BMO Financial Group

Q3 2022 Conference Call

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PRESENTATION

Christine Viau – *Bank of Montreal – Head of Investor Relations*

Thank you, and good morning. We will begin today's call with remarks from Darryl White, BMO's CEO; followed by Tayfun Tuzun, our Chief Financial Officer; and Pat Cronin, our Chief Risk Officer. Also present to take questions are Ernie Johannson from Canadian P&C; Dave Casper from U.S. P&C; Dan Barclay from BMO Capital Markets; and Deland Kamanga from BMO Wealth Management.

As noted on Slide 2, forward-looking statements may be made during this call, which involve assumptions that have inherent risks and uncertainties. Actual results could differ materially from these statements. I would also remind listeners that the bank uses non-GAAP financial measures to arrive at adjusted results. Management measures performance on a reported and adjusted basis and considers both to be useful in assessing underlying business performance.

Darryl and Tayfun will be referring to adjusted results in their remarks unless otherwise noted as reported. And with that, I will turn the call over to Darryl.

Darryl White - *Bank of Montreal - CEO*

Thank you, Christine, and good morning, everyone.

Our performance this quarter continues to demonstrate the strength and quality of our advantaged and diversified business mix, credit excellence and the resilience of our earnings power. Third quarter adjusted earnings per share were $3.09, driven by a very strong performance in our North American P&C businesses. Robust loan growth and margin expansion drove record revenue and over 15% pre-provision pretax earnings growth in both Canadian and U.S. P&C, more than offsetting lower revenue in Capital Markets, which was impacted by more challenging market conditions.

While the economic environment remains uncertain, there are signs that Central Bank actions aimed at taming inflation are having an effect. While economic activity is moderating, low unemployment and still high consumer and business savings are likely to provide some buffer to the downturn.

In the context of slower growth for the Canadian and U.S. economies, we at BMO are operating from a position of strength. Credit remains benign with strong reserves for loan losses to which we added modestly this quarter. Our consistent PPPT performance positions us to support customers while delivering growth through the cycle. For the year-to-date, PPPT of $9.1 billion is up 7% with 1.5% operating leverage and an efficiency ratio of 55.4%. While operating leverage this quarter was impacted by underwriting markdowns due to changing market conditions and severance in capital markets, we continue to expect to deliver positive operating leverage for the year.

Year-to-date ROE was 16%, above our midterm target as we remain focused on driving improved returns and managing the bank for sustained growth. We're actively managing our capital position, balancing the dynamic environment to support client-driven balances and the pending acquisition of Bank of the West. We expect post closing our CET1 ratio to build comfortably above 11% during Q2 of 2023.

We continue to make significant progress in building a high-performing, digitally enabled, future-ready bank and believe that our relentless focus on employee engagement and customer loyalty is the key to the health of our organization and will deliver sustained advantage over time.

Our highly engaged BMO team is activating our winning culture, aligned to a one client, one bank approach, which has been a key contributor to resetting the bank's performance to a higher level. In a recent comprehensive, high-performance cultural employee survey, our results improved from the third to the first quartile placing us among the world's best financial institutions. These results are a testament to our focus on a culture that creates conditions for sustained performance and differentiates us in attracting and retaining the best talent.

And our commitment to providing our customers with exceptional experience and personalized advice in every interaction is now driving world-class client loyalty. This quarter, we received the highest customer satisfaction ranking in the J.D. Power 2022 Canada Retail Banking Advice Satisfaction Study, reclaiming the top spot among Canada's largest banks. In addition, we were again recognized by World Finance Magazine as the best Commercial, Private and Retail Bank in Canada.

These recognitions reflect the investments we're making across our businesses with expanded teams and enhanced digital and marketing capabilities that are driving record new customer acquisition in our North American Personal and Business Banking businesses.

We're introducing new products to help customers progress, including our Smart Money account, which offers a low fee and no overdraft or NSF charges for our U.S. customers, and in Canada, Same Day Grace, the newly launched mobile and online banking feature that proactively helps customers manage their cash balance and avoid missing payments.

Our North American commercial banking businesses are delivering strong loan growth, up 16% in Canada and 15% in the U.S. Growth is broad-based and has been driven by the quality and reputation of our experienced bankers with deep local market and industry expertise who bring the full strength of BMO's capabilities and provide outstanding client service and quick execution, all of which is underpinned by a differentiated risk culture and a consistent risk appetite that has delivered strong credit quality over time.

The result can be seen in the consistently strong performance of our P&C businesses, with peer leading year-to-date PPPT growth of 15% in Canada, and 11% in the U.S., fueling ongoing strategic investments and positive operating leverage.

Investments in our high-return North American wealth businesses delivered good underlying revenue growth despite market declines and a moderation of client trading activity with growth in net new client assets, loans and deposits. Last spring, we introduced a broad suite of free-to-trade ETFs together with enhanced investor education. A year later, this offering is driving strong new client acquisition and growing ETF assets on the platform. In our Asset Management business, we're expanding our Canadian franchise, adding more than 50 experienced investment professionals in key growth areas, including our global equity team who focus on delivering higher returns for our clients.

BMO Capital Markets results this quarter were impacted by the market conditions and lower client activity. Our well-diversified businesses have delivered an average of over $630 million of PPPT over the last 4 quarters and remain positioned to build on the investments we've made to expand capabilities and grow client relationships. This quarter, we further advanced our leadership position in sustainability and our climate ambition to be our clients lead partner in the transition to a net zero world. The announced acquisition of Radicle Group will make BMO a leader in carbon credit development capabilities and the environmental commodity market.

The advantage of our diverse business mix is also evident in the performance of our U.S. segment overall, which is consistently contributing in the range of 35% of the bank's earnings with a year-to-date ROE and efficiency that is in line with the bank overall. We remain strongly positioned for the addition of the Bank of the West.

As we continue to grow the bank, our purpose-driven commitments to a thriving economy, a sustainable future and an inclusive society remain our guiding principle. This quarter, BMO was once again named to Corporate Knights' ranking of Canada's 50 Best Corporate Citizens, ranked first among major Canadian banks.

To conclude, our high-performing bank is well positioned for an evolving economic environment with a proven track record of superior risk management, strong capital and liquidity, engaged employees and loyal customers. We continue to strategically invest for growth to deliver long-term returns for our shareholders and enable progress for the communities we serve, including preparing for the closing and integration of our acquisition of Bank of the West.

I'll now turn it over to Tayfun.

Tayfun Tuzun - *Bank of Montreal - CFO*

Thank you, Darryl. Good morning and thank you for joining us. My comments start on Slide 9.

Third quarter reported EPS was $1.95, and net income was $1.4 billion. Adjusting items are shown on Slide 41 and include the impact of fair value management activities related to the acquisition of Bank of the West, which this quarter reduced net income by $694 million due to changes in interest rates compared with the prior quarter end. The remainder of my comments will focus on adjusted results.

On an adjusted basis, EPS was $3.09 and net income was $2.1 billion, down from $2.3 billion last year. Performance in our P&C businesses was very strong with adjusted year-over-year pre-provision pre-tax earnings growth of 15% in Canada and 16% in the U.S. as continued strong loan growth and margin expansion helped grow revenues at double digits. Revenue this quarter is a record in both businesses.

Continued weaker microenvironment lowered results in Capital Markets, including the impact of severance costs and markdown on loan commitments made earlier in the year and higher PCLs. Early indications quarter-to-date are more constructive.

Total PCL was $136 million, including a $32 million provision for performing loans compared with a total recovery of $70 million in the prior year. Pat will speak to these in his remarks.

Moving to the balance sheet on Slide 10. Loan growth accelerated, up 14% year-over-year and 4% quarter-over-quarter. Business and government loans increased 17% from the prior year, with strong growth across all operating groups. Consumer balances were up 10%, reflecting diversified growth in the P&C businesses and in wealth. Average customer deposits increased 7% year-over-year. Looking ahead, we expect loan growth to continue in our P&C businesses, reflecting strong diversified pipelines.

Turning to Slide 11. Net interest income was up 18% and up 22% on an ex-trading basis from last year, driven by strong balance growth and margin expansion. Net interest margin ex-trading was up 10 basis points from the prior quarter, primarily reflecting higher deposit margins in the P&C businesses. On a sequential basis, NIM was up 6 basis points in Canadian P&C and up 20 basis points in U.S. P&C, with wider deposit margins, partially offset by lower loan margins. Looking into the fourth quarter and next year, NIM in both our P&C businesses and at the all-bank level is expected to continue to widen given the rising rate environment.

Moving to our interest rate sensitivity on Slide 12. A 100-basis point rate shock is expected to benefit net interest income by $525 million over the next 12 months. To date, deposit betas have been slower than our expectations, but we expect them to move higher for future rate hikes. During the quarter, we incrementally added fixed rate investments, locking in higher term rates and reducing our exposure to lower rates in the future.

Turning to Slide 13. Non-interest revenue, net of CCPB, was 19% lower compared to the prior year and 16% on an ex-trading basis, primarily due to the impact of divestitures. In addition, higher card and deposit revenue was more than offset by lower revenue in Capital Markets and lower securities gains, reflecting the market environment. Lower revenue in Capital Markets includes $88 million of markdowns on prior loan underwriting commitments in the U.S. due to widening credit spreads.

Moving to Slide 14. Expenses were up 3% from the prior year. Lower variable compensation was partially offset by higher severance costs in our Capital Markets business. Targeted investments that are driving revenue growth, including sales force expansion and technology, were partially offset by divestitures. Sequentially, expenses were up 3% due to higher technology spend, severance and 3 more days in the quarter, partially offset by lower performance-based compensation.

On a year-to-date basis, and net of divestitures, performance-based compensation and severance, expenses are up 2.4%. This quarter, the two items in Capital Markets moved our operating leverage from being positive to negative 1.9%. Assuming constructive markets, we expect to move to positive operating leverage in Q4 and as Darryl said, deliver positive operating leverage also for the year.

Moving to Slide 15. Our capital position remains strong with a Common Equity Tier 1 ratio of 15.8%, down 20 basis points from the prior quarter. As shown on the slide, increases from internal capital generation and common shares issued under the DRIP were more than offset by growth in risk-weighted assets and a reduction in the benefit from fair value changes related to the Bank of the West acquisition due to changes in interest rates.

As discussed previously, the incremental capital of 70 basis points generated by the fair value management actions is expected to be offset by higher goodwill on closing due to the impact of changes in interest rates since the announcement. Source currency risk-weighted assets were higher, reflecting strong growth in our commercial lending businesses.

Moving to the operating groups and starting on Slide 16. Canadian P&C delivered net income of $965 million, with strong pre-provision pre-tax earnings growth of 15%. Revenue was up 13% from the prior year. Net interest income increased 17%, reflecting strong balance growth and higher margins, while non-interest revenue increased 2%. Expenses were up 10% with continued investment in the business, including in the sales force and in technology. Average loans were up 12%, with 12% growth in residential mortgage lending and 16% in commercial loans. Deposits increased 9% year-over-year and 4% sequentially.

Moving to U.S. P&C on Slide 17. My comments here will speak to the U.S. dollar performance. Net income was $446 million, down 1% from the prior year due to a higher provision for credit losses on performing loans. Pre-provision pre-tax earnings growth was strong, up 16%. Revenue was up 12%, reflecting strong growth in net interest income, partially offset by lower non-interest revenue. Expenses increased 8% due to higher employee costs and technology investments. On the balance sheet, average loans were up 13% from the prior year, reflecting very strong commercial loan growth. Average deposits were stable year-over-year and declined 2% from last quarter, in line with our expectations.

Moving to Slide 18. Wealth Management net income was $325 million, down from $384 million last year. Traditional Wealth net income was $264 million with underlying revenue growth of 3% excluding the impact of divestitures, reflecting higher net interest income, partially offset by weaker global markets. Insurance net income was $61 million compared with $79 million in the prior year. Expenses were down 6%, mainly due to the impact of divestitures, partially offset by investments in the business.

Turning to Slide 19. BMO Capital Markets net income was $266 million compared to $559 million in the prior year, reflecting the impact of continued weakness in the market environment. Revenues in Global Markets declined mostly reflecting lower trading revenue and the impact of a decline in new debt and equity issuances. Similarly, underwriting and advisory revenue in investment and corporate banking was lower due to slow issuance activity. We also had markdowns on loan commitments that were made earlier in the year, which were partially offset by higher corporate banking revenue. Expenses were relatively flat as lower performance-based compensation was offset by severance and business development expenses. The environment so far this quarter is more constructive, and we expect results to show signs of normalization as we approach the end of our fiscal year.

Turning now to Slide 20. Corporate Services net income was $7 million compared to a net loss of $35 million in the prior year.

To conclude, our overall results were strong, boosted by record year-to-date revenue growth in our P&C businesses. Recognizing the pause in revenue growth related to market-sensitive businesses, we continue to focus on managing our company dynamically to continue growing profitably. Our business and geographic diversification continues to be an advantage in maintaining strong performance levels.

And with that, I will turn it over to Pat.

Pat Cronin - *Bank of Montreal - CRO*

Thank you, Tayfun, and good morning, everyone. We were very pleased with our risk performance again this quarter and key portfolio metrics remain strong. This strong performance reflects the combination of disciplined risk origination from prior periods and strong risk management discipline through time.

Starting on Slide 22. The total provision for credit losses was $136 million or 10 basis points, up from $50 million or 4 basis points last quarter. Impaired provisions for the quarter were $104 million or 8 basis points, down from impaired provisions of $120 million or 10 basis points in Q2. Similar to last quarter, the strong impaired loan performance is due to very low formations and delinquency rates. We are pleased with these results but do expect impaired provisions to return to more normal levels over time.

Provision for credit losses on performing loans was $32 million this quarter, reflecting a deteriorating economic outlook relative to the prior quarter and strong portfolio growth. This was largely offset by positive credit migration again this quarter as well as a reduction in the judgment we have been applying specific to COVID-related uncertainty. Given the strong credit profile of our current portfolio and our forecast for impaired losses, we remain comfortable that our $2.3 billion of performing loan allowances provides adequate provisioning against loan losses in the coming year.

Turning to the impaired loan credit performance in the operating groups. Loss provisions remained low across all business segments again this quarter. In Canadian P&C, Personal and Business Banking impaired loan losses were $94 million, up from very low levels in Q2, but still well below pre-COVID levels. U.S. Personal and Business Banking had impaired loan losses of $1 million, flat relative to prior quarter. Consistent with prior quarters, the strong credit performance across our Personal and Business Banking businesses was driven by continued low delinquency rates.

Overall, we saw a little indication of consumer stress in Q3 from interest rate change or inflation. And our consumer segment credit quality remains very strong, with delinquency and insolvency rates still well below pre-COVID levels. With that said, for most RESL products, we do expect the recent interest rate changes to impact borrowers when they refinance or renew, which ultimately could lead to increased delinquency and PCL. We view that risk as modest for several reasons. First, 25% of our installment RESL book is insured; second, renewals are spread out over time and only 10% of our uninsured RESL installment products are up for renewal in the next 12 months, giving borrowers time to adjust. Finally, we have a high credit quality borrower base with an average credit bureau score of 793 and an average LTV of 48%. In fact, less than 2% of our Canadian RESL book is to borrowers with a combination of a credit bureau score less than 680 and an LTV greater than 70%. As you can see on Slide 32, the riskier segment renewing over the next 12 months is nominal, given our portfolio quality.

In our commercial and corporate businesses, we also saw very strong credit performance. In Canadian commercial, we reported impaired loan provisions of $10 million, slightly up from $7 million last quarter, but well below pre-COVID levels. In our U.S. Commercial business, we had impaired loan provisions of $21 million, down from $34 million last quarter. Our Capital Markets business had excellent impaired loan credit performance this quarter with a net recovery of $22 million, driven by 0 new formations this quarter and some modest recoveries.

Overall, we saw a little indication of commercial or corporate borrower stress in Q3, and our wholesale credit quality remains very strong with impairment rates at 15-year lows this quarter and PCL rates well below pre-COVID levels. We continue to benefit from very strong geographic and sector diversification as well as strong structural protections that have consistently driven peer-leading loss rates. We continue to see net positive risk rating migration in Q3, and the portfolio has now migrated to an average credit quality better than pre-pandemic. Our percentage of investment-grade rated borrowers now stands at 62%, more than 10 percentage points higher than what we saw in fiscal '17, highlighting that more recent origination has been of a higher average credit quality, notwithstanding our very good loan growth in both Canada and the U.S. over that time period.

On Slide 24, bank-wide impaired formations were low again this quarter at $341 million, leading to a gross impaired loan balance of $2 billion or 36 basis points. Both formations and gross impaired loan rates continue to be well below pre-COVID levels.

Despite market challenges and high levels of volatility, there was only one trading loss date this quarter as you can see on Slide 26.

The macroeconomic environment and geopolitical situation remain highly uncertain. Consequently, our performing allowances for the coming quarters will likely depend on how the economic outlook changes noting however, that we do still have some COVID-related overlays in our overall balance. We remain comfortable even in the current uncertain environment that our performing loan provision is adequate relative to our expectations for impaired loan losses in the coming year.

While we are pleased with our very low impaired losses this quarter, we do expect high inflation, rising interest rates and other headwinds to result in higher impaired PCL in the coming year. Impaired PCL rates are expected to slowly move up to a level more in line with our pre-pandemic experience, which was in the range of high teens to low 20s in terms of basis points. Despite these headwinds, we are well positioned to manage current or emerging risks given the quality of our portfolio, adequate allowance and strong risk management capabilities.

I will now turn the call back to the operator for the question-and-answer portion of the call.

QUESTIONS AND ANSWERS

John Aiken - *Barclays*

Dave, I wanted to discuss the U.S. deposits. Can you speak to what you saw in terms of customer behaviour in the quarter? And what this leads you to believe in terms of growth moving forward?

Dave Casper - *Bank of Montreal - CEO, BMO Harris Bank N.A. and Group Head, N.A. Commercial Banking*

John, I think actually both in Canada and the U.S., the deposit profile matches exactly the way we modeled the deposits in this rate environment. In the U.S., we have seen a small decline quarter-over-quarter. We are not quite as aggressive in terms of matching some of the competitors' rate offers. We have not moved, for example, our digital deposit offers to an active state yet. And therefore, the betas actually have been below where we have modeled them.

We do expect the betas to go up with each additional rate increase. And at one point, obviously, we will switch our digital offering on. But at this point, the slow outflow matches exactly the way we thought about how the deposits would behave. And the margin expansion that you have seen, the 21-basis point margin expansion in the U.S., reflects that fact.

Ebrahim Poonawala - *BofA Securities*

I guess I just wanted to follow up. I heard you loud and clear in terms of the outlook for positive operating leverage in 4Q. But when we look beyond, and we look at your year-to-date adjusted efficiency ratio of around 55.4%. Give us a sense of should we expect incrementally more improvement over the next year or two years in a backdrop that doesn't get materially better either for capital markets and just overall for the economy? And if so, what are the drivers that would lead that efficiency ratio from the 55.4% into the low 50s?

Darryl White - *Bank of Montreal - CEO*

Ebrahim, it's Darryl. Maybe I'll try to help you with that. Thanks for the question. So as I think about the future and how we travel on our PPPT performance and our operating leverage. Look, we'll fall short here of giving 2023 outlook, we do that at the end of the year, but I can give you some of the considerations as we look at our business planning. We think we've got a lot of good momentum in our businesses, both on the revenue and the cost side. You're right, we're at 55.4% year-to-date. That compares to a peer set that I think averages only 100 basis points lower than that.

So on the one hand -- I would say that number used to be several hundred basis points the gap -- and now it's pretty narrow, and at the same time, it's a little higher than the average. So I think we continue to have a little bit of opportunity there. And as we build our plan, as we go into '23, we continue to think about operating leverage, we do have levers that we can continue to push on. And we'll update you more on that as we get into the beginning of 2023.

Ebrahim Poonawala - *BofA Securities*

Got it. And if I can just quickly follow up in terms of Tayfun on your comments on the margin. I guess one near term, is it possible that we see a similar level of expansion through consolidated and in the segments in the fourth as we did in 3Q? And beyond that, as we think about the deposit pricing and some of the comments you made earlier. Give us a sense of does Bank of the West and when you look at their deposit betas, not very different from U.S. regional bank deposit betas last cycle, how does that inform your deposit strategy in the U.S. as you move towards deal close?

Tayfun Tuzun - *Bank of Montreal - CFO*

I think our NIM performance continues to be very strong. Now to be honest with you, it looks even better when you take into account how well we have protected the downside since the start of the COVID environment. We do expect margin expansion going into next year, as I said. I try not to give quarterly updates because it really depends on the frequency and the magnitude of the rate increases. But yes, we expect NIM expansion next quarter, and we expect NIM expansion into next year.

In terms of the contribution from Bank of the West, they clearly have a very good core deposit portfolio, and core deposit portfolios tend to actually be very beneficial in terms of maintaining margins depending upon what part of the rate cycle you're in. So once we actually absorb that balance sheet and start planning for the future, helped with our now national digital deposit gathering program, I do believe that we will have a better NIM profile even compared to the strong levels today post Bank of the West.

Doug Young - *Desjardins Securities*

Can you size out the book in which you took a mark, I guess, the leverage lending book where we took the mark this quarter? And maybe if you can provide any more details on sector-wise or any details on it? And just provide some colour as to or quantification as to why you feel comfortable with the marks. It sounds like you're feeling comfortable, and things are improving as you move through Q4. Just hoping to get a little more detail on that.

Pat Cronin - *Bank of Montreal - CRO*

Sure. Doug, it's Pat Cronin. Thanks for the question. Maybe I'll do 2 things. First, I'll separate out the loan book, which is quite a bit of a different thing altogether from where the underwriting markdowns came from. So the loan book, then the size of that is what we disclosed in the annual report. So you would have seen that number in last year's annual report, it is slightly over $20 billion under our definition. I want to be clear, our definition is sub-investment-grade loans to portfolio companies of financial sponsors. So that's what's under that definition. And you can apply wholesale loan growth rates that you've seen since that report was published and get a sense of what the current portfolio would look like.

Now of that total, we make a very clear distinction into two segments. The first is parts of that portfolio that are highly secured. So these would be ABL, RBL, real estate secured loans, there's some capital call loans in there. So we treat those quite differently. And in fact, the leverage lending limit that we apply to this business, we don't actually even include those into that limit because we view them as a very different risk profile, and that's supported by years of data around gross impaired loan rates and PCL experience.

So the real portion of the loan book that we limit with our internal limit is traditional cash flow deals to those financial sponsors that I just talked about. That is roughly about 55% of that total that I just talked about. And we're very comfortable with that whole book. The current condition is strong, notwithstanding what you might be reading about in the environment. Our gross impaired loan rates continue to come down. And in fact, we're about 100 basis points lower on the gross impaired loan rate than where we were a year ago. The PCL experience has been very low. I mean, we don't give out detail on the PCL for the segment, but if you look at our overall wholesale PCL this quarter, you can make a pretty good assumption that we saw almost no PCL from that segment this quarter.

And once you size it down to that number, you realize it's actually a relatively small part of the overall portfolio. It's, on any given quarter, just a little over 4% of our business and government loans. And that doesn't even include some portion of that portfolio that we actually risk transfer to third parties. It's really well diversified to your sector question, and it's also diversified by hold size. We, on average, have hold sizes in that business of less than $20 million. So we're actually quite comfortable with the book. We've seen very good performance from our sponsor clients, including during stress where they committed lots of additional capital to support those businesses. And as you know, they're sitting on a lot of dry powder right now. So we would expect, under stress that to be the same.

Now separate that completely from the underwriting book. So these are positions that we do not intend to hold. We are intending to distribute to investor clients. That's been a very good business for us over time. When I look at the fee revenue that we generate relative to the risk inherent in that business, as a risk professional, I think we're very well compensated for the risk that we take. We are going to find quarters like this where the market dislocation is profound and we're not going to be immune to it. But in terms of sizing, we typically don't give that, but as of the end of the quarter, that book would have been in Canadian dollar terms, just slightly north of $4 billion in terms of total underwritings.

But I would note for you, though, that the markdowns that we did take were primarily concentrated in deals that were originated prior to Russia's invasion of Ukraine. So it was quite concentrated. The markdowns that we took were quite consistent with broader base declines in the leverage lending market

Now if you look at the broader leverage lending indices, that's roughly about, on average, the markdowns that we took on those specific positions. Deals that we've originated since the invasion have largely been with better terms and pricing. And in fact, we see virtually none of those with valuation issues that would cause us concern.

Specific to your question about valuation, we subject all of those marks to regular review and then a rigorous and independent review of valuation by the second line at quarter end. And so I would say we're quite comfortable with the marks that we took for Q3. And I would note that about 90% of that markdown was unrealized. We have seen a little bit of modest improvement in that market in Q4. So I'm certainly not calling for a recovery, but at least we're heading in the right direction with a fair bit of unrealized. To the extent those market windows open up for distribution, we'll continue to whittle that book down. But at the same time, we're originating new deals, as I said, at better terms that we're quite comfortable with. Hopefully that answers your question.

Doug Young - *Desjardins Securities*

Very fulsome. I appreciate it. If I can sneak one more in just on corporate. It seems like you had positive earnings in corporate in the quarter. Correct me if I'm wrong, I think in the past, it was guided to $50 million to $75 million quarterly loss. But again, I could be wrong on that. Just wanted to unpack some of the drivers. Was there anything around fund transfer pricing or gains on interest rate hedging or anything unusual that came to corporate?

Tayfun Tuzun - *Bank of Montreal - CFO*

Yes. I think the corporate segment tends to move around a little bit. There were some good mark-to-market valuations in our CRA investments in the U.S. So that had a positive impact. And then compared to last quarter, we recorded the underwriting fees for our equity issuance in corporate. So those two items basically move to Q-over-Q numbers, but there's nothing that is unique this quarter that would impact the number.

Scott Chan - *Canaccord Genuity Corp.*

My question is for Deland on Wealth or Asset Management. You talked in the opening remarks adding 50 investment people on the equity and fixed income team. And just wondering kind of the strategy there because obviously it's a pretty big investment. Is there like internalized asset opportunities? Or is it mostly opportunities to gather assets over the medium term?

Deland Kamanga- *Bank of Montreal – Group Head, BMO Wealth Management*

Great question, Scott, and thank you. And you're actually right on both accounts. When we sold the EMEA business, that took away a lot of the expertise we had in managing a lot of international portfolios, growth portfolios. And so we took this opportunity to restack that. And it allows us to internalize a bunch of mandates that we have and then also expand the mandates to our distribution within our branches. So really, it's going to solve both issues for us.

Scott Chan - *Canaccord Genuity Corp.*

Is the focus on all segments, in particular, retail or institutional or both?

Deland Kamanga- *Bank of Montreal - Group Head, BMO Wealth Management*

Actually, so it's going to allow us to do both. So we have very good institutional capability with the EMEA team. And with that gone, that reduced the amount that we could do, especially with international portfolios, equity and fixed income. So it's going to solve both retail and institutional for us.

Gabriel Dechaine - *National Bank Financial*

A couple of questions here. One for Pat on the credit side. When I look at the migration and the performing portfolio, we saw Stage 2 classified loans going up 18%, about $7 billion worth of loans. There's a lot of moving pieces in the performing provision, but I see that increase in almost $36 million of performing to $22 million of performing PCL this quarter, but the number is small, maybe could have been higher than that?

And then on a margin-related question, and this is pertaining to the U.S. business specifically. Deposit margins are increasing, it's really driving the NIM expansion. I see deposits down 2% sequentially, flat year-over-year and was soft versus some of your peers. I'm wondering how the outlook for deposit growth looks and, if you're seeing any commercial clients taking money out and reinvesting or whatever? And how that could trend over the next few quarters if the deposit base shrinks, how much of the NIM outlook dampens?

Pat Cronin - *Bank of Montreal - CRO*

Gabe, it's Pat. I'll try and answer your first question. The audio quality was not great. But I think you were asking about the increase in Stage 2 balances quarter-over-quarter. And the answer there is quite simple. That's really almost entirely a function of the deterioration in the economic outlook that we use to calculate the provision.

So as you probably know, that affects staging. That really isn't migration in the traditional sense because you would have seen in in the regulatory capital supplement, that credit risk RWA actually went down this quarter, and we had positive risk rating migration in both consumer and wholesale. That's really just purely a function of that worsening economic outlook.

I think the second part of your question maybe was you didn't see that maybe show up in an increase in the provision, if that's the question?

Gabriel Dechaine - *National Bank Financial*

Yes.

Pat Cronin - *Bank of Montreal - CRO*

Okay. That's really a function of the fact that, that economic deterioration would have all else being equal, increased the size of the provision. But as I said in my prepared remarks, that was largely offset by a reduction in the overlays this quarter. As you can imagine, as we get farther out of COVID, some of those specific COVID-related uncertainty overlays are starting to come down. And that's why you didn't see the provision itself go up as much as you might have expected.

Tayfun Tuzun - *Bank of Montreal - CFO*

On the NIM question, Gabriel, if I heard your question correctly, in the U.S., as I said, deposit betas have been slower than we expected. And you did refer to the 2% decline, which again, we expected that type of decline. We continue to protect our turf. We're just not actively pricing up to attract deposit growth because we still have excess deposits in the U.S.

The 20-basis point margin expansion was very strong this quarter. We shouldn't expect 20 basis points every quarter for the next 3, 4 quarters, that's not going to happen. But nevertheless, we still expect expansion going forward, especially in our Personal and Business Banking business. We are benefiting from this more so than in Commercial. In terms of, I think you were asking about client behaviour on deposits. Dave, would you want to comment on what you see from the client side?

Dave Casper - *Bank of Montreal - CEO, BMO Harris Bank N.A. and Group Head, N.A. Commercial Banking*

Sure. So on the commercial side, we've had very modest decline, but very consistent with our peers on the Commercial side. We had surge deposits. We maintain a large portion of those surge deposits larger than actually we thought, but our core deposits, which is really our bread and butter, where our clients are using us for their operating business continues to grow, and we feel really good about that. So the LDRs really are still stronger today than they were pre-pandemic. So we feel very good and expect to be able to manage this quite well. I hope that helps.

Paul Holden - *CIBC Capital Markets*

A real quick one to start. Just to clarify, the loan markdowns. Was that purely mark-to-market or did it include some realized losses as well?

Pat Cronin - *Bank of Montreal - CRO*

About 90% is unrealized. These are rough numbers. Then about 10% realized.

Paul Holden - *CIBC Capital Markets*

Perfect. And then I want to ask you a question on competitive dynamics in the commercial loan segment, both U.S. and Canada. We've heard some comments from Canadian competitors that the market is awfully competitive right now and risk-adjusted margins are not particularly attractive in certain pockets. And then some data points in the U.S. almost point to the opposite sort of conclusion that the banks are tightening up underwriting criteria in commercial loans. So just wondering what your perspective is on both of those markets.

Dave Casper - *Bank of Montreal - CEO, BMO Harris Bank N.A. and Group Head, N.A. Commercial Banking*

I would say, for our business, both in Canada and the U.S., we see actually similar dynamics. Most of our clients, particularly the larger clients do business on sides of the border, compete in similar industries. It is more competitive. And yet if you go back over time, that's almost always said. And from my perspective, and I go back a long way in time, I actually don't think it's much more competitive for us.

You'll always hear this too, we never compete on price. You hear that all the time. The reality is, in our business, price is an important part, but the clients that we're actually attracting and maintaining are looking at who can do the best job for them, helping them grow over the long term. So yes, price is important. But having a long-term perspective and being in the business as long as we have is actually more important. So is it competitive? Yes. Is it more competitive in the U.S. or Canada? I actually don't think it is. And I think we just particularly, I can't really talk about other banks, but for BMO, I actually see really strong continued momentum on new client acquisition for clients that are really looking for long-term supporters.

So I wouldn't get overly exercised over what's happening today. And I actually think our bank will do very well through the cycle and not substantially, certainly not change our risk appetite, but not change our risk reward to any extent as well. Hopefully, that helps. Might not be what you wanted to hear, but that's what's going on.

Meny Grauman - *Scotiabank Global Banking and Markets*

Just two questions on the U.S. P&C business. Two aspects of the results that I was hoping to get a little bit more colour on. One is the sequential decline in non-interest revenue. And the other one, if I look at expenses in U.S. dollars, up I think about 6% quarter-over-quarter. So wondering if you could provide more detail on that expense jump. Is there anything unusual going on in the quarter in the U.S. P&C business from an expense point of view?

Dave Casper - *Bank of Montreal - CEO, BMO Harris Bank N.A. and Group Head, N.A. Commercial Banking*

Let me take the expense question first. We had a little bit higher expense this quarter, but nothing unusual. And if you look at it over the year, we continue to have positive operating leverage. And I'm really quite proud of the fact that our efficiency ratio is now well below 50 for the last several quarters, and I think that's very strong. And I would expect it will continue, to remain positive operating leverage in the U.S. going forward.

The NIR question, there's a couple of things there. It's not overly complicated, but there's one aspect. I think we went down about $14 million in NIR quarter-over-quarter. And there was a $14 million decline in what we call our lease revenue. So let me just explain that very quickly. When clients buy equipment, they have a choice, they can either buy equipment directly and we make a loan. And if we do that, that's all interest. If they decide to lease it, we get that revenue as NIR because they're going to actually take the risk at the end on the residual. So the difference is, over time, more of our clients have actually decided to buy the equipment as opposed to lease it. And so we move it from NIR - income goes from NIR to NII. So that's the substantial portion of the decline.

But there are some other things, we had a record first quarter in terms of some syndication fees, M&A fees, those have declined a little bit in the market as we'd expect. And lastly, while it's not a big deal, it does have some impact in earnings business. We have gotten rid of [much] of our overdraft fees. And so that has a decline as well. And I think that's the right thing to do for our business. And that should explain most of it. Does that help?

Meny Grauman - *Scotiabank Global Banking and Markets*

Yes. That's good detail. Just on the overdraft, would you be able to size that in terms of the impact?

Dave Casper - *Bank of Montreal - CEO, BMO Harris Bank N.A. and Group Head, N.A. Commercial Banking*

This quarter, I think it's relatively modest. I couldn't give you the exact number, but we can get back to you with some further detail. But it's a portion of the of the NIR decline.

Mario Mendonca - *TD Securities*

Tayfun, your comments about BMO being able to protect the margin on the way down but still benefiting on the way up. That's an important one. Could you help me understand, breaking out the NIM, help me understand what's happening with asset yields over the last couple of quarters relative to the positive cost and funding cost generally? Is there a way to break that out? Or do you provide that in your report to shareholders somewhere that I just haven't seen yet?

Tayfun Tuzun - *Bank of Montreal - CFO*

Yes. We can provide you with more details on that, Mario. In general, I think, there are 2 factors that typically are important to note. One is the mix change as we look into our loan portfolio. That helps, as well as spread changes. But I'm happy to sort of follow that up with a more detailed discussion around both the commercial business as well as the retail business and give you directional comments on that.

Mario Mendonca - *TD Securities*

Okay. Sort of a follow-up to there. I like to look at the margins in various parts like your domestic retail, U.S. retail and then everything else, which I'll just call non-retail. And that non-retail margin, which, of course, incorporates wealth, capital markets, that sort of thing, but not the trading. The margin there has been really strong. Can you talk a little bit about what's happening to the bank in the, say, the treasury function or just everything non-retail that's supporting the net interest income?

Tayfun Tuzun - *Bank of Montreal - CFO*

Yes. Look, I mean on the treasury side, as we shared with all of you in the past, our focus has been to manage our NIM to a stable direction. And we have done an excellent job in protecting the NIM. And that clearly has helped us to maintain support as rates have moved up. But at the same time, we also left room for more asset sensitivity.

I think the strength of the deposit franchise, you mentioned the loan side and the asset side, has helped us tremendously in that sense. And that comes true very much so in the U.S., Canada has been more stable. And also, in general, when I look at the composition of our loan portfolios in our P&C businesses, I believe that to a certain extent, our smaller mortgage portfolio is helping us to also have a bit of an outperformance and the way the margin is behaving as well.

Mario Mendonca - *TD Securities*

If I could just quickly follow up, then. BMO is the only bank where the all-bank margin today is above where it was in Q1'20. Every other bank would be slightly below to meaningfully below where it was in Q1'20. Would I be correct in suggesting that, that is very much explained by the different loan composition, BMO's heavier commercial exposure? Is that the sort of structural advantages that you referred to, or one of the advantages you referred to, when you opened up these comments about BMO's business mix? Is that part of the story?

Tayfun Tuzun - *Bank of Montreal - CFO*

I actually think that period-to-period, our hedging strategy and our very close focus in maintaining stability in our NIM is a big factor in that. But in addition to that, I think in general, our more commercial heavy exposure in our loan portfolio would also provide some help.

Darryl White - *Bank of Montreal - CEO*

Mario, I'm going to add to that. We talk about this a lot around here in terms of being margin managers as a core competency. The mix does matter. You're onto an important point. And whether it's in the wealth business, the capital markets business, the commercial business, when you think about them as high-touch relationship businesses, I mean we've been fond of reminding most of you that, for example, in our commercial business, 90% of our relationships are sole or lead relationships. And Dave talked about how we manage those relationships over time. And you heard earlier how we talk about managing deposits. I think the way we approach the relationship manager is a significant input to the question that you're asking. We think it's an advantage.

Lemar Persaud - *Cormark Securities*

I appreciate the update on the status of the Bank of the West acquisition. And I noticed you guys still think it's going to close by the end of the year. What are the greatest risks to that getting pushed out? And then given the big move in interest rates from when the deal was announced today, how should we think about the impact on the accretion estimates?

Darryl White - *Bank of Montreal - CEO*

Yes. Maybe I'll take the first part and I'm going to ask Tayfun if he wants to chime in on the second. I'm going to bore you a little bit with the answer. We don't have much more to say in terms of timing. Our best estimate at the time that we announced the acquisition back on the 20th of December was that it would take approximately a year. And based on what we see and based on what we are involved in today, we stand by that prediction. And we'll update you as and if that changes. But as of now, that's our current view.

Tayfun Tuzun - *Bank of Montreal - CFO*

And in terms of the impact of the rates on accretion, I just want to remind you that the way we've hedged the exposure to higher rate mark and higher goodwill, basically, neutralized the impact from the moment we closed the transaction. So I would say the accretion estimates with respect to rates is the same as we have assumed.

Now going forward, depending upon the rate environment once we close the transaction, we may get more strength if interest rates continue to go up and they bring asset sensitivity to us. But at this point, our accretion estimates stay the same as we announced.

Lemar Persaud - *Cormark Securities*

Okay thanks for that. And then for Pat, I think you mentioned you saw some of those COVID-related overlays in PCL. Can you put some numbers around that? And can you help us think about what the performing PCL would have been if you didn't release some of those COVID overlays?

Pat Cronin - *Bank of Montreal – CRO*

Sure. The two factors that would have otherwise contributed to a build, as I mentioned, were a deterioration in the macroeconomic variables and loan growth. Those two things together would have been roughly about $185 million. And so that was offset by positive credit migration and the reduction in the overlays.

I probably don't want to get into the size of the overlay. I would tell you, going into COVID, we were pretty close to zero on that, plus or minus 5% of our total provision made up of judgment. That would have hit a high back in Q4 of 2021 as we came out of COVID, and it's been reducing for 3 quarters in a row now. We are heading into an environment, while it's uncertain, we expect that our loss estimation models can understand the typical recession. So all I can tell you is I would expect it to continue to come down, all else being equal, but I think I'm going to stop short of giving out specific numbers.

Darko Mihelic - *RBC Capital Markets*

My main questions have been asked and answered, so I'm going to be very quick especially in the interest of time. Just wanted to pin down on a couple of things, though, that I heard this morning. First, Tayfun, in your answer to the question regarding corporate, one thing you left out was the expected earnings per quarter, if you can just give us a hand with that? And then on the question with respect to the marks that were taken in Capital Markets. If I heard correctly, it sounds like the levered lending loan book was around $4 billion. Can you just confirm, when I look at those marks versus those indices that are out there, do your marks include fees accrued or not?

Pat Cronin - *Bank of Montreal – CRO*

Darko, it's Pat. First, on the leverage lending loan book, the sizing that I gave is for the loan book in particular. And on that loan book, we only take provision for credit losses. Now the markdowns that you're talking about, the $88 million apply to the underwriting book. So that's a very separate book, and that is where I sized that at just over $4 billion. So think of those as 2 very separate things. One takes PCL and the other one takes mark-to-market losses that flow through Dan's business. And I think that was your question or no. Did I answer it?

Darko Mihelic - *RBC Capital Markets*

Are there fees accrued in that mark or no?

Pat Cronin - *Bank of Montreal – CRO*

The answer to that is yes. That's inclusive of fees.

Darko Mihelic - *RBC Capital Markets*

Okay. And then just over to Tayfun on the corporate.

Tayfun Tuzun - *Bank of Montreal - CFO*

Yes. On the corporate side, Darko, this quarter clearly was a little bit of an aberration. So we probably will go back to the average of the prior two quarters in the near term, and then we'll give you guidance for '23 when we get to year-end.

Darryl White - *Bank of Montreal - CEO*

Thank you, operator, and I want to thank all of you for your questions. I hope you're not running off the call because before we close, I do want to take a moment to recognize Pat Cronin, who recently announced his intention to retire after nearly 30 years with BMO. Throughout his career, Pat has made, as I think you all know, a significant impact across our bank, including having expertly steered our COVID-19 response and our risk function through the complex credit and market environment and all of these calls that have defined the last few years. He's a trusted adviser, and he's one of the strongest bankers I have ever worked with. I look forward to introducing Piyush Agrawal, our incoming CRO, to you next quarter.

And I'm going to conclude with the key themes, as I always do, credit performance remains strong. We have significant allowance coverage that enables us to protect and grow the bank. Number two, overall results were fundamentally strong with year-to-date PPPT growth of 14% in our P&C businesses taken as a whole. Expenses remain really well managed, particularly given the inflationary pressures, and we're committed to delivering positive operating leverage for the year. And lastly, we're going forward from a position of strength with our advantaged mix, and we believe it's set to perform in any environment and deliver consistent financial performance.

So thank you all for participating in the call, and we look forward to speaking to you again in December.