BMO Financial Group

Q1 2004 CONFERENCE CALL

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BMO - CFO, Senior EVP

Michel Maila
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Frank Techar
BMO - President, CEO of Harris Bankcorp Inc.

Bill Downe
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Yvan Bourdeau
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PRESENTATION

Operator

Good afternoon and welcome to the BMO Financial Group's first-quarter 2004 conference call for February 24, 2004. Your host for today's call is Susan Payne, Senior Vice President of Investor Relations.

Susan Payne - Bank of Montreal - SVP of IR

Thank you, operator. Good afternoon, everyone. This afternoon's brief overview of our first-quarter results will be provided by Tony Comper, Chairman and CEO; Karen Maidment, our CFO; and Mike Maila from Enterprise Risk and Portfolio Management. After Mike'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; 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 & 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 the statements. Now I would like to hand the floor over to Tony.

Tony Comper - Bank of Montreal - Chairman of the Board, CEO

Thanks, Susan. Good afternoon, everyone. We are off to a good start for 2004, with earnings up 34 percent from a year ago, earnings per share up 33 percent, and annualized return on equity surpassing 18 percent. First-quarter results maintained the momentum that was established in the second half of 2003. There is some noise in the numbers due to four items that Karen

Maidment will walk you through shortly. But when you net out the 3-cent impact of these items on our cash earnings per share, we earned $1 a share. About half of the increase came from improved credit performance, while the other half came from higher group operating results.

Private Client Group delivered its best quarterly earnings in more than three years, while the Investment Banking Group posted record quarterly earnings. Both of those groups benefited from improved market conditions and their ongoing focus on productivity. Growth was somewhat less robust in the Personal and Commercial Client Group, where strong volume growth was offset by reduced net interest margin. That was due to low interest rates and the competitive environment, which is an ongoing challenging in Canadian retail banking.

Quarterly results translated into strong performance against our targets for 2004, which we continue to consider achievable. We now anticipate a specific provision for credit losses of $300 million or less for the year. I would note that that excludes the reductions of $40 million of general allowance this quarter, and that is $200 million better than the 2004 target. Mike Maila is going to provide details on this revised guidance. I think it is also worth noting that our high EPS growth rate in the first quarter relative to our annual target for 2004 is in part due to the quarterly earnings pattern in 2003.

Earlier this month, as you know, we continued the expansion of our retail distribution network in the U.S. with an agreement to acquire Chicago-based New Lenox State Bank. That is a high performing community bank with eight prime suburban branches and the last large independent bank in fast-growing Will County, which is the fastest-growing county in the Chicagoland area and in fact it is one of the fastest-growing counties in the United States. That was our 13th acquisition in the U.S. since 1999. The $300 million acquisition will substantially strengthen Harris's number one market-share position in the Will County. It's a perfect strategic and cultural fit as we pursue our plans to become the leading and most successful bank in our chosen markets, and that is a goal that is well within our grasp in greater Chicago. In fact, when the New Lenox deal and the smaller acquisition last December of Lakeland Community Bank closed, Harris will have a 9.9 percent share of retail deposits in greater Chicago, and that is only 0.5 of 1 percent behind the market leader.

The New Lenox deal also enhances our reputation as the acquirer of choice in the most fragmented, and therefore most opportunity-laden, banking marketplace in the United States. This latest acquisition supports one of our seven enterprise priorities for 2004, the pursuit of U.S. acquisitions in high-growth areas to extend the reach and profitability of our U.S. franchise. This year, our main emphasis is on retail banks with up to $2 billion in average assets in Chicago, Illinois, and surrounding states.

Turning a little bit to the other enterprise priorities, productivity improvement continues to be right at the top of the list. We improved the expense to revenue ratio in the first quarter by 270 basis points. That is compared to the same period last year. And while we experienced a falloff of 80 basis points from the fourth quarter, this management team remains confident of our ability to achieve the targeted 150 to 200 basis point improvement for this fiscal year. Also on our priorities list is improving the overall performance of our U.S. operations, improving customer loyalty in our Canadian Personal and Commercial operations, and increasing business referrals to earn a larger share of our customers' business.

When I was talking to our shareholders at this morning's annual meeting, I reflected a bit on our progress in delivering on the promise that I had made five years ago to reposition BMO for a more profitable future. After seven straight quarters of earnings growth for BMO, the good news for shareholders is that relative returns are indeed moving upward. Total return -- shareholder return on an investment in BMO common shares for the five years ended January 31 improved to 15.2 percent, above our Canadian peer group average and well above the TSX average annual total return of 6.5 percent.

Given our strong Tier 1 capital ratio, even with the recent acquisitions and a modest share buyback program, we are in a position to return excess capital to shareholders. Accordingly this morning, we announced a 14 percent increase in BMO common share dividends to 40 cents

per quarter. I should also mention that in future, the quarterly common share dividend will be announced concurrent with the release of quarterly results, as we have done this quarter for the first time. This increase ushers in our twelve consecutive year of dividend increases and reflects management's confidence in both the quality of our earnings and our capacity to beat our stated targets.

For those of you who missed my address to shareholders at our annual meeting this morning, key theme was BMO's pace-setting leadership in corporate governance. And one of the many examples that I cited was the action that we took back in 1997 to ensure that our directors would operate independently of management. At that time, BMO became the first Canadian bank to appoint a Lead Director; and ever since, our Lead Director has conducted a portion of every meeting of the Board without management present, and has undertaken leadership whenever the joint roles of Chairman and Chief Executive Officer might be in conflict. All Board committees have also met regularly without management present.

Earlier today, we went one step further, announcing the impending appointment of a Non-executive Chairman. After 33 years of dedicated service as a Director of Bank of Montreal, the past seven as Lead Director, Blair MacAuley is scheduled to retire at next year's annual meeting. In light of his upcoming retirement, Blair and the Board of Directors have determined that the time is appropriate to split the roles of Chairman and Chief Executive Officer. That is an initiative that I'm already on the record as supporting. This will provide ample time for a smooth transition period. The selection committee of the Board is currently considering candidates among our existing independent directors, and the Board will elect a Non-executive Chair in the near future. That is all the news I have on this initiative at the moment. We will announce more details as soon as they are available. And now, Karen, over to you.

Karen Maidment - Bank of Montreal - CFO, Senior EVP

Thanks, Tony. As Tony said, all operating groups are up year-over-year. In particular, IBG generated their highest quarterly earnings ever and PCG generated the highest quarterly earnings in over three years. Net income at 532 million is up 34 percent over last year and up 4 percent over Q4. ROE for the quarter was a strong 18.3 percent. The provision for credit losses is a net 15 million, made up of specific provisions of 55 less $40 million reduction in the general allowance. And as Tony indicated, we now anticipate our annual provision will be 300 million or less rather than the 500 million or less that we outlined earlier in the year. Our Tier 1 capital ratio remains strong at 9.65 percent and the cash productivity improved 270 basis points year-over-year, while it deteriorated 80 basis points quarter-over-quarter. I will speak to that in a few minutes.

There is a fair bit of noise in the numbers. There are a lot of accounting items that went through, a number of pluses and minuses on timing and accounting and one-time type items. But as we looked at them, most of them had a net effect of 0, with the exception of the four items that we have isolated on slide 3. Those had a net effect of 3 cents a share, and that is how we move ourselves from a cash EPS of $1.03 to $1 as being part of our run rate.

If I go through those, we adopted Section 1100, a new Canadian accounting standards which provides clearer guidance on how to determine accounting policies under GAAP, and the new standard applies to all the Canadian banks. As a result, changes were required in two accounting policies, the mortgage prepayment fees and the shares held by subsidiaries, that resulted in one-time impacts. The mortgage prepayment fee adjustment was a reversal of the deferred mortgage fee balance, and going forward, we will record these fees to P&L immediately rather than defer and amortize, as we had done previously. That is in the spread number on the revenue side.

The second item, BMO's shares, which were held in our subs to support client trading activities, is kind of an unusual one. These were shares that were supporting client business, and from an economic point of view, a true hedge. The new accounting requires that any shares held by subs in BMO, the gains on those shares need to be reported in contributed surplus. As a result, the offset, or the charge to P&L, stayed in the P&L, and that is one-time item. We recorded

that in trading revenue and in the corporate line of business. The remaining two items are a reduction in the general allowance and an adjustment to future income tax liabilities related to real estate in the U.S. that had not previously been recorded. As I said, the net impact of these items were 3 cents a share, or $18 million after-tax, and from our point of view, the sustainable level of the earnings this quarter is about $1 a share. There are a number of other small items, like the Ontario tax changes, the TSX dividend, which we have not included, because as I said earlier, there is a number of offsets to those.

If we move to slide 4, you can see the change in cash EPS versus the previous quarter and last year. Year-over-year, half of the growth is from lower specific provisions for credit losses, reflecting an improving environment, which added 13 cents; and the remainder of the increase is primarily due to business growth in the operating groups. Quarter-over-quarter, the change is 3 cents, which was approximately equal to the effect of the accounting changes. The effects of lower net interest margins and less net investment revenue in corporate offset the benefits of lower specific provisions for credit losses, as well as improved volumes and higher net gains on invested securities.

Turning to slide 5, you can see revenue growth, and adjusting for foreign exchange, acquisitions and accounting changes, you can see that we have achieved core business revenue growth of 6.7 percent year-over-year, with a slight decline of 0.3 percent quarter-over-quarter. The decline over the linked quarter can be attributed mostly to lower net interest margins and less net investment revenue in the corporate line, which more than offset the higher underwriting and trading revenue in IBG and PCG. Year-over-year business growth resulted from higher revenues across all of our operating groups, and you can see the effect of foreign exchange.

On slide 6, net interest margins on a total bank basis decreased both quarter-over-quarter and year-over-year. Excluding the effect of the accounting changes, the total bank net interest margin for the quarter was 186 basis points. Quarter-over-quarter, the lower margins were realized primarily as the result of three things -- competitive environment in the Personal and Commercial, flat yield curve and changing client preferences. Year-over-year the net interest margin is down 8 basis points excluding the impact of the significant items. While the margins increased in the P&C U.S., this was more than offset the lower margins in P&C Canada, again due to the changes in the competitive environment, consumer product preferences, and lower interest rates. IBG's net interest margin was down due to compressed spreads in its interest-sensitive businesses, a decline in higher-yielding corporate loans, and increased interest expense as a result of unwinding certain hedges.

Slide 7 illustrates our strong expense management. Total expenses are up only 1 percent over the linked quarter, and the increase of 2.9 percent in operating expenses is essentially offset by the reduced initiative spending. And again, compared to last year, expenses are down.

Moving to slide 9, you can see the impact on the productivity ratio. Despise a slight deterioration quarter-over-quarter, all operating groups have achieved significant improvements in efficiency over the first quarter of 2003. Cash productivity in IBG in the fourth quarter of '03 and the first quarter of '04 includes the financial result of Harris Nesbitt Gerard, and excluding these costs, IBG's productivity ratio is 46.3 and 50.1 percent respectively. On a year-over-year basis at the total bank level, our cash productivity has improved by 270 basis points, providing momentum towards achieving our target of 150 to 200 for the year.

Slide 10 shows our performance against our fiscal targets. Our high EPS growth in Q1 is in part due to the quarterly earnings patterns in '03. However, other than the revised PCL targets, our outlook is unchanged and we continue to anticipate achieving our targets in fiscal 2004. Now I will have Mike speak to the credit side.

Michel Maila - Bank of Monteal – Enterprise Risk and Portfolio Management, EVP

Thanks, Karen. Good afternoon, everyone. The key highlights of this quarter's credit risk review are summarized on slide 1. Let me walk you briefly through these points one at a time.

As you can see from slide 2, the downward trends in formations of growth-impaired loans

since mid-2002 has resumed this quarter. At 242 million and 0.16 percent of the portfolio, formations this quarter are in fact at their lowest level in nearly four years. And as slide 3 shows, both repayments and loan sales in the impaired portfolio continued at a significant pace this quarter, underscoring again our conservative practices in classifying loans as impaired and in the provisioning against them.

Moreover, as slide 4 indicates, our workout teams generated this quarter higher recoveries of prior write-offs, particularly in the U.S. loan portfolio, and materially larger reversals of provisions on sales of impaired loans, primarily in the power generation sector. These two factors, not unusual in the recovery phase of the credit cycle, clearly contributed significantly to the lower level of specific provisions booked this quarter.

You can see the same on slide 5 in the yellow shaded section of the table relating to the corporate loan portfolio. I would note in this context the sizable decline in specific provisions for that portfolio relative to Q4 of last year and to the year-ago level, which is clearly driving the reduction in specific provisions over that period.

Against this backdrop, our guidance for specific provisions this year has been revised, as Tony and Karen have mentioned, to 300 million or less. We are confident that this target is achievable based on the following. First, favorable credit performance, not only this quarter, but in the previous two quarters as well. Second, consistency of the specific PCL guidance targets for the next three quarters of this year, with the actual specific provision experienced over the past three quarters. Third, our modest and manageable exposure to sectors of concern in the commercial and corporate portfolios. Fourth, the strong performance and continuing stability of our consumer portfolios in both Canada and the U.S. And fifth, an improving operating environment, as evidenced by declining corporate default rates, more buoyant capital markets, and resumption of growth in the U.S. economy.

With respect to the 40 million reduction in the general allowance for credit losses this quarter, this is the outcome of our regular, consistent quarterly process of assessing the sufficiency and appropriateness of the general allowance with respect to our performing credit portfolios. The key considerations guiding this assessment are summarized on slide 7. And as slide 8 illustrates, in reference to the most recent credit cycle, they evidence our prudent approach to ensuring that the general allowance remains adequate on an ongoing basis.

Finally, with respect to market risk, the performance of our trading and underwriting activities was again profitable and relatively stable this quarter. I would like to refer you to the footnote on that slide for a summary of the main changes in modeling and methodology during the quarter. At this point, I would like to turn the call over to the conference operator for the question-and-answer session.

QUESTION AND ANSWER

Operator

Thank you. (OPERATOR INSTRUCTIONS) James Keating.

James Keating - RBC Capital Markets - Analyst

Three or rapid fire questions I think for Karen. First, security gains. I wondered if I could just get an allocation of how security stands by division for all IBG and whether any of it corporate? Second, if I may, slide 7 talked about initiatives having an impact on the expense growth. I just wondered if you could describe little bit more about what the initiatives are. If they are coming down as expense factors, coming down to a sustainable level or dipping below or are they still above where they're sustainable. That would be helpful. And lastly, related to slide 13, which I guess we didn't cover on the call, I would like to just refresh as to whether in the U.S. numbers on slide 13 whether there's any acquisition influence, specifically any margin loans, for example, factored into those growth rates on the U.S. side. Thanks.

Karen Maidment - Bank of Montreal - CFO, Senior EVP

Let's start with 13, and the acquisition impact is not significant there. Frank might want to speak to the margins and then I will come back to the other two questions.

Frank Techar - Bank of Montreal - President, CEO of Harris Bankcorp Inc.

Jamie, slide 13 is the one that has the balance sheet items on it, is that right?

James Keating - RBC Capital Markets - Analyst

Yes, and I meant to ask about volume growth, if I misspoke. I wasn't referring to margins but I am curious about -- the U.S. volume growth in personal loans still looks pretty spectacular. I just wondered if you could talk about -- if I'm reading that right.

Frank Techar - Bank of Montreal - President, CEO of Harris Bankcorp Inc.

Actually, as you know we've got three consumer loan products in the States. We've got the mortgage business, the home equity business, and the auto business. The personal loan totals there are the home equity and auto paper that we underwrite, and we are still seeing plus 20 percent volumes in both of those categories. We are not seeing any slowdown basically from the prior years.

The mortgage business, as expected, we've seen a falloff year-over-year on the back of the refinance activity slowing down dramatically, but the purchase business is still holding up very well. So from a balance sheet perspective, we are still optimistic that aside from the mortgage volumes, we can continue the trends that we saw last year.

Karen Maidment - Bank of Montreal - CFO, Senior EVP

Going back to your other questions, in terms of the security gains, most of them are in IBG. And I think your other question was really around initiatives and sustainability of expenses and productivity. And we are continuing to do initiatives almost as an ongoing process improvement approach to the way we have been tackling the expense to revenue ratio for the last little while. We've been rationalizing businesses, call centers, renegotiating contracts. I think there is more room for expenses to come down.

In continuing that, there's a couple other things. You will notice that the FTE headcount is down, which is going to help our run rate. And the other thing that is in expenses this quarter is in our variable comp cost, the cost of our medium-term incentive program, which I have spoken to earlier in previous quarters -- this had a fair bit of volatility in it. And it had been running about 38 million for the quarter, and it is going to -- we've hedged it, so we're moving into a fixed-rate cost of about 22 million a quarter. So there's things

like that that are in our expense numbers, which give me confidence that we will be able to continue to manage our expenses. I think the issue about how far we get on the productivity ratio will depend, though, in part on the revenue environment.

James Keating - RBC Capital Markets - Analyst

Thank you very much.

Operator

Rob Wessel.

Rob Wessel - National Bank Financial - Analyst

Just a couple quick questions. I'll try to go rapid fire, like Jamie. First of all is on the tax rate -- it did creep up a little bit and I just can't really tell -- was that mostly related to the myriad of one-time items?

Karen Maidment - Bank of Montreal - CFO, Senior EVP

Mostly. 200 basis points of it was due to the $19 million I referred to. So the run rate on the tax, the sustainable rate, will be about 31 to 32 percentage points.

Rob Wessel - National Bank Financial - Analyst

Okay, great. The next question is with respect to the PCL guidance at or below 300 million. We will call that for the next three quarters, unless I'm wrong, sort of in the low 20 basis points. Is that something we should think about as reasonable sort of prospectively, not even '04 and I'm not asking for '05 guidance. But is that sort of a reasonable sort of steady state, the economy is pretty good, things are fine provision ratio?

Michel Maila - Bank of Monteal - Enterprise Risk and Portfolio Management, EVP

Yes, Rob. I think the best way to put it perhaps not in basis points is look at the last three quarters of specific PCLs and they add up to 240. So with respect to the guidance for the next three quarters, 300 less the first quarter of 55, you get back to this 245 level, or about 80 a quarter. That is perhaps one way of looking at it, Rob.

Rob Wessel - National Bank Financial - Analyst

My last question is, I think I ask this every call so I apologize if it just seems repetitive. But on your enterprise parties for '04 on slide 4, you have "aggressively pursue U.S. acquisitions." Can we reasonably conclude from that that aside from the sort of New Lenox building by MSA strategy that maybe you might be thinking -- can we reasonably conclude from that larger acquisitions are more likely? When I say larger, let me predefine that as saying greater than $3 billion.

Tony Comper - Bank of Montreal - Chairman of the Board, CEO

Great than $3 billion (multiple speakers).

Rob Wessel - National Bank Financial - Analyst

Sure, might as well throw in a number.

Tony Comper - Bank of Montreal - Chairman of the Board, CEO

In assets?

Rob Wessel *- National Bank Financial - Analyst*

No, in proceeds. How much it would cost to buy it.

Tony Comper - Bank of Montreal - Chairman of the Board, CEO

I see. That would be a push. I think what my comment -- and then I will hand it over to Frank and Bill -- is that if you look at the pattern of what we have done, that pretty well characterizes what I think you could expect reasonably, all things being equal. The reason I say all things being equals is that, as I said this morning in my comments to the annual meeting, it takes two to tango. It's one thing for us to have an appetite to acquire. It's another thing for the prospective acquirees to have an appetite to be acquired. And the reason that you have not seen more transactions in the sweet spot of our center of gravity, which is Chicagoland, I think is indicative of that.

But I have also always said, Rob, and we reiterate this, is that we will maintain our discipline with respect to our expected returns and what we would expect to get out of it. So the number you mentioned, my perspective would be that's kind of pushing the top end of where you could expect us to be. In fact, it's probably over it. Bill?

Bill Downe - Bank of Montreal - Deputy Chairman of the Board

I think Tony captured it. There's a difference between our capacity and our intent. Our intent is really governed by the ability to make acquisitions within the economic parameters that we have established and the ones that we have adhered to in the 13 transactions we have done in last three years.

Rob Wessel - National Bank Financial - Analyst

Just a quick follow-up. You're not going to grow very fast in terms of the size of the platforms sort of one MSA at a time. That's why I was wondering if maybe there was the recognition of that fact. And maybe it's not even a priority to grow faster than one MSA at a time, but is there a recognition of that, and therefore willing suitors or willing sellers, you would step that up?

Bill Downe – Bank of Montreal – Deputy Chairman of the Board

The more acquisitions that we make and the efficiencies we capture as quickly as we can in the system, the greater ability we have to do the larger transaction. And it will be governed by our ability to do bigger transactions with the same accretion that we have been looking for in the smaller ones up until this date.

Rob Wessel - National Bank Financial - Analyst

Great, thank you very much.

Operator

Steve Cawley.

Steve Cawley - TD Newcrest - Analyst

Karen, I have a question for you. I think some of the numbers that you presented reflect Gerard's impact on the U.S. business, and it appeared to be pretty negative on the expense ratio, which means to me that their contribution on the revenue side was lacking. Can you talk about that?

Karen Maidment - Bank of Montreal - CFO, Senior EVP

You're right. There's an expense drag right now because it is so early in the acquisition and we are absorbing one-time costs associated with getting it onboard. But maybe Yvan can talk about the business generally.

Yvan Bourdeau - Bank of Montreal - President, COO of Nesbitt Burns Investment Banking Group

Thank you, Karen. What you mentioned, Steve, is absolutely right. This is really the second quarter that we have HNG in IBG. The first quarter was really just to sort out the two organizations in the U.S. Since then, we have merged the legal entities. We are now in the process of merging the physical location, and that will be done by May. That obviously, as we do this, we have to incur some one-time costs.

But the encouraging thing is we can see the synergy that exists between the two networks. Already, HNG is really benefiting from the fact that we have several referrals that was sent to them through our network, primarily Harris Nesbitt Midwest, as well as our energy group in Houston. So I would say that most likely you will see a similar pattern in the coming quarters as we line up not only the physical presence of the two organizations but also we integrate the coverage of our clients.

Steve Cawley - TD Newcrest - Analyst

Just to clarify -- you made it sound as if the one-time costs in integrating the physical locations is to come in future periods and not necessarily in Q1.

Yvan Bourdeau - Bank of Montreal - President, COO of Nesbitt Burns Investment Banking Group

Correct. There are still some costs to be incurred, yes.

Steve Cawley - TD Newcrest - Analyst

Will those be outlined clearly or will they just melded with your expense base?

Karen Maidment - Bank of Montreal - CFO, Senior EVP

We will pull out the acquisition effect (ph), like we do the slides -- on slide 7. So you'll be able to see the impact of acquisitions and the one-time costs.

Steve Cawley - TD Newcrest - Analyst

Okay, second question. I harp on this every quarter, it seems, but it doesn't look like that U.S. discount brokerage business is generating the type of operating leverage that I had hoped it would generate. Can you talk about what the profitability was of the U.S. discount brokerage operations? All I see is a negative 1 from the U.S. wealth.

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

Steve, we normally talk about the whole U.S. business. But we're making a lot of progress in both U.S. businesses. It's a little difficult to see because of the currency conversion, but year-over-year, the revenues were up 14 percent and the expenses were up 1 percent, so we had 13 percent differential. The productivity numbers improved year-over-year -- 980 basis points. They improved over the previous quarter by 580 basis points. And we are making progress. Maybe it's not as fast as you would like, but we are happy with the trend, Steve.

Steve Cawley - TD Newcrest - Analyst

I think last quarter you told us that you were accrual breakeven in the discount brokerage. Can you give us some sort of comparable number for this quarter?

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

Last quarter, we were cash net income positive, as we are this quarter too.

Steve Cawley - TD Newcrest - Analyst

Okay. Karen, just one criticism. That corporate support division is really getting to be difficult to follow, especially this quarter with all the one-time items. But modeling that division, I don't know if there is anything that you can reflect on in terms of breaking that out even further, but I think we've talked about the PCLs being included in that. It just doesn't seem to follow logically, as far as I'm concerned, so maybe it's something that we can talk about moving forward. But I think it is pretty hard to model this bank when there is so much variation in that division.

Karen Maidment - Bank of Montreal - CFO, Senior EVP

Yes, Steve, this quarter there was more than the usual amount, and we have tried to bring those

out and we will try to be as clear as we can. But having said that, the accounting standards are different now and you're not going to see estimates of a year and then divide it by four and have sort of smooth emergence of a lot of these numbers. You're going to see more volatility. And to the extent that they don't belong in the operating groups, we will put them in the corporate support. So we will work to explain them as clearly as we can, but I think there is an underlying change that you're going to see in all the banks.

Steve Cawley - TD Newcrest - Analyst

What would you say were the operating earnings in corporate and what do you think is an operating earnings run rate for that division?

Karen Maidment - Bank of Montreal - CFO, Senior EVP

I don't really think of corporate as an operating earnings group. It really is the group where we true up the PCLs between the expected losses and the actual loss. We keep residual pools related to funding. If there is one-time accounting adjustments like the four items that I referred to, we put all of those in corporate so that we wouldn't distort the underlying operating numbers. So there is really not -- we do not model it to a flat number quarter-to-quarter. It is just very difficult to do.

Steve Cawley - TD Newcrest - Analyst

Thanks for your time.

Operator

Michael Goldberg.

Michael Goldberg - Desjardins Securities - Analyst

Thanks, I have a few questions also. First of all, you give us the delta on a quarter-over-quarter and year-over-year basis on performance-based comp, and until now I've been able to keep track of the numbers from old historic numbers that I had. It doesn't seem to be the case this time. Can you give us what the actual performance-based comp was, maybe for the latest quarter and going back the past couple of years quarterly also? If not on the call, maybe after the call.

Karen Maidment - Bank of Montreal - CFO, Senior EVP

Yes, after the call. Where you should see it is on page 13 of the supp-pack, and you can see where we go -- the year-over-year numbers, each quarter we show the trend.

Michael Goldberg - Desjardins Securities - Analyst

I know, but it is not matching up against the historic numbers that I have, so I think it would just be simpler to give the actual number on a regular basis.

Karen Maidment - Bank of Montreal - CFO, Senior EVP

We will follow up with you after, Michael.

Michael Goldberg - Desjardins Securities - Analyst

That's great. Second question, you have reduced your target for specific provisions by about $200 million, let's say, and you still expect to achieve your productivity plan, but you have held your earnings growth outlook at 10 to 15 percent. What are we supposed to interpret from this combination?

Karen Maidment - Bank of Montreal - CFO, Senior EVP

I think the thing that you should interpret is that from the time we did our plan and we gave our guidance, there's two material changes that have occurred. One is on the positive side, credit environment is better than we expected. On the negative side, the interest rate environment in Canada is much worse; and in fact, we have had about three rate cuts; we

could have another one. And when we were building our operating plan, we were assuming that rates would stay flat and then increase about midyear. So while we have seen good volumes in P&C Canada, we are feeling the effect of spread compression as rates are at a low level. So I think it is to early, after the first quarter, to really change the EPS outlook, but those are -- I think the first quarter might characterize how the year may unfold, with our expectations being better on the credit and tighter on the spread side.

Michael Goldberg - Desjardins Securities - Analyst

Okay. And my last question is I'm looking at Mike's presentation, slide 8. And in there it looks like your general allowance is about $200 million above the top end of what you call the normal range. Should we be interpreting from this something about your plan with respect to that normal range? Is it your objective to be somewhere inside that normal range at some point?

Michel Maila - Bank of Monteal - Enterprise Risk and Portfolio Management, EVP

Michael, yes. The number is actually a bit less than 200, but the general view is correct. There is potential over time for our prudent approach on the general allowance to revert to within the normal range, and that would imply a reduction over time. But it is difficult to go beyond that at this point. As I said, this is an exercise we conduct on a quarterly basis.

Michael Goldberg - Desjardins Securities - Analyst

Thanks very much.

Operator

Heather Wolf.

Heather Wolf - Merrill Lynch Canada - Analyst

Good afternoon. Three questions for you. First, in the wholesale bank, a couple of people have touched on the expense levels there. You have had a lot of volatility in your productivity ratio. Can you give us a feel for whether or not the roughly 50 percent excluding the acquisition is somewhat sustainable?

Second question is for Mike. On one of his slides, he had the breakdown of new formations by geography. I'm curious if that is relatively stable or if we are seeing any deterioration in Canada? Then lastly on the share count, just curious what's driving the increase and whether or not you plan to offset with share repurchase?

Tony Comper - Bank of Montreal - Chairman of the Board, CEO

I'll get Bill to address the first and then we will come to Mike and we will come back to Karen.

Bill Downe - Bank of Montreal - Deputy Chairman of the Board

Heather, the answer on sustaining the improvement in productivity in IBG is yes. In the short run, you're going to see, depending on the mix of business, you'll see the productivity ratio deteriorate a little bit. But we are expecting loan growth in the U.S., which will have a lower expense to revenue ratio inherent in it to somewhat offset that. So these gains, not counting HNG, you can expect to see continue into the future.

Michel Maila - Bank of Monteal - Enterprise Risk and Portfolio Management, EVP

Heather, there is no deterioration overall on the Canadian side. What you are seeing is a minor uptick on our cattle farming and related exposures -- from the appendix, you'll see that they have gone up about $10 million. But there is nothing systematic about it.

Karen Maidment - Bank of Montreal - CFO, Senior EVP

Heather, on the number of shares, it is really the shares issued under the stock option plan that

have driven the increase. And we have been doing fairly modest share repurchases and we will continue to do them, but I'm not sure that they will be enough to offset the full dilution that is occurring.

Heather Wolf - Merrill Lynch Canada - Analyst

Perfect. Thanks very much.

Operator

Ian De Verteuil.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

I had a question on slide 6 of Karen's presentation -- NIMs. The first one is for Frank. In Q4, when we saw the significant uptick in NIMs in P&C U.S., you had talked about backing away from some deposit business and that helped your spread. You had talked about mix with the growth in the home equity lines and the auto business. And it is sort of surprising to see that trend reverse as sharply as it did in this quarter, given mix seems to continue to go in favor here. Can you talk to what you are seeing in the U.S. and what we should expect going forward?

Frank Techar - Bank of Montreal - President, CEO of Harris Bankcorp Inc.

Ian, last quarter when we talked about that, you're exactly right. Those two things I mentioned were occurring and they continue into this first quarter of this year as well. The thing that I did not talk about last quarter was the fact that we had one funds transfer price adjustment in the quarter, which bumped up the net interest margin to the 414 level. In reality, it was a timing issue whereby the previous three quarters were understated. And if you back out that adjustment, the 401 for this quarter is basically on a run rate basis very close to the Q4 number.

So if you want to take a look at it from an annual basis, in 2003, our net interest margin was 394. Our expectation going forward for this year is that we are going to come in at or near that level. So we think from the 401 number right now, we might see some deterioration based upon the competitive environment, but we don't think we're going to see any deterioration year-over-year.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

Thank you, that's great. The second question relates again to that same slide. When I look at this P&C is down; IBG is down; and total bank is up quarter-over-quarter. The only thing I can assume from that is this corporate, which presumably is the treasury operations, had a pretty good quarter to offset all the spread compression in Canada and IBG. Am I right on that, Karen, or is there something else I'm missing?

Karen Maidment - Bank of Montreal - CFO, Senior EVP

Yes, but also the onetime accounting changes would have gone through corporate too.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

So is treasury up a lot in the quarter?

Karen Maidment - Bank of Montreal - CFO, Senior EVP

Yes.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

Treasury is up a lot. And that shows up partially in net interest income and partially in trading? Or is it all in net interest income?

Karen Maidment - Bank of Montreal - CFO, Senior EVP

It is some in net interest income, but also in trading.

Ian De Verteuil - BMO Nesbitt Burns - Analyst

Okay, thank you very much.

Operator

Quentin Broad.

Quentin Broad - CIBC World Markets - Analyst

Just a couple of questions. First, in terms of allocation of capital, Karen, it appears that you have allocated in 500 million into corporate -- in excess of 500 million into corporate, stripping it out of the other businesses. I am interested as to why over the last couple of quarters you have been allocating into the corporate side versus leaving it out there? And then in terms of full cycle provisions, I actually like the breakout, Mike, to the individual divisions in terms of your full-cycle expectations. It looks like investment banking is down to 44 million versus 57 million, which is 23 percent. I am just wondering what is happening to your expectations on a full-cycle basis because loans obviously haven't changed -- repo volumes have, but loans haven't.

Karen Maidment - Bank of Montreal - CFO, Senior EVP

On the capital allocation, we're not allocating more to corporate, but the residual ends up in corporate. Because the way that we allocate capital is based on the economic risk, and then we true it up to the regulatory OFSI capital ratio for each of our business units. So as each unit is managing capital quite effectively, they will end up with more or less, depending on what's going on their business. The residual sits in the corporate side. So it's not that we are allocating more to corporate; you are seeing the capital management activities underlying the businesses that would affect the level of capital that is being allocated.

Quentin Broad - CIBC World Markets - Analyst

So the fact that Private Client and IBG are stripping out 300 million each, Karen, that's just they are being more efficient?

Karen Maidment - Bank of Montreal - CFO, Senior EVP

And also in IBG there haven't been as many draws on the loans underneath the Harris Nesbitt franchise. So as clients start drawing on those loans, you're going to see the capital going back in that business. But what you have seen over time with IBG is capital has come out that was supporting what we call the nonrelationship portfolio, which was low ROE; and we're putting back in to support the midmarket franchise and the other businesses that have better profitability. And that is the major reason why the ROE in IBG has gone from about 14 percent to about 18 percent, because the shift in the mix of capital and the profitability associated with it.

Quentin Broad - CIBC World Markets - Analyst

Okay.

Michel Maila - Bank of Monteal - Enterprise Risk and Portfolio Management, EVP

Second point, Quentin, the change in the allocation to IBG year-over-year is primarily due to the same point that Karen just made -- that's the nonrelationship corporate loan portfolio. As you know, it has been reducing quite a bit over the past few years. And we do this exercise once a year on a plan time, and therefore we caught up with the vastly reduced balances on that corporate loan portfolio, which tends to be again higher risk. So it does attract more capital. So also the 40 million you see is due to that effect.

Quentin Broad - CIBC World Markets - Analyst

Sorry, the sequential PCL allocated there, Mike, dropped 57 in Q4 down to 44. That is simply a

timing issue in terms of when you review this versus an actual change in the quarter?

Michel Maila - Bank of Monteal - Enterprise Risk and Portfolio Management, EVP

(multiple speakers) Yes, it is the expected loss, which on an annual basis comes to the 40 million. So it is 13 times 4, Quentin, which we adjust once a year. And then you'll see it for the subsequent three quarters at the same level as you saw it in the first quarter.

Quentin Broad - CIBC World Markets - Analyst

If I could one more. Just in terms of the efficiency ratio, Karen, you talked about revenue challenge and that may predicate whether you get to the 150 basis points to 200 guidance. Just looking at it mathematically, given your first quarter, you've got to average about a 63.9 to hit the low end, the 150 basis point improvement. Is that really going to have to rely on the revenue side that the expense load is not going to change a whole lot off of the Q1 run rate?

Karen Maidment - Bank of Montreal - CFO, Senior EVP

I think there are a few things that are going to cause the expenses to come down and I talked with the MTIP and I talked with the FTE is down. There is no question that we are going to require good revenue growth to get to the higher end of that range. But if you recall last year at this time, we were behind as well. And as the year continued, we were able to achieve our targets. And in some ways, we're in a similar position this year, and I think we are pretty confident and committed to achieving the targets, but I am not sure -- as I said, the high end will really depend on the revenue environment.

Quentin Broad - CIBC World Markets - Analyst

Thanks.

Operator

Darko Mihelic.

Darko Mihelic - Research Capital - Analyst

I just have a couple of questions, and one question is related to a previous question with respect to the share counts. I am just curious as to what is preventing you for buying back more stock. And my second question, Karen, has to do with -- I guess your previous answers indicated that the interest rate environment is different from your expectations at year-end with respect to setting guidance. But I am just curious, because when I look at page 34 at how you're positioning your balance sheet, it looks as though you have been expecting the rate decreases for some time now. You have been actually increasing your gapping there. And I'm wondering if you could just talk to that, because it doesn't appear to be any different.

Karen Maidment - Bank of Montreal - CFO, Senior EVP

Two points, first on the rate. There is no question on the trading side of the house, we have been positioning ourselves for the rate environment that we are in. But on the personal and commercial side, where the absolute level of rates have come down -- I think it has been three rate cuts since we did our plan and there is another one coming possibly -- that has really affected the margin on that business. So while you see, as I indicated, pretty strong volume growth, the revenue is not there because of the margin compression. In terms of the share buybacks, we might be buying a few more right now, but the stock -- we have price hurdles and we follow those pretty disciplined in terms of the extent to which we are buying shares.

Darko Mihelic - Research Capital - Analyst

Thank you very much.

Operator

Jim Bantis.

Jim Bantis - Credit Suisse First Boston - Analyst

Good afternoon. Just some questions regarding slide 23, U.S. retail and mid-market. I was surprised to the decline in the contribution in Q1 '04 from the midmarket U.S., particularly since the bank has been fairly active in terms of building out their product and building out the platform and the economic growth rates coming out of those regions seem strong. Could you just give us a little bit details in terms of what had happened that quarter. Was there anything exceptional and do we expect a rebound?

Yvan Bourdeau - Bank of Montreal - President, COO of Nesbitt Burns Investment Banking Group

Thank you for your question. There is no question that the environment in the U.S. has improved, as you can see with the growth that we saw in the GDP in the last two quarters. By the same token, if you look at our client franchise in the U.S., they are still cautious in the sense that the productivity is in the forefront of their minds. And as we make calls on them, we would absolutely love them if they were to use to a greater extent all the facilities that we put in place for them. Unfortunately, they are still very much concerned about the leverage on their balance sheet. They are still very much concerned about going outright and increasing their CAPEX. So we have seen some improvement in terms of building up their inventories; there is no question about this. But CAPEX still cautious, and also still cautious in terms of potentially acquiring new companies or merging with others that would require utilization of our facilities.

So generally speaking, if you were to look at our page 8 in the sub-pack, for instance, you would see that on a U.S. dollar basis or a U.S. dollar equivalent, at the bottom of the last line, it says average assets. Quarter-over-quarter basically our assets were actually flat, and if you compare Q1 '03 versus Q1 '04, there's a decrease in U.S. dollar of about 1.3 billion. And this is really reflective of what is happening with our clients in the Midwest.

Having said so, maybe on the encouraging side, if you look at total risk-weighted assets, you would see for the first time in some time between Q4 to Q1, our risk-weighted asset actually is going up by 1.8 billion, and even more pronounced or slightly more if you compare to Q1 '03. The main reason there -- actually, there are two reasons. One is that we have increased some of our trading assets and that accounts for about one-third of the risk-weighted asset growth. But two-thirds actually comes from new clients that we have developed in the Midwest, to whom we have provided with some facilities and commitments, but they have not used them. But even if they have not used them, that would have triggered, in fact, an increase in our risk-weighted assets. So from that perspective, I think we are well-positioned. If indeed they start to borrow more, we should see our average asset increase quite largely.

Jim Bantis - Credit Suisse First Boston - Analyst

Thanks, Yvan. That was quite helpful. A quick question for Mike. Could perhaps you elaborate in terms of the loan sales in terms of sectors that the sales were specifically relating to in terms of the portfolio?

Michel Maila - Bank of Monteal - Enterprise Risk and Portfolio Management, EVP

Yes, Jim, it was mostly in the power generation sector. There was some telecom, so the rest was probably diversified.

Jim Bantis - Credit Suisse First Boston - Analyst

Okay, great. Thanks very much.

Susan Payne - Bank of Montreal - SVP of IR

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

Operator

Thank you very much. This concludes today's conference call. Please disconnect your lines and have a wonderful day.

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