BMO Capital Markets

Tax Tailwind Coming to an End

Industry Rating: **Market Perform**

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Although Canadian Banks Should Enjoy a Widening Relative Tax Advantage to Their Global Peers

Highlights

- There is a major federal budget coming up on March 4, 2010, in which the Federal Government should show how they are going to materially reduce the $50 billion plus fiscal deficit they are running. As the largest corporate cash tax payers in the country, Canada's large banks may be perceived as easy targets.
- Our conclusion is that Canadian banks may be adversely impacted by a delay or adjustment to the planned reduction in the statutory federal corporate rate from 19.0% in 2009 to 15.0% in 2013. The province of Ontario may also delay or adjust its planned reduction in corporate rates from 14% to 10%.
- Canadian banks have been major beneficiaries of a decade-long decline in corporate income tax rates and non-income tax levies. Over the last decade, lower taxation has increased the Canadian bank after-tax return on equity (ROE) by about 2¼% (on a base near 15%) and annual EPS growth to 7% from 5%.
- We do not expect a return to higher corporate tax rates in Canada, or any new bank taxes, but we do expect this tax tailwind for bank earnings to dissipate. In other jurisdictions, tax rates and other fees or levies appear to be on the rise, particularly in the bank sector. Accordingly, Canadian banks should remain relative winners with respect to taxes.

Introduction

Governments in other countries are threatening to increase the taxation of banks in their jurisdictions as payback for the recent pain they have inflicted on taxpayers and to create a fund to cover future bailouts. There has been no taxpayer financed bailout of banks in Canada and therefore one would think no reason for governments to go after Canadian banks (the Minister of Finance recently stated that the banks face no new taxes). However, there is a major federal budget coming up on March 4, 2010, and the Federal Government must show how they are going to materially reduce the $50 billion plus fiscal deficit they are running. As the largest corporate cash tax payers in the country, Canada's large banks may be perceived as easy targets. A review of our thoughts on this subject might be useful.

Banks Have Benefitted From Tax Tailwind

With the objective of improving productivity and being globally competitive, Canada has been reducing the taxation of corporate profits. Canada is moving from a high tax to a relatively low tax jurisdiction. The combined federal/provincial corporate tax rate in 2000 was 42.3%. We estimate the rate in 2009 was 31.6% and will be 30.4% in 2010.

Pertinent Canadian bank tax facts are included in Table 1. From the data provided in Table 1, we believe that there are two important items to note. First, reported tax rates are lower than statutory tax rates as banks earn tax exempt income (mainly eligible dividends from Canadian corporations) and income from lower tax jurisdictions. While some banks operate in lower tax jurisdictions, financial institutions often engage in capital arbitrage to allocate a disproportionate amount of capital to lower tax jurisdictions and hence lower effective tax rates. We expect regulators and governments will set limits on this type of capital arbitrage. Governments around the world are looking at the unconsolidated activities of banks in their countries with the desire that banks hold more capital in those jurisdictions where the risks are being taken as additional protection in the event of failure. Currently, we estimate the use of lower tax jurisdictions lowers the Canadian bank tax rate by about 5% (2010E) and increases after-tax earnings by about 6% (2010E). While we do not know how regulators and governments will attempt to curtail this activity, we believe some of this benefit to Canadian bank shareholders will disappear over the next several years (often referred to as the solo capital rules in Basel discussions).

Second, banks pay two types of taxes: income taxes and non-income taxes (includes capital taxes, payroll taxes, GST, business & property taxes). The total tax burden, which includes income taxes and non-income taxes, has grown at a compound annual rate of 2% over the last five and ten years. This total tax burden has fallen from roughly 42% of pre-tax earnings in 2000 to an estimated 30% in 2010. Other countries are imposing material special non-income taxes on their banks (i.e., U.K. tax on excess employee bonuses, materially higher deposit insurance premiums, Obama tax on uninsured bank liabilities, etc.). We do not believe these types of taxes will be imposed in Canada, which would also improve the relative competitive position of Canada and its banks.

Table 1: Canadian Bank Tax Facts (Big 6 Banks - $Cdn million)

												Compound Growth rate	
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010E	Last 10 Years	Last 5 Years
Pre-Tax Earnings	$17,095	$15,937	$12,126	$18,427	$21,520	$20,405	$27,213	$26,716	$15,475	$21,452	$28,800	5.4%	7.1%
Less: Non-Income (Hidden) Taxes(1)	$2,485	$2,794	$2,912	$2,994	$2,980	$3,090	$3,010	$2,870	$2,897	$3,100	$3,200	2.6%	0.7%
Pre Income Tax Earnings (A)	$14,610	$13,143	$9,214	$15,433	$18,540	$17,315	$24,203	$23,846	$12,578	$18,352	$25,600	5.8%	8.1%
Less Impact of:													
Tax Exempt Income (2)	$1,168	$1,178	$1,370	$2,133	$2,135	$2,412	$2,761	$4,273	$4,180	$3,456	$3,300		
Income Earned in Lower Tax Jurisdictions	$3,162	$4,079	$3,293	$3,557	$2,587	$3,580	$5,644	$7,044	$6,014	$4,762	$4,000		
Other (3)	($634)	$752	($195)	($627)	($346)	($2,410)	$2,064	$722	$919	($2,017)	$0		
Total	$3,696	$6,009	$4,468	$5,063	$4,376	$3,582	$10,469	$12,039	$11,113	$6,201	$7,300		
Taxable Income (B)	$10,914	$7,134	$4,746	$10,370	$14,164	$13,733	$13,734	$11,807	$1,465	$12,151	$18,300	5.3%	5.9%
Reported Tax Provision (C)	$4,620	$2,923	$1,816	$3,770	$4,961	$4,778	$4,783	$4,100	$475	$3,835	$5,560		
After Tax Net Income	$9,990	$10,220	$7,398	$11,663	$13,579	$12,537	$19,420	$19,746	$12,103	$14,517	$20,040	7.2%	9.8%
Reported Tax Rate (C as a % of A)	**31.6%**	**22.2%**	**19.7%**	**24.4%**	**26.8%**	**27.6%**	**19.8%**	**17.2%**	**3.8%**	**20.9%**	**21.7%**		
Statutory Tax Rate (C as a % of B)	**42.3%**	**41.0%**	**38.3%**	**36.4%**	**35.0%**	**34.8%**	**34.8%**	**34.7%**	**32.4%**	**31.6%**	**30.4%**		
Use of Lower Tax Jurisdictions Impact	$1,338	$1,672	$1,261	$1,295	$905	$1,246	$1,964	$2,444	$1,961	$1,505	$1,216		
On Tax Rate	-9.2%	-12.7%	-13.7%	-8.4%	-4.9%	-7.2%	-8.1%	-10.2%	-15.6%	-8.2%	-4.8%		
On Net Income	13.4%	16.4%	17.0%	11.1%	6.7%	9.9%	10.1%	12.4%	16.2%	10.4%	6.1%		
Total Tax Burden(4)	7,105	5,717	4,728	6,764	7,941	7,868	7,793	6,970	3,372	6,935	8,760	2.1%	2.2%
Total Tax Burden (%)	**41.6%**	**35.9%**	**39.0%**	**36.7%**	**36.9%**	**38.6%**	**28.6%**	**26.1%**	**21.8%**	**32.3%**	**30.4%**		
Other Income Taxes Booked Directly to Equity (5)	($408)	($1,812)	$333	$3,661	$1,647	$305	$806	$3,417	($7,314)	$5,152	$1,000		

Notes:

(1) Includes capital taxes, payroll taxes, GST, business & property taxes and deposit insurance premiums up until 2007.

(2) Mainly eligible dividends from Canadian corporations which are tax free.

(3) Mainly tax impact of special charges, goodwill impairment, tax recoveries etc.

(4) Total Tax Burden = reported tax provision + Other Non-Income (Hidden) Taxes

(5) mainly income tax charges/recoveries booked directly in shareholders equity via accumulated other comprehensive income (loss).

Note: On a taxable equivalent basis, the reported tax rate has declined from 37.3% to 25.5% from fiscal 2000 to fiscal 2009.

Source: BMO Capital Markets, CBA

Conclusion

Canadian banks have been major beneficiaries of a reduction in their tax burden. Over the last decade, lower income taxation has increased the Canadian bank after-tax return on equity (ROE) by about 2¼ % (on a base near 15%) and annual EPS growth to 7% from 5%. We do not expect a return to higher corporate tax rates in Canada but we do unfortunately expect this tailwind for bank earnings will dissipate at least over the next several years.

Canadian statutory corporate tax rates (federal and provincial) are currently scheduled to decline to the 25–26% level by 2013. However, we believe that the scheduled tax reductions in the upcoming Federal Budget in March will either be delayed or moderated. Moreover, we would not be surprised if planned Ontario corporate tax rate reductions from 14% in 2009 to 10% in 2013 were altered. Nonetheless, current corporate income tax rates are more attractive in Canada than the U.S., which is at 35%, and we believe that most developed countries are likely to raise levies and taxes on banks. Accordingly, Canadian banks should remain relative winners with respect to taxes.

In summary, looking forward, instead of a continuing reduction in Canadian bank tax rates, we believe investors should assume that Canadian bank tax rates will stay flat (at the 2010 level). This outcome should be better than the situation banks in other countries face.

For individual banks, changes in statutory tax rates and hidden taxes have a relatively uniform impact across the group. Major differences within the bank group often revolve around tax benefits of generating income in low tax jurisdictions (see Table 2). Over the last couple of years, TD and BMO have generated the greatest benefit from earnings in relatively low tax jurisdictions while National and RY have benefitted the least. While difficult to predict, we would not be surprised if government and regulatory action reduced the tax benefits from foreign subsidiaries by 25–30% over the next five years.

***Table 2:** Effective Tax Rate Movement Analysis*

2009	BMO	BNS	CM	NA	RY	TD
Canadian statutory tax rate	**31.6%**	**31.6%**	**31.8%**	**32.0%**	**31.4%**	**31.8%**
Impact of:						
Tax rate applicable to foreign subsidiaries	(10.2%)	(6.8%)	(7.3%)	(3.9%)	(6.5%)	(14.1%)
Tax exempt income	(7.7%)	(3.5%)	(2.0%)	(7.8%)	(5.4%)	(10.5%)
Tax rate change	0.2%	2.5%				
Intangible assets / Impairment					5.7%	
Other	(3.4%)	(0.2%)	3.7%	1.4%	3.2%	0.4%
Reported tax rate	***10.5%***	***23.6%***	***26.2%***	***21.7%***	***28.4%***	***7.6%***
2008	**BMO**	**BNS**	**CM**	**NA**	**RY**	**TD**
Canadian statutory tax rate	**32.7%**	**32.6%**	**32.7%**	**32.5%**	**32.5%**	**32.7%**
Impact of:						
Tax rate applicable to foreign subsidiaries	(16.0%)	(9.4%)	7.3%	(7.0%)	(7.5%)	(11.1%)
Tax exempt income	(9.9%)	(7.0%)	3.0%	(10.2%)	(5.4%)	(8.4%)
Tax rate change	0.2%	1.5%			0.8%	
Other	(10.6%)	(0.2%)	9.1%	5.6%	2.4%	0.1%
Reported tax rate	***(3.6%)***	***17.5%***	***52.1%***	***20.9%***	***22.8%***	***13.3%***
2007	**BMO**	**BNS**	**CM**	**NA**	**RY**	**TD**
Canadian statutory tax rate	**35.0%**	**34.7%**	**34.8%**	**33.5%**	**34.6%**	**34.9%**
Impact of:						
Tax rate applicable to foreign subsidiaries	(17.9%)	(8.9%)	(10.4%)	(11.5%)	(10.4%)	(7.2%)
Tax exempt income	(4.9%)	(6.0%)	(5.1%)	(12.5%)	(3.9%)	(9.1%)
Tax rate change	0.1%	0.8%			0.4%	0.3%
Other	(4.4%)	(0.3%)	(5.7%)	2.0%	(0.9%)	(0.6%)
Reported tax rate	***7.9%***	***20.3%***	***13.6%***	***11.5%***	***19.8%***	***18.3%***
2006	**BMO**	**BNS**	**CM**	**NA**	**RY**	**TD**
Canadian statutory tax rate	**34.9%**	**34.9%**	**34.8%**	**33.5%**	**34.7%**	**35.0%**
Impact of:						
Tax rate applicable to foreign subsidiaries	(7.8%)	(10.3%)	(8.1%)	(4.2%)	(9.6%)	(4.5%)
Tax exempt income	(2.6%)	(4.8%)	(4.5%)	(6.7%)	(3.0%)	(4.2%)
Tax rate change	(0.1%)	0.1%			0.2%	0.2%
Other	(3.7%)	(0.7%)	(2.9%)	0.9%	0.3%	(10.7%)
Reported tax rate	***20.7%***	***19.2%***	***19.3%***	***23.5%***	***22.6%***	***15.8%***

Source: Company reports

Other Regulatory Capital and Tax Research Links

"A Long-Term Perspective on Bank Returns and Valuation" released on January 8, 2010

"The Heavy Hand of BIS" released on December 18, 2009

"Regulatory Changes: Broader than Capital Ratios" released on December 10, 2009

"Carney Speech Highlights Higher Capital Requirements" released on October 26, 2009

"New Capital Rules on Trading Books May Not Be Inconsequential" released October 19, 2009

"Regulatory Changes: Not Just a Bank Story" released on October 23, 2009

Table 3: *Canadian Banks - Comparable Statistics*

	Stock Symbol	ROR Target 1-Year	Price Target 1-Year	Rating	Price 28-Jan-10	% Price Change L12-mths	GAAP EPS* 2009	GAAP EPS* 2010E	GAAP EPS* 2011E
S&P/TSX Bank Index		18%	1,994	Market Perform	1,756	54%	105.2	142.2	166.1
Royal Bank	**RY**	20%	$62.00	Market Perform	$53.48	69%	$2.57	$3.92	$4.63
CIBC	**CM**	17%	$72.00	Market Perform	$64.60	33%	$2.64	$5.53	$6.47
Bank of Montreal	**BMO**	15%	$58.00	Market Perform	$52.85	57%	$3.07	$4.18	$4.93
Scotiabank	**BNS**	14%	$50.00	Market Perform	$45.69	47%	$3.31	$3.53	$4.03
TD Bank	**TD**	21%	$74.00	Outperform	$63.30	49%	$3.61	$4.69	$5.55
National Bank	**NA**	16%	$64.00	Market Perform	$57.37	57%	$5.00	$5.40	$5.90
Laurentian Bank	**LB**	16%	$43.00	Market Perform	$38.38	25%	$4.23	$4.30	$4.85
Canadian Western	**CWB**	24%	$25.00	Outperform	$20.50	75%	$1.47	$1.65	$1.90
S&P/TSX Composite		11%	12,250	-	11,274	27%			

	CASH EPS* 2009	CASH EPS* 2010E	CASH EPS* 2011E	P/Cash EPS 2010E	P/Cash EPS Target 2010E	Current BVPS	Current TBVPS	P/B	P/TBV	Cash ROE 2010E	Indicated Dividend	Yield	Mkt Cap ($bil)
S&P/TSX Bank Index	118.3	148.3	172.0	11.8x	13.4x	901.2	636.8	195%	276%	15.9%	74.5	4.2%	$242.4
Royal Bank	$3.40	$4.05	$4.75	13.2x	15.3x	$22.67	$15.55	236%	344%	16.9%	$2.00	3.7%	$75.8
CIBC	$2.50	$5.60	$6.55	11.5x	12.9x	$28.96	$22.47	223%	287%	18.8%	$3.48	5.4%	$24.8
Bank of Montreal	$3.14	$4.25	$5.00	12.4x	13.6x	$31.95	$27.95	165%	189%	13.6%	$2.80	5.3%	$29.2
Scotiabank	$3.37	$3.60	$4.10	12.7x	13.9x	$20.55	$17.74	222%	258%	17.3%	$1.96	4.3%	$46.8
TD Bank	$4.19	$5.25	$6.10	12.1x	14.1x	$41.13	$20.72	154%	305%	13.3%	$2.44	3.9%	$54.4
National Bank	$5.00	$5.40	$5.90	10.6x	11.9x	$33.43	$26.45	172%	217%	16.3%	$2.48	4.3%	$9.2
Laurentian Bank	$4.23	$4.30	$4.85	8.9x	10.0x	$40.21	$33.62	95%	114%	10.7%	$1.44	3.8%	$0.9
Canadian Western	$1.47	$1.65	$1.90	12.4x	15.2x	$12.16	$11.91	169%	172%	13.9%	$0.44	2.1%	$1.3
S&P/TSX Composite	595	720	800	15.7x	17.0x	6,030		187%		9.5%	315	2.8%	

S&P/TSX Bank Index does not include Home Capital in index per share data.

* Unusual items (as defined by ourselves) included in EPS and cash EPS detailed above are; RY – various structured credit losses amounting to $0.65 and other items totalling $0.01 in 2008; market related losses of $0.89, securitization gains of $0.13 and restructuring charge of $0.03 in 2009. Cash earnings exclude impact of unusual $1 bn ($0.71 per share) goodwill writedown in 2009.

CIBC – structured credit and monoline write-downs of $13.94 and other items amounting to $0.25 in 2008 and CLO and structured credit charges, various mark to market losses and write-downs and general provisions of $3.04 in 2009.

BMO - structured credit and market-related net charges of $0.83 and various items netting to a recovery of $0.27 in 2008 and structured credit-related and ABCP charges of $0.84 and $0.15 of severence in 2009.

BNS – structured credit, monoline and market-related writedowns of $0.82 in 2008 and AFS and CDO write-downs and securities gains of $0.17 in 2009.

TD – mark to market gain on CDS of $0.06 and other charges amounting to $0.26 in 2008 and mark to market of CDS and derivatives gains, restructuring charges at TD Commerce and litigation charges of $1.06 in 2009.

NA – ABCP-related charges of $0.67, gain on sale of subsidiaries of $0.48 in 2008 ABCP-related charges of $1.29 in 2009.

LB – a tax items totalling $0.14, a gain on MXX shares of $0.45 and a BCL gain of $0.18 in 2008 and $0.48 in 2009; CWB – tax charges of $0.01 in 2008 and stock based compensation expense of $0.03 in 2009.

Excluding these items, Cash EPS are: RY - $4.29 in 2008 and $4.19 in 2009; CIBC - $7.19 in 2008 and $5.54 in 2009; BMO - $4.39 in 2008 and $4.13 in 2009; BNS - $3.91 in 2008 and $3.58 in 2009; TD - $5.75 in 2008 and $5.25 in 2009; NA – $5.85 in 2008 and $6.29 in 2009; LB - $3.90 in 2008 and $3.75 in 2009; CWB - $1.59 in 2008 and $1.50 in 2009.

Cash earnings are GAAP EPS adjusted for the after-tax impact of amortization of intangibles. Cash ROE is based on common equity, not tangible common equity. S&P/TSX Composite EPS are accrual operating

ONE-YEAR PRICE TARGETS ASSUME:

4.50% 10+year Canada yield one year out current: 3.88%
Current relative yield vs 10+ Bonds: 109.4%
2.50% ave. prime rate (in 2010) - current rate 2.25%
0% dividend growth - last 12 months 0%
Dividend yield of 4.0% or 90% of the long bond rate target
Est. share buybacks in 2009 and 2010 of $0 (down from $2.8 bn in 2007)
New stock supply: In 2009, RY - $2.3 bil, TD - $1.4 bil, BMO - $1.1 bil, BNS - $0.5 bil.
Est. dividend reinvestment flow (DRIP): 2009 - $1.8b, 2010 - $3.0b
2010 estimated relative P/E: 79%
P/BK value ratio of : 200%

COMPARATIVE VALUATION

	Top 6 Cdn. Banks	Top 4 Cdn. Insurers	Top 12 U.S. Banks[1]	Top 4 U.K. Banks[2]	Top 4 Aust. Banks[2]
P/Cash EPS (2010E)[2]	11.8x	11.3x	9.6x	13.7x	14.3x
Yield	4.2%	7.3%	0.7%	2.4%	4.8%
Price/Book	195%	149%	109%	137%	215%
Price Change '10 YTD	-5.4%	0.5%	9.7%	-6.0%	-1.8%
10-Yr Gov't Bonds	3.17	3.17	3.30	3.39	5.32

[1] Source: First Call; YTD return based on Philadelphia KBW 24 Bank Index; Includes 2 largest investment banks and excludes processing banks.

[2] U.K. and Australian banks reflect accrual earnings and IBES estimates.

Source: Company Reports, Bloomberg, Fame, BMO CM estimates

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Buy	Outperform	32.2%	12.3%	38.3%	36.1%	47.9%	50%
Hold	Market Perform	62.6%	10.2%	61.7%	56.9%	48.9%	43%
Sell	Underperform	5.3%	0.0%	0.0%	6.9%	3.2%	7%

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