BMO Financial Group

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CORPORATE PARTICIPANTS

Bill Downe *BMO Financial Group - CEO*

CONFERENCE CALL PARTICIPANTS

Sumit Malhotra *Scotiabank - Analyst*

PRESENTATION

Sumit Malhotra *Scotiabank Capital - Analyst*

Okay. Our next speaker this morning will be Mr. Bill Downe, Chief Executive Officer of BMO Financial Group. Bill joined the Bank of Montreal in 1983 and as has been in his current position since March 2007.

As the slide changes over, I should remind everybody that they can refer to the forward-looking statements and we noted that the statement upfront. So I think we have that covered with the slide on the screen. It's been an interesting summer.

Bill Downe - ***BMO Financial Group - CEO***

I bet you're glad you got that out of the way, the interview with the boss?

Sumit Malhotra *Scotiabank Capital - Analyst*

Yes. I got my pin on here somewhere.

Bill Downe - ***BMO Financial Group - CEO***

You still have it. That's good.

Sumit Malhotra *Scotiabank Capital - Analyst*

The day is still young.

It has been an interesting summer and interesting year for the banks, as I stated in my opening remarks. It feels like operationally, nothing has changed much for the sector and for BMO as well. I believe you are on track for another year of record earnings. Yet, the market reaction has been quite worried, I think is the term to use about what the future growth will look like.

The big factor on the minds of the investors I've talked to is, the group has benefited from a very accommodating credit quality environment for about five or six years now, and the question that's on people's minds I'm going to put to you is, are you anticipating a significant change in your credit quality or your credit provisioning? And number two, almost either way on that answer, how do you expect the bank to sustain its operating performance at the strong levels it's been at in the face of even lower economic growth, interest rates and commodity prices?

Bill Downe - ***BMO Financial Group - CEO***

Well, that's a big combination of questions, but I do think that there is a contrast between the volatility we see in the markets every day that's certainly characterized the last four to five months, the last two weeks in particular, and what's going on or appears to be going on in the real economy where the Canadian economy continues to show reasonable growth. We think we'll probably finish the year just under 2% and given the big move in commodity prices that's actually quite encouraging.

The knock on effect of the drop in commodity prices takes time to work its way in. So, I think all of us are looking forward trying to divine whether it's three, six, or nine months, the impact on regional economies and I think we have to separate the possibility of regional recessions in Canada from a national recession. It is curious that Atlantic Canada turned down a little bit earlier and I think that has something to do with migratory labor and I think there's no question that in Alberta, the unemployment rate will move up, but it's starting at a relatively low rate. So I think there is the ability of even the regional economies to absorb some of this.

So we're not passive in regard to the outlook for Canadian banking. We're more encouraged on the broader base looking at the North American economy and I think the performance of the Canadian banking sector will continue to surprise in this context, I think will continue to surprise on the positive side.

Sumit Malhotra *Scotiabank Capital - Analyst*

And let me come back to you a little bit more specifically on credit quality. So the experience for the bank has been very good over the last few years. I believe you're running around 20 basis points of losses. If I go back to the recent peak in 2009, at least briefly you got over 80 basis points. On the conference call this quarter, your Chief Risk Officer mentioned based on what we're seeing in our stress test scenario, especially in a stronger U.S. environment, we have a hard time seeing numbers get over 40 basis points. Does this really speak to the change in the mix of the bank's portfolio and the fact that you're now bigger in the U.S. and the growth outlook you have there for that economy offsets whatever potential energy-related weakness you could see at home?

Bill Downe - *BMO Financial Group - CEO*

Well, a big diversified portfolio does have the benefit of earnings in one sector to offset losses as they might naturally occur in others. If you look at the last 30 years, our realized loan losses over that period are just under 40 basis points and we haven't moved completely through the low loss sector segment of this recovery I don't believe and I think we'll get back closer to 35 basis points as the long-term experience.

And so then your question is, well, what happens when oil and gas credits start to move through? What I think will be a natural process of restructuring. The industry is going to restructure at lower prices, it has historically. And we have about just over $2 billion of impaired loans and $1.2 billion of those are in the United States. That's going to be a continuing to improve story I think over time. So that's been feeding back into the loan loss provisions.

And then when you put oil and gas in context, it represents just over $6 billion of loans, just about 2% of the $330 billion of loans to the bank. So if you're anticipating long-term provisioning, through-the-cycle provisioning somewhere between 35 basis points and 40 basis points, the magnitude of loan losses that should come out of that sector are entirely consistent with the long-term view that we have.

And the thing about the oil and gas sector that you have to remember, it differs a little bit from some of the others in the nature of the credits with a heavy emphasis on production lending. We have a great deal of more information about the borrowers and about their cash flow than we do in many other sectors. We have our own professional engineers. We get detailed reserve reports from borrowers, well-by-well, field-by-field, then we re-run our own sensitivities on those. So we know where the breakeven points are by well, by field, by province and we can calculate what the likely performance of each entity will be within their own portfolios.

When we sensitize the bank's exposure to downside, interestingly, we get about the same stress losses in the US as we do in Canada. So we don't see a difference between those two markets. The US credits, some of them have higher leverage, but they have a junior debt, which we don't see in Canada.

The way that the security over the collateral functions in the oil and gas business is a little bit different. You can get to the cash flows a lot quicker and the mechanism by which credits are worked out is much more straightforward. And I think of the banks in the world, we probably have the best credentials for long-term involvement in this sector and our history in working out troubled credits in the mid-80s and the late-90s is actually stellar with many of the same people still in place, long tenured bankers.

So I think that what our Chief Risk Officer has said is that the provisioning is consistent with the overall provisioning expectations of the bank and that the market sensitivity to it seems to be excessive.

Sumit Malhotra *Scotiabank Capital - Analyst*

We're going to move off this, but I want to go to one that has the potential to help or one area of the bank that has the potential to help in this regard and that would be the Capital Markets business where BMO has always had a strong energy franchise. Earlier this year, maybe the last time we were hovering around $45 a barrel in WTI, somewhat surprisingly there was a large uptick in equity issuance from certain producers, which did for some time seem to calm the market down and that the companies were building a wall with new equity in between the commodity price and their loan exposure. I think it's fair to say on the whole of those, equity issuances didn't go particularly well for investors. Do you anticipate Capital Markets being an avenue for producers as we go through this fall redetermination period or are we at the stage now where it's more likely to be M&A related for that group?

Bill Downe - *BMO Financial Group - CEO*

Well, the market will have to be open for those companies to be able access new capital, some of them will be able to. In a number of cases, there are financial sponsors already engaged with some of those entities. I would expect you would see them want to put more capital in to protect their position in the long-term value of the investments they have. But the industry restructures pretty rapidly and I say pretty rapidly. In 12 to 18 months I think you'll see very significant change in who owns which properties, and what happens at the same time as the cost base comes down quite dramatically. All you have to do is pull the quarterly statements, a cross-section of independents, intermediate independents in Canada and the United States and look at them, you can see that they've cut their exploration costs dramatically, they are just starting in order to reduce their lifting costs, their transportation costs, their SG&A. Those costs will come down proportionate to the drop in crude.

So many of them who are showing negative earnings now will come back into a positive earnings position. Many of them will sell assets that are too expensive for them to continue to develop to a much more capable deep-pocketed investor and I would expect to see the majors are going to be active in M&A. And this may be property by property, not buying companies, simply because it's much cheaper today to acquire production than it is to drill for it.

Sumit Malhotra *Scotiabank Capital - Analyst*

Let's move to some more specific topics for BMO itself and I think it's fair to say that for the sector on the whole; expense management has taken on a greater focus in terms of conversational points with investors certainly. Back in Q2, BMO did announce a restructuring charge that was predominantly focused on the Capital Markets segment. So maybe looking at expense management more holistically, how should we on the outside, judge the progress of BMO in terms of reducing structural costs, and when I look at the efficiency ratio at the top of the house, just to double check my numbers, I think it's around 62% on an all bank level. What would be a target that you would have to get this ratio down to over the medium-term?

Bill Downe - *BMO Financial Group - CEO*

Well, you're right. We did take a charge in the second quarter of just over $100 million and it was specifically targeted at direct cost take-outs. So we examined some areas where we didn't feel that the return either in a sector of the business or from a subset of the business was justifying the expense level and we went in and took people and expense directly out.

So that was out and it will stay out. The run rate cost savings will be about $100 million a year and I think we expect to get about half of that run rate in the second half of the year. So we're quite pleased with how that works.

But there are structural changes going on in our industry and we're participating in those and you have to recognize that in the last three or four years, we've digested a couple of very significant acquisitions, a very large acquisition in the United States and a good sized acquisition in the UK. And at the same time, as we were digesting those acquisitions, we're basically positioning the bank, so that we would be able to take on future acquisitions without having to rebuild and re-scale the platform. So that's been a process that we've been working through for about three to four years and I think it's positioned us now, so that we will be able to increase the size of the bank, the volume of the bank without having to spend that kind of money a second time.

There are also many examples of disruption taking place in the markets that work in the favor of a bank with a big established client base. We're seeing big opportunities in process simplification that are now technology enabled that we couldn't take advantage of until we had finished really significant platform upgrading. And by platform upgrading, I mean the ability to do things once to serve the Canadian branch system and the U.S. branch system, the deposit system, the loan systems and on the wealth side, both investment management and the finance and sales side. So we have a much more scalable platform and there are still many opportunities on the process side. That's where we're spending money. We're really spending money in process simplification on the one side for us and then simplification for our customers in the use of mobile devices, mobile in branch, mobile to interact with things like bank machines and that gives us a better customer experience and a lower cost of delivery.

So I think there are very significant projects underway that are going to deliver savings and I think you saw the first half of this year, our expenses were running higher than our revenues. In the third quarter, you can see the beginning of really I think some of those dividends coming through where we expect 1.5% to 2% operating leverage in the businesses going forward. And at that rate, bringing the expense to revenue ratio down below 60 theoretically could take 18 months to 24 months.

Sumit Malhotra *Scotiabank Capital- Analyst*

That's very helpful and I wanted to move right to those two key businesses for you and let's start on the U.S. with the P&C Bank. That's actually been one of the segments in which on a constant currency basis, very important point to out these days given some of the fluctuations, the expense control there has been quite good. And some of that higher expense that you referred to, I think we saw more in Canada. Is that a timing issue and that there is some of the technological initiatives still have to work their way into the U.S. or are you still seeing some of the benefits coming through post the final touches on the M&I integration?

Bill Downe - ***BMO Financial Group - CEO***

Clearly, we've been spending money in Canada and that's put pressure on the domestic expense to revenue ratio. In the United States, we start at a higher level. So as we scale up, the more business that we add, the more customers we add, the more volume that we add, the benefits really are much more direct. The truth is in the United States, we've had very good discipline around headcount and the growth of expense and at the same time, we benefited from very strong commercial loan growth.

One of our core strengths is Commercial Banking and as you know, the C&I business has been growing, we say double digits but you can use 15% as a notional level over a number of consecutive years. And that's moderating now. I think a more reasonable number and sustainable number of 10% loan growth provides us with good earnings growth and we believe we have the capacity to hold the line on expenses, so that the expense to revenue ratio there will improve, it won't deteriorate. And that's really I think the key to the U.S. Personal and Commercial Banking business is the strength of commercial.

The retail banking business needs two things. It needs a little bit of relief on administered interest rates because the very significant deposit base will earn a great deal more with just a little bit of relief on interest rates. And then we need to see a pickup in household formation and new home purchasing. We really haven't had a market in which to take advantage of our large footprint across six states. It's a large market as I've said before, with basically the same population and GDP as Canada. We have a Number 3 market position in a high quality and very visible branch distribution systems. So when retail picks up, I think that will also be quite flattering to the aggregate expense to revenue ratio of the bank.

Sumit Malhotra *Scotiabank Capital - Analyst*

You said the magic word just a little bit of relief on interest rates. Depending on what week it is, it sounds like we might get that relief in September, December or maybe it's 2016. When you think about the eventuality of U.S. Federal Reserve rate increases, how quickly do you think that benefits the net interest margin of BMO's U.S. business, which by the way has actually stabilized for a couple of quarters now?

Bill Downe - *BMO Financial Group - CEO*

Yes, it has and I think that's been one of the things that we've been pleased about. The competitive nature of the market was pushing pricing down on renewals and that appears to have stopped. So NIM has stabilized. I think that the way that we look at that interest rate scenario is it's potentially a tailwind that could be sustained for 36 months or longer and the urgency to see a quick jump in interest rates really is offset by the belief that in 2016, 2017 and probably beyond into 2018, we'll have gradual upticks that as I said, we think be very complementary. And there is no point in trying to guess what the administered rate will be in September or at the next determination point. Really the valuation of the Company is based on confidence that that's going to happen and it will be sustained, not intermittent and not one-time.

Sumit Malhotra *Scotiabank Capital - Analyst*

So the worst of the NIM compression in the U.S. appears to be behind you and clearly initial hikes should have a benefit…

Bill Downe - *BMO Financial Group - CEO*

A side effect. We were very pleased that the NIM impact was in the 4 basis point to 6 basis point level last year and then we got down to 1 to 2 basis point, and I think now, we're really thinking in terms of flat-to-stable and then when it starts to move up, it should be pretty much the same pattern, 1 basis point to 2 basis points positive and then 4 basis points to 6 basis points positive and we expect to see it gradually move up.

Sumit Malhotra *Scotiabank Capital - Analyst*

If we cross the border, come back to the Canadian business, you mentioned the expense spend. I think that's self-explanatory and we started to see that moderate in Q3 as you've suggested. Earlier this year, it did appear that BMO was being somewhat more cautious on loan origination domestically than perhaps some of your peers. It's been talked about for a long time at this bank. You've usually been one of the positive outliers in a credit cycle. Was that a decision on your part and the management team's part to let's slow down here and then take the pulse of the economy before we purchase any further?

Bill Downe - *BMO Financial Group - CEO*

Well, the immediate impact of being a positive outlier in the short run is that your earnings grow more slowly, your revenue grows more slowly than everybody else. So it's not usually greeted with very much applause. It takes time to work through and sometimes so long that the people don't remember, but in some areas of direct unsecured consumer lending and in the area of credit cards, we have been cautious. I think all of the attention has been on the housing market. I think there is some structural reasons why the housing market has behaved the way it does. But if you believe that the underlying problem is total debt service to earnings capability of the Canadian consumer, then being a little more conservative in the areas of revolving credit and certainly consistent with or biased against long amortization mortgages, we've similarly been a little more careful with things like auto finance where the terms were just a little bit longer than made sense for the borrower.

We look at all of these things from the point of view of the customer and what's the likelihood that our customers are going to get in trouble. And when we make adjustments as we have in those portfolios, we think it reinforces the commitment we have to customers as much as it protects the bank from what I think will be the inevitable followed at the riskiest end of the curve.

So I think that did impact our Canadian Personal and Commercial Bank. We said in the first half that we were anticipating it would be the weakest part of the year, that we would be stronger in the second half. You saw the third quarter was an improvement. And I think in the context of what I would expect to be a moderate growth Canadian economy and I think it will be a moderate growth Canadian economy, being able to generate let's say 5% growth on the topline and 3.5% expense growth in your Canadian Personal and Commercial Bank business is something that will position the bank very well and that's basically the zip code that we're in.

Sumit Malhotra *Scotiabank Capital - Analyst*

Good. I want to switch to capital and largely because I think one of the hallmarks of your time as CEO has been that BMO has consistently been ahead of the industry in terms of its capital positioning, even at times where some of us didn't know that's where the bar was going to end up and you're there again right now, I believe just over 10.4%. There's been a few false starts around capital levels for the Canadian banks and what I mean by that is we feel like the group is where it needs to be then things seem to…

Bill Downe - *BMO Financial Group - CEO*

That would be a false stop then….

Sumit Malhotra *Scotiabank Capital - Analyst*

False stop that's right. False start from a deployment perspective is what I meant. A few things that continue to be out there this summer, we saw a banking system that's very similar to Canada's when Australia put floors in from a risk weight perspective. Let me stop there and get your view on this. Do you feel at the 10.4% mark, you are more than adequately capitalized for whatever standards are out there? Or do you still have some concern that there could be an even higher level that's required?

Bill Downe - *BMO Financial Group - CEO*

I think there is an ongoing debate among bank regulators globally around the trade-off between model-based capital calculations and a simple leverage ratio and the notion that a standardized floor, against certain asset categories would be preferable to a model-based business. I think it's all a bit of a tug-of-war because 20 years ago, we used very blunt measures of risk and capital and they proved to be not particularly useful.

So I think the distinction that you have to make and you're referring I think to the Australian market, the distinction you have to make between the Australian market and the Canadian market is similar as the economies are and the stability of the systems are is that the Australian housing market doesn't have the benefit of CMHC, it doesn't have a big insured and government insured program for high ratio mortgages and in this market, high ratio mortgages are required to have insurance and I think that really creates a different view on where our floor would be necessary and how important floors would be.

And my view is that if the management of the bank understands the leverage in the balance sheet, they'll weight the concentrations of mortgage and commercial loans and other asset classes in a way that respects the potential impact of a spike that comes when unexpected loss shows up, the sum of years of EL not materializing.

And so I guess in the overall context, I don't believe that we're going to see a big move in Canada that would in any way mirror Australia because the logic of the facts are not the same and you wouldn't argue for it on that basis. I also think that the likelihood of a global consensus around additional actions from the BIS are limited. I think that Basel IV is going to take a lot longer to come into play than Basel III. But responsible management of banks should be looking at their balance sheet at their own leverage and making a decision around what sufficient capital is. So that's the first part of the question.

The management of our capital has always been based on what we thought would give us maximum flexibility, not to be behind the curve, but to be ahead of the curve and what capital does is, it gives you the ability to make acquisitions that enhance your business, that expand your franchise, high-quality customer bases that are in areas where you have experience that are consistent with your brand. And what you've seen us do is build our capital both ahead of what we thought were going to be revised capital standards, and then as well ahead of potential opportunities. And we've dramatically increased capital of the bank, as we saw the Basel requirements in 2009 and 2010 and that positioned us well relative to changing regulation, but it also positioned us to make a timely acquisition that has turned out to be a moment in time. I don't think there's been a transaction quite like it done since.

And similarly, we were active in using excess capital that we were generating because we had a strong capital ratio and buying back stock in 2013. In 2014, we were able to use the capital that we generated to acquire F&C Asset Management, which has now been re-branded as BMO Asset Management in Europe and that was because we were in the right position. And then first half of this year, the first three quarters of the year, we have been more active in share buyback than our peers. But I do think there are going to be opportunities in the marketplace to grow the business and that's really the two sides of having the right view on capital. Understand what you believe the right amount of capital is for the risk that's inherent in the business. Keep an eye not just on the regulatory change, but really the potential regulatory changes, but have the flexibility to deploy capital in the right places for the benefit of the business, to grow the business in the long-term. So it's really two parts.

Sumit Malhotra *Scotiabank Capital - Analyst*

Tough one to leave to the end, but you alluded to it. You've got the capital position in a strong place. You mentioned in your expense spending, part of it was to make sure that when future acquisitions come, you are in a better position to integrate them. When you look at your two acquisition platforms, if you will, U.S. Regional Banking and Global Asset Management, is one more attractive to you than the other in terms of the opportunities and the pricing in the market today?

Bill Downe - *BMO Financial Group - CEO*

I think we're in an ideal time. The North American economy in aggregate is growing and it's going to continue to grow strongly. We're extremely well positioned in both Commercial Banking and in Wealth Management. They are highly complementary. I don't see them as separate choices and it's our view that we should be able to reinvest in both of those businesses at a rate that our earnings really does well support and to the extent that we have somewhat slower growth in the domestic Canadian market offset that quite capably.

Sumit Malhotra *Scotiabank Capital - Analyst*

Bill, thank you for your time.

Bill Downe - *BMO Financial Group - CEO*

It's nice to be here. Thanks very much.