BMO Financial Group

Bank of Montreal at Deutsche Bank Global Financial Services Investor Conference

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

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Jason Braunstein - ***Deutsche Bank – MD, Global Financial Services***

I think we can get started. Tom, thank you for joining us. Just as an intro, BMO is the eighth largest bank in North America. It provides personal and commercial banking services to over 8 million customers in Canada and over 2 million in the U.S.; operates a strong Wealth Management and Capital Markets business in North America and select global markets. And we'll touch on those businesses in the presentation.

Tom joined the Bank in 1992, has held a number of senior executive positions including Chief Risk Officer and positions within Investment and Corporate Banking. Tom has been the Bank's CFO since 2011.

Before we begin, I've been asked to remind you that Tom's comments today may include forward-looking statements. Actual results can differ materially from forecasts, projections or conclusions in these statements. Listeners can find additional details in the public filings of BMO Financial Group.

With that, Tom why don't I start with a few questions and certainly if there're any questions from the audience, please raise your hand. I'm happy to take them. Tom, the Bank reported strong quarterly numbers, I believe it was last week. Maybe we can start there if you can give us a sense of some of the highlights?

Tom Flynn ***- Bank of Montreal - Chief Financial Officer***

Sure, happy to do that, and thank you for the welcome and the invitation to be here. We did report our Q2 results last week and had what we thought was a good quarter, as you said. Earnings per share were up 8% for the quarter, and that number excludes a write-down we had in our Wealth Management business of an investment, it was about $80 million after-tax write-down. And in the numbers that I give, because that was a one-time item, I'll exclude that item which is prominently disclosed in our disclosure documents. Earnings per share up 8%, which we felt good about, supported by good results in our operating groups. Our Canadian Banking business, which is our largest single business representing about 45% of the total, had income that was up 8% year over year.

Our U.S. Banking business was up in Canadian dollars 27% year over year, 21% in U.S. dollars. And the segment there benefited from an acquisition that we closed in Q1, and it was the acquisition of the GE Transportation Finance business. But even excluding the acquisition, we had one of the better quarters that we've had in some time.

And our Capital Markets business had a good quarter, earning about $290 million, and the pre-tax pre-provision growth was 10%. So, good performance from across the divisions.

The Wealth Management business was down a bit from last year. We had a very strong insurance earnings stream a year ago, and we had sort of more normal insurance earnings in the current quarter. And then the traditional wealth part of our Wealth segment was flat year over year at the net income line, due to equity markets being down by about 11%, looking at the Canadian stock exchange.

We have been focused on doing a good job on expense management and managing our operating leverage. Operating leverage in the quarter, in constant currency, was 1.7%, and for the year to date it's 2.4%, and we feel good about those numbers. Our mid-term target is to produce operating leverage of above 2%, and we're looking good on that measure for the year-to-date performance. And then on credit, which we'll probably touch on later, loan losses were up. We've guided to losses moving up through the balance of the year, but they were still very manageable at about 23 basis points of loss, and with that we were able to comfortably earn through the higher rate of provisioning that we're seeing related to oil and gas. So overall, good quarter, in part because of the diversification in our business. And Canadian Banking is about 45%

of the total business from an income perspective, and our other three businesses, Wealth, Capital Markets and the U.S. Banking, make up the balance in relatively even parts. And we find that having a diversified business mix serves us very well through time and that it gives us a more robust income stream through different environments, and that was the case in our second quarter.

Jason Braunstein - *Deutsche Bank – MD, Global Financial Services*

Tom, you mentioned credit, oil and gas is obviously top of mind with many investors. I think the portfolio for you guys is about 2% direct exposure, 2% of total loans. Maybe you could touch on that a little bit. How do you think about cumulative losses in that portfolio, and maybe you can touch on what's driving any differences on what you're experiencing in the Canadian part of that portfolio versus the U.S.?

Tom Flynn *- Bank of Montreal - Chief Financial Officer*

Sure. So, just a few numbers related to the size of our oil and gas related portfolio. The total portfolio is around 2% of our total loans, and that includes E&P companies, service companies that make up about 20% of the total -- sorry, pipeline companies which make up about 20% of the portfolio, and service companies. And the E&P portion is around 70% of the total. Just under half of the portfolio is investment grade rated, and the dollar amount is about $7.3 billion and that's the drawn amount. Undrawn is around $7.5 billion and 60% of that is investment grade. So, at that size we're very comfortable with the exposure, it's not outsized at 2% of loan portfolio, and it's performing in line with expectations.

Our consumer portfolio in the province of Alberta, which is the biggest energy producing province in the country, is 6% of total loans. So, again not outsized at all relative to the total portfolio. And as we've talked about the impact of low energy, at a very high level we've had two messages that we've been communicating. One is, we expect loan losses to go up, because there is an economic cycle playing out in the energy producing regions. And second point is, we don't think they'll go up in a way that will be dramatic or high impact for the Bank, and that's simply because the portfolio isn't that large in the overall mix of the business. For the year, we've guided to loan losses in the range of 20 to 25 [sic] basis points of loans. That's up from around 20 basis points last year, the increase would represent expected higher losses from oil and gas.

Year-to-date, our performance has been better than that guidance. In Q2, we were 23 basis points of loss versus the 25 to 28 basis points guidance. And looking forward, we've really reiterated the guidance, expecting loss over the next two, three, four quarters in the 25 to 30 bps zone. The better performance this quarter, I would attribute really just to some normal variation around a broader trend, as opposed to reading anything more significant into it. Loan losses in any quarter can be a little better or a little worse than you think they're going to be, and fortunately for us they were a little better in the current quarter but we haven’t changed the basic guidance. Clearly, with oil where it is relative to where it was 6 months ago, we’re feeling a little better about things so the current price is helpful. And then on the cumulative loss side, as we look at our portfolio and how we expect it to perform through time, we expect losses that are below the 5% level on the direct exposures that we've got, and that would be covered by the broader guidance that we've given.

So the big two messages are: for sure losses will go up in a sense that that is an ordinary thing when you go through a downturn; secondly, the business is big and diversified and given the size of the portfolio, our expectation is that we will earn through the higher losses.

Jason Braunstein - *Deutsche Bank – MD, Global Financial Services*

Are you seeing any differences between exposures in Canada versus the U.S.?

Tom Flynn ***- Bank of Montreal - Chief Financial Officer***

The structure of the lending is a little different in the two countries, and this is a general statement, so there's truth in it but you don't want to take it too far at the same time. And on average, based on what we see in our portfolio, the companies in the U.S. are somewhat more highly levered and so have sort of more financial risk in their capital structures. But our position tends to be a senior position. And so we don't think the net risk profile for us is really higher in the U.S. versus Canada, although the leverage tends to be higher. And then in Canada, somewhat more of the bank credit is pari passu with bond creditors, whereas in the U.S. you've got sort of more of a hierarchy in the capital structure.

So net-net when we do stress testing, within a margin of error, the losses tend to emerge in the stress work we've done relatively in proportion to the size of the portfolios split between Canada and the US.

Jason Braunstein - ***Deutsche Bank – MD, Global Financial Services***

Can you touch on the contagion, so are you seeing oil and gas contagion across other exposures and what are your expectations or your concerns going forward?

Tom Flynn ***- Bank of Montreal - Chief Financial Officer***

So we're not seeing any contagion at all, I would say. And early on when energy turned lower, we asked ourselves that question. We wondered if that might be the case, but to date we haven't seen any contagion and we're not expecting to see any. And the big reason for that is the rest of the country is doing fine and that's true of the Canadian economy and it's true of the U.S. economy as well. Interest rates are low. We expect Canadian GDP growth this year of around 1.5%, around 2% next year. U.S. numbers a little bit higher. And low energy prices are stimulative to the economy outside of the producing region. So the economic environment is sort of just fine, and that's helping.

And at a sort of human behaviour level, although there are some difficult times in the energy producing regions as people work through the impact of the low energy prices, people outside of those regions recognize that the economy is different. And structurally the economy in Canada or British Columbia would be very different than the economy in Alberta. And I think the consumers in the country recognize that they're not subject to the same pressures that exist in the energy-producing regions.

Jason Braunstein - ***Deutsche Bank – MD, Global Financial Services***

If there are questions in the audience, please raise your hand, I'm happy to take them. Moving to real estate, there's been a lot of talk about housing market in Canada being a bit overheated perhaps. What's your view of the market and how does the Bank manage risk to real estate accounts?

Tom Flynn ***- Bank of Montreal - Chief Financial Officer***

So the market has done very well. I would say better than our expectations in the big cities. And the larger cities of Toronto, Vancouver, and to a lesser degree Montreal, have had markets that are pretty active and robust. Outside of those big centers, the market is more stable. And in the bigger cities, you've got some unique factors that are contributing to the strong performance and they vary by city. But in the City of Toronto, the city grows every year, there's significant migration into the city. There's a greenbelt around the perimeter of the city, as part of the city's urban plan, and so real estate is valuable within the city and we've had some vertical development as a result of the growth and the greenbelt. And the market feels like it's in a solid place, and we see the market pretty much in supply-demand balance given the inflow that comes into the city. And affordability is fine, although house prices are up and consumer leverage is up in Canada, given that interest rates are low.

In the Vancouver market, there is a large element of the market that is driven by some foreign inflow of capital. And the market is more expensive relative to income than it is in Toronto or other parts of the country. That's been the case for some time. And I'd say, we were not expecting the foreign capital that is flowing in to stop, if it did we would expect the market to be down by some amount. And to protect ourselves against the risk of the market there moving down, we do, when we underwrite mortgages, require a higher percentage down payment for more expensive properties to cover the risk in that market.

And then just more generally, I'd say, overall we're very comfortable with our Canadian mortgage portfolio. Around 60% of the total portfolio is insured. The insurance is backed by the federal government, so we don't have counterparty exposure with that insurance. And the loan to value on the uninsured part of the portfolio is 57%. And so, we've got significant equity balance beneath our uninsured mortgage position, which makes us feel good.

Jason Braunstein - ***Deutsche Bank – MD, Global Financial Services***

You spoke a little bit about the factors affecting the economy in Canada. Maybe you can elaborate on that a little bit, give us a sense of where the Bank is seeing the state of the economy in Canada. And the 25%, or so, of your business in the U.S., what are you seeing in the U.S. economy and maybe do that on a relative basis?

Tom Flynn ***- Bank of Montreal - Chief Financial Officer***

Sure. So, overall in Canada, we're expecting growth in the range of 1.5% for the current year, moving up to about 2% next. And that contrasts with pushing 2% for the U.S. in the current year, and sort of pushing 2.5% for the U.S. side next year. So growth in Canada is slightly lower, with that reflecting a drag on growth coming from the oil producing regions.

And the province of Alberta, which again is the big producing region, represents about 18% of the Canadian economy, and there, there is a contraction going on. And to us, as a general statement outside of that area, the two economies feel pretty similar. We see a stable and solid base to business confidence and consumer confidence in both countries. We're living with an economy that's growing. It's kind of new normal growth and that's what we expect, and we think that's what people are coming to expect. And so 2% growth to us isn't a bad thing, and it's kind of a sub-potential performance that more reflects our broader expectation around economic growth rates being somewhat lower than they were pre-crisis.

And importantly, again we think confidence is pretty good in both countries. The Canadian dollar has depreciated meaningfully over the last couple of years. That's helped the export part of our economy and it takes time for that to fully develop. So our hope and expectation is that there will be more upside in the export market coming from the lower Canadian dollar, and interest rates are a little lower in Canada, which relates to the dollar move and it's also helpful for consumers.

Jason Braunstein - *Deutsche Bank – MD, Global Financial Services*

How do you compare the relative opportunities for BMO in the U.S. versus Canada? Maybe you can talk about where you see the profitable organic growth opportunities for the Bank on a relative basis?

Tom Flynn - *Bank of Montreal - Chief Financial Officer*

Sure, so I guess a few things in that regard. We do think we have a good mix of business from a growth perspective for the opportunities that exist in the environment. And first point would be true for both the Canadian business and the U.S. business, and it is that we're stronger in commercial lending than personal lending in both countries.

In Canada, our commercial lending share is approaching 20% and it's number 2 in the market. In the U.S., we have very strong growth and very good performance in the Midwest part of the market and our commercial business is larger than our personal. And we think given consumer leverage in both countries, we're likely to have better growth in commercial lending over the next one, three, five years than we are in personal lending, and our recent numbers bear that out. In the last quarter, our Canadian commercial growth was 10% and our U.S. commercial growth was 13%. So we feel good about performance there.

In the U.S. business, we do see upside in our personal lending business. The aggregate portfolio there hasn't grown in the last few years in part because we have been reducing the higher risk parts of an acquired portfolio, and we're expecting that portfolio to turn to growth with the mortgage and home equity portfolio later this year, and so we're expecting upside there and we hope to get it. And as well in the U.S., we've had one Fed rate increase and it looks like we're going to get another in the summer, at least that would be our read, and maybe more. And we have a nice interest rate sensitivity in the U.S. business, a 100 basis point increase in U.S. rates is around $150-$160 million of revenue to us and about $100 million of that is off of the short end of the curve. So we've had some benefit from that in our results year to date from the one that we've had, and we hope that we have more.

And then just a couple more points. In our Capital Markets business, we have what we describe as a bulge bracket Canadian firm. We're active in all parts of the Capital Markets business, we have strong share positions, typically in the Top 3. And in the U.S., we're focused on the mid-cap part of the market, and we've invested in that platform over the last five years or so by adding talented people to the platform. And we think that we've got an ability to drive more revenue off of the expense base that we've built, and we see traction in that business. So we're expecting to grow the revenues in U.S. Capital Markets, and to have good operating leverage as a result, because we're basically paying market comp, which you need to do in order to retain people, and driving below market revenue per producer. So we're expecting outsized growth from the U.S. Capital Markets business, just from the investments that we've made continuing to run.

And then, Gilles Ouellette who heads up our Wealth business would give me a kick if I didn't mention Wealth, and two things on Wealth. Number one, we've had very good growth over a long period of time. Over last five years or so, we've had double-digit income growth aided by acquisitions, but also organically, and the business has been well managed. The numbers in the current quarter, as we talked about earlier, were softer that reflects equity markets, but through time, we do expect to continue to have good growth in Wealth and it does represent almost 20% of our Group income. And so, it's a large part of the Bank and we do think, somewhat under-appreciated contributor to the Bank results.

Jason Braunstein - *Deutsche Bank – MD, Global Financial Services*

You started to talk about this a little bit, maybe you can elaborate. When you think about Harris Bank, what in your mind is going well at Harris Bank, and what are the areas that you think the Bank can improve?

Tom Flynn - *Bank of Montreal - Chief Financial Officer*

Sure. Harris Bank, which we've now branded BMO Harris Bank, we acquired in the early 1980s, it was a Chicago Bank. And then, in 2011, we closed the acquisition of M&I Bank which was headquartered in Milwaukee, and that basically doubled the size of our U.S. Banking business. It gave us an operation with about 600 branches in the upper Midwest, and a number 4 position in the market overall in the upper Midwest states that we compete in.

To date, we've been very happy with the commercial business, I talked about that a little bit earlier. We've averaged about 15% year-over-year loan growth for 2.5 years. So, very strong performance with that coming from the fact that both Harris and M&I had strong legacy commercial banking businesses. And together, we've got a real powerful competitor in the market. And we've had great management of the business, and we've deployed best practice. So we feel really good about the commercial growth that we've had, and we're expecting it to continue, although with the growth more or like 10% just given the fact that the denominator is that much bigger.

On the personal side of the business, I touched on this as well, we've been running down some higher risk parts of the portfolio for a period of time. The U.S. consumer has been deleveraging, and so we haven't seen that portfolio growing yet. We very much wanted to turn to growth mode, and we're expecting that to occur in the second half of the year. And we do see a meaningful ability to grow that part of the business. And one set of numbers related to that, in the Chicago market we have an 11% or 12% deposit share, so very strong deposit share in the market. And our mortgage share is in the order of 3%. So we're significantly underrepresented in the mortgage product and we're putting more energy into growing that part of the business.

And then last point would be around deposits. We've had good growth in the deposit part of the business, and we expect that to continue and profit potential of that part of the business will increase nicely as we talked about earlier, if and when we get another move from the Fed.

Jason Braunstein - *Deutsche Bank – MD, Global Financial Services*

When we think about acquisitions, I guess the last acquisition that the Bank made was in the U.S., predominantly a U.S. business in the BMO Transportation Finance acquisition. Can you talk about why that acquisition made sense from the Bank's perspective and how it was approached?

Tom Flynn - *Bank of Montreal - Chief Financial Officer*

Sure, so we acquired GE Transportation Finance business in a transaction that closed in December of last year. Transaction size was about $10 billion in loan balances. And it was a good fit for our business for a few reasons. Number one, as we talked about, we have a strength in commercial banking in Canada and the U.S., and the Transportation Finance business is a commercial banking business. And so it fits nicely with our strength. Second point is that, it's a leading business; they're a leader in their segment of the market. They have about 20% share of the Transportation Finance market in the U.S. And we were happy to sort of buy a business that had that kind of a strong position and could operate successfully and continue to do so. And we've had great success in keeping the management team and the customer base, and the integration is going well. So acquiring a leading business isn't something you get the chance to do all that often, and we did have that opportunity with this acquisition.

And then last point would be that it was a nice transaction from a financial perspective, in that we had some excess liquidity in our U.S. Bank and some excess capital. And we were able to bring these assets on board, which improved the profitability of the entity in a nice way.

Jason Braunstein - ***Deutsche Bank – MD, Global Financial Services***

So before the Transportation Finance acquisition, F&C was the largest acquisition for BMO and that was a few years back. Can you talk about what the Bank's overall approach is to acquisitions? And also touch on, when you think about M&I which is six or so years ago, is building BMO Harris further through acquisitions is something that you guys think about or actively pursuing?

Tom Flynn ***- Bank of Montreal - Chief Financial Officer***

So, a few things. The first point would be that we did just close the acquisition of the Transportation Finance business, closed in Q1, reduced our capital ratio by 60 basis points. And so, the immediate focus at the Bank is on integrating that acquisition, and the integration is going well, and building the capital ratio back up somewhat, although we're in a good position at 10% CET1 ratio. And then beyond that, the focus for acquisitions would be in our Wealth Management business where, as you said, we have been active, acquiring F&C Asset Management about 2.5 years ago. And in Wealth Management, we like the Asset Management business, which is a large business for us now. And also Private Banking, which is also one of our larger Wealth Management businesses.

On the U.S. Bank side, we do think the acquisition of M&I gave us critical mass in the Midwest states that we compete in. That doubled the size of our U.S. Banking business and with that, gave us, we think, a platform that has scale in our markets, and is able to compete effectively. And so, other things that we would do in U.S. Banking would be smaller in size and sort of tuck-in type acquisitions that will complement the existing business that we've got. But as I said, the immediate focus, given that we've just closed the transaction, is on getting the integration done, doing a good job of it, and taking the capital ratio up a bit.

Jason Braunstein - ***Deutsche Bank – MD, Global Financial Services***

Digital banking is obviously a big topic across the sector, across geographies. What does digital banking mean to BMO?

Tom Flynn ***- Bank of Montreal - Chief Financial Officer***

Well, I think it means that you need to move with the times, and to be relevant to your customers in different ways, and we're doing that. We have a great set of mobile apps for our Personal Banking business. We've invested in those over time. We have very good online banking capabilities. We have a check image capture capability in our U.S. business. We have a biometric credit card, and we were the first bank to introduce that. Sounds a little bit scary almost, but biometric card means that the card will work with fingerprints and facial recognition technology, and that's mainly for online purchases.

So, I'd say we're investing significantly in mobile-related things and also new format branches, which are smaller and lighter touch, in order to keep a strong position with our business and to do business in the way that our customers want to do business.

And then a little bit under the surface, we've also been working very hard over the last few years to redo the technological infrastructure that underpins our client-facing apps. And we've re-wired a lot of our infrastructure and aggregated our data so that we're better able to introduce new capabilities through time because new applications in essence, need to touch fewer parts of the existing system to become operative, and we've got the client data more aggregated. So we've done a good job we think, sort of increasing the efficiency and the capability of the underlying infrastructure in addition to doing things on the customer side.

Jason Braunstein - ***Deutsche Bank – MD, Global Financial Services***

As you think about the remainder of this year and your outlook for 2017, what are your biggest concerns for the Bank's performance?

Tom Flynn ***- Bank of Montreal - Chief Financial Officer***

I would say that the biggest concern is just a curve ball, and some sort of environmental development that we don't anticipate that would cause meaningful dislocation in the market, and our ability to predict that I think is no better than the ability anyone in the room here would have. And away from that kind of unanticipated event, we have confidence in our ability to continue to grow the business. We've talked about that. Each of our operating groups are working hard on growing their revenues, growing their customer base and driving positive operating leverage, and we expect to be able to move the Bank forward given that focus. And also given the things we're doing on the technology side.

All of that said, higher rates would be nice, and so we'll take higher rates any day we can get them. Our hope is that we do get them. And significantly lower for significantly longer would go in the opposite direction for us.

Audience member

Could you please discuss the improvement in the credit quality, in the Canadian residential mortgage book specifically? I know it's been historically at very low loss levels, but I'm talking about the impaired loans were down pretty dramatically, sequentially and year-over-year as well as kind of early-stage delinquencies which may be a little bit counter-intuitive to the unemployment picture.

Tom Flynn ***- Bank of Montreal - Chief Financial Officer***

So, there are a couple of things going on there. The first is that in the overall portfolio, we're seeing I'd say, mild positive migration outside of the energy producing regions and negative migration in the energy producing regions. But the province of Alberta is only 18% of GDP. So most of the country has positive migration and that's contributing to the positive trend that you see in the disclosure.

There can be a funny issue related to the day that the month-end falls on. And this is a purely technical thing, but when the month-end falls on a weekend, you process fewer payments, and you can have a bit of a uptick in your early stage delinquencies because of that. So, the early stage numbers can be a little variable just based on that quirk. And I think that hurt us a bit last quarter, and contributed to some of the quarter-over-quarter improvement that you've seen. But bigger picture, the trends outside of the producing region are mildly positive. The employment picture is stable, so consistent with that. And delinquency levels in the producing regions are pretty much playing out as we thought they would, and we expected an uptick, we're seeing the uptick. But net-net the overall quality remains high, and the loss rate low.

Jason Braunstein - ***Deutsche Bank – MD, Global Financial Services***

Any questions? I think we've just run out of time. So, any closing remarks you'd like to make?

Tom Flynn ***- Bank of Montreal - Chief Financial Officer***

Maybe just briefly, I'll just reiterate the comments around the mix of business that we've got. And we do think we have a good mix of business for the opportunities in the environment, being overweight in commercial banking, given the expectation that it will have a higher growth in Canada and in the U.S. over the next period of time. Wealth is a large business for us. We think it's a somewhat under-appreciated business because it's only 20%, but it's still 20%. It has had good growth, and we expect that to continue. And we are investing on the technology side, and expect to continue to do that while driving positive operating leverage.

So thank you all very much for your time.

Jason Braunstein - ***Deutsche Bank – MD, Global Financial Services***

Thank you Tom, I appreciate it.