BMO Financial Group

Q2 2005 CONFERENCE CALL

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PRESENTATION

Operator

Good afternoon and welcome to the BMO Financial Group second quarter 2005 conference call for May 25, 2005. Your host for today is Susan Payne, Senior Vice President of Investor Relations. Ms. Payne please go ahead.

Susan Payne *- BMO Financial Group - SVP IR*

Thank you operator. Good afternoon everyone. This afternoon's overview of our second-quarter results will be provided by Tony Comper, President and CEO, Karen Maidment our CFO, Bob McGlashan the head of Corporate Risk Management, and Yvan Bourdeau head of Investment Banking. After Yvan's comments, Tony, Karen, Bob, Yvan and the following members of the management committee will be available to answer your questions. Deputy Chairs Bill Downe and Ron Rogers, Gilles Ouellette from the Private Client Group, Rob Pearce from the Personal Commercial Client Group in Canada. From the Harris Bank, Frank Techar and Lloyd Darlington, head of Technology and Solutions and eBusiness.

At this time I would like to refer our listeners to our investor relations website at BMO.com to view our caution regarding our forward-looking statements and the risk factors pertaining to these statements. Now I will turn it over to Tony.

Tony Comper *- BMO Financial Group - President, CEO*

Thanks, Susan. Good afternoon everyone. Karen is going to walk you through the various accounting changes and other items that complicated the reporting of results this quarter. My own view is that BMO had a mixed second quarter as reported earnings per share increased 3.6% compared to a year ago, and that is unchanged from the first quarter. Personal and Commercial Client Group performed well and the Private Client Group produced another record quarter while earnings in some of our investment banking businesses were lower as were securities gains in our corporate portfolio.

We remain committed to achieving the financial targets that we set for the year. As a reminder, the target for earnings per share excludes changes in the general allowance, and on this basis year-to-date earnings per share have increased 12% from a year ago, that is ahead of our annual target of 3 to 8%. And at 19.5% annualized return on equity so far this year is ahead of our annual target which is 17 to 18%.

The credit story continues to be positive as a result of effective credit management. We now anticipate a specific provision for credit losses of $275 million for 2005, that is down from our most recent estimate of $350 million and the $400 million target for the year that we set back last November. Tier 1 capital ratio is in great shape at 9.38%. The one target where we are lagging is productivity. After improving cash productivity by approximately 420 basis points from 2002, through to the end of 2004, momentum is slowing in this difficult revenue environment. So far this year we have improved the cash productivity ratio by 90 basis points to 62.9 or 31 basis points if you exclude revenue from the restructuring of customer securitization variable interest entities. It will be quite challenging to achieve our target of increasing cash productivity by 150 to 200 basis points a year without compromising business growth which we're not prepared to do. This does not mean that we are any less committed to this important long-term goal.

Good news story this quarter was the strong volume growth in a soft market, delivered by our Canadian personal and commercial team. Slide 5 provides greater clarity on a key contributor to this growth and that is the strength of all of our Canadian commercial businesses which we believe have great ongoing growth potential. It is well-known that BMO ranks a strong second in business banking loans; that is loans up to $5 million as illustrated by market share growth of 26 basis points in the most recent period. What is less well understood since there is no external tracking mechanism, is that we are experiencing even stronger growth in commercial midmarket lending and that is loans above $5 million which is a profitable business for BMO. In fact the midmarket component has grown to one-third of our total commercial loan book in Canada.

And the deposit side is also encouraging; commercial deposits have experienced double-digit growth over the last year. Slide 6 summarizes BMO's economic outlook for the remainder of 2005. In the context of this outlook our key priorities for 2005 remain unchanged. As mentioned we are working hard on productivity which continues to be our top priority. The key priorities is to continued improvement in the performance of our U.S. businesses, which succeeded in boosting year-to-date net income to $285 million and that's from $177 million a year ago. Those results benefited from the recent Mercantile Bancorp acquisition.

This integration is ahead of plan and with the completion of the Harris Charter consolidation this weekend, we anticipate that the benefits of system and process integration will start to accrue in 2006. I think as everyone is aware, our U.S. direct brokerage, Harrisdirect, continues to operate in a highly challenging and competitive market environment with pricing pressures and uncertainty regarding industry consolidation. We're very focused on improving this franchise by executing our strategy, providing value and innovative investment tools for the informed investor and we continue to monitor progress.

I would also point out that this business forms a small part of the Private Client Group which delivered record results this quarter. We're increasing our presence in the United States through both organic growth and de novo expansion and we continue to pursue retail-banking acquisitions. Retail expansion of the Harris franchise beyond our Chicago area footprints will be a key driver of future growth. Our goal is to become the number one personal and commercial bank in the Midwest.

Finally, I would simply remind everyone that we have positioned BMO as Canada's high return, low-risk bank with a good track record for stability, earnings consistency, and strong dividend growth. And we believe that over time we will solidify this reputation. And over to you Karen.

Karen Maidment - ***BMO Financial Group – Senior EVP, CFO***

Thanks Tony, and good afternoon. From a financial perspective I would characterize the quarter as mixed as well. On the positive side, we had strong P&C results on both sides of the border with good volume growth, good expense management, and good contribution from our Chicagoland acquisition as well as solid credit performance.

In P&C Canada, we benefited from both the recovery of prior year's income taxes in the current quarter, and the negative impact of the card fee revenue adjustment in Q2 of last year. Excluding these items P&C Canada still grew net income 13% year-over-year.

We had record earnings in the Private Client Group, with strong revenue growth and good expense management particularly in Canada. On the challenging side we experienced a slowdown in IBG, specifically in our interest rate sensitive businesses in an unfavorable rate environment. In the Corporate Support area last year, we took advantage of the low interest rate environment and realized gains on some of our securities while in the current quarter we have booked a litigation provision in the U.S. significantly affecting year-over-year comparability and which I will provide more details on in a moment.

Overall, although we did expect our earnings momentum to slow compared to the exceptional year in 2004 and a strong Q1, it was a mixed quarter. There are a number of significant items and on slide 3, we provided a summary of them. Also for your reference we have included a more detailed breakdown at the end of our press release on the last page.

In summary, there were 5 significant items in Q2 that increased net income by $63 million or $0.12 per share. They included the general allowance reduction, the benefit to IBG revenue from restructuring our Variable Interest Entities, prior year's tax recovery in P&C Canada, a lower merchant banking fair market value adjustment primarily in IBG, and a litigation provision related to PCG and booked in our corporate U.S. Group. I will highlight a few of these items beginning with the VIEs.

As you may recall, we were required to adopt the CICA accounting change on November 1, 2004, to consolidate our Variable Interest Entities that were set up to assist our customers with the securitization of their assets. In conjunction with that, we were required to reduce retained earnings at that time by $42 million.

During the second quarter, we completed the restructuring of these VIEs, which resulted in a revenue gain of $44 million recorded in other non-interest revenue or $37 million after-tax. We are not permitted to record this gain in retained earnings. The net effect on the capital or the retained earnings is $5 million, which is the market value adjustment during that time period. There is also no impact on Tier 1 capital as we had received capital relief from OSFI while they were on the balance sheet.

The second item I would like to highlight is the litigation provision which relates to the legal claim against the company acquired by our Private Client Group in the U.S. in 2002. The business which was subject to the litigation was institutional trust business and was subsequently transferred to a third party in '02. We have entered into a settlement agreement which is subject to court approval in May and since the claim dates back prior to BMO having made the acquisition the provision was reported in a corporate area since it doesn't relate to the ongoing operations of the Private Client Group. And this accounted for $0.03 a share.

As a reminder Q1 '05 significant items increased net income in that quarter by $53 million or $0.10 a share, so excluding these items in both quarters, cash EPS is $1.09 in each period and net income declined Q over Q by $12 million. Looking at the financials on a reported basis on slide 4, net income of $600 million for Q2 was 2% higher than a year ago and flat to Q1. ROE for the quarter was 19.5% and as Tony mentioned reported earnings per share growth year-over-year is 3.6%. Specific provisions for the quarter were $46 million and we reduced our general allowance by $40 million. Cash productivity slipped this quarter to 64% driven by lower revenues and a negative revenue to expense differential of 1.6%. Our U.S. results also declined from Q1 due to the litigation provision but we're still markedly better than a year ago and on a year-to-date basis.

Turing to slide 6 you can see the change of cash EPS compared to Q1 2005 and Q2 2004. Quarter-over-quarter cash EPS increased $0.02, the reduction in the general allowance and the lower effective tax rate were primarily offset by lower business volume growth and the net effect of significant items. Year-over-year, the increase in cash EPS was $0.04 driven by significant items and a reduced effective tax rate partially offset by lower business growth in IBG.

Slide 7 provides an analysis of revenue, both quarter-over-quarter and year-over-year revenue growth were weak despite solid volume growth in our retail operations and growth in the wealth management group. As IBG revenue was down on lower debt underwriting and lower trading revenue. Year-over-year, business-related revenues were down in IBG on lower spreads in our interest rate sensitive businesses, and a decline in both trading revenue and equity and debt underwriting. However, commission revenue and M&A revenue rose on increased levels of client activity. Corporate revenues were appreciably lower primarily because of the high levels of investment gains in Q2 of last year.

The next slide, slide 8 shows that total bank margin which is the second line from the bottom, was 160 basis points in Q2, down 4 basis points from 164 basis points in Q1 and down 15 basis points from 175 in Q2 of last year. Excluding the impact of the VIEs margins were down 4 basis points quarter-over-quarter and 3 year-over-year. Going forward, total bank margins should improve approximately 12 basis points excluding the impact of the VIEs.

Business expense growth was well contained as shown in slide 9. Both on a quarter-over-quarter and year-over-year basis. Other increases were due to acquisitions and the litigation provision previously mentioned. Wrapping up on slide 12 you can see that based on our year-to-date performance we're well-positioned to achieve all of our targets except for cash productivity which will be challenging in the current revenue environment. In order to achieve 150 basis points improvement revenue in the second half of 2005 would need to improve by approximately $160 million, or expenses must decline by approximately $100 million against the current levels. We're working with the groups all across the bank on this but it will be challenging if the current revenue environment continues. Thank you and over to you Bob.

Bob McGlashan - ***BMO Financial Group – EVP, Head of Corporate Risk Management***

Thanks Karen and good afternoon everyone. You can see on slide 3 credit quality remained stable this quarter as impaired loan balances and formations continue to remain at low levels. On slide 4 this is further evidenced by a total PCL of $6 million for the quarter including a $40 million reduction of the general allowance. The corporate portfolio continues to be in a net recovery position while the level of PCL's on the commercial portfolio remains relatively stable.

The level of PCL's on the consumer portfolio increased mainly due to a provision taken related to the Jetsgo insolvency in respect of Moneris Solutions, a joint venture of the bank involved in the business of processing merchant card transactions. The general allowance reduction was driven by the continued strong performance in Q2 and the current stable credit environment.

On slide 5, new reservations continue to remain low and reversals and recoveries have declined from unusually high levels in 2004. As shown on slide 6, our target specific provision for credit losses for 2005 is now revised to $275 million or less, from $350 million or less. This represents 16 basis points of average net loans and acceptances versus our 15-year average of 39 basis points. Provision of the target specific provision for credit losses is due to a strong Q2 and Q1 performance in conjunction with the following 3 points.

First, the current credit environment is stable and healthy although we believe the cycle is turning. Two, new reservations for 2004 totaled $510 million and we continue to anticipate 2005 new reservations will be similar. 2004 reversals and recoveries were $443 million. However, we anticipate that 2005 reversals and recoveries will be significantly reduced largely as a result of the dramatic reduction in the size of the impaired loan book and GIL formations year-over-year, and a consequent moderation of loan sales activity in the secondary market from that which we experienced in 2003 and the first part of '04.

We continue to track a number of sectors, two of which are detailed in the appendices to this presentation on slides 14 and 15. Although none represent a material exposure to our forecast slide 14 shows that our exposure to the auto manufacturing and supply sector is not material. There were no significant losses in this sector this quarter or last. While the $97 million identified for motor vehicle manufacturing is largely North American manufacturers, the aggregate amount is nonetheless small.

Slide 7 shows our trading and underwriting performances being relatively stable -- with seven days during the quarter with a negative P&L. The largest of which was $3.9 million on April 29, attributed to credit holdbacks and valuation adjustments primarily in capital markets. As you can see on slide 8 we are an active player in the derivatives market and generally rank in second or third position amongst the banks terms of our notional or risk weighted derivatives book. Most of our derivatives business, however, is in plain vanilla interest rates and foreign exchange transactions.

The graph on the right shows that our credit derivatives book was $26 billion as of December 31, 2004, well below the five bank average. On slide 9, you'll see the allocation of our credit protection portfolio by industry. We're active in the use of single name credit default swaps to mitigate risk related to specific credit exposures and indexed credit default swaps to mitigate sectoral risk concentrations. The low ratio of protection bought to BMO's total loan book, about 0.6%, reflects our judicious use of this product. Strategically we did not use credit default swaps to lay off total risk at loan origination to support fee only business. We manage loan risk at origination and supplement with credit default swaps opportunistically for portfolio risk diversification or expected risk migration.

In a moment, Yvan Bourdeau will be giving you more color on a trading book both in terms of credit default swaps, as well as hedge funds but before that, I will touch on the criteria used to determine the eligibility of our counterparties for hedge fund transactions. You will note on slide 11 that our aggregate hedge fund exposure is modest. All counterparties are approved with limits set through our commercial lending process and our requirements include such things as having a good reputation in the market, a prospectus or offering memorandum that clearly defines strategies, risk management, leverage, and redemption policies. We would also require 3 years of audited financial statements prepared by a reputable accounting firm and a minimum net asset level to insure substance and a satisfactory track record.

In addition, we require monthly summaries of net assets and performance, quarterly balance sheets and income statements and at least annually, a schedule of investments using market fair value pricing. And as Yvan will next describe you'll see the nature of the risk we take is conservative. Over to you Yvan.

Yvan Bourdeau *- BMO Nesbitt Burns - President, COO*

Thank you Bob. Moving to slide 10, our CDS or trading book is predominantly in a loan protection position. As illustrated on the slide, our industry exposure is well diversified with significant concentration of risk in only 3 particular industries. We have shifted our term risk to shorter maturities over the past year. One-third of our exposure is to AAA rated entities, and 100 percent of our exposure is in investment-grade. Our derivative trading activities are subject to comprehensive limits and reporting requirements and our derivatives exposures are monitored on a daily basis. On slide 11 you will see our exposure to hedge funds.

Our direct exposure to hedge funds is comprised almost entirely of capital market transactions mainly foreign exchange and interest rate swaps on an uncommitted basis. Any mark-to-market losses in excess of established thresholds are subject to collateralization by the hedge fund. Exposure to fund of hedge funds include capital market transaction as well as direct unsecured loans to accommodate timing differences in the flow of funds. And finally, exposures to prime brokerages are fully margin by marketable securities.

With that, operator, we can now go to questions.

QUESTION AND ANSWER

Operator

Thank you. We will now begin the question-and-answer session. (OPERATOR INSTRUCTIONS) Rob Wessel.

Rob Wessel *- National Bank Financial- Analyst*

Just two quick ones, maybe not quick, I'm not sure. In terms of the forecast improvement in the cash productivity ratio of 150 to 200 basis points, I know the year-to-date target according to slide 4 is 90 basis points improvement. Excluding the VIE benefit or including the VIE benefit, I'm sorry. Is that the right way to think of it? Should we think of it 150 to 200 including the VIE benefit, that is sort of the first technical clarification?

Karen Maidment *- BMO Financial Group – Senior EVP, CFO*

We are looking at it as 29 excluding the VIEs from a run rate perspective but as you can see its 90 on a reported basis.

Rob Wessel *- National Bank Financial- Analyst*

Okay, so does that mean your target includes or excludes when we are thinking of -- and I know you suggested you have difficulty making it but I still wanted to find out?

Karen Maidment *- BMO Financial Group – Senior EVP, CFO*

When we set the target we did not anticipate the VIEs.

Rob Wessel *- National Bank Financial- Analyst*

Okay, fair enough. The second question I want to ask and this is maybe a little more open-ended but when you initially came up with the 150 to 200 basis points, can you just give a little color as to the sources of the improvement, first by segment if you could give some color i.e. by operating division and then second, by sort of improvements in revenue versus slower growth for declines and expenses? Can you just give us a feel for what was underlying that target? And then I guess the follow-up question obviously would be where do you think you're finding it difficult to be done?

Karen Maidment *- BMO Financial Group – Senior EVP, CFO*

As Tony indicated, we look at the productivity as a long run target and we look at it as one of the key sources of improving the overall relative performance of the organization. Of course it is not the only target because we consider capital and return on equity as well. When we set the target for this year it was in the context of the improvements, the substantial improvements, we have made of 420 basis points over the last two years, and so we recognize it was a very challenging target. Each group target is different. Based on where they sit relative to the benchmarks of top tier performance, and each group's revenue growth and related expenses vary again according to what we see as the market outlook at the beginning of the year. And in essence, the productivity concept is one where we try to spend to our level of affordability based on a reasonable revenue environment.

As you can see this year, and of course as the year unfolds, it's always different than you expected at the beginning of the year, but the interest rate environment has been more difficult with lower interest rates but also a flatter yield curve than we had anticipated. Which has really put the pressure on the IBG business and also had us not had as much impact from security gains, and that is where we really found the pressure on the overall productivity target this year. You will see that the PCG and the P&C businesses have shown substantive improvement year-over-year.

Rob Wessel *- National Bank Financial- Analyst*

So just to clarify, Karen, and just not to beat you up or anything I am just kind of curious -- so then is it fair to characterize that the challenges have come more from revenue growth on the capital market side?

Karen Maidment *- BMO Financial Group – Senior EVP, CFO*

That is correct, sort of.

Rob Wessel *- National Bank Financial- Analyst*

The second question I wanted to ask you about is --.

Tony Comper *- BMO Financial Group - President, CEO*

(multiple speakers) You can see that pretty clearly if you look at page 10 in the sub pack, Rob.

Rob Wessel *- National Bank Financial - Analyst*

Okay, great. The second question I have is I guess third question is, we are all sort of following closely what happens in the U.S. discount brokerage sector because it does have an impact on two of the companies in the group. I guess my question is, do you feel that should there be consolidation in the U.S. discount brokerage sector and we will presume you don't participate, that the strategic positioning of Harrisdirect would be materially altered i.e. would be materially worse, that would be my first question, on that issue?

Tony Comper *- BMO Financial Group - President, CEO*

Bill, I will get you to address that.

Bill Downe *- BMO Financial Group - Deputy Chair*

Rob, that's an interesting question. It is one that we have given a fair amount of thought to just because of the level of rumors in the marketplace. Interestingly, it would depend on where the combinations first took place, and secondly, the strength of our own offering against that and by that I mean, you can pick a couple of likely targets and we would have an expectation that there would be some significant account attrition from a combination of two entities that have different cultures and a different product offering. So in actual fact in the short run an announced transaction would probably create opportunities for the unconsolidated parties in the market. In the long run, consolidation is clearly a concern because of big concentrations in a small number of dealers who would have a cost advantage would put pressure on all of us. So I think in the short run, it actually wouldn't have a negative impact on the business opportunity; in the long run it is something that we would not be happy with.

Rob Wessel *- National Bank Financial- Analyst*

Quick clarification, the net earnings contribution from the U.S. discount brokerage side would be roughly what? Just even order of magnitude?

Karen Maidment *- BMO Financial Group – Senior EVP, CFO*

Positive, but pretty modest.

Rob Wessel *- National Bank Financial - Analyst*

Pretty modest would be immaterial?

Karen Maidment *- BMO Financial Group – Senior EVP, CFO*

Yes, immaterial.

Rob Wessel *- National Bank Financial - Analyst*

Last question, before I leave it to someone else in the queue, is to the extent that there is some long-term strategic disadvantage from something that is contributing albeit immaterial amount of earnings, would the bank rule out selling the subsidiary?

Tony Comper *- BMO Financial Group - President, CEO*

What we have done, Rob, we've challenged the management team to come up with a very specific plan which we did at the turn of the year and they are hitting the milestones. And we will continue to monitor closely through and as circumstances change we will change our view.

Rob Wessel *- National Bank Financial - Analyst*

That's great. Thank you very much.

Operator

Jamie Keating.

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

Rob said I had to get earlier in the queue. I have a specific question, page slide 8, looking net interest spreads, and Karen I thank you for breaking out the VIE impact, that is very helpful. It looks like your spreads in total bank are generally pretty flat although the P&C Chicagoland continues to work away; presumably that is a flatter yield curve, and frankly the P&C Canada doesn't look like it's a whole lot better either. Maybe I was anticipating return up earlier; could you just describe what you meant by your comment that I thought you said they should improve some 12 -- I think I am pretty specific on 12 basis points -- is that right, Karen? Did I hear that correctly when you were discussing slide 8?

Karen Maidment - ***BMO Financial Group – Senior EVP, CFO***

I was discussing 12 and that is the effect of the VIEs, (multiple speakers) referring to the Chicagoland and P&C Canada which are really being affected by mix and the low rate environments.

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

Okay. Maybe -- I can't remember if Rob or Frank are present, or maybe if not you can handle it, Karen. I am just curious we were “guesstimating” that the spreads were leveling out and I guess the market is kind of gone away from us on the retail side. But I just wanted to revisit the concept of where the hedges are working or not working and so on and what the unfolding of the spread looks like going forward and what the pushes and pulls are? Are we really at the whims of the market or do we have some hedging benefits starting to come in, in the next few quarters?

Rob Pearce - ***BMO Bank of Montreal - President, CEO, Personal & Commercial Client Group***

Certainly from P&C Canada standpoint I think we have been pretty consistent in our comments on margins which is that they have been pretty stable now for about 5 quarters in our business but the downward pressures from competition and mix are still prevalent as we play out. It's down a little bit in the second quarter; we have a shorter quarter by 3 days and there are some technical reasons why it's down a little bit in the second quarter. But generally they have been pretty stable now for 5 quarters. But the competitive pressures and the mix pressures means there's quite a bit of downward pressure. As the interest rates and yield curves move we might get a little bit of relief there but I think the downward pressures are still the more dominant of the forces that we're facing right now.

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

Rob, is there anything specific in the domestic market that is sort of ratcheting up the price pressure, new parties getting more aggressive again, of the big six that sort of thing?

Rob Pearce - ***BMO Bank of Montreal - President, CEO, Personal & Commercial Client Group***

I think it's fiercely competitive on both the commercial side and the personal side across all of our product lines. There are lots of very good banks that are well capitalized right now looking for opportunities to grow, and that gets played out two ways in this country, it gets played out by price, either in negotiated prices or in new products with price benefits to consumers or businesses. And secondly in credit policies. And those battles are being fought every day in every community in this country.

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

Thank you.

Operator

Quentin Broad.

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

A couple of questions; I will start on the CES, I appreciate the enhanced disclosure. Just in terms of the protection bought against the balance sheet whether it is above (indiscernible), has that changed at all through the last couple of quarters because disclosure in terms of breakdown by sector you haven't given us before. And would that reflect any particular issues you have? Secondly, you talked about the term structures, is it similar to the term structure you outline in the annual report? Thirdly, just with respect to the allocations amongst industry and credit rating on your trading book, would that be equally representative of both protection bought and protection sold on a trading book basis?

Bob McGlashan - ***BMO Financial Group – EVP, Head of Corporate Risk Management***

Quentin, its Bob. I will address loan book bits of that and perhaps Yvan can speak to the trading piece at the end. The exposure, the aggregate exposure has increased a bit over the last several quarters. Not hugely in terms of our total CDS book. It is probably increased from trying to remember where we would have been three quarters ago. But it has gone up probably gone up by about a third I would say over several quarters to the current level. In terms of the duration of that book, it has duration of approximately 3.82 years -- worked that one out for you. I am not sure if there's anything else you are looking for around loan book.

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

And whether you have taken protection, increased protection from any particular industries that you're getting more focused on today?

Bob McGlashan - ***BMO Financial Group – EVP, Head of Corporate Risk Management***

No, you've got to be careful the way you operate with this stuff. If you start buying CDS at a point in time you really feel you have a problem going south it will kill you by the cost, you have to look at it in advance. Typically what we do when we are looking at CDS protection for transactions is we're managing exposure, aggregate exposure as opposed to trying to cover off a loss that we're expecting to have. So the best way to do this is be ahead of the curve in terms of a negative risk migration when you can acquire it at an affordable basis. We haven't ramped up in any particular sector in the last quarter or so, the mix that you see there we have had for some time.

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

Okay.

Yvan Bourdeau - ***BMO Nesbitt Burns - President, COO***

You were referring to a question with regard to the trading book on our CDS book. Two points, one we sell protection as mentioned on slide 11. 100 percent of the counterparties there are truly investment-grade with one-third being AAA. But as when we sell protection when we buy protection, 99% of the protection is bought from a financial institution that the risk management group has to approve limits for. So therefore it is all subjected to the commercial lending practice. And I don't have a breakdown in terms of what or how many percent (indiscernible) of those financial institutions are investment-grade or non investment-grade but my guess would be that most of them would be.

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

Great. Finally for Tony, just the strategic goal to be the number one personal and commercial bank in the U.S. Midwest. I guess I am trying to figure out exactly what that means, is that a market share goal? Is it a profitability goal? Is it a number of branches and could we define perhaps the U.S. Midwest for those of us who can't think beyond Chicagoland?

Tony Comper - ***BMO Financial Group – President, CEO***

That's a good question and the answer is probably all of the above. But it would be defined by first market position, second by financial performance, and third by the growth potential that we see. And when we talk about that area, as you have seen in the most recently, with the most recent acquisition we have done we're now starting to move out beyond simply the Chicagoland and the State of Illinois with that move into Northwest Indiana now. There has been a bit of a trick there because although we say it is a different state and it is (indiscernible) Indiana it is like less than 30 kilometers from downtown Chicago, so it is really -- I would think about it as more of a bedroom community for a lot of the people who are living in that area.

But if you look at that pattern of the Midwest states around Illinois, that is where you can expect to see us, but the fact of the matter is that this is an opportunistic game. What we want to do may not be consistent with what the other sides of the transactions want to do, and you might see us move a little bit farther afield. You might see us look at places like for example Kansas City, which is close. But again its going to be driven opportunistically but you can expect to see the same kind of pattern that we have been pursuing now for three or four years in terms of the acquisition pattern. We would like to ratchet it up a little bit, not a lot.

We would like to acquire somewhat larger properties driven in fact, and Frank can comment on that, driven in fact and in part by the fact that the management team is -- my words, really gotten their act together and I think they are capable of doing larger transactions of the somewhat smaller transactions that we have seen to date. So we're not going to go way off the deep end, but we have talked about moving those acquisitions up. So watch this space and as you look at the distribution of properties that might be of interest to us, there are different numbers and different locations and around that eight state Midwest map, let me characterize it that way.

Quentin Broad - *CIBC World Markets - Analyst*

Who would be number one currently in your mind, Tony?

Tony Comper - *BMO Financial Group – President, CEO*

I wouldn't -- Karen is shaking her head saying I should not respond to that.

Quentin Broad - *CIBC World Markets - Analyst*

Okay.

Tony Comper - *BMO Financial Group - President, CEO*

But you can look at the list and form your own conclusions.

Operator

Ian De Verteuil.

Ian De Verteuil - *BMO Nesbitt Burns - Analyst*

Two questions, the first one relates to the disclosure on hedge funds and just endorse what Quinton said. You guys have set the new levels of disclosure. When I look at slide 11 it says that you've got $1 billion in exposure to hedge funds, across a variety of whether it be working capital loans, or I presume these are like reverse repos. If I were to try to relate this back to page 28 of the supplemental pack that gave the individual loans, would this one billion Canadian of exposures be in the financial services, financial institution sector of that loan exposure? Net loan breakdown?

Unidentified Company Representative

I am sorry, can't hear.

Ian De Verteuil - *BMO Nesbitt Burns - Analyst*

These are loans or reverse repos?

Bob McGlashan - *BMO Financial Group – EVP, Head of Corporate Risk Management*

The loans for hedge funds would show up in financials or is it financial, there has got to be a category here.

Ian De Verteuil - *BMO Nesbitt Burns - Analyst*

Financial institution $6.6 billion.

Bob McGlashan - *BMO Financial Group – EVP, Head of Corporate Risk Management*

Yes, there it is, financial institutions that will be in there. Prime brokerage and funds of funds would be in the repo category mostly.

Ian De Verteuil - *BMO Nesbitt Burns - Analyst*

Just so that I understand on these repos, the hedge fund would have purchased securities and they would put the securities in trust in your account and you would forward proceeds exactly equal to the amount of the securities held, is that correct?

Yvan Bourdeau *- BMO Nesbitt Burns - President, COO*

Yes, it's Yvan speaking, that would take place in the prime brokerage area where we would do security lending as you have just described it.

Ian De Verteuil *- BMO Nesbitt Burns - Analyst*

One of the things I'm interested in is for an individual hedge fund, let's say they had $100, and bought $100 worth of securities and then gave you the $100 of the securities and took $100 cash back from you. They could go out and buy another $100 worth of securities and go to another prime broker and give it to them who would give them back another $100 and they would do another $100, is that possible? Is there some issue of leverage that you have risk to?

Yvan Bourdeau *- BMO Nesbitt Burns - President, COO*

We're fully collateralized by the IDA rules for the prime brokerage, so they would not be able to do that

Bob McGlashan *- BMO Financial Group – EVP, Head of Corporate Risk Management*

If I can add, typically what we do with hedge funds -- almost exclusively what we do with hedge funds is trading, capital markets, treasury type facilities; direct lending is almost nonexistent with hedge funds. So the business of providing them an advance for leveraging, we are absolutely not in.

Ian De Verteuil *- BMO Nesbitt Burns - Analyst*

Okay. So on the fund of funds were you show short-term working capital loans as the nature of the risk, how would that be different?

Bob McGlashan *- BMO Financial Group – EVP, Head of Corporate Risk Management*

There to the extent that they have operating capital requirements where someone has required a redemption, they are waiting for proceeds from a maturing investment, we would provide an advance to facilitate the cash flow gap but again we would not support leverage lending into any , into either of those sectors.

Ian De Verteuil *- BMO Nesbitt Burns - Analyst*

Even when it wasn't fully mature you would have a secured claim on the maturing asset?

Bob McGlashan *- BMO Financial Group – EVP, Head of Corporate Risk Management*

Yes, we still wouldn't go there.

Ian De Verteuil *- BMO Nesbitt Burns - Analyst*

Again thanks to the incremental disclosure; the second question relates to slide 19, which looks at risk-weighted assets. I must say I can't remember when our bank has strapped on it has grown its risk-weighted assets by 6% in the quarter. It looked as if it was across both on balance sheet on off balance sheet guarantees commitments and on market risk. I don't know whether it is a question for Bob or Karen, were there anything particularly in the quarter that caused the risk-weighted to blow up? That will come back off or is this just truly business growth that will result in higher revenues in coming quarters?

Karen Maidment *- BMO Financial Group – Senior EVP, CFO*

There really isn't anything specific; it is across all the businesses and risk categories.

Yvan Bourdeau *- BMO Nesbitt Burns - President, COO*

I would just like to add we had some increase in our loans outstanding both in Canada and the U.S. and obviously those are corporate loans so that is 100 percent risk-weighted assets that would impact that increase and there were as Karen was saying then it is really distributed across other lines of businesses.

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

Is this the leading indicator of higher spread revenues in coming quarters?

Yvan Bourdeau - ***BMO Nesbitt Burns - President, COO***

Maybe if I can answer that one from a U.S. perspective. Just to give you some indication, I would use again the two statistics for the U.S. the utilization rate for our facility for the corporate loans and the second one is the outstanding in Canadian dollar terms. As of the end of January our utilization rate in the U.S. was 52.4%. As of the end of April it was 55.5% so there has been definitely an increase during that quarter. And obviously it translates into higher balances in Canadian dollar terms moving from the U.S. from $13.2 billion to $14 billion. So we had an increase of about $800 million. In Canada the balances have increased from $7.3 to $7.7 billion and utilization rate moved from 32% to 32.9% so we have seen a positive increase in both markets from an IBG perspective.

Karen Maidment - ***BMO Financial Group – Senior EVP, CFO***

So we only put them on in anticipation of higher revenue.

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

Thank you. That's great.

Operator

Darko Mihelic.

Darko Mihelic - ***First Associates Investments Inc. - Analyst***

Actually my questions have just been asked and answered. Thank you.

Operator

(OPERATOR INSTRUCTIONS)

Susan Payne - ***BMO Financial Group - SVP IR***

Operator, are there no further questions?

Operator

Yes, your next question comes from Quentin Broad.

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

No doubt we will get further colour on this in a few weeks, but just to go back to the expense load and ask Frank the perpetual question of if I look at U.S. dollar equivalent NIX ratio at 74.6% on our Canadian GAAP, it looks like it is not making a lot of progress albeit year-on-year it is down 170 basis points, sequential quarter up 250 basis points. So I understand there has been a lot of activity going in due to the acquisitions, what component of that might be stuff we could think about as part of what needs to be done for the acquisition or the activity around surrounding that, versus what might be a core expense load that Harris is focused on to try and reduce? Can you put that into points of the next ratio so that we can understand going forward how much might have to be built-in for becoming the number one commercial bank in the U.S. Midwest?

Frank Techar - ***Harris Bankcorp, Inc. - President, CEO***

Quentin, I probably won't be able to give you what you're looking for but I will try. First of all, you did mention that we have improved year-over-year by 170 basis points and our year-to-date numbers actually 220 basis points better. As Tony mentioned a minute ago, our target in our business is 150 to 200 basis points a year and for the last couple of years we have been on that track. So we are pushing hard to do that, recognizing that we are also pushing hard to defend and compete in this marketplace, and by that I mean we have been investing in new branches. We have been investing in our charter consolidation activities which hopefully are going to come to a positive conclusion this weekend. So at the same time as we are investing and trying to realize market opportunities, we know that we have to improve our efficiency.

So our objective is that, and we believe that we can continue to improve on that type of a basis moving forward. If you look at the uptick in this particular quarter, on a linked basis, there are two reasons primarily -- the first one is Mercantile Bank, the acquisition came in in the first quarter. Obviously we haven't had the opportunity to do much from an integration perspective so our expectation is we will see some improvement with respect to Mercantile going forward. We did have some onetime costs relatively minor but about a half $1 million of onetime costs in that quarter. And also we had a ramp-up in our expense for the Charter consolidation. That is kind of peaking as we speak. Our expectation is we are going to continue to be able to stay on track going forward.

Karen Maidment - ***BMO Financial Group – Senior EVP, CFO***

The other point Quentin that I think is always important to remember is that when Frank's reporting he is reporting on Chicagoland which is really the personal or the retail side. If you add the commercial midmarket that is included in the IBG results the overall productivity ratio is more around 63%, which is a more competitive level.

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

Right. And he has benchmarked on that number?

Karen Maidment - ***BMO Financial Group – Senior EVP, CFO***

We benchmark on both.

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

What does Frank get paid on? Both? Does he get paid on the P&C -- I mean the management group not just Frank, but the management group, the controllables?

Karen Maidment - ***BMO Financial Group – Senior EVP, CFO***

On the combination of the Chicagoland results and the enterprise results.

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

And then if Frank could, if you could Rob gave us a sense of the competitive environment here in Canada on a P&C basis can you just kind of give us a snapshot of what you are seeing on the evolution of the retail markets in the Chicagoland area?

Frank Techar - ***Harris Bankcorp, Inc. - President, CEO***

I think my comments would be no different from the last few quarters, Quentin. We are seeing pressure on our margin although if you look at the numbers back in the deck, for the last three quarters at least we have been relatively flat. We were off 3 basis points this quarter. But relative to what has happened recently that looks pretty good to us, so we are cautiously optimistic about the future. And the pressure we are seeing on the spread side is coming from the rate environment more so than any kind of pickup in competitive dynamics, either by new entrants coming into the markets or competitors acting or behaving in a different way. This is purely because short-term rates are moving up; we can't pass as much of that on to our customers on the loan side as quickly as we would like and we have talked about the fact that we get credit for our core deposits on a long-term rate and the long end of the curve is flatting off. So we are just getting squeezed because of the shape of the curve primarily.

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

Great, thanks.

Susan Payne - ***BMO Financial Group - SVP IR***

We will take our last question.

Operator

Michael Goldberg.

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

Thanks very much. Question about Harrisdirect. I am just wondering when you sit down with your auditors are you getting any questions about the value of the goodwill or the validity of the value of the goodwill that you carry? How do you deal with those questions?

Karen Maidment - ***BMO Financial Group – Senior EVP, CFO***

(Technical difficulty) quarter and we're comfortable with the book value of Harrisdirect.

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

Pardon?

Karen Maidment - ***BMO Financial Group – Senior EVP, CFO***

We are comfortable that there is no goodwill impairment on Harrisdirect as it sits as part of the client-investing segment of our business. So we do review it every quarter.

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

Okay. I am just wondering when you originally bought CSFBdirect, part of the way it was structured was so that your goodwill would be tax-deductible.

Karen Maidment - ***BMO Financial Group – Senior EVP, CFO***

That is correct.

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

Aside from that, has it ever actually made a profit?

Karen Maidment - ***BMO Financial Group – Senior EVP, CFO***

Yes, as I indicated, it has been cash profitable for a number of quarters. There is a fairly heavy amortization of intangibles that is also being charged to Harrisdirect every quarter.

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

Okay. Thank you.

Operator

This concludes the question-and-answer period. Please go ahead Ms. Payne.

Susan Payne - ***BMO Financial Group - SVP IR***

Thanks operator. Thanks for joining us today. I would like to remind our listeners that we will be hosting an investor day in Chicago at the Harris Bank on June the 9th, and this event which will focus on our U.S. businesses will also be webcast and the details of that webcast will be posted on the IR website. If you have any further questions please either call me at area code 416-867-6656 or send us an e-mail at BMO.com/investor relations. Thank you and good afternoon.

Operator

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