BMO Financial Group

Q2 2016 CONFERENCE CALL

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Sharon Haward-Laird - ***Bank of Montreal - Head of Corporate Communications, Government and Investor Relations***

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 our Chief Risk Officer, Surjit Rajpal,.

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 your questions to one or two, and then re-queue.

Frank Techar, our 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 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 both 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.

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.

Operating performance was good this quarter driven by strong growth in our combined Personal and Commercial banking business. Net income[1] was $1.2 billion and earnings per share[1] were $1.73, up 1% year-over-year, or up 8% excluding the write-down of an investment in Wealth Management. And on a year-to-date basis, EPS[1] was up 7%, in-line with our medium-term objectives.

We continued to see the benefits of our focus on expense management and momentum in revenue growth, with positive operating leverage in three of our four operating groups. Total bank operating leverage[1], excluding this quarter's write-down, was 1.6%. This is the fourth consecutive quarter of positive operating leverage.

Credit remained good in the quarter and while we continue to anticipate upward pressure through the balance of the year, we expect losses to be manageable. Surjit will provide more detail in his remarks.

Our capital position was strong in the context of a recently completed acquisition at 10% and ROE was 12.1%, consistent with last quarter. Today we announced an increase in our quarterly dividend of two cents per common share, bringing our annual payout to $3.44, up 5% from last year.

This quarter's results include a $188 million pre-tax charge, which we expect will deliver equivalent run-rate savings within a year. As I said at the annual meeting last month, BMO's agenda is defined by the closely aligned dimensions of efficiency and customer experience. Consistent with our four areas of operating focus, we have been investing in streamlined processes and digitization to bring those parallel goals together.

1 On a reported basis, net income: $973 million, EPS: $1.45 down 3% Y/Y, up 6% excl. the write-down; YTD EPS: up 3%; net operating leverage: 0.2% excl. the write-down

Before I turn things over to Tom to discuss the results in more detail, I'll touch on a few highlights from our operating groups.

Our combined Personal and Commercial banking business delivered net income[2] of $804 million, up 14% from last year.

We're using new tools, insights and ways of connecting to make banking more personal and intuitive. Just recently, we rolled out the first biometric corporate card program in North America that will enable cardholders to verify transactions using facial and fingerprint recognition when making online purchases. We also announced the introduction of Apple Pay to Canadian customers, following the rollout to our U.S. customers last year.

In the U.S. we added two new Smart Branch locations where digital and human interactions blend seamlessly within a smaller format that fits neatly with our customers' busy, connected lives.

Turning to Canadian Personal and Commercial Banking, net income[2] was up 8% and operating leverage was positive for the third consecutive quarter, driven by good balance sheet momentum and strong credit performance.

The employees and leaders in Canadian banking fully embrace our vision to be the bank that defines great customer experience, and it is in that spirit that I would like to acknowledge the people of Fort McMurray and Alberta who have responded so bravely to the fires that have devastated the region.

In economic terms, while there is likely to be a short-term impact on GDP from the temporary curtailment of production, over time we expect to see an increase in investment to rebuild communities. That in no way diminishes the human tragedy for those that live in the region. We have translated our deep concern into action. Employees from across Canada have personally reached out to more than 24,000 customers in the region. We are also offering a financial relief program to support impacted customers needing help with short-term payment deferral options, special accommodations and other assistance.

In the U.S. Personal and Commercial banking business, performance was strong. Net income[2] increased 21% in constant currency, assisted by the contribution from BMO Transportation Finance and strong performance in the existing business. Operating leverage was positive and organic commercial loan growth continued to be strong.

BMO Capital Markets also had a good quarter with pre-provision, pre-tax income[2] up 10% on strong revenue performance. Operating leverage was positive for the third consecutive quarter.

BMO Wealth Management had solid underlying performance, with business growth in Traditional Wealth offset by the impact of the write-down of an investment and lower year-over-year equity markets. Insurance income was down from above-trend levels in the prior year. Our Wealth business continues to have good opportunities for growth and will benefit from the investments that we have made.

Overall, our results demonstrate sustained momentum. In the last quarter, we were encouraged to see a more positive tone in the interest rate, currency and commodity markets and economic fundamentals remain healthy. We are progressing with the work of further differentiating the bank through our digital platforms while driving efficiency and growing customer loyalty as our first priority and we remain confident in our momentum.

And with that, I will now turn the call over to Tom.

Tom Flynn *- Bank of Montreal - CFO*

Thanks Bill and good afternoon.

I'll start on slide 8. Q2 EPS[2] was $1.73, and net income[2] was $1.2 billion, both up 1%. As you have seen, adjusted results in the quarter include a $79 million after-tax write-down of an investment. Excluding this item, EPS[2] was up 8%.

2 On a reported basis, Total P&C: $792 million up 14% Y/Y; Canadian P&C: up 8% Y/Y; U.S. P&C: up 29% Y/Y; BMO Capital Markets PPPT: up 11% Y/Y; EPS: $1.45 down 3% Y/Y; net income: $973 million down 3% Y/Y; EPS: up 6% excl. the write-down

As Bill said, our results demonstrate continued operating momentum and the benefits of our focus on expense management.

Adjusting items this quarter include a restructuring charge of $188 million pre-tax for severance as we accelerate the use of technology to enhance customer experience and focus on driving operational efficiencies. The charge is expected to generate run-rate expense savings approaching $200 million by mid-2017. Adjusting items for the quarter are shown on slide 25.

Net revenue was up 4% or 5% excluding the impact of the stronger U.S. dollar and the write-down.

Net interest income was up 18% Y/Y, or 15% on a constant currency basis primarily due to the benefits of BMO Transportation Finance, higher net interest margin and organic growth.

Net non-interest revenue was down 7% Y/Y, or 4% on a constant currency basis and excluding the write-down due to lower securities gains and insurance revenue.

Expenses[3] continue to be well-managed up 5% from the prior year, or 3% excluding the impact of the U.S. dollar. Year-over-year expense growth has been below 2% for the last four quarters in constant currency terms, and excluding the impact of acquisitions and divestitures.

Operating leverage[3] was 1.7% for the quarter and 2.4% for the year-to-date, on a constant currency basis and excluding the investment write-down.

The effective tax rate[3] was 19.6%, or 25.8% on a teb basis.

Moving to slide 9, our Common Equity Tier 1 Ratio was 10%, down approximately 10 basis points from the prior quarter as a result of good business growth and lower retained earnings build due to the restructuring charge and the investment write-down.

As detailed on the slide, risk-weighted assets decreased by approximately $9 billion as the impact of FX movements, which are largely hedged, and model changes were partially offset by business growth and changes in book quality.

Moving now to our operating groups and starting on slide 10. Canadian P&C had net income[3] of $525 million, up 8% from last year.

Revenue[3] growth was 4%, reflecting higher balances and increased non-interest revenue, partially offset by lower net interest margin. Total loans were up 5%, and deposit growth was good at 7%. NIM was down 4 basis points quarter-over-quarter due to the low interest rate environment and narrower spreads on variable rate lending products.

Expense[3] growth was 3.5% and operating leverage[3] was 0.6%, the third consecutive quarter with positive operating leverage. The efficiency ratio[3] improved 30 basis points year-over-year to 50.3%.

Credit continues to be good with lower provisions year-over-year in both the consumer and commercial portfolios reflecting, in part, the market participation choices we have made over the last few years.

Moving to U.S. P&C on slide 11, net income[3] was $279 million, up 27% from last year. The comments that follow speak to the U.S. dollar performance. Net income[3] of $216 million was up 21%. The acquired BMO Transportation Finance business represented approximately 15% of U.S. P&C's revenue and adjusted expenses in the quarter.

Revenue[3] growth of 24% year-over-year was driven by BMO Transportation Finance, higher loan and deposit volumes. Organic revenue growth was the highest we have seen since Q4 2014.

3 On a reported basis: expenses: up 6% Y/Y, up 5% Y/Y CCY; net operating leverage: 0.4% and 0.7% YTD both CCY and excluding the write-down; effective tax rate: 17.6%, 25.2% on a teb basis; Canadian P&C: $525 million up 8% Y/Y; revenue up 4% Y/Y; expense up 4% Y/Y; operating leverage 0.6%; efficiency ratio improved 30 bps Y/Y to 50.3%; U.S. P&C: net income $267 million up 29% Y/Y; net income US$206 million up 23% Y/Y; revenue up 24% Y/Y

Average loans grew 16% year-over-year due to the acquisition and organic commercial loan growth of above 10%. Net interest margin was up 8 basis points from Q1 from higher deposit spreads and the full quarter impact of BMO Transportation Finance, net of continued commercial loan growth pressure.

Expenses[4] were up 20% year-over-year primarily due to the addition of BMO Transportation Finance. Operating leverage[4] was 3.7% and the efficiency ratio[4] improved 190 basis points year-over-year to 62.0%.

Provisions were up year-over-year due to lower recoveries and the addition of BMO Transportation Finance.

Turning to slide 12, BMO Capital Markets had good results in an improving market environment. Net income[4] was $291 million, down 2% from a good quarter last year due to higher provisions. Pre-provision pre-tax earnings[4] were up 10% from last year.

Revenue[4] was $1.1 billion, up 6%. On a constant currency basis, revenue was up 4% driven by Trading Products partially offset by lower Investment and Corporate Banking revenues.

Expenses[4] were well managed, up 3% year-over-year or up just 1% on a constant currency basis. Operating leverage[4] was 3.0%, and positive for the third quarter in a row and the efficiency ratio[4] was 59.2%. Provisions for credit losses were up primarily due to higher resource-related provisions.

Moving now to slide 13, Wealth Management net income[4] was $158 million. Results include the impact of a $79 million after-tax write-down of an investment, excluding which Traditional Wealth earnings[4] were unchanged from last year at $169 million, with business growth offset by lower equity markets. Insurance earnings were down from an above-trend level a year ago.

Expenses[4] declined 2% year-over-year primarily due to the sale of our U.S. Retirement Services business and lower revenue-based costs.

Assets under management and administration declined 2% year-over-year due to market depreciation partially offset by favourable FX movements.

Turning now to slide 14 for Corporate Services[4], net loss of $101 million compared to a net loss of $121 million a year ago. Results improved from last year due to below-trend expenses and higher credit recoveries in the current quarter.

To conclude, operating results in the quarter demonstrate the benefits of our diversified business mix and our continued focus on driving customer experience and efficiency. And with that, I will turn it over to Surjit.

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

Thank you Tom and good afternoon everyone.

Starting on slide 16, this quarter we had good loss performance with PCLs of $201 million, or 23 bps, up slightly from 21 bps in the prior quarter.

In the quarter we had higher natural resource losses in Capital Markets, mainly oil and gas and benefitted from lower losses in the consumer and commercial segments in both Canadian and US P&C.

On slide 17, impaired loan formations increased, rising to $718 million from $594 million primarily due to oil and gas. Gross Impaired Loans were 62 bps, up from 60 bps in the prior quarter.

Turning to slide 18, we continue to see negative migration in our oil and gas portfolio and, as I have said previously, we expect to see elevated formations and losses. In Alberta, consumer delinquencies increased modestly quarter over quarter, although, total Canadian consumer delinquencies were down.

4 On a reported basis: U.S. P&C: expenses up 20% Y/Y; operating leverage 4.5%; efficiency ratio improved 240 bps Y/Y to 63.5%; BMO Capital Markets: $291 million down 2% Y/Y; PPPT up 11% Y/Y; revenue $1.1 billion up 6% Y/Y, or 4% CCY; expenses up 3% Y/Y or 1% CCY; operating leverage 3.0%; efficiency ratio 59.2%; BMO Wealth Management: $134 million; Traditional Wealth: $66 million; expenses down 2% Y/Y; Corporate Services: ($244) million compared to ($227) million a year ago

Looking at our total allowances, they remain in excess of $2 billion, which is equivalent to 57 bps of loss. This loss coverage is about twice the loss rate I expect for the next four quarters and well above our long-term historical PCL rate of 41 bps. I feel comfortable that our total allowances are appropriate.

We continue to benefit from a well-diversified business mix, by sector, geography, product and currency. Looking ahead over the next four quarters, I expect losses in the mid to high 20 basis points range, although losses will vary quarter to quarter.

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)

And the first question is from John Aiken from Barclays. Please go ahead.

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

Good afternoon. Tom, can you give us a little bit more color around the restructuring charge that was taken this quarter? Is this essentially writing off obsolete systems, or is this part of a broader headcount reduction that's going on in the front line?

Tom Flynn ***- BMO Financial Group - CFO***

Thanks for the question. The restructuring charge itself represents severance cost, not the write-down of any investment. And the underlying activity that drives the charge really relates to the increased use of technology in our business. And that's true both on the customer facing side, where customers are increasingly doing things in a digital way, either mobile or online, but also in terms of how we use technology to drive efficiency in our business. And then more generally, we're working on expense management at the Bank, as you know. And so those are the real drivers of the change, the charge that we took in the quarter, and again, there's nothing in it for any asset write-down of any type.

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

Okay, Tom. And Bill touched on it in his prepared commentary, but you also mentioned that you expect the restructuring charge to get you ongoing cost savings upwards of $200 million. Going back to where we were a year ago when you took a restructuring charge of just over $100 million for roughly the same issues, where do you stand in terms of the cost saves that came out of that restructuring charge?

Tom Flynn ***- BMO Financial Group - CFO***

We're very much on target with the savings that we expected a year ago. The restructuring charge related to severance a year ago was in the zone of $130 million. We said at the time, that the savings would be in the zone of $100 million, and they have been and they're in our numbers and really contribute to the good operating leverage[5] that we've had at the Bank over the last few quarters; 1.7% in the current quarter, 2.4% year-to-date constant currency and adjusting for the write-down, and the low expense growth[5], below 2% also in constant currency and excluding acquisitions over the last four quarters. So the benefits have come through and contributed to those numbers, and we'd expect similar performance looking forward.

John Aiken *- Barclays Capital - Analyst*

Thanks, Tom. I'll requeue.

Operator

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

Meny Grauman *- Cormark Securities - Analyst*

Good afternoon. Just wanted to ask about borrowing base redetermination, if there's any update you can give us on that process?

Surjit Rajpal *- BMO Financial Group - Chief Risk Officer*

Yes, this is Surjit. The borrowing base redetermination process has gone as we roughly expected. We are about three-quarters of the way through and on average, the amounts for the loans have come down by 15% to 20%, which is what we expected at the outset. So they've been in line with what we expected. Because don't forget, we have a good sense of where to expect them based on the price deck that we have. And just to give you a sense, the price deck that we're using now is significantly below what oil prices are trading at currently, or in the month of May.

Meny Grauman *- Cormark Securities - Analyst*

Thanks for that. And just focusing in on credit from a different angle. If I look at the loan loss ratio in your consumer portfolio, it's 17 basis points from 35 basis points in Q1. When you see that kind of number, how do you explain that? Is it something that you think is sustainable at this current level, in the consumer side specifically?

Surjit Rajpal *- BMO Financial Group - Chief Risk Officer*

On the consumer side, I think what we are seeing right now in Canada particularly is that the delinquencies are down, and I mentioned that in my remarks, as well. I think we have not yet seen the full impact of issues in the oil provinces, I believe, and I think as it puts that through, we may see a reversal of that little bit, to some extent. So it's hard to predict, but they're at the low point, at this point in time.

Meny Grauman *- Cormark Securities - Analyst*

Okay. Then if I could add one more, just following up on the restructuring, talking about enhanced use of technology. I'm wondering if you have updated thinking in terms of the implication for branches, any update on that? I see that the Canadian branch count is relatively stable for some time now.

5 On a reported basis: net operating leverage 0.4% and 0.7%, both CCY and excl. the write-down; expenses: up 1% CCY and excl. acquisitions over the last four quarters

Cam Fowler *- BMO Financial Group - Canadian P&C*

Meny, it's Cam Fowler speaking. I would add on that. I think the view on the branch count in the near term is relatively stable to potentially slightly down. You'll note from the data that's available that transactions over the counter in the branch are down double digits year-over-year and mobile usage up in a similar fashion. So there's a great deal that organizations like ours can do to meet their customers where they are in terms of locations and formats and size and shape and staffing. But it seems likely in the medium term that branch counts will be slightly down.

Meny Grauman *- Cormark Securities - Analyst*

Thank you.

Operator

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

Gabriel Dechaine *- Canaccord Genuity - Analyst*

Good afternoon. Actually, my questions are for Surjit. You said that the level of impairments that we saw increase this quarter, that's a trend you expect to continue. I'm just trying to gauge how much higher that can go. If I go back to the last topical loan book during the crisis, commercial real estate, that peaked out at about a 10% GILs ratio. Is that where we're headed in this portfolio or could it get higher?

Surjit Rajpal *- BMO Financial Group - Chief Risk Officer*

It's hard to tell with certainty where it will go, but right now if you look at what the impaired book is, the impaired book is a little under 6% overall.

Gabriel Dechaine *- Canaccord Genuity - Analyst*

Right.

Surjit Rajpal *- BMO Financial Group - Chief Risk Officer*

And in the last quarter, you did see a lot of it in the US. There could be some impairments in Canada down the road. So I don't know whether it will take you all the way up to double digits, but certainly we will see an increase from the current level.

Gabriel Dechaine *- Canaccord Genuity - Analyst*

And then in the same direction, on a cumulative basis since Q3 of last year, you've taken a 15% loss rate against all the formations in that oil and gas book. And it was 10% this quarter. Is that the range we should expect for the loan losses on the portfolio, or how should we anticipate loan losses developing in it? Because the numbers I get there are pretty small in the end.

Surjit Rajpal *- BMO Financial Group - Chief Risk Officer*

So if you look at the last five quarters, and I think it is in the supp pack, if you add up all the numbers over the last five quarters, that number will add up to something like $80 million of PCLs in the oil and gas sector. I would think that number is slightly light, given where we are in the cycle. The numbers going forward will be higher than what you've experienced in the last five quarters. It's been building up. This is the most we've had, at $31 million in one quarter.

Gabriel Dechaine *- Canaccord Genuity - Analyst*

Right.

Surjit Rajpal *- BMO Financial Group - Chief Risk Officer*

So I would see that going up. But as I said in my remarks, I think it will settle, the overall PCL rate for our Bank will settle in the mid to high 20s, and it could spike in any given quarter.

Gabriel Dechaine *- Canaccord Genuity - Analyst*

The overall, PCL ratio for the Bank, you expect mid to high 20s. Okay.

Surjit Rajpal *- BMO Financial Group - Chief Risk Officer*

For the next four quarters.

Gabriel Dechaine *- Canaccord Genuity - Analyst*

All right. And then the capital implications of what's going on in the oil and gas book, last quarter you told me that in your stressed scenario you would see the impact of downgrades having about a 20 basis points impact on your core Tier 1. And we saw about 10 this quarter, if my math is right. Is this more of a -- we're approaching the peak or is the deterioration in credit quality taking place faster than you anticipated?

Surjit Rajpal *- BMO Financial Group - Chief Risk Officer*

Gabriel, I don't know where you're getting your 10% from. I don't believe it's that high.

Gabriel Dechaine *- Canaccord Genuity - Analyst*

10 basis points. It was $2 billion from credit migration and RWA increases.

Surjit Rajpal *- BMO Financial Group - Chief Risk Officer*

But it's not -- you can't make the assumption that the entire RWA increase is because of oil and gas. And I think, as Tom mentioned, there was a book size issue, as well. We've grown the book. And there have been some migrations, and the migration is not all oil and gas.

Gabriel Dechaine *- Canaccord Genuity - Analyst*

It's not?

Surjit Rajpal *- BMO Financial Group - Chief Risk Officer*

It's not all oil and gas. It's other sectors, as well. There's been some negative migration in other resource industries, as well. And as you notice, this quarter we've taken one hit in a mining account, as well.

Gabriel Dechaine *- Canaccord Genuity - Analyst*

Oh, okay. So nothing really to see there either. Okay. And just last one, I'll sneak in there for Cam. Saw the Canadian margin down a little bit this quarter and part of the explanation was due to lower spreads on variable rate loans. I take that as an impact of the prime BA spread narrowing. Is that the issue, and where do you see margins heading from here on out?

Cam Fowler *- BMO Financial Group - Canadian P&C*

I think you've characterized the issue well. Our NIM's been quite strong, as you know, and so I think this is the pressure that you'd expect and as we saw with the peer group in Q1. Looking out to the back half of the year, I would expect maybe 1% to 2%, 1 to 2 points pressure, per quarter in the back half of the year.

Gabriel Dechaine *- Canaccord Genuity - Analyst*

Okay. Thanks. Good afternoon.

Cam Fowler *- BMO Financial Group - Canadian P&C*

Thank you.

Operator

Thank you. The next question is from Robert Sedran from CIBC Capital Markets. Please go ahead.

Robert Sedran *- CIBC World Markets - Analyst*

Hello. Good afternoon. Just a couple of questions on trading, actually. Perhaps first off, why interest rates were particularly strong this time. But then just looking more broadly, over the first half of this year, we've had three or four different kinds of markets and yet the average trading revenue is still comfortably over $400 million. So do you feel comfortable that you've moved to a new run rate on this line?

Darryl White *- BMO Financial Group - BMO Capital Markets*

Well, Rob, it's Darryl. Thanks for your question. And I must admit, the first half is a little more straightforward than the second half of your question. But on the first half, you're quite right. It was a good quarter for us from a trading revenue performance overall, as you've probably determined when you went to the rates. If you unpack it, we saw steady performance in equities, pretty steady in commodities. We actually saw a bit of a dip in FX, and then we had a nice performance in rates, which to circle to your question, that was driven by, yes, a conducive and a constructive market, if you think about the quarter itself, even within that quarter, I would argue there were mixed markets, as you will have observed. But in general, the quarter was better than the first quarter and it was better than Q2 of last year, as you might do your comparisons. So, a constructive market in which I think our teams performed quite well on executing higher than normal client activity.

In terms of the new normal, as you were going to for our trading business, I think we'll continue to see variability in the trading business going forward. We think we're operating pretty efficiently. We've got a pretty conservative risk posture. I won't put a number on it for you. I think the way we're performing now is instructive in terms of a constructive market, I'll put it that way. You'll have to make your assessments as to what the markets are going to do in the further quarters.

Robert Sedran *- CIBC World Markets - Analyst*

As you think forward into 2017, do you think you have found enough mitigation to the total return swap issue that we're unlikely to see a big impact from that issue anymore, or is that still something we need to be thinking about?

Darryl White *- BMO Financial Group - BMO Capital Markets*

I think it's something that we need to be thinking about. I've said before that we are absolutely focused on mitigation and redeployment of those resources. And I think we're part way through that exercise. I can't tell you today that the loop is fully closed. So I can't -- I won't put a number on it. It's something that we're still focused on.

Robert Sedran *- CIBC World Markets - Analyst*

And when would you expect that to start showing through in the results then, middle of next year?

Darryl White *- BMO Financial Group - BMO Capital Markets*

Rob, I think I've said before, and the view hasn't changed relative to a quarter ago, that there will be a little bit of it that we'll experience this year; but for the most part, it's a 2017 story.

Robert Sedran *- CIBC World Markets - Analyst*

Okay. Fair enough. Thanks for your time.

Operator

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

Peter Routledge *- National Bank Financial - Analyst*

Hello. Question about interchange, your deal with Apple. Actually, two. First, just a financial question. From media reports, it looks like Apple will take 15 basis points of interchange revenue. I'm not asking you to confirm that. But is there any reason for me to worry about a financial impact on your card revenues from this deal?

Cam Fowler *- BMO Financial Group - Canadian P&C*

It's Cam speaking. Thanks for the question. The arrangement with Apple, as you'd expect, is about choice for consumers. And if you look at the uptake in other markets, I think you can deduce that in the near term, there's not going to be likely meaningful pressure on interchange or overall payments revenue. But it's a long game and one that we watch closely, and we here are more focused on the value contribution this can make to our customers. But in the near term, I don't think there's going to be too much pressure there.

Peter Routledge *- National Bank Financial - Analyst*

And then the strategic question would be -- I'll just ask the question straight -- haven't the Canadian banks, who have a pretty attractive oligopoly position now, with this Apple Pay deal, just agreed to share their customer relationships with what's probably the most powerful consumer brand in the world? And isn't that a risk long term to your value proposition -- to your strategic position in Canada?

Cam Fowler *- BMO Financial Group - Canadian P&C*

I'd answer the question differently and say it's not about us, it's about the customers. They're the ones who get to choose the way in which they want to make payment and participate in commerce in the country, and we as participants in the market don't always get to choose who will be in and who will be out. It's our job to ensure that what we offer stacks up against everything that's available and in the process, we're protecting the critical things like trust, safety, security, (inaudible), et cetera. So you can read into their entry into the market what you will. It's certainly a new competitor for us.

Peter Routledge *- National Bank Financial - Analyst*

So you do see them as a competitor, Apple, that is.

Cam Fowler *- BMO Financial Group - Canadian P&C*

I do, yes.

Peter Routledge *- National Bank Financial - Analyst*

Okay. Thank you very much.

Operator

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

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

Thanks. Good afternoon. Let me start with Tom Flynn, please, and go back to the restructuring. A couple questions here. First off, when you announced the $150 million or so pretax charge a year ago, you were pretty clear in signaling to the market that you expected that you would be able to deliver positive operating leverage at the all bank level as the benefits flowed through. And I know there's a lot of things that go into operating leverage, but at least by my numbers, we have seen that over the past year consistently. As you look at this new charge today and some of the expense savings you think this can bring to you, is positive operating leverage on an all bank level still the goal or are there other headwinds -- not the goal, I'm sure it's always the goal -- is it still an achievable target for BMO, or are there other headwinds that have entered the equation that make it more difficult?

Tom Flynn ***- BMO Financial Group - CFO***

Thanks for the question. The short answer is that we have delivered positive operating leverage and we expect to continue to. And the number can move around in any quarter, as you suggested in your question. But we do expect to continue delivering positive operating leverage over the balance of this year and into next year.

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

And somewhat related to that, I know these numbers can move around with seasonality and those kind of issues, but with the restructuring charge being announced today, we do see across your geographies decent size reduction in the headcount in Q2. Have you already enacted the bulk of the changes that are required for the restructuring or are there further expense benefits that we're going to see in these numbers going forward?

Tom Flynn ***- BMO Financial Group - CFO***

The benefits will emerge over time. And in the change in FTE that you see in the current quarter, and it's down 600 or 700, there's some contribution from the charge, but it's not that significant. And the change quarter-over-quarter is more a reflection of some carry-through from the charge that we took a year ago, and then generally the focus that we have on managing the expenses in the organization. So most of the benefit will come through in the future over the next four quarters.

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

Thank you for that. My last question is for Surjit, just to go back to a couple of the numbers you gave us. So on the energy portfolio, this quarter we saw decent size increase in the gross impaired loans, and as you mentioned, the number now on impairments on the portfolio is about 5.6%. And the provisions, though, are much lower, at about 110 basis points. That gap between the two measures has opened up. And I know that every loan that goes impaired doesn't necessarily require provisions. But can you help me understand, as that differential widens, should the market expect that BMO is going to have to play some catch-up as far as energy provisions are concerned, or is there a reason that you believe that your actual provisioning rate should be materially lower than what you have in impairments in that portfolio?

Surjit Rajpal ***- BMO Financial Group - Chief Risk Officer***

That's a good question, Sumit. I wouldn't characterize it as catch-up, only because every bank's portfolio is different. And when you examine what happened to our portfolios in the last quarter, most of the impairment that we had was in the US. And the accounts that were impaired were largely those that had considerable amount of junior debt behind us. So we are in a secured position, and so there's plenty of security that doesn't require us to take a provision against the loan. Now there will be situations where we will have impairments where the security will not be completely covering the loan value, nor will the cash flow, in which case we will be taking provisions. So it's not a question of catch-up. It's the sequence with which you see impairments coming into your book, those that are secured and those that are unsecured, where there may be some shortfalls. I hope that clarifies it for you.

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

Where do you think your cumulative loss rate on your energy portfolio, in terms of provisions, is going to end up?

Surjit Rajpal ***- BMO Financial Group - Chief Risk Officer***

It's hard to tell really. And as I said in previous calls, it all depends on how long this persists. And that's why the extreme analysis we did with respect to the stress test, and everything that we're looking at is way inside of those stress tests that we ran. But other than to say, look, in the next four quarters, I think we'll be within the mid to high 20s in terms of our losses and oil will be a different game, hopefully in a year's time. I don't know. It's hard to predict.

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

Thanks for your time.

Operator

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

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

Good afternoon. Could we just flip topics for a second? Page 11 of your presentation, I did some back of the envelope math. I'm just trying to get a handle on what the PCLs ratio would be on the Transportation Finance business specifically, the acquired business. I'm coming up with something like 100 basis points. Does that number make sense to you?

Dave Casper ***- BMO Financial Group - US P&C***

This is Dave. No. I'm not sure how you're doing the math. But no, that's not even close.

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

Okay. So what would that PCLs ratio be on the Transportation Finance business now?

Dave Casper ***- BMO Financial Group - US P&C***

The rough number is in the 20 basis points.

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

Okay. And that's where we're running now, where would that number get us to? What would a normalized number be? And I'll tell you where I'm going with this. The acquisition accounting can sometimes be less than intuitive. And I want to make sure this isn't going to get to a level that materially changes the profitability of the US business.

Dave Casper *- BMO Financial Group - US P&C*

So when we -- let me try to answer that over the long term. When we looked at buying the business, we did look at an average PCL over the cycle. And that average is clearly higher than where we are today. We're not experiencing, and we don't see over the next couple of quarters, anything that would get us close to that average. But it is a cyclical business and we will get there over time, and we're prepared for that and we manage through that.

Mario Mendonca *- TD Securities - Analyst*

So what is that long-term average then that we should be thinking about?

Dave Casper *- BMO Financial Group - US P&C*

I think that long-term average is in the 50 to 60 basis points. That's the long-term average for this business.

Mario Mendonca *- TD Securities - Analyst*

But again, you don't anticipate seeing that any time soon.

Dave Casper *- BMO Financial Group - US P&C*

Well, no I don't --

Mario Mendonca *- TD Securities - Analyst*

If it's running then at only about 20 basis points, on a balance of, say, $9 billion, that's only about $5 million in PCLs this quarter. So we're not looking at a very big number. So I guess the nature of my question is, what really is then causing this increase in PCLs in the US business going, say, from 14 to something in the low 30s then, if it's not the Transportation Finance business?

Dave Casper *- BMO Financial Group - US P&C*

So there are a couple of things. If you're looking at back a year, we had pretty low PCLs. Put the Transportation Finance off to the side for a second, we're actually getting back to a little bit more of a norm. The Transportation Finance -- remember, you said 100 basis points. I said substantially less than that. And it's somewhere, I think, in the 20 to 30 basis points for this quarter, in that range. So the long-term view is we're probably still, on the Commercial side, at the low end of what we would expect for Commercial. We've had a couple of pretty good quarters. And we're very comfortable where the PCL was this quarter, and in the future, we'll see some lumpiness.

Mario Mendonca *- TD Securities - Analyst*

Okay.

Dave Casper *- BMO Financial Group - US P&C*

Not sure if we've totally answered your question.

Mario Mendonca *- TD Securities - Analyst*

I think so. Maybe the right way for me to ask it is this way. If you're running at 20 to 30 basis points right now in Transportation Finance and it eventually gets up to that long-term average of, call it, 60, we're not looking at a material increase in PCLs for that division, the US business, is that fair?

Dave Casper *- BMO Financial Group - US P&C*

I think that's fair.

Mario Mendonca *- TD Securities - Analyst*

Okay. So let's drive on to something else then. Probably best for Bill Downe. Bill, you've talked on a number of occasions about the US consumer loan growth and how you expected that to improve. And admittedly, you talked about it as being a second half of the year event or occurrence. We're just not seeing it, certainly not in Q2. And I know it's not the second half, but it's actually deteriorating a little. So what's giving you the confidence to talk about that second half of year recovery?

Bill Downe *- BMO Financial Group - CEO*

Well, I think a couple of things are specific to BMO, where I think our participation rate in the market has the opportunity to improve in the US, for a number of reasons. We've made systems improvements. Management is extremely engaged in pipeline building, with some success. And I think that the capacity of the distribution system to do more volume without significantly increasing cost says that it's a nice mix. And you look at the unemployment rate in the Midwest, it's a little bit above national averages, but I looked at some numbers today and participation rates are up very significantly. So I think that earnings in our market area, consumer income is probably rising. If you look at the housing market itself, rental housing is pushing right at the limits of capacity. And in a city like Chicago, rents are up very materially over the last 12 and 24 months, and that just reflects pressure in the market.

I think there's a demographic shift. If you look at the difference between Canada and the United States, I think there's a lag. And I think part of it has to do with just the depth of the recession and household formation and just people moving into the housing market, making their first purchase. There's a whole body of thought that these people are never going to move into a house, that they'll live in an apartment for their entire life and this will be a sea change in the way that society seeks housing. I'm not convinced of that, to tell you the truth. I do think we have seen most of the mortgage activity in refinancing for so long that we forget what happens when new home construction does pick up.

So I think that we said the latter half of the year. To me, it's still a reasonable time frame. But if it slipped by a quarter or it slipped by another quarter, it would still happen. And we're well positioned. I just have to remind you that our deposit share in the Chicago market is about three or four times the share of the housing finance market that we have, and we're in a much better position to participate, when it does pick up, than we were a decade ago. Many more branches, many more cities, and much better brand visibility, and I think very good prospects to grow share.

Mario Mendonca *- TD Securities - Analyst*

Can I say that you would be slightly less confident in the second half growth story than you were a few quarters ago?

Bill Downe *- BMO Financial Group - CEO*

Yes, we had expectations around the number of Fed rate increases that would help the returns on deposits. You can guess when the next one takes place, whether it will be two in the next eight months or two in the next six months or whatever it will be. But I think that is an expectation that I would have had more conviction about six months ago. I still think it's going to happen. And this spring season has turned out to be a good season for the pipeline around home equity applications and mortgage applications, and our throughput is increasing. So it's not as though we haven't seen positive indications in the market and I expect to see it flow through. And I think we still expect the retail business to contribute more in the second half than the first half.

Mario Mendonca *- TD Securities - Analyst*

Let me just flip to the final question I wanted to ask about, and it relates to capital. It seems to me, from reading the MD&A this quarter, that you're being more cautious and offering us more potential headwinds on capital and capital formation. I'm referring to the Bank's capital ratio now, the growth in that capital ratio over time. Am I reading that correctly, that you're being a little more careful and cautious in talking about capital going forward?

Bill Downe *- BMO Financial Group - CEO*

Well, I think the numbers speak for themselves. We do expect that capital will grow over time. And I think that's one of the things that we've been able to consistently do is grow capital, give ourselves flexibility. And I think the wild card is, as you know, there are a number of things that will happen through the course of the remainder of 2016 and the beginning of 2017 which do impact the calculation of capital, that does have a small headwind effect, but it's not profound, I don't think. I don't think the recalibration process is going to be profound, and there's some adjustments that I think take effect at the beginning of 2017. So, I think it's prudent to have an eye to those things, but we still have confidence in the ability to generate free capital and grow the capital ratio. And I think when you look back a couple of years from now, you'll have seen really the pattern of the past two or three years just continue.

Mario Mendonca *- TD Securities - Analyst*

That's fair. And there is one that I just forgot. Now let me run it by Tom Flynn real quickly. These restructuring charges, they're really not that unusual anymore, across the industry, we've seen a few. One you call unusual, two, not so much. Where I'm going with this is, can your bank -- and I'm really thinking about this for all the banks -- can they generate positive operating leverage without taking regular restructuring charges early in the year? And when we think about BMO, should we think of these restructuring charge as being all that unusual going forward, if in fact, it's something we might see quite regularly? Can you commit to us today that this would be the last restructuring charge we'll see?

Tom Flynn *- BMO Financial Group - CFO*

I can answer that last question first, and the answer is no. And I guess the way I would think of it is restructuring charges can be episodic. And if you look back at our results over a longer period of time, they're fairly infrequent. If you think about what our results might look like over a longer period of time looking forward, we would expect them to be fairly infrequent. And at the moment, we're living through a period of accelerated change, given the role that technology is having in our business, with our customers, and how we operate the Bank. And given that, over the last couple of years, we have taken a restructuring charge in each year. But I wouldn't expect that to recur through time.

Mario Mendonca *- TD Securities - Analyst*

Thanks, Tom.

Operator

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

Darko Mihelic *- RBC Capital Markets - Analyst*

Hello. Thank you. Actually, why don't I just pick up from right there, Tom. One of the objectives that Bank of Montreal always puts out is positive operating leverage, let's say 2% or so. In the last three years, it was always negative. But now we're getting in 2016 some positive operating leverage, largely on the back of a restructuring charge. And you sound fairly confident you're going to get next year, again largely as a result of the restructuring charge. The question maybe could be rephrased as, can you get positive operating leverage without taking a restructuring charge?

Tom Flynn *- BMO Financial Group - CFO*

One way to think about it is, year-to-date, excluding the impact of currency and the write-down, our operating leverage[6] is positive 2.7. And we took a restructuring charge a year ago that we said would have benefits of about $100 million. And that would represent less than 1% of our expenses. And so we'd still be significantly positive year-to-date without the benefit of the charge, although not as good.

And so I would say absolutely, the restructuring charges that we've taken allow us to do more to manage our expenses and to bring more technology into our business. We think that is good for us economically and it's good for our interactions with the customers. But I wouldn't say that the charge in and of itself or the charges are required to produce the positive operating leverage.

Darko Mihelic *- RBC Capital Markets - Analyst*

Okay. And just, the reverse is also possible. And what I'm curious about is, if we do get an improvement in margins and revenue outlook and so on, is it possible that we overshoot and we see a situation in which 2017 you have well beyond 2% positive operating leverage. Or is that a time where we see compensation expense increase and so on? That's what I'm struggling with, not the negative side of it, Tom, but more on the positive side, if we do in fact have a bit of an economic improvement that it's possible we get well beyond 2%.

6 On a reported basis: net operating leverage: 0.4% CCY and excl. the write-down

Tom Flynn *- BMO Financial Group - CFO*

I guess we think about that, the issues at play in that question, in a few ways. And first and foremost, we want to be competitive in the market and competitive in a timely way. And so, today that means in particular with customers being competitive on the mobile and the digital side and we're investing to do that; and then through time, we talk about wanting to have a reasonable relationship between revenue growth and expense growth, which means producing positive operating leverage and having a net income line that is growing more than it otherwise would as a result. And if the revenue growth was higher next year than it might be this year, some chance the expenses would be higher, but we would be carefully managing the relationship between the two to produce positive operating leverage and to have the benefit of that flowing through.

Darko Mihelic *- RBC Capital Markets - Analyst*

Okay. And maybe just sneak one in here for Surjit. I think, Surjit, you spoke about your overall allowance as being double the loss rate, your longer term loss rate and, therefore, you feel comfortable with them. I'm curious though if you could speak specifically to the collective allowance and why we're not seeing a significant build in the collective allowance?

Surjit Rajpal *- BMO Financial Group - Chief Risk Officer*

The collective allowance at $1.6 billion and change is, again, from my perspective, more covers us quite well. When you just look at what our numbers are, and we have a specific of a little over $400 million put aside for those accounts that are impaired, and for the rest of the book, $1.6 billion in that environment seems more than appropriate. So I would have the same comment if I was looking just at collective alone.

Darko Mihelic *- RBC Capital Markets - Analyst*

But I guess my question is more from a mechanical perspective. Mechanically, we're seeing, on the one hand, we're seeing downgrades in the portfolios, and yet your collective allowance has clearly been very stable over a long period of time and yet we're seeing degradation in the portfolio. So I would have thought that mechanically your collective allowance would go up, irrespective of the fact that it still may be four times your existing specific.

Surjit Rajpal *- BMO Financial Group - Chief Risk Officer*

You're right. If it was simply very formulaic, it would. There's an element of judgment that we use. We didn't take back, we didn't reverse any of our collective, as did a number of the US banks. And the credit profile of our US book increased quite considerably over a period of time, and we kept our collective unchanged. So I think our collective has in it a judgment factor which allows us to feel very comfortable with the negative migration we are seeing in the oil and gas book.

Darko Mihelic *- RBC Capital Markets - Analyst*

Okay. Thank you.

Operator

Thank you. This will conclude the question-and-answer session. I'd like to turn the meeting back over to Mr. Downe.

Bill Downe ***- BMO Financial Group - CEO***

Thank you very much, Operator. And I want to thank all of you for being so attentive to the call. I know this is going to be a very busy week for you.

Before we close it off, I'd like to acknowledge that beginning June 6, Sharon Haward-Laird will assume the leadership of the Bank's North American Treasury and Payment Solutions Group, which is a significant line of business for us. Sharon has worked closely with each of the analysts that are on the call over the past four years; and in that time, her role expanded to include Corporate Communications and Government Relations and she's done an excellent job in all of these roles, has been an important contributor to our effective communication with the financial community and with other stakeholders. And we are very proud to see her taking a next step in her career, and I want to take this opportunity on behalf of all of us around the table here to wish her continued success in her new position.

And with that, that's it for the call. Thanks very much, everyone.