BMO Financial Group

Q2 2004 CONFERENCE CALL

CORPORATE PARTICIPANTS

Susan Payne
Bank of Montreal - SVP of IR

Tony Comper
Bank of Montreal - President & CEO

Karen Maidment
Bank of Montreal - CFO & EVP

Mike Maila
Bank of Montreal – EVP & Head of Corporate Risk

Robert Pearce
Bank of Montreal – President & CEO, Personal & Commercial Group

Bill Downe
Bank of Montreal - Deputy Chair & CEO, BMO Nesbitt Burns

Gilles Ouellette
Bank of Montreal – President & CEO, Private Client Group

Frank Techar
Harris Bank - President & CEO

Yvan Bourdeau
BMO Nesbitt Burns – President and COO

CONFERENCE CALL PARTICIPANTS

Jamie Keating
RBC Capital Markets - Analyst

Steve Cawley
TD Newcrest - Analyst

Heather Wolf
Merrill Lynch Canada - Analyst

Michael Goldberg
Desjardins Securities - Analyst

Ian De Verteuil
BMO Nesbitt Burns - Analayst

Quentin Broad
CIBC World Markets - Analyst

Susan Cohen
Dundee Securities - Analyst

Jim Bantis
CSFB - Analyst

PRESENTATION

Operator

Good afternoon and welcome to the BMO Financial Group second quarter conference call for May 26, 2004. Your host for today is Susan Payne, Senior Vice President of Investor Relations. Ms. Payne, please go ahead.

Susan Payne - Bank of Montreal - SVP of IR

Thank you, operator. Good afternoon everyone. Today's brief overview of our second-quarter results will be provided by Tony Comper, President and CEO; Karen Maidment, our CFO; and Mike Maila from Risk Management. After Mike's presentation, the following members of the management committee will also be available to answer your questions. Bill Downe, Deputy Chair; Frank Techar of the Harris Bank; Rob Pearce from the Personal and Commercial Client Group in Canada; from the Private Client Group, Gilles Ouellette; Yvan Bourdeau, Investment Banking; and Lloyd Darlington who heads up Technology and Solutions in E-business.

At this time, I would like to refer our listeners to our investor relations website at bmo.com to view our forward-looking statements and the risk factors pertaining to these statements. Now I would like to hand the floor over to Tony.

Tony Comper - Bank of Montreal - President & CEO

Thanks, Susan. Good afternoon everyone. All in all, it was a good second quarter. Net income increased 47 percent from a year ago. Earnings per share rose 45 percent, and I take special note of the fact that return on equity reached 20.4 percent. The sharp rise in results is due to strong operating performance in all of our groups and the continuation of good credit performance. We continue to benefit from growth in business volumes, our focus on productivity, and superior asset quality. Results so far this year position us well to achieve all of our annual financial targets.

I'm especially pleased to report that the cash productivity ratio improved 380 basis points in the second quarter from a year ago, as revenue rose 12 percent alongside expense growth of only 5 percent. For the first six months of the year, cash productivity improved 330 basis points. And what's more, productivity remains at the top of our list of enterprise priorities which are unchanged for the remainder of 2004.

We made solid progress during the quarter on all of the enterprise priorities. For example, we completed the acquisition of Lakeland Community Bank and also signed an agreement to acquire New Lenox State Bank in order to extend both the reach and the profitability of our U.S. holdings. When the new Lenox deal closes in the third quarter, and that's our 13th acquisition since 1999, Harris Bank will have a 9.9 percent share of retail deposits in greater Chicago. That's just 50 basis points behind the market leader. And overall, we anticipate that the number of Harris locations will reach 169 by the end of the year, and that's up from 154 to date.

Another notable strategic initiative was the introduction in April of the new Gold WestJet AIR MILES reward option for our Mosaik MasterCard. The partnership with WestJet and the Loyalty Group enables personal and small-business cardholders to collect reward points faster and fly sooner on WestJet and other carriers in addition to other exclusive benefits. We really believe that the new program will help us increase existing customer loyalty and earn a larger share of our customers' business, that's two of our enterprise priorities, and to attract new customers as well. I will conclude my brief overview with the observation that rising results over the past 8 quarters demonstrate the continuing effectiveness of BMO's Canada/U.S. growth strategy.

I'd like to take this opportunity to mark an important passage. Mike Maila makes his last appearance today as BMO's risk management spokesperson for the investor community. He has been appointed Executive Vice President and Head of Market and Operational Risk. During Mike's tenure, BMO has been a recognized leader in credit risk management and risk disclosure. In his new role, he will draw on his considerable expertise in all facets of risk management to help our market and operational risk teams, which are already strong, take the next step to become industry leaders. Mike, you leave our credit portfolio in excellent shape, and I want to thank you warmly for a job exceptionally well done.

Mike passes the baton to Bob McGlashan, Executive Vice President and Head of Corporate Risk Management. Many of you know Bob from his most recent and very successful role as Executive Vice President of Commercial Banking. He brings 30 years of experience at BMO to his new position, including key leadership roles in commercial, corporate and retail banking. Mike and Bob have been easing into their new responsibilities since last November in order to ensure a seamless transition, and the transition will be complete when Bob reports on our risk performance at the third-quarter conference call.

Now I am going to ask Karen Maidment to provide second-quarter financial highlights.

Karen Maidment - Bank of Montreal - CFO & EVP

Thanks, Tony. As Tony mentioned, this quarter was very strong with renewed revenue growth supported by strong operating performance in our groups and the continuation of good credit performance. All operating groups are up year-over-year. In particular, PCG posted strong earnings and IBG continues to generate double-digit returns. P&C's returns would have grown 12 percent excluding an adjustment to the credit card fees which I will discuss later, despite sustained pressure on margins due to the low interest rate environment and the competitive pressure.

On a quarter-over-quarter basis, both IBG and PCG generated higher earnings. P&C, personal and commercial, was down due to the adjustment referred to earlier. Net income at 602 million is up 47 percent over last year and up 13 percent over the first quarter, and the ROE for the quarter is 20.4 percent. The provision for credit losses of 5 million is made up of a specific provision of 45 million, less a 40 million reduction in the general allowance for credit losses. Last quarter we revised our target for the annual specific provisions to $300 million or less for the year, excluding any reduction of our general allowance, versus our original target of $500 million or less.

Our tier 1 capital ratio remains strong at 9.67 percent, and as Tony mentioned our cash productivity ratio has improved 380 basis points year-over-year and 170 basis points quarter-over-quarter. During the quarter, we recorded higher than usual net investment securities gains in our Investment Banking Group, primarily on the sale of fixed income securities in the non-relationship portfolio. The gains of 52 million which were recorded as non-interest revenue in IBG were largely offset by 44 million of interest expense from unwinding the associated interest rate swaps, and that 44 million is recorded in net interest revenue in IBG.

In addition, we realized another 44 million from the sale of fixed income securities in the corporate area of the U.S. These sales were from the securities portfolios used in the management of U.S. interest rate risk and were sold in anticipation of rising interest rates. We also had a $51 million adjustment in the quarter for credit card fees, increasing the estimate of the liability associated with AIR MILES due to recently increasing redemption rates. That was 51 million, and it was charged to the cards line of business in Personal and Commercial Canada.

So if you take the securities gains of 52 and 44, totaling 96 million, and subtract the 44 of interest expense on the swaps, and then the additional 51 credit card fee adjustment, these items pretty much net to zero, which leaves the release of the general of 40 million as the only one-off kind of item for the quarter.

Slide 4 shows the change in cash EPS versus the second quarter last year and versus the first quarter of this year. Quarter-over-quarter the change in EPS was 14 cents and, as you can see, most of the increase was due to business growth. Year-over-year, almost two-thirds of the growth is due to business growth which increased EPS by 22 cents. The reduction of the general allowance of this quarter combined with a lower specific provision for credit losses increased earnings per share by 15 cents.

Turning to slide 5, you can see that revenue growth, we achieved core business growth of 4 percent quarter-over-quarter with an increase of 11.6 percent year-over-year, despite continued pressure on net interest margins. Year-over-year business growth resulted from higher revenues across all our operating groups. In particular, market-sensitive revenues saw the largest increase. The effect of foreign exchange, acquisitions and accounting changes have had minimal impact on our revenue growth, both on a year-over-year and a linked-quarter basis.

On slide 6, you can see net interest margins on a total bank basis decreased both quarter-over-quarter and year-over-year. You will recall that in the first quarter, we recorded an accounting change for mortgage prepayment fees, which increased our net interest margin for the quarter by 6 basis points. So excluding this adjustment, the net interest margin declined 6 basis points quarter-over-quarter, primarily as a result of the competitive environment in personal and commercial and the flat yield curve. Year-over-year the net margin is down 16 basis points, and while margins increased in P&C U.S. year-over-year, this was more than offset by lower margins in P&C Canada.

Year-over-year, IBG's net interest margin was down due to lower balances in corporate loans of preferred shares, and increased interest expense resulting from the unwinding of the hedges, which I referred to earlier related to the sale of the fixed income investment securities, and that accounted for about 6 basis points on the IBG margin.

Slide 7 illustrates our very strong expense management. Total expenses are up less than 1 percent over the previous quarter, and the decline in performance-based compensation is due to lower MTIP or the medium tern incentive plan. As I mentioned last quarter, this cost would decline on a go-forward basis, as the program is now fully hedged. When we compare ourselves to last year, expenses are up driven primarily based on revenue-based compensation related to the increased revenue.

Turning to slide 9, you can see that total bank cash productivity has improved both quarter-over-quarter and year-over-year. Personal and commercial second-quarter results included the adjustment to the credit cards of 51 million.

Excluding this adjustment, P&C's cash productivity ratio for the second quarter would have been 62.2, which is consistent with the first quarter of the year and is an improvement of 200 basis points over the second quarter of last year. On a year-to-date basis at the total bank level, our cash productivity has improved 330 basis points, providing momentum towards achieving the targeted 150 to 200 basis point reduction in this ratio for fiscal 2004.

If we maintain the level of cash productivity we achieved in the second quarter for the second half of the year, we will achieve our target of 150 to 200 basis points improvement for the full year. So for fiscal 2004, this equates to about a 3 percent revenue to expense differential.

Slide 10 shows our performance against our fiscal 2004 target. Our high EPS growth and productivity improvement year-to-date is in part due to the quarterly earnings pattern in 2003. However, if we continue to perform at current levels, we will exceed our EPS and ROE targets. However, we continue to be cautious as we do face some downside risks, namely the continued pressure on interest rate margins, especially in Canada, the unpredictability of market-sensitive revenues, and the timing of sales of nonperforming assets, as the first half of fiscal 2004 benefited from the recoveries on nonperforming loan sales.

I will now turn it over to Mike to talk about asset quality.

Mike Maila - Bank of Montreal - EVP & Head of Corporate Risk

Thanks, Karen and Tony, and good afternoon everyone. I'm going to be quite brief this quarter and make three main points. First, as slide 2 clearly indicates, we continue to be in the recovery stage of the credit cycle. I would highlight in particular the credit performance of our corporate loan portfolio, which not surprisingly continues to generate significant reversals and recovery. This performance reflects two factors; A) our deliberate and conservative practices in classifying loans as impaired, and in provisioning against them quite early in the credit cycle. And B) our proactive yet patient management of the impaired portfolio throughout the cycle to maximize shareholder returns. I believe those two themes are familiar ones to those of you who have been joining us regularly on these conference calls for the past few years.

My second point is that as slide 3 shows, the credit story this quarter is not only about reversals and the recoveries, but also about a significant reduction in the level of new, specific reservations, again mostly in the corporate loan portfolio. Having said that, you can see from the slide that absent any reversals and recoveries, specific PCLs would have been 117 million this quarter versus the actual level of 45 million. Accordingly, we have maintained the specific PCL guidance for this fiscal year as Karen has mentioned at 300 million or less, notwithstanding the fact that specific provisions amounted to only 100 million in the first half of the year.

Finally, turning to slide 4, you can see that this has been a very solid quarter on the trading and underwriting side as well. There was only one trading day out of 65 during the quarter with a negative P&L and quite a small one, in fact. Moreover, we had a highly profitable trading day in late April, and this was primarily as a result of an equity arbitrage opportunity. At this point, I'd like to turn the call over to the conference operator for the question-and-answer session. Operator?

QUESTION AND ANSWER

Operator

We will now begin the question-and-answer session. (OPERATOR INSTRUCTIONS) Jamie Keating, please go ahead.

Jamie Keating - RBC Capital Markets - Analyst

Good afternoon, congratulations all. A couple of quick questions if I may. One is for Mike while we've got him, and congratulations on a good tenure there, Mike Maila. The question is twofold, I guess. One, on your slide 3 you mentioned $117 million of new reservations. I wonder if you could just comment about cyclicality on that number, how you feel about it on a sustained basis? It looks like it's getting nice and low. From an outlook perspective, are we scraping the bottom or can that come down some more?

Also, Mike, if I may, there was I believe a $20 million day in your trading revenue. I'm just wondering if you could describe a bit about what that might have come from.

Mike Maila - Bank of Montreal - EVP & Head of Corporate Risk

Thanks, Jamie, appreciate your comment there. First question on the cyclicality, I think we've touched on that in the past. If you look at the supp-pack, your know our methodology is to charge from the corporate center to the lines of business an amount equal to the expected loss on average through the cycle, and that number for this year is about 480 or so. So that gives you divided by 4 kind of an estimate of a quarterly rate absent any cycles. It's not a forecast, but it's an indication, I think, of the type you're looking for.

With respect to the 20 million, as I said, this was primarily an equity arbitrage opportunity, but there were a couple of other things during a single day, including strong underwriting revenue as well as the normal customer flow that generated good profits. But certainly, we'd single out an equity arbitrage opportunity that is not usual but still quite attractive, and we were properly positioned to take advantage of it.

Jamie Keating - RBC Capital Markets - Analyst

Terrific. Thanks, Mike, that helps a lot.

Operator

Steve Cawley.

Steve Cawley - TD Newcrest - Analyst

Maybe just to continue on that slide 3 of yours, to go into the recoveries of prior write-offs, is there any disclosure within the stat-pack that could give us a sense of what sort of unrealized gains that you could have on the sales of loans that you've taken write-offs before on?

Mike Maila - Bank of Montreal – EVP & Head of Corporate Risk

Thanks, Steve. No, there isn't a discussion of the likely recoveries because these pertain typically to prior years. So you would see, for instance, we've written down a loan to zero in '03, and suddenly we are able to sell it for obviously some positive amount in '04. But you can get a sense from page 31 of the supp-pack, we do disclose the recoveries and the write-offs by market, and you can tell roughly where they are coming from in the portfolio.

Steve Cawley - TD Newcrest - Analyst

So could you even give us a sense of relative to previous quarters, let's say, of that pool of excess, is it much less than it has been previously? Is it the same?

Mike Maila - Bank of Montreal - EVP & Head of Corporate Risk

It has been as Karen mentioned, unusually high, I think slide 3 indicates the last three quarters have been unusually high but that's not surprising necessarily at that point in the cycle. Beyond that it depends on market conditions. So it is hard to project looking forward.

Steve Cawley - TD Newcrest - Analyst

Is it hard to believe that it can get much better?

Mike Maila - Bank of Montreal - EVP & Head of Corporate Risk

Well I leave it to your imagination and optimism. I think we are, as I mentioned before, our practice lends itself to being in a good position to take advantage of these opportunities when they come up.

Steve Cawley - TD Newcrest - Analyst

Tony, maybe just one for you and I will leave it there. I have bugged Gilles a few -- I think each of the last two quarters on the performance of the U.S. discount brokerage ops, and Schwab has made some pretty interesting announcements this week that given that that probably is your most direct competitor, I believe could put pressure on Harrisdirect. Could you tell me why is this an important division for Bank of Montreal moving forward? What is the vision of that division? Why are you holding onto it when it is not making any sort of real profitability?

Tony Comper - Bank of Montreal - President & CEO

Well, in terms of the overall business there is two views of that, one of which is you may recall that at the time we made the acquisition we didn't put anything in there in terms of -- let me put it this way -- getting more out of the client base than the discount brokerage business. So we didn't argue the cross sell, we made the economics of the acquisition stand on its own merits. Now market conditions have gone against the business, and so a lot of the energy that Gilles and his gang have been putting in have been to re-platforming that business. But we still believe and we're still quite optimistic that having that client franchise as part of our private banking operation is an excellent position to be in.

The second thing of which is, and we had a lengthy discussion this morning about this, is that the self-directed investing business is a good business on its own right, and is generating both in Canada and the United States positive cash flows and therefore it is attractive. But also, we believe, and we have it on pretty good evidence by chatting with others who are in this business that given that we are a full-service provider to retail and wealth clients in both Canada and the U.S., we think this is an essential arrow in our quiver if I can characterize it that way; in other words it is hard for us to comprehend being a full-service provider without a direct investing capability. And that's both in Canada and the United States but in the U.S. our approach is slightly different; we don't have the commissioned sales force in the U.S. that we do in Canada. But I am going to get Gilles to supplement that.

Gilles Ouellette – Bank of Montreal - President & CEO, Private Client Group

Our U.S. businesses this year, Steve, are ahead of plan. They are ahead of our internal plans. And we would be even further ahead if we hadn't made the decision in the first quarter to spend more money in direct marketing, in marketing for our direct business. Because we were in a much more favorable investment climate, and we felt we had an opportunity. So we bumped our advertising in the second quarter, and we are very happy with the results. We are opening more accounts and probably more importantly we are opening more large accounts, and that is the market that we're looking for.

Last year we made a number of structural changes to our U.S. businesses, and we talked about this in previous quarters. The results of which, this year our U.S. businesses' productivity numbers are ahead by 1270 basis points. Just to get a better perspective on what is going on there, if you looked at our results year-to-date, our numbers are up where net income at PCG is at $56 million Canadian, which is 90 percent better than last year. And half of that improvement, half of that 56 million is improvement in the U.S. So I think it gives you a perspective here of what is happening with U.S. businesses; they are improving, and we are very, very optimistic for the future of these businesses.

Steve Cawley - TD Newcrest - Analyst

How about even in the future of these businesses with Schwab discounting and with others aggressively marketing?

Gilles Ouellette – Bank of Montreal - President & CEO, Private Client Group

Changes in schedules, not anything, in commission schedules is not anything knew. And you have to remember over the larger accounts -- and even Schwab talked about that -- the commission rates are only a part of the revenue stream you get from these accounts. We changed our commission schedule last summer, last July, and we dropped them below Schwab's. And we are having a look at what they've done here. And we may have a competitive response. But these changes happen all the time, Steve. This is not to be unexpected. And we have to deal with this all the time.

Operator

Heather Wolf.

Heather Wolf - Merrill Lynch Canada - Analyst

Two quick questions. First, is there any relief on the margin side in Canada? And secondly, can you talk a little bit about why it is that Harris Bank results in the U.S. looked a little lackluster?

Tony Comper - Bank of Montreal - President & CEO

I will get Rob to address the first question and then I will turn it to Bill for the second.

Robert Pearce – Bank of Montreal – President & CEO, Personal & Commercial Client Group

Certain margins in Canada have been squeezed. They were down 19 basis points Q1 over Q1. They are down 20 basis points Q2 over Q2. I think looking ahead and actually the 20 basis points they went down in Q2 over Q2, roughly half of that was due to the interest rate environment and about the other half of it is due to the competitive pressures and mix. By mix we mean the consumers buying more low spread products than high spread products. Looking ahead I think mix and the competitive environment will continue to push the margin down because particularly in the back half of the year the lower interest rate environments are going to be fully impacted in Q3 and Q4. But I don't think the level of decline will be nearly as much as it has been in the first half of this year. You'll note that the margin in the second quarter was down only two basis points versus the first quarter. So they are kind of falling down to these levels. They will probably drift down a little bit, but you won't get the same decline Q over Q as you have seen in the first half of the year.

Bill Downe - Bank of Montreal - Deputy Chair, CEO, BMO Nesbitt Burns

Heather, if you look at this quarter in the context of last year you will see that the revenues year-over-year, on the quarters have grown. I look at it more as a pause in one quarter to the next; and you can look at the pattern back through the previous year essentially the same thing. We are bringing two acquisitions online over the next 90 days; there's been a lot of work going into that, and I expect you will see continued growth in both lending and deposits along that historical rate you have seen.

Frank is also on the line although he is not in the city, if you want to make any specific comments I'll defer to you.

Frank Techar - Harris Bank - President & CEO

Just with respect to Chicagoland banking the numbers for this quarter were a bit down on a linked basis. The reason for that is we are continuing to fight the spread compression bug from a deposit spread perspective. We are hopeful that obviously with the rate environment where it is, we're going to get a little relief on that. So we continue to fight in the marketplace on the margin side. I think I said in previous quarters that our expectation is notwithstanding what's going on, we're going to come in very close to where we were last year on a net interest margin perspective. So we think we will see a little softness going through the end of the year but we think we have enough levers to manage that.

And then on the expense side we did close Lakeland this quarter, which increased the expenses a bit. And also we are starting to see a ramp up in expenses from some of the new branch activity. So none of this is unexpected, and we believe we can continue to manage it going forward. And our business volumes continue to be strong, and our expectation is that we will see improvement in the future.

Operator

Michael Goldberg.

Michael Goldberg - Desjardins Securities - Analyst

Any signs of pick up in new business lending at authorizations and/or drawdowns in Canada and the U.S.?

Tony Comper - Bank of Montreal - President & CEO

I will get Rob to deal with the first part of that and I will hand it over to Bill for the second part, Bill and Yvan.

Robert Pearce – Bank of Montreal – President & CEO, Personal & Commercial Client Group

Michael just for clarification, are you talking about the commercial lending part of our book, the business lending part of our book?

Michael Goldberg - Desjardins Securities - Analyst

Yes, I am.

Robert Pearce – Bank of Montreal – President & CEO, Personal & Commercial Client Group

The drawdowns the last couple of months have been pretty solid and importantly the pipelines are good. And we monitor pipelines from deal initiation to closing. But aggressively manage what we call the 80/30 bucket, an 80 percent probability being drawn down in 30 days. That pipeline has been solid, and in fact has been give or take growing a little bit over the last couple of months and has been at pretty good levels. So we're seeing a fair amount of activity. What we aren't seeing is utilization of our operating loans. The leverage in those loans has been pretty solid to drifting down for a number of months. So that is kind of holding back the commercial loan growth from what we hope and expect.

Tony Comper – Bank of Montreal – President & CEO

The only other indicator on that Michael, is that if you look at the national statistics on business loans and they do a same month over same month last year, it has been dropping down. In fact it was down -- I think the pattern over the last three months is year-over-year it was 3 percent down in February, 2 percent down in March and 1 percent down or numbers -- don't hold me to precise numbers but the decline in outstanding loans has been decreasing over the last three months.

Michael Goldberg - Desjardins Securities - Analyst

Well, it is actually for a longer period than that which is why I am asking the question. What do you think it is going to take to reverse this trend that has actually been going on now for a few years?

Tony Comper – Bank of Montreal – President & CEO

Improved economic performance I think is the biggest driver.

Robert Pearce – Bank of Montreal – President & CEO, Personal & Commercial Client Group

And I think lots of businesses are trying to figure out where the Canadian dollar is going to stabilize at. And I think that has been an impact over the last year, too, Michael as people have been working through hedge contracts or worried about their relative currency position and that's affected business investments.

Yvan Bourdeau – BMO Nesbitt Burns – President & COO

In the U.S. Michael, a somewhat similar story in a sense that we all know that the economic environment is certainly improving in the U.S. Our clients are more confident in their business. By the same token, like us they are focusing on productivity gains and therefore they keep a very close eye as to the structure of their balance sheet, and they are also still cautious as to whether or not they should put in place new plans. We still have over capacity in the U.S. If you were to look on the source base in U.S. dollar our outstanding are actually flat for the last three quarters. If you look at Canadian dollar terms, it's actually down because of the depreciation of the U.S. dollar. That is the only factor that has actually reduced in Canadian dollar terms our outstanding from the U.S. franchise.

Michael Goldberg - Desjardins Securities - Analyst

Okay. Thanks very much.

Operator

Ian De Verteuil.

Ian De Verteuil - BMO Nesbitt Burns - Analayst

First question is for Mike. I guess just congratulations on moving on and congratulations on telling us that the low coverage ratios didn't matter for a long time. And I guess, welcome to Bob and just to tell him as long as he runs his loan losses at 5 million a quarter he will do extremely well. The question for Michael is the page 33, your interest rate sensitivity, you have taken it down quite a bit, but it is still, the bank material still stands out as a bank but negatively gaps. And even if you were to think of sort of gapping whether it's positive or negative the Bank Montreal seems to do it more than others. Can you talk about why you have, why the bank's position that way and what looks like an environment where it is probably going higher, not lower?

Karen Maidment - Bank of Montreal - CFO & EVP

If you look at that page you can see that we split it between the structural balance sheet and on the structural side we take very little risk. We take very little risk and in fact in this quarter made some sales and our risk is very, very low. When you look at the GAAP in the U.S. it primarily relates to the IMM book and Yvan can speak to the positioning there.

Yvan Bourdeau – BMO Nesbitt Burns – President & COO

The positioning is very short term; I think in fact the duration of our portfolio in the so-called international money market which is basically U.S. dollar book, is very short, and it is basically following our anticipation that the U.S. interest rate will start or begin to increase shortly, possibly as soon as at the end of June. And traditionally we have had a relatively large international money market book compared to our competitors. But it is as I mentioned many times over several quarters very short duration in nature. And the cycle where it is in a bearish environment it would probably average three to four months' duration. And in the bullish environment it could be as long as nine to ten months. And we've been able to manage that risk very effectively and profitably over several years.

Ian De Verteuil - BMO Nesbitt Burns - Analayst

So the goal here is to take a little extra spread out even though you believe the rates over the next year or so are going higher?

Yvan Bourdeau – BMO Nesbitt Burns – President & COO

What I was saying is in our existing book is very well-positioned, Ian. The question mark and I certainly don't have the answer, is the pace at which the Fed will increase interest rates and when it will start. If the economists and most of them seem to have a similar opinion are anticipating a measured increase of interest rate over the last, the next eighteen months and let's say a 25 basis point at each Fed meeting, that is not a very conducive environment for us to actually put assets on the books. But if we were to be in an environment like in 1994 were the Fed moved very quickly close to 300 points within one year, then the yield curve steepened rapidly, and then you have the opportunity to put assets on the books that would become then profitable and the risk reward is warranted.

Ian De Verteuil - BMO Nesbitt Burns - Analayst

The second question is for Frank, and it relates I guess it's a follow-up on Heather's question. Slide 15 in Karen's presentation she gives volumes and Canada and the U.S. It is hard to -- it is not exactly clear to me what these numbers are showing but it does look as if I understand the residential mortgage volume is being down dramatically in the United States but it's also looks as the deposit volumes are down quite dramatically, as well. Is the bank losing share in the deposit game in Chicagoland?

Frank Techar - Harris Bank - President & CEO

Ian, that's an easy one. I think three quarters ago if you look at this data and what these bars represent are the year-over-year growth for those particular quarters. And you're right, the growth in our deposits has been declining, although it is still positive as of this quarter. A few quarters ago, I mentioned that we have actually taken some management action to manage our net interest margin, in particular with respect to our CD book. We have not been as aggressive in the marketplace with respect to pricing on our CDs, and we've done that very specifically to address the decline in margin. So our deposits are not growing as quickly. Now you can look at that as bad news. We kind of look at it as good news because net-net, our revenue is better off because of it. And also because the CD book is a book that you can manage very quickly in the marketplace, and if we change our pricing philosophy in the future we think volumes will improve rapidly.

The other point to keep in mind if you look under these numbers is our core deposits, which we would characterize as checking accounts, savings accounts and low interest deposit accounts, are growing at in excess of 10 percent. And that growth rate has been very consistent over a quarterly pattern. So the higher yielding deposit categories we are very comfortable with the growth on, and we are sacrificing a bit of overall growth to manage our margins during these past few quarters.

Ian De Verteuil - BMO Nesbitt Burns - Analayst

Thank you. That's very helpful.

Operator

Quentin Broad.

Quentin Broad - CIBC World Markets - Analyst

Nice results. I just want to follow-up on one of Ian’s questions in terms of the risk profile, I want to make sure I understood. If there is a rapidly rising rate environment in the U.S. you are suggesting that you are poorly positioned for that but better positioned for a measured rate hike.

Karen Maidment - Bank of Montreal - CFO & EVP

First of all at the structural balance sheet for the bank, regardless of what happens with rates we are well-positioned, and the impact is minimal on the P&L. What Yvan is talking about is the international money market portfolio, which is very short-term portfolio. Maybe he can add some more color to that.

Yvan Bourdeau – BMO Nesbitt Burns – President & COO

So, Quentin, what I was saying is the existing book is very well-positioned. We have not started to redeploy the assets. And moving forward, because we are not satisfied that the risk reward exists at this point in time for us to do so. And the big question in our mind is if there will be an environment where interest rate will move in a measured way then it's very difficult to maintain in a bearish market a short term duration when every six weeks you have an increase in interest rate by 25 basis points. So most likely we will not be losing money, but it could be an opportunity cost to us because we will not have as much asset deployed under that scenario.

Under a very rapidly increasing interest rate environment, then suddenly the market will react quickly and adjust the yield curve in the futures market and that could be more conducive for us to deploy assets at that point in time in order to get a steeper yield curve and, therefore, a high-risk carry. That is basically what I was saying.

Quentin Broad - CIBC World Markets - Analyst

In 94, which is where you referenced, we flattened out the yield curve, correct, on the short end?

Yvan Bourdeau – BMO Nesbitt Burns – President & COO

Yes. So my point is maybe for six months or so, you will not deploy assets, but at one point in time the yield curve will change shape and you will be in a position to redeploy an asset at a profitable level.

Quentin Broad - CIBC World Markets - Analyst

Secondly, Karen, just on the credit card -- what looks like contra revenue, is this a onetime expectation, or are we to expect given the utilization levels or the success if you will of AIR MILES that this will be a lower going rate of revenue?

Karen Maidment - Bank of Montreal - CFO & EVP

This is a revision of an estimate based on an increasing amount of usage or redemption by customers. Going forward based on if the current redemption rates continue, it will reduce the card revenue by about 5 million a quarter going forward.

Quentin Broad - CIBC World Markets - Analyst

5 million from the previous run rate?

Karen Maidment - Bank of Montreal - CFO & EVP

Right.

Quentin Broad - CIBC World Markets - Analyst

On the loan growth it actually looks pretty decent sequentially in the P&C and even in the wholesale if I look at wholesale loans and acceptances, a 9 percent sequential growth. So wondering given the commentary to Michael's question that it still sounds a little bearish or we start seeing borrowers back. It looks like you're still getting some drawdowns.

Robert Pearce – Bank of Montreal – President & CEO, Personal & Commercial Client Group

Well certainly in the P&C environment the commercial loan growth has been a struggle for us. We are getting drawdowns but you are getting paydowns, plus you are not getting any increase uses of operating lines. So year-over-year our balances are up about 3 percent. What's driving most of our asset growth is on the consumer side. Where we've had strong growth mortgages and in consumer lending. And the card business has picked up somewhat. So that has all been very good. But basically sales overall, and particularly on the personal side, sales of new mortgages and new consumer loans have been very, very good.

Quentin Broad - CIBC World Markets - Analyst

Do you see any change to that near-term or the next 6 to 12 months?

Robert Pearce – Bank of Montreal – President & CEO, Personal & Commercial Client Group

Well, the mortgage market in this country has been very strong for a long time. I think it would have surpassed most of our estimates at this stage, but it continues to be very strong. And sales last month were very, very good for us. So it continues to chug along. I think if interest rates move up, it's going to choke it off at some stage, but I think for now the market is pretty good, and it is showing in our consumer lending and mortgage growth.

Tony Comper - Bank of Montreal - President & CEO

Now there is a long way to go for interest rates to choke off demand. I mean at this level of interest rates, it should come as absolutely zero surprise to anybody why the housing market is so strong. And as I said, you could have a fairly significant increase in interest rates without doing serious damage to the consumer P&L, if I can characterize it that way.

Quentin Broad - CIBC World Markets - Analyst

Great, thank you.

Operator

Susan Cohen, please go ahead.

Susan Cohen - Dundee Securities - Analyst

For the past few quarters your underwriting and advisory fees revenues have been growing very nicely. What is your pipeline looking like going into the third quarter?

Yvan Bourdeau – BMO Nesbitt Burns – President & COO

Yes, the primary source of increase was primarily from the equities market, but also from the debt market. At this point in time there is no reason to believe that equities market will slow down. We feel that there is a pipeline is strong and we are working on several transactions. The debt market is somewhat a bit weaker than it was in the last two or three months, but it is still a reasonable pipeline. So the real question mark that we have looking forward is there still some question marks as to how our clients will react to the potential increase in interest rates, for instance, the potential impact of the price of oil, that is at a very high point and also we have to look into the fact that there are some tension that exists on the geopolitical front. So all these three clouds are somewhat concern on our parts but assuming that our clients are reacting positively to all of them, we should have a reasonable pipeline moving forward.

Susan Cohen - Dundee Securities - Analyst

Perhaps a second question, if I may. Just on the Chicagoland area. Given the consolidation that is happening in that marketplace are you noticing some differences in the market, and are you noticing some competitors becoming more intense?

Frank Techar - Harris Bank - President & CEO

Susan, at this point in time, I think where we are is the news is just as bad as it was a year ago. It is a competitive marketplace. The consolidation at this point and in particular the Banc One, J.P. Morgan deal has not had an impact in the market. We are fighting the deposit price war on a daily basis, and quite frankly I am not sure how much lower it can go or if it can go any lower. There is plenty of competitors, and we all know what we're doing. So my expectation is from a price perspective we're not going to see much more in the way of competition. We could see flurries of advertising that will affect our business and affect activity. But we've seen that in the past, as well. So we are kind of looking at the future as sort of business as usual at this point in time.

Susan Cohen - Dundee Securities - Analyst

Thank you very much.

Operator

Jim Bantis.

Jim Bantis - CSFB - Analyst

Just to follow back on Susan's question regarding the advisory fees, Yvan could you be a little bit more specific regarding the backlog in terms of equity underwriting IPO and M&A? Is it stronger coming out of the quarter than it was in the quarter? Is the size, the backlog or pipeline increased, and has there been any fruits been there from the Gerard Klauer acquisition to date? Thanks very much.

Yvan Bourdeau – BMO Nesbitt Burns – President & COO

So first of all, I would like to as I was mentioning earlier, the momentum is not as strong as it was when we entered Q2. There's no question about that. By the same token, there is an ongoing basis single, what I would call single transaction, around the income trust side or secondary issues that are coming through. And the pipeline is reflective of that and therefore that was basically what I was mentioning earlier. I believe if the environment remains conducive we should be able to continue to have a very reasonable pipeline on the equity front, as well as on the debt side.

The M&A somehow has been slower in the last two quarters and in fact the latter part of our '03. And there is less sign there that activities are actually picking up. But we've had enough inequity from them to end on the debt side to compensate for the slow down on the M&A.

Jim Bantis - CSFB - Analyst

Great. Thank you, and in regards to the U.S. operations?

Yvan Bourdeau – BMO Nesbitt Burns – President & COO

JKM is actually performing better than planned. As of last weekend, we have moved them entirely in our premises in New York City. The integration of the coverage is taking place. We made an announcement two weeks ago whereby we have integrated all of their bankers with our bankers, and we've sorted out all of the clients and we have been able to generate some introduction to them from our lending clients that used to be with Harris Nesbitt Midwest. So, therefore, all the funds are very positive and as I was saying earlier, after two quarters really that they are under our belt, they are ahead of our business plan that we had submitted when we actually purchased them.

Operator

Jamie Keating.

Jamie Keating - RBC Capital Markets - Analyst

This may be for Rob on domestic margins again. And I'm curious Karen's comments I believe were that half the spread compressions related to -- as we used to call primary spread compression, can you describe where you see rates being that would alleviate that pressure and pick up spot on the curve, or describe it how you want. Is there a level at which we need to get back up to where that kind of dissipates altogether?

Robert Pearce – Bank of Montreal – President & CEO, Personal & Commercial Client Group

Jamie, I think what we're feeling the affect of right now is the fall in interest rates since last summer, so interest rates are down roughly 125 basis points, the Bank of Canada rates down since last summer and that is causing the compression. Just if the bank in Canada rates stops falling which virtually every economist is now predicting, that will play itself out two quarters from now. So that is the main part of the impact. The rest of the -- that is roughly half the impact of the declining margin. The other is what we call mix in competitive pressures, and those will continue. So our view going forward, as I mentioned earlier, is in the current interest rate environment margins will continue to decline somewhat but not nearly at the levels of decline that we have absorbed in the first half of this year. And if rates were to move up, margins would probably stabilize and it would take some time for margins to increase again, Jamie, would be our view looking forward.

Jamie Keating - RBC Capital Markets - Analyst

Rob, if I could follow up as well slide 12, Karen has that Canadian and domestic market shares. In the SBB slipped a little bit, I believe if I described that right or whatever the small business is, in the personal loans seem to be falling a lot, too, on a market share basis. Does that concern you, or can you describe the dynamics there?

Robert Pearce – Bank of Montreal – President & CEO, Personal & Commercial Client Group

Yes, the slight fall on the SBB line, on our small business banking line is totally explainable by an adjustment one of our competitors have made. They have shifted a loss of personal loans that our business for self from their personal portfolio into their commercial portfolio. If you were to normalize for that that number of 1923 would actually, which is a five basis point decline from the previous quarter, would actually be up, Jamie. So as I have said every time we get into these numbers there's always noise in them. The noise this quarter was one of our competitors has moved a significant portion of their portfolio from their personal lending book to the commercial lending book, which has caused noise there.

Share overall is pretty solid across the personal banking products with a decline in the personal lending side. The personal lending share numbers has been troubling us for a while. The encouraging front, though, is that sales are up at levels that we haven't seen, so we are showing very, very good sales right now. And I would expect that you would see at least a stabilization of that share number going forward, all things being equal, Jamie, by sales alone.

Jamie Keating - RBC Capital Markets - Analyst

Is that business collateralized lending as well as non?

Robert Pearce – Bank of Montreal – President & CEO, Personal & Commercial Client Group

Yes, it is Jamie. That would be everything from fixed-rate secure terms loans into secure lines of credit, into unsecured lines of credit. So it is the whole gamut, car loans, loans against homes, both term loans and revolving loans.

Jamie Keating - RBC Capital Markets - Analyst

One last quickie, on the personal deposit side the growth rates picked up substantially in the quarter. Can you describe how much is term versus a core or non-term?

Robert Pearce – Bank of Montreal – President & CEO, Personal & Commercial Client Group

All of the term book the way we do the accounting is actually on Gilles' books, so this is on the personal deposit side, is all what we call retail operating deposits which are checking accounts and savings accounts.

Jamie Keating - RBC Capital Markets - Analyst

Thanks very much, Rob.

Operator

Michael Goldberg.

Michael Goldberg - Desjardins Securities - Analyst

On the investment gains that you talked about in the quarter, virtually all of it was in the fixed income area. In the meantime unrealized equity gains have moved higher. Could you give us some idea of your thinking regarding timing on realization of these gains?

Karen Maidment - Bank of Montreal - CFO & EVP

We don't have any specific plans around realization. You are correct. The unrealized balance has grown. When we -- the sales, the realizations that occurred this quarter as I indicated were in two buckets. One was the non-relationship portfolio that the IBG group manages and they are trying to work down as quickly as they can with market conditions exist. They then may speak to that further. The other half was in the U.S. just as we manage our structural balance sheet, and that is something that you can't really predict the timing of when we would realize gains there. Yvan, do you want to talk about the non-relationship?

Yvan Bourdeau – BMO Nesbitt Burns – President & COO

I think Michael you are aware for several years we have identified so-called suboptimal assets, and we have classified them into general buckets. One was loans that were suboptimal and the other one was fixed income instruments, that we call mid-rate bonds. In both cases we've been diligently eliminating or suboptimal asset whenever we could; other than when they were maturing at their natural maturity date or if there was an opportunity in the marketplace where we could eliminate those assets from our balance sheet. In the last quarter it was a very conducive environment for us, given the narrowing of the spreads to eliminate some of our mid-grade bonds and then basically on a flat basis as Karen was explaining, the gain were actually slightly greater than the cost of unwinding swap that we are funding those mid-rate bonds. So we are doing that on an ongoing basis. We manage them, and we think the loan portfolio that is down to in Canadian dollar terms, the risk-weighted assets terms about 1.3 billion should be off our book over the next two years. In the case of the bond because the bond duration is slightly longer we have about one billion in Canadian dollar risk-weighted assets, and now we think that will be over the next 3 to 3.5 years.

Michael Goldberg - Desjardins Securities - Analyst

Thank you.

Operator

Quentin Broad.

Quentin Broad - CIBC World Markets - Analyst

One to Karen if there has been any excess spending activity in the quarter that you talked about previously in terms of spending for the future? And secondly, I guess just for Tony in terms of capital positions obviously the bank still has a strong unrealized gain position. You have got a negative net impaired loan position for the first time since 2000. And you got the very strong Tier 1 capital ratio, so can you update us just in terms of your thinking on utilization of capital and the strong internals that you are generating being through acquisitions, dividends, buybacks and how you're going to manage that, given how good things are on your capital box today?

Tony Comper – Bank of Montreal – President & CEO

The first question I think was for Karen.

Karen Maidment - Bank of Montreal - CFO & EVP

There was really no significant investment type spending this quarter. We will keep looking at it. We are trying to manage the relationship between revenue expenses, and as we look at the balance of the year, if we do have room we could find ourselves reinvesting some of it. But in this quarter we haven't (multiple speakers) material amount.

Tony Comper - Bank of Montreal - President & CEO

In that context though keep in mind that our operating plan includes a fairly significant ongoing component of discretionary expenses both in expenses and in capital. And so we are maintaining that rate. We may slow that down to get the right ratio between the expenses between the revenues from time to time. But already provided for in our run rate is a fairly significant chunk of "discretionary" or investment expenses is another way of putting it.

Karen Maidment - Bank of Montreal - CFO & EVP

That's correct.

Tony Comper - Bank of Montreal – President & CEO

Second thing of which is you actually hit on all the points on capital management.

We kind of think about it as the first draw on the capital would be to support growth, both organic growth in our businesses, and right now with the underutilization of the corporate lines in both the U.S. and Canada, we are at a lower level of risk weighted assets than we would have anticipated when we put our plans together and if that starts to turn around that will do that. And the second one of which is the pattern of acquisitions that you have seen us make, primarily at this point in time focus on retail and commercial banking assets in the greater Chicagoland of Illinois, kind of environment is point number two. And then point number three, our overall abiding philosophy is capital that we do not need to support those two business initiatives we will look at the other levers, i.e. our dividend policy, our share buyback policy, as other means of keeping that capital ratio healthy but in line.

Susan Payne – Bank of Montreal – SVP of IR

Thank you for joining us today. If you have further questions please either call Investor Relations at 416-867-6656 or email us at BMO.com/Investor Relations. Thank you, and good afternoon.

Operator

This concludes today's conference call. Please disconnect your lines, and have a nice day.