Nixon's watershed moment

Royal Bank of Canada had a great crisis, and it's thriving through the recovery as well. It has established its position as one of the biggest, as well as best-run, banks in the world. But its new prominence brings added pressure and responsibility to RBC's long-serving chief executive, Gordon Nixon. He spoke to Clive Horwood

POLITICIANS AND REGULATORS that question the viability of the universal banking model should take a long, hard look at Royal Bank of Canada.

RBC has made healthy profits through the past two years – C$4.55 billion ($4.47 billion) in 2008, and C$3.85 billion in 2009 – despite exposure to troubled residential real estate markets in the southeastern US, and a capital markets business that specialized in credit markets.

Alongside the relatively strong headline numbers, RBC has established itself as bank with an enviably strong financial position. At the end of the first quarter of 2010, it had built up a tier 1 capital ratio of 12.7% – the sort of level regulators dream of across the industry – and maintained a relatively low leverage ratio of 20 times. All of this was achieved while producing a healthy return on equity of 17.5%.

RBC is active in just about every area of banking and financial services. Its bedrock is retail and commercial banking in Canada, but it also operates in wealth management, asset management, insurance and capital markets.

It's a model that has served most of the garlanded winners from the credit crisis well. Think JPMorgan Chase, HSBC and BNP Paribas.

Royal Bank of Canada has earned the right to be mentioned in the same breath.

The transformation of RBC from respected regional bank to global force to be reckoned with has been overseen by its president and chief executive Gordon Nixon. Nixon is one of the longest-serving bank chiefs, having taken the reins of the business in 2001 at the young age of 44.

He's been within the institution that today makes up Royal Bank throughout his career, which began in 1979 in the global markets division of Dominion Securities. While running the firm's Tokyo business in the mid 1980s, RBC bought Dominion. Nixon stayed on and prospered, becoming head of global investment banking in 1995 and then chief executive of RBC Capital Markets in 1999, two years before his appointment as chief executive.

Tall and imposing, as befits a rugby fan, Nixon mixes an easy charm with a straightforward, no-bullshit approach. He's using his new prominence to speak out on the regulatory and operational challenges facing banking today, and he's an eloquent advocate for the industry whose views demand attention.

The main challenge Nixon faces is to keep up the momentum that RBC has built over the past few years, and take advantage of its position of relative strength. Nixon is under pressure to justify the size of the capital cushion he's built. But don't expect any transformational acquisitions, even if Nixon admits he's never received as many calls from investment bankers pitching ideas as he does today. The bank has a good track record for making smaller, accretive buys, and Nixon says that there could be some real opportunities to acquire, particularly in wealth management. But as Nixon says, he'd rather be criticized for having too much rather than too little capital at present.

In capital markets, RBC will continue to play to, and build on, its strengths (see Banking news story on page 31). In the first quarter of 2010, net income from capital markets was C$571 million – second only to Canadian banking, which generated net income of C$777 million. The success of the capital markets business could make it hard for Nixon to maintain the ceiling of 30% that he has imposed on capital markets' share of overall group earnings, although he says that limit is not set in stone.

One big cloud on the horizon is RBC's US banking business, which was heavily exposed to the US residential real estate market. Nixon admits he's not yet convinced that US retail is the best deployment of RBC's capital in the long run, but evinces a desire to improve the division's operating model and efficiencies, diversifying away from the real estate market, before making any strategic decisions.

What Nixon firmly rebuts is the concept of growth for growth's sake. He criticizes banks that took the easy option of growing assets with no regard for the return they made on them. Consider this: at the start of the last decade, RBC and its near namesake Royal Bank of Scotland had similar-sized balance sheets of around $300 billion. Just before the crisis, RBS's balance sheet had ballooned to $1.9 trillion. RBC's remains a steady $700 billion today.

And then there's Nixon himself. He's a rare example of an investment banker who has won the top job at a universal bank. He's perhaps an even rarer example of a bank chief executive who finished the last decade with his reputation enhanced.

That ought to make him a prime candidate for the lead role at some of the biggest banks in the world, when they become available. But Nixon's success at RBC means there aren't that many bigger jobs to go to.

> "When I'm asked what I want my legacy to be when I finally leave Royal Bank, I say that any time a chief executive starts talking about his legacy it's time to sell the shares"

RBC has performed well through the crisis. Do you feel like a winner?
In some ways we feel like a winner because there have been so many losers. But in reality this is a relative game, and there's no doubt we have come out on the right side by virtually any measure of performance.

What also makes me feel pretty good about our institution is that, through the worst financial crisis any of us have experienced, even on an absolute basis our performance has been strong. Our return on equity in 2008 was still 18% and in 2009 was 15%. Compare that with a period such as the early 1990s' downturn, when we lost money two years in a row.

And you've had that performance despite some quite large write-downs of your own?
I don't feel good about writing off $4 billion of mark-to-market losses, or our deterioration of earnings. But to manage through this tumultuous period and still generate good profitability and returns for shareholders is an achievement we're proud of.

Has the diversified nature of RBC helped this outperformance?
The diversification of our business has served us very well during the good times, and it has also contributed to our stability during a difficult period. For example, in 2008 as we were taking write-downs in our capital markets business we were generating record earnings in our Canadian banking business. Our wealth management earnings have been stable and steady. Our international banking operations have done well, even if we have had some difficulties in our US banking business. Insurance performed throughout the piece.

Over the past year, we've had record performance in our capital markets business which has provided us with some upside relative to some other competitors more limited to retail and commercial banking.

At the same time, it seems that Canadian banks in general have survived or even prospered through the past two years. Why is that?
Certainly the Canada story has been very helpful. One of the strongest asset classes on our balance sheet – and they represent a significant portion of it – are residential mortgages. The structure of the Canadian residential mortgage and real estate market has provided real stability to the Canadian system, and clearly we have benefited from that.

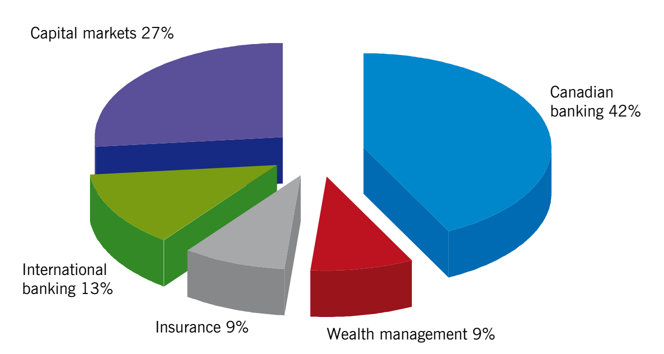
Getting risk/reward right

But the business extends well beyond Canada. Clearly something has gone right on the risk management side.
I think we've managed our risk/reward profile well. The capital markets business is a good example of that. We faced problems in areas such as structured credit, like everyone else did. But the exposure was manageable within the size of our overall business, which was clearly not the case at some other banks.

We've also always been very cautious in the VaR levels we run within our trading book, because the nature of our trading business has tended to be more flow oriented and client driven rather than long-term position taking.

Was there a point where you as a chief executive said the exposure to structured credit, sub-prime and so on was enough, and you pulled back?

A MODEL UNIVERSAL BANK
ROYAL BANK 2009 CORE EARNINGS BY LINE OF BUSINESS



Source: Company reports, Barclays Capital

We were clearly exposed to those businesses. But the key was to size them relative to the overall size of the bank so that we weren't taking risks that we were uncomfortable with.

We have a stated strategy that we don't want our wholesale activities to represent more than 20% to 30% of the overall business. That's intentionally quite loosely defined – it's revenues, it's balance sheet, it's earnings. But we weren't prepared to dramatically grow our balance sheet, as some of our competitors did, on the back of dramatic growth in wholesale.

But while your competitors were apparently making huge profits on the back of that balance sheet growth last decade, weren't you under pressure from shareholders to do the same?
It's quite the contrary. Anyone can grow their asset base. What I could never understand is why banks were growing their assets so quickly but for such low returns on those assets. We continued to focus our attention on return on assets.

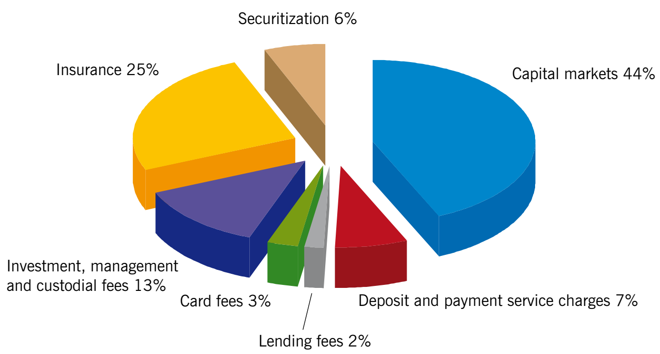
And that was reflected in our share price. Going into the crisis our stock performed as well as the best of our peer group, even though our assets were not rising nearly as quickly. That's because we allocated our capital more judiciously.

So even though now, by market cap, you're one of the world's biggest 15 banks, you're adamant that size in and of itself is not important?
Banking is not a race to the finish in terms of size. When I'm asked what I want my legacy to be when I finally leave Royal Bank, I say that any time a chief executive starts talking about his legacy it's time to sell the shares.

That's particularly the case in financial services. If legacy is purely about size and growth, rather than building a high-quality and sustainable business, then you're in trouble.

Do you have to give some credit for your performance to the regulatory framework in Canada as well?
Sure. We've always operated under a leverage maximum of about 20 to 25 times. Going into the crisis we were at about 21 times. Now we're around 16 times. So part of it was tactical, part of it was the framework we operated in. And politicians, as well as the regulators, deserve credit for that.

A DIVERSIFIED REVENUE BASE
ROYAL BANK NON-INTEREST REVENUE COMPETITION



Source: Company reports, Barclays Capital

We've tended to operate with higher capital and lower leverage than most of the big global banks.

The need for leverage ratios

Do you think that leverage ratios should be applied across the banking system?
Yes. One of the problems with capital is that it is allocated based on the risk of assets. When the meltdown came, it was the high-rated assets that were the worst performing. And because they were well rated they attracted very little capital.

Whatever governments do, whatever regulatory frameworks we put in place, we will always have crises. But because you rarely have a crisis hit where you most expect it, leverage limits are essential.

But you would not want to be seen as a cautious institution, would you?
No. In fact I recently sent a draft of a speech to a colleague who said I might want to downplay the word 'conservative' and use the term 'less reckless'. We manage a $700 billion balance sheet. We have a very active lending portfolio. We are one of the largest trading banks in the world. What I think we have got right is the balance between risk and reward.

And it's not about wholesale versus retail. The biggest bank failures of the crisis were not wholesale banks. Yes, we had Lehman Brothers and Bear Stearns. But Wachovia, Washington Mutual, HBOS and Northern Rock were commercial banks.

So the discussions about investment banking are missing the point?
Unfortunately the political environment has a disproportionate rhetoric directed at wholesale banking and particularly around compensation and trading.

We have five primary businesses: Canadian banking, international banking, insurance, global wealth management and global capital markets. From there we break it down into a total of 35 sub-divisions.

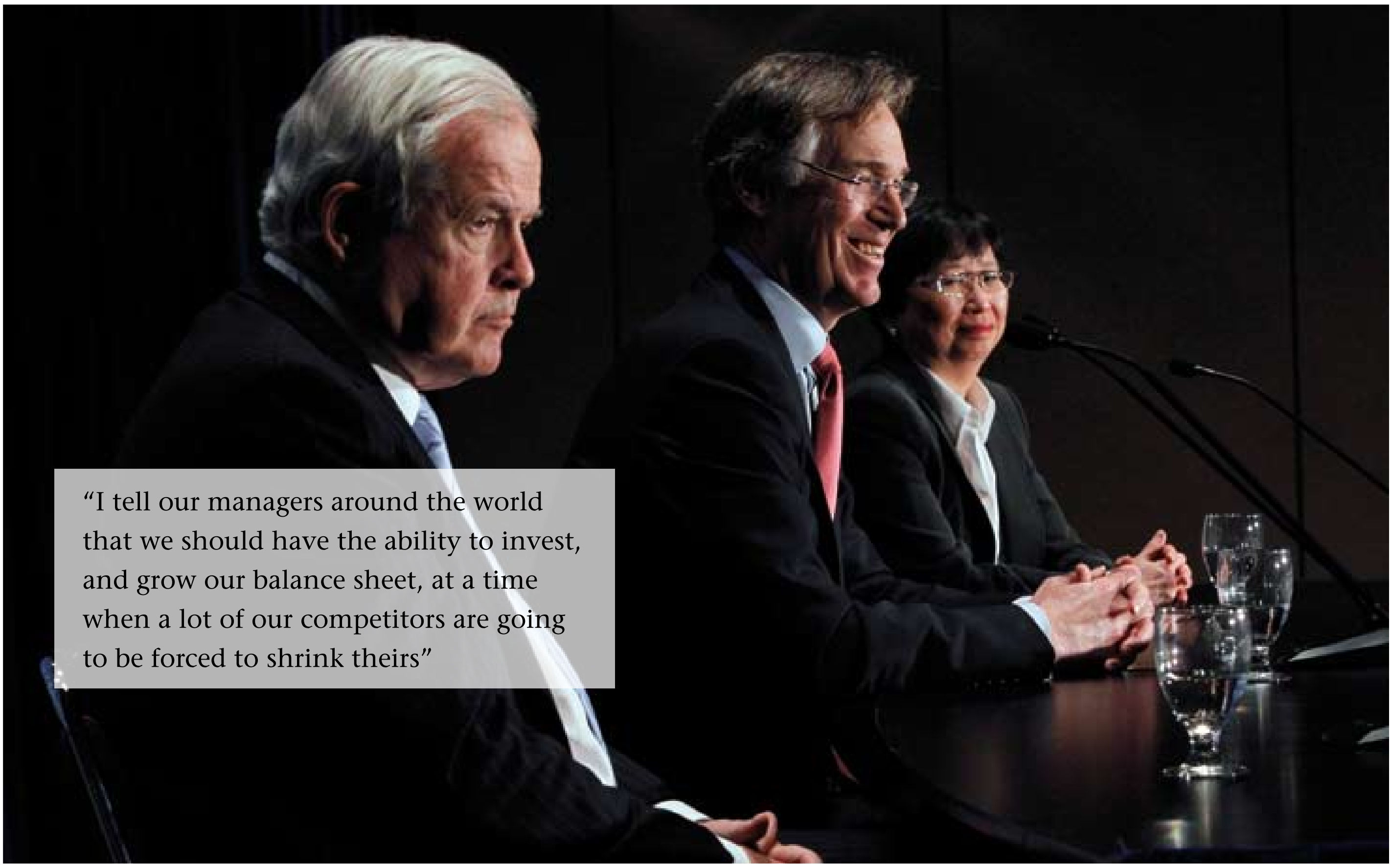
If you look at our US retail banking business it has been painful: clearly the worst-performing part of our bank through the cycle. There's no wholesale or excessive compensation within it.

Do you think this rhetoric poses a threat to banks such as RBC?
There's clearly a risk that any regulatory framework will result in the need for so much capital, much of which will be inefficient, that you could end up with a significant cost to economic growth.

There's no question that capital levels have to go up. The 4% and 6% requirements of the old Basle are outdated. Interestingly in Canada we've been run on ratios of 7% and 10%.

In my mind, there's no question that leverage caps have to be imposed on the system.

Does this mean a one-size-fits-all leverage ratio or different ratios for different types of banks?
One ratio. Clearly institutions that are predominantly retail will get nowhere near the limits. But we've seen that banks with leverage ratios of 60 to 70 times are only a dramatic decline in one asset class away from wiping out their core equity, which cannot happen again.



You're talking about frameworks here, though, rather than line-by-line regulation?
Look at just some of the things that are being talked about: premiums for systemically important institutions; deducting goodwill from core equity; elimination of deferred taxes; significant increases to operating risk capital; transaction taxes; local capitalization of subsidiaries rather than the ability to manage capital at a central level; cyclical capital requirements and so on.

The only result of a too-prescriptive and overly complicated framework will be to stifle economic growth.

Running a universal bank

What's the culture of RBC?
As a diverse business we don't have one culture. We actually encourage the different businesses to develop their own. The culture of our retail bank in Canada cannot be the same as that of our capital markets business. As a global universal bank, you're kidding yourself if you think you can impose one common culture, but we have one set of values that are constant across the organization.

The biggest defining thread across the organization is teamwork and cooperation. Take our executive committee. There's me, the heads of our five businesses, the head of risk, our CFO and our chief operating officer. It's small, which means we all discuss our various businesses and it stops the creation of silos within the bank. We have real opportunities between the business, such as between capital markets and wealth management, and we need a set-up that allows us to realize them. It's a defining feature of what we do and allows us to manage at the enterprise level.

But beneath that there's a high degree of devolution to the individual management teams?
Yes. We control at the executive level, and at the same time give responsibility to each business line head to run and grow their operations. You can't be a hands-on CEO across the board in a company that employs 77,000 people and operates in 55 countries. You're only as good as the people who manage your businesses. I spend a lot of my time making sure we have those people, and that

RBC'S CONSISTENT FINANCIAL PERFORMANCE
Key results 2008 to Q1 2010 (in C$mln)

	Q1 2010	*2009*	*2008*
GROUP			
Total revenue	7,334	29,106	21,582
Provision for credit losses	493	3,413	1,595
PBCAE	1,130	4,609	1,631
Non-interest expense	3,626	14,558	12,351
Goodwill impairment		1,000	
Net income before tax	1,497	5,526	6,005
Net income	1,433	3,858	4,555
BUSINESS LINES net income			
Canadian banking	777	2,663	2,662
Wealth management	219	583	665
Insurance	118	496	389
International banking	-57	-1,446	-153
Capital markets	571	1,768	1,170

Source: RBC company reports

we have the right succession processes in place.

You're a rare example of a former investment banker becoming chief executive of a universal bank that is predominantly retail. Has your background informed the way you run the bank?
It was certainly unusual when I took the job in 2001. One of the real building blocks for me, in the 1990s, was that I was responsible for the integration of Royal Bank's corporate banking business with the investment banking part of Dominion Securities. I think we did that very successfully.

We were very respectful of the relative strengths of each business. We tried to capitalize on the best of both, rather than have investment bankers take charge of the corporate bank, as has happened elsewhere. I learnt a lot from that.

Throughout my tenure we've always continued to focus on all the parts of the business, and we've never veered off having the bank where we want it to be from a business mix and risk perspective.

Do you face a challenge in maintaining that business mix, given that Canada is already a heavily banked market, and most of your retail operations are in developed economies?
I disagree with that. When I took over as CEO, most analysts would say that Canada was a mature market with limited room for growth – so what are you going to do with the bank? Here we are nine years later and we've had double-digit compound growth in Canadian banking. And we still have plenty of room to grow further.

Where can that growth come from?
We deal with about 11 million customers in Canada, out of a population of 34 million. But we're not the core bank of all of those customers – our market share in Canada is around 17%. So there's huge potential for us to do more.

Core banking growth has outpaced GDP growth in Canada. At the same time we've had huge growth in our wealth management business there, as well as insurance and credit cards.

RBC JOINS THE BIG LEAGUE
Biggest global banks by market capitalisation ($bln)

		Current	One year ago
1	Industrial Bank of China	247.5	173.9
2	China Construction Bank	188.7	128.3
3	Bank of America	181	70.6
4	HSBC	180	116.8
5	JPMorgan	178.2	117.7
6	Wells Fargo	161	124.6
7	Bank of China	154	98.1
8	Citigroup	119.4	36.6
9	Santander	112.2	75.3
10	BNP Paribas	93.8	38.33
11	Itaú Unibanco	86.6	46.2
12	Royal Bank of Canada	83	52.2
13	Commonwealth Bank of Australia	80.2	50.7
14	Mitsubishi UFG	76	89.2
15	Toronto Dominion	64	38.4

Market caps converted into US dollars on March 29, 2010
Source: Bloomberg

You mention insurance. There's a trend for banks to exit that business. Are you going to stick with it?
For us it's a relatively new part of the business. We were not allowed to be in the business until the 1990s and we're still prohibited from selling insurance products through our branch networks. But in little over a decade we've grown insurance from zero to around a $500 million a year business.

We like insurance in Canada because it plays into our strengths: our brand, our financial strength, our distribution network.

Tough decisions US banking

Have the difficult experiences in your retail bank in the southeast of the US put you off further investment in US banking?
We have a strategic challenge in the US which we do not yet have the answer to. The US retail model is challenged: it was a stressed model during the good times, let alone during the downturn. Our operation is a regional bank, which is heavily oriented towards real estate as are all regional banks. The deposit market is highly competitive, because smaller US banks aggressively chase deposits to fund their balance sheets. The carry trade is a big business in the US – borrow short, lend long and take advantage of the yield curve.

We are restructuring our bank today to shift away from that model. We want a much higher degree of productivity in the branch network, and a much greater emphasis on retail, non-real-estate related products. But the jury is still out on what sort of return that model will generate relative to other opportunities to invest and get a return on capital.

We'd like to make this model work and invest more in the US. But if we can't generate the same return as on other investments, we'll go in a different direction.

But first you're going to give what you've got a proper go?
We have to make the most of what we've got. The good news in the US is that it is a $30 billion balance sheet bank, and we're a $700 billion bank. So while it has been unprofitable through the crisis, we've been able to manage those losses.

The bad news is it's small – so even if it was a great bank, it's not going to be able to make a fundamental difference to the overall business. Even at a good return on core assets for the US of say 100%, we're only talking about $300 million a year compared with global profits in 2008 of $5.4 billion.

The other option is to invest more and build a sizeable bank through acquisition.
The interesting thing in the US is how little consolidation there has been other than the forced mergers at the height of the crisis. The biggest acquisition in the US banking industry in the past 12 months was worth less than $200 million.

The reason for it is that buyers do not want to take on stressed, uncertain balance sheet. They'd much rather buy with a guarantee from the FDIC. Or sellers can weather the storm through Tarp money. So you have this stand-off.

Our aim is to get our model right.

Will the growth of your wealth management business come from Canada or international?
Our Canadian business is very powerful – we have a great retail brokerage as well as a great asset management business. In the US we also have a retail brokerage with around 2,300 investment advisers, which is about the same size as the brokerage in Canada and makes us one of the top five retail brokers.

Outside North America, our global wealth management business is headquartered in London. It's very significant. So it's a good mixture.

But there's really no such thing as a global wealth platform as the nature of wealth management is quite different between jurisdictions.

Our sweet spot internationally is high-net-worth and ultra-high-net worth clients. We have quality products, stability, and a strong rating. We're seeing a lot of international clients interested in what we have to offer.

We've also acquired a number of trust businesses in the UK and the Channel Islands which will lead the growth of our global transaction banking services.

So wealth management is likely to become a larger share of the business?
One of the strategic decisions we face if we choose to allocate more capital to wealth – which will tend to be more through acquisitions – is do we focus on asset management versus brokerage, or North America versus international? Our view is it will tend more towards the asset management side in the US and Europe.

Building more in capital markets

RBC's capital markets business has had a lot of success in the areas in which it has chosen to operate. Where do you want it to be in five years' time?
Bigger, better and more of a top-tier player in the areas in which we focus. But we have no ambition to be a leading player in areas where we do not have core competency and strength.

You won't see us number one in the league tables for multinational US mergers. You and I both know we're not going to get there. But in mid-market M&A in the US, we can do well. We're a top-tier player in investment banking for energy and mining globally.

And we think our fixed-income business globally ranks among the best in the industry.

In fixed income, you've managed to keep a reputation for being smart without it blowing up in your face.
That's why we don't like to use the word conservative. We're adding to our fixed-income business. Our next natural expansion there is into the euro markets. We've also made a number of hires within our equity capital markets team. We're adding to our infrastructure franchise.

We're investing in commodities, which plays to our strength in energy and mining. Foreign exchange is a natural business for us and we're gaining market share. In total we've hired around 600 people into our capital markets team over the past 12 months. It's a real, global business with a lot of potential.

Can you maintain the momentum in capital markets? Clearly 2009 was for you, like the rest of the industry, a bumper year.
We benefited from the wide spreads in flow products like everyone else, although of course we had a high number of write-downs to deal with as well. Clearly the growth of revenues is not sustainable in the long term. But we should see better returns in terms of the balance sheet.

Won't this growth in the capital markets business put pressure on the 30% upper limit wholesale can have within the group?
The key is to grow all of our businesses simultaneously.

And is that 30% limit non-negotiable?
Nothing is set in stone. Investors have always looked at us with a degree of caution, because we do have a strong wholesale business and it is viewed as relatively risky.

With the profits of the last 12 months, some have now been coming to us saying we should grow it further as there are such large profits to be made. If we breach the 30% threshold because we have built solid, profitable businesses then great, it's a nice problem to have.

But as I said before, the ratio is a nice governor to have because it prevents us from taking the easy option of growing the wholesale business purely through the asset side. And when you look at the nature of RBC, with our five diversified businesses, we think it is the appropriate ratio.

Taking advantage

But now, as one of the banks that has performed best through the crisis, shouldn't you be looking to take advantage of your success and expand the balance sheet?
I tell our managers around the world that we should have the ability to invest, and grow our balance sheet, at a time when a lot of our competitors are going to be forced to shrink theirs.

It means that we should have plenty of opportunity to grow our balance sheet cleverly rather than for the sake of it.

And all the time you're able to do this with the advantage of being one of the few remaining banks with a triple-A rating.
Having a triple-A rating from Moody's certainly gives us a competitive advantage.

You also have a very strong capital base which you have been using to buy back shares. You've also done a lot of smaller, bolt-on acquisitions. Is now the time to look for the transformational deal?
What's transformational? If we did something larger it would have to be consistent with our strategic objectives. I don't think you'll see us do anything that dramatically changes the nature of our business. But we might look at mid-size acquisitions that would allow us to take business, such as global wealth management, forward more quickly than we could manage organically.

A lot of banks are disposing of what have been very good business lines.
And we're a potential buyer of some of those. We've certainly never had as many incoming calls. EM

2010 Private Banking awards

EUROMONEY

2010 EUROMONEY PRIVATE BANKING AWARDS

RBC Wealth Management

Winner of Best Private Banking Services Overall
Canada, Caribbean and Jersey

REGIONAL AWARDS

CANADA

Best Private Banking Services
Best Private Bank for High Net Worth US$1million to US$10million
Best Offshore Services
Best Range of Investment Products

CARIBBEAN

Best Private Banking Services
Best Hedge Fund Investment
Best Specialized Services – Corporate Executives

BAHAMAS

Best Local Bank

BARBADOS

Best Private Banking Services

CAYMAN ISLANDS

Best Foreign Bank
Best Lending/Financing Solutions

JERSEY

Best Private Banking Services
Best Offshore Services
Best Private Bank for High Net Worth US$1million to US$10million
Best Trust Services
Best Tax Guidance and Services
Best Inheritance and Succession Planning
Best Structured Products
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