



National Bank Financial Canadian Financial Services Conference  
Speech By Réal Raymond, President and CEO - National Bank of  
Canada

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Bon matin à tous, good morning everyone.

Welcome and thank you for attending today's conference. I also want to thank Rob Wessel and his team at National Bank Financial for organizing this special event.

In a sense, the timing of National Bank Financial playing host here today couldn't have been better. National Bank is in the midst of a series of successful quarters of top- and bottom-line growth.

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A quick glance at National Bank's numbers shows that its underlying fundamentals are strong and everything seems to be pointing in the right direction.

Net Income Before Interest and Taxes (NIBIT) from regular business increased by \$56 million between Q1 04 and Q1 05. Of that, \$29 million, just over half, or 52%, came from a higher operating margin, with revenues growing 7% and expenses rising only 6%. The other big driver of growth came from a sound credit position leading to a \$27 million improvement in provisions for credit losses.

I assure you we have no intention of letting ourselves get carried away. Those of us who have lived through the ups and downs of

different economic cycles have learned in a very tangible way that sooner or later the industry inevitably hits a speed bump.

My goal today is to demonstrate how the initiatives we are pursuing are not only fuelling short-term growth, but are also positioning us nicely for longer-term secular industry trends.

But first, let me talk about the key drivers of recent profitability growth, and then I will show how they fit into our long run strategy.

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### **Improvement in credit quality**

The improvements we have made in our credit management processes have been a key driver of our recent growth. They also provide us with considerable strength and flexibility going forward.

The \$17 million charge taken in the last quarter is a record low, and the balance sheet ratios are the best in the industry. On a trailing four-quarter basis, loan losses declined from 46 basis points of total loans and BAs in Q1 04, to 27 basis points in Q1 05, accounting for about half of our year-over-year increase in NIBIT.

Although I fully realize that this \$17 million quarterly provision for credit losses looks pretty low on a historical basis, this number should not be seen as an aberration.

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First, the declining credit loss provisions are in line with a down trend that dates back to early 2002, when provisions skyrocketed following the events of 9/11 and the telecom industry fall out.

These declining loss provisions have been justified by the drop in impaired loan formation that we have seen in past years. Moreover, the status of some corporate exposures has recently improved from impaired to current.

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As a result, we recently saw negative impaired loan formation in our Financial Markets sector. Within the P&C sector, impaired loan formation continues to hover around the \$50 million mark on an annual basis, even when taking into consideration the important volume growth of 7.5% for 2004 and 8% already for Q1 of this year.

So this \$17 million can be viewed as a fair representation of the inherent risk of our portfolio at this juncture of the credit cycle. The decline in the underlying risks attached to National Bank's loan portfolio can be seen in all of our primary indicators.

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On the retail side, improvements in our credit management practices have fueled lower delinquency rates, which are now at 40% of what they were in 2001.

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This decline has been helped by a stronger average financial position among households in our home market of Quebec, as evidenced by the positive behavior in personal bankruptcies, in stark contrast to the increase in Ontario and other regions.

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Quebec is also seeing a reduction in business bankruptcies. This has certainly helped in the management of our commercial portfolio.

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For example, the volume of loans on our watch list has dropped substantially and is now at only 60% of the average level we saw during 2001.

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The improvement has been particularly dramatic for large public corporations for which the Expected Default Frequency, or EDF, as calculated by the KMV model, is a widely used indicator. For the Bank, this risk measure has fallen by 75% since the third quarter of 2002 peak to reach 20 basis points.

We also improved our monitoring of both individual accounts and of industry portfolios. We continue to favor a “bottom up” approach that consists of focusing on industries we know, as opposed to trying to match the loan portfolio of the industry, or jumping on opportunities in “hot” sectors.

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For example, as a result of Quebec’s relative strength in farm production and manufacturing, we naturally specialized in these groups, both of which now are overweight in our portfolio. Similarly, our strong presence in energy contrasts sharply with our rather low market share in real estate. These diverging positions are the direct reflection of our differing outlooks on these sectors.

Our profound knowledge of sectors where we concentrate enables us to recognize emerging trends among our clients early, and to take preventive action when potential problems arise.

As CEO, I have made it a strong priority to implement a culture that resists the pressures to build short-term volumes and profits at the expense of long-term credit quality.

That applies across the board, including to investment banking, where our success has been the result of our capacity to close deals rather than taking risky residual exposures on our book.

In the sizeable cross-border deals we were involved in last year, we were very good at using credit mitigation tools in order to end with

an exposure that we were comfortable with. Moreover, these larger exposures are monitored periodically by the Board of Directors.

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Finally, it should also be stressed that, this time around, we will be ahead of the curve if the credit cycle deteriorates markedly. For example, our excess reserves of \$216 million represent more or less one year's worth of loan losses based on the average of the past 10 years (\$223 million). That doesn't mean we consider this money as a licence to take risks. But bankers love this kind of cushion when they go to bed at night.

I hope that I've convinced you that risks can be managed and that we have no hesitation about taking the credit for the improvement in our results stemming from this aspect of our operations.

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### **Other growth drivers**

So where is the rest of our growth coming from? Mostly from revenue gains and consistent productivity improvement. And this is true for all 3 sectors, as they have equally shared the growth so far this year.

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As far as revenue growth is concerned, the 7% jump, year over year or sequentially, implies that we are growing at about two percentage points faster than the economy as a whole.

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Wealth Management has been the fastest growing sector in the past 10 quarters, although Financial Markets proved to be a pleasant

surprise. In early 05, revenues bounced back from the pause of mid-04, and returned to the 10% growth trend line.

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Productivity at the Bank continues to remain remarkably steady. While the ratio fluctuates somewhat from year to year, stemming from a change in business mix, the numbers have been fairly consistent during the past three years. The same thing can be said for numbers by sectors.

The inescapable conclusions are that National Bank has been doing a good job of controlling its costs, and that our excellent performance is not the result of some statistical aberration.

A particularly good credit context might explain growth rates north of 20%. But our current momentum and the leverage remaining in our major strategic initiatives should nevertheless result in continuing double-digit growth in our ongoing core businesses.

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## **Looking ahead**

At this point I want to move beyond talking about our growth fundamentals and how well we have been doing on the credit front. As I mentioned in my introduction, we are happy with our results, but we are also well aware that the banking industry will more than likely slow down at some point in the coming years.

Unfortunately, my crystal ball does not tell me when this slowdown will occur or how brutal it could be. What interests me more than the shape and timing of the next speed bump in the economy is the longer-term secular trends, and how our current strategy positions us to deal with them.

The first trend that I want to talk about is the loan loss cycle becoming more subdued for the banking industry, for both commercial and personal accounts. The industry-wide reductions in loan losses are as much a result of a permanent shift in the risk profile of the banking industry as a temporary favorable credit cycle.

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As I mentioned before, there is a lot of liquidity in the system and many businesses have used this opportunity to beef up their balance sheets. Companies are also increasingly turning to financial markets to finance their high-risk debt.

Greater equity financing and the lower interest rates have considerably reduced the cost of debt servicing for businesses. The result is that businesses are better capitalized and more able to meet their obligations as they become due. In addition, their riskier debt is increasingly held by non-bank players.

The situation is more difficult to decode on the personal banking side. Recent news reports have dramatized the fact that personal debt has been growing faster than disposable income for the past fifteen years.

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But those figures only tell half the story. For one, a large chunk of this new debt has been incurred to finance the acquisition of long term assets, particularly home purchases. As a result, average household net worth has also increased faster than net income.

In fact, it is far from accurate to say that most households are in worse financial shape than they were.

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Consumers' ability to repay personal debt has traditionally been tied directly to the job market, which has been far more stable in Canada during the past ten years than it has been in the U.S.

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The second key trend that we are seeing is the banks' increasing reliance on financial assets rather than loan intermediation to generate growth.

During the past decades, businesses have been increasingly turning to debt and equity markets to raise cash. As a result, the percentage of businesses' external financing provided by banks has dropped from 40% in the early 1990s to about 22% today. Share financing, income trusts and fixed income have displaced direct lending from financial institutions.

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On the consumer side, the picture is less clear as bank debt has indeed risen. A red-hot housing market has boosted mortgage demand and a flood of convenient new credit card and personal line of credit products have stimulated a revolving credit boom.

National Bank has taken advantage of both trends, though we have focused more on trying to steer customers to our more profitable HELOCs (home equity lines of credit) and other lines, as opposed to joining a fierce price war for a few additional shares in the mortgage market. We have preferred to maintain price discipline and build our business profitably over the long-term, rather than to try and attract marginal clients just to get a quick spike in volume numbers.

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Even though personal debt is growing, the recent cyclical surge has only pushed household liabilities slightly, from 16% of their own assets in early 2000 to about 17% today.

Put bluntly, there are 6 times more opportunities to do business with Canadian households in managing their assets than in writing them loans.

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What's more, Canada's population is aging rapidly and, as a result, the credit expansion that we are seeing is likely to be short-lived.

The upshot is that we have to look beyond personal and commercial loans for growth. For that I prefer to turn to far more lucrative fee-based sectors such as securities issues and wealth management.

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To do that, we have redoubled efforts to boost branch productivity. Typical examples of the steps we took were increasing the number of sales staff and assigning financial planners to a growing number of our wealthier clientele. Our results so far in this regard have been impressive. During the past several years we have increased the percentage of our client's managed assets, our "share of wallet", from 32% to close to 40%.

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So it should come as no surprise that all our businesses in the Wealth Management sector are growing rapidly, whether measured by assets managed or administered or by net income.

No matter what business conditions we face in coming years, one thing is certain: Canadians as individuals will continue to be the

ultimate source of new wealth in the economy and National Bank has positioned itself to tap this source of growth.

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National Bank's multi-channel presence in the mutual funds industry, coupled with the \$87 billion in retail brokerage assets that we manage for our clients, or that we administer through Correspondent Network, put us in an excellent position to profit from this trend. In fact, our total retail assets have grown by 16% at National Bank Financial in the past five years.

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Our financial markets business is well positioned, in the sense that there are significant barriers to entry into the field. To become a major dealer in Canada, you need a strong team of investment bankers, a commitment to invest significant capital and resources in trading for your own account, as well as a large retail base to distribute new issues. You don't build that kind of solid combination easily.

The reduction in the incidence of credit risk and our reliance on managing and issuing third party financial assets have accelerated our transformation into an integrated financial services provider. This is by itself the most prominent trend in the banking industry. It means that we are increasingly remunerated through fees, commissions, and gains on financial assets rather than through intermediation margins. This transformation also has dramatic implications on the level of capital needed and its allocation across risk types.

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National Bank has emerged as a leader in terms of migrating from interest-based to fee-based income sources. The transformation has been massive in scope, amounting to a complete repositioning.

One statistic explains it all: we currently generate 64% of our income from non-interest sources, up from 44% in 1997. For their part, the Big Five generate on average 54% of their income from non-interest sources.

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This has been the result of numerous successful and profitable initiatives such as:

- Creating a strong presence in direct property and casualty insurance in Quebec
- Becoming the largest end-to-end service provider for independent investment advisors through National Bank Financial's Correspondent Network
- Being a very efficient manufacturer of structured products for our own clients, using either our branch or brokerage channels, as well as for third parties' clients
- Positioning ourselves as a top tier dealer with a strong fixed income desk, a proven expertise to structure new products such as income trusts and a newly acquired reputation in M&A deals

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- And rapidly growing the Private Investment Management product for our branch clients

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The implications of this transformation are overwhelming. In just a few short years, we have gone from one of the least efficient users of capital in the industry to one of the most effective. In just six years, we have boosted by 64% the level of income we produce by each unit of risk, as measured by BIS assets. The upshot is that we are boosting profitability and reducing risk simultaneously, and we need less capital to run our business than we ever did before.

The secular trends that will affect our industry are very much at work today, though they might be blurred by cyclical developments. National Bank's performance in the past few years can be traced to its capacity to implement a strategy that has allowed us to benefit from those trends. As a result, I'm confident in our ability to continue on our current course.

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## **Conclusion**

The bottom line is that we are proud of our results. Our underlying fundamentals are strong, and we have taken bold initiatives to tighten credit management procedures, increase profitability and better manage risk.

That said, we also recognize that a lot of cards have been falling into place during the recent cycle. We've had a fairly stable economy, there have been no major recessions, and businesses and individuals are in good shape financially, especially in Quebec.

It's true we cannot predict the timing, breath or duration of speed bumps we are likely to hit down the road. Nevertheless, I believe that many of the steps we have taken to boost profitability and reduce risk will also position us well to deal with the coming secular industry movements. And I am confident that we can continue to increase profitability and boost shareholder value for a long time to come.

Thank you.