BMO Financial Group

Q3 2015 CONFERENCE CALL

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PRESENTATION

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

Thank you. 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 re-queue.

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

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 third quarter report to shareholders.

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

Bill Downe *- Bank of Montreal - CEO*

Thank you, Sharon, and welcome to everyone joining us on the call. BMO delivered very good results in the third quarter with net income[1] above $1.2 billion for the first time, up 6% from a year ago which was also a very good quarter. These results are in line with our expectation that performance would improve in the second half of the year. Credit performance was good and consistent with the past three quarters at approximately 20 basis points and our Common Equity Tier 1 ratio was 10.4%.

During the quarter, we bought back 2 million shares and our book value per share increased 19% from the prior year to $55. There was good performance across our operating groups in the quarter, particularly in the combined Personal and Commercial Banking businesses, which posted earnings[1] of $792 million, up 13% year over year, and in Wealth Management where net income[1] was up 10%.

The performance reflects the benefit of BMO's diversified business mix, and confirms that the investments we've made are generating growth, while ensuring that we keep pace with a new generation of banking customers. Our results this quarter also reflect our focus on expense management, which has resulted in positive operating leverage of 2.7%, excluding the impact of the stronger U.S. dollar. Tom is going to take you through the financial results, and Surjit will provide more detail about credit, but I wanted to note a few key items from the quarter starting with highlights from our operating group results.

Canadian Personal and Commercial Banking net income[1] was $557 million, up 6% from a strong Q3 last year consistent with strengthening results in the second half of the year. We're seeing stable revenue growth, moderating expense growth, and good credit performance. During the quarter, we launched BMO AIR MILES World Elite MasterCard and BMO CashBack World Elite MasterCard, expanding our premium product line to meet the needs of customers looking for the flexibility of cash rewards with the value of Canada's leading loyalty program.

U.S. Personal and Commercial Banking had very good results with net income[1] up 15% in source currency or 36% in Canadian dollars. The U.S. business continues to deliver good growth in commercial lending, steady growth in deposits, and very good credit performance.

BMO Wealth Management continues to demonstrate momentum with adjusted net income[1] up 10% from last year. The traditional wealth business has benefited from good growth in client assets, while the insurance business is experiencing a more stable long-term interest rate environment than a year ago. In the quarter, International Finance Magazine named BMO the Best Wealth Management Bank in Canada, noting our compelling offer and high standards of innovation and performance.

1 – on a reported basis: Net income in the quarter was $1.2 billion or $1.80 per share. Combined Personal and Commercial Banking earnings were $778 million, up 13% year-over-year; Canadian Personal and Commercial banking earnings were $556 million, up 6% year-over-year; U.S. Personal and Commercial banking net income was $222 million, or $175 million in source currency; Wealth Management net income was $210 million, up 11% year-over-year

Capital Markets results this quarter were solid given the environment, though down from last year's third quarter which had been particularly strong. Revenue was above $1 billion for the second quarter in a row, with the contribution from Investment and Corporate Banking showing sequential quarters of growth. Expenses were well-managed, down 1% excluding the impact of a stronger U.S. dollar. During the quarter, BMO Capital Markets was recognized by Trade Finance Magazine as the Best Supply Chain Finance Bank in North America for the second consecutive year.

Our results this quarter were delivered against the backdrop of a North American economy in which growth has been slower than expected a year ago. And we do see encouraging signs in the U.S., including stronger employment numbers and a slow but steady improving housing market.

This inevitably will have benefits for the Canadian economy, which has felt the impact of weaker oil prices and moderating growth in emerging markets. Despite perceptions that the economy outside of the oil-producing regions would be impacted, activity has held up. Growth in Ontario and Quebec is broadly unchanged, and the relative strength of the U.S. dollar against the Canadian dollar will be positive for the export sector of the Canadian economy, with a lagged effect.

We're confident about the future in the context of a North American economy that has continued to expand. We're making investments in key initiatives to grow the earnings of the bank and to provide a brand-aligned customer experience. While banking remains fundamentally about people helping people, smart technology has become an indispensable part of how we compete. Work flow is being redirected from traditional channels to digital and mobile.

We're differentiating ourselves by ensuring the bank's digital line-up lives up to our commitment to keep the experience personal, while leveraging our investments north and south of the border. We are also optimizing our physical footprint, and enhancing the channels through which customers connect with us. Recently we expanded our ATM network, installing more than 400 new ATM's at retail locations across Canada, effectively increasing our out of branch network by almost 40%, and expanding our customers' access to cash to nearly 2,500 locations.

Last quarter I talked about some key online and mobile banking innovations at BMO Harris Bank, with the debut of our first smart branch and the launch of Mobile Cash. This quarter we continued to launch leading mobile technologies across the Company. Personal and Commercial Banking introduced Touch ID in Canada. Our mobile banking application for iPhones has been updated to include a login option where fingerprints can securely serve as banking passwords, making us the first big bank in Canada to do so. We also introduced Touch ID and Passcode in the U.S., improving both ease and security of mobile transactions. And BMO Global Asset Management launched a new iPad app designed to promote resource sharing and provide performance tracking for financial advisors and other investment professionals.

This quarter, we also unveiled our redesigned flagship branch at First Canadian Place, which is more open and digitally enabled. Even on a transaction that may have originated online, customers recognize when it makes sense to speak with a banker. In this context, the physical branch remains important. The investment we made at King and Bay demonstrates our conviction that the physical branch can provide seamless integration with technology. Customers are learning to navigate online products in the branch, and we're encouraging them to use their own devices while interacting with our bankers.

Working with our clients in this way is increasing adoption of new technologies that are making it easier for customers to do business with us. Every line of business is finding new ways to serve the fast-changing needs of customers, and we expect this kind of innovation both to enhance the experience with our existing customers and attract new customers. Our strategy is clear and consistent, rooted in a deeply ingrained commitment to our customers, and it's a strategy which will drive growth, as our results today have demonstrated.

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

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

Thank you Bill and good afternoon everyone. I'll start on slide 8. Q3 EPS of $1.86 was up 8%, and net income of $1.2 billion was up 6% from a good Q3 last year. As Bill said, operating group performance for the quarter was good, reflecting the benefits of our diversified business mix and execution on our plans. Adjusting items this quarter are similar to prior quarters and are shown on slide 25.

Net revenue was $4.6 billion, up 9% including a 4% benefit from the stronger U.S. dollar. Higher revenue was largely driven by growth in Canadian P&C and Wealth Management. Net interest income was up 8% from last year, benefiting from the stronger U.S. dollar and volume growth, partially offset by a lower net interest margin. The quarter over quarter increase was also 8%, reflecting the impact of 3 more days and a higher margin and volume growth.

On a net basis, non-interest revenue was up 11% from last year with increases in almost all categories, and was down 2% from the prior quarter due to lower insurance and trading revenues and security gains. Expenses[1] were up 8% from the prior year. Excluding the impact of the stronger U.S. dollar, expenses were well-managed, up just 2% year over year, and were relatively unchanged from Q2 despite 3 more days in the current quarter.

On a net revenue basis, operating leverage was 1.4% and it was 2.7% excluding the impact of the stronger U.S. dollar. The effective tax rate[1] was 19.4%, up from 15.6% last year and down modestly from Q2. The rate was 25% on a teb basis, modestly higher than the prior year and unchanged from Q2.

Moving to slide 9, our Common Equity Tier 1 ratio was 10.4%, up 20 basis points from Q2. Capital levels increased due to higher retained earnings and the impact of the stronger U.S. dollar on accumulated other comprehensive income. Risk weighted assets increased by $9 billion in the quarter. As shown on the slide, the majority of the RWA increase was driven by FX and business growth, with this partially offset by changes in methodology.

Moving now to our operating group performance and starting on slide 10, Canadian P&C net income[1] was $557 million, up 6% from a good Q3 last year and 14% from Q2. Revenue improved to $1.7 billion, up 4% from last year and 6% from the prior quarter. These results are consistent with our expectations for improved performance in the second half of the year.

Total loans were up 3% from last year, and deposit growth was good at 6%. Personal loan growth excluding cards was 2%, with mortgage growth of 4%. Commercial loan growth was 7%. NIM was stable quarter over quarter.

Expenses increased 5% year over year. The quarter over quarter increase of 4% was primarily due to the impact of 3 more days in the current quarter and continued investment in the business. The efficiency ratio of 49.7% improved 90 basis points from Q2. Credit provisions were down from the prior quarter and the prior year.

Moving now to U.S. P&C on slide 11: net income[1] was $235 million, up 36% from last year. In the comments that follow, I'll speak to the U.S. dollar performance. Net income of USD$186 million was up 15% from last year, driven by stable revenue, disciplined expense management and good credit performance. Revenue of USD$727 million was relatively stable from last year, as the benefit of higher balances and non-interest revenue was offset by lower NIM.

Loan growth was 4% driven by double-digit growth in C&I loans. Revenue was up 3% from Q2, largely reflecting 3 more days in the current quarter. NIM was relatively stable, down 1 basis point from Q2. Expenses continued to be well-managed, up 2% year over year due to higher employee-related costs, and expenses were up 3% from Q2, largely due to 3 more days in the current quarter. Credit provisions were down from last year and stable from last quarter.

Turning now to slide 12: BMO Capital Markets had net income[1] of $274 million, lower than strong performance of a year ago. Net income was down from Q2 largely due to higher provisions. Revenue was $1 billion, up 2%. Excluding the impact of the stronger U.S. dollar, revenue was down 2% from the prior year due to lower investment banking client activity, and was flat from Q2. Expenses were well-managed. Excluding the impact of the stronger U.S. dollar, down 1% from last year primarily due to lower employee expenses and flat from Q2. Provisions were up from the prior periods, and the ROE was 15.6%.

Moving on to slide 13: Wealth Management net income[1] was up 10% year over year. I note that this is the first quarter with the full F&C results in both comparative quarters. Traditional wealth earnings were up 8% from the prior year and 5% from Q2, driven by good growth in client assets.

Insurance net income was $56 million, up 16% from last year which was impacted by interest rates. Net income in insurance was down from a strong Q2, which had above trend benefits from portfolio changes and rates. Expenses were up year over year, primarily due to the impact of the stronger U.S. dollar, higher revenue-based costs, and continued investment in the business. Expenses were up modestly from Q2, due to the impact of 3 additional days in the current quarter. Assets under management and administration were up 13% year over year, driven by favorable FX and market appreciation.

Turning now to slide 14: the Corporate Services segment[1] had a net loss of $69 million, compared to a net loss of $54 million in Q3 of last year, and $121 million in the prior quarter. Excluding the group teb adjustment, revenues were higher year over year and from Q2, primarily due to higher treasury-related revenue. Provisions were up from the prior year and from Q2 due to lower loan loss recoveries. Expenses were below trend, down both year over year and from Q2.

To conclude, our results this quarter reflect good operating group performance and were consistent with our expectations for improved performance in the second half of the year.

1 – on a reported basis: Expenses were up 8% year-over-year; the effective tax rate was 19.29%; Canadian Personal and Commercial banking earnings were $556 million, up 6% year-over-year; U.S. Personal and Commercial banking net income was $222 million, or $175 million in source currency; Wealth Management net income was $210 million, up 11% year-over-year; Capital Markets earnings in the quarter were $273 million, down 10% year-over-year; Corporate Services net loss was $75 million

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. We had another good quarter from a risk perspective. Starting on slide 16, PCLs remained stable at $160 million or 20 basis points. PCLs for Canadian P&C were lower, largely because of a $28 million decrease in the consumer segment, reflecting improved performance, as well as the sale of charged-off loans. U.S. P&C PCLs were stable quarter-over-quarter.

In Capital Markets, PCLs are up, primarily due to an increase on a previously provisioned oil and gas loan. Corporate PCLs were higher as the result of lower recoveries. Going to slide 17, formations of $559 million, up from $454 million last quarter with the increase coming from Capital Markets, the largest contributor being oil and gas in the U.S.

The GIL ratio remains steady at 66 basis points, and gross impaired loans increased by $118 million due to the impact of the stronger U.S. dollar. Our oil and gas exposure remains modest at 2% of total loans, more than half of which is investment grade. Consistent with my comments on prior calls, the oil and gas portfolio will see some strain under the prolonged period of low prices. And as you would expect, we are watching our portfolios carefully.

Although in Alberta we have seen a slight quarterly increase in delinquencies in some consumer products, there is no discernible trend. Consumer delinquencies in Alberta are down year over year and remain below national average. Over time, we expect a benefit in some sectors in Canada from the low dollar, and more broadly across North America because of low oil prices.

I'll 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 Mario Mendonca from TD Securities.

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

Good afternoon. Just to start with the stress tests that you've referred to. Probably for Surjit: can you just restate your stress tests with oil at say, $35 and $40? And Sharon has helped me think through this but if you could just restate it first, before I get into my question?

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

Sure. As you know, we had done a stress test at those levels, $35 for one year, followed by $50 the second year, and it's been almost nine months since we did that test. What we did was refresh the test, and we rolled forward that same scenario. So we assumed $35 for the next 12 months, and $50 for the 12 months thereafter. Meaning our starting point was the actual impact of the past eight months on our portfolio.

And when we ran that stress test, we saw a small increase in our total losses. And again, there was nothing that I would say was not manageable at all, very similar to the conclusion we came to the last time around. And in no scenario did the PCLs of the bank, go up anywhere past the historical average of the bank, so around 40 basis points or so.

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

Okay. And so, when you do that stress test, you're obviously taking into account some of the offsets in Ontario and Quebec from lower oil prices and maybe a softer dollar, is that fair?

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

We do. But in the refresh that we did, we muted some of those, given that it could take a little while before some of those benefits are received.

Mario Mendonca *- TD Securities - Analyst*

And again, in these stress [tests], I want to make sure I understand these, because the numbers that the banks are referring to are low, in terms of the losses. And when I speak to some investors, they are questioning, certainly not the honesty of the bankers providing the stress test information, but just, the numbers are just so low, and people are questioning it. So what I want to get at here is, when you do these stress tests, where does unemployment in Canada go?

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

Let's start off by saying, when we do these stress tests, we isolate what we call high impact areas. When you are looking at it from that perspective, you take the oil regions, and Alberta being the big one. Therefore, when you look at it in the perspective of the impacted regions, it becomes somewhat less of a factor.

For example, in Alberta, the consumer loans are 15% of the total bank's book. And in commercial, it's almost a similar number. So the impact of oil and gas again, when you look at it, you've got to look at it in the context of the portfolio that we have.

Part of the oil and gas portfolio is the E&P sector. The E&P sector is close to 70% of our total book, and half of it is corporate, half of it is borrowing base. Overall, just to put things in perspective, our investment grade portfolio is more than half the total exposure of $6.6 billion.

The other sectors are pipelines and services, and pipelines are actually doing quite well. The service sector, which is less than $1 billion of our portfolio, so far has performed well. The service sector is where one would expect to see some strain in, as we haven't yet seen.

In our stress test, we have assumed a fairly large impact on these portfolios. So I just wanted to put that in perspective for you, in terms of the size. The portfolio itself overall, is just about 2%, as I said in my remarks. That's why it may seem a little unreal when I say it's in the 40s, but we are also starting with a base of 20 basis points on our PCLs.

Mario Mendonca *- TD Securities - Analyst*

And for perfect clarity, you are not just stressing that 2%, you're stressing the consumer portfolios in Alberta as well?

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

Absolutely, we are stressing everything.

Mario Mendonca *- TD Securities - Analyst*

With a materially high unemployment?

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

That is correct. The unemployment that we've assumed in Alberta, just for your information to answer your question, was doubling.

Mario Mendonca *- TD Securities - Analyst*

Double, okay.

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

And right now it's at 6%. And I think when we started the last stress test, it was at 4.7%, and we thought it would double in our stress test scenario.

Mario Mendonca *- TD Securities - Analyst*

Okay. And then the final sort of related question then is, capital’s fine, PCLs are 40. Do earnings grow? Does EPS grow in those stress tests or does it decline modestly?

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

Tom, do you want to address the EPS question?

Tom Flynn *- Bank of Montreal - CFO*

Well, I'll address it, but at a high level. We don't give guidance.

The math to look at PCLs going from the current level to the low 40s is pretty straightforward. You can think about that in relation to the growth that we have been producing, and we would expect with an overall North America economy that is doing reasonably well, to be growing the bank's earnings.

Mario Medonca *- TD Securities - Analyst*

The reason I'm asking the question, Tom, is the increase in PCLs is not the only thing that would happen under your stress test. There would be a lot of other things going on with loan growth, if unemployment spiked in Alberta, for example. And that is why I am asking the question, because to stress test your capital, you would have had to estimate your earnings as well. Do earnings go down in those stress tests?

Tom Flynn *- Bank of Montreal - CFO*

And I'll stand by the answer. We don't give earnings guidance. We've tried to be quite detailed, really in the response to the question around the impact of oil, both primary and secondary knock-on impacts. With that, people are able to form their own view around what the whole might look like.

Mario Medonca *- TD Securities - Analyst*

Thanks.

Operator

Thank you. The following question is from Sumit Malhotra from Scotia Capital.

Sumit Malhotra *- Scotiabank - Analyst*

Thanks and good afternoon. To stay with Surjit around a similar topic - you mentioned that you saw the gross impaired loans increase from the energy portfolio this quarter. First off, if we start there, the $105 million formation. Your provisions this year for the energy book have been about a quarter of that. Can you talk to us whether this was one specific loan, whether there's a few files that have started to turn, and how you feel about your provision for these, if at all?

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

Well, from a provision standpoint, we did, I think I mentioned, take a provision on an account, and we took some more on it, and that was in the Capital Markets area. In terms of our formation, it's not one account, but there are a few small accounts that have been moved to the impaired line, but the number is not very large.

When you look at our gross impaired loans, in the oil and gas sector, there is a delta of $18 million since the last quarter. That's not that large a number, given the context in which you are examining this portfolio and the size of this portfolio. Did I miss any part of your question?

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

Well, I am going to go to a second part of it, but you've indicated that we're likely going to see some continued migration, given what we've seen in the commodity price. And maybe this plays into the stress test question, maybe it doesn't. How does capital start to move, or your CET1 ratio start to move, as you bake in more impairments coming through the producer portfolio? What kind of migration do you have to see to start to change your expected rate of default, and how much deterioration in the book would there have to be to wipe out say, a quarter of capital build?

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

Okay, to give you a little sense, we do look at migration in our stress test, and the migration is again, very similar to the PCL. It's extremely manageable. It doesn't wipe out to any extent -- what I would call not manageable at all. There will be clearly a migration, and we will see that happen if the prices remain depressed, but not to cause any alarm.

This is not going to happen overnight. This is going to happen over a period of time, and that will give us time to look at our forecasts better quarter-over-quarter, before we make other decisions with respect to capital. So I think we are quite comfortable, that under this stress scenario, we'd have taken management actions appropriately well ahead of time. Tom, do you want to add anything to that?

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

The only thing I'd add would relate to again, a sense of proportion. The direct exposure is only 2% of the lending portfolio. I think it's about 3% of RWA, and so it's hard to have a big impact on the total bank when those are the numbers.

The portfolios in the region would have some impact as well. Again, there, proportion is our friend, because the portfolio in Alberta is only about 15% of the Canadian portfolio, which is only a part of our overall bank portfolio.

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

While you're here, Tom, just a quick one to wrap it up for me. Your all bank efficiency and operating leverage looked much better this quarter, compared to the last few. Although when I look at it on a segmented basis, when I look at the adjusted expenses, it seemed like the bulk of the improvement was in the corporate services segment.

Your expense line there was noticeably lower than we've seen in quite some time. Is this the benefits of the restructuring starting to come through? If so, I would have thought it would have been mostly in the Capital Markets segment. But why don't I stop, and get your take on why that dropped so much, and whether there was anything unusually low in the Q3 result?

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

Sure. So the operating leverage was better than we've seen, and we think it was good in the quarter. On the numbers that we reported, it was 1.4%. And if you adjust for the stronger U.S. dollar overall as a bank, it was about 2.7%.

The improvement really was driven by work that's going on across the bank. The restructuring charge that we took last quarter did help. In our Capital Markets business, if you adjust for the currency, which I think you need to do to really see the underlying expense trend, expenses were actually down 1% year-over-year. Some of that would have related again, to the benefit of the restructuring that we took.

The Corporate segment expenses were below our average level that we've been running at for say, the last six quarters in the current quarter. Some of that is benefit from the work we're doing to contain costs.

There is some timing in that. And we do expect a bit of a Q4 seasonal uptick to those expenses, which isn't unusual for us. So Corporate helped this quarter, but isn't the whole story. And as we look into next quarter, we're focused on delivering operating leverage at the total bank that would be in the zone of what we had this quarter.

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

Thanks for your time.

Operator

Thank you. The following question is from Meny Grauman from Cormark Securities.

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

Good afternoon. Just wanted to follow-up on the credit issue.

It's more of a timing issue. I was wondering, are you surprised that you haven't seen any issues in the Canadian oil and gas book in particular, and more broadly in Alberta? As a follow-up to that is, how do you explain that? Are we just talking about a lag effect playing out, or are there other mitigating factors that stand in your mind, as being important that I need to consider?

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

I think the pace at which things are happening is not entirely a surprise. Given that after the precipitous decline in oil prices, they edged up a little bit and stayed at the USD$60 level for some time, allowing folks to hedge somewhat, feel better, and give them a little bit of relief in terms of timing. So they are not entirely a surprise.

And as I mentioned in the prior comment, these things don't happen suddenly. So we never expected that anything would happen in oil, either for a quarter or two. So to answer your question, not a surprise. Time will tell.

At the time we did the USD$35 scenario, it seemed something that we couldn't have possibly gotten down to, it seemed unreasonable. And we have to wait and see what happens to oil prices, and how long we think they will stay depressed before we look at it again. I hope that answers your question.

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

Yes, sure. Maybe just to follow-up quickly.

Just in terms of your assumptions and your experience, what kind of lag is reasonable to expect to see a more pronounced impact? I guess, you're saying that you do expect to see something more significant. What kind of lag is reasonable to expect?

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

It's hard to tell. See, this is a cyclical business, you have to recognize it, and we've seen cycles before. This particular cycle started with the supply issue. There was too much supply in the marketplace. Compounding that now, there may be a demand issue. And so, it's hard to predict the timing of these things. But certainly, what we do is we start watching for those areas which will give us the first sign of any patterns. And typically what happens in the industry is, you'll see the service sector, and on the consumer side, you'll see consumer delinquencies rise.

Consumer delinquencies in Alberta are not showing any break. On the service sector, we haven't seen much of it either. When oil and gas companies are stressed, particularly the E&P companies, they try to bring down their costs. They try to reduce the cost and the cost has to be borne by the service sector. You haven't seen that. And the good news is our portfolio is of a good quality where we deal large service providers, and not at the wellhead.

We aren't engaged in those that are very close to the wellhead. I suspect those that are at the wellhead will be impacted first, but we don't have many of those. I can't really give you any specificity in terms of how lagged it's going to be. We are watching closely, and we wouldn't be surprised if we saw something, but we haven't seen anything yet.

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

Thank you very much.

Operator

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

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

Thanks. If I could just ask Surjit a quick follow-up, thinking again about the oil and gas portfolio.

The impact in the stress case that you went through there in some good detail sounds pretty manageable. Do you think, could we see a rise in the collective in advance or any time soon, or in a base case or a stress case? Or are you just more likely to take the losses as they come, given that they are not substantially large in nature, I guess?

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

It's hard to tell whether we would take losses, and be able to write them down right away, or carry a collective against them. Certainly with the migration, the collective allowance will change as they migrate, and not in the impaired state that it will be. It will have an impact on the collective allowance.

But let me remind you again, this is a very small part of our portfolio, and we do have a fairly large sized collective allowance overall. And then, we also expect certain parts of our portfolio to move in just the opposite direction, where we are seeing a migration towards the positive. Our consumer portfolio as an example, this quarter, both in the U.S. and Canada have shown positive migration. So I think there will be some offsetting effects there as well.

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

Okay. And then I wanted to come to Cam, last quarter. We saw some good improvement in incremental operating leverage, but still a bit negative.

Last quarter, you indicated that we should start to see positive operating leverage beginning in Q4. The Canadian macro backdrop clearly weakened over the last three months, Cam. So I'm wondering if you can give us a bit of an update, in terms of your outlook on expenses, thinking about the next little bit?

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

Sure, thanks for the question. I think the quarter's come in very nearly in line with where I thought it would, so that's good.

On the NIAT, we're happy with obviously, because of the strength of the quarter we're building upon last time. The expenses have come in about where I think I guided to last time, and where I thought they would be. And it is a more difficult environment perhaps, but I still would like to see this business getting very near neutral or positive leverage towards the end of Q4, with a focus to getting and staying in the positive zone in ’16.

Steve Theriault *- BofA Merrill Lynch - Analyst*

Thank you.

Operator

The next question is from Robert Sedran from CIBC.

Robert Sedran *- CIBC World Markets - Analyst*

Hi, good afternoon. Just a quick numbers question to start.

If I'm not mistaken, there were some recoveries, and a gain on sale of charged off accounts in the Canadian segment? Can you quantify that in terms of how big the impact was on this quarter?

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

Sure, it's Cam Fowler speaking. I'll take that one.

The improvement in PCLs quarter-on-quarter is $34 million, of which $27 is on the consumer side, of which two-thirds is just better performance across most product areas, and the other third, so $9 million, is the debt sale.

Robert Sedran *- CIBC World Markets - Analyst*

Okay. Thank you. And I wanted to ask about the buyback.

Management teams often talk about being opportunistic with the buyback, the 10.4% CET1 ratio, the share price has not had a good summer. Should we expect you to become more active or to quicken the pace in the next while? Or do concerns about tail risk that have gripped the markets, does that make you want to go to sleep on a big pile of capital?

Bill Downe *- Bank of Montreal - CEO*

I thought Tom was going to answer that, but the last part of your question, Rob, brought me to life. No, we aren't going to go to sleep on a big pile of capital.

If you look at year-to-date, we returned about $2.2 billion to shareholders between the dividend and buybacks. And we're in exactly the same position that we've stated in the last many quarters, and that is that it's a balance between the application of capital to growing the business, and as you said, opportunism in buying back shares.

We really weren't in a position, I don't think, where we would have been permitted to buy back shares in the first hour of the day yesterday. That would have been a very good time to do that.

But to answer your question specifically, we look at acquisition and investment opportunities in the context of the amount of capital we have, the flexibility that having strong capital allows us going forward, and the relative accretion that buying stock at any level implies. And we are more inclined to buy stock at lower prices than we are at higher prices.

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

Since I have roused you, I mean, the --

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

I wasn't too deep, by the way.

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

But the environment you find yourself in today then, is just more or less, nothing's changed? You don't view that the tail risk in the market to be any more significant. You're comfortable with your stress test, and so you don't feel the need to build capital. The numbers we've talked about in the past of roughly 10% CET1 is still a level that you feel conformable as an operating level in this environment?

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

Yes, I think, we're in a comfortable range. I mean, there is no question that we're as vigilant as any participant in the market, around developments that will come from lower commodity prices, lower oil prices. We do have a lot of experience in these sectors. We have very deep sector experience in natural resources, going through many cycles, and the losses tend to be spread over some periods of time.

So we aren't unaware of what the consequences of lower commodity prices are for some period of time. But when we look at the North American economy, there is a reason why we have a diversified North American business. And a great part of it is, that's how our customers see the market as well.

Then on balance, the benefits of that mix are going to balance out the areas of concern, that quite rightly we've been exploring. So our capital is being maintained at a level that ensures we have the flexibility to take advantage of opportunities as they present themselves, and we use the buyback in order to keep it in balance.

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

Thank you.

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

You’re welcome.

Operator

Thank you. The following question is from John Aiken from Barclays.

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

Good afternoon. Cam, can you give us a little bit more color on the reduction that you experienced in your auto loan exposures? And I'm fairly certain that we all know the answer to this, but where have you been reducing, and have you seen growth in other segments, either by credit risk or term, et cetera?

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

Yes, thanks for the question. The reductions have been probably flowing down over five quarters now I think, John. In the three areas that we've focused on, length of amortization, score, would be the two primary ones. And I think what we're seeing now is, we haven't changed our view that we would like to participate in this market, and be selective about how we do so. I think we still feel that way.

What I think we've seen over the last several months is an increase in origination in the spaces we want to participate, mostly because we worked on our own distribution alignment, and making life a little easier for our sales force and our potential clients. So I expect this business to come along a little bit over the next quarter and through 2016, along the lines that I've described it, in terms of our appetite. But I do think it will start to see positive growth in Q4 and Q1.

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

Great. Thanks, Cam. And if you'll allow me to completely beat a dead horse with a final question for Surjit.

Surjit, I believe I understand the stress testing that you've underdone and the parameters you have around that. But I think that you alluded to in one of your previous answers, the fact we really don't know what's going to happen with oil prices. And I know that the bank is the glass is half full, and we on the sell-side, our glass is half empty. But what, have you done any degree of sensitivities around your stress testing, if we have low oil for a longer period of time? Call it sub USD$40 for two years, in terms of what impact that would have on your stress testing?

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

We haven't done any formal ones, but we have done a fair number of the back of the envelope based on a much more detailed stress test that we have done at USD$35 and USD$50. And as I've said, you've got to look at it in the context of the overall oil portfolio. The 2% exposure, more than half of which is investment grade, where some of it is pipelines and midstream, the results don't alarm us, to the extent that I think the glass half empty folks would want us to see us alarmed.

Clearly, this is a sector Canadian banks in particular, have been extremely comfortable with over time. We have been engaged in this and gone through cycles before. We know this can happen. We know it can be prolonged as well.

But we also believe there will be benefits that come from this low oil price scenario. So yes, we have run some sensitivities, but not formal stress tests with lower prices.

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

Great. Thanks, Surjit. Hopefully we put this to bed, but I'm not that confident, you are not going to get more questions. Thanks again.

Operator

Thank you. The following question is from Gabriel Dechaine from Canaccord Genuity.

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

Apologies to John Aiken. I'll ask another oil-related question.

Between Canada and the U.S., I'm not an oil and gas expert, but I hear that the borrowers tend to be lower risk in Canada, lower balance sheet leverage in Canada, lower debt-to-cash flow ratios, things like that. Is that a characteristic that's applicable to BMO's oil and gas book between Canada and the U.S. book, which is proportionately higher in the U.S. than it is in Canada?

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

No, the U.S. book to your last point, our U.S. book is about 35% of our total book, 65% of it is in Canada.

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

Right. But within the U.S. I meant.

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

Within the U.S., we have more of a borrowing base bias than we have in Canada in the E&P sector. So in some ways, they are well-secured.

And don't forget on a borrowing base on a reserve based loan, you do lend only two-thirds based on the present value of your price deck. It's only under a very changed price deck that, we would be putting a new price deck for the redetermination of borrowing bases. That will happen in October and September, October, and November. So they will have some strain.

In terms of more leverage, the U.S. companies have had a lot more access to markets other than the banking market. And the second lien and the high yield market was open to them, and that market is no longer as readily available, given that I think roughly, what we read, about a quarter of the high yield loans that were in the energy sector are right now in this stress territory.

These are again stress pieces. So structurally, the markets are slightly different.

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

Well, maybe just more simply, is the average credit risk higher in your U.S. oil and gas portfolio than it is in Canada? And also, if we see another quarter like this one in terms of the level of formations, could we see BMO take a sectoral provision next quarter, if that were to occur?

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

No. Our average risk profile is not very different between the geographies. And if you are asking me to tell you about our sector provisions, we actually have a collective allowance that's done in a manner in which we look at all our sectors, including the oil and gas sectors.

And in the current environment, I don't see a sector provision only, because I think I know what's happening in our portfolios and that they are migrating. We put collectives in if we have to, as we see things change. But as I said, we are also hoping that there will be offsetting migration elsewhere.

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

Okay. And now if I see the specific coverage ratio, it's around $2 million of allowances in the oil and gas book, and I guess, the $105 million or $100 million-something impaired loans, you've got additional buffers in the collective, so I shouldn't be worried?

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

Well, yes, to your point on the $2 million against the $105 million or so in the impaired loans, that number changes depending on what you write-off. So in the last quarter, we've written down some. And so, that coverage looks a lot lower. But in fact, the good news in this particular quarter was that the new formations we put on, we don't see any losses associated with them, at least not now. And depending on the oil price, things may change. But right now, I think we are adequately provided.

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

Okay.

Just to shift gears to the U.S., we've had three straight quarters now where margins have been flat. Is that surprising to you, or are alternatively are you looking at more stable NIM going forward? Because if that's the case, it could move a pretty big revenue growth tail wind into 2016. So your revenue growth could turn positive more consistently next year. Is that how you're looking at it?

Dave Casper ***- Bank of Montreal - Group Head, U.S. P&C***

So it's Dave. We have been guiding you, probably to the 2 basis points to 3 basis points over the last period of time. We are actually very happy with where it’s been.

I think there's probably going to continue to be some NIM pressure, not as much as has been in the past. I'd say maybe 2 basis points per quarter that would be my hope, and could be, if we had some rate improvement, we'd actually be better than that.

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

So why is it getting better then?

Dave Casper ***- Bank of Montreal - Group Head, U.S. P&C***

Well, a couple of reasons. One of the big drivers of that is the commercial loan spreads on those loans. Over time, those have come down a lot. They have, but it's starting to narrow.

I think we're getting to a point where that will slow, and maybe move back the other way at some point. It's still very competitive in the U.S., but that's a big driver. Also the level of loan growth in any quarter can have an impact as well. Does that help answer the question?

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

That was very helpful. Thank you.

Operator

Thank you. The next question is from Peter Routledge from National Bank Financial.

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

Hi Surjit. Just two quick follow-ups on Gabe's questions. One, you have $6.6 billion drawn oil and gas loans, and $7.9 billion undrawn. What's your assumptions around exposure at default?

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

The exposure at default typically does go up, and you'll see that in our supp pack. We've got our exposure at defaults which include oil and gas, so we don't show them separately. But you'll see our exposures at default for the overall portfolio, they're embedded in there.

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

So when you assume your borrowers go bankrupt in your stress test, you're assuming a pretty high exposure at default, is that fair to say?

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

So let me explain. When you have a borrowing base facility, the amount you authorize, sometimes you can't draw, because you don't have the borrowing base available for it.

So the authorizations can be a little misleading. You aren't allowed to take the money.

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

Okay. So it's not as pronounced as it might be in other sectors?

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

That's right.

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

Okay, thanks. And then what percent of your portfolio is investment grade versus below investment grade?

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

Our investment grade portfolio overall is a little over 55%.

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

Okay, thanks. Change topics.

There has been some news around mortgage underwriting in Canada, specifically about the veracity of certain underwriting information, income verification for example. And I know Bank of Montreal doesn't do third-party mortgages very much.

But the question I have for you is, for the mortgages originated outside your branch network, whether it's mobile mortgage specialists or purchased mortgage from third-parties, what sort of tactics do you employ to prevent misrepresentation of key mortgage underwriting data? And obviously, income would be one key data point, but also appraisals and Beacon scores. Can you give us a sense of, outside the branch network, what you do to ensure the data you're using in your underwriting is precise and accurate?

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

Firstly, let me start by telling you that, when we originate all mortgages, we have a pretty stringent and rigorous way of making sure that all the verifications from income and elsewhere are in order. When we look at third-party mortgages, I think that process is even more stringent.

And we look at all the information that they provide us, and we do, we have a quality assurance associated with that part of the portfolio that we buy from folks. And with what happened in the marketplace when there's an element of what I would call fraudulent representation, we look. We tighten it up even further, to see whether that we've noticed anything, and we haven't.

So we are quite comfortable with the suppliers of third-party mortgage to us, and the processes that we have in place to make sure that nothing surprises us. Cam, do you want to add to that?

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

I would just confirm, as stringent or more, we do audit it, and we always make sure they are CMHC and NHA approved partners.

Peter Routledge *- National Bank Financial - Analyst*

So for a subsection, maybe of third-party mortgages, or your mobile mortgage specialist originated mortgages, for income verification, do you make calls to employers? I presume that's impossible to do for every mortgage, but do you do sort of a random check?

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

I am sure we do, but I can't tell you for certain, because I have not asked that question very specifically, in terms of how many people we call, and when we call them. But the quality assurance program and the audit checks that we do, I'm sure encompass some calling, but I can't tell you for sure right now. I can come back to you, and tell you what we do.

Peter Routledge *- National Bank Financial - Analyst*

That would be great. Thank you for your answers.

Operator

Thank you. The next question is from Darko Mihelic from RBC Capital Markets.

Darko Mihelic *- RBC Capital Markets - Analyst*

Great, thank you. Just wanted to circle back a little bit on the sale of the delinquent loans. I'm just trying to marry this with the loan loss provisions for the credit cards in the quarter.

Is that where it had an impact? Because I see provisions were down significantly quarter over quarter, year-over-year, very low level of 2.6% loss rate. Is that what's happening with the credit card portfolio, or is there something else I'm missing?

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

Yes, I think the sale is having an impact. And having said that, there is also a quality improvement, so it's not just the sale. But certainly it's having an impact on the basis points that you're looking at.

Darko Mihelic *- RBC Capital Markets - Analyst*

So 260 basis points is what I sort of calculate for credit cards in the quarter, the four quarter average prior was something like 360. So it's 100 basis point improvement versus the four quarter average. Am I to think that the 260 is the right number?

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

I don't think it's 100 basis points. I don't know how you are getting to that. $9 million in a quarter does not make that big a difference to the basis point calculation on credit cards.

Darko Mihelic *- RBC Capital Markets - Analyst*

Right. So what I'm specifically looking at, Surjit, is the $52 million that you guys put in your supp pack for credit card losses, and that would compare to $73 million last quarter. And the balances, we can just take from the balance sheet. So maybe we can take this offline, but it just seems that --

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

Yes, let's take this offline, yes.

Darko Mihelic *- RBC Capital Markets - Analyst*

It seems like a very big improvement.

And similarly, I think when you guys disclosed your commercial losses in Canada P&C, and there too, we're seeing a very big improvement and very low levels. You're showing $23 million for the quarter, about 17 basis points of losses. If I only go back to 2014 and 2013, those were as high as 41 basis points and 45 basis points. So it just begs the question, was there anything there in that portfolio that's showing? It's just seemingly hard to understand how commercial continues to get better and better in Canada?

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

Commercial Canada is better than in the past, but it isn't that different from 2014, or I would say even from 2013. A little bit better than 2013, but it hasn't changed too much. So I don't know what numbers you are looking at, I don't see very much of a change between 2014 and 2015 year-to-date on commercial Canada.

Darko Mihelic *- RBC Capital Markets - Analyst*

Okay, we can take that one offline too.

I have the numbers from your disclosures and it just looks like it's a big improvement. I guess, lastly then, just the M&A environment in the U.S. is definitely picking up. Marshall & Ilsley is largely integrated. You have good capital ratios.

I guess, the question for Bill is, getting back to the excess capital question. And I suppose you could buy back stock, but from a strategic point of view, it seems like now would be a good time to get involved, and think about furthering your prospects. Is there something holding you back there, or no? I mean, the concern we've always had is the regulatory environment is difficult in the U.S.

You have a lot of capital there. So maybe you can just -- if you can just speak briefly to what you're seeing on the M&A front? If you are seeing anything at all that would be different today? Would your stance be different today versus where it would have been just a year or two ago?

Bill Downe *- Bank of Montreal - CEO*

I don't, no, our stance isn't different, and I think that a year or two ago, we had capacity. You'll recall we did an asset management transaction in the UK, and that absorbed that capacity in one year.

I think the environment is changing, in the sense that potential sellers are now, I think more interested having conversations. So we have a constant corporate development process. We're in conversations with banks that we think, and have been for as long as I could remember, banks that would be good additions.

I think the environment is fine from the seller's perspective, and that's why you've seen a couple of transactions done. You haven't seen very many done yet. But I think in 2016 and 2017, the consolidation process in the U.S. market will probably pick up.

And at the same time, many of the things that we have been investing in from a systems perspective, will give us confidence in our ability to capture the benefits of scale. So I think that's really the trade off, is an increasing visibility around potential transactions over the next 24 months. And the higher degree of confidence that we can use the gains that came from heavy investment around M&I to profitably increase the size of the business. It would also be nice to see just a little pick up in both new home sales and interest rates on the retail side, to accompany that.

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

Okay. That's helpful, Bill. Thank you.

Operator

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

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

Great. Thanks, everyone for joining us on the call today, and we hope you enjoy the rest of your day. Thank you.

Operator

Thank you. The conference has now ended. Please disconnect your lines at this time. Thank you for your participation.