BMO Financial Group

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Cheryl Pate *Morgan Stanley - Analyst*

PRESENTATION

Cheryl Pate - Morgan Stanley - Analyst

Why don't I go ahead and get started? I am Cheryl Pate, the Canadian Banks analyst here at Morgan Stanley. It is my pleasure today to welcome BMO Financial Group.

BMO is Canada's oldest bank and serves more than 10 million customers [sic] and BMO is focused on delivering a great customer experience and is known for strong credit management. BMO operates 924 branches in Canada and 672 branches in the US. Here to present for BMO today is Tom Flynn.

Tom has been with BMO since 1992 and has held a variety of senior management positions. He has been in his current role of Executive Vice President and Chief Financial Officer since March of 2011. Tom has served as Chief Risk Officer prior to his current role.

Tom, on behalf of everyone here today I'd like to thank you for your participation in this event and I will open it up to you to make some opening remarks before we join the fireside chat.

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

Thank you, Cheryl. It is good to be here in New York. Good morning, everyone. I'll be fairly brief but I will make some comments related to priorities at the Bank and our recent financial results. I will take five or six minutes doing that.

Bank of Montreal is a North American universal bank serving over 12 million customers. We are the eighth largest bank in North America by assets and number nine by market cap. In the first half of this fiscal year approximately 70% of our revenues were generated in Canada and other countries, and the balance in the United States. We have a strong capital base. Our Basel II Tier 1 ratio was 12% at the end of Q2.

Our retail banking business operates in Canada and the US Midwest with nearly 1,600 branches, over 920 in Canada and over 660 in the US. Retail banking is the largest contributor to total bank income. Within this segment, commercial banking is a strength; we rank second in Canada with approximately a 20% share, and in personal banking we have an 11% share.

In the US, we have strong deposit share positions -- number one in Wisconsin, number two in Chicago and number three across our Midwest markets. Our US Commercial business is also strong and we are well-positioned for a business-led recovery relative to peers.

Our Private Client Group manages and administers total assets of approximately $440 billion. This business provides a broad offering of wealth management and insurance to a full range of client segments from mainstream to ultra-high net worth and institutions.

Over 75% of the bank’s operating group revenues and adjusted income comes from these retail businesses.

Our fourth business group, BMO Capital Markets, provides a full range of products and services to corporate, institutional, and government clients. We operate mainly in Canada and the US; as a bulge bracket firm in Canada and with a mid-market focus in the US. We were recently named Best Investment Bank in Canada for the second time and Best Metals and Mining Investment Bank for the third year in a row by Global Finance Magazine.

I will now touch on a few key priorities that we are focused on. First, execution of our North American growth strategy is progressing well and we are pleased with the benefits from our acquisition of Marshall & Ilsley completed about a year ago. The transaction was opportunistic and significantly strengthened our US banking platform. We have taken the best from both organizations in terms of people, processes and products to significantly increase the competitiveness and profitability of our US banking business. Integration is on track and we continue to expect that the more than $300 million in cost synergies that we have talked about will be fully reflected in our run rate results by the end of next year.

Second, each of our businesses operate under a single vision which is to be the bank that defines great customer experience. The consistent focus we have on customers and their success is underpinned by a strong consistent brand

and is grounded in a belief in relationship banking. The importance we place on giving our customers increased confidence has helped us carve out a distinctive position in the marketplace.

And lastly, we are focused on improving our productivity. We are simplifying structures and process to become a more efficient bank. Our effort here is well organized and focused on a number of work streams.

I will wrap up with a few quick comments related to our Q2 numbers which we thought were good. Second-quarter net income was $1.028 billion, adjusted net income was $982 million, up 28% from a year ago. EPS was up 15% to $1.44 per share.

Looking at the operating groups, Personal and Commercial Banking Canada, net income of $446 million was up 8% year-over-year with operating leverage of 2.3% as expenses were well managed.

Personal and Commercial Banking US adjusted earnings of US$137 million more than doubled from a year ago. We remain focused on completing the integration of M&I and building on a leadership position in commercial banking in the US Midwest.

Our Private Client Group had its best quarters in two years with adjusted net income of $150 million. We had good performance across our wealth businesses and from our insurance business in Canada.

And lastly capital markets delivered good earnings in the quarter of $225 million which was in line with a level of a year ago and up about 10% from the prior quarter.

To close, we feel good about the financial performance of our businesses and how we are positioned looking ahead. And with that I would be happy to take your questions.

Cheryl Pate - Morgan Stanley - Analyst

Great. And before we get started here, I would like to remind listeners that Tom's comments may include forward-looking statements and that listeners should consult BMO's disclosures on its website for further details and the caution regarding forward-looking statements.

So, Tom, I thought we would start off talking about the Canadian personal and commercial business, obviously a lot of debate surrounding consumer leverage and the state of the Canadian housing market. Maybe you could lay out your macro thoughts in terms of if we are looking for some sort of correction in housing and how that plays through into lower growth that we are expecting in the consumer lending segment over the next several quarters.

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

Sure. It is our view on the personal business and housing market, that growth is likely to slow. We think that is a good thing because Canadian consumer leverage has increased significantly.

And so, as we look at the business, we are managing our risk in what we think is a prudent way across our portfolios. We don't expect that we are going to have a significant correction in the housing market, and we think that the issues in the market now will manifest themselves through lower growth. And looking at the performance of our bank and the other banks over the last few quarters, you are starting to see loan growth slow. We are running mid-single digits and we think that rate of growth will continue over the next few quarters and we are managing our business based on that kind of an expectation.

The other thing that is impacting the business is lower rates and lower rates put some pressure on net interest margins so that is another factor that has caused us, in part, to focus on productivity and looking to drive the bottom line through a sharper focus on managing productivity.

We do stress testing of different results and I know talking about stress testing is topical. I won't go into the details of the different scenarios that we run, but the structure of the Canadian housing market provides a very significant cushion to the banks from a risk perspective; and the banks don't take mortgage risk above an 80% loan to value and we don't take home equity risk above an 80% loan to value. And where we write mortgages above an 80% loan to value 100% of the mortgage that we do is insured. And so you need a very, very significant correction in the market in order to produce significant impact on earnings. And based on all of the stress testing that we have run, we are very comfortable with our portfolios.

Cheryl Pate - Morgan Stanley - Analyst

BMO did exit the broker channel for mortgages a few years back and have been focused on branch channel originations. And one of your great successes has been the 25 year amortization, simple mortgage. Can you talk about where you are seeing the growth coming within the channel? Albeit with more normalized growth in general, but what your competitive advantage is and how you have been able to take some share given the sort of new product focus?

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

Sure. We exited the broker channel about four years ago and did that mainly because we wanted to focus our employee efforts and our balance sheet on our core customers who we think we will have the opportunity to do business with. And our experience was it was hard to cross sell people who we wrote mortgages for through the broker channel. And so we are focused on maximizing wallet of our core customer and that is why we moved in that direction.

We did have a mortgage offer earlier this year that featured a 25-year amortization and that is a shorter amortization than the average in the market which would be around 30 years and a relatively low rate. And the product was structured, so that customers were basically signing up for shorter amortization at a relatively low rate but a lesser ability to opt into different products through time. So the retention level in the product will be above average.

And we did very well with that product. Our pipelines are stronger than they have been for some time, and we think it is a good product for our customers and the market because although the rate is relatively low, the payments per dollar of mortgage are actually higher because the impact of a shorter amortization period is larger in the determination of the payment than the low rate. So it helps our customers pay off their mortgage more quickly which is good for them and it also doesn't put upward pressure on the housing market because the payment associated with a house purchase is higher.

So it is a good product for the market, good product for our customers, and a good product for us in terms of generating interest in our Bank and our offers and attracting good customers.

Cheryl Pate - Morgan Stanley - Analyst

And maybe to round out the consumer lending, we'll spend a little time on credit card. Obviously a strong MasterCard issuer, there's been obviously an acquisition in this space within your peer group and another peer that is pulling back on the credit card lending. Can you talk about the dynamics you are seeing in the marketplace within the credit card product?

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

Sure. We are a MasterCard issuer in Canada and historically Canadian banks were only able to issue either MasterCard or a Visa product and those rules have recently changed. But most of the banks are very predominant in one or the other card. And we're the number two MasterCard issuing bank in the country. Our portfolio, I think, is about $6 billion in size, slightly underweight as a product for us relative to our peers.

What we have seen there is balance growth has slowed. And so, we haven't pulled back significantly from a risk perspective over the last little while. Our credit performance has been trending over the last few years in a positive direction as unemployment has come down and we are comfortable with the risk profile. Our loss rates would be comfortably below the loss rates in the industry overall, and that would be consistent with our overall credit performance, which is better than the industry average overall.

So, business is relatively stable, growth is down a bit. Again, not a bad thing given the state of consumer leverage. There was one transaction that you referred to in the market and a non-Canadian player exited the market and we don't see that as having a really significant impact on the overall competitive dynamics in the marketplace.

Cheryl Pate - Morgan Stanley - Analyst

Maybe we will turn our focus a little bit to commercial lending which clearly has been an area of focus for all of the Canadian banks as sort of the growth dynamics within the commercial segment are accelerating versus the deceleration on the consumer lending site. And, obviously, BMO has historically been a very strong player in the commercial market.

So, maybe we can talk a little bit about your competitive advantage there and how you are managing through increased competition in the commercial lending space in particular.

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

Sure. So commercial lending is the strength of our bank and we think it is something that positions us well for this environment. Our share position in commercial banking, both Canada and US, is bigger than in personal banking and we think we have good offers. So in Canada in commercial banking, we are number two in the market. We have a 20% share give or take and we have had that strong position for years. And it is based on a business model that focuses on the relationship coverage, looking to provide our customers with a full suite of products -- including lending, deposit products and treasury management products where we have been investing in our technology and good industry expertise.

And we think that kind of a model sets us up well. And we are integrated in that we have got front-line people who know the clients, know industries and we have also got that supported with a risk group that is experienced and does a good job for us.

In the US, we also think we have a very good business in both our Harris Bank and M&I. We had strong core commercial and industrial lending businesses and together, in our Midwest footprint, we think we have got, a great capability and we have put together the two businesses. We have got industry focus, we are focused as well in the US on our treasury management product, which is a good business in that it generates deposits and also fees, and our technology is good and we are starting to see good growth coming out of the combined US commercial business.

In the last quarter our loan growth in the core C&I portfolio was 16% on an annualized basis. The growth in the overall commercial portfolio was lower because we do have a portion of the portfolio that is in runoff, and that is about $3.3 billion coming from mainly the legacy M&I commercial real estate portfolio.

But if you look at the what we would call the core part of the C&I book, the trends are very encouraging. We have had three quarters of growth and the good 16% growth in the last quarter. And our hope and the hope of some of our competitors is that with the economy continuing to grow and, hopefully, Europe settling down and confidence increasing we will start to see growth in the Commercial segment that is in the higher single-digit level on a sustained basis.

Cheryl Pate - Morgan Stanley - Analyst

I think a couple of the initiatives that you've highlighted today and before have been building up from the deposit and the treasury management side of commercial. Thinking particularly in Canada, so can you give us some more color around how that is progressing?

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

Sure. So in Canada we have a 20% share in the commercial market. We are very proud of that and we have built that business. Our deposit share on the commercial side is significantly lower than that and the deposit share numbers are harder to define because the industry data is not as good. But we would be below 15% from a deposit share perspective. And so, we have focused on encouraging our relationship management people to put energy into the deposit product and treasury management products.

We've been doing that for over a year and we are seeing good growth. And in the last few quarters we have had growth that is in the double-digit range, low double digits sort of 10-11% growth in our deposit business. And what we're trying to do in part is just change the culture of the organization in our commercial business; and because we have had a strong lending share and we have got a good capability, that has been the higher profile sort of sexier part of the business and we are promoting with people the value of deposits and the Treasury Management business and encouraging them to focus there and seeing a good pickup.

And part of the theory behind this is that it is easier to do more business with existing customers than to win your customers. And with a loan share that is significantly higher than our deposit share, we think that if we focus on it, there will be a good opportunity for us to grow the business.

Cheryl Pate - Morgan Stanley - Analyst

And then clearly expense management has been very topical this year, as well as consumer lending sort of slows down to a normalized rate and we certainly saw good improvement on the operating leverage front in the second quarter. Maybe you could talk a little bit about specific areas you are looking to manage down costs and weighing that off against investment spend to grow the business as well.

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

I think the natural reaction in the current environment given lower growth and low rates and higher capital on loan liquidity requirements is to focus on productivity. We are doing that in an organized way in the bank across the organization and we have got a team of people focused on that. We saw good results in our P&C Canada business in the last quarter with operating leverage of 2.3% which was a great number in our view. We haven't suggested to people that we will keep up at that rate through the balance of the year, but we are very focused on generating positive operating leverage in the business through the year.

And in our program, we are focused on a few themes. One of them is to look at what we call our core processes and to go through those processes and to define them, introduce better lean methodologies so that we are doing things as efficiently as possible and in a lean fashion, introduce more technology, and in places looking at off shoring. And so an example of that is our mortgage processing in Canada. And we have got about a $65 billion Canadian mortgage portfolio. It is our biggest single product and we are working now on redesigning the entire process for the underwriting and servicing of mortgages and changing the model in significant ways that we think will free up meaningful time for people in the branches, reduce our cycle time to respond to customers significantly so that we are improving the customer experience and lowering our costs because we are designing things in a better lean fashion.

So, that is a little color around one of the processes that we are focused on and we have talked about this as work that will go on for a few years. So we are managing expenses in the current environment, squeezing expenses down in places; but as we look to invest in more technology and lean methodologies in our core processes, you are into the basic functioning of the Bank's operations and that is a big job that just takes time.

And so, we have talked about this as an effort that will go on for a few years as we work through the organization. We are not expecting a fundamental change in the outlook so we think the relevance of this effort will continue for the next several years and we are focused on it and committed to it.

Cheryl Pate - Morgan Stanley - Analyst

Great. Maybe just one last question on the Canadian P&C side. Obviously net interest margins have been under pressure, given the low rate environment and the competitive dynamics, particularly on the lending side.

Could you talk about some of the tools that you are using to help mitigate some of the pressure and areas that you have been able to grow successfully?

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

Sure. So banks in Canada, as you would know, are experiencing pressure that is similar to pressure in the US. The biggest source of the pressure is low rates. Competitive pressure contributes to it; but rates are the larger factor. And looking ahead, we expect some continued downward pressure on the net interest margin. We don't think it will be significant quarter over quarter, but 2, 3, maybe 4 basis points of the pressure absent action is something that we think is likely to occur and there will be a movement around that.

In terms of things we are doing to focus on the issue, one is back to growing our deposit business in the commercial business. And that is profitable business, and additive to both our net interest income and our net interest margin, and we think we will generate disproportionally strong growth in that part of the market.

We do think that the Bank of Canada is likely to raise rates in the first half of next year and we have pushed our expectation out there from a timing perspective. And when that begins to happen, it will be positive from a margin perspective. And so, we are hopeful that we will pick up something there.

And then I guess, lastly, I would say that the industry is mindful of the impact that low rates has on margin and it is a highly competitive industry. But the price competition element is one that I would say has cooled over the last six months compared to where we would have been about a year ago.

Cheryl Pate - Morgan Stanley - Analyst

Maybe we'll move along to the US Personal and Commercial and we talked a little bit about the growth that you are seeing in the C&I portfolio ex the runoff in commercial real estate. Maybe you can give us a little bit of an update on the M&I integration and next major milestones to come.

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

So, we closed our acquisition about 11 months ago. This was a large acquisition for us, $4.1 billion, and roughly doubled the size of our US retail bank and was a really good fit in terms of the geography and the core business that M&I had, and both the geography and the approach to business is highly complementary to our Harris business. And our hope through the downturn was that we would have a chance to materially grow our retail banking business towards the end of the downturn and M&I was always a bank that we thought would fit well with ours and so we are very pleased with how that played out.

Performance to date on almost all measures is ahead of the business case that we had at the time we did the transaction. The businesses have come together from a frontline perspective so we fully integrated the management teams in all of our business groups very, very shortly after closing. We are working on integrating our corporate functions and on doing our systems conversion and the timing for that is that we are looking to complete the major part of the systems conversion in the fall of this year. And work there is on track and we feel good about how it is progressing.

The synergy number that we have talked about is synergies of in excess of $300 million. We're running ahead of schedule on that with the current run rate being comfortably above $100 million and you see that if you look at our combined US expense base compared to the sum of the expense base M&I had and we had pre-transaction there's a significant drop-off between those two numbers. And the synergies will ramp up into next year from the current level once the benefits of the system conversion come through.

The credit performance has been good relative to our initial expectations. So we took a large credit mark on closing and talked about that at the time we announced the deal. And in the three quarters that we've had since closing, credit performance has been better than anticipated on the mark and we have had meaningful income coming from, in effect, the excess of credit mark over the losses that we have had and we continue to be very comfortable.

So, overall we are very pleased. The businesses have come together well. People are united around the combined bank. We are ahead of schedule and we are very confident that the combined business will be bigger, stronger, and more competitive.

Cheryl Pate - Morgan Stanley - Analyst

Why don't I pause for a moment and see if there are any questions from the audience?

Unidentified Audience Member

I just wanted to get an understanding of what is driving the expectation for the higher rates that you are looking for next year. What is the base case assumption that you have feeding into the view that Canada will raise rates probably this year?

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

Well, I did sort of preface my comment there by saying we had pushed out our expectation, and the base case is GDP growth of 2.5% to 3%. You know, there is an assumption that Europe settles down, confidence comes back and growth resumes with a little more conviction. And in statements from the Bank of Canada over the last six months they were becoming a little less dovish in their statements, maybe three-four months ago, based on the economy doing reasonably well and growth expectations being okay. And also a belief that there is a lot of monetary stimulus in the system and we just don't need it anymore and pulling some of that back will create patter in case there is a downturn later in the road and it would be helpful to have rates somewhat higher from a housing market perspective.

The last few statements from the Bank have reflected the reality that uncertainty is higher given Europe; and with that we have pushed out our expectations related to the potential for a hike. But we still think in the first half of next year we will have one and the big two things are we think growth will continue and pick up a little and rates are already very low and monetary policy is very accommodative; and giving a bit of that back as the economy recovers, is what we think will happen and seems to be consistent with the reading of the tea leaves off of the statements from the Bank of Canada.

Unidentified Audience Member

(inaudible -- microphone inaccessible).

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

Yes, the question was is demand from China for resources part of that? I would say it factors into the mix; and Chinese growth has slowed, but we do think that the fundamental trends of there being a good base for demands and commodities will continue.

Unidentified Audience Member

Could you give a little more color on the C&I loan growth, the core loan growth? I think you said it was around 16% or 17% and which industries or types of companies are increasing borrowing?

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

Sure. So the 16% number is the annualized growth number for the last quarter coming from the core portfolio in the US. And it is fairly broad-based. So we are seeing some good trends in the core manufacturing part of the portfolio. Some good trends in our auto dealership finance business and good trends in the financial services part of the portfolio. So, we feel good about that. It is not one sector in particular and it also reflects, I think, just good focus in our business and we went through an exercise of combining people from the two legacy organizations.

We do think we have got very strong leadership in place and we are focused outwardly now, and marketing new customers into the customers that we have got. And that greater energy and stronger capability being applied to the market is contributing to the strong growth rate.

Cheryl Pate - Morgan Stanley - Analyst

Great. Well, thank you, Tom, and please join me in thanking Tom for the presentation today.

Tom Flynn - BMO Financial Group - EVP and Chief Financial Officer

Thank you.