed by the extent that banks use, facilitate or promote tax planning schemes. Even before the financial crisis, the FTA had begun to zero in on global financial institutions and commissioned a study to understand banks' involvement in aggressive tax planning both on their own behalf and for clients. The OECD released the study entitled *Building Transparent Tax Compliance by Banks* early in 2009 and it was swiftly followed by a consultation document, *A Code of Practice on Taxation for Banks*, issued by HM Revenue and Customs in the UK. A 2010 FTA report details the tax compliance risks arising from the huge losses suffered by banks due to the 2008 financial crisis.

The FTA says banks can help reduce these tax compliance risks by:

- Being open and transparent with tax authorities in their planning involving losses (whether or not tax-motivated)

- Ensuring that appropriate corporate governance and tax risk management processes are in place
- Helping tax authorities identify and address areas of uncertainty in the operation of their country's loss recognition and loss relief rules
- Adopting, as part of their business strategies, the pursuit of an enhanced relationship with the tax authorities so they can benefit from early certainty, reduced compliance costs and reduced reputation risk.

A suggested code of conduct for banks accompanied the FTA's report. The code emphasizes that banks should not enter into aggressive tax planning on their own behalf or in their capacity as tax intermediaries. The code also stresses that banks should ensure that they have adequate governance to control the types of transactions they enter into and the associated tax risks. Banks should document their tax risk management strategy and governance processes within a formal policy. They should maintain processes (e.g. product approval committees) to ensure that the tax policy is taken into account in making business decisions.

Rising demands for tax transparency and disclosure

Spurred by the FTA's emphasis on corporate governance and tax risk, the tax authorities are influencing governments to adopt legislation requiring greater transparency and disclosure of possibly inappropriate tax plans. Here in Canada, Quebec introduced a regime in 2009 requiring companies to disclose "aggressive tax planning" transactions, while the federal government is developing rules to establish a similar regime nationally. Meanwhile, the CRA has embarked on a project to evaluate the risk profile of large corporate taxpayers based on their tax governance structure and history of cooperation with the CRA.

Seven building blocks of effective tax risk management

A sound tax governance framework comprises seven building blocks to help the tax function of financial institutions and other large organizations manage tax risk while adding value. Below we describe the qualities of these building blocks in leading organizations in the tax governance area and we present some action items for putting these building blocks in place.

1. Common purpose

Leading practice	The strategic goals and objectives of the tax function are aligned with those of the wider organization.
Action item	Hold a workshop with your organization's key executive stakeholders to ensure the tax strategy is aligned with your overall business strategy.

2. High-performing teams

Leading practice	Your tax function comprises the right number of tax professionals with the right mix of training, skills and experience.
Action item	Develop a high-level vision of your organization's optimal tax team; assess your existing group's current skills, knowledge and abilities; and train or hire tax professionals as needed.

3. Embedded processes

Leading practice	Your tax management strategy is implemented across the organization through embedded processes and controls, and with clarity over accountability and responsibility between the tax function and the organization's other business units.
Action item	Develop a common methodology and approach to tax process management that standardizes, harmonizes and automates the processes and controls across the organization to manage tax risk and inspire confidence in the underlying tax numbers.

4. Timely and accurate information

Leading practice	Required financial and tax reporting data is produced, shared and distributed to the right people, at the right time and in the right format.
Action item	Perform a detailed analysis of current data flow and processes to determine what data is needed and by whom, where the numbers are coming from and who is responsible for their accuracy.

5. Enabling technologies

Leading practice	Labour-intensive processes that consume resources and increase risk are automated through the use of enabling technologies (e.g. enterprise resource planning (ERP) systems, tax software); IT systems are linked to tax management software to create an end-to-end tax information system that supports automation, creates a clear audit trail and produces accurate entity-based financial data.
Action item	Review your organization's current IT systems and, based on this review, design and implement new systems (if necessary), integrate disparate systems, and standardize and automate where possible.

6. One view of performance

Leading practice	The effectiveness of your tax risk management is monitored and measured by reference to commonly understood requirements and agreed key performance indicators (KPIs).
Action item	Conduct interviews with organizational stakeholders to determine their needs and assess how well the tax function is meeting them; then develop relevant KPIs that are aligned with those of the entire organization.

7. Influencing stakeholders

Leading practice	Your tax function understands the goals and constraints of stakeholders and communicating with them effectively to help achieve their goals.
Action item	Create an enterprise-wide communication plan to channel tax compliance, planning and business information between the tax function and internal and external stakeholders.

A framework for tax governance

In this environment, financial institutions need to be able to show that they have a solid tax management foundation in place. The framework should extend to all parts of the business, including those involved in the design and sale of financial products. Once in place, such a framework can help deliver day-to-day compliance and reporting effectively and efficiently while focusing on the right balance between managing tax risk and creating value. In addition, a strong tax governance framework can increase the confidence of customers, shareholders and other stakeholders, such as the tax authorities, that the financial institution is well run and responsible.

Does your financial institution have a strong tax governance framework in place? If so, the bank's board members, executives, tax directors and other stakeholders should be able to answer "yes" to the following questions with confidence:

- Are you aware of the key pressures and challenges facing companies' tax departments?
- Do you know how to successfully achieve balance between managing tax risk and creating value within significant resource constraints?
- Do you know that standardization in tax processes, structures and reporting lines is crucial for achieving a risk/value balance?
- Are you aware of the leading practices in implementing efficient and effective tax management processes?
- Are you aware of the building blocks that you need to put in place to achieve a risk-value balance?
- Have you ever formally evaluated and/or benchmarked your company's tax function and tax risk management philosophy against peer organizations?

Insights into Canadian Banking

Aligning your talent management and business strategy requires a new mindset

Building a competitive advantage hinges on the recognition that the war for talent is never over



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History tends to repeat itself. This was particularly apparent in the wake of the recent economic downturn, when the financial crisis triggered an almost predictable rise in unemployment rates. In the scramble to maintain profitability, countless organizations initiated layoffs, instituted hiring freezes and otherwise shelved new projects and investments. Now that the economy is on an upswing, organizations are refocusing on attracting and developing people

with the skills and capabilities required to help them take advantage of improving market conditions.

In many ways, this renewed focus simply accelerates a trend that began several years ago when financial institutions first started translating advanced talent management theories into tangible efforts. Since that time, numerous Canadian banks have established dedicated talent management teams and integrated workforce planning programs designed to support the organization's short- and long-term resourcing objectives.

Yet, despite this progress, banks now face challenges that barely existed before the financial crisis hit. This is true across all areas of the bank, from client-facing functions to IT and Finance.

To complicate matters, banks must also build new competencies in response to more stringent regulatory mandates. To meet expanding needs for broader skill sets, many banks are scrambling to build internal capacity for people in a



wide range of functions, from financial analysis, finance and accounting to risk management and technology.

Achieving these objectives requires more than a traditional approach to attracting and retaining talent. Recognizing that the war for talent never ends, financial institutions need to make talent attraction, retention and training daily activities. This takes more than a different mindset; in many cases, it also requires a cultural shift.

Learning from the leaders

In the not-so-distant past, talent management was not as complex as it is today. Shifting demographics and technological innovation have changed this equation. As the baby boomer generation retires, many are taking their knowledge with them, leaving organizations with significant talent gaps.

Finding new people to plug these holes is complicated by the vastly divergent motivations displayed by today's younger, multicultural and geographically dispersed workforce. These trends mandate organizations to consider strategies that barely existed only a few decades ago—from flexible work hours,

outsourcing arrangements and mobile workforces to engaging employees through the use of social media.

On the plus side, successful examples already exist. Formal leadership programs now play key roles in attracting, developing, placing and retaining talent at most of Canada's top banks. Similarly, many banks use rotational programs for both existing and new employees as part of their overall efforts to expand their resource capabilities, build greater technical breadth and facilitate their succession planning efforts.

Here's a case in point: One Canadian organization with an established and mature model considers talent management as part of its overall culture and daily practice. As part of its commitment to walk the talk, this organization has embedded accountability for knowledge transfer, development and resource advancement into its job accountabilities, which are linked to specific roles and the incumbents themselves. Leaders are expected to provide mentoring to their identified successors and receive mentoring themselves. In essence, both talent development and resource planning have been embedded into the organizational mindset.

A new way of thinking about talent

To be sure, workforce planning challenges persist. To adapt to shifting market realities, financial institutions must continue to refine their talent management programs to take emerging trends into account as part of their capacity and demand planning. Current programs to address the evolving needs of Generation Y will need to evolve into new programs to address the needs of the emerging Internet generation. And mitigating unforeseen risks requires companies to align their workforce plans to their emerging long-term needs as well.

Fortunately, Canada's banks are well on their way. Already, leaders recognize that conversations around talent cannot remain confined to human resources professionals. Instead, top management must think about talent, care about talent and develop talent all the time. They must identify potential leaders from both of outside the bank and from all levels and departments within the bank. They must discuss resourcing issues at weekly department meetings and monthly reviews. And they must commit to actively seek out opportunities for learning to foster the development of necessary skills.

At the same time, these individual managerial efforts should be supported by more formal organizational structures, processes and technologies. For instance, financial institutions may be able to



avoid potential talent shortages if they understand how labour market forces, new communications approaches and emerging reward cultures will affect their resourcing strategies. They may be able to plug knowledge gaps by sharing and managing information in more collaborative ways. They may be able to heighten employee engagement by continually investing in understanding what motivates their people and providing incentives for the right behaviour. And they will almost certainly improve performance and shareholder value by finding ways for their staff to more effectively collaborate, learn and share knowledge.

Fostering a talent management mindset

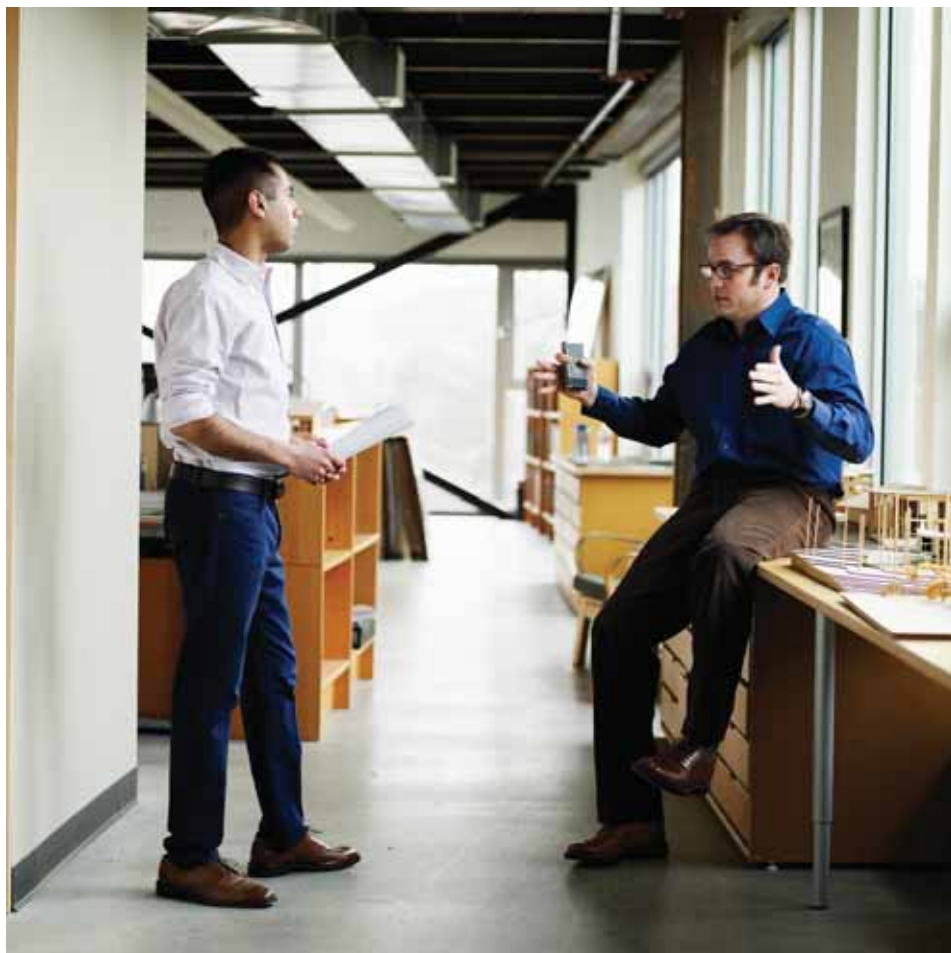
Before workforce planning can yield measurable results, financial institutions must ensure they have the appropriate resources, processes and infrastructure in place. The following questions can help you assess your readiness:

- Do you have fully effective workforce planning tools and techniques that give you a clear view on resource allocation?
- Does every employee understand how their job functions contribute to business success?
- Do you continuously work to identify developmental opportunities for your staff?
- Has your leadership team integrated workforce planning into their daily activities?
- Do you link workforce planning strengths to the performance of individual managers?
- How do you share information and knowledge capital?
- Do you have processes for measuring the progress and effectiveness of your workforce planning strategies?

Taking a long-term view

When considered through this type of integrated lens, it becomes clear that strategic workforce planning requires a cultural shift. Rather than considering how to win the talent war, financial institutions need to adopt programs and practices designed to support employee growth, leverage learning opportunities and foster the ongoing development of critical skills.

As resources become scarcer and the competition for talent continues to heat up, the financial institutions best able to effectively identify, develop, deploy and retain top talent will likely emerge victorious. Similarly, both consumer confidence and business growth depend on the existence of a loyal, committed and happy workforce. By approaching employee engagement as an ongoing strategic imperative, rather than a single initiative, Canada's financial institutions can build a talent culture that positions them to realize improved productivity, profitability and shareholder value over the long term. High-performing organizations recognize this reality, which is why they continue to invest in nurturing high-potential talent.



Securitization vehicles – Is IFRS the end of the road?



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The recent credit crisis severely dampened the popularity of securitization vehicles with investors. With banks and other issuers now recording many of these vehicles and related assets on their balance sheets under IFRS, the future of securitizations in Canada is even more uncertain. As confidence in these vehicles remains low for investors and IFRS eliminates some of their biggest benefits for banks, the industry needs to mitigate the impact by developing a new and more diversified range of financing sources.

One of the biggest changes in banking and credit lending over the past 20 years has been the growing proportion of bank-originated loans sold to investors in securitization vehicles. Banks have developed a host of investment vehicles to accomplish loan securitizations—asset-backed commercial paper, mortgage-backed securities and collateralized loan or debt obligations, to name a few.

Trillions of dollars in loans have been securitized through these vehicles, allowing banks to reduce their regulatory capital requirements and manage their exposure to any one borrower. Banks have also marketed these vehicles to

corporate clients in single or multi-seller form, creating a means for companies to securitize customer accounts and lease receivables, monetize high-quality assets and improve how they manage their balance sheets and lending ratios.

These conduit structures have allowed the banks to generate fees for structuring and managing the vehicles, along with liquidity and commitment fees. These lucrative revenue streams have come to represent a significant part of many banking businesses.

Investor interest fails to rebound

However, securitization activity slowed to a virtual halt in 2008 as the credit crunch swept the globe and investors lost confidence in mortgage- and asset-backed securities. As the debt capital markets recover and market liquidity improves, investor interest in certain securitization vehicles remains slim. To the extent that IFRS has eliminated some benefits of securitizing assets through these investment vehicles, banks have lost a lever for optimizing regulatory capital and managing exposure. And to the extent that their corporate clients begin to shy away from these structures, banks also stand to lose a key source of revenue.



IFRS reporting puts pressure on asset-to-capital ratios

Reporting debt securitizations on balance sheets under IFRS can adversely affect financial results and could diminish the financial benefits of future issuances. IFRS reporting of these vehicles will put pressure on banks' asset-to-capital ratios and limit their ability to undertake such transactions in the future. Risk-based

capital ratios are less affected, muting the impact for larger banks whose assets-to-capital ratios are less of a constraint.



IFRS looks to the transfer of risks and rewards

Under Canadian GAAP, securitization transactions could achieve derecognition and off-balance sheet treatment for various assets, such as loans and mortgages, where the bank or corporation is considered to have transferred control over the assets. But, under IFRS, derecognition is more difficult to achieve because it is based on whether there has been a substantial transfer of risks and rewards as well as a transfer of control.

If the assessment of the transfer of risks and rewards is inconclusive (where some but not substantially all risks are retained), control and the extent of continuing involvement must be assessed. Under Canadian GAAP, the transfer of risks and rewards does not factor into the assessment. But, in many circumstances, the IFRS assessment must go beyond just qualitative considerations to also examine quantitative measures. Banks and corporations transferring assets to investment vehicles must compare who is exposed to the risk of loss and entitled to the rewards before and after the transfer. Where substantially all of the risks and rewards of the assets are retained by the transferor, derecognition of the entire asset under IFRS is not permitted.

Typical Canadian structures used to facilitate securitizations have required the transferor to retain a substantial exposure to the risks and rewards. The requirement served as a form of credit enhancement to support asset-backed security ratings and limit the exposure of investors and sponsoring banks. Under IFRS, these mechanisms prevent derecognition. In certain investment vehicles, a third party or the transferee assumes some, if not substantially all,

of the risks and rewards of the assets. Where the control criteria are also met, such vehicles offer some flexibility for achieving derecognition

In light of the risks and rewards consideration, most existing Canadian securitization vehicles would not qualify for derecognition under IFRS. The underlying assets would therefore need to be recorded or remain on the transferor's balance sheet.

For example, securitization transactions in which the transferor gives collateral or guarantees as a first loss against credit losses inherent in the securitized portfolio of assets may not meet the IFRS derecognition standard where the first loss level is sufficient to cover substantially all of the expected risks inherent in the assets. Increased capital adequacy requirements, lower returns on assets and deferrals of gains and losses on such securitization transactions will result. Additionally, recognizing the transferred assets back on the balance sheet with a corresponding obligation may also strain corporations' balance sheet ratios. To avoid going offside, many corporations have had to renegotiate loan covenants and other metrics with their banking partners, lenders and other stakeholders.

Smaller institutions most affected

Smaller financial institutions with large amounts of securitizations will be most affected by the change to IFRS due to the adverse impact on their asset-to-capital ratios. The Office of the Superintendent of Financial Institutions is considering a multitude of requests from smaller institutions to increase their assigned ratios. While such relief may ultimately be provided, new assigned ratios will not likely increase beyond the existing maximums (e.g. 23:1) for larger institutions.

Institutions that take part in the Canada Mortgage Bond (CMB) program are particularly affected. The program is designed to transfer interest rate and prepayment risk on underlying mortgage-

backed securities back to the originator through a total return swap, also known as a "seller swap." Depending on the mortgage-backed security pools and specific terms and conditions, many institutions in Canada need to recognize the mortgages underpinning the mortgage backed securities on a balance sheet, which can significantly strain their capital ratios.

Mitigating the impact

As the implications of IFRS on securitizations take hold, there are a number of steps that banks should take to help mitigate the impact:

- Assess the impact of transactions that would fail derecognition. Consider the potential effect on capital adequacy and other ratios, such as return on assets.
- Work with investors, originators and legal counsel to develop new securitization structures that meet IFRS derecognition requirements. In principle, to derecognize financial assets on transfer, the transferee must have given up exposure to substantially all of the risks and rewards of owning the assets. Retained interests designed to cover first loss exposure, cash reserve accounts and other mechanisms designed to have the transferor retain this exposure in substance (for example, to enhance or obtain a specific credit rating) would violate this principle and need to be amended or addressed.
- Work with corporate clients to assess whether bank-sponsored structures meet the IFRS derecognition criteria. Corporations can expect to pay a premium to have the bank sponsor an investment vehicle or a third-party investor assume first loss exposure over the transferred assets. Similarly, from a sponsoring bank's perspective, where the transferor or originator of the assets sold into the investment vehicle do not assume the first loss exposure, the bank would need to

accept the risk of either assuming this exposure itself or the exposure of whoever else assumes it.

- Assess the financial impact of compromising credit ratings for securitized pools in exchange for achieving the desired capital and accounting result of derecognition.
- Adjust internal processes and systems for accounting for these transactions; for example, to change how transfers of risk and rewards are measured and documented.
- Create an assessment model that incorporates the full cost-benefit analysis of undertaking securitization transactions. Even if they do not meet the derecognition norms, such transactions could have benefits as a funding alternative to raising deposits.

As for CMB program transactions, where a bank transfers mortgage-backed securities under the program that do not qualify for derecognition, recognizing the underlying mortgages on the balance sheet, along with the corresponding secured financing obligations, and derecognizing the seller swap creates more challenges. Depending on how or if the bank hedged the interest rate and prepayment risks associated with the mortgage-backed securities and the program, accounting under IFRS exposes the economic hedge, adding to the income statement's volatility. Fortunately, the IFRS rules on portfolio hedging are more accommodating (with macro or portfolio hedging permissible), so, in some cases, banks can apply hedge accounting to mitigate income statement volatility.

Looking ahead, while the new IFRS rules make derecognition of financial assets harder to achieve, they do not make it impossible. Canadian banks will therefore need to work with their clients and investors to develop a diversified range of appropriate financing structures and sources.

Knowledge, not data, drives customer profitability

Information is critical, but it is most valuable when it describes customer behaviour



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Banks have had an eye on customer profitability as a key performance metric for decades, yet approaches continue to vary widely in methodology and outcomes. All banks want to measure customer profitability, analyze it and apply the results of their analysis to product development decisions. Banks want to answer fundamental questions: What do our customers need? What products or services should we offer? How do we effectively market our offerings to meet our customers' needs? Which customers should we focus on? Which customers appear to be profitable but are not?

Banks, however, confront a number of challenges in evolving the customer profitability metric. These include the inherent complexity of banking organizations, the siloed nature of internal data management, inadequate costing models and—ironically—shareholder pressure to generate profit. Still, as they strive to meet the evolving needs and expectations of their customers, banks need to work toward a customer profitability measure that effectively balances traditional costing methods, a complex operating environment and an ever-evolving consumer landscape.

Complexity, data and costing

Transforming your approach to customer profitability is clearly a difficult proposition. A bank is a tremendously complex network of organizational structures, strategies, people, systems and information, often operating discretely. With the marketing department often responsible for measuring customer profitability, they tend to assess success or failure relative to specific marketing campaigns for specific products or promotions. Whatever customer information or knowledge is gleaned tends to be

siloed, not necessarily aligned to broader business drivers or strategies, and certainly not a usable aggregate view of product profitability across geographies or customer segments. This segmentation is not just a choice or an accident of corporate evolution; rather, individual groups and bank functions must remain agile and independent of the whole. For example, online banking must be clearly differentiated from retail banking and marketing. And if there is no larger enterprise focus on integrating capabilities, communication and evolution become problematic.

To complicate matters, what if a bank client is also an insurance client, a small business owner or has an investment account with the bank? Integrating the array of information these relationships generate to deliver a single, unified client view is certainly a customer profitability panacea, and banks have had some success in understanding this across a single channel, such as in branch banking. But the bank-to-customer relationship needs to be 360 degrees, in all directions—a seamless three-dimensional understanding that connects mobile banking, social networking, ATMs and telephone banking, as well as traditional branch interaction. Integration, however, has not kept pace with channel expansion. Silos persist and overcoming complexity remains a problem.

Costing, a key customer profitability input, is similarly affected by complexity. Most banks rely on an activity-based costing model, typically creating cost ratios that they then apply to the variable component of costs—for retail banking, the selling costs of products and services. Again, this works reasonably well for a single channel, but offers little perspective across multiple channels. Clearly, there is an opportunity for banks to enhance the way activity-based costing feeds into customer profitability. This requires a costing model that integrates costing across all channels. The model will have maximum integrity when it helps banks understand profitability at the customer, product and channel levels.

Real-time information creates immediate opportunities

Collecting and applying ongoing, real-time information to the process is a critical initial step. Monthly data on transactions, costs, revenue, sales and transfer pricing is not necessarily stale data, but neither is it immediate. When a customer visits a bank representative, the interaction is generally managed with relatively sophisticated customer relationship management tools that often include positioned sales offers of the latest products. Such prompts are often based on some level of specific customer analysis, but if that analysis isn't based on the most current information, sales opportunities can be missed.

By using customer profitability data at every channel across segments and geographies, banks can gain a much clearer picture of not only where they generate profit, but of what type of profit specific customers tend to generate. Importantly, real-time access does not have to mean instant access to the bank's complete data set (an unrealistic

capability at present), but it should apply to data used to identify and deliver specific offerings.

At the most sophisticated level, this would deliver targeted offers based on customers' current and most relevant financial behaviours—increasing sales, bank profitability and customer satisfaction. Ideally, this happens not only at the front-end channel, where significant investments have already been made, but at all channels, including ATM, mobile, internet and phone.

When you have complete profiles for thousands of similar individual customers, you can begin to make inferences about customers entering that segment and begin to drive profit in the most immediately reactive ways, while also letting customers know just how much you are paying attention to their needs and expectations. No matter what channel a customer goes through, the bank should be able to address their needs effectively within the expected timeframe. Real-time offers through online channels should be made immediately or that, too, is lost profit. While this can be done with existing tools and processes, banks generally do not employ real-time interaction and data integration at this level.

What will prompt change?

While this kind of profitability analysis is common to internet-based businesses, it is very complex and expensive in the "real world." For organizations already achieving a certain level of profitability, the necessary changes can be hard to justify. But the pressures are there and mounting, including:

- **Competitive pressure** – Although new entrants to the Canadian banking market tend to be niche oriented—for example, those that cater to a specific demographic or offer mono line (typically credit card) products—the cumulative effect of smaller players is likely the erosion of the major Canadian banks' market share for certain types of products or, in these target demographics, limiting customer and growth potential. In addition, following the global financial crisis, Canada's reputation as a sound environment for financial services has attracted many foreign institutions, each of which may appeal, in part, to the existing Canadian customer base.
- **Internal pressure** – Profitability data often resides within the marketing function and is not typically shared throughout the enterprise. Other lines of business, however, are calling for this information in formats they can apply to product development, customer intelligence and in the development of line of business strategies.
- **Simple business intelligence** – Going forward, bank profitability will increasingly rely on data clarity, consistency and currency. Consider the example of transfer pricing ratios: How old is the data that is used? Where did it come from? How much does it reflect the data it is being applied against? If current transfer pricing data is applied to months-old customer data, is it relevant? Data must also be managed with an enterprise approach—not necessarily collected and used within all groups or areas, but universally accessible.





To contribute to a truly accurate profitability picture, data must not only be current and strategically aligned, it must also be integrated and available.

The more you know about your customers, the better you can serve them. And if you can do that in a way that meets their needs as well as those of your employees and shareholders, you have a winning combination. You can conceivably stay one step ahead of consumer demand—and drive further demand—by providing more capabilities, services and offers, but until you have a complete and balanced understanding of customer profitability, you can't intelligently analyze the risk/reward implications.

Taking the broad view – and applying it

In the retail banking landscape, where understanding customer profitability is critical, banks are, in some ways, stymied by seemingly conflicting drivers. On one hand, the bank is under shareholder pressure to deliver profits. On the other, as banking channels and public interfaces continue to expand, banks feel the responsibility to provide services and interact with the public across the networks they prefer—and doing that effectively and comprehensively introduces additional cost to the business.

These business drivers may seem to be opposed, but they are not (though decisions are often made as if they were). Ultimately, selling retail products and services hinges on banks understanding who their clients are and what they need, both as groups and as individuals. Despite the potential for information exchange enabled by real-time interactive channels, banks do not currently use these to effectively measure customer behaviour and leverage it in product development.

Banks are constantly working on data quality and integration issues—standards, accessibility, consistency, currency, accuracy—and with much success. By systematically applying these improvements across internal functions and to the full continuum of bank-customer interaction, the opportunity exists to improve profitability while meeting evolving customer needs and expectations. However, a wall remains between IT capabilities and the needs and expectations of the various business lines. Until these functions are strategically aligned, even the best data cannot be put to the most effective use. Interestingly, one of the enablers for enhancing data integration and integrity is the common move to a shared services model across many business functions within the enterprise. Currently, there is as much variation in maturity, readiness and adoption of these models as there are models themselves. But the premise is to not only share infrastructures, resources and processes, but to also gain in the consolidation of enterprise information—i.e. customer information. Aside from the tangential benefits shared services operating models can bring to understanding customer profitability, many banks are taking a “virtual” approach. Through the utilization of information aggregation systems, banks are “integrating on the fly”—in part to respond to the increasing requirements surrounding the handling of customer information and also to respond to the large internal demand for data.

How it all plays out

Taking all challenges into consideration—competitive pressures, organizational complexities, stakeholder demands and budgetary constraints—it may seem daunting to move forward to harness the potential of understanding customer profitability. Business cases aside, the promise of developing a comprehensive, enterprise-wide customer profitability measurement and management program lies beyond simply understanding the final measures. The process itself necessitates breaking down organizational silos (to information at least) and developing a comprehensive view of products, organizational structures and their relative costs and contributions to overall bank performance and even correlations to individual, regional and group performance. While customer profitability measurement provides a lens to the end result of the bank's efforts, the individual measures, once clearly understood, can provide a new and results-oriented view to the levers of organizational performance.

Insights into Canadian Banking

When sustainability becomes strategic

To further rebuild stakeholder confidence, financial institutions may need to broaden their governance and disclosure policies



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Although the worst of the global financial crisis is past, its legacy continues to place new demands on financial institutions around the world.

Decreased customer and stakeholder loyalty has been one of the prime ripple effects. A 2010 survey by AllixPartners showed a nearly 36 percent increase in customer distrust of banks between 2008 and 2009. This trend, although perhaps more muted in Canada, is not without its consequences. The same survey showed that a full 33 percent are changing their investment behaviour and 31 percent are changing their current banking relationship.

These trends indicate that financial institutions face growing challenges in rebuilding stakeholder confidence and restoring customer loyalty. Gone are the days when stakeholders believed that financial reports alone could tell a complete story about enterprise performance. Today, investors and customers expect more comprehensive management of, and broader disclosure of results related to, a full range of both economic and sustainability-related issues, including ethics, corporate governance, risk management and environmental performance.



The need for more comprehensive initiatives

Given the increased expectation of transparency and responsible business practices, many financial institutions are realizing the value of integrating the principles of corporate responsibility and sustainability into core business activities. Responsibility programs traditionally founded in philanthropic commitments are now extending far beyond donation and sponsorship based activities, and are helping drive service excellence and innovation that reflects the changing demands of customers.

Innovative financial institutions are introducing new products, services and programs specifically geared towards advancing sustainability, such as paperless accounts and loans for solar homes. Moreover, new investment and lending policies that demonstrate adherence to sustainable practices are becoming more common—even when this means re-examining historical investments. The rationale for these changes stems from societal pressures, but can contribute to both sustainable growth and improved business performance.

The rewards: Pursuing mutual benefit

Companies cannot create a sustainable enterprise and build social capital overnight. Yet, organizations that commit to sustainable business practices typically find that the rewards outweigh the risks and costs. Organizations taking sustainability into account when making strategic decisions often uncover new stores of innovation that position them to access new markets, introduce new products and services, and reduce costs.

Canada's financial institutions are beginning to benefit in similar ways. For example, financial institutions that capitalize on emerging emissions trading schemes and carbon funds can create new service revenue streams. Likewise, financial institutions that adopt innovative lending practices supporting marginalized communities and populations with limited access to financial services tap underserved markets. Cost reduction is possible through enhancing resource efficiencies, rationalizing assets and suppliers, and reducing waste. Sustainable business practices also improve risk management by broadening

regulatory compliance and ensuring business partners and suppliers adhere to minimum environmental and safety standards. A competitive advantage can be realized by incorporating ethical and sustainable evaluation criteria into investment analysis and decision-making processes.

In order to drive these types of organizational change, financial institutions are paying increasing attention to the information and tools available to guide strategic decision making.

Adopting sustainability reporting best practices

Canadian banks will need to further evolve their approach to sustainability reporting to remain competitive on the global stage. To achieve this goal, financial institutions should:

- Determine materiality in the context of sustainability reporting. As this concept is broader than financial statement materiality, financial institutions need to consider whether issues like brand management, stakeholder engagement, supplier standards and climate change risks require inclusion in ongoing sustainability disclosures
- Strengthen their reporting processes and controls by expanding their enterprise risk assessments, business practices, information systems and internal controls to address sustainability issues
- Ensure that independent third parties can assure the accuracy of information included in their sustainability reports
- Continually adopt innovative corporate responsibility practices that enable them to create value—both for the enterprise in particular and for society in general.





Voluntary disclosure, regulatory compliance and risk management

In an environment of increased stakeholder interest in non-traditional performance measures, the activities encompassed by sustainability reporting are on the rise. Voluntary initiatives—like the UN Global Compact and the Carbon Disclosure Project—require signatories to disclose their performance across a wide range of categories. Other initiatives focus specifically on financial industry practices, such as the UN Principles for Responsible Investment and the Equator Principles, which encourage institutional investors to adhere to key principles designed to minimize the negative effects that environmental, social and corporate governance issues can have on investment portfolio performance.

While many of these sustainability reporting frameworks remain voluntary, their adoption is growing and the tide is turning. In countries such as Denmark, France and South Africa, publicly listed companies are already required to report comprehensive sustainability information. While there are no similar requirements in Canada, the Canadian Securities Administrators (CSA) released guidance in October 2010 designed to

help report issuers understand their existing environmental disclosure requirements. A global drive towards an integrated framework for financial and sustainability reporting by public companies is well underway.

In the meantime, private and institutional investors are increasingly relying on voluntary environmental, social and governance disclosures when making investment decisions. This is compelling companies in the capital markets to step up their commitment to sustainability reporting and work towards continuous performance improvement.

Enhanced reporting practices

Financial institutions are recognizing the need to implement well-controlled information systems and monitor their sustainability initiatives in a way that allows them to report on their progress in a timely, comprehensive and credible manner. Equally importantly, they are beginning to use this information to enhance management decision making. This may explain why sustainability reporting—which has long been the domain of environmental, health and safety, and even marketing departments—is increasingly coming under the purview of the CFO. This trend is set to expand as rating agencies and investors increasingly incorporate sustainability measures and disclosures in their financial decision making.

Making this transition to expanded non-traditional management information and public disclosures is no easy task, but there are initiatives that lead the way. The Global Reporting Initiative (GRI), for instance, provides Financial Services Sector-specific guidance for the disclosure of economic, social and environmental information.

To achieve a GRI A level declaration—indicating the highest level of transparency—a financial institution's sustainability report must follow the guidelines set out in the GRI Financial Services Sector Supplement (FSSS). Financial institutions declaring a "+" after

their declaration level must have had the report assured by an independent third party, using a systematic process that allows the assurance provider to draw conclusions on the veracity of the report and its data and claims. Most major Canadian banks declared a GRI C level in their 2009 reports, implying that not all indicators were included nor third-party assurance obtained. None have yet achieved A+ level status—the benchmark reporting level established by a select group of their international counterparts.

The Global Reporting Initiative (GRI) Financial Services Sector Supplement (FSSS)

The GRI FSSS was created through a multi-stakeholder process that included the broad global participation of industry, academics and NGOs, among others. The FSSS provides additional interpretation of the existing cross-industry GRI G3 guidelines and indicator content, and also introduces a number of new sector-specific performance indicators. The FSSS was created to ensure that sustainability reports produced by financial services companies address all key sector issues.

In the FSSS, the coverage of the G3 guidelines is expanded in the areas of:

- Product portfolio
- Audit
- Active ownership
- Economic performance
- Emissions, effluents and waste
- Investment and procurement practices
- Community
- Product and service labelling.

**GRI reporting levels:
A sustainability blind
spot for financial services?**

The financial sector has taken up the sustainability challenge, offering new “green” products and financing and occupying LEED-certified buildings. But are these efforts enough to project a “sustainable brand”? Research into GRI reporting across all sectors of Canadian economic sectors shows that multiple Canadian companies are reporting at level A, while the majority of the Canadian financial sector reports at level C. Although formal sustainability performance reporting at any level is a sound step toward strengthening stakeholder confidence, higher levels of disclosure would further help financial institutions credibly build their reputations as “sustainable” organizations.

The future

Ultimately, financial institutions that best understand how their operations affect society and in turn work towards building stronger communities, while minimizing their direct and indirect impact on the environment, will be those best positioned to expand their market share in the years to come.



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