BMO Financial Group

Q3 2004 CONFERENCE CALL

CORPORATE PARTICIPANTS

Susan Payne
Bank of Montreal – SVP, IR

Tony Comper
Bank of Montreal - President and CEO

Karen Maidment
Bank of Montreal - CFO and EVP

Bob McGlashan
Bank of Montreal – EVP, Head of Corporate Risk Management, Enterprise Risk and Portfolio Management

Rob Pearce
Bank of Montreal - President and CEO Personal & Commercial Client Group

Frank Techar
Bank of Montreal - President and CEO Harris

Yvan Bourdeau
BMO Nesbitt Burns, Investment Banking – President & CEO

Bill Downe
Bank of Montreal - Deputy Chair

Gilles Ouellette
Bank of Montreal - President and CEO Private Client Group

CONFERENCE CALL PARTICIPANTS

Jamie Keating
RBC Capital Markets - Analyst

Jim Bantis
CSFB - Analyst

Susan Cohen
Dundee Securities - Analyst

Rafael Bello
Smith Barney - Analyst

Robert Wessel
National Bank Financial - Analyst

Steve Cawley
TD Newcrest - Analyst

Ian De Verteuil
BMO Nesbitt Burns - Analyst

Michael Goldberg
Desjardins Securities - Analyst

Quentin Broad
CIBC World Markets - Analyst

Darko Mihelic
First Associates - Analyst

PRESENTATION

Operator

Welcome to the BMO financial group's third-quarter 2004 conference call for August 24, 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, IR

Good afternoon, everyone. This afternoon's brief overview of our third quarter results will be provided by Tony Comper, President and CEO; Karen Maidment, our CFO; and Bob McGlashan from Risk Management.

After Bob's presentation the following members of the management committee will also be available to answer your questions -- Bill Downe, Deputy Chair; Ron Rogers, Deputy Chair; Yvan Bourdeau, Investment Banking; Frank Techar of the Harris Bank; Ron Pierce form the Personal and Commercial Client Group in Canada; from the Private Client Group, Gilles Ouellette; and Lloyd Darlington, who heads up Technology & Solutions and 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 and CEO

Thanks, Susan, and good afternoon, everyone. BMO's results in the third quarter were strong and broadly based, as all 3 operating groups contributed to net income of $654 million. That is a 30 percent increase year-over-year, and the return on equity reached 21 percent as BMO continued to benefit from superior asset quality.

The key drivers of earnings growth were a $200 million improvement in credit performance, volume based revenue growth, and cost-containment. At this point in the credit cycle, we are reaping the benefits of a very effective credit management; and Bob McGlashan will talk more about this shortly.

The financial performance so far this year positions us well to achieve or exceed all of our annual financial targets. With 36 percent growth in earnings per share for the year to date we anticipate finishing the year well above the target of 10 to 15 percent. With a year-to-date annualized return on equity of 20 percent, we anticipate exceeding the annual target of 16 to 18 percent. With a provision for credit losses at $30 million for the year-to-date, before the reduction of $120 million of general allowance, we now anticipate a specific provision of $100 million or less in fiscal 2004 compared with the annual target of $500 million or less and our most recent estimate of $300 million or less.

Progress in improving the cash productivity ratio slowed this quarter as weaker market conditions affected operating performance in both of the Investment Banking and the Private Client Groups. However, with a 220 basis point improvement for the year-to-date, we anticipate achieving our annual target of 150 to 200 basis points. As a key driver to enhanced shareholder value, productivity continues to be our number 1 priority, and we will take all the steps necessary to regain momentum.

At BMO we effectively manage our capital through a combination of organic growth, acquisitions, dividends, and share buyback, taking a balanced approach to delivering strong short-term returns for shareholders while investing in the organic growth and acquisitions that will lead to higher future returns. As a result, we're confident that we are well positioned competitively from a capital management perspective. Our Tier 1 ratio now stands at 9.44 percent. That is well above the regulatory requirement, but it's not as high as some of our peers.

My team's confidence in the sustainability of earnings growth at BMO is reflected in the announcement today of a 10 percent increase in our quarterly dividend to 44 cents a share. This is our second dividend increase this year, for a total dividend increase of 26 percent. And as another part of our effective capital management program, we recently announced a new share buyback program to repurchase up to 15 million common shares.

In addition to our number 1 priority, our number 1 strategic priority to improve productivity, we continue to work hard to improve the performance of our U.S. operations, which this quarter benefited from excellent credit performance, volume increases in retail and business banking, and the recent acquisitions. This was offset by weaker market conditions that affected both of the Private Client Group and the Investment Banking Groups.

Part of our effort to increase the reach and profitability of our U.S. businesses, Chicagoland banking completed the acquisition of New Lenox State Bank on June 1, adding 8 new locations and bringing our U.S. branch count to 163. With 5 more full-service branches scheduled to open in the fourth quarter, we anticipate having 168 locations at the end of the year, and there's more work to be done as we continue to focus on improving the profitability of all of our U.S. businesses.

Overall we remain committed to our enterprise growth strategy of strengthening our broadbased Canadian franchise while improving and selectively expanding our U.S. franchise. We continue our active search for U.S. retail acquisitions in the Chicago area, Illinois more broadly, and the surrounding states, targeting digestible bolt-on properties roughly in the size range of the properties that we have acquired over the past several years.

In conclusion, I would simply note that BMO's 3-year total shareholder return is 14 percent and the 5-year return is 18.7 percent. We believe that this is the result of BMO's track record for delivering rising earnings for 9 consecutive quarters as we move closer to our goal of becoming a top-performing financial services organization.

This consistency demonstrates the effectiveness, I believe, of our low-risk, high-return management philosophy and provides solid proof that our more focused and disciplined approach to both strategy and to execution is producing the intended payback for our shareholders. Karen, over to you.

Karen Maidment - Bank of Montreal - CFO and EVP

Thanks, Tony. As Tony indicated, we had record earnings of $654 million this quarter, primarily due to strong credit performing, but earnings are also up in all of our operating groups year-over-year. If we adjust for the provision for credit losses and use a consistent tax rate, our cash EPS is up 5 percent. On a quarter-over-quarter basis, revenue was lower in IBG and PCG, as expected due to weaker capital markets. But P&C in both Canada and the U.S. showed strong growth.

I'd like to draw your attention to an accounting issue regarding our provisioning methodology. In the quarter IBG benefited from a $39 million reduction in its provision for credit losses on a recovery on a loan that was previously written off in 2001. Under our current expected loss methodology, we charge expected losses to businesses and true it up in the corporate area, which is the difference between these charges and the provisions required under Generally Accepted Accounting Principles. As the charge was previously booked to IBG in 2001, the recovery was recorded there this quarter. This was an unusual situation, and we would not expect it to reoccur. This one large recovery plus interest recovered on this loan added 59 million pretax to IBG's earnings this quarter or 38 million after-tax.

Going back to the quarter, net income at 654 million is up 30 percent over last year and 9 percent over the second quarter; and our return on equity for the quarter was 21 percent. The $110 million of net recovery of credit losses consisted of 70 million net recovery of specific losses and 40 million reduction of the general allowance. The specific recovery relates to the reduction of previously established allowances and recoveries on loans previously written off, and includes one large amount, which I just described. We now anticipate the specific provisions for 2004 to be 100 million or less.

Our Tier 1 capital ratio remains strong at 9.44 percent. The ratio is down quarter over quarter due in part to an increase in risk-weighted assets, with notable growth in personal and commercial, including the completion of our acquisition of New Lenox State Bank on June 1, as well as dividend payments and ongoing share repurchases. Offsetting these decreases was the net income for the quarter, and all of these elements are part of our active capital management program, as Tony described.

Our cash productivity ratio, one of the key areas of focus, has improved 20 basis points year-over-year, but declined 20 basis points quarter-over-quarter.

Turning to slide 4, you can see the change in cash EPS compared to the second quarter of this year and the third quarter of last year. Quarter-over-quarter, the change in cash EPS was 10 cents. The decline in business growth in IBG and PCG was more than offset by favorable credit performance. Year-over-year the change in cash EPS was 28 cents, with over three-quarters of the growth due to the reduction of the general allowance this quarter, combined with lower specific provisions for credit losses. Business growth contributed 7 cents to EPS, and strong volume growth in P&C banking was partially offset by lower origination fees and trading revenue in IBG and PCG.

Turning to revenue growth on slide 5, you can see improvement in P&C revenue was more than offset by the lower revenue on the IBG and PCG as capital markets were down from a very strong second quarter. So as you can see, core business growth is therefore down 2.7 percent quarter-over-quarter. Year-over-year business growth of 3.8 percent resulted from higher revenues across all of our operating groups. And the combined effect of foreign exchange and acquisitions had a minimal impact on a revenue growth, both on a year-over-year and a linked-quarter basis.

On slide 6 you can see that we have achieved strong revenue growth on a year-to-date basis at 6.4 percent, with 6.9 percent from core business growth.

On slide 7 you will see net interest margins on a total bank basis, and they've increased both quarter-over-quarter and year-over-year. Year-over-year the net interest margin is up 8 basis points. The decrease in P&C Canada is due to changes in consumer product preferences and the competitive low rate environment; while the decline in P&C U.S. is the result of adding assets with positive profit contribution but lower spread, and changes in the balance sheet mix.

These decreases were offset by an increase in IBG's margin, which reflects interest collections on loans that were previously impaired or written off, including $20 million on a single account. The increase in IBG's net interest margin quarter-over-quarter includes the 6 million or 6 basis point impact of interest collections described above; a reduction of lower spread trading related to assets; combined with the $44 million charge in Q2 for the unwinding of the interest rate hedges.

Slide 8 illustrates our strong operating expense management. Total expenses are down 2 percent over the linked quarter. The decline in performance-based compensation is largely in IBG and Private Client, which is related to the slowing of capital markets activities and slower revenues. When we compare to last year, our expenses are up, driven primarily by the higher variable compensation.

Turning to slide 11, you can see the total bank cash productivity ratio has slowed slightly quarter-over-quarter, but improved slightly year-over-year. Our year-to-date cash productivity has improved 220 basis points. If we maintain or slightly exceed the year-to-date level of 62.8 percent, we will achieve our target of 150 to 200 basis point reduction for the year. If we have flat revenue growth in the fourth quarter with similar expense growth, we would still achieve our cash productivity improvement target of 150 basis points. And to the extent revenue growth exceeds expense growth, there is potential upside. For the year this equates to about 3 percent revenue to expense differential.

I'd like to wrap up on slide 12, which shows our performance against the fiscal 2004 targets. Our strong results year-to-date make us confident that we will achieve or exceed all of our targets, which we established at the beginning of the year. We anticipate both EPS and ROE will surpass our annual targets. Based on the strength of the credit performance in the first 3 quarters of the year and where we are in the credit cycle, as I said earlier we now expect specific provision for credit losses to be 100 million or less for the year.

Clearly we are unable to predict loan recoveries. However, if you assume that our annual provision ends up at the high end of the range or 100 million, the impact would be a reduction of 18 cents from our Q3 EPS. If the provision ends up at the lower end or ends up at 30, with a PCL of zero for the fourth quarter that reduction is cut in half to 9 cents. Over to you, Bob.

Bob McGlashan - Bank of Montreal - EVP

Thanks, Karen. Good afternoon everyone. Today I have a very short presentation with 3 main messages. First, we remain in a stable to improving part of the credit cycle and a continued reduction in both impaired loans and impaired loan formations demonstrate continued improvement in the credit quality of our loan book.

On slide 3, this is further evidenced by a total PCL recovery of $110 million for the quarter, including a $40 million reduction of the general allowance.

Slide 4 shows a trend of declining new reservations and strong reversals and recoveries. As we've mentioned to you in the past, the strategic approach within our loan workout units of value maximization from working through these transactions over time is producing these strong results, consistent this part of the cycle. Reversals and recoveries are difficult to predict for any given quarter, though, and our third quarter benefited from two particularly large accounts which totaled $52 million, one of which for 39 that Karen has already referenced. The new reservations came almost entirely from our consumer and commercial portfolios, which continue to be relatively stable over time.

Second, we now expect our annual specific provisions for credit losses, excluding reversals of the general allowance, to be $100 million or less for fiscal 2004, the lowest since 1998. And finally, our trading and underwriting performance has been stable, with only one day during the quarter with a negative P&L of less than $3 million. With that, operator, we can now go to questions.

QUESTION AND ANSWER

Operator

(OPERATOR INSTRUCTIONS) Jamie Keating.

Jamie Keating - RBC Capital Markets - Analyst

Well done, everyone. I wondered if we could get a little more detail on the two accounts, maybe just geography and/or business lines for those. I'm also curious about the noncore commercial assistance. I think that was the reference that was given for the improvement in NII for the retail business. I wondered if you can just elucidate on that a bit, Karen, or whoever wants to.

And may be for Tony, if I could just ask broadly; the earnings base we're setting up in '04 on the face of it looks like a tough earnings base to grow 10 percent off in '05. So I would I guess appreciate your thoughts on what level of normalization might be appropriate here, to think ahead to '05, in terms of how much earnings growth might be targeted.

For example, I think Karen mentioned 5 percent implied growth underlying excluding a lot of the benefit of all of these recoveries and reversals. And maybe she is pointing us towards what would be the number that should be beatable by a target basis in '05, for example.

Tony Comper - Bank of Montreal - President and CEO

I will start, Jamie, then I will get Bob and Mike to talk about the credit situation. On the earnings, as you know we will be coming out in the fourth quarter with our targets for next year, and so I'm not really in a position that I would want to talk about our looking at that right now, Jamie. We are just going through the business planning cycle; and when we have our fourth-quarter call that's when we will be trueing up what we are expecting and what our targets will be for next year. But you make a good point, and we will look at that. We are right in the middle of our business planning cycle right now. Bob?

Bob McGlashan - Bank of Montreal - EVP

With respect to the accounts, Jamie, one was in the power generation sector, and the other in the food-processing sector, both of which were in the U.S. One a reversal for 13 million; and the other a recovery of a previously written off amount for $39 million.

Jamie Keating - RBC Capital Markets - Analyst

Terrific. Thanks.

Tony Comper - Bank of Montreal - President and CEO

Rob Pearce, do you want to deal with Jamie's other question?

Rob Pearce - Bank of Montreal - President and CEO Personal & Commercial Client Group

Yes, just on the improvement in our margin, we were down -- in P&C Canada we were down 7 basis points Q3 this year versus Q3 last year, but up 4 points on a linked-quarter basis. That increase in the linked-quarter basis was due particularly to the collection of some penalty interest on some mortgage payouts and some small equity gains in part of our venture capital portfolio. That basically accounted for all of the increase on a linked-quarter basis.

But the good news is that margins were down -- Q1 over Q1 were down 20 points; were down 19 points Q2 over Q2; and even on a normalized basis would have been down 10 or 11. So the anticipated slowing of the rate of decline of our margin has proven out in the third quarter.

Jamie Keating - RBC Capital Markets - Analyst

Well done. Thanks, Rob. Appreciate it, everyone.

Operator

Jim Bantis.

Jim Bantis - CSFB - Analyst

Just looking at the very strong asset growth coming out of the retail network on page 6 of your slide, roughly just under 4 billion. Could you break that up between the organic growth and the addition coming from New Lenox in the U.S.?

And regarding the organic growth in Canada, maybe we can tie that into some of your discussion in the MD&A, referring to the market share declines. I guess what I am just trying to figure out -- we have seen some nice asset growth, but is the bank standing still relative to its peers, or is it gaining some ground? Thank you.

Tony Comper - Bank of Montreal - President and CEO

I will get Rob to handle the first part of that; then I'll get Frank to comment on the contribution of the New Lenox, although I think it is de minimus is my observation. But Rob, go ahead.

Rob Pearce - Bank of Montreal - President and CEO Personal & Commercial Client Group

A couple things. On the balance sheet side in Canada we've had pretty strong momentum. In other words we have been increasing at an increasing rate of gain across most of our productlines for the last number of quarters. You just see that playing out in the third quarter.

We had good mortgage growth, we had good deposit growth, those types of things. About the only area that we haven't really got strong momentum in is the commercial loan book, which has been growing at 2 or 3 percent now for the last number of quarters. But the good news is that we have seen an improvement in market share on the commercial loan side. It bumped up this quarter. We are up 8 points. And we also saw a nice 10 basis point increase in the personal loan share this quarter, which was also good news.

We saw a little bit of decline on the deposit side, at least in the personal deposit business. The commercial deposit business market share is a little more difficult. We have had some large growth there. But on the personal side we saw a little bit of decline this quarter. Worried about it a little bit; not quite sure what to make of it. But clearly a competitive environment for the deposit business, both in the checking account and savings accounts business. But overall pretty good momentum, and we've had some nice share bump.

Tony Comper - Bank of Montreal - President and CEO

Karen, do you want to talk about the New Lenox?

Karen Maidment - Bank of Montreal - CFO and EVP

Sure. In the financial statements that are attached to the press release, you will see in note 4 a breakdown of the assets that were acquired with New Lenox. You can see the total assets were 1.5 billion Canadian and a purchase price of just over 300 million Canadian. The impact on the P&L is de minimus, because it closed June 1. So the breakdown is on that note 4 of the press release, the financial statements.

Tony Comper - Bank of Montreal - President and CEO

Frank, do you want to add anything to that?

Frank Techar - Bank of Montreal - President and CEO Harris Bank

Jim, I would just point you to the slides. I think they're page 15 and 16 in the deck, where we show the breakdown of the growth in the Canadian business and the U.S. business. You can see for all of the asset categories and the liability categories in this quarter there was a little bit of a bump. And that bump was due to one month of New Lenox plus a full quarter of Lakeland.

But my overall comment would be the very strong asset growth that we've seen through the first 2 quarters ex-acquisition have continued, both on the personal side and on the commercial side here in the U.S. So we are seeing the benefit of the acquisitions on top of continued strong growth in home equities, in autos, and also on the commercial side of the business.

Jim Bantis - CSFB - Analyst

That is very helpful. Thanks very much.

Operator

Susan Cohen.

Susan Cohen - Dundee Securities - Analyst

You've certainly been releasing general reserves over the past several quarters. How comfortable are you with your level of general reserves right now? And are you comfortable enough to potentially release additional reserves at this point?

And then second question is, can you give us any kind of idea of your pipeline on investment banking at this point, going into the fourth quarter?

Tony Comper - Bank of Montreal - President and CEO

Thanks, Susan. I will get Bob to handle the first question. I'll get Yvan to handle the second one.

Bob McGlashan - Bank of Montreal - EVP

The general reserve methodology that we apply we work through in a very detailed fashion each quarter. At current level we are very comfortable with our general reserve. I couldn't begin to speculate on what it might look like in the fourth quarter, because we really have to wait until the end of that period of time in order to complete our analysis. But to answer the first part of that question, we're very comfortable with the level of our general allowance at this point.

Tony Comper - Bank of Montreal - President and CEO

Yvan, the pipeline for investment banking.

Yvan Bourdeau - BMO Nesbitt Burns, Investment Banking - President & COO

The Pipeline is reasonable and similar to last quarter particularly in the M&A and advisory fee business. However both the debt and equity origination pipeline has slowed down somewhat since the second half of the third quarter. It is difficult to assess at this point in time whether market conditions will improve sufficiently in Q4 to bring the debt and equity origination pipeline to a similar level as in Q2.

Operator

Rafael Bello.

Rafael Bello - Smith Barney - Analyst

Could you please elaborate a bit more on your potential U.S. acquisitions? You mentioned in your presentation aggressively pursuing U.S. acquisitions. You alluded to some of the sizes that you are looking at. But in particular I am a little bit interested in hearing your comments about potentially going outside the Chicago area; and that in the context of the high prices that U.S. banks command these days.

Tony Comper - Bank of Montreal - President and CEO

They are. You are right, Rafael. The prices are high, and they are higher for higher-quality assets. But I think what I would do is I would point you back to the pattern of acquisitions that we have done over the last in particular 2 to 3 years. And they have been primarily -- and I will set aside for a second some of the assets that we have been acquiring in our Private Client Group in the U.S. -- but you've seen us focus on solid retail commercial banking operations in Chicagoland. But as I always say, it takes -- it is one thing to be willing and anxious to make acquisitions. It is another thing for the sellers to be interested to be selling them.

So our team under Frank's direction is kind of actively looking at every single thing that goes on. I think I can fairly say that there hasn't been a transaction in our radar screen that we haven't had a look at. That doesn't mean to say that there is a lot going on. As you've seen, we've been probably the principal acquirer within the Chicagoland area within the last couple of years.

Having said that, we will be opportunistic, and if something pops up that isn't directly in Chicagoland, might be in the broader cachement area of Illinois, let me put it that way, or the surrounding states, we will also take a look at that. We're not going to give up on our financial discipline of making sure that these acquisitions are accretive to cash earnings in a short period of time, which we define as 2 years. And they must generate an internal rate of return of equal to or north of 15 percent. So the pattern that you have seen is what you can expect to see us continue.

Rafael Bello - Smith Barney - Analyst

Yes, thank you. Now just a quick follow-up. Considering the high prices being paid, would you be a seller?

Tony Comper - Bank of Montreal - President and CEO

Would we be a seller? I do not think so. Our whole strategy is to continue to grow the assets that we have, which are performing very well. And I would be disinclined -- when you look at the growth that we've been achieving in the Chicagoland area both organically and through acquisitions, I think this is a good return for our shareholders, given that we're applying the financial discipline I talked about. Frank, do you want to add anything to that?

Frank Techar - Bank of Montreal - President and CEO Harris Bank

No, Tony. I think that covers it.

Operator

Robert Wessel.

Robert Wessel - National Bank Financial - Analyst

I just have a couple of easy ones. The first one is the effective tax rate just ticked up a little bit. Can we look at this and say -- and I know it's hard to forecast the tax rate going forward -- but can we look at this and say this was sort of what a normal run rate may be? Just a little bit on the high side; and stick with maybe what we've seen in previous quarters? That's the first question.

Karen Maidment - Bank of Montreal - CFO and EVP

Tax rate for the quarter was 32.8. It was up a little bit. That is really related to the fact that earnings are up so much in higher tax jurisdictions; and also the effective tax benefits are a little smaller as your earnings rise. I think for the year we are looking at about 32 to 32.5 as being the tax rate that we would expect.

Robert Wessel - National Bank Financial - Analyst

Just one more question. Was Harris Direct in the U.S. profitable this quarter? Or can you give us what its cash earnings were?

Karen Maidment - Bank of Montreal - CFO and EVP

We had cash earnings in PCG of 7 million this quarter, bringing the year-to-date to 27 million, up from flat last year.

Robert Wessel - National Bank Financial - Analyst

That is exclusively the private client?

Karen Maidment - Bank of Montreal - CFO and EVP

That is the private client.

Robert Wessel - National Bank Financial - Analyst

I'm sorry; it is exclusively the discount broker?

Karen Maidment - Bank of Montreal - CFO and EVP

No, that's the Private Client Group in the U.S., which is mainly the discount broker and the private bank.

Robert Wessel - National Bank Financial - Analyst

Okay, would you be so kind as to break out the discount broker?

Karen Maidment - Bank of Montreal - CFO and EVP

We have not broken that out in our disclosure.

Robert Wessel - National Bank Financial - Analyst

great. Thank you very much.

Operator

Steve Cawley.

Steve Cawley - TD Newcrest - Analyst

The question is on credit. Obviously a great quarter on credit, but not really sustainable. In the last 3 years, you have been averaging a PCL rate of about 32 basis points. My question is more or less this. When we start looking backwards in time -- yes, BMO has always been one of the better banks, but do you now have better tools? Do you now have better hedging strategies, more liquidity in some markets? Such that maybe we are getting to a point in time where PCL rates for the industry in general, if it is managed properly, could be a lot lower than what we've seen in the past?

Tony Comper - Bank of Montreal - President and CEO

Robert, do you want to deal with that?

Rob Pearce - Bank of Montreal - President and CEO Personal & Commercial Client Group

I'm afraid the magic is not in tools or market activities, but rather it is a core of how we go about our business. We've mentioned for a long time that we are pretty conservative in terms of the way we approach the marketplace, as well as the provisioning that we apply. So when you look at the loss experience over time, you would expect, in fact, at this part of the cycle and in fact for the last year or so to see relatively improving trend, which is what we've been showing.

So we are not particularly surprised or believing that it is some systemic change to what's going on in the marketplace that is causing these results. But rather our specific approach to the way we manage our portfolio and the clients we deal with.

Steve Cawley - TD Newcrest - Analyst

Separately, I don't think we have the disclosure to go far back on this, but has there been a period where BMO has had this level of recoveries and specific provision allowance reversals?

Bob McGlashan - Bank of Montreal - EVP

I'm having a little trouble coming up with the answer to that specifically, but not that I'm aware of.

Steve Cawley - TD Newcrest - Analyst

So this would be, let's say, the best that we've seen ever?

Bob McGlashan - Bank of Montreal - EVP

Yes; 1998 was very strong year for us in relative terms, but this has been a very, very, very strong year.

Tony Comper - Bank of Montreal - President and CEO

Steve, the further comment on that, just to elaborate -- Bob is absolutely right. We use all the tools that are available today to help us manage the portfolio, but there is a huge amount of judgment and experience in the individual risk underwriters within the credit area that we believe is at the centerpiece of why we do as well as we do.

The second part of that, though, comes to the end of the cycle, which is when you're into working out of the loans and going into the recoveries and the reversals. We've got a particularly skilled team that has done some -- and in this quarter you have seen it, but you have seen it in other quarters as well -- has done an absolutely remarkable job in terms of rehabilitating some of the clients that earlier had some significant difficulties.

Steve Cawley - TD Newcrest - Analyst

You provide us with no sort of metric to follow what the potential recoveries can be. Is there any other information that you can provide us, to give us a sense of where you stand, let's say if you would have had at the beginning of this year a potential pot of recoveries? Are we getting towards the bottom of this pot?

Bob McGlashan - Bank of Montreal - EVP

For starters, we can't quantify a pot, never have been able to, and certainly couldn't today. We anticipate recoveries as we come through this part of the cycle as a result of the efforts Tony was talking about with respect to our work-out units.

But in terms of trying to quantify for you specifically, so how much is left and when can we expect it to arrive? -- it really is not possible for us to do. And the volatility around the timing of this stuff, we know roughly within a cycle where is it going to happen. But quarter by quarter it is really not possible for us to (multiple speakers).

Steve Cawley - TD Newcrest - Analyst

Thanks very much.

Operator

Ian De Verteuil.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

Actually I think it was '97; not '98 you had recoveries in the commercial and corporate. The questions I had related to the NIMs on slide 7. The U.S. NIMs being down. I think, Karen, you had mentioned that they were new assets put on the books that were very profitable but at lower margin. Maybe you could comment on what you meant by that or what those assets are.

Karen Maidment - Bank of Montreal - CFO and EVP

They were securities that were in our structural portfolio that we moved into the Chicagoland business, just debt type securities that have lower margins. But as I said, profitable. That really is what the impact was on this quarter's margin.

Rob Pearce - Bank of Montreal - President and CEO Personal & Commercial Client Group

Maybe I can jump in here just for a minute. These securities were municipal bonds that historically we've held in our corporate portfolio. These are actually relationship assets that were being held in the wrong place, in effect. The municipalities aren't allowed to in most cases take on bank credit, and so they issue bonds and their banks participate in these.

And so we moved them, but we've had them on the books for as long as I can remember. So this was not a market transaction. It was really moving assets out of corporate and into Chicagoland banking. That was the majority of the decline in net interest margin for this quarter.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

That would've been out of IBG into private client (multiple speakers)?

Karen Maidment - Bank of Montreal - CFO and EVP

No. Out of the corporate group, and into P&C U.S.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

The second question on spreads, again on page 7. Rob you had mentioned that there were some penalty gains and I think you said merchant banking gains. If you were to strip those out, what were NIMs in the quarter just sequentially?

Rob Pearce - Bank of Montreal - President and CEO Personal & Commercial Client Group

On a linked-quarter basis we are up about 4 points. Those two items that you raise basically explain that increase. So if you took it out, Q3 over Q3 would have been down around 11, give or take.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

Thank you.

Karen Maidment - Bank of Montreal - CFO and EVP

Ian, when we bring all of these different factors together, we think the sort of sustainable level of the total bank spread is around the 185 to just under 190 level. You will see that last quarter we had the hedge cost that brought it down a little bit. This quarter we have the recoveries that Rob spoke to and the cash collections that took it up a little. So it's around that level on a sustainable basis.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

That is very helpful. Thank you.

Operator

Michael Goldberg.

Michael Goldberg - Desjardins Securities - Analyst

The first question I had is you've had good growth in risk weighted assets in the past couple of quarters, partly due now to the acquisition. Yet at the same time, your tangible and total common equity ratios on risk weighted assets have weakened somewhat. Two questions related to this.

First of all, do you expect the growth to continue or even pick up in risk weighted assets once business loan growth starts to gain some traction? And secondly, what happens to your dividend growth and buyback prospects in that type of condition?

Tony Comper - Bank of Montreal - President and CEO

The answer to the first question is I sure hope so.

Karen Maidment - Bank of Montreal - CFO and EVP

Yes, the risk weighted asset growth, you're right, has been primarily in the personal and commercial in Canada, as well as the acquisitions in Chicagoland this quarter. We anticipate, as we go into the next year, that more risk-weighted assets will be deployed into the U.S. market to support the mid market lending activities.

And that is really our first draw on our capital, is to deploy it in the operations through organic growth, through acquisitions. And then the dividend and the share buyback are the other elements of the capital plan.

I think this quarter is pretty illustrative of the way we are approaching capital, because if you look at our Tier 1 ratio, the beginning of the quarter it was 9.67; at the end of the quarter it was 9.44. 48 basis points would have been an increase due to net income, and we used 26 basis points for higher risk-weighted assets. We used 16 basis points for dividends, and 13 basis points to support the acquisition in the U.S. So you can see that we are managing the capital I think pretty effectively and consistent with the strategy.

Michael Goldberg - Desjardins Securities - Analyst

Okay. I had one other question. You're investigating the restructuring of securitization vehicles and related hedge accounting in order to meet nonconsolidation criteria for next year. Do these items get included in risk-weighted assets? And if so, how much do they add? And would they end up being reduced or excluded if you can do that restructuring?

Karen Maidment - Bank of Montreal - CFO and EVP

No, we are still looking at the restructuring. We've got some disclosure on the notes to the financial statements, in the discussion of U.S. GAAP. But it's pretty hard to predict at this point. In time our expectation is that we will have them restructured.

Michael Goldberg - Desjardins Securities - Analyst

Do they get included now in risk-weighted assets?

Karen Maidment - Bank of Montreal - CFO and EVP

Off-balance sheet. To the extent off balance sheet vehicles are counted there is a different ratio; but that's how they would be included. They are not included as a consolidated asset.

Michael Goldberg - Desjardins Securities - Analyst

Okay. I will re-queue.

Operator

(OPERATOR INSTRUCTIONS) Quentin Broad.

Quentin Broad - CIBC World Markets - Analyst

A couple of questions intertwined for Bob McGlashan. Just in terms of the credit, Bob, my takeaway from the PCL levels, if we allocated out some of the recoveries -- that we are running still a normalized credit cycle of about 480 million, ex of what goes through corporate.

Then secondly just on this whole recovery issue, if I look back in time I think Ian was right. We had probably the highest recoveries in '97; I think it was about 160 million, which was a fairly lengthy delay off the back of when you took the big hits in the very early '90s; versus here it seems that we are getting an accelerated recovery. Is that what is going on?

And is it because of just the market for distressed debt has come back much quicker? Is it because tools -- going to I think a previous question -- tools that are being used are better this go-round, liquidity? I just think it seems like the recovery activity is just coming quicker. It may not be bigger in magnitude, but coming quicker.

Bob McGlashan - Bank of Montreal - EVP

Thanks, Quentin. The accelerated recovery component of your question I can speak to. We've had over the course of this year, the first

3 quarters, although not so much this past quarter, fairly heavy volume of opportunity in the secondary market to sell assets. That certainly has helped a great deal in terms of the recovery.

But I will still come back to our core strategic approach, which is the way we work out and work through our troubled transactions. This group of work-out specialists is doing a particularly terrific job. Again to reference a couple of fairly large transactions, which make this quarter look perhaps even better than it might otherwise, we would expect these things to happen in time. But it is so difficult to predict the precise timing.

Quentin Broad - CIBC World Markets - Analyst

On the 480 million, is that still the normalized run rate if we add back the --?

Bob McGlashan - Bank of Montreal - EVP

Yes, it is. It is a cycle neutral number. Our expected loss is in fact 480 million.

Quentin Broad - CIBC World Markets - Analyst

Great. For Tony just a more macro question. As you look at the current environment versus the past environments you've been able to oversee at the BMO, do you see this as being a great opportunity in front of you, coming out of what was a bad credit cycle? It is neutral to the historical exit sort of credit cycles, capital markets. Just I guess your general field for the current environment both in Canada and the U.S. would be appreciated.

Tony Comper - Bank of Montreal - President and CEO

It's pretty strong, actually, and I know that there is kind of a polarity of views on exactly what the state of the U.S. economy is at this point in time, with the Fed looking quite bullish in comparison to some of the labor statistics that we're talking about and things of that nature.

But in general I think that the combination of still absolutely low level of interest rates on both sides of the border, expectation for modest impact on inflation, pretty strong earnings growth in corporates on both sides of the border -- I think I am pretty bullish in terms of the economic outlook for the coming period of time.

As I said, we are in that sweet spot in the credit cycle where in fact all the formations are coming down. So all the indicators are that the credit cycle continues to improve. There's going to be a legitimate question about how long can this go on in terms of the credit cycle. Nobody really knows. So we will be cautiously optimistic that we will continue to enjoy this for the foreseeable future.

Quentin Broad - CIBC World Markets - Analyst

And in Canada, Tony, any material difference from your U.S.?

Tony Comper - Bank of Montreal - President and CEO

No, I think in fact we've all been pleasantly surprised at how well the Canadian economy has been performing. Exports are strong. Commodity prices are strong. And notwithstanding a strong dollar, as I said exports continue to be strong. So I think the surprises have been to the upside in the Canadian economy. If we start to get an upward drift in the U.S. economy, that will be even more positive for the Canadian economy.

Quentin Broad - CIBC World Markets - Analyst

Thank you.

Operator

Darko Mihelic.

Darko Mihelic - First Associates - Analyst

Actually most of my questions have been asked and answered. Just one question on costs with respect to the acquisition in the quarter. Was that U.S. 50 (ph) million onetime expense included in this quarter's expenses?

Karen Maidment - Bank of Montreal - CFO and EVP

Can you ask the question again? I just didn't hear it clearly.

Darko Mihelic - First Associates - Analyst

The New Lenox acquisition, was the $50 million U.S. onetime expense that you talked about during when you announced the acquisition -- was that actually in this quarter's expenses?

Karen Maidment - Bank of Montreal - CFO and EVP

Not all of it, no. Because we just began the acquisition on June 1, so that is part of the transition costs related to integrating it.

Darko Mihelic - First Associates - Analyst

So realistically you've had really good success here on the cost side, I would say for the last 7, 8 quarters. I know you're going to talk about this in Q4, but can we really expect this continued cost reduction without some sort of impact on the revenue side for BMO going forward?

Tony Comper - Bank of Montreal - President and CEO

Let me field that, and then Karen can supplement that. When I talk about this to all of our colleagues, and I'll be doing that again at 5:00 this afternoon, it is not as much about cost as it is about productivity. And productivity always has both components, the revenue component and the cost component.

So as we look at -- the closer we are to client-facing activities, it is more of a sales and revenue. And as we back more internally into the bank, it's more about cost and business processes. So it depends on where you are in the overall structure. I happen to believe the objectives that we have set ourselves of improving our productivity, i.e. revenues in relationship to costs, the goal that we set ourselves of improving that by 150 to 200 basis points is a sustainable goal that we will have year in year out.

Darko Mihelic - First Associates - Analyst

Great. Thank you.

Operator

Ian De Verteuil.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

More questions on the credit again, for Bob. I guess when you produce a great quarter like this for your first quarter in charge of risk, Bob, this is what you get. You have said there were two particular names where there were large recoveries; one was power generation, I think you said 39 million; and food processing, which I think you said was 13.

Tony Comper - Bank of Montreal - President and CEO

The reverse actually, Ian.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

Okay, 13 on power gen and 39 on food process.

Tony Comper - Bank of Montreal - President and CEO

Correct.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

When I look at the sequential, when I look at page 28 and 29 of the sup pack, and just look at the quarterly trends, I would have thought those two areas would have had fairly meaningful drops in net impaireds if you've got these big recoveries. Whether it is net impaireds or gross impaireds. But neither seems to have changed very much.

So for example if it is 39 million in food processing, your gross exposure looks as if it is down 25 million; but you have had 39 million of recoveries. Can you maybe flesh out? Maybe I'm missing something in the accounting treatment here.

Bob McGlashan - Bank of Montreal - EVP

For the two, 13 would have had an impact because it was a reversal. But the larger of the two, 39, was actually a write-off recovery, so it would not have appeared there in the first place. It would already have gone through the income statement.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

I see. So just the 13 which was the power gen would show up here.

Bob McGlashan - Bank of Montreal - EVP

Yes.

Karen Maidment - Bank of Montreal - CFO and EVP

(inaudible) recovery it's something that has already been written off and come right out of the account. So the recovery is just the cash goes directly to revenue. On the reversals it's something that is already provided for and that we have later determined that we don't need to provide for it, or we don't need to provide that much. And therefore that's where it will hit these numbers.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

And the second sort of unique thing in the quarter was the very big interest recoveries, which is interest received but not previously accrued. I think you said it was 33 million, one of which was 20. Was that 20 related to one of these two?

Karen Maidment - Bank of Montreal - CFO and EVP

Yes. It was related to the 39 million recovery that we reported in IBG.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

So there was a food processing name that sort of added 60 million to pretax earnings?

Karen Maidment - Bank of Montreal - CFO and EVP

That would be correct.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

Thank you. That's a 59. Thank you very much.

Operator

Jamie Keating.

Jamie Keating - RBC Capital Markets - Analyst

Actually Ian got my question. Thank you.

Operator

Michael Goldberg.

Michael Goldberg - Desjardins Securities - Analyst

First, what I am going to start with is, where on the income statement do the gains on sale of impaired loans go? Does that go into other revenue?

Karen Maidment - Bank of Montreal - CFO and EVP

It depends on whether or not the loan has been written off or not. So if the loan has been written off and it is a recovery, it would go through the revenue account. So in the case that we were talking about just now, the cash recoveries, that would have gone through net interest margin on the income statement. If it is related to fees, it would go into other revenue and the fee category that it would relate to.

Michael Goldberg - Desjardins Securities - Analyst

Just to be more specific, I think if I can recall the numbers you had proceeds of $22 million this quarter on loans with a book value of 13 million. So $9 million this quarter, and I am just trying to figure out where that $9 million would have gone.

Bob McGlashan - Bank of Montreal - EVP

We're having trouble coming up with a specific answer for you at this point; but perhaps we could --.

Michael Goldberg - Desjardins Securities - Analyst

You can touch on it off-line.

Tony Comper - Bank of Montreal - President and CEO

Susan will get back to you, Michael, on that one.

Michael Goldberg - Desjardins Securities - Analyst

Also how much did New Lenox add to personal saving and checking deposits in the quarter?

Tony Comper - Bank of Montreal - President and CEO

Frank, do you want to tackle that?

Frank Techar - Bank of Montreal - President and CEO Harris Bank

Again, the total amount that we moved over from New Lenox at closing was about $800 million in deposits. And again, we only had New Lenox in the quarter for 1 month. So the impact for the quarter would have been about a third of that.

Michael Goldberg - Desjardins Securities - Analyst

But you added the deposits in full when you bought the bank. So what I'm asking is how much of the -- you show in the notes that there were deposits of 1225 in New Lenox. How much of that was personal saving and checking deposits?

Frank Techar - Bank of Montreal - President and CEO Harris Bank

I don't have that in front of me.

Karen Maidment - Bank of Montreal - CFO and EVP

We could provide that breakdown.

Frank Techar - Bank of Montreal - President and CEO Harris Bank

We can do that. I'm going to suggest it was probably two-thirds personal, one-third commercial, if that's what your question was.

Michael Goldberg - Desjardins Securities - Analyst

I really don't care about the time deposits. All I care about is the demand and notice deposits. That's what I am really asking about.

Frank Techar - Bank of Montreal - President and CEO Harris Bank

We would have to get back to you on that one just to give you an accurate number.

Michael Goldberg - Desjardins Securities - Analyst

And the last question. Karen, you said something about 5 percent earnings per share growth excluding cyclical credit benefits. Was that year-over-year from your 95-cent EPS in the third quarter last year?

And that 5 percent is in part due to very good cost control. I figure probably close to like 1 percent on normal costs. So it seems to indicate really still very little top-line growth. So I am just wondering sort of in a big picture way if you or Tony or whoever else would like to comment about whether you see any near-term prospects for a pickup in top-line growth.

Karen Maidment - Bank of Montreal - CFO and EVP

The 5 percent, the way we calculated it, was normalizing the credit and the taxes to last year's level, just to show what the revenue and expenses were. And you're right, expenses were very well controlled. Revenue a little bit slower than we had seen, in part related to the slowness in the activities or the underlying capital markets.

It's interesting to note -- I was looking at our second-quarter results and comparing them to the other Canadian banks. Our revenues were top tier. So I think that we are producing good revenue growth. I think it is a difficult environment, particularly in some of the capital markets in the trading activities. But if you look at the volume growth, and we look at where we are at, and we look at the possibilities going forward, we think we are going to achieve appropriate levels of revenue growth.

Michael Goldberg - Desjardins Securities - Analyst

What is an appropriate level of revenue growth?

Karen Maidment - Bank of Montreal - CFO and EVP

It's going to be in excess of GDP; and really that's where we are targeting, so that we can grow market share in our key markets.

Michael Goldberg - Desjardins Securities - Analyst

Okay. Thanks.

Operator

Jim Bantis.

Jim Bantis - CSFB - Analyst

Just a follow-up, perhaps for Tony. The retail business seems to be performing quite well, particularly with the improvement in the efficiency ratio. The Harris business combined with the bit market platform has been turning around as well. The only fly in the ointment is really the North American direct investing business.

To what extent, Tony, are you going to be committed to this business over the next 4 quarters? I think you need a little bit more flexibility in terms of capital, and this is a business where, as you have seen, the market share has left you a little bit relative to your peers. I am not sure how much 17,000 new accounts a quarter are relevant to the business going forward. Could you just maybe elaborate? You have had it now for over a year, and how it really fits in from a cross-selling perspective? And maybe it is time to really take a look at it from a strategic perspective and returns.

Tony Comper - Bank of Montreal - President and CEO

I am going to give it over to Bill. But just to give you a little bit of the backdrop, remember we have been in the direct investing business in

Canada for a long, long time. And that business is performing very well for us, and that was kind of what led us into the attractive early acquisitions that we made in the direct investing business, before we did the acquisition of the accounts from CSFB and then subsequently Morgan Stanley.

So we have a lengthy experience with this direct investing business in Canada. Less so in the United States but I think we feel we know how to manage this business. Certainly that has been the case in what has been a very difficult environment over the last 2 or 3 years. I think the team has done a remarkable job in terms of resizing the platform to accommodate the fact that markets were in the tank. But I am going to get Bill to turn directly to the point you're asking about there, Jim. Bill Downe.

Bill Downe - Bank of Montreal - Deputy Chair

Jim, I would go back to page 7 of the sup pack and the line that I think you always have to go back to if you want to track this business, which is down at the bottom, the U.S. segment results in U.S. dollars. If you look at the revenue line over the 9 quarters and the net income line over the 9 quarters, you can see the progress that we continue to make in both private banking and in Harris Direct.

In both cases we are making investments in the business. We're incurring costs as we refine the business and the business model. The most recent quarter reflects a drop in trading which you can see across the whole market. But right now we really focused on increasing the results of that segment of the market, quarter by quarter, and I think that's really what you should watch for. Because you can see in 9 quarters a fairly big swing in the contribution to the total company. So the story is positive in the numbers.

Jim Bantis - CSFB - Analyst

Just looking at that slide on, slide 7, I am just wanting to see what specifically line item that you're referring to.

Tony Comper - Bank of Montreal - President and CEO

We're having difficulty hearing you.

Jim Bantis - CSFB - Analyst

Sorry. I do see the slide you're referring to; and specifically the losses going to a flat positive level now in terms of cash net income. I just put it in the context of a better use of capital and a return on investment; and recognizing that perhaps it is -- but maybe you're convincing me otherwise -- that it was not at the corest level, if that is a word, in terms of your business into the U.S.

Gilles Ouellette - Bank of Montreal - President and CEO Private Client Group

What we bought that asset 2 years ago this was an underperforming asset. We knew there was a lot of work to be done. It was a business that we were very familiar with, and we've been at it now for a couple of years. You can see by that line that Bill was referring to, certainly we feel that we have made progress. It hasn't been because we've had a lot of help from the markets. We have had to restructure the U.S. businesses.

And from this level I don't think it takes a lot of help from the markets to make these U.S. assets very profitable. So we are still very much -- we feel very much on track. But from quarter to quarter you're going to end up getting some soft quarters. But if you look at it from year-to-year we feel we're making lots of progress.

Jim Bantis - CSFB - Analyst

That's great. I appreciate you reiterating your commitment to the business. Thanks very much.

Operator

Jamie Keating.

Jamie Keating - RBC Capital Markets - Analyst

Unrealized securities gains, page 19 in the sup pack. Numbers down a fair bit, as I think we would all have expected. I wonder if you could give us a bit of an update post quarter how that is faring? And if you have any color on where they went?

I guess I don't think, unless I am missing something, you haven't triggered a lot of securities gains during the quarter. I get $5 million on the noninterest income page. Is there anywhere else that they've been triggered? Or are we seeing it there? And is it all due to market moves?

Karen Maidment - Bank of Montreal - CFO and EVP

Jamie, you're right. We only had 5 million of security gains this quarter, so we didn't sell them. It's really the decline is due to rising interest rates and lower equity markets. So they are all unrealized, the unrealized components.

Jamie Keating - RBC Capital Markets - Analyst

Would you offer any hints as to what direction we're going since? Has that stabilized a bit?

Karen Maidment - Bank of Montreal - CFO and EVP

It all depends on rates and markets.

Jamie Keating - RBC Capital Markets - Analyst

Okay. Thank you, guys.

Karen Maidment - Bank of Montreal - CFO and EVP

Back to a question Michael Goldberg asked a while ago, on the press release page 13. Michael, we sold some nonperforming loans that had a book value of 13 million for proceeds of 22. So the gain on sale would be 9, and that would be recorded in the other revenue section or the other-other category, which is in the sup pack; $9 million.

Operator

Quentin Broad.

Quentin Broad - CIBC World Markets - Analyst

Karen, while you're on that topic, to follow-up, the lending fee number at 89 versus 70 last quarter; how much of that difference would be caused by the recovery activity, if any?

Karen Maidment - Bank of Montreal - CFO and EVP

The lending fees? Pretty minimal.

Quentin Broad - CIBC World Markets - Analyst

So 89, is that coming from a strong pickup in borrowing activity and new line execution?

Karen Maidment - Bank of Montreal - CFO and EVP

The 22, though. It would include the 22 that I had referred to. I'm sorry for the confusion.

Quentin Broad - CIBC World Markets - Analyst

Okay, so 67 is the number without that, against the 70 last quarter?

Karen Maidment - Bank of Montreal - CFO and EVP

Right. There's normally a few in every quarter, but this quarter had the larger amount.

Quentin Broad - CIBC World Markets - Analyst

Great. Thanks, Karen.

Operator

This concludes the question-and-answer period. I would now like to turn the call back over to Ms. Susan Payne.

Susan Payne - Bank of Montreal – SVP, IR

Thank you, operator; and thank you for joining us today. If you have any further questions, and Michael will get back to you on the other question, please either call investor relations 416-867-6656 or email us at BMO.comRelations. Thank you and good afternoon.

Operator

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