MANAGEMENT DISCUSSION AND ANALYSIS OF OPERATING PERFORMANCE

Management Discussion and Analysis of Operating Performance

HIGHLIGHTS

Figure 1 KEY PERFORMANCE MEASURES

(millions of dollars)	1996	1995	1994	1993	1992
Net income	**$ 914**	$ 794	$ 683	$ 275	$ 408
Net income per common share – basic	**2.95**	2.51	2.14	.82	1.25
– fully diluted	**2.89**	2.48	2.12	.82	1.25
Productivity ratio (expenses as a % of revenue)	**61.0%**	60.2%	59.6%	59.2%	57.6%
Provision for credit losses as a % of net average loans and bankers' acceptances	**.18**	.23	.48	.91	.94
Return on common equity	**15.4**	14.3	13.3	5.4	8.4
Return on assets	**.80**	.76	.72	.34	.58
Net common equity as a % of risk-weighted assets	**6.2**	6.7	6.5	6.3	6.9
Tier 1 capital to risk-weighted assets[1]	**6.8**	7.4	7.2	7.0	7.4
Dividends as a % of closing market price[2]	**4.2**	4.3	3.8	4.2	4.1
Total market return	**36.2**	20.1	1.4	20.1	2.1

[1] 1994 Tier 1 capital includes proceeds of a preferred share issue on November 1, 1994 of $225 million. 1993 Tier 1 capital has been restated to reflect the proceeds of a U.S. $175 million preferred share issue on November 1, 1993.

[2] Calculated as a percentage of the prior year's closing market price per common share.

Overview

Net income continued to grow reaching $914 million in 1996, up 15% from 1995 and 34% from 1994. Net income per common share, return on common equity and return on assets have also improved. The improved performance is attributable to:

- a record level of other income, which increased 21% over last year and reflected growth in brokerage and other securities operations;
- a 9% growth in the Bank's average earning assets to $102.8 billion; and
- a 15% decline in the provision for credit losses to $152 million, the lowest level in over ten years.

These positive factors were partially offset by a 12 basis point decline in the net interest margin.

Initiatives undertaken to further enhance shareholder value during the year included the:

- acquisition of Waterhouse Investor Services, Inc. This doubled the Bank's size in the rapidly growing discount brokerage business. Waterhouse, which has 600,000 accounts and 90 branches in 41 states and the District of Columbia, will join forces with Green Line Investor Services, making it the third largest discount broker in North America. Both will continue to operate under their current names and management but will share technology and expertise;
- listing on the New York Stock Exchange;
- announcement of the largest share buyback in Canadian banking history, calling for the repurchase of up to 47 million common shares (16 million of which were repurchased this year). After this buyback, the Bank will remain one of the most strongly capitalized banks in Canada;
- sale of the Bank's institutional and pension custody business to another bank. The Bank lacked the volumes and economies of scale necessary for long-term superior returns;
- agreement with two other banks to "co-source" cheque and document processing services. A new jointly-owned company has been formed to handle all three institutions' activities, improving economies of scale and reducing processing costs. This will be phased in over the next three years and will result in annual expenditure savings of at least 15% for these services; and
- acquisition of the Quantitative Capital Division of AMI Partners Inc. The Bank became Canada's largest index investment manager with this acquisition.

To further enhance customer service, the Bank:

- unveiled TD Access: PC – North America's first fully integrated personal computer banking and brokerage delivery channel, offering personal and commercial banking and discount brokerage services all in one Windows-based package;
- announced a new pilot project with two other financial institutions to test eXACT, a computer chip based "smart" card for small purchases;
- launched TD Life Insurance Company, a wholly-owned subsidiary, and introduced a new health service called TD LifeLine. TD LifeLine will provide toll-free hotline telephone access to a wide variety of health and lifestyle information and will roll out a full range of life and health insurance products;
- introduced the TD Asset Accumulator Account making it easier for customers to manage asset allocation and foreign content by consolidating TD and other mutual funds and investments in one account;
- will be offering securities trading on the Internet with Green Line WebBroker, allowing investors to buy and sell North American equities, options and mutual funds; and
- introduced two new mutual funds.

The economic environment

The weak economic conditions that prevailed during calendar 1995 continued into the first part of 1996, as Canada's real gross domestic product grew at an annualized rate of only 1.3% in both the first and second quarters of the year. However, the pace of economic growth began to pick up in the second half of the year.

- Whereas 1995's poor economic performance reflected weakness in final demand that was partially offset by a large buildup in non-farm inventories, the sluggish growth in the first half of 1996 reflected a sharp drop in non-farm business inventories that offset much of the strong increase in final demand. The latter was boosted by a surge in Canada's surplus in international trade in response to the continuing economic expansion in the U.S. With inventories in better alignment with sales by mid-1996, a major source of economic weakness was removed, and later economic indicators suggest that the pace of overall economic growth accelerated during the summer months.
- Residential construction activity has been strong in 1996, stimulated by steady declines in mortgage rates. Sales of existing homes have increased sharply, followed by more moderate gains in new housing starts.
- In spite of employment cutbacks in the public sector related to the continuing fiscal restraint by the federal and provincial governments, 148,000 net new jobs were created during the first ten months of 1996 – more than were created during the full year 1995. However, job growth was not fast enough to bring the unemployment rate below the 9.5% that prevailed in 1995.
- Although the Canadian economy began to strengthen in 1996, a great deal of slack remains in both the labour market and in productive capacity, dampening inflationary pressures. In October, the rate of overall consumer price inflation was 1.8% and the core rate of inflation (excluding food, energy and indirect taxes) was only 1.3%, near the bottom of the Bank of Canada's 1% to 3% target range. No significant acceleration in the rate of inflation seems likely in the near term.
- One of the most striking developments of importance for financial markets was the emergence of an international current account surplus in the second quarter of 1996 – the first since 1984. It seems likely that a small current account surplus will be achieved for the year as a whole and will increase in future years, enabling Canada to begin to reduce its very large net international debt.
- Also important for financial markets in 1996 was the continued improvement in the fiscal positions of the federal and provincial governments. The combined federal and provincial budget deficit for the fiscal year ended March 31, 1996 was $40.4 billion, down from $53.3 billion in the previous fiscal year and well below the peak deficit of $65.9 billion in fiscal 1992-1993. If the budget plans made this past spring are realized, the combined deficit will fall below $35 billion in the current fiscal year.

Financial markets

The Canadian financial environment improved significantly in 1996, benefiting from continued low inflation, shrinking government budget deficits and the emergence of an international current account surplus, all of which helped to restore the confidence of international investors in Canadian financial assets.

- Canadian short-term interest rates declined virtually without interruption during the first ten months of the year, despite occasional jumps in U.S. short-term rates. The yield on Government of Canada three-month treasury bills fell from an average of 5.79% in December 1995 to 3.35% in October 1996, and chartered bank prime lending rates dropped from 7.50% at the end of 1995 to 5% at the end of October 1996 – the lowest rate since early 1959.
- Canadian long-term bond yields were somewhat more volatile, following U.S. yields up during the first part of 1996 (although not by as much), but falling after mid-year. In October, the yield on the Government of Canada benchmark long bond averaged 7.29%, compared with an average of 7.71% in December 1995.
- Falling interest rates have had a positive impact on Canadian stock markets. The Toronto Stock Exchange 300 composite index rose by almost 19% from 4,714 at the end of 1995 to 5,599 on October 31, 1996.
- The Canadian dollar demonstrated considerable stability in 1996, trading mainly within the relatively narrow range of 72 to 74 U.S. cents.
- One of the most significant financial developments in 1996 was the emergence of large negative spreads between Canadian and U.S. short and medium-term interest rates, as Canadian rates fell below U.S. rates, and the dramatic narrowing of long-term bond yield spreads. The spread between Canadian and U.S. three-month treasury bill yields swung from a positive 48 basis points in December 1995 to a negative 177 basis points in October. The spread between long-term government bond yields narrowed from 165 basis points in December 1995 to 48 basis points in October 1996.

Figures 2-10 BUSINESS PERFORMANCE

Figure 2 CONSOLIDATED STATEMENT OF INCOME (TEB)

(millions of dollars)	Canada		United States		Other international		Total		
	1996	1995	**1996**	1995	**1996**	1995	**1996**	1995	1994
Net interest income	**$ 2,226**	$ 2,153	**$ 273**	$ 254	**$ 109**	$ 105	**$ 2,608**	$ 2,512	$ 2,483
Taxable equivalent adjustment	**136**	120	**–**	–	**–**	–	**136**	120	109
Net interest income (TEB)	**2,362**	2,273	**273**	254	**109**	105	**2,744**	2,632	2,592
Provision for credit losses	**125**	166	**30**	31	**(3)**	(17)	**152**	180	345
Net interest income after credit loss provision (TEB)	**2,237**	2,107	**243**	223	**112**	122	**2,592**	2,452	2,247
Other income	**1,379**	1,149	**174**	148	**55**	30	**1,608**	1,327	1,147
Net interest and other income (TEB)	**3,616**	3,256	**417**	371	**167**	152	**4,200**	3,779	3,394
Non-interest expenses	**2,414**	2,251	**142**	96	**98**	66	**2,654**	2,413	2,209
Net income before provision for income taxes (TEB)	**1,202**	1,005	**275**	275	**69**	86	**1,546**	1,366	1,185
Imputed income taxes on grossed-up income	**523**	452	**110**	115	**(1)**	5	**632**	572	502
Net income	**$ 679**	$ 553	**$ 165**	$ 160	**$ 70**	$ 81	**$ 914**	$ 794	$ 683
Percentage contribution to consolidated net income	**74.3%**	69.6%	**18.0%**	20.1%	**7.7%**	10.3%	**100%**	100%	100%

Figure 3 EARNINGS PER COMMON SHARE ANALYSIS

	1996	**1995**	**1994**
Prior year's basic earnings per common share	**$ 2.51**	$ 2.14	$ .82
Increases (decreases)			
Net interest income (TEB) – asset growth	**.89**	.80	1.25
– margin	**(.44)**	(.67)	(.36)
Provision for credit losses	**.09**	.55	.84
Other income	**.98**	.60	.49
Non-interest expenses	**(.88)**	(.68)	(.14)
Imputed income taxes	**(.22)**	(.24)	(.72)
Preferred dividends	**.02**	.01	(.04)
Current year's earnings per common share – basic	**$ 2.95**	$ 2.51	$ 2.14
– fully diluted	**$ 2.89**	$ 2.48	$ 2.12
Number of common shares (millions) – at year end	**302.7**	301.4	301.2
– average	**298.6**	301.3	301.1

Figure 4 AVERAGE BALANCES AND INTEREST RATES (TEB)

(millions of dollars)			1996			1995			1994
	Average balance	Interest	Average rate	Average balance	Interest	Average rate	Average balance	Interest	Average rate
Assets									
Deposits with banks	$ 3,914	$ 200	5.12%	$ 3,306	$ 148	4.46%	$ 2,259	$ 79	3.50%
Securities									
Investment	11,638	745	6.41	13,794	871	6.32	12,319	697	5.65
Trading	10,314	618	5.99	5,535	395	7.15	3,859	184	4.77
Total securities	21,952	1,363	6.21	19,329	1,266	6.56	16,178	881	5.44
Loans									
Residential mortgages	27,331	2,195	8.03	25,830	2,179	8.44	24,590	2,051	8.34
Consumer instalment, credit card and other personal	9,415	900	9.56	8,675	904	10.42	7,983	717	8.98
Business and government	31,597	2,472	7.82	32,849	2,778	8.46	32,674	2,126	6.51
Securities purchased under resale agreements	8,592	469	5.45	4,262	245	5.75	2,969	101	3.39
Total loans	76,935	6,036	7.85	71,616	6,106	8.53	68,216	4,995	7.32
Total earning assets	102,801	7,599	7.39	94,251	7,520	7.98	86,653	5,955	6.87
Customers' liability under acceptances	6,247	–	–	5,997	–	–	4,396	–	–
Other assets	4,730	–	–	3,992	–	–	4,271	–	–
Total assets	$113,778	$ 7,599	6.68%	$104,240	$ 7,520	7.22%	$ 95,320	$ 5,955	6.25%
Liabilities									
Deposits									
Banks	$ 10,924	$ 592	5.42%	$ 12,057	$ 704	5.84%	$ 11,931	$ 440	3.69%
Personal	40,204	1,881	4.68	39,657	2,069	5.22	38,834	1,653	4.26
Business and government	30,763	1,485	4.83	28,379	1,513	5.33	25,661	1,059	4.13
Total deposits	81,891	3,958	4.83	80,093	4,286	5.35	76,426	3,152	4.12
Subordinated notes	2,420	157	6.49	2,561	170	6.63	2,477	133	5.39
Securities sold short or under repurchase agreements	13,241	719	5.43	6,840	403	5.89	3,065	68	2.21
Other interest-bearing liabilities	264	21	8.07	311	29	9.35	147	10	6.80
Total interest-bearing liabilities	97,816	4,855	4.96	89,805	4,888	5.44	82,115	3,363	4.10
Acceptances	6,247	–	–	5,997	–	–	4,396	–	–
Other liabilities	3,336	–	–	2,466	–	–	3,373	–	–
Equity – preferred	558	–	–	619	–	–	636	–	–
– common	5,821	–	–	5,353	–	–	4,800	–	–
Total liabilities	$113,778	$ 4,855	4.27%	$104,240	$ 4,888	4.69%	$ 95,320	$ 3,363	3.53%
Total net interest income		$ 2,744	2.41%		$ 2,632	2.53%		$ 2,592	2.72%

Average balances and interest rates

Total average earning assets increased $8.6 billion during 1996 compared to an increase of $7.6 billion during 1995. As in the prior year, the largest increase occured in trading securities.

Securities

Average trading securities increased by $4.8 billion during 1996, reflecting growth in the Bank's investment dealer operations in Toronto, London and New York in the latter part of fiscal 1995.

At year end, the market value of the Bank's debt and equity securities portfolios held for investment and liquidity purposes was $213 million above book value. This improvement of $253 million from October 31, 1995 was assisted by declines in market interest rates and continued strong equities markets.

Loans

Average loans increased 7% in 1996. The $4.3 billion increase in securities purchased under resale agreements was the major contributor to that growth and reflected the expansion of the Bank's New York trading operations. The increase of $1.5 billion in residential mortgages can be attributed to higher real estate activity caused by lower interest rates.

Despite our growth in volume, our market share in Canadian currency personal loans and residential mortgages remained at approximately 13.4% during the past three years. The Bank's market share in Canadian currency business loans and bankers' acceptances declined to 12.3% from 12.4% in 1995 and 12.1% in 1994.

Deposits and other interest liabilities

The $8.0 billion increase in total interest-bearing liabilities was largely due to an increase in securities sold short or under repurchase agreements.

Total average deposits increased by $1.8 billion during 1996 compared to $3.7 billion during 1995. During 1996, the $2.4 and $.5 billion growth in business and government, and personal deposits, respectively, was offset by a $1.1 billion decrease in bank deposits.

The Bank's market share in Canadian currency business non-term deposits increased to 14.9% from 14.3% in 1995 and 14.5% in 1994. The Bank's market share in Canadian currency business term deposits increased to 11.9% from 9.9% in 1995 and 10.9% in 1994. The Bank's market share in Canadian currency personal non-term deposits reached 15.6% from 15.4% in 1995 and 1994. However, the Bank's market share in Canadian currency term deposits remained at 11.9% in 1996 and 1995 compared to 12.7% in 1994.

Figure 5 NET INTEREST RATE MARGIN (TEB)

(millions of dollars)	1996			1995			1994		
	Average earning assets	Net interest income	Margin	Average earning assets	Net interest income	Margin	Average earning assets	Net interest income	Margin
Canada	$ 74,882	$ 2,333	3.12%	$ 72,171	$ 2,255	3.12%	$ 66,165	$ 2,260	3.42%
United States	18,179	220	1.21	15,766	208	1.32	14,955	228	1.52
Other international	9,740	88	.90	6,314	77	1.22	5,533	72	1.31
	102,801	2,641	2.57	94,251	2,540	2.70	86,653	2,560	2.95
Net investment securities gains		103			92			32	
Total Bank	$102,801	$ 2,744	2.67%	$ 94,251	$ 2,632	2.79%	$ 86,653	$ 2,592	2.99%
Percentage increase over previous year	9.1%	4.2%		8.8%	1.6%		14.3%	11.5%	

Net interest rate margin

Net interest margin continued to decline in 1996, both before and after net investment securities gains. While the margin in Canada remained unchanged, the Bank experienced declines in margins in both U.S. and other international operations.

In the U.S., the 11 basis point decline in the margin was mainly caused by an increase in securities purchased under resale agreements, which are lower yielding assets.

The $101 million increase in total net interest income before net investment securities gains is attributable to an increase in average earning assets, partially offset by the margin decrease described above.

Economic conditions continued to have a favourable impact on the equity markets and the Bank's securities gains, which reached $103 million in 1996, were slightly above the $92 million achieved in 1995 and more than triple the amount in 1994.

Figure 6 ANALYSIS OF CHANGE IN NET INTEREST INCOME (TEB)

(millions of dollars)	1996 vs. 1995			1995 vs. 1994		
	Favourable (unfavourable) due to change in			Favourable (unfavourable) due to change in		
	Average volume	Average rate	Net change	Average volume	Average rate	Net change
Total earning assets	$ 594	$ (526)	$ 68	$ 416	$ 1,089	$ 1,505
Total interest-bearing liabilities	(453)	486	33	(251)	(1,274)	(1,525)
Net interest income	141	(40)	101	165	(185)	(20)
Net investment securities gains	–	11	11	–	60	60
Net interest income	$ 141	$ (29)	$ 112	$ 165	$ (125)	$ 40

Figure 7 OTHER INCOME

(millions of dollars)	1996	1995	1994	1993	1992	Five-year growth rate
Brokerage and other securities services	**$ 366**	$ 215	$ 178	$ 123	$ 81	41.7%
Credit fees	**312**	289	243	178	171	12.1
Service charges	**260**	251	240	231	228	3.4
Card services	**150**	133	87	109	96	9.9
Foreign exchange	**144**	130	154	153	160	(1.0)
Mutual funds	**74**	52	52	26	9	95.3
Derivative financial instruments	**69**	41	45	33	(1)	28.8
Other[1]	**233**	216	148	147	112	20.8
Total	**$ 1,608**	$ 1,327	$ 1,147	$ 1,000	$ 856	14.5%
Percentage increase (decrease) over previous year	**21.1%**	15.8%	14.7%	16.8%	4.6%	

[1] Other includes payroll and cash management services, property rental income, insurance and trust fees.

Other income

Other income increased $281 million in 1996 to $1,608 million.

Major contributions to this increase included:

- $151 million in the Bank's growing brokerage and other securities services, particularly in discount brokerage;
- $28 million in derivative financial instruments revenue, where favourable market conditions prevailed;
- $27 million from the sale of the institutional and pension custody business in the other category;
- $23 million in credit fees as a result of greater customer activity; and
- $22 million in the mutual fund business due to strong growth in fund assets under administration.

Figure 8 ASSETS UNDER ADMINISTRATION AT YEAR END

(millions of dollars)	1996	1995	1994	1996/1995 % increase (decrease)
Retail				
Brokerage – Canada	**$ 18,103**	$ 15,034	$ 11,660	**20.4**
– United States	**18,433**	–	–	**–**
Total brokerage	**36,536**	15,034	11,660	**100+**
Mutual funds – Canada	**9,507**	5,806	5,492	**63.7**
– United States	**2,632**	–	–	**–**
Total mutual funds	**12,139**	5,806	5,492	**100+**
Other	**12,469**	12,755	9,051	**(2.2)**
Total retail	**61,144**	33,595	26,203	**82.0**
Corporate				
Portfolio management	**9,998**	2,215	474	**100+**
Other	**14,457**	12,946	8,475	**11.7**
Total corporate	**24,455**	15,161	8,949	**61.3**
Total assets under administration before institutional and pension custody business	**85,599**	48,756	35,152	**75.6**
Institutional and pension custody business sold	**–**	49,831	44,936	**–**
Total assets under administration	**$ 85,599**	$ 98,587	$ 80,088	**(13.2)**

Assets under administration

The Bank provides custodial and management services on assets owned by customers.

Assets under administration totalled $85.6 billion at October 31, 1996, a decrease of 13% over 1995. This decrease is largely attributable to the $49.8 billion decrease resulting from the sale of the Bank's institutional and pension custody business to another bank.

However, it was partially offset by the $27.5 billion increase in retail assets under administration. Total retail assets under administration grew to a balance of $61.1 billion, more than double the Bank's personal term deposit balances at year end. The Waterhouse acquisition in the U.S. contributed significantly to this increase.

The Bank's increase in mutual fund assets under administration is reflected in its growth in market share in Canada to 4.9% from 4.1% in 1995 and 4.5% in 1994, making it the sixth largest amongst all mutual fund companies in Canada.

We expect retail assets under administration to continue to grow as a result of the:

- acquisition of Waterhouse Investor Services, Inc. in the U.S.;
- strong performance of the Bank's mutual funds versus the competition;
- opening of Green Line Investor Services (Hong Kong) Inc.;
- unveiling of TD Access: PC, which includes a brokerage program; and
- introduction during the year of health sciences and U.S. blue chip equity funds.

Figure 9 NON-INTEREST EXPENSES AND PRODUCTIVITY RATIO

(millions of dollars)	1996	1995	1994	1993	1992	Five-year growth rate
Salaries and staff benefits						
Salaries	**$ 1,337**	$ 1,210	$ 1,116	$ 968	$ 890	9.3%
Staff benefits	**115**	95	105	93	81	11.9
Salaries and staff benefits total	**1,452**	1,305	1,221	1,061	971	9.5
Occupancy						
Rent	**154**	152	146	147	128	5.9
Depreciation	**64**	61	61	55	49	8.2
Other	**65**	70	69	64	60	3.0
Occupancy total	**283**	283	276	266	237	5.6
Equipment						
Rent	**51**	51	40	33	24	25.9
Depreciation	**71**	67	58	59	57	4.8
Other	**115**	98	81	71	73	10.6
Equipment total	**237**	216	179	163	154	10.8
Other						
Marketing and business development	**134**	113	99	90	72	16.3
Professional fees and services	**133**	123	116	92	71	28.3
Capital and business taxes	**93**	87	76	76	74	7.3
Communications	**92**	75	70	61	55	13.6
Deposit insurance premiums	**68**	61	52	37	27	21.2
Postage	**46**	42	38	34	29	11.1
Travel and relocation	**30**	28	25	24	27	2.8
Other	**86**	80	57	121	57	6.9
Other total	**682**	609	533	535	412	13.9
Expenses before restructuring	**2,654**	2,413	2,209	2,025	1,774	10.2
Restructuring	**–**	–	–	140	–	–
Total	**$ 2,654**	$ 2,413	$ 2,209	$ 2,165	$ 1,774	10.2%
Percentage increase	**10.0%**	9.3%	2.0%	22.0%	8.5%	
Productivity ratio						
Net interest income (TEB)	**$ 2,744**	$ 2,632	$ 2,592	$ 2,324	$ 2,226	
Other income	**1,608**	1,327	1,147	1,000	856	
Total revenue (TEB)	**4,352**	3,959	3,739	3,324	3,082	
Non-interest expenses	**2,654**	2,413	2,209	2,165	1,774	
Deduct (add) one time costs or (credits)[1]	**–**	29	(20)	198	–	
Adjusted expenses	**$ 2,654**	$ 2,384	$ 2,229	$ 1,967	$ 1,774	
Productivity ratio (adjusted expenses as a % of total revenue (TEB))	**61.0%**	60.2%	59.6%	59.2%	57.6%	

[1] One time costs and credits relate to the acquisition of new businesses.

Non-interest expenses and productivity ratio

Adjusted non-interest expenses increased $270 million during 1996 and $155 million during 1995, due to:

- continued expansion and activity in our securities businesses;
- performance related compensation including compensation linked to the appreciation in the Bank's share price;
- further development of the Bank's computer and telephone banking systems; and
- higher government levies.

Since the rate of growth in non-interest expenses exceeded that of revenue, the productivity ratio deteriorated slightly during the year.

Figure 10 TAXES

(millions of dollars)	1996	1995	1994	1993	1992
Income taxes					
Provision					
Income statement	**$ 496**	$ 452	$ 393	$ 163	$ 227
Shareholders' equity	**(10)**	2	(17)	(7)	(9)
Total income taxes	**486**	454	376	156	218
Other taxes					
Payroll taxes	**78**	73	72	65	58
Deposit insurance premiums	**68**	61	52	37	27
Capital taxes	**68**	62	53	54	53
GST and provincial sales taxes	**67**	59	55	52	46
Municipal and business taxes	**62**	65	58	55	51
Cost of primary reserve	**–**	–	3	4	7
Total other taxes	**343**	320	293	267	242
Total taxes	**$ 829**	$ 774	$ 669	$ 423	$ 460
Canada	**$ 711**	$ 647	$ 569	$ 341	$ 428
United States	**114**	119	82	64	63
Other international	**4**	8	18	18	(31)
Total taxes	**$ 829**	$ 774	$ 669	$ 423	$ 460
Taxes as a % of net income before taxes	**47.3%**	49.5%	48.9%	60.0%	52.4%

Taxes

Tax expenses continue to grow steadily. For every dollar of pre-tax income earned, almost 48 cents is paid out as income tax or some other type of government levy. While income taxes vary with earnings, other levies are payable regardless of the level of earnings. Income tax rates in Canada are generally higher than rates in other countries. As a result, taxes paid in Canada are significantly higher than the portion of the Bank's business in Canada. Approximately 86% of all taxes are paid in Canada. However only 74% of the Bank's net income was derived from Canada and 73% of earning assets were located in Canada in 1996. Despite the banking industry's already high level of contribution to government revenues, both the federal and Ontario governments targeted banks for tax increases in their 1996 budgets.

There are numerous differences between accounting and tax rules for the timing of recognition of revenues and expenses. For the Bank, the overall result of all timing differences is that income is reported for tax purposes earlier than it is for accounting purposes. The tax payable on timing differences gives rise to a deferred tax asset, which is included in other assets on the balance sheet. The accumulated balance of $148 million at October 31, 1996 represents an advance payment of income tax, mostly to governments in Canada. The components of the deferred tax balance are shown in Note 17 of the Notes to the consolidated financial statements.

The statutory income tax rate applicable to the Bank's earnings in Canada was 43.0%, up slightly from 1995, mostly due to an increase in the rate of federal surtax. Income tax expense in the Consolidated statement of income was 35.2% of pre-tax income. Tax expense is lower than the statutory rate primarily because of two items: lower tax rates in some of the Bank's foreign subsidiaries and tax-exempt dividends earned on Canadian share investments. Under Canadian tax rules, dividends from other Canadian corporations are not taxable since they represent a distribution of earnings that have already been subject to corporate income tax. Because of this tax exemption, dividend rates are less than interest rates on loans but generate approximately the same after-tax income for similar levels of risk. Details on the Bank's effective tax rates are provided in Note 17 of the Notes to the consolidated financial statements.

Figures 11-19

Risk management

Overview

One of the Bank's key objectives is to be the best risk manager among major Canadian banks. This requires a well-established infrastructure to manage the major business risks to which the Bank is exposed. A fundamental principle is the involvement of qualified risk management professionals acting independently from the business units to establish a policy framework and define the risk limits of the Bank.

Corporate policies and limits to control the Bank's credit exposure and exposure to market risk in connection with the Bank's trading activities are set by the Bank's Risk Management Division headed by a Vice Chairman.

Interest rate risk and liquidity risk relative to the Bank's balance sheet are the responsibility of the Asset and Liability Committee which includes senior executives and is chaired by the Chairman and Chief Executive Officer.

Foreign exchange risk on a total Bank basis, excluding exposures relating to trading activities, is managed by the Foreign Currency Exposure Committee chaired by a Vice Chairman. Operational risk is managed through strong internal controls, which include regular internal audits by the Bank's Audit Division.

The Bank's policies and strategies for managing each of the major financial risks are reviewed at least annually by the Risk Policy Committee comprised of the Bank's most senior executives and by the Board of Directors.

Credit risk

Credit risk is the risk of financial loss occurring as a result of a default by a borrower or counterparty on their obligation to the Bank. Direct loans, off-balance sheet commitments to extend credit, settlement exposures, derivatives transactions and securities inventories are all subject to credit risk.

The Bank's key objective in managing credit risk is to limit annual average provisions for losses on credit exposures of all types to .30% of loans and bankers' acceptances over a complete business cycle. With relatively strong economic conditions globally during 1996, the Bank is operating below this benchmark at .18%.

Risk Management Division establishes policies and procedures for the management of credit risk including:

- exposure guidelines to limit portfolio concentrations of credit exposure in relation to common equity by country, industry and affiliated group;
- approval of discretionary limits to approve credit lines accorded to officers throughout the Bank;
- control of all major credit decisions within Risk Management Division;
- formulation of standards for the measurement of credit exposure for all types of facilities;
- approval of the application of scorecarding techniques in the adjudication of personal credit;
- approval of all policies pertaining to all other products and services which have credit risk;

- establishing risk rating criteria for business accounts based on a ten-category rating system;
- an obligatory annual review of each credit being conducted under the direction of the Bank's senior risk management personnel, including a review of the risk rating on the account; and
- review of each classified business credit exposure at least quarterly. Classified credit exposures are those on which the risk of loss to the Bank is considered higher than the Bank's normal standards. General provisions are established to reflect the risk of losses inherent in the portfolio but which have not yet been specifically identified. Where in management's opinion the Bank no longer has reasonable assurance as to the timely collection of the full amount of the principal and interest of a loan, such a loan is further classified as impaired. Specific provisions are established for impaired loans when it is felt that a loss will be incurred or when the estimated value based on discounting expected future cash flows at the rate in force at the time the loan was granted is less than the recorded value. More details on impaired loans are provided in figure 15 of the Management discussion and analysis of operating performance and Note 1, subsections (e) and (f) of the Notes to the consolidated financial statements.

A Risk Adjusted Return on Capital model is employed to assess the return on individual credit relationships in relation to the structure and maturity of the loan and creditworthiness of the borrower.

All credit policies and procedures are reviewed and approved annually by the Board of Directors.

Figure 11 TOTAL ASSETS AT YEAR END BASED ON LOCATION OF ULTIMATE RISK

(millions of dollars)	1996	1995	1994	1996 % mix	1995 % mix	1994 % mix
Canada	**$ 86,117**	$ 81,979	$ 75,948	**68.6**	75.2	76.1
United States	**25,913**	20,188	17,974	**20.6**	18.5	18.0
Total Canada and United States	**112,030**	102,167	93,922	**89.2**	93.7	94.1
Other International						
United Kingdom	**5,553**	1,838	1,662	**4.4**	1.7	1.7
Europe – other	**1,995**	1,063	714	**1.6**	1.0	.7
Australia	**2,542**	1,096	1,759	**2.0**	1.0	1.8
Japan	**1,563**	1,379	830	**1.2**	1.3	.8
Other	**1,961**	1,465	872	**1.6**	1.3	.9
Total assets	**$ 125,644**	$ 109,008	$ 99,759	**100.0**	100.0	100.0

Total assets based on location of ultimate risk

Total assets by location of ultimate risk is a measure of the Bank's exposure to political risk. The Bank minimizes this risk by concentrating its assets in Canada and the United States. At year end, 89% of the Bank's assets were located in these markets.

Figure 12 LOANS AND BANKERS' ACCEPTANCES AT YEAR END

(millions of dollars)

	Canada		United States		Other international		Total		
By sector	**1996**	1995	**1996**	1995	**1996**	1995	**1996**	1995	1994
Residential mortgage	**$ 28,624**	$ 26,327	**$ –**	$ –	**$ –**	$ –	**$ 28,624**	$ 26,327	$ 25,180
Consumer instalment, credit card and other personal	**9,936**	9,081	**786**	54	**10**	12	**10,732**	9,147	8,564
Total residential and personal	**38,560**	35,408	**786**	54	**10**	12	**39,356**	35,474	33,744
Real estate development									
Commercial and industrial	**2,133**	2,541	**539**	815	**36**	59	**2,708**	3,415	3,782
Residential	**1,192**	1,195	**47**	63	**–**	–	**1,239**	1,258	1,390
Shopping centres	**598**	617	**104**	137	**13**	12	**715**	766	723
Total real estate	**3,923**	4,353	**690**	1,015	**49**	71	**4,662**	5,439	5,895
Communication	**518**	753	**2,333**	2,294	**1,633**	948	**4,484**	3,995	4,206
Financial	**1,860**	1,822	**989**	557	**773**	820	**3,622**	3,199	2,639
Utilities	**204**	236	**1,566**	1,918	**1,063**	219	**2,833**	2,373	2,581
Cable television	**549**	561	**1,795**	1,809	**116**	–	**2,460**	2,370	2,547
Food, beverage and tobacco	**1,854**	1,756	**141**	137	**260**	235	**2,255**	2,128	1,858
Forestry	**1,202**	1,174	**492**	506	**247**	192	**1,941**	1,872	2,313
Oil and gas	**1,190**	1,279	**522**	398	**173**	187	**1,885**	1,864	1,554
Metals and mining	**1,050**	1,119	**238**	133	**364**	157	**1,652**	1,409	1,342
Health and social services	**769**	824	**627**	551	**5**	4	**1,401**	1,379	1,267
Agriculture	**1,304**	1,291	**15**	39	**2**	5	**1,321**	1,335	1,246
Chemical	**730**	574	**338**	336	**215**	172	**1,283**	1,082	1,327
Automotive	**860**	792	**117**	127	**137**	101	**1,114**	1,020	904
Transportation	**771**	424	**78**	124	**252**	50	**1,101**	598	672
Apparel and textile	**578**	614	**208**	164	**23**	24	**809**	802	684
Retail	**598**	626	**45**	69	**31**	24	**674**	719	906
Construction	**567**	560	**60**	37	**27**	24	**654**	621	478
Appliance and electrical	**301**	295	**171**	324	**51**	76	**523**	695	564
Government	**439**	836	**33**	34	**–**	–	**472**	870	1,007
Hotels	**284**	303	**–**	–	**–**	–	**284**	303	320
All other loans	**2,473**	2,204	**912**	496	**631**	345	**4,016**	3,045	2,880
Total business and government	**22,024**	22,396	**11,370**	11,068	**6,052**	3,654	**39,446**	37,118	37,190
Securities purchased under resale agreements	**6,082**	6,197	**6,904**	166	**77**	–	**13,063**	6,363	2,736
Total	**$ 66,666**	$ 64,001	**$ 19,060**	$ 11,288	**$ 6,139**	$ 3,666	**$ 91,865**	$ 78,955	$ 73,670
Percentage growth	**4.2**	10.7	**68.9**	(6.9)	**67.4**	(1.1)	**16.4**	7.2	10.4

By location of ultimate risk	**1996**	1995	1994	**1996 % mix**	1995 % mix	1994 % mix
Canada						
Atlantic	**$ 2,178**	$ 2,128	$ 2,168	**2.4**	2.7	2.9
Québec	**5,534**	5,526	5,325	**6.0**	7.0	7.2
Ontario	**39,218**	37,507	35,038	**42.7**	47.5	47.6
Prairies	**8,940**	9,015	8,405	**9.7**	11.4	11.4
British Columbia	**8,329**	7,362	6,838	**9.1**	9.3	9.3
Total Canada	**64,199**	61,538	57,774	**69.9**	77.9	78.4
United States	**19,466**	13,685	12,172	**21.2**	17.3	16.6
Other international						
United Kingdom	**4,133**	1,294	1,252	**4.5**	1.6	1.7
Europe – other	**540**	336	259	**.6**	.4	.4
Australia	**1,971**	830	1,429	**2.1**	1.1	1.9
Japan	**105**	207	91	**.1**	.3	.1
Other	**1,451**	1,065	693	**1.6**	1.4	.9
Total other international	**8,200**	3,732	3,724	**8.9**	4.8	5.0
Total U.S. and other international	**27,666**	17,417	15,896	**30.1**	22.1	21.6
Total	**$ 91,865**	$ 78,955	$ 73,670	**100.0**	100.0	100.0
Percentage growth over previous year						
Canada	**4.3%**	6.5%	9.5%			
International	**58.8**	9.6	13.8			
Total	**16.4%**	7.2%	10.4%			

Loans and bankers' acceptances

The increase in securities purchased under resale agreements of $6.7 billion in 1996 and $3.6 billion in 1995 contributed significantly to the total increase in loans and bankers' acceptances of $12.9 billion in 1996 and $5.3 billion in 1995.

Personal loans and residential mortgages increased by $3.9 billion during 1996, of which $.7 billion relates to Waterhouse, and by $1.7 billion during 1995.

Business and government loans increased by $2.3 billion during 1996 after a decrease of $72 million during 1995. The 1996 increase in business and government loans was broadly distributed among most sectors. All business and government loans are risk rated on a ten-category rating system which is an essential part of the Bank's risk management system, particularly as it relates to managing its concentration to any one industry or group of companies.

Figure 13 REAL ESTATE DEVELOPMENT LOANS AND BANKERS' ACCEPTANCES

(millions of dollars)	1996				1995			
		Impaired		Net impaired as % of		Impaired		Net impaired as % of
	Total	Gross	Net	total	Total	Gross	Net	total
Domestic								
Residential	**$ 1,192**	**$ 43**	**$ 9**	**.8**	$ 1,195	$ 113	$ 78	6.5
Retail	**598**	**11**	**6**	**1.0**	617	14	12	1.9
Commercial/industrial	**2,133**	**159**	**29**	**1.4**	2,541	172	52	2.0
Total domestic	**3,923**	**213**	**44**	**1.1**	4,353	299	142	3.3
United States								
Residential	**47**	**–**	**–**	**–**	63	–	–	–
Retail	**104**	**13**	**11**	**10.6**	137	24	23	16.8
Commercial/industrial	**539**	**169**	**134**	**24.9**	815	270	225	27.6
Total United States	**690**	**182**	**145**	**21.0**	1,015	294	248	24.4
Other International								
Residential	**–**	**–**	**–**	**–**	–	–	–	–
Retail	**13**	**–**	**–**	**–**	12	–	–	–
Commercial/industrial	**36**	**1**	**–**	**–**	59	4	2	3.4
Total other international	**49**	**1**	**–**	**–**	71	4	2	2.8
Total U.S. and other international	**739**	**183**	**145**	**19.6**	1,086	298	250	23.0
Total	**$ 4,662**	**$ 396**	**$ 189**	**4.1**	$ 5,439	$ 597	$ 392	7.2

Real estate development loans and bankers' acceptances

The Bank's strategy is to confine its real estate lending activity primarily to Canada and to continue to reduce its exposure in the commercial/industrial sector. In 1996, the decline in real estate development loans and bankers' acceptances related to the domestic and U.S. portfolio. The residential and retail sectors in Canada have largely returned to stable market conditions and the outlook for the commercial/industrial sector appears to be improving. Portfolio quality improved significantly with net impaired real estate development loans and bankers' acceptances declining year over year from 7.2% to 4.1% of total real estate loans and bankers' acceptances.

Figure 14 LOANS TO SMALL BUSINESS

(millions of dollars)	Loans authorized			Amount outstanding		
Loan amount	**1996**	1995	1994	**1996**	1995	1994
(thousands of dollars)						
0-24	**$ 267**	$ 251	$ 234	**$ 179**	$ 220	$ 193
25-49	**415**	404	391	**285**	282	268
50-99	**915**	882	842	**627**	613	580
100-249	**2,200**	2,174	2,086	**1,491**	1,511	1,426
250-499	**2,094**	2,024	2,056	**1,327**	1,343	1,328
500-999	**2,372**	2,270	2,241	**1,307**	1,328	1,351
1,000-4,999	**6,617**	6,347	6,683	**3,132**	3,278	3,305
Total*	**$ 14,880**	$ 14,352	$ 14,533	**$ 8,348**	$ 8,575	$ 8,451

* Personal loans used for business purposes are not included in these totals.

Loans to small business

During 1996, we were successful in increasing loans authorized to small business in every size category and in every region of Canada. The Main$treet Banking program, started in 1995, should prove successful in expanding our activities in this important sector and in providing every small business with the option of dealing with their local branch for loans up to $250,000.

Figure 15 IMPAIRED LOANS LESS ALLOWANCE FOR CREDIT LOSSES AT YEAR END

(millions of dollars)	Canada		United States		Other international		Total		
By sector	**1996**	1995	**1996**	1995	**1996**	1995	**1996**	1995	1994
Residential mortgages	**$ 52**	$ 43	**$ –**	$ –	**$ –**	$ –	**$ 52**	$ 43	$ 62
Consumer instalment, credit card and other personal	**23**	24	**–**	–	**–**	–	**23**	24	17
Total residential and personal	**75**	67	**–**	–	**–**	–	**75**	67	79
Real estate development									
Commercial and industrial	**29**	52	**134**	225	**–**	2	**163**	279	191
Residential	**9**	78	**–**	–	**–**	–	**9**	78	100
Shopping centres	**6**	12	**11**	23	**–**	–	**17**	35	16
Total real estate	**44**	142	**145**	248	**–**	2	**189**	392	307
Communication	**–**	110	**–**	–	**–**	–	**–**	110	15
Financial	**2**	9	**–**	–	**–**	–	**2**	9	15
Utilities	**–**	1	**17**	–	**–**	–	**17**	1	40
Forestry	**–**	–	**–**	–	**–**	–	**–**	–	131
Oil and gas	**1**	4	**–**	–	**–**	–	**1**	4	5
Metals and mining	**–**	3	**–**	1	**–**	–	**–**	4	34
Health and social services	**2**	7	**–**	23	**–**	–	**2**	30	7
Agriculture	**2**	7	**–**	–	**–**	–	**2**	7	5
Chemical	**13**	3	**–**	–	**–**	–	**13**	3	1
Automotive	**2**	4	**–**	–	**–**	–	**2**	4	10
Apparel and textile	**–**	2	**–**	–	**–**	–	**–**	2	4
Retail	**–**	2	**–**	–	**–**	–	**–**	2	20
Appliance and electrical	**14**	21	**–**	–	**–**	–	**14**	21	21
Construction	**–**	3	**–**	–	**–**	–	**–**	3	5
Transportation	**–**	–	**–**	7	**–**	–	**–**	7	8
Hotels	**5**	15	**–**	–	**–**	–	**5**	15	7
All other loans	**15**	23	**7**	–	**–**	–	**22**	23	13
Total business and government	**100**	356	**169**	279	**–**	2	**269**	637	648
Total net impaired loans	**$ 175**	$ 423	**$ 169**	$ 279	**$ –**	$ 2	**$ 344**	$ 704	$ 727
Amounts due on defaulted derivative financial instruments included above	**$ –**	$ –	**$ –**	$ 4	**$ –**	$ –	**$ –**	$ 4	$ 8
Impaired loans as a % of common equity							**5.6**	12.8	14.4

By location of ultimate risk	**1996**	1995	1994	**1996 % mix**	1995 % mix	1994 % mix
Canada						
Atlantic	**$ 3**	$ 8	$ 6	**.9**	1.2	.8
Québec	**29**	77	79	**8.4**	10.9	10.9
Ontario	**142**	329	259	**41.3**	46.7	35.6
Prairies	**1**	8	6	**.3**	1.1	.8
British Columbia	**–**	1	167	**–**	.2	23.0
Total Canada	**175**	423	517	**50.9**	60.1	71.1
United States	**169**	279	175	**49.1**	39.6	24.1
Other international						
United Kingdom	**–**	2	9	**–**	.3	1.2
Europe – other	**–**	–	–	**–**	–	–
Australia	**–**	–	26	**–**	–	3.6
Other	**–**	–	–	**–**	–	–
Total other international	**–**	2	35	**–**	.3	4.8
Total U.S. and other international	**169**	281	210	**49.1**	39.9	28.9
Total net impaired loans	**$ 344**	$ 704	$ 727	**100.0**	100.0	100.0
Net impaired loans as a % of net loans and bankers' acceptances	**.4%**	.9%	1.0%			

Net impaired loans

Net impaired loans decreased by a further $360 million during 1996. This decrease is attributable to reductions in impaired loans in the real estate and communications industries.

Figure 16 IMPACT ON NET INTEREST INCOME DUE TO IMPAIRED LOANS

(millions of dollars)	1996	1995	1994
Reduction / (increase) in net interest income due to impaired loans			
Gross	**$ 79**	$ 137	$ 140
Recoveries	**(44)**	(81)	(47)
Net reduction	**$ 35**	$ 56	$ 93

Figure 17 PROVISION FOR CREDIT LOSSES

(millions of dollars)	Canada		United States		Other international		Total		
By sector	**1996**	1995	**1996**	1995	**1996**	1995	**1996**	1995	1994
Residential mortgages	**$ 6**	$ 9	**$ –**	$ –	**$ –**	$ –	**$ 6**	$ 9	$ 7
Consumer instalment, credit card and other personal	**81**	84	**–**	–	**–**	–	**81**	84	105
Total residential and personal	**87**	93	**–**	–	**–**	–	**87**	93	112
Real estate development									
Commercial and industrial	**15**	4	**9**	52	**(1)**	(4)	**23**	52	169
Residential	**(17)**	9	**1**	11	**–**	–	**(16)**	20	46
Shopping centres	**5**	74	**10**	8	**–**	–	**15**	82	37
Total real estate	**3**	87	**20**	71	**(1)**	(4)	**22**	154	252
Communication	**(5)**	79	**2**	(27)	**(2)**	(4)	**(5)**	48	(15)
Financial	**–**	(3)	**–**	–	**–**	(1)	**–**	(4)	8
Utilities	**–**	–	**7**	(2)	**–**	–	**7**	(2)	1
Cable television	**–**	(1)	**–**	–	**–**	–	**–**	(1)	1
Food, beverage and tobacco	**–**	8	**–**	–	**–**	–	**–**	8	(3)
Forestry	**19**	(98)	**1**	(12)	**–**	–	**20**	(110)	32
Metals and mining	**(7)**	(5)	**(2)**	3	**–**	–	**(9)**	(2)	(54)
Health and social services	**2**	2	**6**	(1)	**–**	–	**8**	1	(3)
Agriculture	**–**	2	**–**	–	**–**	–	**–**	2	(1)
Chemical	**5**	–	**–**	5	**–**	–	**5**	5	1
Automotive	**–**	4	**–**	–	**–**	–	**–**	4	5
Apparel and textile	**(3)**	(1)	**(1)**	–	**–**	–	**(4)**	(1)	18
Retail	**9**	(1)	**–**	(5)	**–**	(6)	**9**	(12)	4
Appliance and electrical	**(1)**	1	**–**	–	**–**	–	**(1)**	1	(1)
Construction	**1**	–	**–**	–	**–**	–	**1**	–	4
Transportation	**6**	(1)	**(1)**	–	**–**	3	**5**	2	(20)
Hotels	**–**	(5)	**–**	–	**–**	–	**–**	(5)	7
All other	**9**	5	**(2)**	(1)	**–**	(5)	**7**	(1)	(3)
Total business and government	**38**	73	**30**	31	**(3)**	(17)	**65**	87	233
Total	**$ 125**	$ 166	**$ 30**	$ 31	**$ (3)**	$ (17)	**$ 152**	$ 180	$ 345
Provision on defaulted derivative financial instruments included above	**$ –**	$ –	**$ –**	$ –	**$ –**	$ –	**$ –**	$ –	$ (4)

By location of ultimate risk	**1996**	1995	1994	**1996 % mix**	1995 % mix	1994 % mix
Canada						
Atlantic	**$ 2**	$ 1	$ 5	**1.3**	.5	1.4
Québec	**3**	30	82	**2.0**	16.7	23.8
Ontario	**75**	136	194	**49.3**	75.5	56.2
Prairies	**8**	3	(4)	**5.3**	1.7	(1.1)
British Columbia	**37**	(4)	5	**24.3**	(2.2)	1.4
Total Canada	**125**	166	282	**82.2**	92.2	81.7
United States	**30**	31	97	**19.7**	17.2	28.1
Other international						
United Kingdom	**(3)**	(6)	(22)	**(1.9)**	(3.3)	(6.4)
Europe – other	**–**	–	–	**–**	–	–
Australia	**–**	(11)	(12)	**–**	(6.1)	(3.4)
Other	**–**	–	–	**–**	–	–
Total other international	**(3)**	(17)	(34)	**(1.9)**	(9.4)	(9.8)
Total U.S. and other international	**27**	14	63	**17.8**	7.8	18.3
Total	**$ 152**	$ 180	$ 345	**100.0**	100.0	100.0

Provision for credit losses as a % of net average loans and bankers' acceptances outstanding	**1996**	1995	1994
Canada			
Residential mortgages	**.02%**	.03%	.03%
Personal	**.86**	.97	1.32
Business and other	**.14**	.27	.71
Total Canada	**.20**	.27	.50
United States	**.21**	.26	.83
Other international	**(.06)**	(.45)	(.91)
Total	**.18%**	.23%	.48%

Provision for credit losses

As a result of continued improvement in the quality of the Bank's corporate loans, the provision for loan losses has been reduced to $152 million from $180 million in 1995 and $345 million in 1994. Both the provision and the related ratio of the provision for credit losses as a percentage of average loans and bankers' acceptances were at their lowest level in over ten years.

The total real estate sector has continued to show significant improvement. The related provision has decreased by $132 million in 1996 compared to a decrease of $98 million in 1995.

Market risk

Market risk can be defined as the risk of loss resulting from changes in the prices of financial instruments in the markets in which the Bank trades. The Bank engages in trading activities to meet the financial needs of its customers and to generate revenues through its trading activities. The Bank has three fundamental trading activities which generate revenue:

- market making to service the needs of the Bank's clients with the intention of making a profit based on the spread between bid and ask prices;
- arbitrage of risk positions between closely related markets; and
- proprietary trading in anticipation of changes which may occur in markets.

The vast majority of the Bank's trading activity relates to market making, which is a relatively stable business with revenues substantially related to the volume of trading activity. Trading portfolios consist of cash instruments (eg. bonds, treasury bills, spot foreign exchange and equities) and derivative financial instruments (eg. interest rate, foreign exchange and equity swaps and options, and interest rate and foreign exchange forwards and futures).

The management of market risk exposures in relation to established limits is the primary responsibility of qualified trading personnel in each regional trading centre based on practices and procedures established by the Risk Management Division, including:

- establishing methodologies for valuation of trading positions and for measuring the effect of movements in market prices on such positions;
- approval of trading limits for each business unit. Limits for interest rate contracts are based on statistical measures such as Value at Risk and such other notional, liquidity and stop loss limits as are appropriate based on the specific trading activity. Value at Risk is calculated as the potential overnight financial loss from adverse market movements which would cover 97.5% of potential market price movements with no change in trading positions;
- performing alternative scenario analyses to estimate the impact of sudden and extreme movements in market prices on the trading portfolio; and
- approval of all new trading products to ensure all management and control procedures are in place before new products are launched.

All market risk policies and procedures are reviewed annually by the Board of Directors.

Figure 18 Derivative financial instruments at year end

(millions of dollars)

By sector	Canada 1996	Canada 1995	Canada 1994	United States 1996	United States 1995	United States 1994	Other international 1996	Other international 1995	Other international 1994	Total 1996	Total 1995	Total 1994
Current replacement cost:												
Financial	**$ 2,286**	$ 2,235	$ 1,657	**$ 525**	$ 590	$ 458	**$ 1,969**	$ 3,029	$ 2,152	**$ 4,780**	$ 5,854	$ 4,267
Government	**384**	232	113	**–**	1	2	**16**	–	2	**400**	233	117
Utilities	**245**	151	128	**52**	77	29	**–**	1	29	**297**	229	186
Cable television	**173**	84	24	**20**	39	76	**–**	23	–	**193**	146	100
Communication	**92**	100	108	**10**	7	24	**25**	14	56	**127**	121	188
Oil and gas	**26**	40	35	**10**	15	14	**4**	–	2	**40**	55	51
Forestry	**18**	26	19	**25**	23	35	**2**	3	1	**45**	52	55
Food, beverage and tobacco	**28**	22	16	**8**	11	23	**8**	7	3	**44**	40	42
Chemical	**5**	10	11	**12**	16	30	**4**	4	15	**21**	30	56
Transportation	**10**	9	16	**–**	–	6	**–**	2	5	**10**	11	27
Health and social services	**–**	1	–	**1**	6	15	**–**	–	–	**1**	7	15
Real estate	**7**	3	6	**–**	–	3	**3**	2	1	**10**	5	10
Other	**129**	89	33	**11**	2	11	**13**	88	26	**153**	179	70
Current replacement cost	**$ 3,403**	$ 3,002	$ 2,166	**$ 674**	$ 787	$ 726	**$ 2,044**	$ 3,173	$ 2,292	**$ 6,121**	$ 6,962	$ 5,184

Derivatives

The current replacement cost of derivative financial instruments represents the estimated amounts that would be received by the Bank if the instruments were sold. At year end, 78% of these amounts related to instruments with counterparties in the financial industry and 67% were with counterparties resident in North America. The impact of netting agreements has been excluded from the calculation of current replacement cost.

Interest rate risk

Interest rate risk is measured by the extent to which changes in market interest rates impact margins, net interest income and the economic value of the Bank's equity. To the extent the term structure of interest-bearing assets differs from that of liabilities, net interest income will increase or decrease as a result of movements in interest rates. If, for example, longer term fixed rate assets are funded with short-term deposits and interest rates rise, interest margins will be reduced and net interest income will decline. The Bank's goal is to achieve stable earnings growth through active management of its asset and liability positions. The Asset and Liability Committee (ALCO) manages interest rate risk by increasing or decreasing positions within limits specified in the Bank's interest rate risk policies. These limits restrict the potential impact of movements in interest rates on current earnings and on the value of interest sensitive assets and liabilities. In managing the term structure of our assets and liabilities the ALCO considers, among other things, current economic forecasts, the expected direction of interest rates and market spreads between assets and liabilities of the same maturity. Changes to positions are usually accomplished through changes in the Bank's funding mix, hedging with derivative products or varying the Bank's holdings of government securities. The Bank has access to all these markets and can quickly reposition itself as market conditions dictate.

The Bank's interest rate risk policies are reviewed and approved annually by the Board of Directors.

Foreign exchange risk

The Bank has assets and liabilities denominated in several foreign currencies. Foreign exchange risk arises when the actual or forecasted assets in a foreign currency are either greater or less than the liabilities in that currency.

In order to minimize the impact of exchange rate volatility, the ratio of the net foreign currency investments in Bank subsidiaries to total foreign currency assets is kept at a level that is approximately equal to the Bank's common equity to total assets ratio. The Bank does not actively speculate in foreign exchange and has established specific foreign exchange risk management policies. Foreign exchange risk is managed by the Foreign Currency Exposure Committee.

The Bank's policies for foreign exchange risk management are reviewed and approved by the Board of Directors annually.

Liquidity risk

The objective of sound and prudential liquidity management is to ensure that funds will be available at all times to honour all cash outflow obligations as they become due. To minimize liquidity risk, the Bank ensures that core and long-term deposits are maintained at a very high proportion of total deposits relative to that represented by wholesale demand, notice and short-term deposits. As well, the Bank's prudent funding management recognizes the impact of large single depositors and ensures that there is no reliance on one customer or small group of customers.

The Bank also maintains liquid assets in both Canadian and foreign currencies at prudential levels to ensure that cash can quickly be made available to honour its obligations. The Bank has specific policies regarding required liquid asset coverage of short-term wholesale deposits and policies limiting dependence on individual depositors. These policies are monitored by the ALCO.

Liquidity management also recognizes the impact of potential cash outflows arising from irrevocable commitments to fund new assets or from bankers' acceptances falling into bank loans. The Bank monitors known cash outflows from large funding commitments as well as from bankers' acceptance maturities.

In the event of a liquidity crisis, contingency plans are in place to ensure the Bank continues to honour all of its cash outflow obligations.

The Bank's liquidity management policies are reviewed and approved annually by the Board of Directors.

Figure 19 INTEREST SENSITIVITY AT YEAR END

(billions of dollars) 1996	Within 3 months[1]	3 months to 1 year[2]	Total within 1 year[2]	1 year to 5 years[2]	Over 5 years[2]	Non-interest sensitive[3]	Total
Assets							
Cash resources	**$ 2.9**	**$ 1.0**	**$ 3.9**	**$ –**	**$ –**	**$ 1.3**	**$ 5.2**
Securities	**17.7**	**1.8**	**19.5**	**3.0**	**.2**	**1.5**	**24.2**
Loans	**49.8**	**13.9**	**63.7**	**20.6**	**.5**	**.7**	**85.5**
Other	**6.4**	**–**	**6.4**	**–**	**–**	**4.3**	**10.7**
Total assets	**76.8**	**16.7**	**93.5**	**23.6**	**.7**	**7.8**	**125.6**
Liabilities							
Deposits	**56.3**	**15.5**	**71.8**	**12.7**	**.1**	**3.0**	**87.6**
Subordinated notes	**.5**	**.3**	**.8**	**.3**	**1.2**	**–**	**2.3**
Other	**24.7**	**–**	**24.7**	**.1**	**–**	**4.2**	**29.0**
Shareholders' equity	**.1**	**–**	**.1**	**–**	**.5**	**6.1**	**6.7**
Total liabilities and shareholders' equity	**81.6**	**15.8**	**97.4**	**13.1**	**1.8**	**13.3**	**125.6**
On-balance sheet sensitivity position	**(4.8)**	**.9**	**(3.9)**	**10.5**	**(1.1)**	**(5.5)**	**–**
Off-balance sheet sensitivity position	**(1.8)**	**1.0**	**(.8)**	**(.4)**	**1.2**	**–**	**–**
Total interest rate sensitivity position	**$ (6.6)**	**$ 1.9**	**$ (4.7)**	**$ 10.1**	**$ .1**	**$ (5.5)**	**$ –**
Components of the position							
Canadian currency	**$ (6.0)**	**$ 1.9**	**$ (4.1)**	**$ 9.2**	**$ .3**	**$ (5.4)**	**$ –**
Foreign currency	**(.6)**	**–**	**(.6)**	**.9**	**(.2)**	**(.1)**	**–**
1995							
Assets							
Cash resources	$ 3.6	$ .2	$ 3.8	$ –	$ –	$ .5	$ 4.3
Securities	13.6	2.3	15.9	4.3	.2	1.8	22.2
Loans	40.8	10.8	51.6	19.4	.7	1.0	72.7
Other	6.6	–	6.6	–	–	3.0	9.6
Total assets	64.6	13.3	77.9	23.7	.9	6.3	108.8
Liabilities							
Deposits	53.9	14.4	68.3	9.4	.4	3.0	81.1
Subordinated notes	.2	–	.2	1.0	1.2	–	2.4
Other	15.6	–	15.6	.1	–	3.5	19.2
Shareholders' equity	.1	–	.1	–	.5	5.5	6.1
Total liabilities and shareholders' equity	69.8	14.4	84.2	10.5	2.1	12.0	108.8
On-balance sheet sensitivity position	(5.2)	(1.1)	(6.3)	13.2	(1.2)	(5.7)	–
Off-balance sheet sensitivity position	4.2	(.9)	3.3	(4.9)	1.6	–	–
Total interest rate sensitivity position	$ (1.0)	$ (2.0)	$ (3.0)	$ 8.3	$ .4	$ (5.7)	$ –
Components of the position							
Canadian currency	$ (1.5)	$ (1.0)	$ (2.5)	$ 7.7	$ .4	$ (5.6)	$ –
Foreign currency	.5	(1.0)	(.5)	.6	–	(.1)	–

[1] Includes instruments which reprice immediately.
[2] Includes all fixed rate instruments that will reprice within the noted time frames.
[3] Includes instruments that will never reprice.

Interest rate sensitivity

After maintaining the Bank's interest rate risk position at fairly constant and conservative levels throughout 1995, the Bank's objective in 1996 was to increase the position moderately to take advantage of the reduction in Canadian rates and the positively sloping yield curve. The resulting improvements in income served to somewhat offset a decrease in margins on core deposits and equity that was also caused by the lowering of interest rates. The Bank's liability sensitive position within one year as at October 31, 1996 was $4.7 billion compared to $3.0 billion one year earlier.

An immediate and sustained one per cent increase in rates would reduce net income after tax by approximately $23 million as at October 31, 1996 versus $30 million as at October 31, 1995. The same one per cent increase in rates would reduce the present value of common equity by approximately $160 million versus $102 million last year.

Liquidity

The Bank maintains a strong liquidity position in both Canadian and U.S. dollars. As at October 31, 1996, the Bank's liquidity was supported by $10.9 billion and $4.2 billion in highly liquid Canadian and U.S. assets, respectively (compared to $11.9 billion and $4.1 billion, respectively at October 31, 1995). These assets include Canadian and U.S. government bonds and treasury bills, deposits with the Bank of Canada, top investment grade bankers' acceptances and commercial paper. As well, the Bank's liquidity is supported by a stable base of personal Canadian dollar core and term deposits. As at October 31, 1996, Canadian currency personal deposits were 70% of total Canadian currency deposits.

Operational risk

Operational risk is the risk of loss resulting from errors or fraud. These risks are mitigated through:

- internal controls designed to prevent employees from performing incompatible functions, safeguard assets, ensure that transactions are recorded correctly and financial statements are accurately prepared, and verify that the Bank is in compliance with regulations;
- the Bank's Audit Division which performs regular audits to ensure that internal controls are functioning adequately and that correct accounting procedures are being followed;
- trained and competent personnel;
- systems support by competent and well-trained professionals; and
- continual upgrades of our systems and procedures.

In the event of a disaster, contingency plans are in place to ensure business operations will continue.

Figures 20-21

Capital management

Figure 20 Capital structure and ratios at year end

(millions of dollars)	Proforma 1996[1]	1996	1995	1994
Tier 1 capital[2]				
Retained earnings	**$ 4,840**	**$ 4,840**	$ 4,636	$ 4,163
Common shares	**1,305**	**1,305**	882	879
Qualifying preferred shares	**534**	**534**	535	537
Less: unamortized goodwill	**522**	**522**	–	–
Total Tier 1 capital	**6,157**	**6,157**	6,053	5,579
Tier 2 capital[1]				
Preferred shares	**–**	**–**	–	85
Subordinated notes	**2,685**	**2,335**	2,404	2,469
Less: amortization of subordinated notes	**59**	**59**	29	15
Total Tier 2 capital	**2,626**	**2,276**	2,375	2,539
Total capital[1,2]	**$ 8,783**	**$ 8,433**	$ 8,428	$ 8,118
Capital ratios[1,2]				
To total assets				
Common shareholders' equity	**4.9%**	**4.9%**	5.1%	5.1%
Total shareholders' equity	**5.3**	**5.3**	5.6	5.7
To risk-weighted assets				
Net common shareholders' equity	**6.2**	**6.2**	6.7	6.5
Tier 1 capital	**6.8**	**6.8**	7.4	7.2
Tier 2 capital	**2.9**	**2.5**	2.9	3.3
Total capital	**9.7**	**9.3**	10.3	10.4
Assets to capital multiple[3]	**15.0**	**15.7**	13.8	13.1

[1] 1996 proforma includes the November 1, 1996 issuance of a $350 million subordinated note.

[2] 1994 Tier 1 and total capital include $225 million proceeds from a preferred share issue received November 1, 1994.Excluding these proceeds, 1994 ratios affected by this issue were total shareholders' equity to total assets 5.5%, Tier 1 capital to risk-weighted assets 6.9%, total capital to risk-weighted assets 10.2% and assets to capital multiple 13.5.

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

Capital structure and ratios

Capital management controls the acquisition, maintenance and retirement of capital. The objectives are to provide sufficient capital to maintain the confidence of investors and depositors while providing a satisfactory return to common shareholders, who provide the vast majority of the capital. Adequate capital is critical to the continuing operations of the Bank, as evidenced by the fact that under the Bank Act most capital decision-making is reserved for the Board of Directors.

Management of the Bank's capital includes the following specific objectives:

- to be an adequately capitalized financial institution as defined by relevant regulatory authorities and as compared to its peer group;
- to maintain capitalization consistent with strong ratings;
- to achieve the lowest overall cost of capital consistent with preserving the appropriate mix of capital elements;
- to ensure that sufficient and appropriate capital is either at hand or readily available at reasonable cost to facilitate expansion and provide sufficient protection against unexpected events; and
- to provide a satisfactory return to common shareholders.

The $355 million proforma increase in total capital resulted from:

- earnings after dividends of $580 million, offset by unamortized goodwill of $522 million from the acquisition of Waterhouse;
- a proforma increase of $281 million in subordinated notes; and
- the issuance of 16.7 million common shares with a value of $459 million as part of the purchase consideration for Waterhouse. This was partly offset by the repurchase of 16.1 million common shares on Canadian stock exchanges. The Bank intends to repurchase a further amount of up to 30 million additional common shares prior to October 31, 1997, subject to the continued maintenance of adequate capital ratios.

Capital ratios provide measures of financial strength and flexibility. The Office of the Superintendent of Financial Institutions Canada measures the capital adequacy of Canadian banks in accordance with its instructions for determining risk-adjusted capital and risk-weighted assets and off-balance sheet exposures. The risk-based approach is based on the Bank for International Settlements' agreed framework for achieving a more consistent measurement of capital adequacy and standards for banks engaged in international business.

The Bank regards the ratio of net common shareholders' equity to risk-weighted assets as the most important benchmark of capital adequacy since it excludes preferred shares which are sometimes regarded as not possessing the same capital quality as common equity. In addition, the ratio deducts intangible assets, principally goodwill, which are also deducted from Tier 1 capital, in order to facilitate comparison among banks.

While the Bank's ratio of net common shareholders' equity to risk-weighted assets has been affected by the deduction of $522 million in goodwill, the year end ratio of 6.2% places it in the top position compared to other major Canadian banks.

Figure 21 RISK-WEIGHTED ASSETS AT YEAR END

(millions of dollars)	1996 Balance	1996 Risk-weighted balance	1995 Balance	1995 Risk-weighted balance	1994 Balance	1994 Risk-weighted balance
Balance sheet assets						
Cash resources	**$ 5,216**	**$ 862**	$ 4,351	$ 765	$ 3,148	$ 497
Securities	**24,224**	**10,785**	22,128	8,557	19,310	4,860
Loans	**85,454**	**46,570**	72,658	42,125	68,861	43,364
Customers' liability under acceptances	**6,411**	**6,411**	6,297	6,297	4,809	4,809
Other assets	**4,339**	**3,524**	3,574	2,962	3,631	2,645
Total balance sheet assets	**$ 125,644**	**68,152**	$ 109,008	60,706	$ 99,759	56,175
Credit instruments						
Guarantees and standby letters of credit		**5,807**		5,455		5,335
Documentary and commercial letters of credit		**108**		57		74
Note issuance facilities/revolving underwriting facilities		**58**		126		181
Commitments to extend credit		**13,593**		12,590		13,563
Total credit instruments		**19,566**		18,228		19,153
Derivative financial instruments						
Interest rate contracts						
Forward rate agreements		**10**		15		14
Swaps		**965**		795		661
Options purchased		**104**		175		88
Total interest rate contracts		**1,079**		985		763
Foreign exchange contracts						
Forward contracts		**993**		1,623		1,073
Swaps		**150**		113		107
Cross currency interest rate swaps		**289**		333		416
Options purchased		**83**		100		48
Total foreign exchange contracts		**1,515**		2,169		1,644
Equity and commodity contracts		**84**		46		–
Total derivative financial instruments		**2,678**		3,200		2,407
Total risk-weighted assets		**$ 90,396**		$ 82,134		$ 77,735

Risk-weighted assets

With the growth in total assets of $16.6 billion in 1996 and $9.2 billion in 1995, the Bank's risk-weighted balance sheet assets increased by $7.4 billion in 1996 and $4.5 billion in 1995.

When risk assessments are made, balance sheet and off-balance sheet exposures are reviewed collectively. The risk associated with derivative financial instruments was relatively low, in 1996 and 1995, comprising only 3% and 4% of the total risk-weighted assets at October 31, 1996 and 1995, respectively. The variety of methods used to monitor and control the various financial risks to which the Bank is exposed are outlined in the introduction to the risk management section of the Management discussion and analysis of operating performance.