# BMO Financial Group

## Q2 2015 CONFERENCE CALL

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## PRESENTATION

**Sharon Haward-Laird** *- Bank of Montreal - Head of Corporate Communications and IR*

Thank you very much. Good afternoon everyone and thanks for joining us today.

Our agenda for today's investor presentation is as follows: We will begin the call with remarks from Bill Downe, BMO's CEO; followed by presentations from Tom Flynn, the Bank's Chief Financial Officer; and Surjit Rajpal, our Chief Risk Officer. After their presentations we will have a short question and answer period where we will take questions from pre-qualified analysts. To give everyone an opportunity to participate, please keep it to one question and then requeue.

Frank Techar, Chief Operating Officer; Cam Fowler from Canadian P&C; Mark Furlong from U.S. P&C; Darryl White from BMO Capital Markets; and Gilles Ouellette from Wealth Management are with us this afternoon to take questions.

Dave Casper, who will be President and CEO of BMO Harris Bank and Group Head Commercial Banking effective June 1, is also with us and will speak to U.S. P&C results starting next quarter.

On behalf of those speaking today, I note that forward-looking statements may be made during this call. Actual results could differ materially from forecasts, projections or conclusions in these statements.

I would also remind listeners that the Bank uses non-GAAP financial measures to arrive at adjusted results to assess and measure performance by business and the overall Bank. Management assesses performance on a reported and adjusted basis, and considers both to be useful in assessing underlying business performance.

Bill and Tom will be referring to adjusted results in their remarks unless otherwise noted. Additional information on adjusting items, the Bank's reported results, and factors and assumptions related to forward-looking information can be found in our Annual Report and our Second Quarter Report to Shareholders.

With that said, I will hand things over to Bill.

**Bill Downe** *- Bank of Montreal - CEO*

Thank you, Sharon. Good afternoon to everyone joining us on the call.

BMO delivered good results in the second quarter with net income of $1.1 billion, up 5% from last year and 10% from the first quarter. Our operating groups performed well with good year-over-year net income growth in Wealth Management and in our combined Personal and Commercial Banking business. In Capital Markets results were significantly higher than in the prior period.

Tom is going to take you through the financial results and Surjit will provide more detail about credit, but I wanted to highlight a few key items from the quarter.

BMO's capital position is strong, with a common equity Tier 1 ratio of 10.2%. We bought back 3 million shares in the quarter, returning $1.5 billion of capital to shareholders in the first half of the year. We also announced a $0.02 increase in our quarterly dividend to $0.82 per common share, up 5% since last year. Credit performance continued to be good with provisions at 20 basis points, in line with the prior quarter and the prior year.

As I said last quarter, we're keeping a close check on expense growth. We took a charge this quarter of $106 million after-tax, which will result in an annual run rate expense savings of about $100 million. With our advantaged business mix, our diversified North American footprint, and our clear and consistent focus on customer experience, we also expect revenue growth to pick up over the remainder of the year.

Turning briefly to the operating groups; our combined Personal and Commercial banking earnings were $706 million, up 8% from last year.

Canadian Personal and Commercial Banking reported net income of $487 million, as higher revenues were offset by increased expenses and loan loss provisions. We have a number of significant initiatives underway which reinforce our strategy, which is based on understanding that our customers believe that money is personal and their bank should be too. One of these initiatives is our new Savings Builder Account. By encouraging customers to save, earn and repeat, we're helping them get into the habit of saving for the future, and at the same time we're continuing to provide them with innovative products that are well aligned with our brand. We expect the results from Canadian P&C to continue to improve in the second half.

U.S. Personal and Commercial Banking had good results, with net income up 29% from last year, or 14% in source currency, with ongoing strength in commercial lending, good growth in deposits, improved credit, and disciplined expense control.

BMO Wealth Management continued to demonstrate strong momentum, with double digit net income growth from last year. Net income was up 23% in our traditional wealth business, reflecting good organic growth in client assets and the addition of F&C. In insurance, where earnings have been negatively impacted by long-term interest rates over the last few years, there was a benefit this quarter from an increase in rates.

Capital Markets results rebounded nicely from last quarter, reflecting higher revenue from our Trading Products business and stable revenues with an improving pipeline in Investment and Corporate Banking. Return on equity also improved to 18%.

Our operating group results this quarter demonstrate the benefits of our business mix, which is well diversified by geography and customer type.

I'll now take a moment to acknowledge Mark Furlong, who as you know, has decided to retire June 1. On behalf of everyone at BMO, I'd like to thank Mark for his leadership since we brought together two prominent Midwestern institutions in 2011. Mark has been a unifying force for all involved during this period. We transformed our competitive position in the U.S. and introduced a new brand, BMO Harris Bank, to our customers and the marketplace. There can be no doubt about the instrumental role Mark played in establishing what BMO Harris Bank is today. We will all miss his contribution as a key member of BMO's management team.

With this management transition underway, it seems timely to reflect on the progress we’ve made in the U.S. over the past few years across each of our businesses.

In U.S. P&C we had an ambitious agenda that we delivered on, rebranding over 600 bank branches, converting our core banking platform, and exceeding our initial projections for synergies. We also maintained strong deposit market share across our footprint, ranking number two in both Chicago and Wisconsin. Loan growth has been particularly robust in our commercial lending business, evidenced by three years of double digit growth. In our retail bank, the U.S. consumer has rebuilt their balance sheet and there are good signs of progress, with chequing account balances up 10% from last year. And in business banking there was growth in core loans for the sixth consecutive quarter.

We've also improved our access to online and mobile banking while ensuring that we keep the experience personal. Two recent examples of this are the debut of BMO Harris Bank's first Smart Branch, which enables our customers to complete transactions with video teller ATMs, and the launch of Mobile Cash, a new technology that allows customers to use their smartphone to withdraw money at 850 of our ATMs. We expect this kind of innovation to attract new customers and make the experience better for our existing customers.

Our other two U.S. businesses are also well positioned for future growth. Wealth Management occupies a prominent position in the world's largest and most affluent banking market. Since we purchased M&I, our U.S. assets under management and administration have grown from $85 billion to more than $330 billion.

More recently, BMO Funds was rated second among U.S. mutual Fund families by Barron's Lipper, recognizing the investment capability of BMO Global Asset Management. With the strength of the BMO brand and a broad retail presence in our key markets, there continues to be great potential for future growth in our private bank and asset management businesses.

In our U.S. Capital Markets business we have a mid-cap strategy that's focused on key sectors where we have particular expertise. And that strategy has been successful, with net income more than doubling in source currency since 2011.

In Investment Banking we've gained share in our target segments, and our progress in deepening relationships has driven an increase in our equity client vote ranking with the largest U.S. institutional investors. With this strong foundation we expect the contribution from our U.S. Capital Markets business to continue to improve.

In summary, since 2011 we've transformed our competitive position in the U.S. and have built a diversified North American banking platform. Our strategy has resulted in progress in our financial results, despite the headwinds from low interest rates, with our U.S. segment contribution to total bank net income increasing from 11% to 20%.

With the appointment of Dave Casper as President and CEO of BMO Harris Bank and Group Head, Commercial Banking and Alex Dousmanis-Curtis as Group Head, U.S. Retail and Business Banking, our businesses are in the very capable hands of two accomplished leaders who together will provide tremendous continuity at a time when we expect to accelerate the growth of our customer base. We are as confident as ever in the position of our U.S. businesses.

To wrap up, we had good operating group performance this quarter. Looking ahead, with our consistent strategy and a deeply ingrained commitment to customers, we're confident in the opportunities for growth across the bank.

And with that Tom, I'll turn it over to you.

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**Tom Flynn** ***- Bank of Montreal - CFO***

Thanks Bill, and good afternoon everyone.

I'll start on slide number 9. Q2 EPS of $1.71 and net income of $1.1 billion were both up 5% from last year. As Bill said, underlying business results for the quarter were good, reflecting the benefits of our diversified business model.

Adjusting items this quarter include a charge of $106 million after-tax, primarily related to restructuring, which will drive operating efficiencies. Adjusting items are shown on slide 26.

Net revenue was $4.5 billion, up 11%, including a 3% benefit from a stronger U.S. dollar. The increase was driven by growth in Wealth Management, Canadian P&C and BMO Capital Markets.

Net interest income was up 2% year-over-year, due to the impact of the stronger U.S. dollar and volume growth, partially offset by net interest margin and lower revenue in Corporate, which was largely from purchased performing loans. The quarter-over-quarter decline reflects the impact of three fewer days in the current quarter.

On a net revenue basis, non-interest revenue was up 21% from last year, primarily due to higher mutual fund and investment management and custodial fees, in part due to the acquisition of F&C, as well as higher trading and insurance revenue. Non-interest revenue was up 14% from the prior quarter, primarily due to higher trading and insurance revenue.

Q2 expenses were up 13% from the prior year, or 5% excluding the impact of the stronger U.S. dollar and the acquisition of F&C. Expenses were down 1% from Q1, or down 3% excluding the impact of the stronger U.S. dollar, due to $87 million of stock-based compensation for employees eligible to retire expensed in Q1 and three fewer days in the current quarter.

The effective tax rate of 19.8% was up from the prior year and Q1 primarily due to lower tax-exempt income. The rate was 25% on a TEB basis, modestly higher than the prior year and Q1.

Moving to slide 10, our Common Equity Tier 1 ratio was 10.2%, up 10 basis points from Q1, as lower RWA was partially offset by a decrease in capital. The factors driving the change in both capital and risk-weighted assets are detailed on the slide. As Bill noted, we increased the dividend and bought back 3 million shares in the quarter.

Moving now to our operating group performance and starting on slide 11.

Canadian P&C net income was $487 million, up 1% from last year. Revenue growth improved from last quarter to 4.4%, reflecting higher balances and non-interest revenue. As we said last quarter, we expect revenue and expense performance to be better in the second half of the year versus the first half of the year.

Total loans were up 3% from last year and deposit growth was strong at 7%. Personal loan growth was 2% and commercial loan growth was 6%.

NIM was up 3 basis points from last quarter, largely due to improved loan spreads. NIM is expected to be relatively stable over the balance of the year.

Expenses increased 6% year-over-year, reflecting continued investment in the business, including the impact of higher costs associated with the changing business and regulatory environment. Expenses were down 3% from the prior quarter, driven by the impact of fewer days and lower employee costs.

Moving now to U.S. P&C on slide 12, in Canadian dollar terms, net income was $219 million, up 29% from last year. In source currency, net income of $176 million was up 14%, driven by lower provisions for credit losses and good expense management.

Revenue of $707 million was relatively stable from last year, as higher volume growth and mortgage banking revenue was offset by lower NIM and other fee revenue. Loan growth was 6% year-over-year, driven by strong commercial loan growth.

Revenue was down 2% from Q1, largely reflecting fewer days in the current quarter. NIM was relatively stable, up 1 basis point from Q1, driven by a decline in low spread assets partially offset by competitive pressures on loan spreads.

Expenses continued to be well managed and were relatively stable both year-over-year and from Q1. Our total Personal and Commercial business in Canada and the U.S. had net income that was up 8% from last year.

Turning to Slide 13, BMO Capital Markets net income of $296 million was down 3% year-over-year as higher revenue from Trading Products was offset by higher expenses and a less favorable tax rate. Net income increased 34% from Q1, driven by higher revenues and lower employee-related expenses.

Revenue was up 6% year-over-year and 10% from the prior quarter due to higher Trading Products revenue and the impact of the stronger U.S. dollar. The prior quarter was impacted by a credit and funding valuation adjustment, as you will recall.

Excluding the impact of the stronger U.S. dollar, expenses were up just 1% from last year and were down 3% from Q1, primarily due to stock-based compensation for employees eligible to retire, which is expensed in the first quarter of each year. ROE was good at 17.9%.

Moving on to slide 14. Wealth Management net income was up 34% year-over-year, driven by continued very good growth in traditional wealth and strong results in insurance.

Traditional wealth earnings were up 23%, driven by good organic growth and the benefit from the acquired F&C business. Insurance net income was up significantly from last year, primarily due to a benefit from movements in interest rates in the current quarter relative to a year ago, as well as changes in our investments to improve asset liability management.

Traditional wealth management net income was up 9% from the prior quarter due to good organic growth. Net income in insurance increased $65 million quarter-over-quarter due to favorable movements in long-term interest rates this quarter relative to last.

Expenses were up year over, year primarily due to the acquisition of F&C, higher revenue-based costs, and the impact of the stronger U.S. dollar. Expenses were relatively stable compared to Q1. Assets under management and administration were up 36%, or 14% excluding F&C, driven by the stronger U.S. dollar, market appreciation, and new client assets.

Turning now to slide 15, the Corporate Services segment had a net loss of $121 million compared to a net loss of $58 million in Q2 of last year and $74 million in the prior quarter. Excluding the group TEB adjustments, year-over-year results were lower primarily due to lower benefits from purchased loan portfolios and higher regulatory-related costs. Quarter-over-quarter, excluding the impact of the group TEB adjustments, results were lower than trend primarily due to lower treasury-related revenues and lower purchased performing loan portfolio revenue, partially offset by lower expenses.

To conclude, the results this quarter demonstrate the benefits of our diversified business mix and the progress that we are making in our businesses.

And with that, I will hand it over to Surjit.

**Surjit Rajpal** ***- Bank of Montreal - Chief Risk Officer***

Thank you Tom, and good afternoon everyone. Starting on slide 17, specific PCLs were $161 million, flat quarter-over-quarter, or 20 basis points. In Canada, commercial losses were stable, while consumer losses increased to $114 million and are in line with recent results.

In the US, both consumer and commercial losses were lower, reflecting an improved economic environment. The PCL recovery in Corporate Services decreased by $14 million, mainly as a result of the wind-down of the FDIC indemnification relating to certain acquired U.S. commercial loans.

Moving to slide 18, formations were $454 million, slightly higher than last quarter, due to normal variability in commercial and corporate portfolios. Gross impaired loans decreased, with the GIL ratio improving to 65 basis points, down 4 basis points from last quarter.

On slide 19, our portfolio remains well diversified by geography and industry, with 55% of loans in consumer and 45% in commercial and corporate. You will note that our oil and gas exposures represent approximately 2% of total loans, unchanged from last quarter.

We have seen some negative migration in this portfolio, largely in borrowing base transactions, which is not unexpected given the decline in oil prices. We also continue to monitor our consumer portfolios in the oil-impacted provinces, and have not seen any deterioration.

Overall, we remain comfortable with our exposures. In summary, we had good credit results this quarter, reflective of solid performance across all portfolios.

I will now turn it over to the operator for the question and answer portion of today's presentation.

## QUESTION AND ANSWER

**Operator**

Thank you.

(Operator Instructions)

The first question is from Sumit Malhotra of Scotia Capital. Please go ahead.

**Sumit Malhotra** ***- Scotiabank - Analyst***

Thanks, good afternoon.

Wanted to start with a couple of questions on the restructuring charge, please. First off, on the aggregate pre-tax $149 million number, it was mentioned that there was also a legal settlement included in that.

It's probably for Tom. Would you be able to split how much is legal and how much you think relates to the actual restructuring efforts?

**Tom Flynn** ***- Bank of Montreal - CFO***

Sure. It is Tom.

85% to 90% of the total charge relates to the restructuring and the balance is to the legacy legal item.

**Sumit Malhotra** ***- Scotiabank - Analyst***

All right, thank you for that. And then when we focus in on the actual restructuring and tie in Bill's comments about $100 million in run rate savings. First off, I'll assume that's a 2016 target in terms of when that savings starts to come through. Please correct me if I'm wrong there.

And when you think about that savings and the actual restructuring, could you talk to us about what segments would be most impacted here? And should we be focusing in on areas such as headcount and branches, or is it more broad-based than that?

**Tom Flynn** ***- Bank of Montreal - CFO***

It's Tom. I'll take that.

So firstly the charge relates, as Bill said, to looking to drive operational efficiencies in our businesses and to allocate resources in a way that we think makes sense and lines up with the opportunities that we've got in the business. The $100 million number is a full run rate benefit number. And we would expect a little over half of that to be in the actual results for the current fiscal year, and with that, higher on a run rate basis by the end of next year.

In terms of impacts, we did look across the organization as we considered opportunities to drive efficiencies. All parts of the Bank have participated in the exercise, including our operating groups, our functions and our business groups.

We would be a little bit overweight in the Capital Markets segment in terms of the allocation of the benefits that would come from the charge, but all parts of the Bank participated. And the benefits will come from things like thinning out the management ranks where we felt that was a prudent thing to do; realizing benefits from work that we have been doing around process improvement and digitization; and in places, looking to simply operate in a more efficient basis, or on a more efficient basis by reducing the resources that we have lined up against the opportunity in the marketplace.

**Sumit Malhotra** ***- Scotiabank - Analyst***

Thank you for that fulsome answer. And I'm going to re-queue after this last part.

So just to ensure I have it clear, the charge has been taken here in Q2. Going forward, you don't envision the reported number having any more impact as a result of restructuring costs, but the ongoing core numbers should benefit from the savings starting to come through?

**Tom Flynn** ***- Bank of Montreal - CFO***

That is all correct.

**Sumit Malhotra** ***- Scotiabank - Analyst***

Thank you for your time.

**Operator**

Thank you. The following question is from John Aiken of Barclays. Please go ahead.

**John Aiken** ***- Barclays Capital - Analyst***

Good afternoon. Bill, in terms of the increase to the dividend that you announced this quarter, when we take a look at the pro-forma payout ratio on the $0.82, we're still running at the high end of the range on the adjusted earnings basis. Are we to take this that there's a fair degree of confidence in the back-end load coming from the domestic retail banking being able to earn into this, or is this more of an underscoring the strength of the capital ratios that you've reported this quarter?

**Bill Downe** ***- Bank of Montreal - CEO***

John, I think it speaks to both. We've always said that the dividend will be adjusted consistent with growth in earnings. And what we're doing is reflecting the confidence we have in the individual businesses and the earnings in the quarter, and the consequences that Tom talked about on the other side of the chart. So I would say it's both, it reflects the strength of the capital position and our outlook.

**John Aiken** ***- Barclays Capital - Analyst***

Going forward, one more for Tom, can we expect the reported numbers to come up towards the adjusted number in the latter half of the year into 2016, as the payout ratio is well above the target ratio on a reported basis?

**Tom Flynn** ***- Bank of Montreal - CFO***

There's always going to be a permanent difference there related to the amortization of intangibles. And so that number will have some decline curve, but not a sharp one. So that difference will continue.

The charge we've talked about was a one-time item this quarter, so that will go away. And then lastly, we've had some integration expenses related to the integration of F&C, and those will decline as we move through this year and into next year. So I'd back out the charge, which is a discrete larger item, and then expect a modest decline in the gap through time.

**John Aiken** ***- Barclays Capital - Analyst***

Great. Thanks Tom.

**Operator**

Thank you. The following question is from Gabriel Dechaine of Canaccord Genuity. Please go ahead.

**Gabriel Dechaine** ***- Canaccord Genuity - Analyst***

Good afternoon.

My first question is on the Canadian P&C business. Another soft quarter, and you've guided to a pick-up in the second half. By my math, if we can see that expense growth rate cut in half, you're flirting with the 5% earnings growth level. And Bill was implying that there's some upside to revenue, or you have a better outlook for revenue growth going forward.

I wonder if there's some upside to that 5%, if it's in Canada or if it's in the US. Maybe wrap all that up and give me some confidence that the Canadian business is going to pick up from its current levels.

**Cam Fowler** ***- Bank of Montreal - Group Head of Canadian P&C***

Gabriel, hi. It's Cam speaking. Thanks for the question.

I'll comment on the Canadian business specifically. As you say, the quarter has played out as I expected it would. The revenue at 4.4%, better than 3%, and NIM up 3 bps is helpful.

I think what you're asking for is if we do follow through on some expense containment, which we will be doing, and when PCLs return to four-quarter averages, as we expect that they will, how does the back half feel and what's your confidence? For me, I expect that we'll be in the mid-single digits on net income. I think NIM will hold on for us, expense growth will moderate and the PCL will be back in line. So I think together you'll see that in both quarters of the back half of the year, and that's why we feel confident.

**Gabriel Dechaine** ***- Canaccord Genuity - Analyst***

And no rebound…?

**Cam Fowler** ***- Bank of Montreal - Group Head of Canadian P&C***

This has been a bit of a bridge quarter, as I see it. And Q1 was a little slower, we had to make some adjustments in Q2, which we have done, and Q3 and Q4 will benefit from those.

**Gabriel Dechaine** ***- Canaccord Genuity - Analyst***

What about loan growth, because that's been trailing off for several quarters. You were starting from a very high level in 2013 and into 2014, but the trend in loan growth has been downwards for quite some time now.

**Cam Fowler** ***- Bank of Montreal - Group Head of Canadian P&C***

Well, I think there's a few things at play here. First of all, the quarter-on-quarter loan growth is driven by two things. Number one, seasonality. And number two, participation choices we've made in auto, which I've described over the last couple of calls.

Looking at those things specifically, the auto business is down 2 points on the quarter because of some conservative choices we've made on LTV and length of amortization and credit scores. We are seeing originations pick up a little bit there. And I expect that business moves for us in the back half of the year.

The cards business, it's down 3% quarter-over-quarter. But that's almost -- it's very similar to the number that we were between Q1 and Q2 last year. The holiday season spending is in Q1 and it's not in Q2.

And I think I've described some platform changes we've made, as well as two very strong product releases we have in the market now, the World Air Miles and the World Cash Back that give us confidence that both balances and revenue will move in the back half on cards.

And in commercial lending, I think we also feel that there's good opportunity there as pipelines are very healthy, as are draws, and we like our sector focus. So those are a few examples that, I think, back up our confidence in the back half from a balance perspective.

**Gabriel Dechaine** ***- Canaccord Genuity - Analyst***

Thanks for the details.

And then Tom, I think it was in 2013 you'd given some guidance on the impact of a rate increase on your NII. And could you update that figure for us, please? And how it's split between Canada and the US, which I think in U.S. is obviously more likely to see. And if you need to see a parallel increase in the timing of the higher NII, that would be helpful.

Thanks.

**Tom Flynn** ***- Bank of Montreal - CFO***

Okay, I'll respond to that.

There's a lot in that question, and the ultimate impacts will depend on how the yield curve moves and how markets evolve. But to give you a sense, in a simple scenario where the yield curve is up by 100 basis points on a parallel basis, the revenue benefit would be in the order of $230 million to the Bank. And of that, a little over $150 million would be in the U.S. and the smaller amount in Canada.

And of the U.S. amount, a good majority, about two-thirds, would be driven off of the short end of the curve versus the long end of the curve. And that's in part given how we're positioned. But in part as well, as you know, because the benefit from an increase in the longer end of the curve rolls in through time as your balances mature over time. So that gives you a sense of the total magnitude and then the split Canada/US, and for the U.S. the short piece.

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**Gabriel Dechaine** ***- Canaccord Genuity - Analyst***

That's exactly what I wanted. Thanks.

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**Operator**

Thank you. The following question is from Meny Grauman of Cormark Securities. Please go ahead.

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**Meny Grauman** ***- Cormark Securities - Analyst***

Hi, good afternoon.

Question following up on the loan growth in Canada, specifically residential mortgage growth. I'm wondering what the dynamics are in terms of market share. And in 2014 you talked a lot about gaining market share. I'm wondering how the market share gains are stacking up. Are you losing some ground now? So any color on that would be helpful. Thank you.

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**Cam Fowler** ***- Bank of Montreal - Group Head of Canadian P&C***

It's Cam Fowler speaking. Thanks for the question.

We did make some nice gains in 2014 on the mortgage side. That's flattened a little bit in Q1 and Q2. The nature of our performance in the mortgage market is one where we really invest in this time of the year, in the Spring campaign, and it drives much of what we do for the next few quarters.

Q3 and early Q4 are our main booking quarters. I would say that in terms of competition and activity in the market and our pipelines, I'm pleased. Things look healthy and in line with last year.

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**Meny Grauman** ***- Cormark Securities - Analyst***

Have you approached this Spring mortgage market differently than you have in the past, in 2014 in particular? Is anything -- any sort of changes in terms of how aggressive you want to be out in the market that's changed?

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**Cam Fowler** ***- Bank of Montreal - Group Head of Canadian P&C***

No, nothing has changed.

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**Operator**

Thank you. The following question is from Steve Theriault of Bank of America Merrill Lynch. Please go ahead.

**Steve Theriault** ***- BofA Merrill Lynch - Analyst***

So if I could start with a follow-up for Bill. Bill, you've been running, or you once ran with a payout ratio higher than peers, even at the upper end for a while. So I'll take a different slant at it. Is there any thought on your part or at the Board level of revisiting the payout ratio target, particularly given that it seems as though transformational deals are not likely on the table? Or under the current regulatory backdrop, is that not really on your mind?

**Bill Downe** ***- Bank of Montreal - CEO***

Steve, I wouldn't say that it is. I think the balance is still there between the first choice and preference being to plow retained earnings back into organic business growth. And where it can be done in a sensible way, with expectations of a good return, expanding the business through acquisition.

And really, this dividend payout ratio in my view, has the benefit of really being in the sweet zone for most shareholders. The confidence of a good consistent return in the dividend, but it also protects the Bank through the business cycle. And I think that's a sensible way to look at it.

**Steve Theriault** ***- BofA Merrill Lynch - Analyst***

Okay. And then for Darryl. Darryl, the federal budget clearly targeting some tax-efficient trading businesses. I know the outcome is uncertain and there will probably be some flow on that, I suspect through the summer. But can you tell us how much of your TEB, or your Capital Markets earnings are linked to the tax strategies the government is looking at?

I know there could certainly be changes through the usual budget process. It's very difficult to tell from the disclosures how analysts and investors should think about what's really at risk here in terms of earnings.

**Darryl White** ***- Bank of Montreal - CEO & Group Head of BMO Capital Markets***

Thanks, Steve.

As you point out, there are a lot of things still to be settled including the timing around implementation. So I would say at this point we're going to continue to work with our clients that are impacted by the proposal.

It's too early to say with any certainty what the ultimate impact would be. But as you know, businesses have changed before, markets have changed before. And we and others have reallocated resources accordingly.

So you put all of that together and the way I think about it is that in any event, we don't expect it to be a big item for the Bank. And we wouldn't expect the impact to be greater than the low single digits of total Bank net income.

**Steve Theriault** ***- BofA Merrill Lynch - Analyst***

So low single digits of total Bank net income. And is that -- that's keeping in mind mitigation, I gather, of some form or fashion?

**Darryl White** ***- Bank of Montreal - CEO & Group Head of BMO Capital Markets***

It's keeping in mind, Steve, some mitigation. But I would go back to my comment that it's difficult at this stage to know how much mitigation there will be, how you can redeploy and what the ultimate impact would be. Some, yes.

**Steve Theriault** ***- BofA Merrill Lynch - Analyst***

Low single -- so less than 5%, I can probably extrapolate from low single digits?

**Darryl White** ***- Bank of Montreal - CEO & Group Head of BMO Capital Markets***

I think well below 5%.

**Steve Theriault** ***- BofA Merrill Lynch - Analyst***

Okay, thank you.

**Operator**

Thank you. The following question is from Robert Sedran of CIBC. Please go ahead.

**Robert Sedran** ***- CIBC World Markets - Analyst***

Hi there.

Tom, I just wanted to come back to the restructuring charge for a second, because if I'm looking at this correctly, I believe there's been a couple of these in the past two or three years at the Bank. And I'm curious to know how this one differs from the other ones that were taken.

And whether some of this just reflects some of the headcount repositioning and business restructuring we've already seen in the Capital Markets business through the first half of the year. Like, is this a prospective charge, or is it about things that have already been done?

**Tom Flynn** ***- Bank of Montreal - CFO***

It's a charge that reflects decisions that were made during the course of the quarter, and with those decisions some actions did take place during the quarter and there was some media related to those. So you're right to think that this isn't new. In a way, this is just a financial consequence of some of the things that you've read about in the paper flowing through. And you'd expect that to occur.

In terms of what's similar and what's different to charges we've taken in the past. We've taken the odd charge; I don't know that we're overweight with charges, and really they reflect work going on to drive efficiencies in the business, enhance our processes in fundamental ways, and increase the amount of digitization that we have in the business and to operate in a leaner fashion.

And the actions from the charge relate to steps we're taking to remove costs from the business. So there's pretty much one-to-one relationship between the charge and full cost reduction that will flow from it to our businesses.

**Robert Sedran** ***- CIBC World Markets - Analyst***

So this is a little bit of everything then. It's some severance, it's some spending on technology, it's organizational redesign. It's just a bit of a grab bag of a bunch of different things that are going on from an efficiency perspective?

**Tom Flynn** ***- Bank of Montreal - CFO***

I'd say not really. It's not technology per se. The technology expense would be in our run rate expense level. But it's in part the consequence of investment in technology, in that the technology makes our operations more efficient.

We're doing more things through technology. And as a result, in places we need fewer people. So the amount of the charge relates entirely to severance, and not anything but. And then there are a few reasons for that severance to be incurred.

**Robert Sedran** ***- CIBC World Markets - Analyst***

Okay. I think I've got it now. Thank you.

**Operator**

Thank you. The following question is from Sohrab Movahedi of BMO Capital Markets. Please go ahead.

**Sohrab Movahedi** ***- BMO Capital Markets - Analyst***

Thank you.

Bill, you noted that through the first half of the year the Bank has returned about $1.5 billion between buybacks and dividends. Is there any updated thoughts as to what the right capital return level, aside payout ratios, would be for BMO as you think about the next 12 to 18 months?

**Bill Downe** ***- Bank of Montreal - CEO***

Well, thanks for the question, Sohrab.

I think it's really tied to opportunity. In the places where we see a pick-up in balance growth, it will absorb capital beyond the amount of the dividend. And if you look at the last three or four years, I think it's been instructive that in 2014 we spent over $1 billion on an acquisition that was immediately accretive and advanced our position in global asset management business quite nicely. And in the year before, we absorbed the surplus capital with a buyback, and in the first half of this year similarly we absorbed it with a buyback.

I think I've said this before. In order of priority, beyond the dividend, if organic growth could absorb all of the retained earnings that would drive the highest return to shareholders, and we would focus on that. And then with respect to acquisition, it's always going to be tied to the discipline around the right path to accretion and the strategic nature of it. So no, I wouldn't say that there is a objective for return to shareholders beyond the payout range on the dividend.

**Sohrab Movahedi** ***- BMO Capital Markets - Analyst***

Okay thank you, and if I can just tag along another one.

Very quickly, Tom, I know when you commented on the Canadian Bank P&C segment, you talked about -- you provided a bit of perspective as to what you think margins would probably do for the balance of the year. I may have missed it. Did you provide similar commentary around U.S. P&C?

**Tom Flynn** ***- Bank of Montreal - CFO***

I didn't directly.

**Sohrab Movahedi** ***- BMO Capital Markets - Analyst***

Okay.

**Tom Flynn** ***- Bank of Montreal - CFO***

My comment on the change in the quarter, and clearly we had a better performance on NIM this quarter than we have for the last few. The outlook over the balance of the year is for some continued pressure on the margin coming from competition in the commercial part of the business.

The margin can move around for a variety of reasons, as you know, quarter-to-quarter. But we would expect something like 2 to 3 basis points per quarter over the balance of the year.

**Sohrab Movahedi** *- BMO Capital Markets - Analyst*

Thank you very much.

**Operator**

Thank you. The following question is from Mario Mendonca of TD Securities. Please go ahead.

**Mario Mendonca** *- TD Securities - Analyst*

Good afternoon. I want to revisit the volume growth in domestic retail, and this might be good for Surjit and Cam. The slowdown, or the decline in mortgages, personal loans, cards, I guess pretty much everything other than commercial is notable, particularly because the market share gains that the Bank had experienced in 2014. So what would be helpful to understand is, to what extent did this decline or slowdown really reflect a slowdown in the economy generally, in which case we would see it across your peers, or a significant change in the loan adjudication process for BMO?

**Cam Fowler** *- Bank of Montreal - Group Head of Canadian P&C*

It's Cam. I'll start.

I don't see the changes that we've seen from a share and growth perspective to be linked as much to adjudication. I see the performance far more linked to where we're putting energy and where we've made participation choices.

I spoke about the auto space already.

Using cards as another example, this is a space where we've invested, and in fact been a little bit focused the past year, year and a half. And although we have had some positive momentum in some bits of that business, the balances and the revenue have been a little slower to come by. So that to me is just more about business performance where, as I said earlier, I expect to see improvements in the back half of the year.

Using mortgages as another example. I think we are perhaps in a space where we are looking to put good numbers on top of good numbers where the market is a little slower than it was before. But again, I think it might be better to reflect on this performance after Q3 and Q4 and see how we feel.

**Mario Mendonca** *- TD Securities - Analyst*

So when you say participation choices, I inferred from that a change in your adjudication. So maybe you're making a distinction that I'm not making. So when you say participation choices, what does that mean?

**Cam Fowler** *- Bank of Montreal - Group Head of Canadian P&C*

Well, that means auto specifically. Who do we want to be doing business with in the auto sector. In the past few quarters, I've made the point that there were trends in the longer amortization and high LTV that were making us a little bit uncomfortable.

We believe in this business. We like the risk-adjusted returns. We just wanted to pull back a little bit from a risk perspective on that, which we did do.

And you can see that in the numbers. We're down 8% on the year and 2% on the quarter. But that said, I think I said earlier, the monthly originations are beginning to improve. And we're sort of sticking to our prudence with respect to participation in auto. But that's really the only area I'd focus on.

**Mario Mendonca** ***- TD Securities - Analyst***

So you wouldn't say there have been any participation choices as it relates to mortgages, then?

**Cam Fowler** ***- Bank of Montreal - Group Head of Canadian P&C***

Not particularly.

**Mario Mendonca** ***- TD Securities - Analyst***

Thanks very much.

**Surjit Rajpal** ***- Bank of Montreal - Chief Risk Officer***

I have nothing to add. I think Cam said it really well. We make risk return choices and price accordingly. I think he's accurate in his assessment.

**Mario Mendonca** ***- TD Securities - Analyst***

Thanks.

**Operator**

Thank you. The following question is from Peter Routledge of NBF. Please go ahead.

**Peter Routledge** ***- National Bank Financial - Analyst***

It's probably for Darryl on the synthetic equity arrangements. The way the government wrote about this potential change to the tax rules, it seemed like the rules would change abruptly in the Fall. How disruptive would that be to markets in Canada?

**Darryl White** ***- Bank of Montreal - CEO & Group Head of BMO Capital Markets***

Peter, it's hard to know. That's a conversation that is alive, I think, in the markets and as a result of it being alive right now, folks have an opportunity to sort of think about that and position accordingly. At this point we're not out thinking about or declaring the disruption in the markets. There could be some impact on our client base, but it's not, at this point, a place that I'm prepared to declare with any specificity what we think the outcome will be.

**Peter Routledge** ***- National Bank Financial - Analyst***

That's fair, thanks. And not a related question, but I noticed in trading revenue the taxable equivalent offset is volatile quarter to quarter. What drives that volatility?

**Darryl White** ***- Bank of Montreal - CEO & Group Head of BMO Capital Markets***

Well, yes. If you look -- Peter, if you look overall at the trading revenues, the volatility that you refer to on a TEB basis, in fact, if you just look at it in aggregate, I would say when you look at this particular quarter, it's a pretty good indication of the client businesses behaving in a consolidated, strong way. There was a stable market environment, as you know. I think we performed well in that environment.

Folks are tending to look a little bit at that volatility question on a TEB basis in our interest rates. If you look in the supp pack at our interest rate performance, I look at that and I think that yes, it was a good quarter from a performance perspective, but we've been there before on our rates and it's not above our historical highs. I think what is good in this quarter is that it's not just an interest rate fixed-income trading performance. We've had good performance in our equities and our FX, as well. So you put it all together, and it's good client-driven trading quarter in a period where our risk levels, frankly, were down. Our VaR, if you look at our supp pack is down. So it's really simply a solid, relatively clean quarter, which might look volatile on the surface, but really the reason for that apparent volatility would be that there are no areas of particular weakness.

**Peter Routledge** *- National Bank Financial - Analyst*

And just bigger picture question. Growth in your business has been pretty impressive overall, and certainly, the market environment is helping you along the way, along with good execution. We're heading probably into a market where Canadian rates, long rates are flat and the U.S. yield curve starts to back up at the long end. Is that environment as accommodative as what we're in right now?

**Darryl White** *- Bank of Montreal - CEO & Group Head of BMO Capital Markets*

Peter, it might well be. I think the environment that is not as accommodative is one where we see sharp spikes involved, as you saw during fiscal Q1. So that remains to be seen. It remains to be seen how the markets would react to any specific changes with respect to benchmark yields.

But to your general question, I can see the markets being as accommodative, with the caveat being what I said: any very significant vol shifts are not particularly conducive. And I don't know if we're going to see those or not. We'll just have to see over the course of the next couple quarters.

**Peter Routledge** *- National Bank Financial - Analyst*

The spike in long-term yields in April didn't hurt you, though?

**Darryl White** *- Bank of Montreal - CEO & Group Head of BMO Capital Markets*

Not particularly.

**Peter Routledge** *- National Bank Financial - Analyst*

Thanks very much.

**Operator**

Thank you. The following question is from Doug Young of Desjardins Capital Markets. Please go ahead.

**Doug Young** *- Desjardins Securities - Analyst*

Hi, good afternoon. Just on the credit side, I had a question. You mentioned that you did have negative migration in the quarter. I think your watchlist increased by $300 million. And I think your collective provisions didn't change.

So I'm just trying to understand, and correct me if I'm wrong, I think it's fairly formulaic, and I'm trying to understand why your collective provisions wouldn't have changed. And I guess in the same vein, what would cause the collectives to change moving forward?

**Surjit Rajpal** - ***Bank of Montreal - Chief Risk Officer***

Let me start. This is Surjit. Let me start with the second part of your question. The risk levels in a company are reflected in the collective. And so changes in risk levels are reflected in changes in collective.

So going back to your question on the oil and gas portfolio per se, looked at in the broader context we've seen migration, positive migration in our portfolios in the U.S. And as a Company overall, there has been no change in the collective allowance because the positives have offset the negatives.

So it becomes difficult for you to really look at a certain segment when you look at just the collective allowance as closely. I hope that clarifies it for you.

**Doug Young** - ***Desjardins Securities - Analyst***

Yes. So, I am correct to assume this is fairly formulaic. So I guess you're essentially saying in the U.S. you've had some positive migrations, you've had some negative in Canada, but net-net, like within a boundary?

**Surjit Rajpal** - ***Bank of Montreal - Chief Risk Officer***

I wouldn't say it's formulaic. There's an element of judgment involved, as well.

**Doug Young** - ***Desjardins Securities - Analyst***

Okay. I may come back to you on some of this stuff. Just the second question I had. I know you gave in the U.S. some guidelines around what you expect on the NIMs. On the PCLs, obviously they were extremely low, and I'm sorry, I apologize if you've talked about this already. But was there anything unusual in the quarter on the PCL side? And when should we expect U.S. PCLs to normalize here?

**Surjit Rajpal** - ***Bank of Montreal - Chief Risk Officer***

The PCLs in the US, again, are -- as I think I mentioned in my remarks, are reflective of the improving economic conditions. And we don't see a change in those conditions. So, I think the level of PCLs will remain at a low level. We are seeing recoveries though. So the past few quarters, we have seen recoveries. And they're the only part that I think will provide some variability.

**Doug Young** - ***Desjardins Securities - Analyst***

Can you quantify what the recoveries were this quarter?

**Surjit Rajpal** - ***Bank of Montreal - Chief Risk Officer***

I don't have that number offhand, but they were not out of line with last quarter.

**Doug Young** - ***Desjardins Securities - Analyst***

And so this quarter is not an abnormally low quarter? This level of PCLs that we saw this quarter could be sustained over the next few quarters. Is that what I'm reading here?

**Surjit Rajpal** - ***Bank of Montreal - Chief Risk Officer***

Yes. The recoveries can be bumpy. But for the last two quarters I would say that yes, they would be about the -- the variability I'm looking at is not that different.

**Doug Young** *- Desjardins Securities - Analyst*

Okay, great. Thank you.

**Operator**

Thank you. The following question is from Darko Mihelic of RBC Capital Markets. Please go ahead.

**Darko Mihelic** *- RBC Capital Markets - Analyst*

Hi, thank you. My questions actually all sprung up from the conference call. So just looking for a little bit of clarification. The first question is on the Capital Markets business, and specifically with respect to the synthetic derivatives proportion.

I'm a little bit shocked by the number. So when you say single digit and below 5%, I do a little bit of rudimentary math, I say 3% of BMO's overall net income. That's $130 million. That's more than 10% of your business. So first of all, am I way off base on that?

And then secondly, if I go back to what the budget had said, it said about $365 million was the benefit to Canada by closing this tax loophole. So it looked like you'd be about one-third of it, which would suggest that perhaps you have a disproportionate share of this business. So can you talk to that? Can you just talk to that, and maybe perhaps clarify it for me if I'm off on my math?

**Tom Flynn** *- Bank of Montreal - CFO*

It's Tom. I'll take a shot at it.

The situation is one, as Darryl said, that isn't fully developed. So there's the usual uncertainty that goes along with that. And we don't think this will be a really significant item for the Bank. And we don't think it will exceed the low single digits. And so low single digits isn't bumping into 5%; it's more like below 3%.

And with that, what we're trying to say really is, there is the potential for some impact. And we wanted to acknowledge that, but we don't think it's a really significant impact. And it's not bumping into higher numbers.

**Darko Mihelic** *- RBC Capital Markets - Analyst*

But these are numbers after mitigation. So I'm just -- would it be fair to say that this is disproportionate -- that Bank of Montreal's Capital Markets business has a disproportionate share, or is the governments number just too low?

**Tom Flynn** *- Bank of Montreal - CFO*

Well, we obviously can't comment on the number that the government has.

**Darko Mihelic** *- RBC Capital Markets - Analyst*

Okay fair enough.

And then second question. Just getting back to Cam, your answer with respect to what it is that improves in the back half of the year made it sound like your expectation is credit will get better, NIMs are stable, loan growth perhaps improves, and certainly efficiency improves. But you didn't mention fees. So am I to assume that the fee increases that you've put through on the P&C side really won't have any material impact in the back half of the year?

**Cam Fowler** ***- Bank of Montreal - Group Head of Canadian P&C***

Thanks for the question.

From time to time we make these changes, but in terms of the things that will drive improved net income and overall stronger growth, I don't think that any type of fee changes we've made are going to be material compared to those. I think this is going to be one of those things where it's a mix of reduced expense growth, stable NIM, PCLs better, revenue stable, and they come together to form the better NIAT. And as I think I mentioned earlier, we are targeting positive operating leverage by Q4.

**Darko Mihelic** ***- RBC Capital Markets - Analyst***

Okay. All right, thank you.

**Operator**

Thank you. The following question is from Sumit Malhotra of Scotia Capital. Please go ahead.

**Sumit Malhotra** ***- Scotiabank - Analyst***

Thanks for getting me in.

Just a quick one, more for model purposes than anything else, and not a line we usually focus on. But in the mutual fund revenues of the Bank this quarter, the mutual fund AUM was up 1% to 2% while the fees booked were up double digits sequentially. I think it's 12% here, if I've got it right. Was there anything unusual that was included in the funds fees this quarter?

**Tom Flynn** ***- Bank of Montreal - CFO***

The wealth revenues were strong for the quarter, as you know and as we talked about. It partly reflects the acquisition of F&C. In some of our businesses we do have performance-related fees, and the schedule for receipt of those varies through the year, depending on the fund.

And there was not a lot of help from that, but a little bit of help from that in the quarter. But the bigger issue is that the core business is doing very well. This is a bit of a technical thing, but the average U.S. dollar was stronger during the year than it was at the end. So that might contribute to a bit of a disconnect between the final AUM number and the revenue numbers.

**Sumit Malhotra** ***- Scotiabank - Analyst***

Yes, the AUM gets translated on the spot and the revenue gets translated on the income. So that could explain some of it?

**Darryl White** ***- Bank of Montreal - CEO & Group Head of BMO Capital Markets***

That would be part of it.

**Sumit Malhotra** ***- Scotiabank - Analyst***

All right. Not the biggest deal in the world, but did mess up the model a little bit so I thought I'd check. Thanks for your time.

**Operator**

Thank you. There are no further questions registered at this time. I'd like to turn the meeting back over to Ms. Haward-Laird.

**Sharon Haward-Laird** ***- Bank of Montreal - Head of Corporate Communications and IR***

Thank you everyone for joining us on the call today. If there are any follow-up questions, we're happy to take them in IR. Have a good day.