"The Financial Crisis – A Canadian Perspective on Lessons Learned and Avoiding the Next Crisis"

Remarks by Richard Nesbitt
Chief Operating Officer, CIBC
London School of Economics
October 3, 2013
Check Against Delivery

Good afternoon.

It's good to be with you today, and to be back at the LSE. Having done my Masters of Science in Accounting and Finance here nearly 30 years ago, it always brings back fond memories.

Clearly, much has changed since my time here. Students no longer use typewriters to write their essays, cell phones didn't exist, and I now have gray hair. But much has stayed the same. The LSE continues to pursue and achieve academic excellence. And it continues to challenge its students and encourage them to think independently.

This approach has certainly helped me over the course of my career in capital markets, especially during times of challenge and change. This includes the last five years, where we experienced a global financial crisis from which we are still seeing the fallout and slow recovery.

Today, I will:

1. First lay out a simple premise about the causes of the crisis that took hold in 2008.
2. I'll briefly walk through the broader economic environment and high profile issues that arose.
3. From there, I will highlight why Canada faired better than most…and briefly touch on the outlook for Canada.
4. I'll then bring it back to what happened at CIBC and how we responded.
5. And lastly, I'll close with my thoughts on what can be done to avoid another financial crisis.

So, what caused the financial crisis?

In my view, while there were many connected issues, there were really two key factors. The first was the significant excessive indebtedness of both consumers and governments around the world. Second, fueled by government policy and low interest rates, a mania developed around the real estate and housing market.

If I was to boil it down further, the thread that ties it all together is wide-spread greed. Governments were living beyond their means; banks and institutions were pursuing short-term profit over sustainable results; and consumers wanted more than they could realistically afford.

It was wholly unsustainable.

To briefly paint the picture…in mid-to-late 2007, issues began to emerge. There were large losses by some of the big US investment banks related to subprime exposure. These first write downs were like a canary in a coal mine.

- From there, unease began to build around global mortgage and credit markets, heightening as many banks announcing related losses.
- The global credit crunch began deepening, and
- CEOs from big banks like Merrill Lynch and Citigroup resigned over losses related to subprime debt.

By the time I arrived at CIBC in early 2008, signs of trouble were clear. By then, the US government started to take a more active and forceful role. It took control of key institutions like Freddie Mac and Fannie May. It also took stakes in many banks – the first time since the great depression that the government has taken ownership in private commercial banks.

The Fed engineered JP Morgan's acquisition of Bear Stearns as it collapsed. It also played a key role in Bank of America's acquisition of Merrill Lynch – a transaction that has been disastrous for BofA and its shareholders in hindsight.

By the time Lehman Brothers went bankrupt in September of '08 the writing was on the wall.

The fall of Lehman spread fear through the markets. The fear was evident in the following weeks when the US Congress failed to pass its $700 billion plan to buy toxic assets from financial institutions, known as the Troubled Asset Relief Program, or TARP. On the day that TARP was voted down the Dow fell 7%. It had plummeted a full 18% by the end of the week when Congress passed the program.

The week that Lehman collapsed was pivotal in the crisis. Until that week, we managed alone. We had plans on how to handle a Lehman collapse, but we knew that others could fall as well.

We were surprised by how fast things changed.

- Merrill Lynch was bought by Bank of America
- AIG was bailed out
- Government leaders stated that no systematically important bank would be allowed to fail
- Central banks moved to inject liquidity

The crisis changed completely following that week. Now we faced a reconstruction phase which, while difficult, brought order to a chaotic situation.

In the face of this, by year-end the:

- Dow was down 34%, the steepest decline since 1931
- The S&P 500 down 40%, the worst drop since 1937
- And the TSX was down 35%, the worst since 1931
- 25 banks had also failed

So what about Canada?

Canada was not unscathed by the financial crisis. It has been said that when the US sneezes, Canada catches a cold. Whether this is true or not, with three quarters of Canada’s exports destined for the US, our economy is closely bound to our neighbour to the south. And more than that, the global economy has tied our individual national economies together more closely than ever.

In Canada, while the recession wasn’t as severe as seen elsewhere, it took hold quickly. Over the first nine months of the slow down:

- Canada’s GDP declined 3.3%
- Our exports dropped dramatically by 16%
- There was a 22% drop in investments as people sat on the sidelines given the extraordinary uncertainty and volatility

But, we also recovered more quickly than most countries.

This is in large part because we took measured, well-coordinated action, and because we had room to maneuver and respond to the crisis and its aftershocks.

As a country we have a prudent regulatory environment, sound fiscal policy and a highly concentrated banking industry. Industry leaders were able to work closely and with a shared purpose with regulators and governments to address the situation.

So when the crisis emerged, the dialogue was very open and all parties were highly engaged and thoughtful in their approach and actions.

Included at the table as the crisis unfolded was the current Governor of the Bank of England, Mark Carney. At the time he was the head of the Bank of Canada. He played a central role in coordinating Canada's response and keeping the lines of communication open. Similar to other central banks, The Bank of Canada also injected significant liquidity into the market.

We also had strong underlying credit fundamentals.

Households and government balance sheets were relatively sound. Governments were able to inject more than a percentage point a year to support growth and recovery. And household consumption dropped by less than half of what it had in the previous two recessions. Interestingly, while household indebtedness in Canada was lower than either the US or the UK in 2008, in recent years, ours has been climbing and the US and UK's has moved down.

Further, we have a stable real estate market that didn't see the same mania take hold that you saw in the US.

Let's turn to CIBC's experience during the crisis.

At the end of '07 we had notional exposure of $35 billion to the US and non-US residential mortgage market. Over the course of 2008, we posted $7.3B in structured credit losses.

CIBC's course of action was led by our CEO, Gerry McCaughey, and included putting new leaders in key posts. I was brought in to lead CIBC's wholesale bank, a new CFO came on board and an internal shuffle saw our existing CFO take over the Risk portfolio.

We also:

- Exited structured credit
- Made the tough decision to cancel a share buy-back
- Issued $2.9B in equity in January of 2008 before the crisis fully took hold
- Managed-down run-off book transactions
- Extended term of debt financing, and
- Reduced our funding needs

Coming into CIBC at this time, my first priority was to de-risk our wholesale bank. We focused on five key areas to accomplish this.

1. We divested or exited and realigned businesses with an eye to creating a franchise that would generate recurring, sustainable revenue.
    - Specifically, we exited US investment banking and equities, as well as leveraged finance in the US and UK.
    - We also split apart our investment banking and corporate lending groups and put separate leaders in place.
2. We enhanced our focus on our clients and creating deeper relationships with them.
3. To support this focus, we expanded offerings to address client needs and grow earnings in areas that were central to what we do. This included investments in our electronic and core trading businesses.
4. We also ensured that we were using our resources thoughtfully. As you all know, resources in business are scarce. In addition, running a capital markets business is not

something you can do without taking on some degree of risk. We needed to be sure that when we did deploy risk that it was well managed and in support of our clients.

5. And finally, we were very focused on our people. With a new strategy in place, we put new business leaders into key roles to deliver on it. We did that in Canada and around the world. As a result, we have greater bench strength across our business.

Because of CIBC's and Canada's broader response, we faired well coming out of the crisis.

I am very proud of the work and progress we made at CIBC and within our capital markets business. We now have a client-focused business that has:

- Proven it can deliver high-quality, consistent and sustainable earnings,
- Increased profitability, and
- Improved employee satisfaction.
- And importantly, we have established a strong platform from which to grow going forward.

This year, CIBC was once again ranked as the strongest bank in North America and third strongest in the world.

I would argue that this is the direct result of strong leadership, a bit of luck and decisive action taken at the right time – supported by a solid Canadian tailwind.

Being proactive has enabled us to be prepared for developments since the financial crisis, namely the ongoing European debt crisis and fiscal uncertainties in the U.S. As well, the retreat of many banks, particularly European banks, has created great opportunities for those with the resources to compete for clients' business.

CIBC is not the only Canadian bank that has faired well coming out of the crisis. Many have taken the opportunity to make strategic acquisitions at attractive prices, particularly in the US. CIBC has done this, as have our peers like TD and the Bank of Montreal.

As a result of the strong underlying fundamentals and actions taken, Canadian banks have been ranked as the soundest in the world by the World Economic Forum for six straight years.

Looking ahead, the future is bright for Canada. This is in large part because of our deep and significant natural resources. Canada's prosperity has been closely tied to our ability to create value from our vast natural resources. This was true more than a century ago, and it remains true today.

The economic impact of our natural resources is large. Even coming out of the recent recession, our resources sectors generated approximately 15 per cent of Canada's total nominal gross domestic product of $1.7 trillion. Together, our three key natural resources sectors – energy, minerals and mining, and forestry – directly employ over three-quarters of a million people. They account for roughly one-half of Canada's exports, and in 2011 attracted over $105 billion in new capital investment.

Canada's wealth of natural resources reaches from coast-to-coast-to-coast.

Canada has 10 per cent of the world's forests. In fact, forests cover roughly half our land. And it is remarkable that we harvest less than one per cent of our forests each year, yet we are still the world's largest forest exporter. The forestry industry had a challenging time following the 2008 housing crisis and recession. It has since recovered as US markets have improved and as new markets open in Asia.

We are one of the world's leading mining countries, with more than 60 minerals and metals. Canada is the leading producer of potash globally and we rank among the top five producers of uranium, nickel and diamonds, among many others. Our 200 plus mines are located across the country, mostly in five provinces, including British Columbia, and Newfoundland and Labrador – our most easterly and westerly provinces.

It is also a very important time for the energy sector, in large part because of the opportunities being created as innovation and new technologies allow us to tap resources that were previously inaccessible.

Canada ranks third in the world in our proven oil reserves, behind Saudi Arabia and Venezuela. Canada's current oil production is about 3.3 million barrels per day. If the existing slate of proposed infrastructure proceeds as planned, this production could increase by a further two million barrels a day within 10 years. And while estimates vary, production from Canada's oil sands could double current oil production to more than six million barrels a day by 2030.

In addition, we have significant natural gas resources. Canada currently ranks third in natural gas production. As advances in shale gas allow us to access significant natural gas reserves, Canada's energy sector will have the opportunity to grow. Natural gas, when converted to liquid form, will provide international energy markets with a source of energy that has been safely used and transported around the world for 50 years.

Looking at renewable energy, Canada is the world's third largest producer of hydroelectricity. We have more than 500 hydroelectric stations across the country that generate approximately 350 million megawatt hours of electricity. The bulk of installed hydroelectric capacity is in Quebec, but given our rich water resources, provinces including British Columbia, Manitoba, Ontario, and Newfoundland and Labrador also play important roles in this sector.

For now, and for the future, Canada's success will remain closely tied to the success of our natural resources sector.

Supported by our rich natural resources and relatively quick recovery from the crisis, Canada is on track to balance its budget in 2015. This would likely make us the first G20 country to be able to balance the books post-crisis.

Stepping back from CIBC and Canada, and asking what can be done to avoid this in the future is an important question, and one that many have weighed in on.

The prevailing wisdom is that regulation is the answer. And there is significantly more regulation coming our way. This regulation will require banks to have more capital on hand and more liquidity.

The best and brightest among us will adapt. They will find new ways to compete and offer innovative solutions for clients…and they will prosper. Others will not be able to compete. As a result, I expect to see further consolidation in the industry in the years ahead.

At CIBC we're embracing the new regulatory environment, and believe there is a long-lasting competitive advantage in doing so. But regulation alone can't prevent future financial crises. It is only part of the answer.

It seems that just about every four to five years, there is a significant event in the markets and the industry.

- Asia and Russia in '97 and '98
- Dotcom crash in the late '90's
- Debt and currency crises in Argentina and Brazil in 2001 and 2002
- And, most recently the European debt crisis.

The next crisis could come from the less regulated shadow banking sector, or elsewhere. There is also a looming pension crisis on the horizon.

So, what can we do to better manage, and perhaps reduce the severity of crises like these?

I'll start by saying something that shouldn't come as a surprise to you given my career – I believe in capitalism. I believe that companies have the right to succeed and be rewarded, and the right to fail and pay the price of failure.

As a result, I would argue that there should be no such thing as being too big to fail. If we take away the possibility of failure, companies do not have the same incentives to compete and manage for downside risk. The living wills that are required under new regulations like Dodd-Frank are helpful in this regard. If a company fails, the living wills give us a road map to dissolve a company quickly and in an orderly fashion.

Planning, leadership and good corporate governance are also important.

Planning lays the groundwork for success, helps build commitment to common goals, bring discipline to how companies operate, and can help avoid disaster.

Leadership starts at the top and ensures that the right questions get asked and that plans are executed as expected. And, good corporate governance, including board governance and active oversight are critical issues that we need to continue to push forward. It is in all of our best interest to reflect on the role bank's boards and governance played in the crisis. There are lessons to be learned that will help us in the future.

Next, I believe there is a role for investment banks to play in ensuring that they operate in a safe and sound manner, with their clients best interests at heart. Leaders must build cultures that value and reward sustainable success and long-term value creation. By this I mean leadership for the sake of the broader good of clients, markets and the economy as a whole.

It’s instructive what can be learned from those who did not act with this principle in mind.

And finally, I’ll close with a message for those of you who are at the outset of your career. As future leaders, it will be up to you avoid future crises.

In my time at CIBC, my goal has always been to hand the bank over to the next generation in even better shape than it is today. It is your turn next.

By getting an education, you are developing skills that will help guard against these types of issues. Chief among these are strong quantitative skills, critical thinking, leadership and accountability.

It’s also important to learn to be unafraid of change, no matter how sizeable it may be. When you see change coming, prepare for it early and adapt before you are forced to.

With that, I’d like to pause and open the floor to any questions.