Remarks by

William Downe
Chief Executive Officer, BMO Financial Group

at

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Theme Panel: “*Transitioning to the ‘New Normal’ in Banking*”

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The following remarks on the theme *Transitioning to the 'New Normal' in Banking* were delivered by BMO Financial Group Chief Executive Officer William Downe as part of the Federal Reserve Bank of Chicago's 50th Annual Conference on Bank Structure and Competition, held in Chicago, Illinois, on May 8, 2014.

(Please check against delivery)

First, I want to say thank you for inviting me to be here today – in particular you, Dan Sullivan, and your colleagues in research.

Going back to the summer of 2006, I was new in my job and feeling a little uneasy about Chairman Greenspan's constant references to irrational exuberance. Following an introduction by Mike Moscow, I began a dialogue with the staff of the Chicago Fed that brought us together at least quarterly for the next three years to talk about economic data and what choices – from both a public policy and a management action perspective – might be helpful.

Cathy Lemieux joined many of the conversations for what turned out to be an education in real time. It was a source of reassurance to know how useful history can be, even in uncharted territory. And it was a reminder that facts, however inconvenient, are necessary to making better choices, even among unattractive alternatives.

This conference, in its 50th year, is a very good place for people who believe that good policy matters, and I am grateful to be included.

Let me provide a little context for the focus of my comments this morning.

The bank I work for opened its doors in 1817, established a New York agency in 1818 and founded our first office in Chicago in 1860.

- We serve 12 million customers across a contiguous footprint with a population of 75 million and a GDP of close to $4 trillion.
- In 2006, as we headed into the downturn, BMO's Basel II Tier 1 capital ratio was 9.3%. We estimate that under the Basel III framework, our pro-forma common equity ratio would have been approximately 7.5%.
- In four years of recession and subsequent slow recovery, we absorbed loan losses equivalent to 26% of our pre-tax, pre-provision income. Based on a recent Moody's study[1], major U.S. banks recorded losses of about 50%, while losses at U.K. banks were about 103% and at Irish banks were about 500%, calculated on a similar basis.
- At the end of fiscal 2013, our Basel III Common Equity Ratio, fully implemented to 2019 rules, was 9.9%. This capital build was accomplished primarily with retained earnings and a voluntary equity raise in the fall of 2008.
- The compound growth rate of the bank's book value from 2006 to 2013 was 9.8%, and our ROE in 2013 was 15%.

[1] Source: *Special Comment: Australian and Canadian Banks Pursue Different Strategies to Deploy Capital Generated by Strong Domestic Franchises*, Moody's Investor Service (April 16, 2014)

There is no question that – from the inception of the downturn – we benefited from the policy actions of the U.S. and Canadian governments in providing an extraordinary injection of liquidity and a similarly aggressive fiscal stimulus.

Importantly, as things progressed, we remained grounded in the work we do for customers: taking deposits, facilitating payments, providing credit – helping them to make better decisions with better information and to have confidence in the decisions they make. The recovery, while slow, has been built on relationships anchored in trust.

Financial reform was clearly called for and has been sweeping in its extent and contribution to future confidence. It's now time to pause and think about the impact of further financial reform on the new normal for banking.

Our first reflection on the change in environment and regulatory reform is that, in sum, it has been constructive. Work to date has captured necessary reforms and has evolved how we think about leverage. It has stamped out irresponsible behaviors that extended well beyond banking.

We have little disagreement with reform to date, but it does raise one question: *What is the ultimate destination*? How much capital is required to support a stable system that fosters trust but still leaves room for innovation? It stands to reason that if innovation becomes solely the domain of non-regulated industry actors, a different form of instability will emerge.

And so, as I think about the topic of this panel – *Transitioning to the 'New Normal' in Banking* – and about what the new normal is going to look like, there are three themes I would like to touch on this morning:

- The first is the importance of understanding what customers expect from their bank.
- The second is that the impact of financial reform is going to have a profound effect on what the new normal is, ***but we need to agree on what it is we are trying to solve for.***
- And my third theme is that there remain open questions to be answered.

Theme 1: What customers expect from a bank

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Most fundamentally, we believe there is value in serving customers well. We take great pride in being a bank, and the men and women I work with take great pride in being bankers. This has been the case for nearly two centuries.

What we do for customers, and for society at large, is important to employees, management and our Board of Directors. We create jobs, provide credit to individuals and businesses, invest directly in the community, pay taxes and earn a return for our shareholders.

Finding the right balance between making customers' lives easier – from individual savers to the largest institutions – and maintaining confidence in a financial system that is inherently complex has been a focus for the simple reason that trust makes the services we provide more valuable.

The vast majority of our 46,000 employees come to work every day motivated to do a good job for the customer.

Each year, as part of an annual engagement survey, we ask BMO employees to respond to this statement: *I have a clear understanding of how my work contributes to achieving a great customer experience.* Ninety-one percent respond with a high measure of agreement.

In response to the statement: *My work gives me a feeling of personal accomplishment*, eighty percent of employees respond with a high measure of agreement.

Customers want this level of engagement.

The Ernst & Young 2012 Global Banking Survey[2] confirmed something we already knew:

- 83% of customers expect advice on complex products to be part of the standard service a bank provides.
- 70% of customers are willing to provide their bank with more information if this leads to greater personalization or better service.

I think that pretty much sums up what customers expect from a bank.

Theme 2: Agreeing on what it is we are trying to solve for

The second theme I wanted to touch on in the context of financial reform is agreeing on what it is we are trying to solve for. Let's be clear about which outcomes we care about.

A. Stability

If financial reform is solely about stability, it can be accomplished through buffers: capital, leverage and liquidity. And if plenty is good, then more may be better.

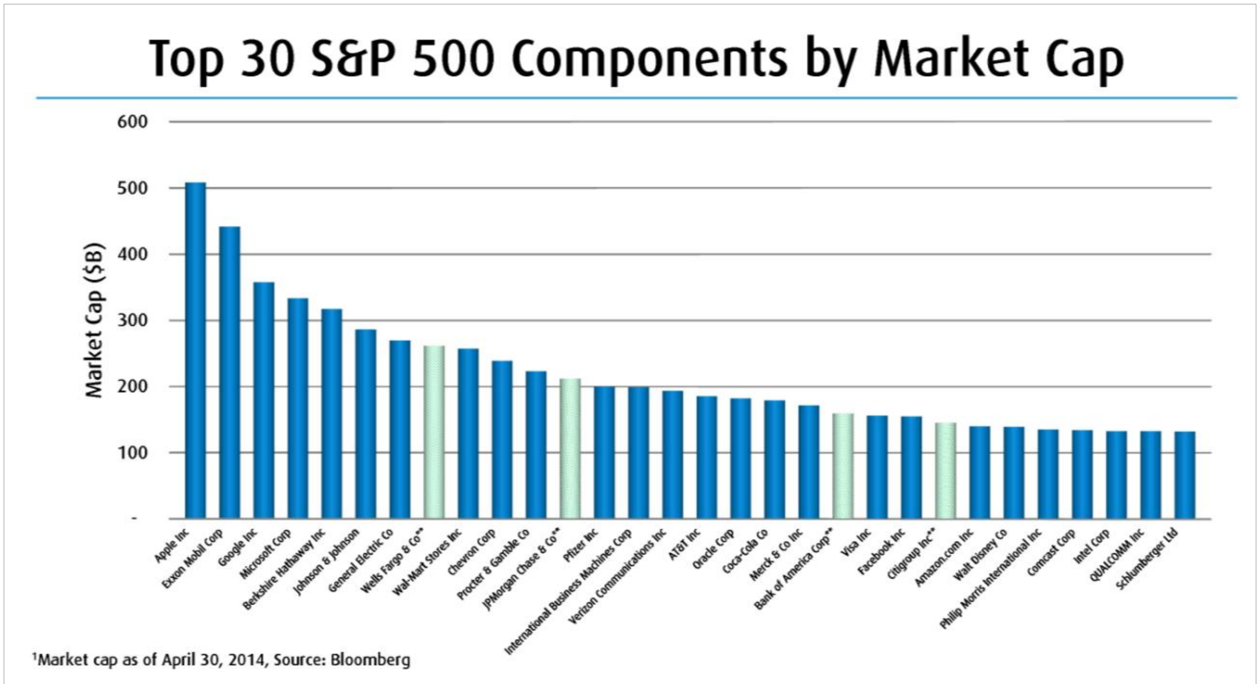
But is it the case that financial stability has a linear relationship with capital level, or is there a plateau. And if there is, at what capital level does it kick in – and at what point would the curve begin to bend backward?

I am probably stating the obvious, but if we push capital significantly above the current level, to the point where it becomes uneconomic to investors, capital will return to shareholders, and the white space will be filled by non-banks. *The return for sound risk intermediation must be sufficient to attract capital.*

The question of too big to fail is somewhat linked to this. While I don't have a strong view on how big is too big, when we think about size, we have to think about it on a relative basis – and whether the efficiency of the biggest companies is at all facilitated by the size of banks.

[2] Source: *The customer takes control: Global Banking Survey 2012*, Ernst & Young

It may help to put the largest banks in the context of the 30 largest S&P companies in the United States. The country's four largest banks are in positions 8, 12, 20 and 23. And the fifth-largest bank is number 51.



The sensitivity to ever higher capital levels won't be felt right now, because there is so much liquidity in the system. But when the recovery is in full flight, households, businesses, and governments will rely on the expansion of credit to grow.

B. Full Employment, Better Outcomes for Consumers and Financial Resilience

If it is full employment, better outcomes for consumers ***and*** financial resilience that we are seeking from regulatory reform, then there is real value in bank intermediation, because it's highly efficient, highly reliable – and a true value creator.

But there is a need for constructive thought on how to give customers a fair deal. There are minimum profitability requirements to provide customers with the value-added services they require.

Certainty has real value, and the suggestion that required capital levels will be subject to continuous change gets in the way of strategic thinking. In fact, it may be that the G20 meeting scheduled for November 2014 in Brisbane should be the line in the sand to resolve the remaining open questions about the global reform agenda.

There Are Other Factors Shaping Our Industry

As important as financial reform is to future prosperity, the world isn't standing still. There are four factors with which we must contend. They are accelerating and shaping our industry – and we are possibly at a unique juncture.

The first factor is the rise of the consumer. As customers increasingly embrace digital communications and continuous access to information, they look for instant responses to all of their transactional needs. They have a growing appetite for personalized service, in the moment. And their preferences change frequently.

There is a pressure to reconcile, simultaneously, the requirement for agility and the need to maintain absolute reliability. How we interpret this dual requirement is not simply to stay in step, but to remain a step ahead of what customers expect from a bank. We don't have to look far to see how quickly those expectations are changing. BMO retail customers now do 41% of their banking from their computer, their tablet or their smartphone. And the growth rate is exponential.

The second factor is disruptive technology and innovation. Innovations like mobile internet, the automation of knowledge work, the internet of things – that is, device to device connections making decisions on our behalf and creating data – along with advanced robotics, energy storage and 3-D printing all affect every company in our commercial banking client base. And we are all likely attributing too much value to established models and have too little understanding of how to attribute value to emerging models.

The third factor is talent, because if the new normal implies an extraordinary pace of change, it's going to take extraordinary talent – people who are agile, naturally in a mode of continuous reinvention and able to walk away from mature models. This point is not that we face skills shortages. The traditional model of work has become outdated both for employers, who face changing business needs, and for employees, who increasingly prefer workforce structures that are less conventional. There are implications for our industry.

And finally, leadership. Context defines leadership requirements – and the context has shifted.

Leaders are required to reconcile:

- a different workforce
- a global, borderless context
- performance volatility as a given, and
- stakeholders whose expectations and interests do not necessarily align.

Because of a decline in trust tied to institutional scale, only a clean record of delivery will trump statements of intent. People watch *what* you do with more interest than what you *say* you do.

Traditional assumptions about the role of banking and the intermediation of risk are under examination. This forces us to reflect on the role of the regulated part of financial services and the constraints on innovation we want to see.

Innovation in the industry, for much of the past four or five decades, drove real consumer benefit. There are many examples: multi-branch banking, debit cards and ATMs are just a few. But it is also true that in the five years leading up to the recession, a great deal of innovation was designed to make products generate a margin where one did not exist. Pricing for risk had disappeared.

That was not value creation. In the new normal, innovation will have to create utility for customers through better long-term outcomes *for them*, including peace of mind. We all agree.

Having decided on what it is we're trying to solve for in reaching the new normal, there are, as a result, questions with implications for the strategies of individual banks, as well as for our collective view of what constitutes a healthy banking system. This brings me to my third theme.

Theme 3: Open Questions

There remain questions that need to be openly discussed – questions that are relevant to individual banks making decisions about strategy, and also relevant to our collective aspiration for a healthy banking system.

- What proportion of the intermediation of payments, savings, borrowing and investing should regulated institutions represent?
- What is the optimal level of capital for banks to hold – a level that is sufficient to absorb the unexpected loss in the system and generate an economic return that will induce investors to continue making that capital available?
- What will be required of non-banks that participate in banking-like activities? Will Facebook, Alibaba or peer-to-peer lending illuminate areas of potential and spur investment in the banking model or circumvent the structures designed to create long-term financial stability?

Conclusion

For bankers asking the question *Now what?* the first part of the answer lies in never losing sight of the value to society of trust and confidence. The discipline and structure of the banking industry ensure financial stability – they do not undermine it.

And the second part of the answer lies in banks not losing sight of what banks do: we help people manage spending, grow savings, borrow smartly and invest wisely.

We should be optimistic about the role of the banking sector in the new normal, predicated on a clear understanding that the services we provide have real societal value – for which we can be paid.

Thank you.