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Rick Waugh
CEO, Scotiabank

THE FUTURE OF FINANCIAL SERVICES: FINDING THE RIGHT BALANCE FOR STABILITY AND ECONOMIC GROWTH

Chairman: **Noble Chummar**
President, The Empire Club of Canada

Head Table Guests

Andrea Wood, Vice-President, Legal Service, Telus; Christyn Tozzi, Student, Ryerson University; M.J. Perry, Vice-President and Owner, Mr. Disc ow ount Ltd., and Director, The Empire Club of Canada; Shah Shafi, Financial Advisor, Scotiabank; Terry Campbell, President, Canadian Bankers Association; John W. Torrey, Partner, Fasken Martineau Dumoulin LLP; Steve McDonald, Co-CEO, Global Banking and Markets, Scotiabank; Malliha Wilson, Assistant Deputy Attorney General, Ministry of the Attorney General of the Province of Ontario; John Doig, Chief Marketing Officer, Scotiabank; and Dr. Gordon McIvor, Executive Director, National Executive Forum on Public Property, and Director, The Empire Club of Canada.

Introduction by Noble Chummar

As of yesterday, for the sixth year in a row, the World Economic Forum recognized Canada's banking system as the most efficient and most sound banking system in the world. In the aftermath of the global financial crisis, this news is both reassuring and encouraging to the Canadian public.

Under the leadership of CEOs of Canadian banks including our guest speaker, Canada was able to mitigate the drastic effects of the subprime mortgage crisis in the United States that eventually led to a global recession.

While Canadian banks provide security within the shorelines of this nation, their reach extends much further. Modern-day Canadian banks are better titled as financial institution powerhouses, with operations touching every corner of the globe.

Scotiabank, for example, is Canada's most global bank, with operations in more than 50 countries. Since 2007, the bank has made more than 20 international acquisitions in Latin America and Asia, worth about $6 billion.

Scotiabank's 2012 annual report disclosed that 31 per cent of its net income came from Canadian banking. The other 69 per cent came from a combination of international banking, global wealth management, and global markets.

The Empire Club is very grateful to have Rick Waugh here to discuss the financial services industry, its response to the repercussions of the global financial crisis, and its implications onboth the Canadian and world economy.

Mr. Waugh began his career with the Bank of Nova Scotia in Winnipeg in 1970 as a branch employee and, over the years, has served in the bank's treasury, corporate, international and retail banking areas. In 1985, he moved to New York as the most senior executive in the United States.

Mr. Waugh returned to Toronto in 1993 and was appointed Vice- Chairman of Corporate Banking in 1995, and then Vice-Chairman of International Banking and Wealth Management in 1998. In 2003, Mr. Waugh became President and CEO.

Last year, Mr. Waugh was named an Officer of the Order of Canada for his role in strengthening the financial services industry in both Canada and abroad. Every world-class leader knows when it's time to pass on the reins. Mr. Waugh has announced his retirement so someone else can continue his legacy and also have a chance of being richer than they think.

Past Presidents, members, ladies and gentlemen, please join me in welcoming Mr. Rick Waugh to the Empire Club of Canada.

Rick Waugh

When I was asked to speak here today, it was suggested that I discuss my career and my time as CEO. It has lasted 43 years, through the good and the bad and multiple crises in Canada and around the world. We could all be in this room for a long time if I did that and most of you will be asleep—or wish you were! So in the interest of brevity—and your well-being—I will stick to a significant topic that I feel very strongly about.

We are about to mark the sixth anniversary of the beginning of the financial crisis—and it's been about five years since the failure of Lehman Brothers, AIG, Bear Stearns and others.

For those of us in banking, the failure of Lehman is one of those things that you remember where you were when you first heard it. I was travelling in Asia and I immediately got on a plane home. Since the Bear Stearns problems, we had been worried about Lehman—despite its single "A" rating—and we had significantly brought down our exposure and held zero credit risk. Despite this, like many financial institutions, we took a direct loss on Lehman. However, it wasn't material and we earned a profit for the year of more than $3 billion with a return on equity of over 16 per cent. But while Lehman deserved to fail, what made things much worse was that no one really knew how to resolve a complex bank failure.

The consequences of Lehman's collapse—the direct costs, but far more importantly the indirect and lasting costs to the financial sector and the global economy— were staggering. Regulators, policymakers and the financial industry are still working on repairs and reforms. I've spoken about the unintended negative effects of regulation on the banking sector, our financial markets and world economic growth many times in both public and private settings—yet it bears repeating.

The recent emphasis on leverage ratios among regulators around the world confirms my view that we have not yet struck the right balance in the solutions being pursued.

What I really want to talk about today is:

- How regulation is having a transformational effect on the financial industry and by extension on global economic growth.
- How we collectively must strike the right balance between capital buffers, good assets, liquidity, risk culture and management.
- And how the quality of a bank's assets—the number one factor in its safety—depends on the quality of its risk management, which is driven by a strong risk culture based on values, accountability and the right incentives.

Banks play a fundamental role in the economy. You entrust us with your deposits. And we put those deposits back to work in the system, making money available to finance business investment, innovation and job creation. It involves the proper management of capital, liquidity and risk—and the operative word is "manage." This process is essential for functioning markets, and trust in the safety and efficiency of the system is essential for growth.

Through the course of the financial crisis that trust was broken. As a result, in an effort to restore confidence in the system, regulation has changed and increased significantly, especially as it relates to capital and leverage ratios. The problem is that capital and leverage ratios only tell part of the story and solve part of the problem.

For the past several years, I have been Vice-Chair of the Board of the Institute of International Finance (IIF). The IIF is the world's only global association of financial institutions with almost 500 members.

The IIF recognized at an early stage in the financial crisis that the internal risk management practices of banks were a major contributing factor. The IIF put in place a research program to

develop and promote sound practices and to monitor their implementation. This included recommendations on risk management, compensation, liquidity, accountability and transparency.

I chaired the Committee on Governance and Industry Practice, which is responsible for the research and communication of industry responses. We strongly advocated that the improvements in firms' own risk management practices are as important—if not more so—than strengthened regulation in achieving greater financial stability.

Focusing on capital and leverage can have unintended consequences. It's like trying to improve road safety by requiring cars to have more and bigger airbags without taking into account the decisions of the driver. Eventually you have so many airbags that there's no room for passengers and the driver can't see out the window. The car can't perform its function properly, and you've really done nothing to prevent collisions because airbags only deploy once it's too late.

Leverage ratios—and an over-reliance on capital— have similar issues. They dictate capital levels, but they have not historically accounted for the level of risk in banks' assets. And it's the quality of assets held by a bank that matters more than anything else to its safety.

Leverage ratios and the original Basel-based capital rules treated a government-backed home loan the same as a subprime mortgage security. That encourages stockpiling of risky assets to achieve a higher return on capital—exactly the kind of behaviour that led to the financial crisis and the collapse of Lehman Brothers.

So, what is the result of an over-reliance on capital and now leverage ratios?

It's clear to me that there is a direct impact on economic growth at a critical time.

There is a debate between regulators, policymakers, economists and the industry about how to increase financial system safety while ensuring economic growth. Studies vary in their estimates

of how much the regulations will affect growth, but they all conclude that the regulations will come at some cost. Regulators and some policymakers say it's worth the cost to make us safe. In fact the G20 has recognized the importance of this issue and is currently studying the effects of financial regulation on the availability of long-term investment financing. We need this examination and debate to continue. Yes, we don't want a global crisis, but we do want a return to strong economic growth and job creation.

Let me give you a clearer sense of exactly how the over-reliance on things like capital and leverage ratios directly impact growth.

According to a survey conducted by the International Institute for Finance, regulation is having a transformational effect, and it's arguably greater than any of the current market forces banks are facing.

In response to regulatory requirements for more capital and liquidity, 44 per cent of banks are exiting activities as well as markets and geographies. In fact, Scotiabank has benefitted from this. We bought E*TRADE, Dundee Wealth, ING Direct and several banks internationally as other banks exited businesses. And, I believe that the industry will see more—perhaps much more—of this to come.

Let me give you two other recent examples. Last month Barclays and Deutsche Bank announced far reaching measures to meet growing capital requirements. In the case of Barclays:

- It will issue common equity that will dilute shareholder value by close to $10 billion.
- It also plans to shrink its loan book by well over $100 billion.

The U.K. economy has struggled to emerge from its second recession in five years. Naturally, this is something Governor Carney is concerned about. This will not make it any easier.

Meanwhile, Deutsche Bank plans to reduce loans by nearly $350 billion. That is roughly equivalent to the economic output of Denmark.

These are loans that may have gone—directly or indirectly—to help spur business investment and create jobs.

And fewer loans to businesses and entrepreneurs is just part of the equation:

- High-skill, high-wage jobs are being shed by the thousands.
- Urban centres are being weakened through the loss of quality head-office jobs and supporting jobs in IT and professional services.
- Banks are exiting countries at a time when businesses need access to global banks to facilitate trade.
- And it is hurting shareholders. Banks are some of the most widely held companies, and their performance affects millions of people from individual investors to participants in major pension plans.

What happens in the U.K., Germany and the U.S. matters to us, not just because slower growth in those markets means less demand for Canadian businesses, but because these banks lend to businesses in other markets. It affects us all.

Banking across borders facilitated the great push of globalization over the past several decades. It facilitated the rise of our standard of living. It also led to the development of emerging markets and a widening of the middle class in those markets that is driving global growth today.

As banks decide to exit markets it means less choice, reduced competition, less liquidity and higher funding costs for businesses and consumers. So how do we strike the right balance to ensure economic growth?

The best buffer in a crisis that I know for a bank is consistent profitability and earning a good return on our shareholders' equity, based on good-quality and well managed assets. Being

well capitalized is also incredibly important to ensure trust. I can tell you from experience that finding the right balance has benefitted us greatly.

Pre-crisis, Scotiabank was sitting with a high-tier 1 capital ratio under Basel II standards—well beyond regulatory requirements. It was high enough that we were being criticized by some analysts for not undertaking share buy backs or special dividends. Because of our high capital levels and a return on equity that remained in the high teens, we were the only Canadian bank that did not have to issue equity during the crisis period and we were able to deploy capital to take advantage of a number of strategic acquisitions. In fact, since the crisis we've made some 40 acquisitions for more than $13 billion and still increased our loans to customers and our dividends to shareholders.

But in the case of Lehman, their capital as measured by the leverage ratio—total assets divided by shareholders' equity—looked very strong. But the assets on their books were very risky, so risky that they were unable to sell or use those assets as collateral in the market or to gain liquidity from the central bank. Capital as defined by regulators was not the problem. Lack of liquidity was the immediate issue.

The recent focus on leverage ratios by officials around the world is therefore troubling. It is troubling because there is no agreement on the appropriate ratio, and it does not measure risk.

I understand the motivation to look for an additional tool. There is no doubt that regulators have been worried that under Basel III capital rules individual banks are measuring risk-weighted assets differently. Care is needed in using these new—but old—measures so that the riskiness of assets is not lost and any effort to increase transparency is not muddied by the fact that different jurisdictions may require different ratios and management may make different judgments. It can seem confusing. But simply put, we need capital to give comfort and trust, but it is the quality of a bank's assets that generates profitability, and protects

it from ever needing to use the capital buffer. And the quality of its assets depends on the quality of its risk management. This is why developing a strong risk culture and expertise within each organization is so important.

If regulators and policymakers spent more time working with the industry on building this strength versus continuing to add more complexity and fragmentation to the regulatory environment, I believe we could make much better progress to avoid crises and generate growth in our economies. We all share the same goals—to make this world a better place for our children, our countries and our economies.

In order for banks to help economies grow, a certain level of risk must be taken. It's how those risks are managed that makes all the difference. Those who get risk management right thrive; those who don't falter.

So what does it take to get risk management right?

Risk management refers to all of the different parts that ensure a financial institution is run safely and soundly.

One of the key elements of risk management is establishing a strong risk culture where the tone is set at the top, and then embedding that culture throughout the organization. You need to have the proper incentives to support the right behaviour. It takes the right people, who are well-trained, customer-focused, and who have strong personal and community values. It's about how we behave and execute the policies and processes in place.

Every large, modern financial institution has sophisticated risk models and rules. But as we have seen, not all of us are good at managing risk or using the tools that the models provide. That's because the human element, the culture of the organization, our values and understanding our customers, play an essential role. It's the people using the tools that determine if the tools work or not.

Providing credit or investing is an art, not a science or a computer model. If it was, there would be no credit or market losses. And we would all be richer than we think!

When I attend meetings with my counter parts around the world, I often remind myself, and them, that I have been fortunate to be one of the few CEOs who has actually been a branch manager or credit officer. I know what it is like to sit across from a customer and assess whether or not they will repay the loan, despite having what appears to be a good job, collateral, or a nice smile. That's where values and judgment come in, because the toughest decisions are rarely black and white. They are usually grey and we rely on our training, our values and our culture to guide us to the right decisions.

So is the financial industry making progress on this front?

The IIF regularly surveys financial institutions around the world to get a picture of the state of the industry. This year's survey shows that banks around the world continue to focus more on risk culture and risk management and their importance in the safety of the financial system.

Chief Risk Officers are now reporting directly to their CEOs, with independent access to the Board. This is something, by the way, that most Canadian banks have always done and we have consistently, over decades, outperformed our international peers in terms of credit and market losses. The industry is moving to ensure it makes good decisions on managing the risks. Regulators must resist adding more capital rules and instead collaborate with the industry on finding the right balance.

So, can regulators and policymakers work together with the industry on issues of culture, values and tone from the top?

The short answer is yes; however, I would argue strongly for principles-based supervision versus prescribed rules.

In conclusion, issues of trade, globalization and regulation are having a transformative effect on financial services and other industries and indeed on financial markets and the global economy.

The economy is still in a delicate period with little ability to absorb more challenges. The private sector, including banks, must be part of the solution.

These are complex challenges and regulators, policymakers, the financial industry and other interested parties must work together to find the right mix of capital buffers, good assets, liquidity and risk culture. We need sound principles-based supervision, rather than overly prescriptive rules and capital levels, which will not prevent the next crisis. We must balance the need to protect savings with the need for banks to perform their function of providing investment and growth.

One reason Toronto thrives as a world-class city today is because it is home to well-managed banks, who have remained profitable by embracing the right balance of capital, risk management and values.

Most importantly, our banks have maintained the trust of their customers and shareholders. In fact, just yesterday the World Economic Forum named the Canadian banking system the soundest in the world for the sixth year in a row.

Ultimately, it comes down to finding the right balance. Our collective future prosperity depends on our ability to collaborate and to find this balance, which is, of course, the Canadian way.

Thank you.

The appreciation of the meeting was expressed by Dr. Gordon McIvor, Executive Director, National Executive Forum on Public Property, and Director, The Empire Club of Canada.