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CONFERENCE CALL PARTICIPANTS

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PRESENTATION

Peter Routledge *- National Bank Financial - Analyst*

Okay, we're back, everyone, with Surjit Rajpal, who is the Chief Risk Officer at the Bank of Montreal. Surjit joined BMO in 1982. In 1985, he became Senior Vice President of Global Distribution in Chicago. In 2006, he became Executive Managing Director and Global Head of Loan Products and Merchant Banking. And then about five years ago in 2011, Surjit was appointed to his current position as Chief Risk Officer.

Before we start, I would just like to remind everyone that Surjit's comments today may include forward-looking statements. Actual results could differ materially from forecasts, projections or conclusions in these statements. Listeners can find additional details in the public filings of BMO Financial Group. All right. Surjit, thanks for being here.

Surjit Rajpal *- Bank of Montreal - Chief Risk Officer*

Thank you.

Peter Routledge *- National Bank Financial - Analyst*

So, lead-off question, what are the key messages you hope to leave investors with today?

Surjit Rajpal *- Bank of Montreal - Chief Risk Officer*

Well, so if I give you the key messages, then you don't have to look forward to the rest of stuff I'm going to say in response to the other questions.

One of the key messages that I want to leave you with is that we have a business mix that is incredible in normal times as well as in stressed times. Geographically, we are well diversified. From a customer segmentation standpoint, we are very well diversified. From a loan standpoint, we are very well diversified. And some of our recent acquisitions have actually added to that element of diversification.

We bought M&I in 2011, and more recently we bought the Transportation Finance assets from GE Capital, and that's added to this diversification that we have across geographies and across products. And even from a currency standpoint, we remain quite well hedged as a consequence.

So the first message is that, look, this business mix that we have serves us well in stressed and non-stressed environments and even from a risk management perspective. From my perspective, managing risk in areas that you understand and know well; we're still largely a North American bank, we do business outside as well -- makes that a great strength of the bank. So that's the key message I'd like to leave with you.

The second message I'd like to leave with you is -- which actually is linked to the first message, and that is that we have a really strong risk culture in the company, and that manifests itself in the results of the company.

When you look back at the way we operate, we have -- since 1990, our average PCLs on the credit side are 41 basis points. And when you look at our Canadian peers, they are about 55 basis points. In 2014 and 2015, we had 19 basis points and our peers were somewhere around 30ish.

Now one could ask: Why is that the case? Why are PCLs that low? And quite honestly, our PCL's are low because we consider our strength and risk to be a defining characteristic of our company. And what I mean by that is we spend very little time looking at what others do, in terms of guiding us as to what we should be doing. We rely more on our own risk management processes and models and use our judgment. We don't rely much on the rating agencies for that matter, in terms of what they rate our clients at. We don't rely on optimizing our regulatory capital. So we don't govern ourselves by what makes sense essentially from a regulatory capital standpoint, but from an economic capital standpoint.

And I think these are the factors that actually contribute long-term to our contribution from a superior performance from a credit loss perspective.

The third thing is that we are diversified, and a lot of questions that I get asked in our quarterly calls relate to oil and gas. So what I wanted to say about that is we have a really strong management team generally, but in terms of oil and gas we have a world-class team. And also for natural resources, we have a world-class team. And a lot of us in the management team of the bank have had direct experience, including our CEO, has had direct experience in the energy sector, which is cyclical. We understand that. So we feel comfortable not just because it's less than 2% of our exposure, but because we've gone through this and we have the experience to be able to maneuver through that cycle.

So those three would be my key messages.

Peter Routledge - ***National Bank Financial - Analyst***

Okay. So my first question for you is one I'm going to ask all the Chief Risk Officers here today. What keeps you up at night?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

Well, last night was a very entirely different reason; I ate too much at dinner. So that's what kept me up. But really there are reasons why a risk professional should have disturbed nights, not necessarily keeping them up completely but disturbed nights. And I'll tell you what I worry about. What I worry about is that in this cycle, we have seen tepid growth globally. And one of my concerns is that there could be a slowdown in global growth, and that could come from an overlay from the geopolitical side, and one doesn't know where that will come from. It could come from left field. It could be a result of Brexit or the refuge problem. It could come from the disputes in the South China Sea. It could come from any terrorism in any part of the world. It could come from, even to some extent as I was thinking about it, it could even come from the political rhetoric in an election year in my home country.

And we tend to ignore that aspect of it somewhat. And quite honestly, I don't know what will cause it, but certainly if things were to slow down and despite being a diversified company with a good business mix, we'll all get impacted.

So I worry about that. If there was one key worry, that is what I worry about, because I don't know where it's going to come from.

Peter Routledge - ***National Bank Financial - Analyst***

Okay. Another issue that I'm trying to think a little bit more about is cyber security and cyber threats. BMO has a discussion of that in its annual report. It talks about the threat of hacking, identity theft, as well as the possibility of denial of service resulting from efforts targeted at causing system failure and service disruption.

So can you elaborate on this, on the issue of cyber security? What worries you most? What has BMO done over the last couple of years to build its defenses?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

So the way we look at cyber security, you get attacked for various reasons. And there are bad actors that will try to attack you for various reasons, whether to steal your data, whether to disrupt you or to disrupt the system.

The way we have approached it is we have got to protect ourselves against any known risk, a possible risk that we can think of. And the way we've gone about it is we look at our own employees as being one source of weakness that can be exploited. So the access rights that they have to our systems, as employees, we monitor. We monitor some of the things that they do that are inappropriate.

We also look at people who've left us. We look at people who are contractors, whether their access rights have been taken away at the right time.

We look at things like -- and more recently, we've been looking at things like whether even absence notifications are appropriate, or whether they actually are giving somebody an in into what's going on in the Company and with some of the key people.

So the first thing you do is you look at what is it internally you can do. And we also have exercises that we do to test whether some of the things that we are teaching them. We teach our people -- there is an education process they go through and that's mandatory.

So we will have made-up phishing attacks, see how they react. So it's sort of in your DNA, you sensitize your entire workforce to be conscious that they could be used as a source. So that's one.

The second thing you look at is your vendors, your third parties that you deal with. And you have criteria that you determine that you will not deal with vendors that do not have robust systems in place that can cause them to be the source of infiltration into your systems.

And the third one is with respect to external parties that you know nothing about. These are the hackers, these are the terrorists, if you want to call them that. Call them what you want to, but these are people that are trying to attack you maybe to prove a point, maybe to steal data.

And there we've got software. We've got software that we will put in place and -- to make sure that a few things happen. Like, one, if you were to get attacked, is there a way in which we can isolate the system and carry on operating; meaning is there a bypass that we've created? How quickly can we detect that something is infected? How quickly can we restore things back to normal?

And we spend a lot of time and money doing that, and we also have a strong governance process around all information security. And our CEO meets every month with the CRO, CFO, Head of Information Security, Head of Technology and Operations, and we meet and discuss it.

And we are also very well connected with the intelligence community. We are members of FS-ISAC in the U.S.; in Canada, we are getting closer to working very closely with the banks. This is an industry problem, and this is one area where the banks are not shy to share because it could be any one of them that can be exposed to this sort of danger.

So I think there's a lot of work that has been done, but there is a lot of work that needs to be done because you still do not know the nature of some of these attacks that will try to paralyze you. And it's a growing field.

Peter Routledge - ***National Bank Financial - Analyst***

Before I jump to my next question, I'll go out and see if there are any questions for Surjit.

Okay, I'm going to ask you about stress testing. I'll come back in another 10 minutes or so.

One of the key lessons from the last financial crisis, the big one, was the realization that stress tests that were run in the, call it the early to mid-2000s, just weren't adequate to the magnitude of the crisis that we ultimately experienced. So can you talk about how BMO's stress testing approach has changed since 2009?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

Well, you make an observation about adequacy of stress tests to what happened in 2008, and that's an interesting way to look at it. We've always done stress tests. I think what people realized in the last crisis was that you probably have to take stress tests and use harsher scenarios than you are used to.

And when you talk about plausible scenarios, you generally go into that zone where things look good at the end. And I think what the industry realized was, look, you've got to do things that make you look -- take you to the extreme, and then see whether you are resilient enough.

So what's changed since then is that stress testing is being used much more so for looking at what your risk appetite should be. It dictates what your limit structure should be. It dictates your business strategy. And you are using stress testing even for other purposes like your resolution plans, which are now mandatory. You're supposed to have a resolution plan which banks didn't have pre-crisis.

So I think stress testing as a discipline has gone, and we've made it almost like in everybody's DNA where you naturally do stress testing and what we would call downside analysis and stress testing. But what's also changed is that we do a lot more than single variable testing than we would do in the past.

We now have the capability, and we have the capability because the data that we capture today is a lot more granular and a lot more detailed than we had in the past. So that's one weakness that was exposed in the last crisis, and banks did not have the kind of data that was required to manage the risks from it appropriately or as swiftly as one would warn them.

There was a lot of manual processes, and today we can find out data much faster. The data is of better quality, and so we use that data much more effectively in our portfolio management of the bank and so that's changed. That's a huge change.

Peter Routledge - ***National Bank Financial - Analyst***

By virtue of your platform, you -- or BMO has to do stress tests every year mandated by the Comprehensive Capital Analysis and Review and the Dodd-Frank Capital Stress Tests.

So have you -- and you've passed them and BMO looks quite strong on those tests, so I want to mention that upfront. But what have you learned from the U.S. experience that you've ported back into Canada?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

What we've learned from the U.S. experience, and it's interesting, stress testing in the U.S. was the mainstay of how a U.S. regulator looks at the strength of the banking system. And what we've learned is that the focus on granularity in the models, that models are built bottom-up as opposed to top down, has been the focus. And a lot of us were quite satisfied building top-down models, which for capital adequacy purposes were more than adequate.

But when you build models with a granularity and build them from a bottom-up approach, these models are incredibly useful, not just for the stress tests that we do in CCAR but even for regular portfolio management. For managing the bank, they are much better, and the data that you need for them is great.

So what we've learned is, while the process is cumbersome and a lot of people complain about the regulatory burden, there is a big spillover benefit to anyone who has completed a CCAR. Because you're ahead of the pack in terms of the quality of your models, the data use that you now are able to put those models through.

So we feel -- we're fortunate that we've had this experience two years in a row, and we are about to make our submissions this year for the current year and done well, that we are in great shape from the point of view of improving our models and our capability on that front.

Peter Routledge - ***National Bank Financial - Analyst***

Okay. I'm going to jump to a question about household exposure. What I spend a lot of time in the last six months worried about is unsecured household debt. BMO's exposure at default to Canadian unsecured household debt I calculate at about $32 billion.

So the big-picture question I have in my mind is we've had 20 years of a pretty good environment for households, and unemployment hasn't really been a challenge. You've got rising house prices and falling interest rates, and that over a 20-year period produces data that shows a very low probability of default for the average Canadian household, which is great. And I wonder, could that ever change? Could your capital models now be under estimating the probability of default going forward? I.e., with the last 20 years so great, it’s a poor indicator of what might happen over the next 20 years?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

So if you look at the capital models that we use, if you went strictly on the basis of historical performance of this market, then I think you should be worried. But when you look at what parameters I use when we calculate our capital, be it for economic capital purposes or regulatory capital purposes, the probability of default in this sector is adjusted for the experience and for the outlook.

And when you look at the parameters that are used, when you look at loss given default, it's loss at the time of default. It isn't an historical default rate that you use. And when you look at exposure, again, you look at exposure at a default level, not in good times.

So I think the parameters that are used are conservative enough. Now having said that, the benefit you get from stress testing is that you actually stress all this in whatever scenario you want to build.

Peter Routledge - ***National Bank Financial - Analyst***

So you stress an environment far worse than what we've seen?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

Far worse.

Peter Routledge - ***National Bank Financial - Analyst***

Okay.

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

And you see the outcome and then give yourself comfort. In Canada, the experience on the housing front has been -- it's very benign and people have generally been paying back their mortgages, which is great. But will that continue to be the case? We will have to see, and we build that into our models. A lot of it is guaranteed, as you know.

Peter Routledge - ***National Bank Financial - Analyst***

How important are house prices in isolation to Canadian household credit quality? As unlikely as this scenario is, if we had a situation where unemployment was relatively contained, but we did see a 20% to 30% peak-to-trough house price correction in a particular region, how would that impact household credit quality?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

Two comments on that. One, average loan-to-values with the kind of decline you are talking about, our average loan-to-values are -- we pretty much accommodate them without much of a stress at all. Having said that, it's not just the household value falling that causes people to stop paying.

I think when you see -- when you look at delinquencies that happen in not just the household debt but in the non-household debt which is unsecured, it's more a function of the unemployment rate. So you'd have to look at what really caused that decline. Was it just a reduction in the values? Is that going to then lead to unemployment in some pockets, or was it because of a spike in interest rates and, therefore, impacts the affordability of the clients to pay back?

So it all depends on the scenario, but as I said, the comfort we have is that our loan-to-value on our uninsured parts, as well as our absolute exposures to our non-real estate exposures is not that large, and more dictated by the unemployment rate than with the housing prices alone.

Peter Routledge - ***National Bank Financial - Analyst***

Okay. I'll come out to the audience and see if we have any questions for Surjit. Right down here in front.

Unidentified Audience Member

So off the top in your opening remarks, you talked about BMO's strong culture of risk and risk philosophy. I'm sure you get a lot of questions from other BMO executives asking you, do you think we're getting compensated enough for the risks that we are taking, especially in a world where costs of capital are going up and net interest margins are being squeezed from low-bond yields. And to that, there can be a variety of answers, such as maybe not, but we're willing to accept that. Or another answer could be, no, maybe we need to take more risk to keep our reward in line; or conversely, we aren't getting paid enough for the risks that we're taking, let's scale back.

So as a CRO, and coming from an institution with a strong philosophy and culture on risk, what's your personal philosophy to that question and to the questions you get from the executives you talk to at BMO that do ask you, are we getting compensated enough for the risks that we are taking?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

So since you asked me for my personal philosophy, I'll make this a little personal. I grew up in an environment where I believed that there was a price for every risk, it didn't matter. I can price any risk you want.

And what I realized when I took this job -- I had been in the business all my life and took this job -- I realized that there was some risks that were inappropriate for a deposit-taking institution to take. You are probably better off in other parts of the sector.

For example, a lot of them are perhaps better off with hedge funds. So as deposit-taking institutions, you have to define what really is the boundaries of the products you want to do and the risks you want to take, which totally was -- which was different from my old way of looking at things, which was for every risk there is a price. And so long as you are appropriately compensated, you should take that risk.

Now to your point in terms of, yes, we have a philosophy where we are -- we have a good risk culture in the company. We have done -- we're really the oldest bank here. We've been around 200 years, and we don't want that to change. We want to be around for a very long time. And in order to look at the company from that standpoint and say, look, we basically don't want to do anything stupid, but by the same token we have to look at things from a risk return standpoint.

So when I talk about risk, it's not risk alone; it's risk return, but then again, within the boundaries of what we consider to be suitable risk. And we spend a lot of time defining our risk appetite at the enterprise level and in concert with my colleagues in the businesses. For each one of their businesses, we have a risk appetite statement.

So there is no confusion as to what we will or won't do. That debate happens at the time we set up the boundaries for those risks that we're going to take in each one of the businesses. There is always a natural tendency to look over your shoulder, see what others are doing. And if others are doing it, there is always a case to be made, why are we not doing it?

So yes, I do get asked those questions, but we really don't worry too much about what others are doing. We look at it from our standpoint. So if there's one thing that I tell our folks is, look, I don't care what others do. Is it good for us, and why are we doing it? And risk return is certainly part of that equation.

Now to perhaps the real question, could we have -- can you lose a little bit of money and make a lot more money? Well, if the answer to that question is yes, I think we should take a little bit more risk and make more money. There's no disconnect between me and the businesses there.

I think so long as it's appropriate and so long as it's manageable, so long as it's well understood and can be monitored, I have no issue with taking more risk for higher return, but still within the Bank's risk appetite. I don't know whether that answers your question. Thanks.

Peter Routledge - ***National Bank Financial - Analyst***

Any others? Okay, I'm going to jump into oil and gas exposure. I think as of the last quarter, BMO had about $7.4 billion in lending exposure to -- drawn exposures to oil and gas clients; $8.2 billion in undrawn exposure at default.

So I wonder if you could just give us a sense of the investment grade versus below investment grade in those two categories?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

I think as of -- it was about 50-50.

Peter Routledge - ***National Bank Financial - Analyst***

On both?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

Yes, on totals.

Peter Routledge - ***National Bank Financial - Analyst***

Okay.

Surjit Rajpal *- Bank of Montreal - Chief Risk Officer*

And there will be migration. Look, the sector is one where there is strain, and so you will find those percentages will vary over time.

Peter Routledge *- National Bank Financial - Analyst*

Okay. In my own stress testing and in my conversations with the banks, a big issue where I have had a disconnect is loss given default. And I've used loss given default assumptions going back to the mid-1980s, which were close to 50%, which is quite conservative. Let's call it that.

So help me understand why a loss given default might not be that severe at this time for BMO, for those loans, obviously, that go into default?

Surjit Rajpal *- Bank of Montreal - Chief Risk Officer*

So we've looked at -- so we've gone past where the prices are today. I think WTI is about $38 today. And if you look at the strip prices, we've done stress tests at well below these prices. And the lowest we've gone is $25 for three years.

And when we look at that scenario, you do get to default rates which are very similar to that which happened in the 1980s. But you mentioned 50% loss given default; our models don't say that. We don't believe our experience says that.

Because when you look at the sector and you look at the composition of the sector, we've got E&P exposures, we've got reserve-based lending. And typically in reserve-based lending, your values don't go down to zero. They go down to something that's pretty good. And if you lose a third on your noninvestment grade clients, that's a lot of money.

So when you talk about 50%, I think that's very harsh. Our assumptions would be that our loss given default rates would be 41 bps at most.

Peter Routledge *- National Bank Financial - Analyst*

How would you monetize the collateral and reserve-based lending to drive down the loss given default?

Surjit Rajpal *- Bank of Montreal - Chief Risk Officer*

There are various -- you don't monetize your collateral as you look at the Company and you say, what you going to do about it? And in some cases, the reserves have a longer life and you can still make cash on cash, you can make money and you need more time, then we would look at it in terms of stretching the term of a transaction, setting out the term.

You can also structure in terms of tranching it, so you get price for the risk that you take. You also look at options. If it's not viable from a size standpoint, you look at combinations, and that is where the M&A activity will happen.

So some of these clients will have to sell. If they are smaller, they will have to sell. So it's a myriad of options that will have to be exercised; some that get restructured, some that get sold, some that get extended.

Peter Routledge *- National Bank Financial - Analyst*

Okay. I'm going to jump to a capital question. BMO has very strong capital, and I have noticed that in your risk weightings, some of your assets are risk-weighted under the internal ratings-based approach; and that others of your assets are risk-weighted under the standardized approach, which is generally a little more onerous.

And now that you've owned M&I for close to five years now, are you getting to the point where you could transition that portfolio or parts of it to the advanced approach, and would that free up a little capital for you?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

I think it would be a little longer before we transition our M&I book to the AIRB approach. There is still a little bit of work to be done. I think it will be about a year before that process is complete. And at this point in time, my expectation is that our capital will come down a little bit.

It also depends on what the standardized approach changes to in the interim. But at this point, the feeling is that it will be a benefit to us.

Peter Routledge - ***National Bank Financial - Analyst***

Okay. Then another question I'm asking everyone is the new recapitalization regime calls for bail-in debt feature. Senior deposit notes with longer than 400-day maturities will have a clause, probably a statutory clause in which they will convert to equity if the regulatory authorities deem it necessary.

I wondered, would your -- how does BMO think of its capital after those instruments get fully implemented? Will you want a higher component of common equity in your capital structure because you have such a greater share of senior obligations that do have this conversion feature?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

I think I walked in when you probably asked a similar question of Sean, the CFO of Scotia.

Peter Routledge - ***National Bank Financial - Analyst***

I did.

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

And I think the response is really no different. It all depends. I think this is still in the proposal stage. We don't know where it will land, and there will be a transition period. And clearly, equity is the highest cost option.

So we'll have to look at it from everybody's standpoint, from a cost standpoint, from a mix standpoint. And in the end, we will be satisfied with what we have. I'm not terribly worried at this point, and Tom Flynn, our CFO, obviously worries more about it than I do. But I don't think it's something that overall is a cause for worry. We will deal with it as it happens.

Peter Routledge - ***National Bank Financial - Analyst***

One issue with the bail-in feature is that it could precipitate more downside volatility if we ever got into a really uncertain economic situation; i.e., people would worry about the conversion feature and they would sell the equity, and that would put just pressure on the institution in terms of its equity valuation.

As Chief Risk Officer, is that something you worry about or is that more of a CEO level issue?

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

We all worry about it, but I don't worry as much as the others would, because I look at it from the point of view of what is our total loss-absorbing capacity. And do we in our stress have the resilience, looking at it on that basis? Forget what the regulators want, whether it's 17% or 20%. But from my perspective, if in severe stress situations we can take a bank and resolve it, as opposed to let it go into receivership and leave it in the recovery mode and come back, I think that's what I worry about. I said, look, we should always have the resilience to be able to recover, as opposed to require to resolve it. And if we have that capacity, I think that's what I would focus on.

Peter Routledge - ***National Bank Financial - Analyst***

Well, we're out of time. Thank you for your time and wish you all the best.

Surjit Rajpal - ***Bank of Montreal - Chief Risk Officer***

Thank you.