BMO Financial Group

Q2 2013 CONFERENCE CALL

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PRESENTATION

Operator

Good afternoon, and welcome to the BMO Financial Group's Q2 2013 earnings release and conference call for May 29, 2013. Your host for today is Ms. Sharon Haward-Laird, Head, Investor Relations. Ms. Haward-Laird, please go ahead.

Sharon Haward-Laird - *BMO Financial Group - Head of IR*

Thank you. Good afternoon everyone and thanks for joining us today. Our agenda for today's investor presentation is as follows:

We will begin the call with remarks from Bill Downe, BMO's CEO followed by presentations from Tom Flynn, the bank's Chief Financial Officer and Surjit Rajpal, our Chief Risk Officer.

After their presentations we will have a short question and answer period where we will take questions from pre-qualified analysts. To give everyone an opportunity to participate, please keep it to one or two questions and then re-queue.

Also with us this afternoon to take questions are BMO's business unit heads – Tom Milroy from BMO Capital Markets, Gilles Ouellette from the Private Client Group, Frank Techar, Head of P&C Canada and Mark Furlong from P&C U.S.

On behalf of those speaking today, I note that forward-looking statements may be made during this call. Actual results could differ materially from forecasts, projections or conclusions in these statements. Information about material factors that could cause results to differ and the material assumptions underlying these forward-looking statements, can be found in our annual MD&A and our second quarter report to shareholders.

With that said, I will hand things over to Bill.

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

Thank you, Sharon.

And welcome to all of you on the call.

This morning BMO reported solid Q2 results -- the 5th consecutive quarter of adjusted earnings of 1 billion.

For the first 6 months of the year, adjusted EPS[1] increased 4% with operating group adjusted net income[1] up 12%. Each of our businesses has grown from a year ago.

We continue to see good net income growth from our capital markets and traditional wealth businesses. And Personal and Commercial banking had strong balance sheet growth in the quarter.

We have a consistent strategy. It's well explained, it's easy to understand and we haven't deviated from it. We have been deliberate about the path forward.

In the context of moderating growth in consumer debt in Canada -- which appears to have plateaued -- we have an advantaged business mix, diversified by both geography and consumer segment.

1 – on a reported basis: YTD EPS decreased 6%; Operating group net income up 12%

We're well positioned given our U.S. businesses and expect to see continued benefits from our strength in commercial banking, capital markets and wealth -- important areas for growth in the current environment.

A few highlights from our second quarter results.

Reported net income was $975 million or 1.42 per share.

On an adjusted basis, net income was $997 million or 1.46 per share, 2 cents[1] ahead of last year. Revenues[1] were $3.8 billion and ROE[1] was 14.5%.

Year over year, adjusted expense growth[1] was 1.9% and has been moderating as a result of our continued focus on efficiency. This will support future growth while creating value for customers that translates into financial performance for the Bank.

Our approach is deliberate -- we're making fundamental changes to the business that will reap benefits over time including: simplification of the organization; moving senior executives closer to the customer; taking process out of front-line sales; reducing repetitive tasks; and strengthening infrastructure.

As we've said before, we are taking concrete steps to be more efficient -- optimizing businesses, core processes and the resources of the Bank. The restructuring charge this quarter is part of an active ongoing commitment to align non-interest expense with the current and future business environment.

Credit performance in the quarter was good -- provision for credit losses was down significantly year over year. Surjit will give you more detail on credit later in the call.

Our Basel III Common Equity Tier 1 ratio was 9.7% at the end of Q2. This strong position continues to give us flexibility.

At the beginning of the calendar year we spoke of our intention to acquire shares under our normal course issuer bid. In the second quarter, we purchased approximately 4 million shares and we'll continue to be active under this program.

While we've seen good balance sheet growth -- with capital growing at a faster rate, purchasing shares is an attractive use of the excess capital we're generating.

Turning to the operating groups:

P&C Canada's adjusted net income[1] for Q2 was $431 million. Loan growth remained robust with the total portfolio up 15 billion or 10%.

We're focused on growing high quality assets and attracting new customers to the Bank. I'm confident the strategy we're following will translate customer loyalty and balance growth into sustainable revenue growth.

As an example, we've gained share in mortgages by bringing in new customers and encouraging them to borrow smartly with shorter amortization periods -- and we've executed on cross-sell.

Year over year loan growth in Commercial banking has been particularly strong and this continued in the second quarter with loans up 12%. This is the fourth consecutive quarter of accelerating growth and loans were up 4.6% Q2 over Q1.

Commercial deposits were also up 12% -- the third consecutive quarter of improvement bringing deposit growth more in line with our strong loan growth. We have taken direct action to increase the focus of commercial bankers on deposit origination and it's paying off.

P&C US adjusted net income[1] was 163 million in source currency -- 3% ahead of last year. Year-to-date, P&C US earnings[1] are up 9%.

1 – on a reported basis: EPS down 9 cents from last year; Revenues were $3.9 billion; ROE was 14.2%; Expense growth was 3%;
P&C Canada net income was $430 million; P&C US net income was US$152 million, 6% ahead of last year; YTD P&C US earnings up 12%

Total loans grew quarter over quarter and year over year as the core commercial and industrial portfolio demonstrated continued momentum. Year over year growth of 17% and sequential growth of 4% in core C&I loans more than offset lower growth areas and non-strategic run-off which is now less of a headwind.

The efficiency ratio[1] was 59.6% in the quarter.

In the short-run, administered rates have had a downward impact on deposit spreads for the entire banking sector in the United States, at a point in time this will reverse.

We continue to track and evaluate brand performance across our footprint. Brand awareness has increased significantly for BMO Harris Bank with particularly strong gains in Indiana and Minnesota. We're making gains against key competitors -- and importantly, awareness and favorability continues to build among non-customers.

BMO Capital Markets delivered Q2 adjusted net income[1] of $276 million with ROE of 19.4%.

Results were highlighted by good year over year revenue growth reflecting increased trading and corporate banking.

Year-to-date, we rank 1st in Equity Capital Markets in the Canadian League tables. These rankings reflect our commitment to focusing on clients and our strong market position.

Private Client Group produced second quarter adjusted net income[1] of $148 million. Traditional wealth[1] was up 14% from last year largely driven by growth in new client assets and focused cost management.

Good underlying growth in the Insurance business continues in both creditor as well as life products through our vast network of managing general agents -- and online sales continue to grow.

There's been variability in this business due to movements in long-term rates and we would expect to see benefits when rates rise. We remain confident in this business.

Before wrapping up, a few words on the business environment going forward.

The Canadian economy continues to grow modestly. In the long-run, slowing household credit and fiscal policy restraint are necessary for healthier growth in the future.

The U.S. economy continues to show strength, particularly in productivity and global competitiveness. Importantly, unemployment is expected to decline from 7.4% this year to 6.7% in 2014 -- the lowest rate in five years which further supports a better operating environment for each of our U.S. businesses.

To conclude, we continue to focus on the areas where we have strengths and competitive advantage.

Our capital markets and wealth franchises are delivering strong earnings grounded in Canada with important contributions from the U.S. where combined year to date earnings are 47% ahead of last year. We expect to generate incremental returns from the investments we've made in the United States.

We're effectively leveraging our large North American platform in commercial banking, with strong loan growth in both Canada and the U.S. – and this will support future earnings growth.

And we'll continue to focus on efficiency while creating value for our customers that will translate into financial performance for the Bank.

And with that, Tom, I'll turn it over to you.

1 – on a reported basis: P&C US efficiency ratio was 62.2%; BMO CM net income of $275MM; PCG net income $141 million; traditional wealth up 11% from last year

Tom Flynn - *BMO Financial Group – EVP & CFO*

Thanks Bill and good afternoon everyone.

Moving to slide 7, BMO had a solid quarter with reported net income of $975 million. On an adjusted basis, net income[1] was $997 million, up 2% and EPS[1] was 1.46. Adjusted ROE was 14.5% on a very strong capital position.

Year-to-date adjusted EPS[1] was up 4%.

We had strong year-over-year growth in the Private Client Group excluding Insurance, and in Capital Markets. We have continued growth in commercial banking, with strong loan and deposit growth of 12% in Canada, and core loan balances up 17% year-over-year in the U.S. Lower interest rates reduced Insurance income by approximately 5 cents per share.

Consistent with past quarters our retail businesses contributed over 75% of operating group revenue.

Items removed to arrive at adjusted net income were generally similar in character to prior quarters, and totaled just $22 million or 4 cents per share. Slide 29 shows details on the adjusting items, including a restructuring charge of $59 million after-tax related to our on-going focus on managing productivity.

Moving to slide 8, Q2 adjusted revenue[1] was $3.8 billion, up 1% year-over-year and down 3% from the first quarter, largely due to fewer days and lower Capital Markets revenue.

Adjusted net interest income[1] was lower due to fewer days in the quarter and quarter-over-quarter as volume growth was offset by lower margins.

Year-over-year adjusted non-interest revenue[1] was up 4% due to higher trading revenues and good growth in mutual fund revenues and lending fees. Quarter-over-quarter adjusted non-interest revenue reflects lower underwriting, lending and advisory fees from the high level in Q1.

Turning to slide 9, Q2 adjusted expenses[1] of $2.4 billion were up 2% year-over-year as higher employee costs and select initiative spending were partially offset by the benefits of a focus on expense management. Excluding the impact of the higher U.S. dollar, expenses were up just 1%.

Quarter-over-quarter adjusted expenses[1] were down 2% and down 3% in source currency, largely due to costs related to employees eligible to retire in the first quarter and fewer days.

As shown on slide 10, capital ratios are strong.

The Basel III Common Equity Tier 1 ratio was 9.7%, up 30 basis points from the first quarter.

The increase reflects higher retained earnings and a decrease in RWA mainly due to lower risk in certain portfolios and improved risk assessments.

During the quarter we repurchased 4 million shares under our normal course issuer bid, and as Bill said we expect to continue to be active under the program.

Moving to slide 11, in Q2, P&C Canada adjusted net income[1] was 431 million, essentially flat year-over-year. Results reflect a combination of volume growth, better credit provisions and lower margins.

Loan growth continued to be strong in the quarter with total loans up 10% from last year and good sequential loan growth of approximately 2%.

1 – on a reported basis: net income was down 5% and EPS was $1.42; ROE was 14.2%; YTD EPS down 6%. Q2 revenue was $3.9 billion flat Y/Y, down 3% Q/Q; net interest income was lower; non-interest revenue was down 1%; Expenses of $2.6 billion, were up 3%; P&C Canada net income was $430 million

NIM declined 6 basis points quarter-over-quarter primarily due to changes in mix and lower deposit spreads in the low rate environment. Loan spreads were unchanged.

Lastly, expenses were down 2% quarter-over-quarter due to fewer days in the current quarter and compensation in Q1 for employees eligible to retire. Expenses were up 3% year-over-year, reflecting select investment in the business including higher employee-related costs.

Moving to slide 12, P&C US adjusted net income[1] was US$163 million, up 3% year-over-year and down from a strong first quarter.

Revenue of US$718 million was down 4% from a year ago, as increased commercial lending fees and strong growth in the core C&I loan portfolio were offset by lower margins and deposit fees.

NIM was down by 4 basis points quarter-over-quarter primarily due to lower loan and deposit spreads.

Adjusted expenses[1] were down primarily due to synergies net of selective investment in the business. The efficiency ratio[1] improved from last year to 59.6%.

Total loans were up both year-over-year and quarter-over-quarter. Core C&I loan growth continued to be strong with balances up 17% year-over-year, and 4% quarter-over-quarter.

Turning to slide 13, BMO Capital Markets adjusted net income[1] of $276 million was up 19% year-over-year and down from a very strong first quarter. ROE remained good at 19.4%

The performance compared to a year ago reflects good results across a number of business lines with higher revenue driven by trading and corporate banking and improved performance from the US segment.

Turning to slide 14, Private Client Group adjusted net income[1] was $148 million. As noted earlier, the Insurance business was impacted by lower interest rates in the quarter.

Traditional Wealth results[1] were strong, up 14% year-over-year and 8% quarter-over-quarter due to increased revenue driven by growth in new client assets, improved market conditions and a continued focus on productivity.

Assets under management and administration were up a nice 12% year-over-year and 4% quarter-over-quarter.

Turning now to slide 15, the Corporate segment had a net loss of $26 million on both a reported and adjusted basis.

Adjusted revenues were down year-over-year due to a higher teb group offset and a variety of items none of which were individually significant.

Adjusted recoveries of credit losses were stable year-over-year and up quarter-over-quarter reflecting higher recoveries on the purchased credit impaired loan portfolio. As a reminder we record all acquired loan accounting items in the Corporate segment.

Adjusted expenses declined year-over-year primarily due to lower technology related costs. The quarter-over-quarter expense decline of $54 million was mainly due to lower performance based compensation, due in part to the costs for employees eligible to retire recognized in the first quarter, as well as lower severance costs.

And with that, I will turn it over to Surjit.

Surjit Rajpal - ***BMO Financial Group – EVP & Chief Risk Officer***

Thank you Tom and good afternoon everyone.

1 – on a reported basis: P&C US net income was $152 million, up 6% Y/Y and down Q/Q; Expenses were down and the efficiency ratio improved to 62.2%; BMO CM net income of $275 million up 18% Y/Y and down Q/Q; PCG net income was $141 million; traditional wealth up 11% Y/Y and 8% Q/Q

It has been another good quarter from a risk perspective.

Referring to slide 18, specific provisions excluding the purchased portfolio were $217 million dollars, or 35 basis points and 30 basis points year-to-date. This quarter's provisions are up from last quarter, which included higher recoveries and reversals.

Provisions for the purchased performing portfolio were $65 million dollars, down $17 million dollars quarter-over-quarter, reflecting reductions in both the consumer and commercial portfolios.

The recovery on the purchased credit impaired portfolio was $107 million dollars, an increase of $48 million dollars from last quarter. The portfolio is now down to roughly 36% of its original size. We attribute this performance to an improving US credit environment and the Bank's strong work-out capabilities. Our strategy of value maximization remains unchanged.

On the next slide, total impaired formations at $595 million were lower this quarter, with the majority of the decrease coming from the US portfolios.

With respect to real estate in Canada, the government mandated lending changes are having the intended impact on the housing market: slowing activity and reducing the likelihood of a significant correction. Our real-estate secured portfolio is small relative to peers, well-diversified and of a high quality.

Overall, I am satisfied with our credit performance this quarter and I remain optimistic about our credit outlook given the improving economy in the US and moderating Canadian housing conditions.

I will now turn over to the operator for the question and answer portion of today's presentation.

QUESTION AND ANSWER

Operator

Thank you.

(Operator Instructions)

The first question is from Gabriel Dechaine from Credit Suisse. Please go ahead.

Gabriel Dechaine - *Credit Suisse - Analyst*

Good afternoon. My first question is for Frank. Just on the NIM trends, I guess I'll get the ball rolling on NIM. In Canada, I guess you've had some strong deposit growth in the high interest savings account and that's got new customers into the bank, but also caused some to switch out of checking into the HISA. Wondering how big of an impact that had and is this part of a persistent issue we should expect in coming quarters?

And I've got one for Surjit. Just on page 17 of your presentation there, if you can help me just understand a bit more of the composition of two loan portfolios, the CRE/investor-owned in Canada, that's $10.7 billion, and then the owner-occupied commercial mortgage, $2.1 billion, really what the $10.7 billion break down is between developer and REITs or whatever, and then the owner-occupied as just an example of what that could be. Thanks.

Frank Techar - BMO Financial Group - President & CEO - P&C Banking Canada

Thanks, Gabriel. It's Frank. I'll take the first one. As you pointed out, our margin this quarter was down a little bit more than we expected, 6 basis points. It was a few basis points more. The primary reason was stronger growth in our low margin, high interest savings account. We have been repositioning our deposit line up over the last few quarters, and we did see some balance movement from core checking products to high interest savings account. So to your question, I'm not concerned about this, as we are in flight with some planned changes that are going to address the issue over coming quarters. It wasn't a big surprise, and I'm not expecting it to be a big impact going forward.

Gabriel Dechaine - *Credit Suisse - Analyst*

Why not? Sorry. Because you had promotional pricing and that's going away? Or, why wouldn't you be?

Frank Techar - BMO Financial Group - President & CEO - P&C Banking Canada

Well, we're adjusting some of the features to the products that we believe will mitigate some of the movement that we've seen.

Gabriel Dechaine - *Credit Suisse - Analyst*

Okay.

Frank Techar - BMO Financial Group - President & CEO - P&C Banking Canada

Overall, just to the NIM question, as long as I have the floor, I haven't changed my view on NIM, as a result of the answer to your question. Consistent with my comments last quarter, I expect to see moderating NIM declines of 2 to 4 basis points for each of the next couple of quarters, and my expectation is we're going to see that reduce even more as we go into 2014, in the 1 to 2 basis point per quarter range.

I will just say and reinforce what Tom said earlier, we've seen no sequential decline in our loan spreads. And our loan spreads have been relatively flat now for three quarters, and this was due to our very strong growth in higher spread commercial loans and slower growth in our residential lending. And I expect those trends to continue. So from a confidence perspective, that coupled with stronger deposit growth, it gives me confidence that these moderating trends are going to show up in future quarters.

Gabriel Dechaine - *Credit Suisse - Analyst*

Thanks, Frank.

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

Gabriel, this is Surjit. Your question on the CRE investor-owned mortgages, the builder component of it is not a very large component. It's roughly, let's say about 25% or so. And even within that builder component, the condo part, which we've looked at in the past, is a very small portion. On the high rise side, it's about $800 million, and the total is about $1 billion. So that's as far as the builder portion is concerned. The investor-owned portion is very well diversified across different segments. With respect to your owner-occupied commercial mortgages, and owner-occupied commercial mortgage is one where the person who actually takes the mortgage is also using it for their own business purposes, generally. So that category is a separate category.

Gabriel Dechaine - ***Credit Suisse - Analyst***

Like a guy that owns a factory, I guess? Sorry. Hello?

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

Yes.

Gabriel Dechaine - ***Credit Suisse - Analyst***

Okay, sorry. The investor-owned, that would be REITs or something like that?

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

Yes, that could be REITs, as well. But it would be a combination of even businesses across various industries that have borrowed, on a mortgage basis, for real estate that they actually use for their business purposes. So it's very well diversified book. And it could be a combination of office, factories, everything, all kinds of real estate.

Gabriel Dechaine - ***Credit Suisse - Analyst***

Thank you, Surjit. Sorry for cutting you off earlier.

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

Thank you.

Operator

Thank you. The next question is from Steve Theriault from Bank of America Merrill Lynch. Please go ahead.

Steve Theriault - ***BofA Merrill Lynch - Analyst***

Thanks very much. A couple questions. First for, probably, Tom. Tom, so you mentioned the risk weighted asset shrinkage this quarter, which was a little surprising. Can you give us a little detail around some of the model refinements, some of the changes in collateral that came through this quarter? And maybe more importantly, is there more of this coming down the pipe for you guys, or was this just a coincidental culmination of a number of things that came together just coincidentally all at the same time?

Tom Flynn - BMO Financial Group - EVP & CFO

Sure, it's Tom. I'll give you some color on this. The reduction in RWA was about $3 billion in the quarter, related to both having lower risk in the portfolio and also some changes in our risk calibrations. So on the lower risk in the quarter point, our securitization risk weighted assets were down close to $1 billion. Most of that related to reductions in our legacy run-off structured credit positions and also a bit of positive migration in those portfolios. Given the new capital rules related to derivatives, we have been spending time looking at collateral management and also working to move some of our business into CCPs. And those two things contributed around $1 billion in aggregate to the reduction in RWA over the course of the quarter. Our average stress VAR was down a bit in the quarter, and so that contributed to lower market risk. And that was mainly just lower volumes in some of the portfolios. And then lastly, we had a credit card securitization-related transaction that reduced the RWA in that area.

And then in addition to those items, which I would characterize as items related to simply having lower risk in the portfolio, and as a result, lower RWA, there were some changes in our risk assessments that resulted in lower RWA. And to the point around expectations going forward, I'd look to the capital build that we've had over time. And we have had very good strength in the capital ratio over the last couple of years, probably stronger than we'll expect going forward, because we do have good volume growth in the portfolio. But we do expect the capital ratio to continue to grow quarter-by-quarter, on average, not quite by as much as we saw this quarter, but the trend should be a positive one.

Steve Theriault - *BofA Merrill Lynch - Analyst*

And is that most of Links and Parkland in those items? What are they running at now? I know they are probably 80% lower than what they were at the peak.

Tom Flynn - BMO Financial Group - EVP & CFO

They're more like 90-plus percent lower. There's a very good story around that. The Links and Parkland assets are down to approximately $200 million at the current point, and we expect that they will be gone in short order. So that part of our RWA will be shrinking further, although the current number is very low.

Steve Theriault - *BofA Merrill Lynch - Analyst*

Thanks, Tom. Second one is for Mark Furlong. The synergies now have mostly come through, but the efficiency ratio is, on an adjusted basis, is still hanging around close to 60%. One thing I wanted to ask, Mark, is how much of the run rate synergies have been or are being reinvested versus flowing through to the bottom line? Are we talking a quarter, or is it more like really three quarters? It's hard to tell. And the second part was again on efficiencies, can you give us a bit of an outlook for second half of the year? Is 60% from this quarter or 57% from Q1 more indicative of what you'd expect? Thanks.

Mark Furlong - BMO Financial Group - President & CEO, P&C Banking U.S.

So I think, Tom, were you going to handle the synergies, where we're at?

Tom Flynn - BMO Financial Group - EVP & CFO

Sure, on the synergies, we've talked about progress over time. And as we look at our tracker on synergies, we're now around the 85% mark in terms of realizing on the expense reductions that we targeted from the transaction, and we feel good about those. The reductions are coming through in a variety of areas, including in Mark's business, but also in our US wealth business, which with the combination of Harris and M&I is a good size, and we've done a good job managing that business through the transition, and also from our technology and operations and corporate areas. So the synergies come through in a variety of areas. We do have reinvestment, and we've talked about that for a number of quarters. And the reinvestment relates to taking advantage of opportunities that we see in the market. And Mark will elaborate on these, if he wants, but the two in particular in that business have been on the commercial side and the mortgage side, where we've had good results and the market opportunity is good.

Mark Furlong - BMO Financial Group - President & CEO, P&C Banking U.S.

So to answer the second part of the question, the goal is to get the efficiency ratio into the mid-50s. I'm not sure that we'll get it there by the end of this year. Really, the driver from this point on is going to be the revenue side. We've taken most of the expenses we're going to take out with any real substance, and so now it's really top line growth. So that's kind of what we'll fight the second half of the year. We see really good volumes across all the businesses, but we're faced with the same pricing challenges as you see all across the US banks. But we have good momentum in the rest of the business. I don't know that we're going to get to the mid-50s by the end of this year. We'll have to see.

Steve Theriault - *BofA Merrill Lynch - Analyst*

In terms of that coming through the revenue line, I presume you certainly need some assistance from just better market conditions?

Mark Furlong - BMO Financial Group - President & CEO, P&C Banking U.S.

That's a good question. I think certainly that great economic tail winds are always wonderful. But I would say that you start out with the same pricing pressures you see affecting other US banks, they are affecting us. But we've had good volume growth, and expect to see good volume growth, on the C&I side. That growth has been strong. Now we're six or seven quarters in a row, and great activity all throughout the businesses and all throughout the markets. On the commercial real estate side, we really haven't landed on one of those quarters where you see the growth yet. But in the first half of 2013, we booked over $1.2 billion of commitments and we've only funded a quarter of those. And when you get pay downs in that portfolio, of course we will begin to see some momentum, because we still see some very good opportunities that we have this quarter and going into the fourth quarter.

And on the consumer side, that's more a function of we're selling 60% or so of what we originate. That's down a little bit from where we were a couple quarters ago. And so what we portfolio just isn't quite enough to keep up with the amortization. But we're up 6% linked quarter. The home equity side, our fundings are up 15%, commitments are up 10%. The auto side originations are up 5%.

Really, the metrics on the sales side across-the-board, pretty much without exception in both the personal business and commercial business are strong. So we're seeing the good volume growth we expect, and see no reason why we wouldn't continue to see it. Economic tail wind would make that even better. And for example, you saw the release on housing that Case Shiller came out with earlier, and nice to see a big market like ours in Chicago would be up 7.8%. The challenge in Chicago, of course, is it's still down quite a bit from the peak. But the great thing is that momentum wasn't there a year ago, and so that will be another positive reinforcer and wealth creator in Chicago that will be a big part of our base to grow from, too. So probably a little long-winded answer, but just trying to give you a little bit of perspective on different pieces of our business and why we feel good about it.

Steve Theriault - *BofA Merrill Lynch - Analyst*

Thanks Mark. I appreciate the color.

Operator

Thank you. The next question is from Brad Smith from Stonecap Securities. Please go ahead.

Brad Smith - *Stonecap Securities Inc. - Analyst*

Thanks very much. My question also deals with the efficiency ratio in the US. When we went into this M&I transaction, I think you originally estimated that the synergies would be $250 million. And I think that number is now up to $400 million. I believe the run rate revenues of the combined business was just north of $3 billion on an annualized basis at the time. So can you explain to me why the efficiency ratio hasn't come down considerably? I think if you just took the $250 million and compared it to the $3.2 billion run rate revenues, you would expect something in the 7% to 8%, 700 basis point to 800 basis point decline in an efficiency ratio, all other things held equal. Of course, I know everything is changing. But the fact that we've seen virtually no decline in the efficiency ratio, in fact it may have deteriorated, is there something else that's working in counter purpose to that efficiency improvement?

Tom Flynn - BMO Financial Group - EVP & CFO

It's Tom. I guess I would go back farther in time. I think if you looked at our efficiency ratio pre-transaction, in 2008, 2009, 2010, it was much higher than the current 59% to 60% that we're looking at. And so the number has come down materially from the level that we were running at pre-transaction. If you're looking in the supp., the numbers you're looking at reflect the benefits of the transaction. And as we've talked about before, the synergies came in, in part higher than we first projected because both organizations started to contain expense growth as soon as we announced the transaction, and so that resulted in the productivity ratio when we closed being down from where it had been running earlier, and I think helps to connect the dots.

Brad Smith - *Stonecap Securities Inc. - Analyst*

Thanks.

Operator

Thank you. The next question is from Mario Mendonca from Canaccord Genuity. Please go ahead.

Mario Mendonca - *Canaccord Genuity - Analyst*

Good afternoon. Probably for Tom, the bank talked about 2% operating leverage on a total bank basis, and I think you've even suggested that was possible in 2013. With half the year behind us, what does it feel like? Is that 2% operating leverage a reasonable expectation for all of 2013, or did I misinterpret that in the past?

Tom Flynn - BMO Financial Group - EVP & CFO

As we were ending last year, we talked about our mid-term target, which is the 2%, and expressed the hope that we would be able to achieve that in the current year. Sitting here at the halfway point, I think it's fair to say that revenue in areas have been lower than we thought it would be, and with that, the operating leverage is not as strong. And I think hitting 2% for the year will be a tough number to hit, at this point. We are focused in all of the businesses on hitting positive operating leverage going forward. And our current expectation would be that for the year, we'll be in positive territory, but 2% is a pretty big number from where we sit today.

Mario Mendonca - *Canaccord Genuity - Analyst*

Okay, a follow-up question for Surjit. I think you made a fairly astute call in suggesting that the recoveries on the impaired loan portfolio would be lower, somewhere between 200 and 250, and that seems to be shaking out. What I'm interested in is the decline in the reserve from 405 last quarter to 284 this quarter. That was fairly substantial decline in one quarter, and I suppose that connects to the 107 million we saw in recoveries. What do you figure happened in the quarter that would cause such a quick decline, and is it something you could see happening again next quarter?

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

Yes, the improvement in the US, particularly in the residential market, causes that number to go down. Because when we do our cash flow re-estimation based on how we see our cash flows from individual transactions coming out, we are able to go back and reverse some of the mark that we've taken against it, so that causes it to go. Plus we've had a lot of recoveries and resolutions as well during the period of the last quarter. So the reduction to the little under 300 is not surprising at all. In fact, if the market did keep improving, that number will come down. And by the way, we are following a pretty aggressive resolution and recovery program, including loan sales, so I would expect that you will see good results coming forward as well in the next half of the year.

Mario Mendonca - *Canaccord Genuity - Analyst*

Okay. And then -- that's helpful. And I'm sorry if I can just squeeze one more in. The restructuring charges that we saw this quarter, maybe Tom again, how do you make the distinction between an expense that you would call restructuring and just a normal expense? Is there a lot of subjectivity that goes into this, or do you have nice tight definitions?

Tom Flynn - BMO Financial Group - EVP & CFO

I would say we have pretty tight definitions. In the ordinary course in all of the groups and the functions and our technology group, you have what I'd characterize as ordinary course severance-related activity. And we take those charges as they come. And the larger restructuring charge that we've taken in the quarter reflects a bank-wide program that we have in place to focus on improving productivity and improving our ability to have resources focused on the front line. And when we've got an initiative that is bank-wide and formal in nature, and as Bill said in his comments, go to how we're running the company, we think that that kind of a charge or expense has a different character and we group it together and call it out.

Mario Mendonca - *Canaccord Genuity - Analyst*

Thank you.

Operator

Thank you. The next question is from Robert Sedran from CIBC. Please go ahead.

Robert Sedran - *CIBC World Markets - Analyst*

Hello. Tom, just a question on the insurance revenues. Was the charge this quarter related to an ultimate reinvestment rate or the initial reinvestment rate, or perhaps something else? What I'm trying to get at is that rates have backed up fairly meaningfully so far in the third quarter, so is the benefit as rates are reversing, is that benefit going to be felt in Q3 or is it going to be felt at some point in the future?

Tom Flynn - BMO Financial Group - EVP & CFO

So in the current quarter, the rate related charge in insurance is about two-thirds related to the move in rates in the quarter and one-third related to the ultimate reinvestment reset, which occurs periodically, as you know. Rates are up meaningfully so far in the third quarter. We're hopeful for that business, that that continues. And there would be a significant flow through into the P&L, if it does. We've probably got one more ultimate reinvestment rate lump to take in the fourth quarter. And it will be sort of $10 million to $12 million. And you can project those, because the reset is based on a formula and it moves slowly through time. So if rates hold where they are, we'll be up in the third quarter and then we'd have a lesser adjustment in the fourth quarter related to the ultimate reinvestment rate.

Robert Sedran - *CIBC World Markets - Analyst*

Okay. Thank you, that's helpful. Just a quick question on the tax rate, on a TEB basis, it's been up the last couple of quarters compared with the last three quarters of last year, is there something odd the last couple of quarters, or perhaps the last three quarters of last year? Where would you put a TEB tax rate right now?

Tom Flynn - BMO Financial Group - EVP & CFO

I think the current rate, which is around 20%, is a pretty good rate to use. The number does move around quarter to quarter, for a variety of reasons. But the current level is a pretty reasonable level to think about.

Robert Sedran - *CIBC World Markets - Analyst*

Thank you.

Operator

Thank you. The next question is from Darko Mihelic from Cormark Securities. Please go ahead.

Darko Mihelic - *Cormark Securities - Analyst*

Hello. Thank you. A question for Surjit. With respect to the construction formations this quarter, this is the first time we've seen a nice sizeable one since last year. Is there something chronic going on, or was that a condo developer? Can you give us any sort of flavor on what that impairment was related to?

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

I missed the question. You're talking about --

Darko Mihelic - *Cormark Securities - Analyst*

The impaired loan formation of $30 million in the construction portfolio.

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

No, it's not related to any one. It's a combination of a few.

Darko Mihelic - *Cormark Securities - Analyst*

Oh, it's a combo of a few. Okay.

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

And the one that is the slightly larger one is really not directly related to the building trade. It's a contracting and engineering company, mechanical and electrical company. So it's not specific to any particular name.

Darko Mihelic - *Cormark Securities - Analyst*

Okay. So we still haven't seen any signs of weakness, let's say, in construction?

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

No.

Darko Mihelic - *Cormark Securities - Analyst*

And I wanted to ask also, as well, I wanted to ask you particularly, because I think you're one of the better positioned banks to answer this question for me. We're revisiting the whole concept of adverse scenarios with respect to residential home prices. And all of you run your stress tests and you all suggest that in moderately to severe adverse scenarios the outcome is manageable. Two questions on that. The first is, when you say manageable, does that mean you still make money? And secondly, when you run these adverse scenarios and you have a large decline in real estate prices, do you assume that all claims are honored by CMHC or do you assume that some level of claims are refused?

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

Let me start. I'll start with the question you asked last and I'll go back into the stresses that we run. When we do our stress scenarios, we do assume a certain level of insurance claims that may get disputed, and we go back to our track record with CMHC in determining what that level should be. With respect to stress testing our portfolios in a scenario that could be adverse, when we say that we are able to manage, it's a combination of things. Firstly, I think even if our losses from that particular segment were to go up -- and I'm not talking about the consumer segment in total, because strangely but logically, the losses really do not come out of the residential mortgages or from the HELOCs. They actually are felt more acutely in the personal lines of credit, as well as in credit cards. So that's the segment of the personal business that gets impacted. Now fortunately for us, we are not very big in the personal line segment -- personal lending segment, relative to our size. But when we stress it, in some scenarios the losses go up by 2 times. And in more adverse scenarios, they can go up 4 times. And when you look at it from that basis, our P&C business does get impacted, but it's quite easily able to absorb it and still remain profitable.

Darko Mihelic - *Cormark Securities - Analyst*

Okay. That's very helpful. Thanks a lot, Surjit.

Operator

Thank you. The next question is from Michael Goldberg from Desjardins Securities. Please go ahead.

Michael Goldberg - *Desjardins Securities - Analyst*

Thank you. A few questions. First of all, with a 9.7% CET1 ratio now, what do you do? You said continued stock buybacks are good, but is your next priority growing your business in order to use up this capital that's being generated, or what?

Bill Downe - BMO Financial Group - President & CEO

Michael, it's Bill. We've seen strong loan growth in commercial banking on both sides of the border, and we've seen very good personal loan growth in Canada. I expect at some point we're going to see a pick up in personal loan growth in the United States, which has been very, very quiet for some extended time. And if you even look at the mortgage market, it's been largely refinancing on low interest rates. But with construction picking up and new buyers coming into the housing market, with the consumer balance sheet being healthy, or much more healthy than it was. You've seen what's going on in the car lending business in the United States. There's just a broad pick up. So I think the first priority for the use of capital is organic growth and good balance sheet growth. And we're really spending both money and energy on building the visibility of the bank's presence in the US. And as Frank can elaborate, and I'm sure he would be happy to, on increasing our position in the Canadian market.

But as I said, and I think I specifically said, buyback continues to be an attractive use of capital above that level. And we have been generating an increasing common equity ratio, B3 common equity ratio, since the announcement of the acquisition of M&I. And we're now in a position where we have great flexibility in that regard.

Michael Goldberg - *Desjardins Securities - Analyst*

Okay. Next question for Surjit, you had high cured sales and repayments offsetting gross formation since M&I was acquired, presumably from the purchased credit impaired portfolio. How much longer before these cured sales and repayments decrease to more normal levels?

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

I missed the last part of your question. How much longer before -- ?

Michael Goldberg - *Desjardins Securities - Analyst*

The cured sales and repayments decrease to more normal levels?

Sharon Haward-Laird - BMO Financial Group - Head of IR

Sorry, Michael, we're just not following the terminology you're using.

Michael Goldberg - *Desjardins Securities - Analyst*

Okay. Maybe I should follow-up offline.

Sharon Haward-Laird - BMO Financial Group - Head of IR

Yes, I'd be happy to do that after. Thank you.

Michael Goldberg - *Desjardins Securities - Analyst*

Okay. And finally, I'm sure you're aware of what TD talked about in terms of positioning itself for interest rates to rise in the US. What would be the impact of a 25 basis point increase along the curve for you guys?

Tom Flynn - BMO Financial Group - EVP & CFO

It's Tom, Michael. I'll say a few things. Firstly, we have, over the last several quarters, moved our positioning around somewhat. We haven't moved it radically, but we have shortened our duration and reduced our security holdings in places, and increased our sensitivity to rate increases from a negative position a year ago to a positive position in our plus 100 scenario in the current quarter. There's a lot of complexity involved in your question related to what the impact is of a 25 basis point move. So I'll preface my answer by saying that. But if the curve was to go up by 25 basis points, you would in effect have a repricing of the yield that you earn on your floating rate deposits and your non-rate sensitive deposits. The repricing would occur through time, so this is not a number that would hit the P&L in a short period of time. You'd have to reprice the portfolio over time. We have about $160 billion in total of those deposits. Some of the increase would end up being passed on to our customers, some would be retained. And as a ballpark kind of a number to think about, we think it would translate into $190 million of pre-tax revenue.

Michael Goldberg - *Desjardins Securities - Analyst*

So is that the amount over time?

Tom Flynn - BMO Financial Group - EVP & CFO

That's the amount over time.

Michael Goldberg - *Desjardins Securities - Analyst*

Okay. Thank you.

Operator

Thank you. The next question is from John Aiken from Barclays. Please go ahead.

John Aiken - *Barclays Capital - Analyst*

Good afternoon. A question for Tom Milroy. Tom, if the Bloomberg headlines are to be believed, it looks like you're doing an expansive rollout again on the US equity side. Can you let us know whether or not this is a change in the strategy, if this is a tweaking, and where you expect to see the US business going in context of the moderating commodity markets?

Tom Milroy - BMO Financial Group - President & CEO - BMO Capital Markets

Thanks, John. Yes, you can't believe everything you read in Bloomberg. This is tweaking. We are pretty happy with the strategy we have in the US. We're just trying to make sure we have the right people in the right seats. And if you look at the US business, we're pretty excited about the results so far this year and we think that we're seeing the reward for our efforts. That being said, as you know, the equity part of the business is pretty tough everywhere right now. But we think we've now positioned to be able to capitalize in that area when things go forward.

In terms of the commodities, it depends how you look at commodities. Broad based, last year and even the first part, we've seen -- in terms of the energy space, we continue to have good business and good flow. In metals and mining, obviously, we've seen a little bit of a slowdown. But that business, even though we have such a significant share in it, it represents, at least if I look backwards last year, approximately 3% of our total revenues. So we've seen some pullback in the market generally, but we've also seen ourselves win more than our fair share of what's out there. So we're pretty comfortable for both in terms of where we're positioned against the metals and mining part of the commodities question, and in the US, we're very pleased with continuing to execute on the plan we have and the progress we're making.

John Aiken - *Barclays Capital - Analyst*

Great. Thanks, Tom.

Operator

Thank you. The next question is from Peter Routledge from National Bank Financial. Please go ahead.

Peter Routledge - *National Bank Financial - Analyst*

Hello. I have just a follow-up on Darko's question. Just on the CMHC issue, for what reasons would they reject a claim, generically?

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

They would reject a claim if the underwriting or adjudication being done was done incorrectly, not in keeping with the criteria that they have for insuring mortgages. So if we've made a mistake in adjudicating the loan in the first place and use something that -- and basically made a mistake, then they would not honor it. Also I think, and I'm going by memory here, I think the other issue where they can is where there's internal fraud associated with it. I think those are the two major circumstances under which they could repudiate the claim.

Peter Routledge - *National Bank Financial - Analyst*

Would one of those stakes be like appraisals?

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

It would depend on the situation. I don't think it would be appraisals, because the appraisals are being received at the time we would have made the loan.

Peter Routledge - *National Bank Financial - Analyst*

I guess where I'm going with this is in the case in the US, you had some systemic problems with fraud at origination and then incompetence around documentation. Stepping back at 50,000 feet, is there any systemic issues in Canada that might cause a similar set of problems in the mortgage system in Canada, that you can see?

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

Not that I can see. But if it was proven that systematically valuations were being done erroneously by somebody, then it could become an issue. But I don't think that's the case here, and so it's hard to see.

Peter Routledge - *National Bank Financial - Analyst*

Okay. Just another question on credit, since I have you. Credit card balances are declining across the industry, not just at BMO, but certainly at BMO, as well. Is there any early warning sign in that? Are people feeling the stress and maybe they're paying their credit cards down today, but tomorrow they go delinquent? And then, are you seeing any very early stage delinquency issues elsewhere in your card portfolio that maybe not worry you, but that you're watching closely?

Surjit Rajpal - BMO Financial Group - EVP & Chief Risk Officer

We always watch our delinquencies on the card portfolio. And the delinquencies are at roughly the same levels as they've been in the past. And nothing has translated into losses. There are some early stage delinquencies that we watch. And we take a risk-based approach to how we follow-up on the collection process, when it comes to delinquencies. We have not seen anything on that front yet. And yes, the balances are down, but I wouldn't read into it that people are paying them down and at the same time there's a feel that they will default later. I wouldn't link the two necessarily. I don't think there's a basis to link that. I'll ask Frank whether he has a different perspective on it, but I don't link the two.

Frank Techar - BMO Financial Group - President & CEO - P&C Banking Canada

Yes, I'd agree with Surjit, Peter. I think card growth has been relatively soft in the industry, as you point out. Ours has been particularly soft, mainly because of management decisions we've made around being a little cautious over the last few quarters, back into last year, just recognizing the risk that we saw, and the potential risk that we saw in the marketplace. So I'd chalk it up more to our caution, more so than seeing some type of customer change regarding their risk.

Peter Routledge - *National Bank Financial - Analyst*

Okay. Thank you.

Operator

Thank you. The next question is from Sumit Malhotra from Macquarie Capital Markets. Please go ahead.

Sumit Malhotra - *Macquarie Securities - Analyst*

Good afternoon. Two hopefully quick ones, please. First, for Tom Flynn, just a follow-up on insurance, if I heard your answer to Rob's question correctly, of the $0.05 EPS impact in insurance, I think you said about two-thirds of that was due to the fluctuation in interest rates during the quarter. Is that correct?

Tom Flynn - BMO Financial Group - EVP & CFO

That's correct.

Sumit Malhotra - *Macquarie Securities - Analyst*

So if I look at that, the revenue was from your supplement was down about $40 million in that business. And I think the spot move in 10-year yields in the US and Canada was about 25 basis points in the quarter. It seems like we talk about this business and its fluctuation a lot, compared to how big it is for BMO. So how comfortable are you with the fact that a relatively small business is driving an EPS change of $0.03 to $0.05 on an interest rate move that doesn't seem that big?

Tom Flynn - BMO Financial Group - EVP & CFO

The rate exposure is roughly $10 million per 10 bps. The way I think about this is it's a number that --

Sumit Malhotra - *Macquarie Securities - Analyst*

Sorry, Tom. That's quarterly? $10 million per 10 bps per quarter, or it doesn't really matter? $10 million for 10 bps is what you're saying?

Tom Flynn - BMO Financial Group - EVP & CFO

That's right. So the way I think about it is this is a number that can be material in the context of the PCG earnings, if rates move significantly. We had that in the second quarter. At the level of BMO overall, I call it a nuisance issue. And we would rather not talk about a $34 million change in the insurance business because of rates; but at the end of the day, it's not a material number. And so we think that we're in a reasonable place with the business from an overall risk perspective. It's large enough to change the way you might feel about the quarter, so we disclose the impact, because it does have impact at the bank level, even though it isn't that big. And our other thought behind this exposure is that we've had a huge move down in rates over a long period of time. We have reduced the sensitivity to rates somewhat over the last couple years, probably by around 15%. But we don't think it makes sense to neutralize the exposure, given where we are in the rate cycle. And if rates start moving back up, this obviously will go the other way for us. And so we think that's not an unreasonable place to be.

Sumit Malhotra - *Macquarie Securities - Analyst*

And we could see that come out as soon as this quarter, or at least a portion of it?

Tom Flynn - BMO Financial Group - EVP & CFO

Yes.

Sumit Malhotra - *Macquarie Securities - Analyst*

And then lastly, for Tom Milroy. Your corporate loan -- I think you said on an average basis -- so average corporate loans in the Capital Markets segment came back with a very strong increase this quarter. I think currency may have played a role there. But a couple of your competitors have talked about using corporate lending as a differentiator as a way to win investment banking business, particularly outside of Canada. You've had some big wins on the commodity side, particularly in M&A. I don't think all of those have actually hit your results yet. But do you view corporate lending the same way? Is this a tool that BMO can use to perhaps win more investment banking business outside of Canada, in some non-traditional sectors that we wouldn't see at home?

Tom Milroy - BMO Financial Group - President & CEO - BMO Capital Markets

It's a good question, because what we absolutely view corporate banking as a core product of Capital Markets. And so we've been pretty confident and we've said, I guess on past calls, that we think as things start to improve, you would see us being able to deploy our balance sheet more with existing clients, and frankly targeted to where we're targeted. So in terms of seeing it outside, are they in areas where we haven't been before? I would say not necessarily, but we continue to expand our client base. And as we do that, obviously, the opportunity to sell, not just to corporate banking, but all our products increases.

Sumit Malhotra - *Macquarie Securities - Analyst*

Thanks for your time.

Operator

Thank you. This will conclude the question-and-answer session. I would like to turn the meeting back over to Ms. Haward-Laird.

Sharon Haward-Laird - BMO Financial Group - Head of IR

Thank you, everyone, and thank you for joining us today. If we didn't get to any questions, please call us in Investor Relations and we'd be happy to answer them. Thank you.