

# Report to Shareholders

## First Quarter 2003

### The National Bank announces record net income for the first quarter of fiscal 2003

- Net income of \$166 million, an increase of 14%
- 32% growth in net income for Personal and Commercial
- Decrease in the provision for credit losses
- Tier 1 capital ratio of 10.2%
- Normal course issuer bid launched for the repurchase of 9.1 million common shares

**MONTREAL, February 27, 2003** – National Bank of Canada declared net income of \$166 million for the first quarter ended January 31, 2003, an increase of 14% compared to \$146 million for the corresponding period of 2002. Earnings per share were \$0.88 for the quarter versus \$0.73 for the first quarter of 2002, up 21%. Return on common shareholders' equity was 17.6% for the first quarter of 2003 compared to 15.0% for the year earlier period.

This growth in quarterly net income, the largest in the Bank's history, was chiefly attributable to the 32% increase in net income for the Personal and Commercial segment. The 6% rise in revenues due to the wider spread and the growth in deposit volumes of individuals and small businesses accounted for the increase in this segment's net income.

Commenting on these results, Réal Raymond, President and Chief Executive Officer, focused on "the remarkable performance of banking activities with individuals and businesses. I am satisfied with the performance of the Bank's other segments given the uncertain capital market environment."

As at January 31, 2003, the specific and general allowances exceeded impaired loans by \$175 million compared to \$159 million as at October 31, 2002.

	For the quarter ended January 31		
	2003	2002	%
<b>Net income</b>			
Personal and Commercial	91	69	+32
Wealth Management	19	23	-17
Financial Markets	64	57	+12
Other	(8)	(3)	
<b>Total</b>	<u>166</u>	<u>146</u>	+14
<b>Earnings per share</b>	<u>\$0.88</u>	<u>\$0.73</u>	+21
<b>Return on common shareholders' equity</b>	17.6 %	15.0 %	

On January 31, 2003, the Bank issued \$200 million of First Preferred Shares Series 15 with non-cumulative dividends and a fixed rate of 5.85%. On January 20, 2003, the Bank initiated a normal course issuer bid for the repurchase of up to 9.1 million common shares. As at January 31, 2003, 1.4 million shares had been repurchased for an aggregate consideration of \$46 million.

### Business Development

In the first quarter, the Bank took the following specific steps to better serve its customers and to develop new products.

In view of current market conditions and in order to meet the needs of customers looking for secure financial products during RRSP season, the National Bank introduced the Canadian Blue Chip Portfolio-Linked Note, a product with guaranteed principal. This new product, which is added to the Bank's other GICs, was extensively promoted both on television and in the branch network.

To further promote its line of financial products, the National Bank acquired the deposit portfolio of Standard Life Trust Company. The National Bank will be managing this \$38.4 million portfolio and more than 300 independent brokers will be renewing these deposit certificates with the Bank.

Always looking for ways to create added value for its customers, the National Bank signed an agreement with Workopolis, a leader in recruitment and job search solutions. Workopolis offers the Bank's business customers ad placement services through the Bank's Internet Banking Solutions portal. With these services, customers can save time and reduce their recruitment costs.

Lastly, after a selection process, the National Bank announced last December that BOS had been chosen as its new advertising agency. As such, BOS will help the Bank prepare and carry out its marketing strategies and advertising campaigns.

For more information:

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*Quarterly financial statements are available at all times on the National Bank of Canada website at [www.nbc.ca/investorrelations](http://www.nbc.ca/investorrelations).*

#### Conference call on results for the first quarter of fiscal 2003

- A conference call for financial analysts will be held on February 27, 2003 at **12:30 p.m. Eastern time**.
- Access by telephone:  
**1-800-387-6216 or (416) 405-9328**
- The conference call will be webcast live at [www.nbc.ca/investorrelations](http://www.nbc.ca/investorrelations)
- The Report to Shareholders, supplementary financial information and a slide presentation will be available on the investor relations page of the National Bank's website shortly before the start of the conference call.

#### Recording of the conference call

- A recording of the conference call can be heard until March 6, 2003 by calling 1-800-408-3053 or (416) 695-5800. The access code is 1373037.
- A recording of the webcast will also be available on the Internet after the call at [www.nbc.ca/investorrelations](http://www.nbc.ca/investorrelations).

## Management's Analysis of the Financial Condition and Operating Results

The following text presents management's analysis of the Bank's financial condition and operating results as presented in the unaudited consolidated financial statements for the first quarter of 2003.

### Strategic Objectives

The National Bank published in its 2002 Annual Report the strategic objectives which it set for itself for fiscal 2003. The table below compares these objectives to the results for the first quarter of 2003.

	Objectives	Q1 Results
Growth in earnings per share	5% - 10%	21%
Return on common shareholders' equity	14% - 16%	17.6%
Tier 1 capital ratio	8.75% - 9.50%	10.2%
Dividend payout ratio	30% - 40%	35%*

\* Based on the earnings per share of the last four quarters excluding the impairment charge for an investment

Other income for the quarter totalled \$480 million compared to \$381 million for the first quarter of 2002, for an increase of \$99 million or 26%. The acquisitions of Putnam Lovell and Altamira contributed \$20 million and \$16 million, respectively, to the growth in other income. The gain generated by the initial public offering of The Toronto Stock Exchange, less the loss on the investment in Cognicase Inc. after it was acquired by CGI, added approximately \$21 million to other income. Lastly, other income for Personal and Commercial activities grew by \$15 million or approximately 11%.

### Operating Expenses

Operating expenses for the first quarter of 2003 amounted to \$548 million versus \$501 million for the corresponding period of 2002. The acquisitions of Putnam Lovell and Altamira added \$33 million to operating expenses compared to the same quarter of 2002. If the impact of the acquisitions is excluded, the increase in operating expenses was \$14 million or 2.8% compared to the first quarter of 2002.

### Results by Segment

The revenues of each segment are presented on a taxable equivalent basis, i.e., they are grossed up to make the income earned on certain securities comparable with income from other financial instruments. An equivalent amount was added to income taxes. In addition, the provision for credit losses of each operating segment is based on expected losses which are calculated using statistical analyses. The difference between expected losses and actual losses is charged to the "Other" heading.

## Analysis of Results

### Operating Results

For the first quarter ended January 31, 2003, the National Bank earned net income of \$166 million, an increase of 14% compared to \$146 million for the first quarter of 2002. Earnings per share were \$0.88 for the quarter versus \$0.73 for the corresponding period of 2002, up 21%. Return on common shareholders' equity rose to 17.6% for the first quarter of 2003 compared to 15.0% for the quarter ended January 31, 2002.

### Revenues

Total income for the first quarter of 2003 was \$835 million, up 10% compared to \$762 million for the year earlier period.

Net interest income amounted to \$355 million in the first quarter of 2003 versus \$381 million for the corresponding period of 2002. Of the \$26 million decrease, \$21 million was attributable to the Financial Markets segment, in particular, due to asset and liability matching operations that had benefitted from a favourable interest rate environment in the first quarter of 2002 and lower corporate loan volumes. Net interest income for the "Other" heading was down \$11 million primarily due to the cost of financing the acquisitions made during fiscal 2002. On the other hand, net interest income for Personal and Commercial rose 4% to reach \$312 million. The increase was mainly due to the spread which widened from 3.06% in the first quarter of 2002 to 3.23% this quarter.

## Management's Analysis of the Financial Condition and Operating Results (cont.)

### Personal and Commercial

Personal and Commercial posted net income of \$91 million for the first quarter of 2003, up 32% from \$69 million for the corresponding period in 2002. Revenues were \$468 million, for an increase of \$28 million or 6%. Net interest income rose \$13 million owing mainly to the improved interest margin which reached 3.23% for the first quarter of 2003 as against 3.06% for the same period a year earlier. The average volume of loans and acceptances was down by approximately \$400 million primarily due to commercial loans. The average volume of deposits however was up by more than \$1 billion. At \$273 million, operating expenses for the quarter remained relatively unchanged from the first quarter of 2002. The efficiency ratio improved, going from 62.3% in the first quarter of 2002 to 58.3% this quarter. Lastly, expected loan losses declined by \$5 million or 9% from the corresponding period in 2002, thereby reflecting the improved quality of the loan portfolio.

### Wealth Management

Net income for the Wealth Management segment totalled \$19 million, down \$4 million over the first quarter of the previous year. Revenues amounted to \$162 million this quarter compared to \$160 million for the same period in 2002. The additional \$16 million in revenues from Altamira was largely offset by lower revenues from retail brokerage activities. At \$131 million, operating expenses were up \$7 million primarily because of the addition of expenses at Altamira.

### Financial Markets

For the first quarter of 2003, Financial Markets posted net income of \$64 million for a 12% increase. Revenues for the quarter reached \$237 million, for an increase of \$40 million or 20%, which was mainly attributable to an additional \$20 million in revenues from Putnam Lovell and a \$26 million gain from the initial public offering of The Toronto Stock Exchange. These increases were partly offset by lower revenues from asset and liability matching, as well as the lower volume of corporate loans. At \$128 million, operating expenses rose \$35 million mainly as a result of variable remuneration and the Putnam Lovell acquisition. Expected loan losses were \$10 million for the first quarter of 2003 compared to \$13 million for the same period a year earlier.

### Other

Revenues from the "Other" heading, excluding securitization operations and the cost of financing acquisitions, included the \$4.4 million write-down of an investment in Cognicase following CGI's acquisition of this company. The provision for credit losses for the "Other" heading included the difference between expected losses charged to operating segments and actual loan losses incurred. The favourable \$196 million difference was primarily attributable to the revision of the estimated allowance of \$185 million recorded in the first quarter of 2002. Discontinued operations showed a net gain of \$118 million further to the sale of asset-based lending operations in the United States in the first quarter of 2002.

## Risk Management

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### Credit Risk

The provision for credit losses for the quarter was \$41 million as against \$245 million for the corresponding quarter of 2002. Excluding the revision of the estimated allowance of \$185 million recorded in the first quarter of 2002, the provision for credit losses was reduced by \$19 million.

As at January 31, 2003, allowances for credit losses exceeded impaired loans by \$175 million compared to \$159 million as at October 31, 2002, for an improvement of \$16 million. New formations of gross impaired loans (less recoveries) amounted to \$29 million for the quarter compared to \$17 million for the previous quarter.

The ratio of gross private impaired loans to total tangible capital and allowances improved to 12.7% as at January 31, 2003 versus 14.1% as at October 31, 2002.

## Management's Analysis of the Financial Condition and Operating Results (cont.)

### Market Risk – Trading Activities

The VaR (Value-at-Risk) simulation model is one of the main tools used in managing the market risks associated with trading activities. The VaR measure is based on a 99% confidence level and uses two years of historical data for its computation. Effective November 1, 2002, the Bank started using two years of data instead of three years. No material change in VaR behaviour was observed following this change. Market risk management is described in greater detail on page 49 of the 2002 Annual Report.

The table below illustrates the distribution of market risks by type of risk, namely, interest rate, foreign exchange and price risk, including commodity and equity risk.

### Balance Sheet

As at January 31, 2003, the Bank's total assets amounted to \$73.1 billion as against \$74.6 billion as at October 31, 2002 and \$76.0 billion as at January 31, 2002. The table below presents the main loan and deposit headings.

Average monthly volumes (millions of dollars)	January 2003	October 2002	January 2002
<b>Loans and acceptances*</b>			
Residential mortgages	17,530	17,452	17,177
Consumer loans	4,329	4,467	4,204
Credit card receivables	1,453	1,383	1,305
Corporate loans	15,370	15,342	16,568
Bankers' acceptances	3,213	3,341	3,759
	<b>41,895</b>	<b>41,985</b>	<b>43,013</b>
<b>Deposits</b>			
Personal (balance)	23,000	22,607	22,388
Off-balance sheet personal savings (balance)	46,468	45,636	41,559
Commercial	8,659	7,648	7,662

\* including securitized assets

Residential mortgage loans totalled \$17.5 billion as at January 31, 2003, up 2% from last year. Credit card receivables advanced 11% over one year to reach \$1.5 billion as at January 31, 2003. Loans to businesses amounting to \$15.4 billion were down \$1.2 billion owing chiefly to corporate and international loans. Since October 31, 2002, the loan portfolio has remained relatively stable.

Personal deposits rose by more than \$600 million over one year and by nearly \$400 million since October 31, 2002 for a total of \$23 billion at the end of the quarter. Off-balance sheet savings administered by the Bank and its subsidiaries grew by \$4.9 billion since January 31, 2002, primarily because of the acquisition of Altamira. As at January 31, 2003, commercial deposits were approximately \$1 billion higher than as at January 31, 2002 and as at October 31, 2002 owing mainly to deposits from small and medium-size businesses.

### Capital

Tier 1 and total capital ratios, in accordance with the rules of the Bank for International Settlements, were 10.2% and 14.3% respectively as at January 31, 2003 compared to 9.6% and 13.6% as at October 31, 2002. The improvement in capital ratios was chiefly owing to the issue of \$200 million of preferred shares.

### Dividends

At its meeting on February 27, 2003, the Board of Directors declared regular dividends on the various classes and series of preferred shares as well as a dividend of 26 cents per common share, payable on May 1, 2003 to shareholders of record on March 27, 2003.

### Trading Activities <sup>(1)</sup>

(millions of dollars)

Global VaR by risk category	For the quarter ended January 31, 2003				For the quarter ended October 31, 2002			
	Period end	High	Average	Low	Period end	High	Average	Low
Interest rate	(3)	(4)	(3)	(3)	(4)	(5)	(3)	(2)
Foreign exchange	(1)	(1)	(1)	–	(1)	(2)	(1)	–
Price	(3)	(4)	(2)	(1)	(2)	(2)	(2)	(1)
Global VaR <sup>(2)</sup>	(5)	(5)	(4)	(3)	(4)	(6)	(4)	(2)

<sup>(1)</sup> Amounts are presented on a pre-tax basis and represent one-day VaR.

<sup>(2)</sup> Global VaR reflects the correlation effect from each of the risk categories through diversification.

## Highlights

(unaudited)	Quarter ended January 31		% Change
	2003	2002	
<b>Operating results</b>			
(millions of dollars)			
Total revenues	\$835	\$762	10
Net income	166	146	14
Return on common shareholders' equity	17.6 %	15.0 %	
<b>Per common share</b>			
Net income	\$0.88	\$0.73	21
Dividends paid	0.26	0.21	24
Book value	20.22	19.56	3
Stock trading range			
High	33.10	30.07	
Low	29.95	24.70	
Close	31.76	30.00	
<b>Financial position</b>			
(millions of dollars)			
	January 31	October 31	
	2003	2002	
Total assets	\$73,125	\$74,611	(2)
Loans and acceptances	43,725	43,800	-
Deposits	49,930	51,690	(3)
Subordinated debentures and shareholders' equity	5,752	5,493	5
Capital ratios - BIS			
Tier 1	10.2 %	9.6 %	
Total	14.3 %	13.6 %	
Impaired loans, net of specific and general allowances	(175)	(159)	
as a % of loans and acceptances	(0.4)%	(0.4)%	
Assets under administration/management	139,542	140,737	
Total personal savings	69,468	68,243	
Interest coverage	7.86	7.39	
Asset coverage	3.18	3.02	
<b>Other information</b>			
Number of employees	17,153	17,285	(1)
Number of branches in Canada	491	507	(3)
Number of banking machines	811	826	(2)

## Consolidated Statement of Income

(unaudited) (millions of dollars except per share amounts)	Quarter ended		
	January 31 2003	October 31 2002	January 31 2002
<b>Interest income and dividends</b>			
Loans	466	475	496
Securities	150	130	138
Deposits with financial institutions	37	37	54
	<b>653</b>	<b>642</b>	<b>688</b>
<b>Interest expense</b>			
Deposits	257	233	268
Subordinated debentures	27	27	28
Other	14	21	11
	<b>298</b>	<b>281</b>	<b>307</b>
<b>Net interest income</b>	<b>355</b>	<b>361</b>	<b>381</b>
<b>Other income</b>			
Capital market fees	136	134	128
Deposit and payment service charges	42	43	42
Trading activities and gains on investment account securities, net	51	3	-
Card service revenues	12	13	12
Lending fees	50	45	44
Acceptances, letters of credit and guarantee	19	15	17
Securitization revenues (Note 7)	54	66	46
Foreign exchange revenues	17	17	15
Trust services and mutual funds	54	52	33
Other	45	46	44
	<b>480</b>	<b>434</b>	<b>381</b>
<b>Total revenues</b>	<b>835</b>	<b>795</b>	<b>762</b>
<b>Provision for credit losses</b>	<b>41</b>	<b>53</b>	<b>245</b>
	<b>794</b>	<b>742</b>	<b>517</b>
<b>Operating expenses</b>			
Salaries and staff benefits	317	300	282
Occupancy and amortization	45	55	44
Computers and equipment	63	68	57
Communications	21	20	18
Other	102	97	100
	<b>548</b>	<b>540</b>	<b>501</b>
<b>Income before income taxes, non-controlling interest and discontinued operations</b>	<b>246</b>	<b>202</b>	<b>16</b>
Income taxes charged (recovered)	73	56	(19)
	<b>173</b>	<b>146</b>	<b>35</b>
Non-controlling interest	7	7	7
<b>Income before discontinued operations</b>	<b>166</b>	<b>139</b>	<b>28</b>
Discontinued operations	-	(4)	118
<b>Net income</b>	<b>166</b>	<b>135</b>	<b>146</b>
Dividends on preferred shares	5	5	7
<b>Net income applicable to common shares</b>	<b>161</b>	<b>130</b>	<b>139</b>
Number of common shares outstanding (thousands)			
Average - basic	182,728	183,124	190,450
Average - diluted	183,905	184,168	191,350
End of period	181,563	182,596	190,500
<b>Income before discontinued operations per common share</b>			
Basic	0.88	0.73	0.11
Diluted	0.88	0.73	0.11
<b>Net income per common share</b>			
Basic	0.88	0.71	0.73
Diluted	0.88	0.71	0.73
<b>Dividends per common share</b>	<b>0.26</b>	<b>0.24</b>	<b>0.21</b>

## Consolidated Balance Sheet

(unaudited)  
(millions of dollars)

	January 31 2003	October 31 2002	January 31 2002
<b>ASSETS</b>			
<b>Cash resources</b>			
Cash and deposits with Bank of Canada	302	245	605
Deposits with financial institutions	6,130	6,619	8,453
	<b>6,432</b>	<b>6,864</b>	<b>9,058</b>
<b>Securities</b>			
Investment account	7,325	6,712	6,899
Trading account	11,669	13,179	12,031
Loan substitutes	64	76	78
	<b>19,058</b>	<b>19,967</b>	<b>19,008</b>
<b>Loans</b>			
Residential mortgage	12,962	12,867	12,264
Personal and credit card	5,744	5,561	5,654
Business and government	19,094	20,680	18,964
Securities purchased under reverse repurchase agreements	3,426	2,366	4,730
Allowance for credit losses	(635)	(662)	(696)
	<b>40,591</b>	<b>40,812</b>	<b>40,916</b>
<b>Other</b>			
Customers' liability under acceptances	3,134	2,988	3,033
Assets held for disposal	281	313	610
Premises and equipment	246	255	243
Goodwill	660	661	283
Intangible assets	184	184	12
Other assets	2,539	2,567	2,807
	<b>7,044</b>	<b>6,968</b>	<b>6,988</b>
	<b>73,125</b>	<b>74,611</b>	<b>75,970</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
<b>Deposits</b>			
Personal	23,000	22,607	22,388
Business and government	21,400	22,582	22,121
Deposit-taking institutions	5,530	6,501	6,016
	<b>49,930</b>	<b>51,690</b>	<b>50,525</b>
<b>Other</b>			
Acceptances	3,134	2,988	3,033
Obligations related to securities sold short	6,085	5,542	5,730
Obligations related to securities sold under repurchase agreements	3,293	4,416	6,134
Other liabilities	4,473	3,996	4,282
	<b>16,985</b>	<b>16,942</b>	<b>19,179</b>
<b>Subordinated debentures</b>	<b>1,581</b>	<b>1,592</b>	<b>1,645</b>
<b>Non-controlling interest</b>	<b>458</b>	<b>486</b>	<b>494</b>
<b>Shareholders' equity</b>			
Preferred shares	500	300	400
Common shares	1,633	1,639	1,672
Retained earnings	2,038	1,962	2,055
	<b>4,171</b>	<b>3,901</b>	<b>4,127</b>
	<b>73,125</b>	<b>74,611</b>	<b>75,970</b>

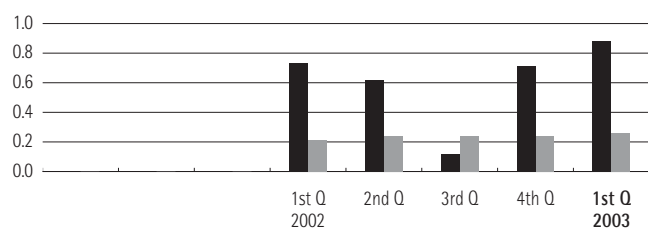
## Consolidated Statement of Changes in Shareholders' Equity

(unaudited)  
(millions of dollars)

	Quarter ended January 31	
	2003	2002
<b>Capital stock at beginning of period</b>	1,939	2,160
Issuance of common shares	7	4
Issuance of preferred shares (Note 6)	200	-
Repurchase of common shares for cancellation (Note 6)	(13)	-
Redemption of preferred shares, Series 10	-	(92)
<b>Capital stock at end of period</b>	<b>2,133</b>	<b>2,072</b>
<b>Retained earnings at beginning of period</b>	1,962	1,956
Net income	166	146
Dividends		
Preferred shares	(5)	(7)
Common shares	(48)	(40)
Premium paid on common shares repurchased for cancellation (Note 6)	(33)	-
Share issuance expenses, net of income taxes	(4)	-
<b>Retained earnings at end of period</b>	<b>2,038</b>	<b>2,055</b>
<b>Shareholders' equity</b>	<b>4,171</b>	<b>4,127</b>

### Net Income per Common Share

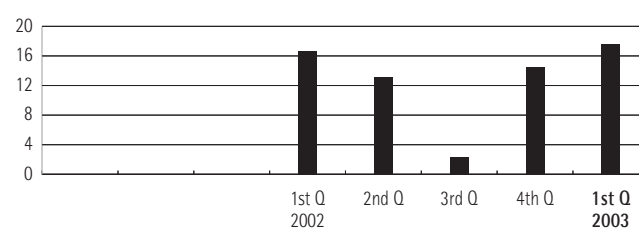
(dollars)



■ Net income per common share	0.73	0.62	0.12	0.71	0.88
■ Dividend per share	0.21	0.24	0.24	0.24	0.26

### Return on Common Shareholders' Equity

(percentage)



■	15.0	13.1	2.3	14.5	17.6
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## Consolidated Statement of Cash Flows

(unaudited)  
(millions of dollars)

	Quarter ended January 31	
	2003	2002
<b>Cash flows from operating activities</b>		
Net income	166	146
Adjustments for:		
Provision for credit losses excluding discontinued operations	41	245
Provision for credit losses attributed to discontinued operations	-	(50)
Amortization of premises and equipment	11	12
Future income taxes	6	11
Adjustment upon foreign currency translation of subordinated debentures	(11)	(1)
Gain on sale of investment account securities, net	(13)	(8)
Change in interest payable	(1)	(59)
Change in interest receivable	13	19
Change in income taxes payable	6	110
Change in unrealized losses and amounts payable on derivative contracts	228	85
Change in trading account securities	1,510	(1,039)
Change in other items	269	149
	<b>2,225</b>	<b>(380)</b>
<b>Cash flows from financing activities</b>		
Change in deposits	(1,760)	(911)
Redemption and maturity of subordinated debentures	-	(1)
Issuance of common shares	7	4
Issuance of preferred shares	200	-
Common shares repurchased for cancellation	(46)	-
Preferred shares redeemed for cancellation	-	(92)
Dividends paid	(96)	(49)
Change in obligations related to securities sold short	543	351
Change in obligations related to securities sold under repurchase agreements	(1,123)	1,727
Change in other items	(4)	-
	<b>(2,279)</b>	<b>1,029</b>
<b>Cash flows from investing activities</b>		
Change in loans	1,633	1,388
Change in securitization of assets	(361)	(568)
Proceeds from sale of asset-based loans	-	2,540
Purchases of investment account securities	(5,765)	(4,360)
Sale of investment account securities	5,177	4,271
Change in securities purchased under reverse repurchase agreements	(1,060)	(689)
Change in premises and equipment	(2)	(5)
	<b>(378)</b>	<b>2,577</b>
<b>Increase (decrease) in cash and cash equivalents</b>	<b>(432)</b>	<b>3,226</b>
Cash and cash equivalents at beginning of period	6,864	5,832
Cash and cash equivalents at end of period	<b>6,432</b>	<b>9,058</b>
<b>Cash and cash equivalents</b>		
Cash and deposits with Bank of Canada	302	605
Deposits with financial institutions	6,130	8,453
Total	<b>6,432</b>	<b>9,058</b>
Interest and dividends paid	396	431
Income taxes paid (recovered)	61	(140)

## Segment Disclosures <sup>(1)</sup>

### Quarter ended January 31

(taxable equivalent basis)  
(unaudited) (millions of dollars)

	2003	2002	2003	2002	2003	2002	2003	2002	2003	2002
	Personal and Commercial		Wealth Management		Financial Markets		Other		Total	
Net interest income <sup>(2)</sup>	312	299	23	22	71	92	(38)	(27)	368	386
Other income <sup>(2)</sup>	156	141	139	138	166	105	31	35	492	419
Total revenues	468	440	162	160	237	197	(7)	8	860	805
Operating expenses	273	274	131	124	128	93	16	10	548	501
Contribution	195	166	31	36	109	104	(23)	(2)	312	304
Provision for credit losses <sup>(3)</sup>	53	58	–	–	10	13	(22)	174	41	245
Income before income taxes, non-controlling interest and discontinued operations	142	108	31	36	99	91	(1)	(176)	271	59
Income taxes <sup>(2)</sup>	51	39	11	12	35	34	1	(61)	98	24
Non-controlling interest	–	–	1	1	–	–	6	6	7	7
Income before discontinued operations	91	69	19	23	64	57	(8)	(121)	166	28
Discontinued operations	–	–	–	–	–	–	–	118	–	118
Net income	91	69	19	23	64	57	(8)	(3)	166	146
Average assets	38,342	38,726	672	799	37,222	38,675	(5,916)	(7,184)	70,320	71,016

#### Personal and Commercial

This segment comprises the branch network, intermediary services, credit cards, insurance, commercial banking services and real estate.

#### Wealth Management

This segment comprises full-service retail brokerage, discount brokerage, mutual funds, trust services and portfolio management.

#### Financial Markets

This segment consists of corporate financing and lending, treasury operations, which include asset and liability management, and corporate brokerage.

#### Other

This heading comprises securitization operations, gains on the sale of operations, certain non-recurring items, discontinued operations and the unallocated portion of centralized service units.

(1) Since November 1st 2002, the Bank has modified the composition of its reportable segments in order to reflect changes to its organizational structure. The comparative figures have been restated to give effect to the current period's organizational structure.

(2) Net interest income was grossed up by \$13 million (\$5 million in 2002) and other income by \$12 million (\$38 million in 2002) to bring the tax-exempt income earned on certain securities in line with the income earned on other financial instruments. An equivalent amount was added to income taxes.

(3) Provisions for credit losses for the segments are determined based on expected losses, which are established through statistical analysis. The difference between actual losses and expected losses is recorded under the "Other" heading.

## Notes to the Consolidated Financial Statements (unaudited) (millions of dollars)

*These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements for the year ended October 31, 2002. Certain comparative figures have been reclassified to comply with the presentation adopted in fiscal 2003.*

### 1. Significant Accounting Policies

These unaudited interim consolidated financial statements of the Bank were prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and the accounting policies adopted in the Bank's most recent annual report for the year ended October 31, 2002, with the exception of the new standard described in Note 2 and the recording in the first quarter of 2002 of the difference between the general allowance for credit risk according to the guidance provided by the Superintendent of Financial Institutions Canada and according to Canadian GAAP, as described in Note 28 of the 2002 annual consolidated financial statements.

Had the Bank followed Canadian GAAP in the first quarter of 2002, net income would have decreased by \$57 million, the provision for credit losses would have increased by \$97 million, income taxes would have decreased by \$40 million, and basic and diluted net income per common share would have decreased by \$0.30. Furthermore, return on common shareholders' equity would have decreased by 6.26%.

### 2. Recent Standard Adopted

#### Stock-Based Compensation

On November 1, 2002, the Bank adopted the requirements of the standard of the Canadian Institute of Chartered Accountants (the "CICA") entitled "Stock-Based Compensation and Other Stock-Based Payments". It establishes standards for the recognition, measurement and disclosure of stock-based compensation and other stock-based payments made in exchange for goods and services. A description of these new accounting policies and the impact of the adoption of this new standard on the consolidated financial statements for the first quarter of 2003 is presented below.

#### A. Stock Appreciation Rights (SAR) Plan

In accordance with this new standard, SARs are recorded at fair value by valuing, on an ongoing basis, the excess of the stock price over the exercise price of the option. The new standard applies to SARs outstanding at the date of the adoption of the recommendations and to subsequent awards. The Bank's obligation, which results from the variation in the stock's market price, is recognized in income on a straight-line basis over the vesting period, namely, four years, and a corresponding amount is included in "Other liabilities". When the vesting period expires and until the SARs are exercised, the change in the obligation attributable to variations in the stock price is recognized by increasing or decreasing the compensa-

tion expense for the period in which the variations occur. With regard to SARs outstanding as at the date of the adoption of the recommendations, the application of the new standard's transitional provisions, taking into account the liability previously recognized by the Bank, did not require any cumulative adjustment to the balance of retained earnings as at November 1, 2002. Furthermore, the new standard had no material impact on the consolidated financial statements for the first quarter of 2003.

#### B. Stock Option Plan

As encouraged in the new standard, the Bank has chosen to adopt the fair value-based method to record stock options awarded as of November 1, 2002. The fair value of the stock options is evaluated on the grant date using the Black-Scholes model. The cost is recognized using a straight-line method over the vesting period, namely, four years, as an increase to the compensation expense and to contributed surplus. When the options are exercised, the proceeds and the contributed surplus are credited to common share paid-up capital. For options awarded before November 1, 2002, the Bank continues to apply the accounting policy described in Note 1 of the 2002 annual consolidated financial statements.

The fair value on the grant date of the options awarded in the first quarter of 2003 was evaluated at \$7.90 using the Black-Scholes model. The following assumptions were used: i) a risk-free interest rate of 5.26%, ii) an expected life of options of 10 years, iii) an expected volatility of 27% and iv) an expected dividend yield of 3.36%. During the first quarter of 2003, the Bank awarded 1,542,700 options at the exercise price of \$30.95 per share.

The impact of the adoption of the fair value-based method on the consolidated financial statements for the quarter ended January 31, 2003 was an increase of \$381,000 in compensation expense and in contributed surplus.

### 3. Recent Standards Pending Adoption

#### Disclosure of Guarantees

In February 2003, the CICA issued Accounting Guideline 14 entitled "Disclosure of Guarantees". This accounting guideline broadens the definition of guarantees and requires that the guarantor disclose significant information on the guarantees which he has provided. In particular, the guideline requires the disclosure of the nature of the guarantee, how the guarantee arose and the events or conditions that would require the guarantor to perform under the guarantee, the maximum potential future payments, and the recourse that would enable the guarantor to recover from third parties if the guarantee is exercised. The Bank will adopt the accounting guideline in the interim financial statements for the period ending on April 30, 2003. The Bank is presently evaluating the impact that this guideline will have on disclosure requirements.

#### Consolidation of Special-Purpose Entities

In August 2002, the CICA issued a draft Accounting Guideline entitled "Consolidation of Special-Purpose Entities" and intends to issue, in April 2003, the final guideline which will be harmonized with corresponding U.S. standard. The proposed accounting guideline provides guidance on determining who is the primary beneficiary of the special-purpose entity and who will therefore be required to consolidate the special-purpose entities. The accounting guideline will be issued as soon as possible in order that it may be applied at the same time as the U.S. standard, but a mandatory effective date has yet to be determined. As regards U.S. GAAP, the new consolidation requirements will apply to all special-purpose entities created after January 31, 2003, and for special-purpose entities created before this date, they will apply at the beginning of the fourth quarter of the Bank's fiscal 2003. The Bank is currently evaluating the impact of the new accounting guideline.

#### Disposal of Long-Lived Assets and Discontinued Operations

In 2002, the CICA issued a new standard entitled "Disposal of Long-Lived Assets and Discontinued Operations", which establishes standards for the recognition, measurement and disclosure of the disposal of non-monetary long-lived assets. Long-lived assets to be disposed of other than by sale should continue to be classified as held-for-use until their disposal. Long-lived assets held for sale that meet certain criteria should be presented separately on the balance sheet and measured at the lower of their carrying value or fair value, less cost to sell.

Furthermore, according to this new standard, the definition of discontinued operations has been broadened. This change may affect the presentation of future discontinued operations.

This new standard will apply to discontinued operations already underway, subsequent to a commitment to follow a plan, as of May 1, 2003. These new requirements should not have a material impact for the Bank.

#### Impairment of Long-Lived Assets

In 2002, the CICA issued a new standard entitled "Impairment of Long-Lived Assets", which establishes standards for the recognition, measurement and disclosure of the impairment of long-lived assets. This standard stipulates that an impairment loss should be recognized when the carrying value of a long-lived asset intended for use exceeds the sum of the undiscounted cash flows expected from its use and eventual disposition. The impairment loss is to be measured as the excess of the carrying value of the asset over its fair value. The Bank will adopt this standard effective November 1, 2003.

#### 4. Loans and Impaired Loans

	Gross amount	Impaired loans			Net
		Gross	Specific allowance	Country risk allowance	
<b>January 31, 2003</b>					
Residential mortgage	12 962	14	4	-	10
Personal and credit card	5 744	30	13	-	17
Business and government	19 094	416	191	22	203
Securities purchased under reverse repurchase agreements	3 426	-	-	-	-
	41 226	460	208	22	230
General allowance <sup>(1)</sup>					(405)
Impaired loans, net of specific and general allowances					(175)
<b>October 31, 2002</b>					
Residential mortgage	12 867	23	3	-	20
Personal and credit card	5 561	33	12	-	21
Business and government	20 680	447	220	22	205
Securities purchased under reverse repurchase agreements	2 366	-	-	-	-
	41 474	503	235	22	246
General allowance <sup>(1)</sup>					(405)
Impaired loans, net of specific and general allowances					(159)

(1) The general allowance for credit risk was taken for the bank's loans in their entirety.

#### 5. Allowances for Credit Losses

For the 3-month period ended	Specific allowance	Allocated general allowance	Unallocated general allowance	Country risk allowance (loans and securities)	January 31	January 31
					2003	2002
Allowances at beginning	235	296	109	22	662	879
Transfer of allowance for assets held for disposal	-	-	-	-	-	(31)
Amounts related to discontinued operations	-	-	-	-	-	(65)
Provision for credit losses	41	4	(4)	-	41	245
Write-offs	(80)	-	-	-	(80)	(323)
Recoveries	12	-	-	-	12	(9)
Allowances at end of period	208	300	105	22	635	696

#### 6. Capital Stock

Issued and fully paid as at January 31, 2003	
First preferred shares	
5,000,000 shares, Series 12	125
7,000,000 shares, Series 13	175
8,000,000 shares, Series 15	200
	500
181,563,094 common shares	1,633
	2,133
6,883,297 stock options outstanding	N/A

#### Issuance of preferred shares

On January 31, 2003, the Bank issued 8,000,000 first preferred shares with non-cumulative preferential dividends payable quarterly in an amount of \$0.365625 per share, Series 15, for an aggregate consideration of \$194,665,000, net of commissions totalling \$5,335,000.

These shares are redeemable at the Bank's option, subject to the prior approval of the Superintendent of Financial Institutions as of May 15, 2008, in whole or in part, at a price equal to \$26 per share if they are redeemed before May 15, 2009, at \$25.75 per share if they are redeemed during the 12-month period prior to May 15, 2010, at \$25.50 per share if they are redeemed during the 12-month period prior to May 15, 2011, at \$25.25 per share if they are redeemed during the 12-month period prior to May 15, 2012, and at \$25.00 per share if they are redeemed as of May 15, 2012, in each case, plus all declared and unpaid dividends at the date fixed for redemption.

#### Repurchase of common shares

On January 20, 2003, the Bank made a normal course issuer bid for the repurchase of up to 9,100,000 common shares over a 12-month period ending no later than January 19, 2004. Purchases were made on the open market at market prices through the facilities of The Toronto Stock Exchange. Premiums paid above the average book value of the common shares were charged to retained earnings. As at January 31, 2003, the Bank had repurchased 1,427,600 common shares at a cost of \$46 million, which reduced common equity capital by \$13 million and retained earnings by \$33 million.

#### 7. Securitization

##### CMHC-guaranteed mortgage loans

During the first quarter of 2003, the Bank securitized residential mortgage loans guaranteed by the CMHC totalling \$276 million through the creation of mortgage-backed securities. The Bank sold all these securities in addition to \$21 million in mortgage-backed securities created in October 2002. The Bank received cash proceeds totalling \$296 million and retained the rights to future excess interest in the amount of \$13 million. A \$12 million pre-tax gain, net of transaction costs of \$1 million, was recognized in the consolidated statement of income under "Securitization revenues".

##### Credit card receivables

Total securitized credit card receivables went from \$1.2 billion as at October 31, 2002 to \$1 billion as at January 31, 2003 because \$200 million matured during the first quarter of 2003.

## Economic Commentary

### The American Economy Poised To Rebound

With the American economy at a standstill in the last quarter of 2002, it is enough to revive fears of a new recession or, even worse, a Japanese-style downward deflation-depression spiral. We, however, believe that the U.S. economy will bounce back.

So far, consumers have been keeping the economy afloat, even though the jobs lost during the last recession have not been recovered. This resiliency stems from the highly unusual fact that real wages have continued to rise even in the midst of a recession. The consequence is that the economy's total payroll has continued to grow despite job cuts. One reason for wage increases is that the job market has remained tight. In fact, since the start of the recession and the jobless recovery, the unemployment rate has not exceeded 6%. Another reason is that productivity gains have enabled businesses to raise salaries. In addition to wage increases, consumers have also benefitted from lower taxes and low interest rates.

Nevertheless, it obviously cannot be assumed that the American economy is out of the woods until businesses take a load off consumers and get back to investing and hiring. We expect this transition to come about in 2003.

At first glance, excess production capacity is not conducive to corporate spending. In fact, excess capacity will certainly influence companies' decision to invest in new infrastructures. However, three-quarters of investment goes towards equipment, half of which falls into the category of information technology. This type of equipment depreciates so rapidly that hardware and software installed to deal with the Year 2000 bug will soon need replacing. Lastly, statistics on the capacity utilization rate must be taken with a grain of salt as they only reflect the manufacturing sector, which is becoming increasingly marginal in the United States.

Not only must companies feel the need to invest, they must also have the means to do so. During the last recession, investment was reduced to the point where it could be financed almost entirely through internally generated funds. That way, businesses avoid having to take on debt or issuing capital stock in a market where capital has become costly. It also means that budgets earmarked for investment can be increased as profitability improves.

Corporate profitability will almost certainly improve, even though companies will have a hard time raising prices. The key here is productivity gains. Productivity gains have been substantial in recent years, and 2002 was no exception, having risen 4.7% – the largest increase in 50 years. As a result, companies have been able to contain unit labour costs in spite of wage increases, and their profit margins have even strengthened.

Some feel that the U.S. economy is on the verge of crumbling under the weight of corporate and household debt. In such a scenario, it would embark on a deflation-depression spiral just as Japan did at the end of the 1980s. However, the U.S. economy differs in two major respects from the Japanese economy at that time.

First, American banks are well capitalized and have emerged from the recession relatively unscathed. This is attributable to the fact that they were not left holding the lion's share of financing the technology bubble. That privilege went instead to stock and bond markets.

Secondly, authorities did not err in their judgement. For example, the Federal Reserve promptly lowered interest rates, something Japan's central bank did not do. Since then, all statements issued by the Fed leave no doubt that it will wait for sure signs that investment and employment are firmly back on track before raising rates. What's more, at the very start of the recession, the federal government was in a budget surplus situation, and U.S. debt was relatively low. Authorities took advantage of that to make full use of government spending. Rarely have monetary policy and fiscal policy worked hand in hand so forcefully. And that's not all: the depreciation of the U.S. dollar also comes into play.

Of course, the American economy is not free of all risk. For starters, energy prices could rise further if mounting geopolitical tensions result in oil supplies being cut off. Corporate profitability would undoubtedly be compromised. Another risk is that productivity gains would no longer offset higher payroll costs.

At this stage, however, it would be premature at the very least to consider the U.S. economy as being on the brink of depression.

## Bank News

**Bank mergers:** In an address to the Standing Committee on Finance of the House of Commons and the Standing Senate Committee on Banking, Trade and Commerce, Réal Raymond indicated that the National Bank would be interested in acquiring viable local networks of basic services for individuals and SMEs or national operational units divested as the result of two large Canadian banks merging. He added that mergers could provide an opportunity for the Bank to continue its expansion outside Quebec and thereby help maintain competition on a national scale.

**Address to the Canadian Club of Montreal:** Réal Raymond commented that the resurgence of Montreal's economy, particularly noticeable over the past few years, is attributable to the balance and great diversity of its knowledge-based economy. The city's strength lies in having developed a highly diversified high-tech industry, as opposed to one founded on just a few big-name players.

**No. 1 in customer service:** The National Bank has good reason to be proud of its customer service. For the second year in a row, Altamira, now a Bank subsidiary, captured the Dalbar Mutual Fund Service Award for service to English-speaking and French-speaking customers. What's more, National Bank Discount Brokerage came out the winner for a fourth consecutive quarter for the quality of its customer service. These awards confirm the National Bank's commitment towards quality of service as both a priority and a competitive advantage. Dalbar is a financial services research firm that specializes in measuring the performance of financial institutions and professionals in terms of customer satisfaction, service quality and effective communications.

**Important date:** Shareholders of the National Bank are invited to attend the Annual Meeting of Shareholders scheduled for Wednesday, March 12 at 9:30 a.m. at the Palais des Congrès, Room 710, 201 Viger West, Montreal.

**Public accountability statement:** For the National Bank and its employees, community involvement is not just a responsibility, it's also a way of life and part of the job. The 2002 Social Responsibility Report offers concrete examples of the Bank's involvement in the communities where it is present. Donations to charitable organizations, volunteer work by employees, initiatives to improve access to its services, support to SMEs and concern for the environment are just some of the topics covered in this document. The Social Responsibility Report is available on the Bank's website at [www.nbc.ca](http://www.nbc.ca). Copies can also be obtained by calling TelNat at 1-888-4TELNAT or (514) 394-5555.

**United Way/Centraide campaign:** The National Bank's community involvement is multi-dimensional. For instance, its employees, officers and retired employees raised \$444,000 for the Centraide campaign of Greater Montreal, which the Bank matched with a corporate donation of \$450,000 for a total of \$894,000. In addition, National Bank branches have been participating in the Mira Foundation's funding drives since 1988. Over the fall season, the campaign raised \$288,733 through sales of an activity book for people aged 7 through 77. The Mira Foundation is an organization that trains guide dogs and service dogs to assist people with physical or visual impairments.

### Caution regarding forward-looking statements

*As part of its analyses and reports, National Bank of Canada from time to time makes forward-looking statements concerning the economy, market changes, the achievement of strategic objectives, certain risks and other related matters. By their very nature, such forward-looking statements involve inherent risks and uncertainties. It is therefore possible that express or implied projections contained in such statements will not materialize and will differ materially from actual future results. Such differences may be caused by factors which include,*

*but are not limited to, changes in Canadian and/or global economic conditions, particularly fluctuations in interest rates, currencies and other financial instruments, market conditions, technological changes or regulatory developments. Investors and others who base themselves on the Bank's forward-looking statements to make decisions should carefully consider the above factors as well as the uncertainties they represent and the risks they entail. The Bank therefore cautions readers not to place undue reliance on these forward-looking statements.*



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## General Information

### Investor Relations

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Financial analysts and investors who want to obtain financial information on the Bank are asked to contact the Investor Relations Department, by telephone at (514) 394-0296, by fax at (514) 394-6196 or by e-mail at [investorrelations@nbc.ca](mailto:investorrelations@nbc.ca). For more information about the Bank and its publications, you can visit the Bank's website at [www.nbc.ca](http://www.nbc.ca)

### Direct Deposit Service for Dividends

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For security purposes, the National Bank offers its shareholders the possibility of having their dividend payments deposited directly to an account at the financial institution of their choice, provided it is equipped with an electronic funds transfer system.

Additional information may be obtained from the Registrar, National Bank Trust, at 1-800-341-1419 or (514) 871-7171, or by e-mail at [cliente@tbn.nbc.ca](mailto:cliente@tbn.nbc.ca)

### Dividend Reinvestment and Share Purchase Plan

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The National Bank offers holders of its common or preferred shares a Dividend Reinvestment and Share Purchase Plan through which they can reinvest their dividends in common shares of the Bank without paying any commissions or administration fees.

Participants in the Plan may reinvest all cash dividends paid on their eligible shares or, if they wish, make optional cash payments of at least \$500 per payment, to a maximum of \$5,000 per quarter.

Additional information may be obtained from the Registrar, National Bank Trust, at 1-800-341-1419 or (514) 871-7171, or by e-mail at [cliente@tbn.nbc.ca](mailto:cliente@tbn.nbc.ca).

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