BMO Financial Group

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Assumptions about the performance of the Canadian and U.S. economies, as well as overall market conditions and their combined effect on our business, are material factors we consider when determining our strategic priorities, objectives and expectations for our business. In determining our expectations for economic growth, both broadly and in the financial services sector, we primarily consider historical economic data provided by the Canadian and U.S. governments and their agencies. See the Economic Review and Outlook section of our Third Quarter 2015 Report to Shareholders..

Non-GAAP Measures

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Examples of non-GAAP amounts or measures include: efficiency and leverage ratios; revenue and other measures presented on a taxable equivalent basis (teb); amounts presented net of applicable taxes; adjusted net income, revenues, non-interest expenses, earnings per share, effective tax rate, ROE, efficiency ratio and other adjusted measures which exclude the impact of certain items such as, acquisition integration costs, amortization of acquisition-related intangible assets, decrease (increase) in collective allowance for credit losses and restructuring costs.

Bank of Montreal provides supplemental information on combined business segments to facilitate comparisons to peers.

PRESENTATION

Robert Sedran - CIBC - Analyst

Good morning everyone. Welcome to Day 2 of our Eastern Institutional Investor Conference. We begin Day 2 with Tom Flynn, the Chief Financial Officer of the Bank of Montreal. Tom has been CFO since March 2011, a role he received as a reward for being the Chief Risk Officer through the liquidity crisis. He has been with BMO since 1992, holding a number of different roles since that time.

Before we begin I have been asked to tell you that Tom's comments today may include forward-looking statements. Actual results could differ materially from forecasts, projections or conclusions in these statements. Listeners can find additional details in the public filings of BMO Financial Group.

So, with that, welcome to Montreal.

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

Good to be here. Thank you. Particularly good to be here, fire side.

Robert Sedran - CIBC - Analyst

Yes, it's beautiful.

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

It is very nice.

Robert Sedran - CIBC - Analyst

You're making people that are on the lines jealous that they don't get to see this beautiful scene in person.

I want to start with a bit of a general question. It has the feel and everyone's talking about a bit of an uneven, let's call it, operating environment. I'm curious to know how BMO is thinking about the planning scenario. Are we charging forward to get growth? Are we cautious to protect the downside, something in between and I'd be particularly curious to hear that view on each side of the border.

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

Sure. Happy to take that question and I'd say the answer is a bit of both in that the number one thing that we look to do with our business is to grow. As we look at the North American economy, we think the economy is growing. We're expecting nominal growth next year of 4.5% to 5%. Canada a little lower than the U.S., but better than we think some believe it will be off the back of the stimulus from lower oil outside of the producing regions, and the benefits of a lower currency and better growth in the U.S. So we start with nominal growth around the kind of zone, 4.5% to 5%.

When you look at our business, we do have a diversified business and we think that's a virtuous thing because it makes us more robust through time. And so, building off that nominal rate of growth, which we would like to achieve, we have a Wealth business that represents about 20% of our income, a higher percent of our revenue and that business has been and we think will continue to grow at a solidly double-digit growth rate. That moves us up and we have a lot of confidence in that and a good business there that's well managed.

In our U.S. banking business, as you know, we've had very good growth, in particular the commercial part of the business, solidly double-digit loan growth in that business. We do expect that to continue and new for next year, we're expecting our personal business to begin to grow. Consumer lending in the U.S. has been tough as a result of deleveraging and a weak recovery. We've run off parts of the higher risk M&I portfolio that we bought a few years ago. Those two things we think are beginning to fade and with that, we think our loan balances in the personal part of our U.S. Personal and

Commercial business will start to trend positive after a slight decline for the last few years. In the middle of next year, it could be Q2, it could be Q3, but we think that will flip and that will be a positive for us.

In the Capital Market business, we have a big and strong business in Canada, but we also have a meaningful business in the U.S., which not all of the Canadian banks have. It's about 30%, 35% of our total Capital Market business. We've invested in that business through time and we think that the platform that we've built can support significantly higher revenues. And with reasonable economic growth in the U.S., and we hope and expect reasonable capital markets, we're expecting significantly higher than nominal GDP growth from that part of our business.

Robert Sedran - CIBC - Analyst

That's topline?

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

That's topline, but it's topline with good operating leverage in effect because the expense base is in place. And so, we'd expect very good operating leverage from that business because we've invested in it and we think it can drive more revenue. So when you roll all of that up and you think about the Canadian business, for us in Canada, having strength in commercial where growth has been stronger than personal, and we do think personal lending volumes will be in the zone of nominal GDP, not higher given consumer leverage, we think that's the better thing for long-term stability. We hope that's the case, but we'll benefit from a stronger commercial mix.

We'd expect with all of the above, revenue growth that's north of nominal GDP growth, operating leverage in the business, which we're working hard to achieve, and with that, we'll be working to generate income growth that's in the zone of our mid-term target, which is EPS growth of 7% to 10%.

Robert Sedran - CIBC - Analyst

That's an aggressive assumption. Well, I shouldn’t say assumption. When you think about where expectations sit, that's well north of where expectations are. So maybe I wasn't going to go over here yet, but let's go to loan losses, because that's the one thing you didn't talk about and has the potential, to at least in the market size these days, slide that number much lower than 7% to 10% earnings growth.

Can you talk, I'm tired of the oil conversation already, but we're going to go there anyway. Can you talk about the issues around oil and I'd be really curious to hear your opinion again on both sides of the border in terms of your exposures and how they might be different between Canada and United States?

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

So I'll start with the exposure, which is not outsized as you know, our portfolio is a little over $6 billion for the direct energy exposure. That's about 2% of our loan portfolio – so not outsized. In the producing regions of the country, our exposures are roughly in line with what you would expect given the size of the economy and the population. We're little underweight, but not meaningfully.

We're trying to say two things as it relates to the impact from lower oil, two or three things, but really two on the credit side. The first is, we think a statement of the obvious and not a matter of great concern, but just a reality of life, is that when the commodity corrects by the amount that it has corrected by, companies reduce capital expenditures, they reduce employment levels and loan losses will trend up to a degree. That's a business cycle. This is a business cycle in a localized area.

We're expecting some increase in losses as a result, but the second point is that in the context of the overall business, we don't think the losses are problematic, they're very manageable. We've given our stress test numbers as the other banks have, and we're very comfortable with the exposure. We've gone through many, many cycles through time. We do think it's important to keep what's happening in the energy business in context. That means that this is a localized issue. It's a significant issue in the producing regions for the individuals that are going through a change. But the producing regions are a minority of the Canadian economy and so that's our friend as it relates to thinking about the level of PCL that we'll have and the level of growth that we expect to be able to generate.

And then more broadly, low oil is stimulative. There's a debate going on related to the extent to which consumers will spend versus save the benefit, but there is a benefit and either thing is positive. We are in the savings business. We're in the loan business. We have the potential to benefit on both sides, and we do think that the North American economy through time in Canada, although there is a negative adjustment period related to the reduction in CapEx, but through time will benefit from the impact of lower oil and that will be true globally as well.

Robert Sedran - CIBC - Analyst

And are you seeing that in your footprint today even if it's just the early signs of it in Canada? Are you seeing that benefit starting to show through?

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

I would say anecdotally in early citing ways, yes, but it's early, and so do we give confidence to the statement, no because it's early. And then equally, we haven't actually seen credit start to turn in a discernible way, was the phrase that Surjit Rajpal, our Chief Risk Officer put it on our conference call. So it takes time for these things to work through and I think it's relatively early days on both sides.

Robert Sedran - CIBC - Analyst

Okay, as always, if anyone has a question, I'm happy to stop, I've got a microphone here that I'll wander over with. I haven’t had anybody take me up on the offer right away before.

Unidentified Audience Member

I just want to quiz you a little bit. So management is targeting 7% to 10% earnings per share long-term growth. How is it expressed in your KPIs, key performance indicators for your compensation?

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

So the 7% to 10%, as you said, is a mid-term target. That's a phrase that we use. It's a mid-term target. And we have a number of other metrics that we look at as well. For compensation purposes, we have a set of metrics that we look at and they include earnings growth, revenues, revenue growth, productivity, performance and there's a measure of customer loyalty. And those are the main sort of financial metrics that we look at.

In addition, we look at relative total shareholder return, so those are the main metrics that we look at. When we benchmark our financial performance, it's relative to plan. That's the principal lens we assess performance on, for purposes of comp with a judgmental overlay related to relative performance. We consider the relative performance as well, but the main benchmark is off of our plan and the plan in any given year doesn't necessarily reconcile to our mid-term targets. They are explicitly mid-term targets, so there can be a variance either way, lower or higher in any particular year.

Robert Sedran - CIBC - Analyst

So you made an acquisition last week, you announced an acquisition last week. I want to talk a little bit about GE. I know there's only so much you can say until you actually own the assets, but what is it about that portfolio, aside from it being commercial in the United States, what is it about that portfolio that fits in and made it a target for Bank of Montreal? And I'd also like you to touch on the price you paid for it and the accretion because we don't often see accretive deals in banking, so even with using cash. So I'm curious to hear how you managed to get the deal done.

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

Okay. So a few things. We're happy with the transaction. We think it's a good transaction for the Bank. We've said that it will increase our net income by about 3% and the impact to EPS varies depending on the amount of share buyback activity people baked into their forecast. So it's on average a little bit lower, not at all significantly but a touch lower. It fits for us because we have through time looked to grow our U.S. business.

And in our U.S. business like our Canadian business, we have a strength in commercial lending. You kind of dismissed that up front but it’s very important to us but we think it's important to grow off of businesses that you know and you're good at. This is a business that we view as fundamentally being a commercial one. That's our strongest suit in the banking world and so we're happy to extend it with this portfolio.

As we looked at the particular asset within that sort of commercial sphere, one of the things we really like about it is it's a leading business and they are one of the top, if not the top lenders to the transportation segment in the U.S. The market share numbers are kind of noisy, they're hard to get, but it's in the zone of 20%. Leading businesses are more resilient through time. This company has a very good management team and we're looking forward to working with them as they join our company and we've got a lot of confidence in them.

The portfolio is highly diversified. If you look at it, it's concentrated in the sense that, it's one vertical, which is transportation, but it's diversified in the sense that it services basically industrial America. The underlying users of the equipment are very representative of the broader economy and with that you've got a lot of diversification from an industry perspective and diversification from a geographic perspective and so we took comfort from that.

Lastly, we don't think that transportation is going to go out of business. We think there is good core resiliency to the underlying demand for the product that will allow this portfolio to grow through time.

Robert Sedran - CIBC - Analyst

Is this a kind of grow-in-line-with-the-market type business given that its already got a large market share or do you think there is opportunity? And I'd be curious, part of the question is, since GE put everything on the block, how has it been performing? Has it been growing? Has been kind of going sideways?

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

I'll deal with that first. It's been growing and it's been growing sort of in line with to a little ahead of what they've been doing over the last year or two. So no negative impact from the business that we could see related to the fact that it's being sold and that goes back to the management team that's highly motivated, and in part, was looking to set themselves up for the future and the best way to do that is by delivering good performance, which is what they've been doing.

From a longer-term growth perspective, we think that the business will grow pretty much in line with the rest of our business. It is a mature industry and their share is relatively high. So it's hard to see a growth rate that's significantly above what we'd expect for the overall business. But we do think it will be a good solid contributor.

One of the other appeals of the business to us is that it's a higher returning asset than we have on average in our U.S. business. We'd like to get the return on equity and the return on assets up in the U.S. business, and this will help us do that. One of the ways that we're funding the transaction and repositioning the balance sheet in the U.S. is by reducing an indirect auto portfolio that we have, which is basically auto purchase lending. So if you buy a car from a dealer, we'll finance that purchase. And that's a very competitive business. Spreads are low and so we're going to reduce that portfolio through time, just by having fewer originations concentrating more in our footprint. And that reduction, together with the good deals from the portfolio we're acquiring, we'll help with their overall ROA and ROE for the U.S. business.

Robert Sedran - CIBC - Analyst

So you plan to stay in that indirect auto business, just you're going to refocus on the footprint?

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

That's correct. We'll stay in the business. We think it's a valuable part of our business in footprint, but not as attractive as a business to deploy capital and liquidity outside of it.

Robert Sedran - CIBC - Analyst

Since we’re talking U.S., let’s stick with the U.S., it's Fed day today. How important is the decision this afternoon?

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

Well, I think the direction the Fed takes over the next year is very important and one meeting isn't a life or death event. The markets have been jittery in part because of the uncertainty related to the Fed. So, I have to say I'm sympathetic with the view that it would be good to have greater clarity from them just so that we can reduce the source of uncertainty one way or the other. We'll see what we get.

Personally, for what it's worth, I'm surprised at the probability that the market has baked in for a cut. I think the odds myself are higher than I'm seeing just because from a policy perspective, with rates as low as they are, and the fiscal situation the way it is, there's not that much policy flexibility to respond to another downturn, and with unemployment in the U.S. below 5%, it would feel better to me to have rates higher and more flexibility should we need to lower rates at some point in the future.

So, we're hopeful that rates start to trend up. We do think rates will trend up based on the underlying economic trends in the U.S. and we hope that we'll get a relatively clear message from the Fed related to how that will play out. In our business, just to give you a sense of the revenue sensitivity, the numbers we've provided is that a 100 basis point parallel shift up in the curve, so short and long, is worth in the zone of $250 million of revenue and around $150 million of that is in the U.S. and around $100 million of that is off the short-end. So, we have an attractive sensitivity to rates. From a P&L perspective, we're hopeful that the rates go up. From a fundamental view, we do think the time has come for them to raise.

Robert Sedran - CIBC - Analyst

Would it be at least directionally consistent to divide that by four to get the 25 basis point? What I'm trying to get at is that does this 25 basis points matter to the outlook for 2016 in terms of net income?

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

In a full sense, not a whole lot. 25 basis points is not a huge amount. If the long-end it doesn't shift up in the numbers I just used in the U.S. The $25 million is a little bit of help for the margin in the U.S. business, but it's not a huge change. I think the bigger picture is what does the rate environment look like over the next year or two, and so I would expect over that period that we're talking about, we're talking about more than just a 25 bp move and that does start to become significant.

Rates are huge sensitivity for banks and we've ridden rates down, as a bank and as an industry, it has taken a lot of revenue out of the business. Our margins have contracted and profitability has remained reasonably robust in the face of that. We're hopeful that over the next few years, that trend will reverse and there will be a benefit. We're not counting on it, in the sense that we're actively managing the business away from that potential benefit to drive our business forward, but there is a significant sensitivity.

Robert Sedran - CIBC - Analyst

You talked a little bit about the U.S. loan growth and personal coming back, watching the U.S. banks, not just BMO or even TD, but watching the U.S. banks generally, has been a bit of a frustrating exercise and that the earnings never seem to grow. When we see this kind of loan growth, at what point can we match this sort of topline expectation or this sort of loan growth expectation with an earnings expectation?

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

Well, so, a couple points. In our U.S. banking business, year-to-date our net income is up about 10%, a little over 10%, and in the last quarter, we were up about 15%. That income is coming from revenues that are fairly stable, to your point; good expense management with expenses that have been pretty stable as well and a better credit picture. All in, again, year-to-date in U.S. dollars, income is up a little over 10%.

Looking out to next year, our expectation is that we'll have better revenue growth and that revenue growth will come, partly from continued good growth on the commercial side of the business where over the last two years, we've averaged 15% or 15% plus commercial loan growth on a year-over-year basis. Going forward, we expect that growth number to come down, because the denominator is bigger.

We're expecting more like 10% in growth rate terms, but still good growth in dollar terms off the bigger base, positive growth on the personal side beginning midyear and a more stable margin situation. With that, we would hope to have revenue growth more in the 4% to 5% kind of a zone in our U.S. banking business.

In that number, we have a little assumed a pickup from higher rates, but it's coming as well from the basic operating business. On the expense side, we continue to actively manage the expenses. I think U.S. banks generally have done a pretty good job on expenses and the revenue growth hasn't been strong. Expense growth has been fairly muted, as well. In our U.S. business, we're focused on managing our channel strategy, increasing sales force productivity through active management, introducing some new products, improving our mortgage processes to make them more automated and more efficient. We think those things will help the business as well.

Robert Sedran - CIBC - Analyst

That kind of growth rate I guess is roughly what we used to assume from the Canadian business as well. Are we entering a period in which the Canadian and the U.S. businesses are going to start to diverge a little bit in terms of their growth rate? From a medium term perspective, how would you think of the Canadian business versus the U.S. business in terms of growth rates in the P&C banking side?

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

So, I'll break it down into two parts, because I think that the trend could vary through time. In the near term, so next year, year and a bit, we'd expect revenue growth that was pretty similar; different drivers, but fairly similar revenue growth. Canada on the personal side is growing at sort of nominal GDP, maybe loan growth goes a snick below, but the commercial side is better as you know. In the last quarter our commercial loan growth was 7%. We expect continued growth in that zone roughly, so upper single digits.

When you put those two things together with an expectation that margins will be fairly stable, and that we'll be driving some operating leverage, we think we'll have performance in Canada from a revenue perspective that's in the mid-single digits as well, like the U.S. The Canadian business does have the advantage of coming off, as we speak, a higher run rate growth level than the U.S., which has been dealing with the issues that we talked about earlier.

We expect the U.S. to sort of move up to the Canadian level. Beyond that initial phase of a year, year and a bit, I think it will depend on what happens with rates. There is the big sensitivity like we talked about and then how the economies perform. We do think for us, our U.S. business will be a relative source of upside off of the revenue growth that we've seen over the last few years.

Robert Sedran - CIBC - Analyst

So let's talk a little bit about the Canadian business because it had a better quarter in Q3 posting some improving trends in Q3. It's fair to say it's been a disappointing year-to-date, bit of a rough start to the year. Maybe you won't say it, let me say it.

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

I wasn't going to bite at that.

Robert Sedran - CIBC - Analyst

Right, okay, fair enough. What has been a slower growth and you put up, but you'll at least allow that.

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

Yes, for sure.

Robert Sedran - CIBC - Analyst

So what has been behind that and why is it turning?

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

Okay. So the way we've described, is we've said the first half of the year wasn't going to reflect the potential of the business and the second half would be better. We used that kind of language at our Q1 earnings release, acknowledging in essence the point that you just made. And the story is a bit of a two-parter. On the expense and operating leverage side, we set our business plan about a year ago from where we are today, and that plan was predicated on better growth than the Canadian economy had and with that assumption, we had higher expense growth.

And so in the first couple quarters of the year, we had high expense growth relative to our revenue growth and we've been working to reduce that rate of expense growth. You saw that the third quarter had better operating leverage than the first or the second quarter, and we expect that trend to continue. So we're doing a better job on expenses and really in the first couple of quarters had a bit of a squeeze given that we assumed growth would be better than it ended up being. And with that, that we would have the revenue cover for the higher expenses.

On the revenue line, our revenue growth has been lower than we would like in the business. A couple of reasons for that. One is that about a year to a year and a half ago, we reduced growth in a part of our auto lending portfolio and specifically the sort of longer amortization part of the portfolio. And with that, our growth in that portfolio has actually been negative year-over-year in some of the quarters and it's about a $10 billion portfolio.

Our view was that we weren't being paid for the risk. The business wasn't necessarily, in an absolute sense, a bad business, but we didn't like the risk return on it. So, we dialed back our growth and banks do that from time-to-time. They make capital allocation decisions, and we thought that it was a right thing to do even though it came at the expense of a bit of revenue growth over the last year. We'll move through the adjustment from that as we go forward, because we'll have a lower base in that part of the portfolio.

Our card revenue has been below the market level. We have been focused for the last six months, on revitalizing the growth rate in that part of the business. We have some new product offers coming in, in particular in the premium part of the market. We have new management in that part of the business and they've got some new ideas that they are bringing to the picture. So, we expect better performance there. That is the highest margin product. We think that will help with revenue growth overall.

The last point would be, we've been through the year installing a new system in our commercial lending business. We expect the system to generate nice improvements and efficiency when fully implemented because it will automate more of our processes and leave our coverage people, our relationship people, with more time to cover clients and to generate revenue. But as we've worked through the implementation of that system, it's taken more time for our client people to adapt to the new system than we had expected.

With that, we still had 7% revenue growth in the commercial business this quarter, and it was similar the quarter before. So the growth is reasonable, but we think there's upside there once we're through this conversion, which is a big conversion, we're putting in place a new system for the administration of commercial loans. It's a big system.

Those things together with all of the normal things that you do in the business, we think will contribute to an uptick in the revenue growth and we've got a positive trend on the expense side. Together, we think with that we'll have the better second half than the first half, which we've talked about, and performance in '16 is a little better than in '15.

Robert Sedran - CIBC - Analyst

Okay. We've got a couple of minutes left. You touched on expenses; that's been a recurring theme. I've been a skeptic on the expense front, because it feels like there's a whole lot of stuff you have to spend on in addition to finding some savings in the core business. Are expenses a lever, or are we just trying to find savings to be able to spend on new technology and new branches and all the rest?

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

So I think as we look at driving operating leverage and income growth, expenses are a lever. At our bank, we're trying to balance investing in things that we need to invest to move the business forward, and that would include technology on a variety of fronts and process improvements, with containing expense growth elsewhere. That has been a big focus for us. You saw our operating leverage improve in the third quarter; it was about 1.5%, reported and over 2% if you adjust for the currency. So we had a pretty good operating leverage quarter in the third quarter and the best of the year.

And in our organization, the expense focus has multiple facets. We do have an organized program around this. The first is just to contain expense growth in non-client areas. As a general matter, the budgets that people have for expense growth are modest and with that we're driving the organization to create efficiencies in the business. In addition, we're doing a lot of work around technology and channels as you know again and looking to move more activity out of the branches, which are a relatively high cost way to transact, to do more online and mobile, which is very low cost and also customer friendly.

We're automating core processes to make them more efficient. We're looking to lever, and this is partly cost, partly revenue, data and analytics. And so, as part of what we're doing on the technology side in addition to creating apps that people like to use, we have been working hard to reengineer our core technology architecture in a way that will allow us through time to change it in a more nimble way.

We're basically taking a system that had a lot of points of connection, kind of like a spaghetti diagram, not quite, but that kind of a direction, and making it into a system that's more aggregated, has data that's to a greater degree, far greater degree, in one place and a foundation that allows us to change customer apps in a lighter way in terms of the number of parts of our systems we need to touch. That will lower the cost of technology investment through time and also allow us to make changes more quickly.

Last point would be that, we did take a restructuring charge earlier in the year. From that we expect to drive savings of about $100 million. The charge in total was just under a $150 million and we're expecting around half of that for this year and the balance in the first half of next year. That charge was part of the broader effort and is one lever that we're acting on in order to reduce the rate of expense growth and really take resources out of areas where we don't think that they're being fully utilized or the market opportunity is there to get the full bang for the buck that we're looking for.

Robert Sedran - CIBC - Analyst

We are out of time. Thank you very much, Tom, for your participation this year.

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

Thank you for having me.