BMO Financial Group

Q1 2006 CONFERENCE CALL

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Assumptions about the performance of the Canadian and U.S. economies in 2006 and how that will affect our businesses are material factors we consider when setting our strategic priorities and objectives, and in determining our financial targets, including provision for credit losses. Key assumptions include our assumption that the Canadian and U.S. economies will expand at a healthy pace in 2006 and that inflation will remain low. We also have assumed that interest rates will increase gradually in both countries in 2006 and that the Canadian dollar will hold onto its recent gains in value. In determining our expectations for economic growth, both broadly and in the financial services sector, we primarily consider historical economic data provided by the Canadian and U.S. governments and their agencies. Tax laws in the countries in which we operate, primarily Canada and the United States, are material factors we consider when determining our sustainable effective tax rate.

PRESENTATION

Operator

Good afternoon and welcome to BMO Financial Group's first-quarter 2006 conference call for March 2, 2006. Your host for today is Susan Payne, Senior Vice President of Investor Relations. Ms. Payne, please go ahead.

Susan Payne ***- SVP, Investor Relations***

Good afternoon, everyone. This afternoon's brief overview of our first-quarter results will be provided by Tony Comper, President and CEO; Karen Maidment, our Chief Financial and Administrative Officer; and Bob McGlashan our Chief Risk Officer. After Bob's presentation Tony, Karen, Bob and the following members of the management committee will be available to answer your questions -- our Chief Operating Officer, Bill Downe; Yvan Bordeau from Investment Banking; Gilles Ouellette from the Private Client Group; Rob Pearce from the Personal and Commercial Client Group in Canada; and Frank Techar of the Harris Bank.

At this time I would like to caution our listeners by stating the following on behalf of those speaking today. Forward-looking statements may be made during this call and there are risks that actual results could differ materially from forecasts, projections or conclusions in the forward-looking statements. Certain material factors and assumptions were applied in drawing the conclusions or making the forecasts or projections in the forward-looking statements. You may find additional information about such material factors and assumptions and the material factors that could cause actual results to so differ in the cautionary regarding forward-looking statements set forth in the news release or on our Investor Relations website at BMO.com. With that now said I'd like to hand the floor over to Tony.

Tony Comper ***- President and CEO***

Thanks, Susan, and good afternoon, everyone. And given that our annual meeting has just ended here in Calgary I'm going to be pretty brief. I'd like to note that some of my comments today will be forward-looking and I remind you of the caution noted at the beginning of the meeting, as Susan said.

With net income $630 million in the first quarter the year is off to a good start. Earnings per share are up a solid 5.2% from a year ago and EPS increased 11%; now that's excluding the $32 million recovery of income taxes that benefited results in our Investment Banking Group a year ago. This indicates I think strong underlying operating performance. Adjusting for the tax recovery, all three client operating groups delivered higher earnings than a year ago and revenue growth was strong, particularly considering the sale of Harrisdirect in the fourth quarter of last year.

Yesterday we announced a $0.04 or 8.2% increase in common dividends, ushering in our 14th consecutive year of rising dividends. The increase reflects the solid performance in the quarter, our recognition that dividends are important to investors in today's environment and our desire to maintain a competitive dividend ratio.

We're on track to achieve the financial targets that we set for the year. 5.2% growth in earnings per share is in line with our annual target of 5 to 10%. At 18.5% return on equity is within our target range of 17 to 19%. At $52 million the specific provision for credit losses reflects the strong performance of our credit portfolios and we're now anticipating a specific provision of $325 million or less in fiscal 2006 which is $75 million better than the target that we initially communicated for the year at the close of the fourth quarter.

And the Tier I capital ratio has improved to a very strong 10.38%, that's well above the target of at least 8% providing us with greater flexibility for capital management. The cash productivity improvement of 80 basis points from a year ago, although below the range that we set of 100 to 150 basis points, is consistent with our expectations for the quarter and we're on track to achieve our annual target.

The economic outlook, the backdrop under which these results will unfold, remains unchanged. We also remain committed to the enterprise priorities for 2006 that I set out last quarter. While we're still in the early stages of implementation, we're putting increased emphasis on revenue generation while maintaining the cost discipline that we have developed over the last couple of years and continuing to invest in business growth.

We believe that we have successfully positioned BMO as Canada's high return, low risk bank with a high return on equity and a good track record for stability, earnings consistency and strong dividend growth. And we anticipate that the BMO's strong fundamentals will become increasingly attractive to investors as the credit cycle progresses. Karen, over to you.

Karen Maidment - Chief Financial and Administrative Officer

Thanks, Tony. Good afternoon. Looking at the financials, as Tony said, we had a good quarter. On a reported basis net income was $630 million, up $28 million or almost 5% from a year ago and, as you'll recall, we had the $32 million recovery of prior year's taxes in Q1 '05 and adjusting for that net income increased $60 million or 11%. On the capital side we achieved an ROE of 18.5% and ended the quarter with a strong Tier I capital ratio of 10.38. And as Bob will cover, asset quality remains strong.

On slide 3 you'll see that, unlike the previous quarters used for comparison, this quarter was a clean one and there were no significant or unusual items. As you'll recall, we sold Harrisdirect on October 6, 2005 and, just to clarify, our '05 results included their operating results and a gain on sale and the '06 results do not. In Q1 '05 Harrisdirect's revenues were $55 million, non-interest expenses were $58 million and net loss was $2 million. In Q4 of '05 Harrisdirect's revenue, including the gain on sale, was $96 million, non-interest expenses were $60 million and net income was $19 million.

Looking at the Group net income on slide 5, all operating groups' performance was up year-over-year if you exclude the $32 million recovery I referred to in IBG. P&C earnings were driven by revenue growth in both Canada and the U.S. partially offset by increases in the provision for expected credit losses and expenses. You'll recall that BMO's practice is to charge loss provisions to the client operating groups each year using an expected loss methodology based on each group's share of expected losses over an economic cycle and corporate gets the difference between this expected loss and actuals. The positive impact of PCL's and corporate reflects lower actual losses than what have been allocated to operating groups and would relate to both IBG and P&C Canada.

P&C Canada's earnings were up $3 million or 1% and P&C Chicagoland banking was up $3 million or 11%. PCG continued to achieve very strong year-over-year growth through increased operating revenues across all lines of business posting earnings of $94 million. IBG's earnings decreased $9 million or 3.6% year-over-year, but excluding the income item we referred to, were up $23 million or 11%. This is largely due to favorable trading conditions and increased client activities associated with higher volatility and energy prices. This is part of IBG's strategy and well-established expertise in the energy sector of providing our clients with hedging services.

The next slide shows year-over-year and quarter-over-quarter change in cash EPS. Quarter-over-quarter cash EPS decreased $0.07 or 5% but, excluding the significant items in Q4 of '05, actually increased $0.02 or about 2%. The $0.04 of business growth in the quarter was essentially offset by the change in the effective tax rate and PCL's were fairly flat. Year-over-year the increase in cash EPS was $0.05 or 4% driven by strong business growth primarily in PCG and IBG.

Slide 7 shows revenue growth at 3% year-over-year and really 6.5% if you factor out the impact of the U.S. dollar and the disposition of Harrisdirect achieved by very strong growth in the investment banking group and the private client group. Specifically IBG was up $53 million due to higher commodity derivatives and interest rate trading revenues, higher M&A fees and growth in corporate loan volumes.

Private Client Group was $42 million higher on increased managed asset levels in the mutual fund businesses and higher commissions and fee-based revenue in our brokerage businesses. P&C Canada increased $28 million driven by strong volume growth in both personal and commercial products, higher card revenues and increased sales of term investment products and mutual funds. And P&C Chicagoland banking was up $90 million driven by consumer and commercial loan growth and the impact of acquisitions.

On slide 8 you'll see that the total bank margin was stable at 150 basis points in Q1 compared to last quarter and down 6 basis points from a year ago. P&C Chicagoland banking is up 4 basis points due to a decrease in non-earning assets and improved spreads on deposits. IBG's net interest margin increased 6 basis points quarter-over-quarter from the higher trading interest income and a small increase in cash collections.

And P&C Canada is down 12 basis points due to continued shifts in customer product preferences towards lower spread products, increased competition particularly in personal mortgages and the interest rate environment. Specifically when we looked at P&C Canada, of the 12 basis points decline we believe 7 relates primarily to the growth in some of the lower spread products, mortgages and the premium rate savings account. The remaining 5 basis points relate to non-core items and some accounting adjustments related to Q4 of '05.

Expenses decreased $91 million quarter-over-quarter and increased $12 million year-over-year. Excluding the impact of Harrisdirect in 2005 they declined $31 million or 1.9% quarter-over-quarter and increased $70 million or about 5% year-over-year. The Q-over-Q decrease is largely due to marketing costs and investments in our distribution network in Q4 in P&C Canada and the benefit of our ongoing focus on expense management.

Year-over-year expenses increased essentially as a result of higher employee-related costs resulting from an expansion of both the retail and commercial salesforces and increased initiative expenditures in P&C Canada. Performance-based compensation costs increased on both periods, principally in PCG and IBG, consistent with revenue growth in businesses with higher variable cost.

And as you'll see on slide 10, there was an improvement of 80 basis points in the cash productivity ratio year-over-year, but a deterioration of 18 basis points quarter-over-quarter. Excluding the impact of the significant items in Q4 '05, the cash productivity ratio actually improved 191 basis points on a linked basis. Although the improvement this quarter is slightly below our annual target of 100 to 150 basis points, it's consistent with our expectations for the quarter.

Turning to the U.S. performance on slide 11, results in source currency totaled $109 million, up $23 million quarter-over-quarter and down $19 million year-over-year. The largest contributor to the improvement is IBG as increased commodity derivatives trading revenue was only partially offset by higher performance-based expenses and the Q4 '05 gain on the sale of Harrisdirect. The decline year-over-year was mainly due to higher expenses primarily as a result of higher performance-based costs offset in part by stronger commodities trading, revenue and IBG.

Tier I capital was strong at 10.38%, as you can see from slide 12, well above our stated target of the minimum of 8% while our total capital ratio was 11.84. The bank's risk-weighted assets increased $1.1 billion quarter-over-quarter to $151.9 billion principally as a result of higher mortgages in P&C Canada and market risk in IBG that relates to the higher volatility in the energy prices.

Wrapping up on slide 13 and drawing your attention again to the forward-looking statement caution, you'll see that we are on track to achieve all five of our financial targets for the year. As for the cash productivity ratio improvement, as I've indicated before, although our improvement of 80 basis points this quarter is slightly lower than our annual target of 100 to 150 basis points, it's nevertheless consistent with our expectations for the quarter. Over to you, Bob.

Bob McGlashan *- EVP and Chief Risk Officer*

Thanks, Karen, and good afternoon, everyone. Before I begin I'd like to draw your attention to the caution regarding forward-looking statements on slide 2. As you can see on slide 3, BMO continues to maintain its strong credit performance. On slide 4 credit quality continued to improve this quarter, impaired loan formations remained at low levels, and quarter end gross impaired loans at 745 million are the lowest we've experienced in over two decades.

On slide six, new specific provisions remained low compared to historical levels. Reversals and recoveries for the quarter were comparable to Q4 and lower than the comparable quarter of 2005. This is expected at this point in the credit cycle given the smaller pool of gross impaired loans. Our specific PCL was $52 million for quarter one and a decrease of $5 million from Q4 and an increase of $9 million from the comparable quarter in '05.

On slide 7, Q1 specific PCL represents 12 basis points of average net loans and acceptances including reverse repos while Q4 and fiscal 2005 were both at 13 basis points. Specific PCL remains low compared to our 15 year average of 38 basis points and a Canadian competitor average of 59 basis points.

As shown on slide 8, our target PCL for fiscal 2006 has been revised to $325 million or less from $400 million or less at the beginning of the year. The reduction in our target is due to favorable Q1 results along with expectations of a softer deterioration in the credit environment in the latter half of the year than was originally expected. It should be noted there is upside risk in these numbers which relates to a more aggressive deterioration in the economy than that which we now expect.

The increase over fiscal 2005 is due to an expected increase in the level of new specific provisions in light of very low gross impaired loan balances, lower levels of reversals and recoveries. Our target PCL represents 18 basis points of average net loans and acceptances consistent with this period in the cycle and well below our 15 year average of 38 basis points.

While we continue to track a number of sectors including auto, airline, forestry and the sectors most sensitive to rising energy prices, none represent a material risk. We also remain attentive to those factors that could affect credit quality in the consumer, corporate and commercial portfolios including continuing high energy costs, the impact of the sharp appreciation of the Canadian dollar relative to the U.S. dollar on export sectors, and the potential impact of rising interest rates.

On the consumer side there's a strong correlation between consumer loan losses and the unemployment rate which is currently low and expected to remain low for the remainder of 2006 and into 2007. As we've reported in the past, slide 9 illustrates our exposure to the auto manufacturing and supply sectors and, of note, there were no significant losses in this sector this quarter or last.

Finally slide 10 shows our trading and underwriting performance has been relatively stable with only one day during the quarter with a negative P&L of 2.3 million, this was primarily due to general market volatility. The largest P&L gains were $17 million and $21 million on November 30, and December 30, 2005 respectively, mostly due to normal month end credit holdbacks and valuation adjustments in capital markets. With that, operator, we can now go to questions.

QUESTION AND ANSWER

Operator

Jim Bantis.

Jim Bantis - ***Credit Suisse - Analyst***

Good afternoon. Just a couple of quick questions. Just want to circle back on net interest margin out of Canada and the volatility over the past couple of quarters. When we go back to Q4 it looked there were higher spread assets and better margins in consumer lending leading to the increase and now we've got a considerable shift. And I'm wondering if perhaps Rob can talk more about the 7 basis points drop and the 5 basis points drop being non-core. A cynic might say is this just BMO being a very aggressive with pricing in order to gain market share in areas where perhaps it's sagged recently? And then I've just got a follow-up question on the trading.

Rob Pearce - ***President and CEO, PCCG - Canada***

Jim, it's Rob. I'll take a shot at sort of explaining the margin situation. As Karen said in her notes there was a bunch of adjustments and reconciliations that went on in the fourth quarter mainly in some of our auto portfolios, which did improve our margin by 5 basis points in that quarter. But if you look at margins generally, we are concerned with the magnitude of the decline and what is happening in the marketplace, and our margins have clearly gone down more in this quarter than we expected.

There are really three forces at play when you look at the big picture. You've got mix issues, funding issues and then what I would call market pricing issues. If you look Q1 over Q1 at the 10 basis points decline, on the mix side clearly we've got assets growing more rapidly than we've got liabilities growing. So basically our loan book is up 9.5% and our deposit book is only up about 5%, just under that. Within that you've got the mix issue, which Karen highlighted, where you've got mortgages growing more rapidly; it's our most rapidly growing product category, we're up 12% year-over-year. And on the deposit side our most rapidly growing product is the premium rate savings account. And those mix issues put pressure on the margins.

On the funding side in a rising rate environment prime to BA spreads have narrowed. That's hurt our variable-rate mortgage book and basically our loan products in general. And as well, the absolute level of interest rates in the flat yield curve has put funding pressure in too. And so while it's difficult to isolate, those funding issues, if you were to isolate them, account for most of the decline Q1 over Q1. And then you've got the pricing issues. Clearly we try and offset some of this with pricing initiatives mainly on the deposit side of our book and we've actually had some spread improvement on that side, but competition is fierce particularly in the mortgage business.

If you look on a linked quarter basis, the 12 basis point decline or the net 7 basis point decline that Karen mentioned, the mix issue is mainly the growth in mortgages; the housing market is very strong, the mortgage market is very strong. On the funding side, again, you've got those two pressures, the prime to BA and low rates generally in the flat curve account for most of the 7 basis point decline on a linked quarter basis. And then you've got pricing and clearly aggressive mortgage pricing has hurt us somewhat.

We got lots of action under way to mitigate some of this NIM decline the big one being a review of our mortgage pricing strategy and pricing discretion in the field and the behavior that's going on transaction by transaction to ensure that we are not making a fierce very hot market, a very competitive market for mortgages worse by our actions. So that's kind of the story. We've got a mix issue. We've got the funding mechanisms of prime to BA in the low interest rate environment generally and then we've got the pricing that's going on in the competitive environment including in our book.

Jim Bantis - ***Credit Suisse - Analyst***

Rob, thanks very much for that answer, I appreciate that. If you can look at the month of February and obviously a few days here in March, have you seen any changes with respect to the conditions you described or the discretion that your staff have at the branch level?

Rob Pearce - ***President and CEO, PCCG - Canada***

Forward-looking, with all the conditions that go on forward-looking, personally I haven't seen any data since the end of January. But all the forces that I described, Jim, remain in effect. I think our actions, and our actions are designed to provide some relief to this issue, but as I've said all along, the way I see it in the marketplace, there's more downward pressure on margins than there is upward relief on margins. I think the basic story that I've said over many quarters, Jim, remain in effect -- that the pressures are more down than up, but clearly we're trying to take some reactions to mitigate it to the best of our ability.

Jim Bantis - ***Credit Suisse - Analyst***

Great, thank you. And my second question relates to slide 24. It makes a comment with respect to the ROE and the investment bank slipping quarter-over-quarter and year-over-year primarily due to higher allocated capital. And I just want to clarify the reason

for the higher allocated capital. Is it coming primarily to the increase in trading revenue activity?

Karen Maidment - ***Chief Financial & Administrative Officer***

I'll make a couple comments and then Yvan can jump in. Our capital allocation process is one where we allocate capital on an annual basis and in doing that we allocate it on an economic capital basis and true it up to the regulatory so that each business ends up with allocated capital to 8% capital levels. So what happens every year when you turn from the Q4 to the Q1? The true up really relates to growth from the prior year and also what we think is in the pipeline in terms of growth going forward. Yvan can talk about the specifics, but that gives you a sense of the process. And then it remains very static throughout the year unless there's a large acquisition or something like that.

Yvan Bordeau - ***President and COO, BMO Nesbitt Burns***

The only thing I would add, Jim, is if you go back when we put forward our business plan for this year, and that was last summer, we were anticipating a higher utilization rate and higher growth out of commercial loans particularly from the U.S. And therefore we had anticipated that our risk-weighted asset would go up at a higher rate than they have actually gone up. And the result of this as we go through the process that Karen has just described is capital is allocated to us based on the plan that we have submitted and that's where the approximate $400 million in additional capital year-over-year came from.

Jim Bantis - ***Credit Suisse - Analyst***

Great, thank you. A quick question for Tony. The Bank beat expectations this quarter and one of the primary drivers for the variance was higher trading revenue. And I'm trying to reconcile that with the mantra of the Bank being high return, low risk. And really if you equate it to what the market is saying today with the stock being down 2%, maybe the market is uneasy about assigning higher multiple, higher valuations to variances coming off the trading side and I just wanted your thoughts on that, please.

Tony Comper - ***President and CEO***

Jim, we did have good trading results but it comes from the way in which we're managing the business and a lot of it's client flows. I'll get Yvan to comment on that. And so I don't think -- in fact, we're well within our risk parameters in the capital markets area and all the trading portfolios, it's just that they've had a particularly good result and they're kind of getting it right. And so we'll see how it goes. But there's no indication that there's any assumption of risk that's outside of our appetite or parameters for risk. Yvan?

Yvan Bordeau - ***President and COO, BMO Nesbitt Burns***

Jim, I'd just one to add a few more comments. If you were to go back to the slide that Bob presented and look at our histogram you will see that our utilization of VAR is actually quite steady throughout the period and if you were to go back quarter-over-quarter you would see the same pattern. And that is basically, based on our (indiscernible) on the trading side that in most cases and most lines of business that we do try first to make money through the flow of our client positioning and servicing their needs.

Obviously in Q4 you saw that pattern also where we had a higher trading result and particularly again this quarter. And it was really related to the fact that in the commodity area, for instance, where we have a very professional desk, volatility was high and in those circumstances normally spreads are not as narrow as they would be normally. And out of our normal commercial flow we would make some money but the flows are much greater than they would be normally and therefore that's where a good part of the revenue came through.

That is also true through our foreign exchange desk where we had volatility also associated with the full Canadian dollar as it was appreciating against the U.S. dollar and it was also the case on our equity front. So our number one characteristic is, yes, we take proprietary risk. But, as you can see from the VAR, it's relatively steady and our philosophy is to try first and foremost to generate profit out of our commercial flows.

Jim Bantis - ***Credit Suisse - Analyst***

Great, thanks very much.

Operator

Jamie Keating.

Jamie Keating - ***RBC Capital Markets - Analyst***

I have a follow-up for Yvan perhaps. Looking at what's happened to commodity pricing and volatility, Yvan, is there any reason to believe that the fundamental level of trading revenue should be slightly a step function higher than previously because of that or is it purely volatility and we should expect it to level off to say perhaps a four quarter trailing average? Is there anything fundamentally different that's elevated pricing levels?

Yvan Bordeau - ***President and COO, BMO Nesbitt Burns***

I think if you look at the different areas into which we trade, and I'll start first with foreign exchange, you saw on an improvement

quarter-over-quarter and there's still a volatility associated in that market particularly with regard to the Canadian dollar still continuing to appreciate, maybe not at the same pace as it has over the last six months, but still appreciation is taking place. So I would anticipate that opportunity will still be prevalent for us in that area.

With regard to the equity line of business, the same comment would apply. You saw an improvement quarter-over-quarter and we see also the similar type of pattern as we've experienced in Q4 and in Q1. So I would expect that -- it's always difficult to predict obviously trading revenue, but I would expect also on the equity front that our potential to generate revenue would be similar to what we've experienced in the past.

Where I think I have a bit of a different view is, I think the one that you're relating to, is first on the interest rate area. In Q1 we were well-positioning for a flattening of the yield curve and that has already happened and we see the Fed funds going to 5% in March. And with that last move I anticipate -- I've been saying that for some quarters incidentally -- but I anticipate this may be the last one for some time. That it would be a bit more difficult in the interest rate area to continue at the pace that we have generated in the previous two quarters.

And they last one which is commodity, same pattern. If you were to look in all of last year, really Q4 is when we really did extremely well in the commodity area and we did even better in Q1. And all of this was related to both oil and gas where we have the bulk of our revenue being generated from a commodities point of view. And on the oil front, although there's still some volatility, it has abated and therefore I would say the potential is not as great and it seems the price for natural gas is also kind of stabilizing somewhat. So I would say probably in Q2 probably less opportunity for us to generate the same level of revenue from commodities.

Jamie Keating *- RBC Capital Markets - Analyst*

Very helpful, thank you, Yvan. One other quick question perhaps for Bob, related to expected credit losses in the retail area, so perhaps Rob wants this one too. But I guess you've moved the step up a level and I'm trying to understand if I've got this right, but I was thinking in terms of expected loss rates over the cycle and so I hope I'm not being redundant to ask, but I was just curious about why we've moved it up a level this quarter, what specific catalysts there were and if it's changed the cycle view for retail in any respect.

Bob McGlashan *- EVP and Chief Risk Officer*

Jamie, let me make sure I've got the question straight, but you're talking about an increase in EL that's been assigned to the retail bank?

Jamie Keating *- RBC Capital Markets - Analyst*

Yes, that's my premise. Is that correct?

Bob McGlashan *- EVP and Chief Risk Officer*

Yes, it is. It is fundamentally driven by a volume increase year-over-year. We fix it at the beginning of the year through the planning cycle. So if you have a large volume increase, all other things being equal, your expected loss number goes up on your portfolio.

Jamie Keating *- RBC Capital Markets - Analyst*

Okay. So Bob, there's no other change in assumptions per se?

Rob Pearce *- President and CEO, PCCG - Canada*

Well, actually the model gets updated a little bit and some of the work that we've been doing on Basel has worked its way into that formula. But as Bob said most of it is volume driven.

Bob McGlashan *- EVP and Chief Risk Officer*

There's no deterioration that you should be concerned about.

Jamie Keating *- RBC Capital Markets - Analyst*

I guess if I could just briefly follow-up on that. This is a very bland generalization, but if pricing relative to the market, for example, is lower and market share is rising and mortgages could be an example thereof -- I don't know the details on other products -- but it could lead some to the conclusion that the credit could deteriorate with adverse selection presumably not a high probability situation with BMO, but I wondered if you'd just have any thoughts on that?

Bob McGlashan *- EVP and Chief Risk Officer*

Rob may have something to add here, but I don't see a correlation to spread. Frankly the market isn't half as efficient as we wish it was otherwise you'd actually get paid better for the risks you take. I think we assess our risk and then you get the best price you can for it. So I wouldn't see the correlation you're referring to.

Rob Pearce *- President and CEO, PCCG - Canada*

And Jamie, if I can just add that I agree with Bob's comments and would add -- if you look at our share improvement which I think is

great news and particularly in consumer lending where we've had a tough ride of it, we've got it going up this quarter, that's not pricing based or anything, that's just better product and better sales and better technology that we've put in place.

But I think if you look across the piece, even if we just held share in this quarter, the pressures that I described on the funding side would have driven them down. So making a direct correlation between our NIM performance and our share performance is really an overgeneralization. Most of it's in the funding mechanisms and, as I described, the prime to BA situation and the flat and low curve.

Jamie Keating - ***RBC Capital Markets - Analyst***

And Rob, one other quickie is the commercial banking share -- I don't know, maybe it's sort of leveled off a bit here. Are we going to see it -- if I'm looking at slide 17 right, it’s still a little bit down the last two quarters consecutively? Any comments there?

Rob Pearce - ***President and CEO, PCCG - Canada***

Some of it's in the noise and the number, Jamie, and as you know, that kind of jumps around. I always remind you when we talk about share too that those numbers only reflect 0 to 5 million which excludes our corporate finance business which, as you know, is a strong and competitive advantage that we've got. But I'm actually very pleased with the performance of the commercial lending business. Our pipelines have been strong and continue to be strong. Our new loan drawdowns in the quarters were at very high-level so there was lots of volume going through those pipelines; we had lots of good draws.

We've added to our sales force, we've improved our product offering and we've got loan growth of almost 6% year-over-year which is the highest number probably in the last four or five years, Jamie. So overall I'm very pleased with the performance of our commercial business, the commercial lending side in particular and don't get that fussed about a couple of basis points here and there in market share, although clearly would like it to go up rather than down.

Jamie Keating - ***RBC Capital Markets - Analyst***

Fair point. Thanks a lot, Rob.

Operator

Quentin Broad.

Quentin Broad - ***CIBC World Markets - Analyst***

A quick question. Karen, just the salaries and employee benefits this quarter, is there an allocation in there given the sequential decline or did I -- is there something else going on? The sequential decline in salaries and increase in employee benefits, it looks reasonably material?

Karen Maidment - ***Chief Financial & Administrative Officer***

The employee benefits is really just the first quarter. It always goes up because CPP and (multiple speakers) and all those things kick in and that's the biggest single factor in those numbers.

Quentin Broad - ***CIBC World Markets - Analyst***

So there isn't any allocation to salaries?

Karen Maidment - ***Chief Financial & Administrative Officer***

No.

Quentin Broad - ***CIBC World Markets - Analyst***

Okay. Secondly, just in terms of funding the businesses, I actually thought your treasury operations took the brunt of the funding cost changes versus then transferring -- transfer pricing into the P&C Chicagoland, P&C Canada, etc. Am I mistaken in that belief?

Karen Maidment - ***Chief Financial & Administrative Officer***

The treasury area does not keep any residual costs or profits. And so really what's happening is match funding in the products where it's appropriate and in other -- the return on capital is all on a five-year roll and the investments are invested to achieve a five-year roll and the lines of businesses are credited with that rate. What's happening, that Rob is talking about, is because the loans are growing so much faster than deposits we're relying on wholesale funding, BA’s move up in a rising interest rate environment more quickly than prime and that's providing a bit of a squeeze on the mortgage product.

Quentin Broad - ***CIBC World Markets - Analyst***

A squeeze that you're putting back into the P&C Canada not retaining in corporate?

Karen Maidment - ***Chief Financial & Administrative Officer***

Yes, nothing is sitting in corporate.

Quentin Broad - ***CIBC World Markets - Analyst***

Okay. And then to Rob, on these notions of margins and that at every bank we hear kind of a similar thing, that it's very competitive out there and we tend to think there's a finite number of competitors and everybody says it's not me. So you have been certainly over the last several quarters, eight quarters maybe, talking a little about share and how you've been under pressure on share and now we see some stabilization -- we also see the margin under pressure.

So if it's not you who is it that's out there -- or is it just everybody is culpable in terms of driving pricing down where you're going to take out any advantage that might be given back to you through the yield curve starting to steepen up?

Rob Pearce *- President and CEO, PCCG - Canada*

Yes, I mean, it's hard to know who started the war and who's adding gasoline to it. Clearly our intent is to compete in the marketplaces that we're in and go toe to toe with anybody that's out there day in and day out. As I said in my opening comment about NIM in general and particularly on the mortgage side, we're relooking at our strategy and our pricing discretion just to make sure that we're not making the battle -- the pricing battle and the war that's going on out there worse than it otherwise would be.

But it's a competitive marketplace. We have lots of banks and lots of financial services providers in this country who are doing very well right now with lots of capital looking to grow in this business. And I think you're seeing that manifest itself in our numbers and in the industry in general.

Quentin Broad *- CIBC World Markets - Analyst*

Okay. Finally then, I don't know if Frank is there, but just in the U.S. margin -- runs a little contrary to a lot of the pressure that's being talked about in the U.S. So it seemed to have escaped P&C Chicagoland. Any particular reasons in there why you've been able to buck a trend that we're certainly seeing in the U.S. regional banks?

Frank Techar *- President and CEO, Harris Bankcorp*

Well yes, a couple of comments, Quentin. One is we're happy with the quarter, that in this case we did buck the trend a bit. We're still seeing the same pressure. My view on spreads going forward is it's going to continue to be tough. As Yvan says, as long as the Fed keeps raising rates our asset yields are going to be under pressure. For this quarter in particular we put in place some tighter management controls around our operating cash balances and reserves that we hold at the Fed and both those categories attract a funding cost for us. They're non-earning assets.

And as a result of that those changes -- we had an 8 basis point lift in our margin for the quarter, so that coupled with the fact that our deposit spreads continue to improve. And if you look at pages 19 and 21, you can see the consumer and business deposit growth that I would characterize as good but not really robust. We are definitely managing for yield in our deposit book.

We continue to grow the asset book -- or the assets in line I believe with the market, but we're lagging a bit on deposits and we're really trying to manage the yield, getting through this year with our expectation that rates are going to continue to go up. So it was a good quarter. The nonearning asset change that we made helped us out this quarter. Our expectation is it's going to continue to be tough going through the last three quarters of the year.

Quentin Broad *- CIBC World Markets - Analyst*

Thanks, Frank.

Operator

Michael Goldberg.

Michael Goldberg *- Desjardins Securities - Analyst*

My first question is about the revenue variance related to Harrisdirect quarter-over-quarter, the $96 million. Did you say that that includes the $49 million gain that you had?

Karen Maidment *- Chief Financial & Administrative Officer*

Yes.

Michael Goldberg *- Desjardins Securities - Analyst*

Aside from brokerage commissions, what other key lines would Harrisdirect revenue have mainly been going into?

Karen Maidment *- Chief Financial & Administrative Officer*

If you looked on the non-interest revenue page in the supp pack, the Harrisdirect impact, which would be on page 12, would be in securities commissions, as you mentioned. Also -- I'm just having a look here. Mutual fund revenues, a little bit in the underwriting and advisory and the gain is in the “Other” category, at the very bottom in Q4. So it just sort of spreads its way through those few categories.

Michael Goldberg *- Desjardins Securities - Analyst*

Okay. And just another one for Tony. Do you think that now that we've got an inverted yield curve in the U.S., do you think that this will actually result in any opportunities for you to expand your U.S. platform at a reasonable cost?

Tony Comper - ***President and CEO***

It's a good question, Michael. I wish I could say yes; although our experience is that it doesn't necessarily work out that way. When we these impacts and we're seeing it in all of the regional banks. We're seeing a compression in spreads and we're seeing PE ratios down a bit and stocks trading down and our relative -- if you can look at the relative differential it improves and you look at the Canadian dollar then you say this looks like an opportunistic market.

When you talk to potential prospects they go, well, you know what? Margins are squeezed and revenues are down and the stock price is down a little bit and maybe now is not the best time to talk about that. So you get a different kind of reaction. You would expect that to be the case. That's the intuitive feeling, but it hasn't necessarily materialized in a huge receptivity on the M&A front.

Michael Goldberg - ***Desjardins Securities - Analyst***

Okay. The $78 million of gross formations in the first quarter, how much better is this than you would have expected to be normal coming into 2006?

Bob McGlashan - ***EVP and Chief Risk Officer***

Probably in the 15 to 20 range. On the other side of that equation the reversals and recoveries were also a little lighter. So you kind of get a bump from both of them?

Michael Goldberg - ***Desjardins Securities - Analyst***

Okay, thanks a lot.

Operator

Ian de Verteuil.

Ian de Verteuil - ***BMO Nesbitt Burns - Analyst***

Rob, I don't want to be accused of pouring gasoline on the fire here, but I do have some questions on spread.

Rob Pearce - ***President and CEO, PCCG - Canada***

That's fine, Ian.

Ian de Verteuil - ***BMO Nesbitt Burns - Analyst***

You listed a variety of things that obviously are realities of the industry -- loan growth exceeding deposit growth, prime BA spreads and competitive pressures. I can't think of any bank that doesn't face those issues, yet the average bank is down 3 basis points this quarter -- 2 or 3 basis points, you're down 7. So the only thing that I've heard that is different about the BMO is that your residential mortgage growth could be quite a bit faster than your unsecured growth. Is there any other difference you can think of from your business to what else we see out there?

Rob Pearce - ***President and CEO, PCCG - Canada***

I think the big factor -- and frankly, I don't have a good model for this, Ian -- but it's really the mix of everybody's businesses. As you know, I've got north of $100 million in loans and about 40 some odd million dollars -- $45 million in deposits because of the way that we treat certain products within the institution. Everybody's in a different place and we have a different mix of consumer lending versus mortgages and retail deposits versus long-term deposits. So I think it's the gearing and the leverage in all of that mix that is important. That actually makes for some of the big difference.

Ian de Verteuil - ***BMO Nesbitt Burns - Analyst***

Sorry, when you say the gearing and that, what do you mean by that?

Rob Pearce - ***President and CEO, PCCG - Canada***

Sorry, Ian, could you repeat that? I actually said $100 million, I meant $100 billion, sorry.

Ian de Verteuil - ***BMO Nesbitt Burns - Analyst***

But you said the difference could be the gearing I think is the --.

Rob Pearce - ***President and CEO, PCCG - Canada***

I think in different interest rate environments that different business mixes produce different outcomes. That's actually what I meant by that term. It was a loose term.

Ian de Verteuil - ***BMO Nesbitt Burns - Analyst***

So could it be that of those that have bigger unsecured books that are maybe not rate sensitive, as rates rise -- I mean, I would have thought that the BMO, with a more secure, more conservative book, as rates rise you wouldn't be repricing the loans as quickly as

others would be. I think other banks have very big credit card books for example; as rates rise they should feel more pressure then you would. Is there anything -- I guess I'm just grappling here to figure out the variation.

Rob Pearce ***- President and CEO, PCCG - Canada***

Hard to solve here real-time, Ian. I think the big factors are, as I described, in the funding mechanisms and the growth in mortgages versus the growth in deposits are the big issues here.

Ian de Verteuil ***- BMO Nesbitt Burns - Analyst***

Okay, thanks.

Operator

Jamie Keating.

Jamie Keating ***- RBC Capital Markets - Analyst***

This is for Tony I think. Other banks are starting to make a move into sub prime or other channels like the mortgage channel and that represents an opportunity either on the one hand to improve margins and the other is volume. Tony, is your focus primarily on the U.S. or is there opportunity in Canada as well for BMO following…?

Tony Comper ***- President and CEO***

Jamie, we look at everything that's on offer and we'll take a hard look at it. I really do think though, you've made the point and I would reiterate, that our concentration in terms of acquisition has been in the U.S. where we think there are more opportunities that are more aligned to the mix of our business in the U.S.

And so I'm not going to say that we wouldn't look at some of the businesses that are a little bit off our core business mixes and structure. We would of course if we thought that that was going to meet the criteria that we set for ourselves which is meet the financial criteria, meet the strategic criteria and be culturally compatible. But so we're in there, we'll look at them, but we will probably continue to concentrate on the acquisition activity in the U.S. as opposed to some of the smaller opportunities that might be available in Canada.

Jamie Keating ***- RBC Capital Markets - Analyst***

Thanks, Tony.

Tony Comper ***- President and CEO***

If that's the last question, before we terminate the call I just want to make an announcement. Susan Payne who, as you know, is our SVP of Investor Relations, has accepted the position of Senior Managing Director in Harris Private Bank in Chicago effective April 15th. Since this is Susan's last quarterly meeting I wanted to take this opportunity to personally thank her for the I think really exceptional job that she's done as head of IR and wish her the very best in her new leadership role. And I'm sure that Susan will demonstrate the same outstanding level of professionalism and dedication that she's brought to Investor Relations.

Susan successor is Viki Lazaris, also effective April 15th. Viki has excellent credentials to lead our IR team. In addition to holding senior finance positions in our Corporate Finance group and in the Personal and Commercial Client Group she gained extensive experience supporting several Investor Relations teams as a performance management leader prior to joining BMO. She'll be in touch with investors and analysts in the near future to introduce herself more fully.

In the meantime, if you have any further questions regarding our first-quarter results, kindly call Investor Relations in the usual manner. Thanks, everyone, for taking the time and I wish all the best. And good luck to both Susan and to Viki who's taking over for Susan. So I know it's a busy day for you guys so thank you, everyone, for taking time to participate in our call and we'll talk to you next quarter.

Operator

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