BMO Financial Group

Scotiabank – 2017 Global Financial Summit

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Sumit Malhotra *Scotiabank - Analyst*

PRESENTATION

Sumit Malhotra *Scotiabank - Analyst*
All right, we will keep it going right away here with our next guest this morning. Very pleased to be joined by Mr. Bill Downe, Chief Executive Officer of the Bank of Montreal. Bill joined the bank in 1983 and has been CEO since March of 2007. So is the longest serving Chief Executive, who is going to be with me up here today.

Bill Downe *BMO Financial Group - CEO*
Thanks, Sumit. Nice intro.

Sumit Malhotra *Scotiabank - Analyst*
So oftentimes when we are up here, I welcome you to the stage and I ask you to kick off with a little bit of a state of the union, if you will, on what's happening with BMO. And oftentimes, it tends to be shorter term in nature.

Today is a bit different. Unless something changes drastically in the next two months, it's the last time you and I are going to be up here. That's correct?

Bill Downe *BMO Financial Group - CEO*
Yes, I think that’s a high probability.

Sumit Malhotra *Scotiabank - Analyst*
So let's look at it this way. You told me once that when a CEO starts talking about his legacy, it's time to sell the stock. I'm not going to ask you about legacy. But rather than do just what happened last week or what's happening with housing, you are going to be transitioning. And I think it's fair to say you are transitioning from a position of managing the bank to being a shareholder of the bank. And from what Darryl tells me, he's hoping it's as a passive shareholder and not an overly active one.

Bill Downe *BMO Financial Group - CEO*
We'll see.

Sumit Malhotra *Scotiabank - Analyst*
With that said, why don't we start off with some thoughts from you as a shareholder. And what gives you confidence in what I assume is a significant investment for you going forward?

Bill Downe *BMO Financial Group - CEO*
Well, thank you for the generous opening question. I can answer the question both as management and as a shareholder because I have been a significant shareholder for at least the last decade. And I see it the same way.

It's really a forward-looking view that I have, and the position of the bank is based on the four operating groups and their potential.

Personal and Commercial banking in Canada, I think of any market where you could say do you have an advantaged position, we have evolved into a place where I think I can say that now. That the strength of our commercial banking business, which gives us the number two share, which is right on top of the number one share of close to 20% of lending through the cycle, has in my view sustainability. It's a very easy-to-defend capability because it really rests on the quality of the lenders, the knowledge of the market, segment expertise. And we just excel in that business.

And it means that in a period of time when there is an adjustment taking place in segments of the market, like residential housing, we can continue to grow our earnings without over-concentrating in the areas that we don't particularly want to be concentrated in. So you can see much slower mortgage growth in the last three years in our portfolio. We have just around $100 billion of Canadian mortgages and the other large banks have $200-billion-plus of mortgages. And we are getting ready to go into the part of the cycle I think where quality mortgage growth is going to be easier to maintain. And that we have the opportunity to not only maintain market share, but probably increment market share in the high-quality part of the market.

So I think that business is ideally positioned for where we are in the cycle. The Canadian economy is growing very strongly, and that's the commercial marketplace. The consumer is going to benefit from rising wages, which we are seeing, lower unemployment. And interest rates, although there's upward pressure on interest rates, interest rates are not making the access to finance by either businesses or individuals too expensive. So that business is running exceptionally well.

And the transition to a much more digital world is an area where I think we really have a lead on the market in many respects because of the work we have done on the capability of the technology of the bank. So we have been able to roll out things onto our platform because of the strength of the platform. It's not really the new applications, but it's the way that they work and the cost to develop. Like fast opening of an online account in under seven minutes, things like SmartFolio. These are capabilities that are possible because of the underlying investment in the platform. So even in terms of what happens as the behaviour of consumers shift, the emphasis in the branch goes to advice-based sales. Fulfillment is much more self-serve. The relatively smaller share of personal banking that we have, it will be less expensive I think for us to take share there.

In the U.S., after the recession, we saw commercial loan growth -- once again, very strong commercial platform, at 12% to 15% when the rest of the market was on its heels. This year, we've slowed; I think year to date, our revenue growth is around 2.5%. I look at our U.S. peers, it's actually around 2%. So we are still a little bit ahead, but it is the case that in the first half of the year, the commercial marketplace was taking a wait-and-see approach. I think Congress is going to demonstrate its ability to act. But whether it does or not, I think there is pent-up energy in the commercial sector. And I think we are going to see a pickup in of both investment and borrowing and more transactional activity in the commercial space. So I think growth will pick up there.

And after we acquired the business that is now BMO Transportation Finance, we went through an 8- to 10-month period of rapidly rebuilding our capital. I think this time last year we were sitting in a CET1 of 10.1%. We closed the quarter at 11.2%. And in that time period, we did constrain risk-weighted asset growth temporarily, and those constraints are off. So I think that business, you'd have to look at the numbers with a little bit of care. But the third quarter was a strengthening or basically a reversal of the second quarter, which was the weak quarter. So I think the remainder of 2017 and 2018, I think the prospects for that business are very good.

And in both Canada and the United States, we occupy the quality segment of the market. Reputationally, the quality of our infrastructure, and as I mentioned, the quality of the technology. So I am very confident in those businesses.

Wealth management has continued to grow at about twice the rate of the bank for a decade. And as a consequence, it's becoming a larger part of the business.

And Capital Markets is growing into the capabilities in the United States that we've built. So the performance of that business is just going to continue to show strength.

So across-the-board, I think the businesses and the prospects for the businesses are very positive.

Sumit Malhotra *Scotiabank - Analyst*

That's good. Thank you for that. I have a few things for you. And in all seriousness, between our jokes, I did want this conversation, given that you are -- I don't think I said it directly -- but you will be retiring at the end of October. I was hoping that we could weave in and out in terms of a look-back, look-forward on some of the things that have been accomplished over your tenure while tying it into what comes in the future.

One of the big ones, and I think speaks to your comments on housing in Canada, is what I perceive to have been the out-performance of BMO quite consistently when it comes to credit quality within the group. Whether it was tech, media, telecom, energy, the U.S. downturn, I feel like under your stewardship, the bank has been an outlier when it comes to credit quality.

Do you think there is something in the DNA of BMO from a risk perspective that has allowed you to avoid some of these missteps? And then secondly, we think about housing right now in Canada and how good the credit quality metrics look. Are there parts of the market in either Canada or the U.S. that give you some cause for concern on credit?

Bill Downe *BMO Financial Group - CEO*

I think the tradition in the bank of the management of risk has always been based on deep sector knowledge. So when we've had sectors -- and I can look now with some confidence across 30-plus years of pretty specific metrics on all dimensions of performance in risk. And over that 30-plus-year period, we have seen the aggregate provisions of the bank just under 40 basis points versus our Canadian peers, which have been just around 54 basis points. And it hasn't been, Sumit, it hasn't been in the last 10 years. It has been many consecutive periods.

I think it does relate to, first of all, a client focus, where we talk about the risk of transactions through the eyes of the client. We don't want them to jeopardize their capital in their company by being over-levered. And we also have a deep understanding of cycles. So we are much more active in the marketplace in what other people believe are the down parts of the cycle, and we build market share. Oil and Gas is a very good example; commercial real estate is another good example, but I can take any specific segment. What we see is we grow market share in periods like the last six or seven years when many of our competitors are still in shock from losses they have taken. And we expect to have a lower loss experience through the cycle.

We generally start to recognize in our provisions before the rest of the market in downturns. And right now, it is a benign market. We're running about 22 basis points; our Canadian peers are about 12 or 13 basis points above that.

I think that there is a reasonable prospect in terms of the next two or three years that we will continue to see good performance. Because in the aftermath of the Great Recession, we saw recoveries that were spread out over a much longer period of time. And I think there is still a backlog of written-off loans that have not been abandoned that will continue to feed in and maintain probably a better loss experience than some people would expect. So I think that will continue, but it really relates to discipline.

In the Canadian housing market, we led the market to much shorter amortizations, as you know. It was controversial at the time that we did that. We took a fair amount of front-page news. Politicians and analysts who were trying to understand what it was we were doing. But once we explained it, I think people said the logic of it is actually very sensible: shorten the amortization period and then you create some flexibility.

So the Canadian housing market has had adjustments in the past where the market moved down by 20% or 25%. The resilience of the market is much higher today than it was, in my view, six or seven years ago. Because we have seen a restructuring where most of the mortgages now are written to five-year terms, which means they are not all going to be reset at the same time. Most of the amortization periods are 10 or 15 years shorter than they were. So that has created some flexibility.

The loan to value in both the insured and the uninsured portfolio has been conservative. And we are very familiar with the loss experienced in U.S. residential lending, because we were involved in it. And the characteristics of this market are different.

The supply-demand situation in Canadian housing really means that in the most concentrated urban markets, you are going to have relentless upward pressure on price. It's not going to stop, simply because there are people moving into these cities who need housing. The trick there is to balance the risk, make certain that you are lending to borrowers who have good track record of meeting their obligations, and that they have sufficient equity in their home that they can withstand the downturn. And things like subsequent levels or areas of government regulation actually help us. The B20 regulations, if brought in, will have minimal impact on our ability to underwrite and grow our portfolio because we operate at a high standard to begin with.

So I think that for an individual, the prospect of buying a house in a market like Vancouver or Toronto, where the possibility of a housing correction I think is reasonably good, starting with sufficient equity and the ability to -- assuming that you are buying a residence to be your home -- to ride through a market downturn is a sensible thing to do. And we want to make home financing available to people who are in that circumstance.

Sumit Malhotra ***Scotiabank - Analyst***
And just to put a final point on this, we've obviously got a few topics to cover. As you mentioned, BMO's exposure in its loan portfolio to Canadian residential real estate lending, either mortgages or HELOCs, is by far the lowest in the sector. And I think your growth rate of late has been somewhat below average.

In your view, is that a purposeful move that you are positioned this way? Or is it more a structural reflection of your bigger commercial franchise? Meaning, have you, to use the term that was used by the last guest, have you taken your foot off the gas? Or is it more happenstance in your opinion?

Bill Downe ***BMO Financial Group - CEO***
I think we have adhered to a set of standards that we think will endure and allow us to continue to originate mortgages and participate in the market without changing our expected loss experience outside of our tolerances.

And I think that we are at a point in the cycle where we are happy with the quality of the portfolio and the size of our portfolio relative to the overall market. And we should maintain or grow share from this point forward without impacting the credit quality. I don't think we will have to do anything to reduce the quality of the credit.

Sumit Malhotra ***Scotiabank - Analyst***
Good. And that's why I wanted to tie in what is happening now with kind of that historical out-performance as well.

Bill Downe ***BMO Financial Group - CEO***
It's nice to be able to look in 30 years and say through all cycles, the philosophy of the bank has been evident in the performance.

Sumit Malhotra ***Scotiabank - Analyst***
Yes. And I think energy was a good example of that. You had given us some slides that I call the 1986 experience. And it's funny, I think I've been up here for a few years with you now, and we talked a lot about energy two years ago. But it probably won't come up today.

Bill Downe ***BMO Financial Group - CEO***
I think if you are going to lend money into segments of the market, you need to have a deep understanding of the dynamics of those markets. Because you underwrite loans with an expectation of loss, and if you do your job well, your losses will be in-line with your expected loss. And your profit will be what you think it's going to be. That has been our experience.

And I think it has to do with really three very critical important dimensions of risk management. One is the choices you make. So where you are going to participate, the companies or the individuals that you will extend credit to and the markets in which you will do that.

The way you underwrite. And that has everything to do with terms, structuring in a way that it's easy for the client to understand the terms and operate within the constraints of the terms, but also to protect them and the bank.

And then finally supervision. I don't believe you can extend credit and then go sleep until the maturity date. You have to follow the book and understand the dynamics of the book. And you have to get to your clients early in a downturn. In the case of the energy downturn, we were in early conversation with all of our clients. And the performance of $6 billion-plus of credit - with a very material adjustment in the price of crude - was the book grew and the size of the business grew, which I think to me is really the bottom line.

Sumit Malhotra ***Scotiabank - Analyst***
Credit qualities: look-back, look-forward, number one. Let's take it to the U.S. and specifically let's go back to December of 2010. We are maybe out of the crisis at this point; we are not completely sure. At least the equity market wasn't. Neither was the U.S. economy.

Bill Downe ***BMO Financial Group - CEO***
No, I don't think the regulators were either.

Sumit Malhotra ***Scotiabank - Analyst***
And that leads me to the question. I think history is going to show that buying a U.S. regional back in

December of 2010 was a very good move. But at that time, from an economic banking sector regulatory perspective, what gave the BMO management team the confidence that this was the time to, pardon the pun, but to double down on the US franchise? Because it was effectively a doubling of your asset base.

Bill Downe ***BMO Financial Group - CEO***
Right. It was really the culmination of 25 years of relationship building across the market with banks that we thought were approaching their customers the way we do. But the prices were always a little bit high for us and what we were willing to pay perhaps a little bit low for the owners or the Board members of many of those banks.

And we just happened to be much more alert I think in 2010 to a transition that was happening in the market, where fatigue was setting in on the part of a number of banks who were uncertain how they were going to navigate their way back to growth. And regulators who really didn't want to see higher levels of concentration in any bank that wasn't exceptionally well-managed.

So in that year, we moved our CET1 ratio above 10% and made it clear to the regulators and to the market how we calculated that ratio - but it in our financial disclosure, projected out to 2019 - and that gave us a huge advantage. There wasn't anyone else who was actually doing the work at that level of detail. There was only two other banks in the United States who estimated what their CET1 ratio when implemented would be.

We also spent a lot of time with the rating agencies and with the regulators. And we did a transaction in a window that was very difficult for anyone to follow us. We used the transaction to transform our existing business. We wanted to upgrade the technology. We wanted to make it run on exactly the same set of rails as our Canadian system. And we effectively doubled our deposit base.

But more importantly, we took our branch footprint from the smallest in Canada to the second largest of the Canadian banks. That really gives us the opportunity to grow the business with a higher level of confidence in productivity, competitiveness, ability to innovate, and do things in Canada and the United States simultaneously now with the same management. So it was transformational in many ways.

And then I think we benefited enormously from a more rapid recovery in credit markets than people thought. So the provisions that we took as a precaution effectively funded the rebuilding of a much more contemporary technology platform for the bank.

So it worked out exceptionally well in a number of ways. And we have a number one, two, or three market position in six states with a population and GDP greater than Canada now. And prior to that, we were heavily concentrated in the state of Illinois.

Sumit Malhotra ***Scotiabank - Analyst***
I want to do that look and take it forward now to where the business is today. To that last point, obviously, again, conservatism on credit upfront did have a capital cost to the bank. But you earned it back via the provisioning, and obviously capital rebuild has been one of the strengths.

How do you think seven years later that larger position in the U.S. Midwest has changed the perception and the prowess of BMO's U.S. franchise? And not only in the P&C bank, but as you mentioned in your opening, over the last year we've seen a much more robust U.S. capital markets performance from this bank as well. And I know that's something that Darryl has been quite proud of.

Bill Downe ***BMO Financial Group - CEO***
Well, if you look at 200 years of Bank of Montreal history, in the last 100 years, we have been active in the U.S. market as an ever-present commercial bank. But our capital markets business didn't have the benefit of the visibility of the brand more broadly. And we were really focused on just a couple of industry segments.

But when the commercial banking business became a national business -- and now it is a national business; goes beyond the six states -- that created visibility for BMO that I think was very constructive for capital markets. We also made it clear that the focus of the capital markets is in the midcap sector, which is right up against the large commercial banking presence we have.

I believe we bank more large privately owned commercial companies in the United States than any other bank. And that includes the U.S. banks. That creates a feeder ultimately for M&A and equity and debt issuance that is much larger than the investment bank had access to.

And our distribution capability for U.S. equities now is recognized as being beyond the U.S. So we have a distribution platform in Europe for U.S. equities that's really based on the focus that we have in the market.

So I think it's changed the game for capital markets. It's reduced the reliance on trading as the principal source of revenue. And the reason why you've seen the growth in capital markets in aggregate in the last two or three years and the improvement in relationship between expense and revenue is that business is just coming into its own. And the brand visibility has certainly helped.

Commercial banking also has evolved so that we are not just leading and syndicating bank loans, but for many of these companies, we've moved up to lead bank status on equity issuance and on public debt issuance. And I think that's just going to continue to expand.

And you look at our market share positions: we moved past all of the U.S. boutiques. And we are in a zone that the profitability is, I think, much easier to maintain than if we went head-to-head with a bulge bracket firms. So commercial is very strong and the investment bank I think now has the advantage of a national presence in commercial banking.

The part of the business that has not yet demonstrated its full potential is the retail bank. And there are a couple of reasons for that. If you look at the history of BMO as a commercial bank, most of the retail banking was concentrated on the wealthy clients. So it was more of a private bank alignment. And the level of automation was very low.

When we put the businesses together, we modernized the delivery platform. And so I think that we are going to see an expansion in new home construction without question in the Midwest. And we will participate much more actively in the mortgage market in the future than we have in the past.

Take the city of Chicago as an example. Our deposit share is 11% or 12% and our mortgage share historically has only been around 2%. So I think there is real operating leverage in that business.

And I can say that with confidence because the quality of the branch system, the quality of the online capability, the visibility of the bank in the communities in that time period that you have described has really dramatically changed. So I think that's probably the one part of the story that has yet to emerge, but one where I have some confidence we are going to see some very significant income contribution over the next five-plus years.

Sumit Malhotra ***Scotiabank - Analyst***
Let's wrap up the U.S. with very much a "here-and-now". Post the election, there was a good amount of euphoria in the market about the ability of the new administration to, I'm going to say, enact business-friendly policy, whether that was tax reform, whether that was lowering regulation or regulatory costs.

Although the economic and the market environment still has been relatively conducive, clearly there has been no shortage of policy uncertainty. How is the bank, and more importantly your clients, particularly in commercial, managing through this situation? You talked about pent-up demand. There certainly has been a detrimental impact on near-term activity. And I think that explains some of the volatility in the results over the last couple of quarters.

Bill Downe ***BMO Financial Group - CEO***
Well, there is no question that even without legislative regulatory reform, the regulatory burden that our customers are confronted with, and the burden on the banking system, has moderated very significantly.

And I think it would have moderated in any case without the election of a President who is as outspoken as this one. And we have relationships with the Fed and the OCC that go back basically to the origin, certainly the establishment of the Federal Reserve Bank.

And through the cycle, what happens and what we have experienced before is, there is a rapid tightening down on all of the institutions when the market goes south. But we've seen a real moderation in the quality of engagement that we have with our principal regulators over the last three years, and this precedes the election of the President.

It is also the case that there is an enormous amount of high-quality content in Dodd-Frank. The administration of Dodd-Frank and the interpretation of many parts of it have the greatest scope. And if you talk to Barney Frank, he will tell you the ability to operate within the framework of Dodd-Frank in a much more productive way is probably greater than the opportunity around the amendment. So I can see a sea-change in the attitude around government intervention in both markets and in commercial operations. I think our customers are feeling much better about that.

I think the promise of tax reform will be the acid test for the Republican Party, if they are able to do it. But even in the absence of tax reform, I think getting by the next budget cycle and the debt ceiling, if that happens, will be the point at which you will see a release of that pent-up energy and we will see a pickup in growth.

But notwithstanding that, I expect that our commercial business is going to grow faster in the remainder of this year and in 2018 than it has done in 2017 for the reasons I said earlier.

Sumit Malhotra ***Scotiabank - Analyst***
Very good. In our last few minutes, let's talk about expenses and technology and keep the theme going. I feel like over your time as CEO, we've seen a shift in how the market thinks about expense management. Put it simply: when revenue is growing at 10% a year, they didn't really care that much if expenses grew at 7%.

I think especially in what I have termed the restructuring era over the last few years, the delivery of positive operating leverage has become at least a short-term differentiator between banks. From a management perspective, you've got investments to make in the business. At the same time, you are on that treadmill that the market wants to see results.

How has cost control shifted as a management priority over your time as CEO? And for your successor, how does he manage the trade-off between investing in the business and delivering efficiency improvement?

Bill Downe ***BMO Financial Group - CEO***
Well, I think we have an advantage with respect to productivity that comes from digital technology, simply because the investment levels have been very high since the acquisition of M&I. And so the foundation is very strong.

I think we are at a point now where the return from much of that investment is going to fuel whatever future investment is necessary in the evolution of the platform. So I think that as a starting point is a good place to be.

But there is a band around productivity where -- and we are adhering to a 2% operating leverage objective. We continued to adhere to it even when we were spending heavily and it was very hard for us to show that level of operating leverage. But the last 8, 10 quarters, and if you look at the rolling average, we are producing very good productivity, and I think it is a sustainable level of productivity increase -- but there is a band, and I think there is 4 or 5 or 6 points of expense to revenue ratio that the bank will be able to capture. But I would discourage management from going too hard beyond that point because what we've seen in the case of both European and US banks that you get to an efficient frontier. Or maybe it's an inefficient frontier, where your productivity increase is really coming from underinvestment in core capabilities and that puts you way off-side ultimately with markets and with regulators.

But many of the things that have been expensive up until now, because we've initially solved them with more people, like compliance, the anti-money laundering frameworks that we have in place, are going to benefit enormously from augmented intelligence. And I think you'll see a very rapid rationalization of the more pen-and-paper or laptop computer methods of supervision of those portfolios. I think they are all going to be evolving pretty rapidly. And things like audit functions are going to go from batch processing to continuous auditing. A lot of those things are going to make the non-customer-facing parts of our business more efficient. But I still think there is a band where you should look -- we should continue to look for 2 points of operating leverage until we have improved the expense to revenue ratio.

Sumit Malhotra ***Scotiabank - Analyst***
5 points or 6 points.

Bill Downe ***BMO Financial Group - CEO***
Yes. And I think that is a reasonable if you do the arithmetic, if you do 2 points of operating leverage every year, it takes you 4 or 5 years to get 5 points of productivity.

Sumit Malhotra ***Scotiabank - Analyst***
And I think you are in and around 60 now. So that would certainly give you good amount of runway.

Bill Downe ***BMO Financial Group - CEO***
Yes, I think getting into the low 50s is a sensible thing to do. But I think when you push -- some of the big U.S. banks that have pushed down into the 40s have ended up with a big problem on their hands within three or four years.

Sumit Malhotra ***Scotiabank - Analyst***
And last one before we wrap it up, and it's something that we probably don't think about as much. Technology gets almost to be a catchall for the banks when you think about how you are interacting with your customers and how you are lowering costs.

Are there other aspects that your push into investing in technology -- whether it's the talent that you have brought into the bank, whether it's the ability to have better predictive metrics on credit or capital -- are there other examples you can cite as to how investing more in technology than you ever have is benefiting shareholders?

Bill Downe ***BMO Financial Group - CEO***
Well, the benefit to our clients of our investment in usable technology is very evident. Whether it's the ability of a client to manage their cash or manage their own capital investments, we provide very significant new and useful information back through the digital capabilities we have.
So you can do a financial plan if you are a small company or a midsize company, you can begin a financial planning process on our website in a way that you couldn't before. And you can use that information on a mobile device that you can carry around with you.

And similarly, individuals' ability to control their spending, grow their savings, manage their investments, all of those things are becoming easier and easier. But I think the drive on technology, in my view, isn't to lower the cost of doing the same transactions. It's to change the nature of the transactions in a way that the value to the customer, and the understood value, is much higher.

The cost of execution shouldn't rise, but you should capture some of that value in higher margins and higher profitability. And that is really the evolution of the business. As each layer of commoditization takes place, the ability to reinvent the customer value proposition is what we are doing and it is paying off.

Sumit Malhotra ***Scotiabank - Analyst***
What I want to say is I looked back at the numbers. For me, the BMO that we see today basically was formed in and around the M&I deal, solidifying or doubling that presence in the U.S. in addition to some of the changes that were already underfoot or underway in Canada, if you will.

So I looked at the numbers. Since that M&I deal was announced in 2010, the annual shareholder return has been 12% on average over the subsequent 7 years. Operating EPS is up 8% per year and the asset base or asset growth as your time as CEO has been 7% a year.

It's been a pretty good run. And I think my time as an analyst has basically overlapped your entire tenure as CEO. So I want to thank you for all your help the last 10 years.

Bill Downe ***BMO Financial Group - CEO***
That's very kind of you.

Sumit Malhotra ***Scotiabank - Analyst***
And it has been a pleasure.

Bill Downe ***BMO Financial Group - CEO***
Thank you. It's been a pleasure being part of your summit.