BMO Financial Group

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PRESENTATION

Robert Sedran *- CIBC World Markets - Moderator*

Our next guest is Dave Casper. He is the Group Head of Commercial Banking and President and CEO of BMO Harris. Dave has had his current position since 2015, but joined Harris and BMO in 1978, so pretty much has seen everything that BMO has done in the United States and I hope to hear a lot about it in the next half hour.

Before we begin, I have been asked to tell you that Dave'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. Hopefully you have started listening now.

Dave, I thought we could start off with a bit of a state of the nation, if you want to make some opening comments about how you're feeling about the business, how you're feeling about the outlook generally in the U.S.

Dave Casper *- Bank of Montreal - Group Head of Commercial Banking, President & CEO*

I would say to answer your question, I'm feeling really very good about the U.S. The business – and just to put it in perspective for you - the business is now over 25% of the business of Bank of Montreal. And the personal and commercial business that I am part of, has really over the last 10 years -- and for those that have followed BMO for long period of time, BMO bought Harris Bank in 1984 and it was a good-sized regional bank. Shortly after buying Harris Bank, they really wanted to buy M&I. M&I is a bank just to the north of Wisconsin -- it took us 25 years to do it. It always made sense and it was a good strategic fit, and good financial fit, good cultural fit. But it was always a little too expensive.

But my point is, it was about $100 million of earnings - even as late as 2005 - the overall Personal & Commercial business in the U.S. Today it'll be over $1 billion in 2016. So, it's had very strong growth. Most of that growth has come from -- we've had two acquisitions, Harris and the M&I acquisition, then our Transportation Finance business, which we just bought and we will talk about that in a little bit -- and then we've had very good organic growth.

In the business today, the commercial business is clearly growing faster than our retail business. But both businesses have some pretty good momentum now.

The general view, and I think we should probably talk about this a little more later, but the general view is that credit quality is still pretty good in the U.S. Certainly not as good of a time to lend money today as it would have been in 2009, but still pretty good, and looking for decent growth.

We had really strong growth in the third quarter. We had 9% improvement in our operating leverage. We hit below 60% for the first time in our P&C U.S. business in a long time. That's a combination of good growth, an acquisition and pretty good expense management.

So all in all, I think things are good and I expect things to continue to be strong.

Robert Sedran *- CIBC World Markets - Moderator*

There's a bit of a disconnect, it seems, between the economic data and what people like you are seeing on the ground. It would suggest sluggish growth, and then I see high single-digit to low double-digit commercial loan growth over time.

So why is that disconnect there, and is it really that strong underlying? And when you think about what industries are growing and where you are growing, can you put a little bit of colour on this picture for us?

Dave Casper *- Bank of Montreal - Group Head of Commercial Banking, President & CEO*

There is a bit of disconnect, but both sides are real. It is sluggish. Business owners and most of our commercial businesses with medium-size companies -- business owners are reluctant, there's a lot of reasons for that.

We have had for a long time a pretty strong commercial banking presence in the United States. We have a lot of good customers and over time we've grown that.

The disconnect is, I think, sluggish, but our clients tend to be more growth-oriented. I think they have been around a bit longer. They feel that this is, just as we do as a company, we feel this is still a good time to grow.

Our growth has been a couple things. We made the acquisition of M&I. That doubled our business in the United States. It was a great acquisition because both banks had strengths and some weaknesses. For example, we at BMO, before M&I, didn't really have an equipment finance business. Over the last four years as we put the banks together, every BMO client that in the past, if they were going to do equipment finance would seek other sources. Now they would use the equipment finance business that we have at M&I. That gave us some really strong organic growth that we would not have otherwise had.

Conversely, BMO had a pretty strong asset-based lending business and this is the business where we're financing working capital growth with receivables and inventory as our primary collateral. It’s a very good business for us. M&I did not have that, so all of their customers, if they needed asset-based lending, were going to other sources. That, over the last four years, has been part of our growth. That won't always be there, but we filled the pipeline basically on both sides by doing it.

Other things that we've done that we didn't attempt before -- which kind of goes to the business that we have on both sides of the border on the commercial side. Many of you may know, BMO in Canada is one of the largest if not the largest, non-captive provider of dealer finance. That's been a great business for us in Canada over the long period of time.

In 2009, in the U.S. we did not have that at all. We probably are the only bank in the world that in 2009 in the United States built an inventory finance business for auto dealers. Everybody was leaving the market, we joined it. That's a $3 billion business for us now in the United States. That's growth that we never were in.

So part of our growth, to answer your question, is doing things that we hadn't done in the past. We are also growing in ways we have not done before on the commercial side. Ten years ago we would not have thought about having any commercial business, really, where we didn't have a footprint.

Most of our footprint in the United States is in the Midwest, in an area that has a GDP about the size of Canada in six states. That is where most of our retail footprint is. But today we have basically a national business on the commercial side. For example, we've now just gone into Dallas where we don't have any retail footprint but we have an awful lot of employees and now we're building a commercial business there. Very slowly over time, but that will help us grow as well.

There are no particular industries that are big concentrations for us, to your question, we're not doubling down on any particular area. Real estate, we've had good growth in. But we see now in real estate, there are some pockets of real estate where it's getting a little frothy and we will move around and do something else.

The business in the U.S. is a really diversified business on the commercial side. No big chunks, no big reliances and I think I would say it's opportunistic over a long period of time.

Robert Sedran ***- CIBC World Markets - Moderator***

The outside the footprint growth is one of those things that I know we know, and also do not think about so much, it's always regarded as a Midwestern bank. Are you growing both sides of the balance sheet across the country, or are you funding loan growth elsewhere with Midwest deposits?

Dave Casper ***- Bank of Montreal - Group Head of Commercial Banking, President & CEO***

No. We are definitely funding on the commercial side. We fund our growth through big growth in our retail deposits, which have been probably the best part of our retail business by far. Really strong deposit gathering business and they continue to fund that. And it funds some of the lending growth.

But because our businesses are national -- so if there’s a company in California that we're doing business with -- we would not likely do business with them unless they are giving us treasury management business. So, we will provide in the United States, just as in Canada, and you don't have to have local footprint to collect those deposits. The California company has clients all over the United States. We have lock boxes where we collect those deposits and those are our deposits that fund our growth. As we expand nationally, we absolutely will get the treasury management business that goes along with that and that is a big part of the fund.

Robert Sedran *- CIBC World Markets - Moderator*

The deposit outlook is actually an interesting one, because with rates where they are, I guess I would be curious to know what kind of deposits you're capturing. What kind of product, what kind of customer you're getting, how rate sensitive they are, if at all at this point?

And is it all about cash management treasury systems that is allowing you to collect these deposits? Even on the retail side, if you could provide some colour on that.

Dave Casper *- Bank of Montreal - Group Head of Commercial Banking, President & CEO*

Let's start on retail. That has been a really strong opportunity for us.

I think - and there the deposits are coming from the Midwest - I think we've had, for a long period of time, a really strong deposit gathering business. We have a good online system. We have about 600 branches in the Midwest, and we have focus on getting and retaining clients.

The most important thing most people in the branch do for us is when the customers come in -- and they still do, by the way, they still show up, a lot more online than ever before but people still show up. Business customers too, show up. Every business customer happens to be a retail customer, many of them are. We've done a really good job of finding out what they need and building that so we've got generations and generations of families in Chicago or Wisconsin that bank with us on a personal side. And that grows over time. That's been a very good strong part of our growth.

On the commercial side, as I said before, we've grown the commercial business but we try to grow it in areas where we are always going to have the treasury management as well. We just don't want to be providing capital to commercial clients if we don't have a really good strong shot at getting their operating business.

Now, that's not the only thing we try to get on the commercial side. In the commercial business we're a very large feeder into the wealth management business. And very good cross-sell – you know, these companies as they grow, they create a fair amount of wealth and if we can capture that, then that's strong.

What we've done on the Capital Markets side, and we've added, with a group that we just brought on -- a smaller M&A firm called Greene Holcomb up in Minneapolis -- the ability to capture those companies that are $50 million, $100 million, $150 million of value when they finally sell. And the firm that we bought is really helping realize that and help them. Once they sell that business, as you know -- and there's hopefully a place that they will put that investment, and it goes back into our Wealth Management business.

We've really tried to connect all the dots in the U.S. and grow it and build it into a very important part of BMO over the long run. And the deposit taking is a very important part of it, both on the retail side and the commercial side.

Unidentified Participant

How do you track that cross-selling activity, and how do you pay for that cross-selling, particularly when you go outside of business lines?

Dave Casper *- Bank of Montreal - Group Head of Commercial Banking, President & CEO*

We track it regularly and we do it between our wealth management teams, our commercial teams and our investment banking teams. We look at opportunities, we set what we think are reasonable goals for the year. And then we're constantly updating those.

I think your question is how do we pay for it? How do we incentivize? It's a great question.

It starts with the way we have really thought about the bank, and this will be going into our 200th year of trying to get this right. It's one bank. And so if you are in the capital markets business, which I spent about half of my career in, or if you're in the commercial, which I spent the other half of my career in, or if you're in wealth management -- you really have to, when you obtain a client, you have to start thinking right off the bat - what can we do for this company that will cross all of our lines of business?

We pay for it in our overall -- we have discretionary incentive system, and we look at it and these can be big hits if they are done well. So we try to incent the people by saying, do the right thing for the client, we are not going to pay you on any particular transaction but we will look at the end of the year and see how you did against cross-selling and that's part of your overall compensation.

These are sophisticated bankers that have been in the market for long period of time. Many, like myself have been in the commercial side or the wealth side or the capital markets side. So they get what a client needs. I think that philosophy -- one bank, do what's right for the shareholder, we will take care of you - that works as long as people believe it.

There are people sometimes -- but what about that deal? You really try to pull it back and say -- who all helped in doing that. But we've got really good cooperation and there are parts of the incentive where people say you have to have done this to get paid.

So I think it really works. It works because the people at the top of the house actually believe it. Whether it's Darryl White who runs our investment banking business, or Gilles who runs our wealth management business, myself or Cam Fowler. People get it and they know that this is what we need to do to grow the business.

We've been in the U.S. since 1984 in a big way. Every day, we're realizing the power that we have being a big bank that has a big operation in both Canada and the U.S.

Does that help get to your question – but it's not pushback – it’s “The” question, and we have to get it right.

Unidentified Participant

There are very few organizations that would stand up and say, we want you to operate in a silo.

It's one thing to espouse it, it's one thing to believe it, it's another for people to actually see it impact them and usually that comes in the form of compensation and incentive systems that get aligned with that process.

Dave Casper ***- Bank of Montreal - Group Head of Commercial Banking, President & CEO***

I think it does. I really do think it does and I think people -- at the end of the day people have to believe that regardless of what is in the incentive system at the end of the year, what was done and what they've done to really build up the one bank view really does work and they get paid for it. And it's not just a one-year deal.

We just closed something and it was five years in the making. We won the business and we knew that someday they'll sell. This was a business that said they would sell and they needed the capital. The team that was involved in that execution was there five years ago too. That doesn't always happen. When it works, it really works well. I think it will continue to work. It's a great question and it's something we spent an awful lot of time on. It's not perfect and I think it's better than a lot of places.

Robert Sedran ***- CIBC World Markets - Moderator***

I want to talk about the profitability of some of this activity. Is the obligatory Federal Reserve question at this point when I think about the evolution of the net interest margin, competition on the deposit side, competition on the loan side, just the interest rate environment generally?

How do you think about -- if the Fed moves, they are not moving much. So how do you think about the pressures on this business and should we see an evolution higher over time because you're getting both sides of the balance sheet? Or absent higher interest rates, is there going to continue to be a leak in the margin?

Dave Casper ***- Bank of Montreal - Group Head of Commercial Banking, President & CEO***

There's a whole bunch of questions inside that. But I think if you look at our net interest margin, and you look at it maybe over the last year, year-over-year we are up probably 12 basis points. That's unusual, most banks are down. We are up for two reasons.

The Fed rate, which helped everybody. And this time around there was not a lot of give back of the 25 basis points. When you're down to where you are, at zero, it's hard to give much back.

The other reason we are up is the acquisition in December of our transportation finance business which was a double whammy. We reduced a little bit of our indirect auto business which had low spreads and put on $8 billion or $9 billion of transportation assets with higher spreads.

We are up 12, but underlying that, Rob, is a continuation of decreases in spreads that I don't see -- and it's been 2 or 3 basis points a quarter that's largely driven by the competitive nature in the U.S. commercial market, more so on the commercial than the retail. And I think your question is do I see that? Maybe I see that declining a little bit, hopefully offset by interest rate increases from the Fed. I think, by and large, it's pretty competitive. I would see a general kind of slight drifting down. Even with some action by the Fed but they could -- who knows what they will do.

Robert Sedran ***- CIBC World Markets - Moderator***

Are you seeing competitive pressure on price, on terms or covenant-light stuff? And how much are you willing to say, that does not work for us. Because you're putting up some very strong growth despite -- to the extent that you are holding on price.

Dave Casper ***- Bank of Montreal - Group Head of Commercial Banking, President & CEO***

I think we see it, we see the competitive nature in price, we see it in terms, we see it in everything you mentioned. I think we feel very comfortable that we are living within our risk appetite and we're definitely not doing a lot of things that we've seen. We've seen -- the good and bad of being around for as long as we have -- there's nothing really new, it comes in different forms.

To the point that I think I started at the outset and I think your -- part of your question. If you take 2005 to 2016 and you look at the risk-reward equilibrium, 2005 and 2006 were absolutely off the charts in terms of risk-reward. Just awful.

I think even during that period of time, some of us -- I don't know that I had a sense how bad it was. I think everybody knew it was getting bad. It moved very quickly in 2008 and 2009, it was a very difficult time. Lots of clients were struggling. Many clients would say to me - they said- I feel like I am a better risk than a lot of the banks I am doing business with. And trust me, they were not that great of risks. And that was true because the banks really struggled. It was very difficult time then to get any kind of credit. We are not there.

I mean, that was a great time to lend money but we are nowhere near 2005 either, or 2006, or even early parts of 2007. I think it will continue, because we have so much money, it will continue to be frothy.

So many banks are really struggling to get any kind of loan growth. They don't have the ability that some of us have to maybe grow into different markets and take more market share as opposed to just staying in your own market and trying to race to the bottom as Victor quite aptly pointed out in another part of his business.

It's a tough time. You never know exactly when to lift your foot off the gas or step down. I think what we've done and we've seen in certain parts of our business, we will lighten up a little bit. Not because we see big problems but just -- it won't be this good for long.

We've had, as you point out, we've had really strong growth in our lending businesses. And we haven't really felt like we've changed our risk culture at all. It's the same people making the loans and we're just smarter now because we've lived through one more disaster back in 2008. That doesn't mean we won't make mistakes and still make them. But I feel pretty good, is the long answer.

Robert Sedran ***- CIBC World Markets - Moderator***

With the exception of energy losses we're pretty much operating at trough loan losses and we don't typically stay there for very long and we've been there for a while. One of your opening comments was – that things feel okay but we don't know how long. Where are we in the cycle? And does that influence what your risk appetite -- the longer this goes, at this level -- does it change your risk appetite as you go?

Dave Casper ***- Bank of Montreal - Group Head of Commercial Banking, President & CEO***

Our risk appetite is our risk appetite and we try to stay in that box through the cycle. Which I think has allowed us to be a really good bank for long period of time.

What we don't want to do is keep moving the goalposts. We have a view of where we want to play. I think it is going to get -- we're going to fall off the bottom and start coming back up as an industry. I think that's pretty natural but I don't see us -- I think your question is, are we concerned?

Robert Sedran ***- CIBC World Markets - Moderator***

Is this late cycle, is what I'm wondering?

Dave Casper ***- Bank of Montreal - Group Head of Commercial Banking, President & CEO***

It's not 2007. And I don't know that we want to keep going back to that level.

I think we are at a point where I can see over the next two or three years, there are going to be higher losses. There are going to be -- just rates itself, it's hard to go bankrupt these days with rates at 1%. I've seen some companies try really hard and they still can't do it.

But as rates jump up that will put some more pressure on things. We obviously, I think most banks, are not assuming these rates will stay the same. As the economy cycles -- I still think we have some more good years in the economy, but as rates go up we will see some pressures. I don't think -- I would not put in your forecast big loan losses.

And BMO for example, I think our long-term is about 41 basis points and that is pretty good compared to the industry. We're 25, 28, 29 now. We're still well below the average.

Robert Sedran ***- CIBC World Markets - Moderator***

Do you think that average still holds?

Dave Casper ***- Bank of Montreal - Group Head of Commercial Banking, President & CEO***

The great thing about averages is it definitely holds because it's 10 or 11 or 12 years.

Robert Sedran ***- CIBC World Markets - Moderator***

I feel like we're operating below those levels across the industry and maybe risk management has gotten better, and maybe we are in a different period.

Dave Casper ***- Bank of Montreal - Group Head of Commercial Banking, President & CEO***

I don't know. It's a great question. I don't know if the -- as much as I'd like to say in every cycle bankers get smarter -- but there's no evidence, going back hundreds of years --

Robert Sedran ***- CIBC World Markets - Moderator***

That bankers get smarter?

Dave Casper ***- Bank of Montreal - Group Head of Commercial Banking, President & CEO***

No, I'm sorry to say. I wish it was true. And what we try and what BMO -- there's no real benefit to making the same mistake twice.

We really do try to understand where we've made mistakes. And it's mostly around doing business with the right people. That is really the critical part.

Robert Sedran ***- CIBC World Markets - Moderator***

You've touched on transportation finance a couple times in your answers to other questions. Let's focus on that one a little bit because I guess it is since December now, you've had it for coming up on one year. Probably a bit of a light integration considering that it's a bit of a standalone business, but can you talk about the learnings since close and what is going well and what is going not as well as you'd like?

Dave Casper ***- Bank of Montreal - Group Head of Commercial Banking, President & CEO***

Just to pull it back a little bit, when GE announced a year ago April that they were going to get out of this business, get out of all of the finance businesses, we looked at all of them. We thought this one really fit us. You called it a standalone business and some people have called it portfolios. But it's not really a portfolio. It is a business as you say. And we are trying not to have it be a standalone because there are some really good opportunities.

What's worked well from the beginning, to your question, everything we thought about the management and the customers and how they've run their business and their leadership within the business, they are the largest truck and trailer financier in North America. And it's a business on both sides of the border.

Everything about what we thought has turned out to be true. We've kept all of the management team -- virtually all of the management team, which was great - because for a lot of people, anytime anything is for sale, people start thinking about other places. That management team really liked BMO and they liked what we were going to be able to offer for them over the long period of time.

So from that standpoint, things are working really well. We still have to do integration. They have a lending system which is an important part of the business. The great thing about this business is, and it's a bit of a FinTech business in a way, a third to a half of their business is making loans through dealers, very much like an indirect auto business, where they can decision in 60 to 90 seconds. These are loans under $1 million, that's four or five trucks.

And they have built a model over a long period of time that has been very successful. And integrating that and putting that on our platform is critical. We're basically picking it up and moving it onto our platform so we don't miss a beat. That will take place next year.

The guts of the back office integration are still to come. We're working with GE, who has provided, basically, a TSA for all businesses that GE sold. And that's really working well.
The customers, like us, and where I think there's real opportunity, is every one of these customers is banking – deposit services - and GE did not offer that, so over time that is a real opportunity for us to win that business. We are not forcing it on day one. We are not saying you have to move your business in order to finance the trucks because that's not the right way to treat clients.

But the individuals that we brought on board have really good solid long-term relationships with the dealers, manufacturers and end-users. So it's kind of a natural over time that they will bank with us as long as we give them the right services. That's the upside that we really won't see that for two or three years.

The only thing that -- and it's not even a negative, but we knew this was a cyclical business. We've modeled that in and it is a cyclical business. The two years before we bought it were the best new truck sales in a long time. And truck sales this year are down industry-wide 20% or 25%. We're not down quite that much. But that's okay too because if you don't sell trucks for a year then there's less pressure -- after a while there's less pressure on used prices and everything comes back. It's actually one of the more predictable businesses we`ve seen.

Robert Sedran ***- CIBC World Markets - Moderator***

It's a high loss rate business though --

Dave Casper ***- Bank of Montreal - Group Head of Commercial Banking, President & CEO***

It`s not high loss, but higher expected loss than our other business, absolutely. We've mapped it out at 55 to 60 basis points over the cycle. The couple years before we bought it, they were really low. But they will go up and they will crossover.

But the spreads in this business are substantially better and part of that is, I think they've done a very good job -- and we wish we would do this more in all of our businesses -- of never competing on price. They compete on speed and service and in that market they're absolutely the best. That's what we liked about it, Rob. It was really good business.

Robert Sedran ***- CIBC World Markets - Moderator***

I've got another half an hour of questions but I've got five seconds left. Dave, thank you.

Dave Casper ***- Bank of Montreal - Group Head of Commercial Banking, President & CEO***

Thank you so much, I really enjoyed it.